

PROACTIVE BUDGETING

(Editor's Note: Many Vermont municipalities are currently in the throes of drafting their budgets for next year. To assist you, this issue includes the following article, an Ask the League question on reserve funds, and a commentary by Executive Director Steve Jeffrey on the budgetary needs of the listers' office.)

Municipal finance has always survived with a “current year” focus, getting through each budget year without paying much heed to the long-term needs of the community. This focus on purely financial resources is reflected in the financial statements in many annual reports; very few municipalities show sufficient information to provide the reader with a long-term picture of the financial health of the town, i.e. its economic resources shown in a balance sheet.

As municipalities begin to comply with the reporting standards of the Government Accounting Standards Board (GASB) Statement 34, the differences between this traditional budgetary compliance model and the long-term planning model championed by GASB become increasingly evident. When Vermont municipalities move toward this new way of tracking their finances, the benefits of sharing a more complete financial picture with taxpayers, and thinking more proactively about budgeting, should become apparent.

A long-term view of your municipality's financial condition should be the foundation for your budget planning. It is important to emphasize the word “planning” here. Budgeting is the process of allocating resources and that process should include careful consideration of the goals of your community. It's tough to determine what the best use of the resources may be when you have no clearly defined direction. For instance, it is important for a municipality to analyze its overall debt load and its budgetary impact prior to approving more debt financing. Knowing where you are financially, comparing it to where you've been, and deciding where you want to be in the future makes decision-making a whole lot easier.

FORECASTING AND TRENDS

Your budget consists of operating costs, capital costs and debt service, and transfers from reserves or other funds. Separating it into those three categories makes it easier to both understand and project future expenses. Operating costs, made up of labor and non-labor line items, are the largest share of your appropriation. Trending (the process of compiling and analyzing your historical data) all of these costs by category will give you a better sense as to where the largest increases are occurring. A history of at least three years (preferably five or more, if possible) worth of data is key to determining how the distribution of your costs is shifting. You may see that benefits costs are increasing as a percentage of your overall budget, reducing the non-labor costs proportionately. That may indicate that you've been sacrificing one area of the budget to fund another, a decision that may have been made unintentionally when you agreed to fund a particular benefit without fully understanding the impact on the rest of the budget.

Revenues should be trended as well, keeping track of current property taxes, delinquent property taxes, non-tax revenue and user fees separately. Understanding your tax collection trends is crucial to the budgeting process, for in most towns, tax revenue may be as much as 90% or more of total revenue. If you don't know the percentage that is generally collected each year of both current and delinquent, you may have a hard time forecasting revenue for the ensuing budget year.

For both expenditures and revenues, it is a good practice to try to come up with multi-year forecasts. Using historical data and projecting future benefits, salary, capital and debt costs, increasing non-labor costs by an inflation rate, and projecting tax revenue based on grand list increases, as well as trended tax collection rates, may give you a fairly good idea of any problems that may be looming over the next couple of years. This allows you to plan your current budget to anticipate and correct future shortfalls by reserving fund balance, for instance.

CAPITAL AND DEBT

Capital improvement planning is key to maintaining your assets and infrastructure, as well as to matching the benefit with the cost. Reactive capital replacement, paying for replacements only as needed (“pay as you go”), places the burden of payment on those taxpayers who happened to be around when the purchase was made. Once it is paid for, everyone else gets use of the asset without footing any of the bill. A good capital plan will spread the costs, whether through debt, cash or reserve financing, over the useful lives of the assets.

Remember that you are trading cash for an asset, and even though you have spent the cash, you have an asset of equal value that will be used over a number of years. Depreciation expense uses up that asset, showing the declining value over time. This is the main difference between a current budget or financial resources focus and a long-term or economic resources focus. If you're just looking at your current cash, you've expended \$100,000. However, you've received an ambulance that will last for the next 10 years and has a \$100,000 value this year.

Debt that isn't properly managed can be a drain on resources available for operating uses. Knowing how much of your assets are tied up in debt is extremely important. Total debt as a percentage of your grand list or per capita debt are good ratios to know, and debt payments as a percentage of total budget will help you understand how much of your operating funds are tied up in capital. Large fluctuations in these percentages or continuous increases may be a red flag and force you to reevaluate your priorities.

FUND BALANCE

Use of unreserved fund balance is a somewhat controversial area due to differing standards recommended by GASB and required by Vermont statute. To be fiscally prudent, it would be wise to maintain about 5% of your budget in undesignated fund balance (not reserved for any other purpose). Some would argue that those funds should be returned to the taxpayer by reducing the ensuing year's taxes by the amount of the prior year's undesignated fund balance. This limits the municipality's ability to recover when an emergency creates expenditures in excess of what was budgeted, or revenue is less than anticipated, and forces the taxpayers to fund a deficit the next year.

Asking taxpayers to fund an undesignated fund balance should be part of your budget planning process. The GFOA (Government Finance Officers Association) recommends that municipalities adopt a policy for maintaining undesignated fund balance at a level appropriate for their particular circumstances. This amount should be approved at your annual meeting as part of your budget. (See this month's Ask the League article for the Municipal Assistance Center's guidance on "emergency/rainy day" funds.) Proactive budgeting will allow you to understand and take control of your finances. The choices and decisions that you make should be informed. Poor planning can lead to bad decisions, which in turn can lead to financial disasters.

- Michael Gilbar, Director, VLCT Administrative Services

(Staff members from VLCT's Municipal Assistance Center are available for onsite trainings on any of these topics. If you would like to schedule an on-site training for your town, call VLCT MAC at 800/649-7915.)

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