# Elements of a Comprehensive Local Government Debt Policy

*An analysis of 97 debt policies from a large sample of cities identifies 36 factors commonly considered and their frequency of use.*

**by Rowan Miranda, Ronald Picur, and Doug Straley**

A formal debt policy is essential to effective financial management. In 1995, the Government Finance Officers Association (GFOA) stated that a formal policy is a recommended practice that should be followed by all jurisdictions intending to issue debt. A debt policy improves the quality of decisions, provides justification for the structure of debt issuance, identifies policy goals, and demonstrates a commitment to long-term financial planning. For these reasons, a debt policy is viewed favorably by credit rating agencies. The GFOA's statement outlined several major elements that should be addressed by a debt policy; these are shown in the accompanying sidebar.

Debt policies are written guidelines and restrictions affecting the amount, issuance process, and type of debt issued by a governmental entity. This article summarizes the findings of a November 1995 survey which studied such policies across a large sample of cities. An analysis of individual policy statements identified elements that are not included in the GFOA's recommended practice but are nevertheless relevant to a comprehensive debt policy. The findings of this study are presented by the authors as a checklist of elements for financial managers to consider when designing a debt policy.

In 1995, the City of Pittsburgh sought to compare its debt issuance practices to those of comparable jurisdictions as part of an effort to develop a new debt policy. The following methodology was utilized. A sample of cities was identified based on membership in the GFOA. Membership information was provided by the GFOA for all municipalities with a population of 25,000 or more, and a sample of 600 municipalities was identified, based on population.

In August 1995, a standard letter was sent to the chief financial officer of each of the 600 municipalities; the letter requested a copy of the formal debt policy adopted by that government. Follow-up phone calls were made approximately three weeks after the letter was sent if no response had been received by that time. In several cases, the government reported that it had no formal debt policy but that its statutory restrictions were viewed as the "policy statement." No response was received from several governments despite written requests and follow-up phone calls. The number of debt policies received was 97, 16 percent of the sample.

Each policy statement was reviewed using content analysis—a methodology frequently used in the social sciences. Content analysis entails ascertaining patterns in policy statements and then classifying these patterns by theme. By its very nature, content analysis is a qualitative methodology and hence subjective. The application of the methodology was relatively straightforward since common features were repetitively identified and classified through an iterative process.

Seven major categories were identified by the content analysis: 1) conditions for debt issuance; 2) restrictions/limitations on debt issuance; 3) debt service limitations; 4) limitations on outstanding debt; 5) characteristics/terms/provisions of debt issuance; 6) debt issuance process; and 7) other forms of debt. Subcategories were developed under each of the seven major categories. The resulting 36 subcategories, or elements of debt policy statements, are discussed in the following seven sections of this article; examples are cited to amplify or illustrate the nature of policies encompassed in the various categories. Exhibit 1 lists the frequency of 36 elements within the debt policies analyzed.

## Conditions for Debt Issuance

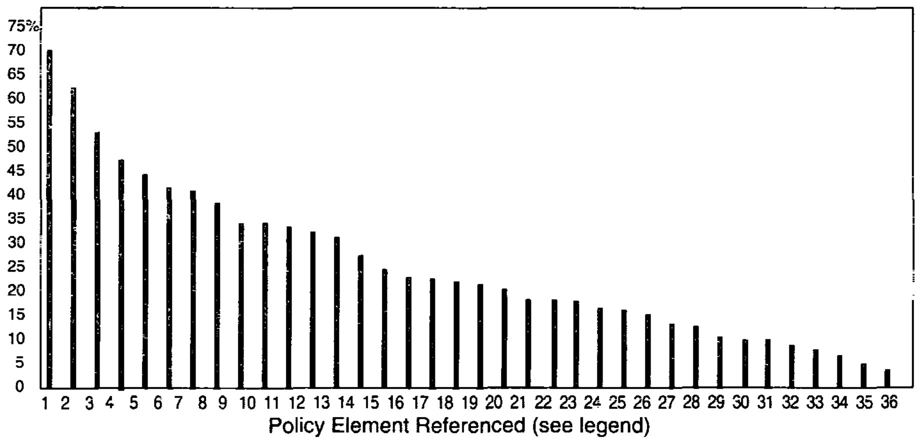
A number of policies were identified which generally specified the conditions or purposes for which debt could be issued; these were classified into the five subcategories discussed below: 1) purposes and uses of debt, 2) capital expenditures,

**ELEMENTS OF A DEBT POLICY**

- Purposes for which debt may be issued
- Legal debt limitations, or limitations established by policy
- Use of moral obligation pledges
- Types of debt permitted to be issued and criteria for issuance
- Structural features that may be considered
- Credit objectives
- Method of sale
- Selection of external financial professionals
- Refunding of debt
- Disclosure (primary and secondary market)
- Compliance with federal tax law provisions, including arbitrage requirements
- Integration of capital planning and debt financing activities
- Investment of bond proceeds where otherwise not covered by explicit written law or written investment policy

Source: GFOA Recommended Practice "Development of a Debt Policy," GFOA 1995.

**Exhibit 1**
**FREQUENCY OF ELEMENTS APPEARING IN DEBT POLICY STATEMENTS**
**(97 sample cities)**




| DEBT CATEGORIES | | |
|---|---|---|
| 1 Purposes and uses of debt | 14 Maturity guidelines | 26 When not to issue debt |
| 2 Types of debt | 15 General fund revenue | 27 Operating revenue |
| 3 Capital expenditure | 16 Expenditure limitations | 28 Lease debt |
| 4 Refunding bonds | 17 Professional services | 29 Capitalized interest guidelines |
| 5 Disclosure | 18 Short-term debt | 30 Market value limitations |
| 6 Statutory limitations | 19 Sale process | 31 Insurance/letters of credit/ other enhancements |
| 7 Project life | 20 Assessed value | 32 Limited tax GO bonds |
| 8 Rating agency relations | 21 Analysis requirements | 33 Inter-fund borrowing |
| 9 Operating budget | 22 Reserve capacity | 34 Variable rate debt |
| 10 Revenue and TIF bond | 23 Per capita limitations | 35 Debt service funds |
| 11 Bond rating goals | 24 Size of issuance | 36 Derivative restrictions |
| 12 Miscellaneous limitations | 25 Intergovernmental coordination | |
| 13 Repayment provisions | | |

**Exhibit 2**
**CONDITIONS FOR DEBT ISSUANCE**

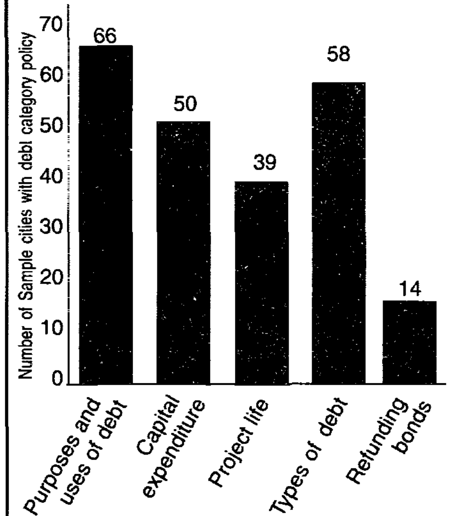
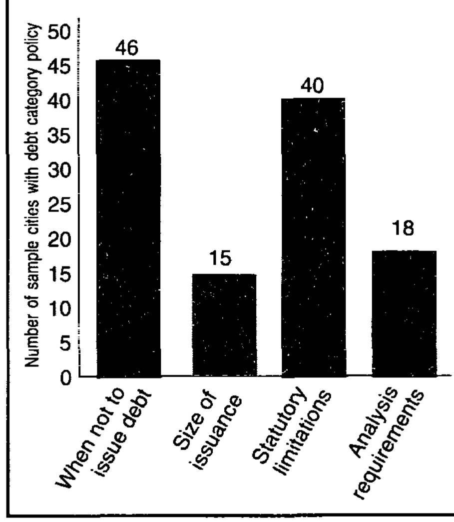



**Exhibit 3**
**RESTRICTIONS OR LIMITATIONS ON DEBT ISSUANCE**




3) project life, 4) types of debt, and 5) refunding bonds policies.

Purposes and uses of debt policies identify the nature of projects and/or expenditures for which bond proceeds can be used. Project-oriented policies generally focused on "major capital infrastructure creation including planning, design, and land acquisition" or "meeting the capital needs of the community." Philosophical policies are used to set a tone such as "debt should not constitute an unreasonable burden to residents and taxpayers" or "use self-supporting debt wherever possible." Equity is also a concern ("matching of benefits with payment" or "a significant proportion of citizens should benefit").

Capital expenditure policies restrict debt issuance to capital needs identified and formalized in a capital improvement program (CIP). Other policies describe specific restrictions on the CIP, such as "15 percent of the CIP will be funded on a pay-as-you-go basis."

Project life policies restrict use of debt to capital projects that have a minimum specified economic life; e.g. "issue debt only when the economic/useful life of the assets is greater than five years."

Types of debt restrictions describe what types of debt the government can issue. A common theme is that general obligation (GO) debt should be used only as a last resort ("wherever possible, the city will use revenue, self-supporting, or special assessment bonds instead of GO bonds"). However, several governments identified conditions where GO debt can be issued in lieu of revenue bonds. Other policies suggest a broad adoption and interpretation of the formal statement, "capital leases, certificates of participation, and lease-purchase financing will be treated as debt and subject to the same policies."

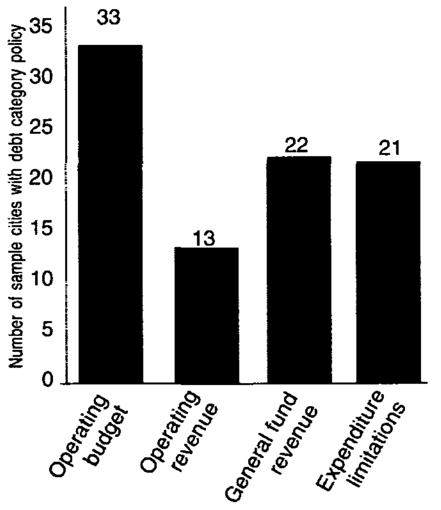
Refunding bonds policies describe conditions and/or limitations under which refunding bonds can be issued; e.g. "issue refunding bonds only if the present value of debt service savings exceeds two percent of the debt service amount of the refunded bonds." Exhibit 2 charts the frequency of these subcategories in the policies of the study.

## Restrictions on Debt Issuance

A second group of policies, discussed below, shares a common theme of restrictions and/or limitations on use of debt including specific prohibitions against debt issuance. These are categorized according to 1) when not to issue debt, 2) size of issuance, 3) statutory limitations, 4) analysis requirements, and 5) reserve capacity. The frequency of appearance of these policies among the study groups is shown in Exhibit 3.

When not to issue debt statements place specific prohibitions on issuing GO debt.

Exhibit 4
DEBT SERVICE LIMITATIONS




These prohibitions include: current operations, enterprise activities, enterprise funds, vehicles and/or rolling stock, leased or lease-purchase items, or any purpose for which financing sources are not clearly identified.

Size of issuance restrictions generally apply to smaller governments and limit annual debt issuance to a specific dollar amount as a means of "avoiding arbitrage compliance restrictions" or to receive "yield advantages associated with bank qualified obligations."

Statutory limitations face most local governments but only a few incorporate these limitations into formal debt policies. Such governments reference constitutional limits that generally restrict outstanding debt to a stated percentage—ranging from 2.5 percent to 20 percent—of the tax base, which is generally expressed as assessed or market value.

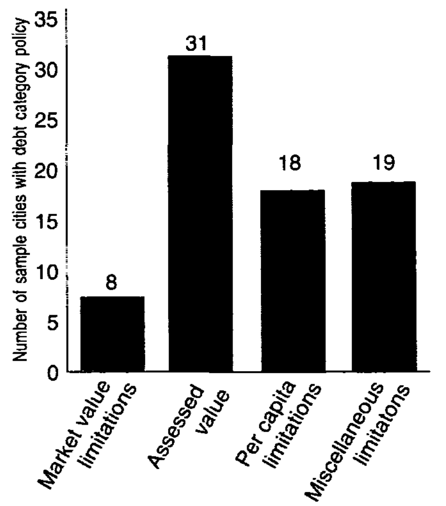
Analysis requirements describe tests that are to be conducted prior to issuance of debt, including impact on future budgets, sufficiency of revenues dedicated to debt service or operating cost of capital asset, and impact on ability to provide future services.

Reserve capacity guidelines reserve a portion of authorized/statutory debt capacity for emergency purposes; they range from 20 percent to 30 percent in the survey sample.

## Debt Service Limitations

In general, the sample policies limit debt service expenditures to some definition of

Exhibit 5
LIMITATIONS ON
OUTSTANDING DEBT




resources available to the government: 1) operating budget, 2) operating revenue, 3) general fund revenue, and 4) expenditure limitations (Exhibit 4).

Operating budget policies express limitations regarding how much of the operating budget can be devoted to debt service. The scope of the "operating budget" is not defined in most policy statements; it is assumed to be clearly understood by the budget officials. For example, the scope could vary from solely the general fund to all four governmental funds. In addition, unless one assumes a balanced budget, these policies are ambiguous since "operating budget" does not specify the "resources/revenues" side or "appropriations/expenditures" side of the budget. Philosophically oriented policies stated that "debt service payments should be a predictable and manageable part of the operating budget." Quantitative policies limited debt service expenditures from as little as 5 percent to as much as 30 percent of the total operating budget (however defined by that government).

Operating revenue policies restrict debt service expenditures to a percentage of total operating revenues. No definitions are incorporated in the policy statements, leaving open to interpretation the scope of fund(s) encompassed in "operating revenues." For example, operating revenues could be restricted to the general fund; alternatively, some analysts include special revenue and debt service funds within their definition of operating funds since those funds are used regularly for the day-to-day operations of the government.

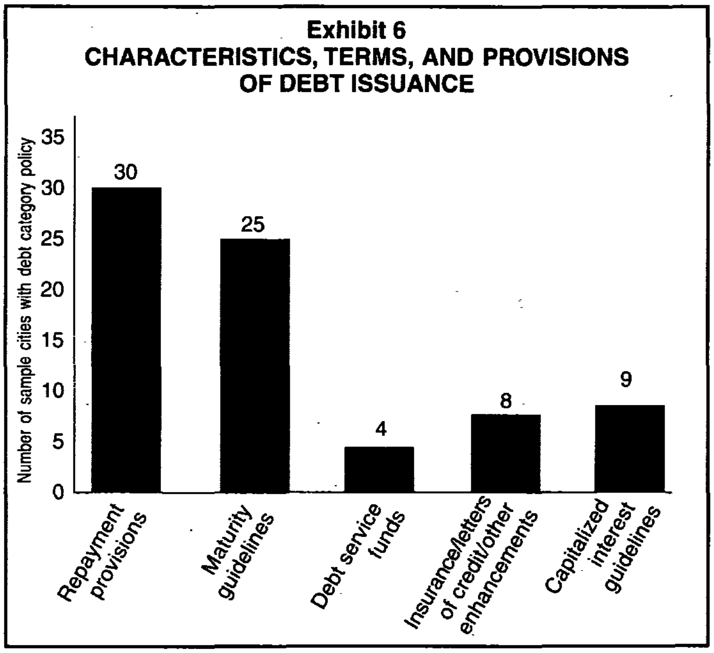
General fund revenue policies specifically restrict debt service expenditures to a percentage of general fund revenue.

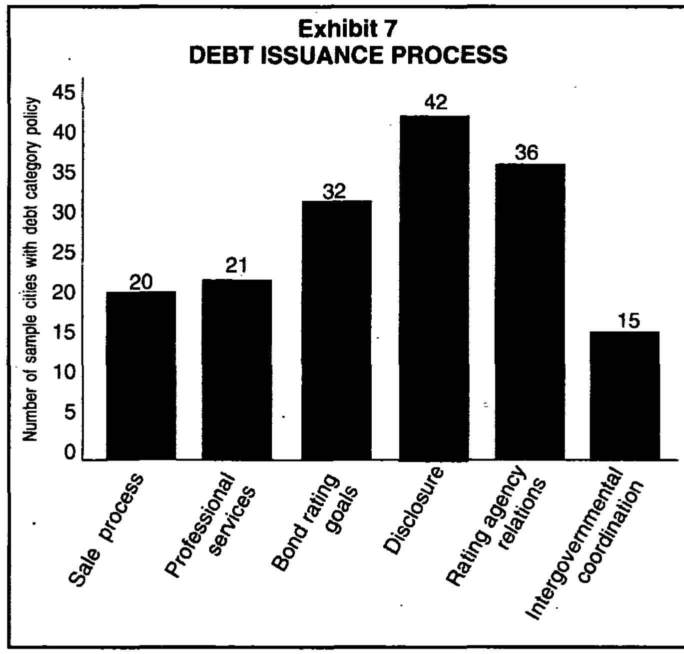
Expenditure limitations are presumably a more ambiguous restriction since expenditures (i.e., appropriations) can either: 1) exceed revenues—i.e., a government can reduce previously accumulated resources by "spending down" fund balance, or 2) be less than revenues by appropriating expenditures at a lower level, thereby increasing its fund balance by budgeting a surplus. Variations include 1) the fund scope—general fund, general fund plus debt service funds, or all governmental funds, and 2) the percentage limitation, which generally ranges from 10 percent to 25 percent.

## Limitations on Outstanding Debt

These policies limit the total amount of outstanding debt to a measure of the tax base (property values or population). There is a litany of key variables guiding these policies. For example, there are wide variations of how "debt" is measured including: net GO debt, total direct plus overlapping debt, GO debt, GO bonds, net debt, bonded debt, total GO debt payable from property tax levies, total GO net debt, total tax-supported debt, outstanding debt total indebtedness, overall net debt attributable to the general fund, total long-term debt principal outstanding, total long-term bonded debt, total GO net debt (including GO debt supported by utilities), GO debt being repaid from property taxes, net direct debt, and total direct debt. Although many are simply different labels (reflecting local use and practice) for the same numerical value, other variations represent substantively different measures, such as net direct debt versus total direct plus overlapping debt. As such, restrictions represented by this category of policies are substantively different and must be placed in the local context. The other major variation relates to the definition of the "tax base." These differences constituted the basis for the classification used to report the survey results shown in Exhibit 5: 1) market value limitations, 2) assessed value, 3) per capita limitations, and 4) miscellaneous limitations.

Market value limitations restrict outstanding debt to a specific percentage of market value (with variations on definitions for property and market value). Percentages ranged from 2 percent to 10 percent.




Assessed value policies restrict outstanding debt to some percentage of assessed value; value is primarily defined as assessed value, but also included were current assessed value and total equalized assessed value. Percentages ranged from 2 percent to 15 percent.

Per capita limitations restrict outstanding debt to a specified dollar amount, generally per capita or percentage of per capita income. Amounts ranged from $200 to $1,300 per capita and 6.5 percent to 10 percent of per capita income. In addition, several governments provided for an automatic inflationary adjustment by incorporating the Consumer Price Index into the policy.

Miscellaneous limitations include polices linking debt to taxation (percentage of the total property tax levy), revenue, dollar amount, and debt burden (e.g., "within the norm of comparable cities").

## Characteristics of Debt Issuance

These policies relate to characteristics of the debt being issued that are generally legal in nature and incorporated into various official documents including the bond ordinance. Shown in Exhibit 6, they are 1) repayment provisions, 2) maturity guidelines, 3) debt service funds, 4) insurance/letters of credit/other enhancements, and 5) capitalized interest guidelines.

Repayment provisions place restrictions on debt service payments; they include 1) policies related to time-pattern, which describe the structure and pattern that should be utilized, including front-loaded, level principal, level debt service, or 50 percent of principal repaid within 10 years; 2) policies related to sources suggesting use of funds other than property taxes (e.g., user fees for revenue bonds), where possible, to pay debt service; and 3) policies related to equity suggesting that those who benefit from projects should be the source of debt service payments.

Maturity guidelines generally relate to either the maximum term or average maturity life of the debt and include variations on 1) life of the asset ("the term of the bond should be less than the useful life of the asset") and 2) policies related to the number of years that restrict maximum maturity to a period ranging from 10 to 20 years.

Debt service funds are required for most bond issues through the bond ordinance. Several debt policies require the creation of such a fund and specify minimum such as 100 percent and maximum (125 percent) levels, as a function of the next year's funding requirements.

Insurance/letters of credit/other enhancements are generally philosophical in nature and indicate when such instruments should be used; e.g., if cost effective, for marketing purposes, if net savings occur, or when considering insurance for each bond issue.

Capitalized interest guidelines were adopted by a small number of governments. These restrictions limit use of this financing technique to "enterprise activities for expenses incurred prior to actual operation."

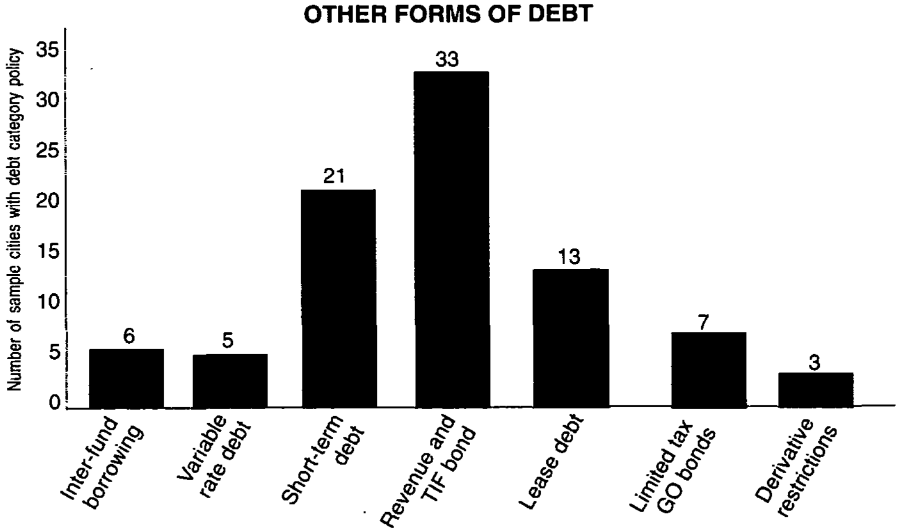
## Debt Issuance Process

These policies relate to various process activities associated with issuing the debt. Charted in Exhibit 7, the categories seen most frequently are 1) sale process, 2) professional services, 3) bond rating goals, 4) disclosure requirements, 5) rating agency relations, and 6) intergovernmental coordination.

Sale process policies are generally philosophical and suggest use of a competitive bidding process unless "it is in the best interests...to conduct a negotiated sale." Other policies suggest use of negotiated issues "due to market volatility" or for "unusual or complex financing." Several policies spoke to public notices or other features of a public sale.

Professional services policies describe the circumstances for and scope of professional services, particularly regarding use of financial advisors and bond counsel. Several policies addressed the selection process (e.g., "competitive request for proposal every three to five years") or the term for the advisor (e.g., "every three years"). These were philosophical in nature also, stating the need for professional

Exhibit 8
OTHER FORMS OF DEBT




services "as necessary" or the scope of work to be provided (e.g., debt structuring, debt management plan, or preparation of the official statement).

Bond rating goals are generally philosophical in nature, such as "the city will seek to maintain and improve its bond rating to minimize borrowing costs and to ensure its access to credit markets." Several policies stated an objective of maintaining a (specified) minimum credit rating.

Disclosure requirements are broadly gauged, such as "the city will follow a policy of full disclosure on every financial report and bond prospectus."

Rating agency relations are emphasized in most debt policies through statements such as "the city shall encourage and maintain good relations with financial and bond rating agencies."

Intergovernmental coordination was emphasized by several governments in order to direct communication processes with other governments sharing the same tax base.

## Other Forms of Debt

Several governments identified specific policies related to debt issues other than GO instruments; these are 1) inter-fund borrowing, 2) variable rate debt, 3) short-term debt, 4) revenue and tax increment financing (TIF) bond, 5) lease debt, 6) limited tax GO bond, and 7) derivative restrictions. Surprisingly, few debt policies include such provisions and even then they are generally limited to a specific instrument. The numbers of cities reporting these policies are charted in Exhibit 8.

Inter-fund borrowing restrictions state when such borrowings can occur—primarily for short-term cash flow needs—and general terms for loans such as "internal interest payments will be made at prevailing interest rates." These policies are also philosophical in nature; e.g., "when it would reduce the costs of interest, debt issuance, or administration."

Variable rate debt policies state when such instruments can be used; for example, "as an integral part of a long-term strategy" or "only as a source of interim financing."

Short-term debt issuance policies primarily relate to revenue anticipation notes (RANs), bond anticipation notes (BANs), or tax anticipation notes (TANs) and circumstances when they can be used. Limits include the maximum term—"from one to three years"—or maximum size—"up to 5 percent of operating revenue." Specified purposes include cash flow needs, temporary financing for capital improvements, and major equipment leasing.

Revenue and tax increment financing bond policies identify coverage requirements—e.g., 125 percent or 130 percent—as debt policies.

Lease debt policies place restrictions on leased debt such as "lease payments as a percentage (10 percent) of current revenues," "useful life of assets not to exceed 25 years," or for specific purposes.

Limited tax GO bond policies outline circumstances under which these instruments can be issued; for example, "only when constraints preclude the preferred practice of voter-approved GO bonds."

Derivative restrictions were cited by only one city. They specified when these instruments can be used and mandated an evaluation of risks such as counterparty risk. As a result of the Orange County, California, bankruptcy related to investment losses in which derivatives played a prominent role, more jurisdictions are now including derivatives restrictions in their policies.

## Conclusions

This study examined the breadth of debt policies used by a large sample of GFOA cities. While a formal debt policy statement is a recommended practice of the GFOA, the response rate of this study suggests that less than 20 percent of GFOA municipalities have such policies. Many cities are content with allowing statutory guidelines to be their debt policy. Of those governments that had formal policies, analysts found a substantial variation in the scope and content of statements that were surveyed. The purpose of this article is to provide financial professionals with a comprehensive categorization of specific components of policies in use today. It also could provide a checklist for review and updating of current policy so as to better reflect the complexities of contemporary public finance. ☐

ROWAN MIRANDA, *PH.D., CGFM, became director of the GFOA's Research Center in June 1997. He was formerly director of budget and finance for the County of Allegheny, Pennsylvania, and an assistant professor of public management and policy at the University of Pittsburgh.* RONALD PICUR, *PH.D., CPA, CGFM is a professor of accounting at the University of Illinois at Chicago. He is also affiliated with Pandolfi, Topolski, Weiss & Co., Ltd., an Illinois-based CPA firm, and was formerly the Comptroller of the City of Chicago.* DOUG STRALEY *is senior budget analyst for the County of Allegheny. He holds a masters degree in public and international affairs from the University of Pittsburgh.*