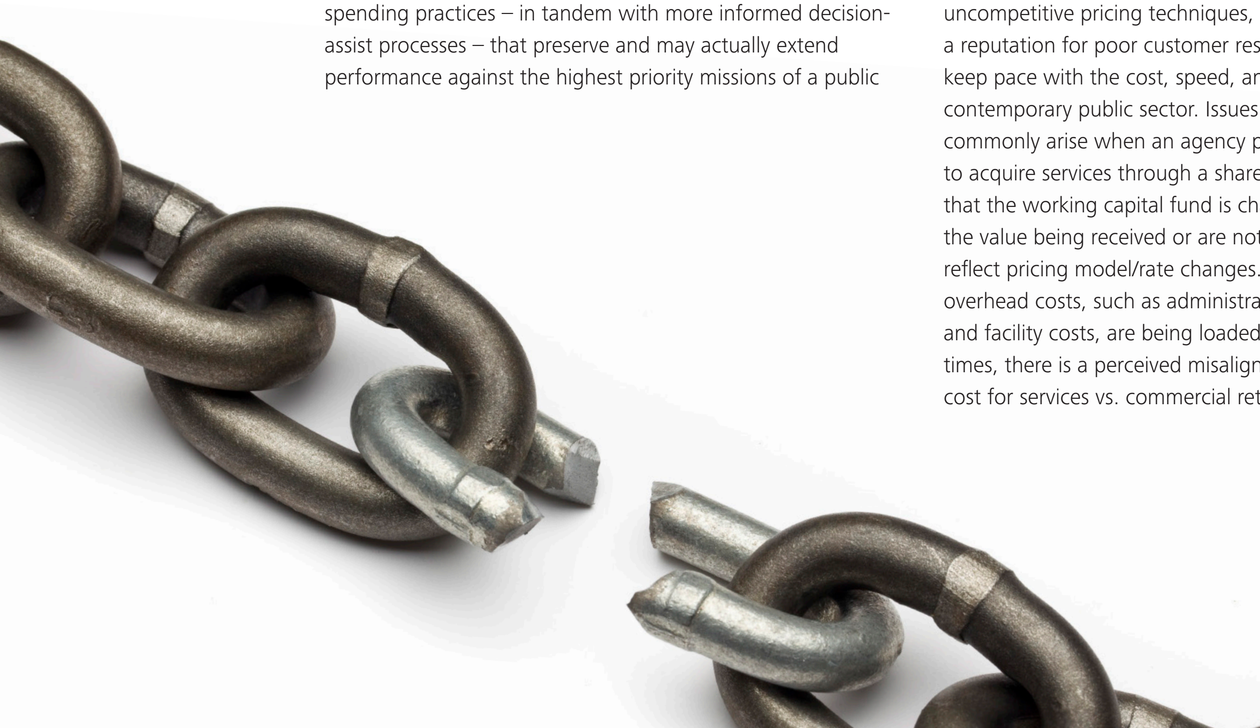
Responsive working capital funds
Effectively break the budget allocation/cost-cutting cycle

Budget cuts are considered the best – if not truest – path to limit spending by public agencies. But does this axiom need to be challenged? After all, each new fiscal year provides agencies with obligational authority that effectively allows them to "start fresh." Without structural financial management changes, agencies may reduce their budgets substantially yet still spend unsustainably as they work toward expected levels of mission performance.

In the prevailing environment of fiscal austerity, public agencies are absorbing or imposing painful budget cuts each year only to have that budgetary authority reinstated to some extent the following year. Reductions intended to set an agency on a different fiscal course are often exposed each year as ephemeral if not illusory. This cycle forces agencies to function in an environment of fiscal uncertainty that strains their ability to meet citizen service and mission mandates while diluting the contribution of valuable talent during the arduous annual budget justification process.

A responsive *working capital fund* may prove key to breaking this cycle. Working capital funds may enable agencies to pivot away from a preponderant focus on cost cutting to a more strategic spending management posture. They provide agencies a mechanism to implement more disciplined spending practices – in tandem with more informed decision-assist processes – that preserve and may actually extend performance against the highest priority missions of a public agency. Cost containment is no longer a byproduct of budget execution, but rather becomes instantiated across the agency's program decision points. Such an approach can also increase transparency of agency costs, better enhance agency assets, promote efficient spending behavior, and elevate further reductions in overall spending while benefiting agency missions and programs.



Working capital funds—back to a better future?

As a financial tool for managing common services, a working capital fund uses a market function to finance its service delivery but with the goal of resource efficiency rather than profitability. A working capital fund relies on "sales revenue" rather than direct appropriations to finance its service delivery to customers. By aiming to break even every fiscal year, a working capital fund develops prices for its services that generate enough revenue to fully recover the costs of operations from its customers — i.e., its agency divisions or programs. A key attribute of a working capital fund is that its authority remains available across fiscal accounting periods. It is similar to that of a no-year appropriation in that the money is "available until expended."

Revolutionary when they were first conceived in the 1970s, today's working capital funds are often perceived to have uncompetitive pricing techniques, outmoded processes, and a reputation for poor customer responsiveness, struggling to keep pace with the cost, speed, and agility demands of the contemporary public sector. Issues with pricing techniques commonly arise when an agency program manager is forced to acquire services through a shared services model but feels that the working capital fund is charging rates that are beyond the value being received or are not being updated timely to reflect pricing model/rate changes. Sometimes this is because overhead costs, such as administrative personnel, real estate, and facility costs, are being loaded onto those rates; other times, there is a perceived misalignment between the agency's cost for services vs. commercial retail-based pricing models.

A common observation from some agencies with working capital funds is that the governance boards seem divorced from the agency's core mission or purpose. They are characterized as more attentive to the propagation of the fund and the execution of its enabling functions (i.e., cash management, billing, and service level agreement administration) than to supporting service delivery to fund customers.

Despite these headwinds, working capital funds that reflect a commercially oriented, responsive approach offer considerable upside potential as a complement to an agency's general (appropriated) fund. A responsive working capital fund is designed, from the ground up, to react more dynamically to changing agency priorities and manage the agency's spending. Leveraging pricing mechanisms and effective practices from the private sector, along with a life-cycle approach to services acquisition, a responsive working capital fund can provide greater autonomy, authority, and agility to an agency's programs. At the same time, a responsive working capital fund can promote sustained confidence across the agency by providing increased visibility into its governance practices, pricing, and service delivery levels.

Transformative potential of responsive working capital funds

A well-designed, responsive working capital fund offers many potential benefits, including maximizing current resource efficiency, providing enhanced fiscal transparency, and enabling service delivery transformation.

Maximizing resource efficiency

In apparent equal measure, policy analysts and reform-minded critics decry the "spend it or lose it" pressures that complicate efforts to control federal agency expenditures, even in times of fiscal austerity. To justify current-year appropriations and preserve future budgets, agencies establish expenditure targets that include obligating all funds by their expiration at the close of the fiscal year. However, agencies don't want to "spend too little," as the Brookings Institution Defense Analyst Michael Hanlon notes,[1] and risk losing future funding, so they rush to place funds on contract as the fiscal year winds down. For example, 9 percent of federal contract spending occurred in the last week of September in fiscal year 2012, representing $45 billion.[2]

Much of this end-of-year spending is inefficient: Jeffrey Liebman of Harvard University and Neale Mahoney of Stanford University conclude that it is of lower quality than spending obligated earlier in the year.[3] The number of lower priority projects that are funded increases when appropriations are delayed and the time to spend funds is compressed.

Responsive working capital funds hold the potential to dampen, if not reverse, this dynamic by providing agencies a means to manage services spending more efficiently and in tighter alignment with mission priorities. In a working capital fund, support service providers are required to justify the agency's need for their services by developing fully burdened service prices that are charged to their customers. When services are no longer "free," program managers are incentivized to be more judicious in tasking the support service provider – procuring only the services they need to consume, and not a penny more. If program managers are able to save money by reducing unnecessary support services, they have the opportunity to harvest the excess capital for sustainable top-line spending reduction or to reinvest in higher priority initiatives or unfunded, mandated requirements.

In contrast to the high rate of spending that has become customary in the final weeks of a federal agency's fiscal year, working capital funds demonstrate a far more metered or normalized spending pattern. When "spend it or lose it" pressures are alleviated, requirements are more tightly correlated with resources, excess services capacity and inventory are diminished, and acquired services and products may be of higher quality.

Providing enhanced fiscal transparency

Agencies interested in promoting an environment conducive to managerial cost accounting (and SSFAS 4 compliance) could benefit from responsive working capital funds that enable the alignment of demand to spending to cost. Under working capital funds, services costs can be clarified and simplified in part because the responsive working capital fund model (like all working capital funds) demands the total recovery of costs.

This level of cost transparency is enhanced by a responsive working-capital customer-buyer relationship. Through effective governance, a customer council has a vested interest in demanding detailed substantiation of costs that the working capital fund passes to its customers; to remain economically viable, a working capital fund is incentivized to create a sophisticated pricing model to rationalize its costs.

But more importantly, with an emphasis on transparency, agencies can more effectively trace support services expenditures to outputs and performance outcomes. This approach enables agencies to more clearly associate budget requests with their primary mission or citizen service activities. They can then focus more resources on their mission instead of ancillary (support) services and enjoy clearer insight into costs directly related to the mission.

[1] "Why defense spending mysteriously surged 13% last quarter — and boosted GDP," Brad Plumer, The Washington Post, October 26, 2012, http://www.washingtonpost.com/blogs/wonkblog/wp/2012/10/26/why-defense-spending-mysteriously-surged-last-quarter-and-boosted-gdp/.

[2] "As Congress fights over the budget, agencies go on their 'use it or lose it' shopping sprees," David Fahrenthold, The Washington Post, September 28, 2013, http://articles.washingtonpost.com/2013-09-28/politics/42478900_1_money-government-spending-toner-cartridges.

[3] "Do Expiring Budgets Lead to Wasteful Year-End Spending? Evidence from Federal Procurement," Jeffrey B. Liebman and Neale Mahoney, The National Bureau of Economic Research, September 2013, http://www.nber.org/papers/w19481.

Enabling service delivery transformation

A fundamental precept of a revolving working capital fund is that it enhances service delivery by placing greater responsibility on customer organizations to acquire and consume only what they need. A responsive working capital fund can more accurately align payment to discrete performance results. This business model also provides agencies the means to support enterprisewide (intra-agency) shared services initiatives to a degree not afforded by less flexible structures.

Taken a step further, working capital funds can facilitate interagency collaboration and eliminate redundancies toward a shared purpose performance vision. For example, the intelligence community is a confederation of 16 independent agencies managed under an assortment of different departments. However, these agencies have common service support needs that are unique to intelligence community mission requirements – including highly secure email and phone networks, specially designed and constructed facilities, classified procurement vehicles, and others. Integrating these services into a community-wide platform through a responsive working capital fund could enable the intelligence community to drive efficiencies through economies of scale and improved customer spending behavior.

Adopting a responsive working capital fund approach

Working capital funds may not be a great fit for every agency. So how can agencies decide whether a working capital fund model is a good approach, and, if so, whether they are ready to move in that direction? The following are important factors for effective implementation:

An information-enabled business posture

Agencies should carefully assess their internal markets and analyze internal demand for services so actual requirements inform the design of service delivery levels and pricing structures. Traditional appropriations mechanisms often muddy the waters. For example, when an agency submits its budget to Congress, the requirements for particular services are typically articulated, captured, cost-estimated, and budgeted approximately 18 to 24 months in advance. However, by the time that budget makes its way through its reviews, the business landscape may have changed considerably. An agency may find it has funds to purchase 100,000 hours of a service for which demand is now either substantially higher or lower, resulting in either a significant excess capacity or shortfall. In other words, an agency's efficiencies are tightly correlated with demand predictability.

An integrated suite of planning, budgeting/rate setting, cost accounting, and budget execution support systems and tools are necessary to provide business managers with timely, accurate, and useful workload and financial results. With a responsive working capital fund model, an agency can forecast demand on far tighter timelines. Such a model enables far greater sensitivity to demand surge or contraction and, therefore, greater accuracy and efficiency.

Rationalized overhead costs

For services that are common or in fairly consistent demand across an agency, the case can be made that those fit under a shared services umbrella and therefore a responsive working capital fund model. But how does an agency accurately structure, price, and acquire those services, which are likely to be sourced to an external provider, in such a way that it gains buy-in from its customer community?

It is important that the agency have a detailed understanding of its overhead cost burdens and avoid overloading these costs onto the services to be procured through its working capital fund. The mechanism the agency establishes to price and deliver its shared services structure — including pricing, performance incentives, variable- and fixed-cost components, and many other dimensions — must be tethered to and mirror the contract structure to avoid an economic disconnect. Customers must be able to segregate and rationalize the working capital fund's overhead costs with the value that the fund creates. For this reason, the agency's finance department cannot go at this alone; stakeholders from across the agency need to be involved to provide clarity, balanced perspectives, and alignment.

Externalized cost of service infrastructure

Shared services costs need to be both accurate and fair, yet services procured through traditional working capital funds often aren't perceived to be either one. For example, a working capital fund's prices might be *accurately* burdened, because of accounting practices and standards, so that a proportionate cost of gate guards' and parking garage attendants' costs are priced into every minute of computer time provided by a particular facility.

Compounding matters are the approaches taken by external service providers that often deliver the shared services on behalf of the working capital fund. Such providers often have one fee structure for private sector clients and something very different for government clients. Instead, for a working capital fund to be responsive, there needs to be a far clearer understanding of and alignment between the agency's requirements and the shared service provider's fee structures — and those fee structures should be more aligned with what the service provider charges its commercial clients.

Overcoming potential deployment barriers

At least partially due to preconceived notions about traditional working capital funds, agencies may face several barriers. The first of these is potential organizational inertia. A strong signal from agency leadership — a departmental secretary or deputy secretary, for example — that this is a strategic priority is needed to focus attention on the transformational changes required to make a working capital fund responsive. The new funding model should be codified in the agency's strategic plan, and the agency's top executive needs to at least sponsor, if not champion, the transformation.

For those reasons, the initiative cannot reside solely in the finance department and be the responsibility of the chief financial officer (CFO) alone, although the CFO certainly will be involved. When finance "owns" the initiative and imposes it on the organization, there is a risk that the rest of the organization might perceive the project to be another finance mechanism — a back-office refinement. Instead, other influential people across the agency need to have a stake in the initiative, understand what's in it for them, take at least partial ownership and, later, benefit from its success.

Additionally, agencies may avoid working capital funds due to the administrative burdens and policies that are necessary to execute its operations as intended. Some examples include service level agreement (SLA) establishment, billing, forced monopoly of services, new governance councils, etc. This is why it's critical that the agency activity advocates and socializes the economic and mission-related benefits of a working capital fund to stimulate awareness and buy-in from its customers.

Another potential barrier is developing and presenting a compelling business case to Congress for the change to a responsive working capital fund. As presently defined, working capital funds require legislative charters enacted or authorized by Congress. When government agencies shift away from the annual constitutional appropriations process, Congress gets a say in whether the business case for a working capital fund is valid. Today, anything more than just an administrative check may have a degree of implementation difficulty, especially if the authority to establish a working capital fund is hung up in the larger funding bill for an agency.

Finally, agency leadership should effectively cede control of acquiring services to the agency's lines of business and programs. By providing agency programs with greater autonomy, responsibility, and authority, agencies generally see enhanced productivity — primarily because they choose to use a lot less and therefore pay for a lot less. However, due to strong program office objection, agency leadership may balk at moving to shared services through a responsive working capital fund, as they may perceive it to introduce risk into a carefully controlled process.

Conclusion

The budget results that demanded of agencies today are significant. Structural change through a more responsive working capital fund is one answer that is often overlooked as a way to break the cycle of government cuts and regenerating appropriations.

By focusing on the cost dimensions of an agency's financial posture, including how internal services are delivered, priced, and funded, agencies can interrupt this cycle and achieve sustainable reductions while preserving or even improving performance of agencies' core missions.

Find out more

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