Budget Advisory Committee

City of Englewood, Colorado
City Manager's Office
1000 Englewood Parkway
Englewood, CO 80110-2373
Website: **www.englewoodgov.org**

AGENDA

Englewood Civic Center
City Council Conference Room, Third Floor
Tuesday, March 18, 2014
4:30pm to 6:00pm

These meetings are recorded, please be mindful of side conversations.

1. Call to Order and Roll Call of Members
2. Clarification to the Meeting Recording – February 25, 2014
3. New Business
   - City Department Presentation – Fire Department (Andrew Marsh)
     - Members to review the 2/24/2014 Study Session Fire Study Presentation Materials (Denver and South Metro) located on City Website at the following link: http://www.englewoodgov.org/inside-city-hall/city-council/agendas-and-minutes
   - Initial General Fund Budget Revenues Five Year Forecast (this information will be presented to City Council at the April 28 Study Session), Budget Guidelines and Budget Calendar (Gary Sears)
   - Member Discussion of Reserve Level (Gary Sears)
   - Member Discussion of Timeline for Deliverables (Citizen's Budget and Recommendation to Council)
4. Old Business – December 17, 2013 Agenda Items Deferred
   - Discussion of Deliverable Items continued from the 12/17/2013 Meeting:
     - Compile a list of Items that we think are important for inclusion in the citizens budget document, for example:
       - 1. Where does the money come from?
       - 2. How do we spend it?
       - 3. Outcomes and Services
       - 4. Future vision and values
     - Compile a list of Revenue generation ideas
     - Compile a list of what we can do as a body, how we see our role as a body
5. Budget Advisory Members' Choice
6. Adjourn

Please note: If you have a disability and need auxiliary aids or services, please notify the City of Englewood (303-762-2409) at least 48 hours in advance of when services are needed. Thank you.

City of Englewood, Colorado

2015 Budget Calendar

Time Frame	Task	Department(s)
January - April, 2014	Review and calculate revenue projections for General Fund, Special Revenue Funds, Debt Service Funds and Capital Projects Funds	FAS
April-May, 2014	Update Department Service Enhancement and Capital Request Forms	All Departments
4/1-30/2014	Study Session-2013 Overview, 2014 Budget and 2015 Budget Planning Discussion including Five Year Budget Projection and LTAR funds with City Council and Executive Management Staff	All Departments
Week of May 5, 2014	Distribute Divisional Budget workbooks, budget pages in network folders.	FAS
Week of May 12, 2014	Budget Training on Completing the Excel Budget Workbooks and the Word Budget Pages	FAS
June 23, 2014	Information Technology Related Service Enhancement and Capital Request forms due to IT Director	All Departments
July 14, 2014	Service Enhancement and Capital Request forms returned to Revenue and Budget Office	All Departments
July 14, 2014	Departments submit proposed budgets and Divisional Budget pages to Budget Office.	All Departments
July 14, 2014	Study Session-June 2014 Financial Report (Revenue and Expediture Update)	FAS
Weeks of July 28, 2014 and August 4, 2014	Departments review budgets workbooks and budget pages with CMO	All Departments
August 25, 2014	Study Session-Discuss Proposed 2015 Budget	All Departments
Week of August 26, 2014	CMO finalizes PROPOSED BUDGET; Finalize Budget Pages for Proposed Budget	CMO/FAS
July - Aug 31, 2014	Proposed Budget document prepared, Budget Overview prepared. Provide the City Attorney's Office with DRAFT Ordinances for the Budget, Appropriation and the Mill Levy	FAS
August 27, 2014	Publish on Official City Website the time & place of Budget Hearing (Charter Article X Part I Budget §87)	FAS
August 29, September 5 and 12, 2014	***Publish in the Herald the time & place of Budget Hearing (Charter Article X Part I Budget §87)***	***FAS***
September 4, 2014	Proposed budget to Council (legally required by September 15 - Charter Article X Part I Budget §82)	FAS
September 8, 2014	Study Session Preliminary Budget Review 6-9pm (Tentative)	All Departments
September 15, 2014	***Public Hearing (Charter Article X Part I Budget §87)***	***CMO***
September 22, 2014	***Budget Workshop - 6:00pm to 9:30pm***	***All Departments***
Oct 1 - Dec 31, 2014	Produce and Distribute Budget Document (including the Colorado Department of Local Government and GFOA)	FAS
October 6, 2014	First Reading: Introduce bills for ordinances-Mill Levy, Budget and Appropriations (Charter Article X Part I Budget §89-90)	FAS
October 20, 2014	Second Reading: Introduce bills for ordinances-Mill Levy, Budget and Appropriations (Charter Article X Part I Budget §89-90)	FAS
December 8, 2014	Final Assessed Valuation from Arapahoe County	FAS
December 15, 2014	***Certify Mill Levy to Arapahoe County***	***FAS***

PLEASE NOTE: Bold/Italic dates are legal requirements by Charter or State Statute.

CMO - City Manager's Office

FAS - Finance and Administrative Services

City of Englewood Department of Finance and Administrative Services

Memorandum

To: Gary Sears, City Manager, Mike Flaherty, Deputy City Manager
From: Frank Gryglewicz, Director of Finance and Administrative Services
Date: March 3, 2014
Re: Preliminary 2015 Draft Budget Guidelines and Forecast for the April 28, 2014 Study Session

The initial 2014 forecast and the 2015 preliminary budget will be discussed earlier in the year than usual. City Council and staff will discuss the preliminary 2014 forecast and 2015 budget scenarios at the April 28, 2014 Study Session. The Budget Advisory Committee (BAC) will be invited to attend the Study Session.

The attached General Fund spreadsheet shows past (unaudited 2013), current (estimated) and future forecasts using relatively conservative growth for revenues and expenditure. The estimate for 2014 is at budget because of lack of actual financial information to make changes to year-end estimates at this time.

Because overall revenue growth is forecast to grow moderately, expenditures must be *tightly* controlled.

- The estimated revenues and expenditures for 2014 are as budgeted. Year-end estimates will most likely change as actual information is received and updated at mid-year.
- Wages *and* benefits are forecast to increase three percent. Contractual, commodities, and capital are initially forecast to increase three percent as well.
- Required pension contributions are determined by applicable actuarial studies (defined benefit) or pre-determined contribution levels (defined contribution). Contributions for the defined benefit plans are very difficult to forecast because they are reliant on highly variable investment performance. Additional pension contributions may result from union negotiations.
- Workers Compensation premiums will be provided by Human Resources later in the year.
- Property and Liability premiums will be provided by Human Resources later in the year.
- Transfers into the General Fund from other funds will be limited as those funds build up their reserves.
- No new programs or personnel may be added without the City Manager's *prior* approval. Please submit separately a service enhancement request form of new programs or positions for consideration by the City Manager.
- Budget workbooks will be prepared and updated to reflect negotiated pay increases, personal leave, merit pay, and holiday pay as soon as possible (see attachment).
- All departments should review the services and programs they provide that may be eliminated, reduced, contracted, "regionalized," or privatized with minimal impact on the City's service levels.
- Please identify any new revenue sources available or charges/fees that may be increased without a TABOR (tax increases, etc.) vote.
- Please review current fee structure and make adjustments if applicable.
- All open positions are "frozen" and must not be filled without the *prior* approval of the City Manager.
- Capital expenditure requests will be submitted separately for consideration into the Multiple Year Capital Plan (MYCP).

BEST PRACTICE

Replenishing Fund Balance in the General Fund (2011) (Budget and CAAFR) (new)

Background. It is essential that governments maintain adequate levels of fund balance to mitigate risks and provide a back-up for revenue shortfalls.

The adequacy of unrestricted fund balance[1] in the general fund should be assessed based upon a government's specific circumstances. Nevertheless, the GFOA recommends, at a minimum, that general-purpose governments, regardless of size, incorporate in its financial policies that unrestricted fund balance in their general fund be no less than two months of regular general fund operating revenues or regular general fund operating expenditures.

If fund balance falls below a government's policy level, then it is important to have a solid plan to replenish fund balance levels. Rating agencies consider the government's fund balance policy, history of use of fund balance, and policy and practice of replenishment of fund balance when assigning ratings. Thus, a well developed and transparent strategy to replenish fund balance may reduce the cost of borrowing. However, it can be challenging to build fund balances back up to the recommended levels because of other financial needs and various political considerations.

Recommendation. The Government Finance Officers Association (GFOA) recommends that governments adopt a formal fund balance policy that defines the appropriate level of fund balance target levels. Also, management should consider specifying the purposes for which various portions of the fund balances are intended. For example, one portion of the fund balance may be for working capital, one for budgetary stabilization, and one for responding to extreme events. This additional transparency helps decision makers understand the reason for maintaining the target levels described in the fund balance policy.

Governments should also consider providing broad guidance in their financial policies for how resources will be directed to fund balance replenishment. For example, a policy may define the revenue sources that would typically be looked to for replenishment of fund balance. This might include non-recurring revenues, budget surpluses, and excess resources in other funds (if legally permissible and if there is defensible rationale). Year-end surpluses are an especially appropriate source for replenishing fund balance.

Finally, a government should consider including in its financial policy a statement that establishes the broad strategic intent of replenishing fund balances as soon as economic conditions allow. This emphasizes fund balance replenishment as a financial management priority.

Governments are subject to a number of factors that could require the use of fund balances. It is therefore incumbent on jurisdictions to minimize the use of fund balance, except in very specific circumstances. Replenishment should take place in a prompt fashion with amounts that have been used to ensure that the jurisdiction is properly prepared for contingencies. With the foundation of a financial policy in place, governments should use their long-term financial planning and budget processes to develop a more detailed strategy for using and replenishing fund balance. With these criteria in mind, the government should develop a replenishment strategy and timeline for replenishing fund balances as soon as possible, and that is still appropriate to prevailing budgetary and economic conditions and that considers the following:

1. The policy should define the time period within which and contingencies for which fund balances will be used. This gives the public a sense for how fund balance is being used as a "bridge" to ensure stable cash flow and provide service continuity.
2. The policy should describe how the government's expenditure levels will be adjusted to match any new economic realities that are behind the use of fund balance as a financing bridge.

3. The policy should describe the time period over which the components of fund balance will be replenished and the means by which they will be replenished. Frequently, a key part of the replenishment plan will be to control operating expenditures and use budget surpluses to replenish fund balance. The replenishment plan might also specify any particular revenue source that will aid in the replenishment of fund balances. For example, if the government has a volatile sales tax yield, it might specify that yields that are significantly above average would be used to replenish fund balances.

Generally, governments should seek to replenish their fund balances within one to three years of use. However, when developing the specifics of the replenishment plan, governments should consider a number of factors that influence the rate and time period over which fund balances will be replenished. Factors influencing the replenishment time horizon include:

1. *The budgetary reasons behind the fund balance targets.* The government should consider special conditions that may have caused it to set its fund balance target levels higher than the GFOA-recommended minimum level. For example, if targets are higher because the community has very volatile cash flows, then the government would want to build the fund balances back up more quickly compared to governments with more stable cash flows.
2. *Recovering from an extreme event.* An extreme event, such as a natural disaster, that has required the government to use a portion of its fund balance, may make it infeasible to replenish the fund balance as quickly as normal, depending upon the severity of the event.
3. *Political continuity.* Replenishing fund balance takes political will, and that will is often strengthened by the memory of the financial challenge that caused the use of fund balances in the first place. If the governing board and/or management are already committed to a particular financial policy, the replenishment strategy should be as consistent as possible with that policy in order to maximize political support.
4. *Financial planning time horizons.* Fund balances should typically be replenished within the time horizon covered by the organization's long-term financial plan. This puts the entire replenishment plan in context and shows the public and decision makers the expected positive outcome of the replenishment strategy.
5. *Long-term forecasts and economic conditions.* Expectations for poor economic conditions may delay the point at which fund balances can be replenished. However, in its replenishment plan the government should be sure to set a benchmark (e.g., after fund balances have dropped to a certain point below desired target levels) for when use of fund balance is no longer acceptable as a source of funds.
6. *Milestones for gradual replenishment.* A replenishment plan will likely be more successful if it establishes replenishment milestones at various time intervals. This is especially important if replenishment is expected to take place over multiple years (e.g., if you are starting from 75% of your target, set a goal to reach 80 percent of target in one year, 90 percent in two years, and 100 percent in three years).
7. *External financing expectations.* A replenishment plan that is not consistent with credit rating agency expectations may increase the government's cost of borrowing. It is important that the logic used by the government to develop the replenishment plan be communicated in an effective fashion to external lenders.

References.

- GFOA Best Practice Appropriate Level of Unrestricted Fund Balance in the General Fund, 2009.
- For a fuller explanation of the concept of "bridging" in financial distress, please visit GFOA's financial recovery website at www.gfoa.org/financialrecovery .

Approved by the GFOA's Executive Board, February, 2011

[1]Unrestricted fund balance comprises the committed, assigned, and unassigned fund balance categories.

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BEST PRACTICE

STRUCTURALLY BALANCED BUDGET POLICY (Budget) (2013)

Background. Most state and local governments are subject to a requirement to pass a balanced budget. However, a budget that may fit the statutory definition of a "balanced budget" may not, in fact, be financially sustainable. For example, a budget that is balanced by such standards could include the use of non-recurring resources, such as asset sales or reserves, to fund ongoing expenditures, and thus not be in structural balance. A true structurally balanced budget is one that supports financial sustainability for multiple years into the future. A government needs to make sure that it is aware of the distinction between satisfying the statutory definition and achieving a true structurally balanced budget.

Recommendation. GFOA recommends that governments adopt rigorous policies, for all operating funds,[1] aimed at achieving and maintaining a structurally balanced budget. The policy should include parameters for achieving and maintaining structural balance where recurring revenues are equal to recurring expenditures in the adopted budget.

As a first step, the government should identify key items related to structural balance. These include: *recurring and non-recurring revenues, recurring and non-recurring expenditures, and reserves.*

Recurring revenues are the portion of a government's revenues that can reasonably be expected to continue year to year, with some degree of predictability. Property taxes are an example of recurring revenue. A settlement from a lawsuit is a good example of non-recurring revenue.

Some revenue sources may have both non-recurring and recurring components. These sources require finance officials to exercise judgment in determining how much of the source is truly recurring. For instance, a government may regularly receive sales tax revenues, but a large part of its base may be made up of retailers with highly volatile sales. In this case, it may be prudent to regard unusually high revenue yields as a non-recurring revenue under the assumption that such revenues are unlikely to continue, making it imprudent to use them for recurring expenditures. Another example might be building permit revenues in a period of high growth in the community. Governments should review their revenue portfolio to identify non-recurring revenues and revenues with potentially volatile components, such as the examples above.

Recurring expenditures appear in the budget each year. Salaries, benefits, materials and services, and asset maintenance costs are common examples of recurring expenditures. Capital asset acquisitions are typically not thought of as recurring because although some capital assets may be acquired every year, they are not the same assets year after year. In general, recurring expenditures should be those that you

[1] Note that this Best Practice excludes non-operating funds like capital and debt funds. While governments should ensure that these funds are financially sustainable as well, the specific recommendations found in this Best Practice may not always be a match to the circumstances of non-operating funds.

expect to fund every year in order to maintain current/status quo service levels. In general, a government has a greater degree of flexibility to defer non-recurring expenditures than recurring ones.

Reserves are the portion of fund balance that is set aside as hedge against risk. The government should define a minimum amount of funds it will hold in reserve.[2] This serves as a "bottom line measure" to help determine the extent to which structural balance goals are being achieved – if reserves are maintained at their desired levels, it is an indication that the organization is maintaining a structurally balanced budget. If reserves are declining, it may indicate an imbalance in the budget (e.g., if reserves are being used to fund on-going expenditures). It should be noted that reserves levels are not a perfect measure of structural balance, but are a good and readily available measure.

With the forgoing terms defined, a government should adopt a formal policy calling for structural balance of the budget. The policy should call for the budget to be structurally balanced, where recurring revenues equal or exceed recurring expenditures. The policy should also call for the budget presentation to identify how recurring revenues are aligned with or not aligned with recurring expenditures.[3]

For a variety of reasons, true structural balance may not be possible for a government at a given time. In such a case, using reserves to balance the budget may be considered but only in the context of a plan to return to structural balance, replenish fund balance, and ultimately remediate the negative impacts of any other short-term balancing actions that may be taken. Further, the plan should be clear about the time period over which returning to structural balance, replenishing reserves, and remediating the negative impacts of balancing actions are to occur. [4]

Approved by the GFOA's Executive Board, February, 2012.

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[2] See GFOA Best Practice "Appropriate Level of Unrestricted Fund Balance in the General Fund" (2002 and 2009). GFOA recommends, at a minimum, that general-purpose governments, regardless of size, maintain unrestricted fund balance in their general fund of no less than two months of regular general fund operating revenues or regular general fund operating expenditures

[3] Please note that the best practice is not advocating that recurring revenues be formally allocated or "earmarked" to recurring expenditures, but rather is advocating that the budget presentation provide transparency as to whether recurring revenues and recurring expenditures are balanced.

[4] See GFOA Best Practice "Replenishing Fund Balance in the General Fund." (2011).

of comparative analysis with other spending options undermines accountability and government leaders' control over spending. As a matter of policy, budget scholars advise that all spending be covered in the operating and capital budgets.

One other issue concerns how governments budget for internal services. Governments set up internal service funds as a tool to control costs. For example, a motor vehicles pool may be accounted for as an internal service fund, in which case each department (internal user) is charged for the use of city or county vehicles. From a budgeting perspective, the question is how to budget for this internal service: as a line-item expenditure for each department, or as a lump-sum appropriation to the motor vehicles department that is then allocated to each departmental user? The first method is much preferred. Each department has an incentive to ration its use of the internal service in accordance with the funds it has available for the activity. Occasionally, an internal service may require a subsidy from the operating budget because usage does not provide the level of funding needed to sustain the desired quality of service. For example, the motor vehicles department may not have a sufficient volume of activity to cover its annual direct and indirect operating costs, in which case a subsidy will be needed if the jurisdiction decides to retain the service rather than outsource it to a private provider.

Pension obligations Pension liabilities have become a major issue for many local governments, particularly those that have failed to adequately fund their obligations as they are incurred. Failure to include pension obligations in the operating budget shifts the liability to future taxpayers and creates what accountants call an unfunded benefit. The Governmental Accounting Standards Board (GASB) has issued guidelines for reporting pension obligations as well as for the failure to fully fund those obligations as the liability is incurred.[17] Local governments typically extend health care benefits to their retirees—what accountants have labeled **other post-employment benefits (OPEB).** In the past, local governments typically did not include funding for these liabilities in their operating budgets and are now having to pay for past OPEB from current revenues while also setting aside funds for future retirees. The GASB has issued guidelines as well for reporting OPEB.[18]

Budgetary balance At first glance, the definition of a balanced budget may appear obvious. If current revenues equal current expenditures, the budget is balanced; thus, a deficit budget occurs when revenues fall short of expenditures, which requires the government to borrow money or draw on fund balances carried over from previous years in order to cover current expenditures. But as noted earlier in the chapter, political gamesmanship has made even something as simple as defining a balanced budget enormously complex. Questions arise over whether the balance test applies to only the executive's proposed budget or also to the budget adopted by the legislature or to the year-end balance remaining in the budget. There is also the question of how the balance should be measured—on a cash basis or an accrual basis? (These terms are defined and discussed in Chapter 10).

Occasionally, a local government will want to draw down its fund balance—the accumulated year-end surpluses available for reappropriation. In this case, it will intentionally adopt a budget in which estimated current revenues are less than appropriations, with the difference made up by drawing down the fund balance:

Estimated revenues + fund balance = appropriations.

The budget policy should specify the expectation for a balanced budget and the amount of money to be retained in the fund balance as a reserve for contingencies. Figure 8–4, a summary of all funds from the Cambridge, Massachusetts, budget comparing total revenues with expenditures, shows not only a balanced budget but also the budget's comprehensiveness.

Budget reserves Although policies on budget coverage and a balanced budget are not always clearly articulated, many governments have adopted explicit policy guidelines for budget reserves. To accumulate money for future purposes or unforeseen events, governments establish reserve accounts in various funds and then earmark the money for that purpose. The more common types of reserves are for

- Cash flow requirements
- Revenue stabilization (or rainy day funds)
- Unforeseen contingencies
- Equipment replacement and building improvements
- Debt service.

Cash flow requirements Because revenue inflow never coincides with the outflow of payments, governments must maintain sufficient cash on hand to satisfy cash flow needs. The amount of reserve for this purpose—sometimes called operating reserves—depends on the timing of tax and utility payments. For example, most cities in Texas begin their fiscal year on October 1, yet property taxes are not due until the following

Figure 8–4 FY 2013 adopted budget summary, Cambridge, Massachusetts

FY11 ACTUAL	FY12 PROJECTED	PROGRAM EXPENDITURES	FY13 BUDGET
$43,306,480	$59,086,955	General Government	$54,107,840
101,400,990	103,892,585	Public Safety	107,945,475
99,945,230	97,231,260	Community Maintenance & Development	101,363,435
30,152,565	31,830,665	Human Resource Development	32,618,030
135,368,315	139,883,265	Education	144,987,705
44,892,125	47,973,095	Intergovernmental	47,206,080
$455,065,705	$479,897,825		$488,228,565

FINANCING PLAN	FY13 BUDGET
Taxes	$352,409,135
Licenses & Permits	7,515,500
Fines & Forfeits	9,422,205
Charges for Service	69,593,055
Intergovernmental Revenue	38,147,710
Miscellaneous Revenue	11,140,960
	$488,228,565

Source: City of Cambridge, Massachusetts, *Annual Budget 2012–2013*, I-5, cambridgema gov/budget/fy12 submittedbudget.aspx.

January 31. Sufficient cash must be reserved in a fund balance to cover disbursements during that period.

For general fund services, one rule of thumb is that there should be enough cash on hand to cover disbursements for sixty days. A government should first examine its cash flow needs and the margin of protection required, and then specify in its budget policy the size of cash flow reserve it wishes to maintain. Some funds may require higher levels of operating reserves than others because of the cyclicality of their revenue stream. For example, enterprise funds such as a water fund may require a higher operating reserve because of the uneven flow of revenues, which peak during the dry summer months.

Revenue stabilization Following the bitter impact of recessions over the past two decades, many state and local governments established **revenue stabilization reserves,** or rainy day accounts, usually maintained in the general fund, to provide resources when revenues decline because of an economic slowdown. While the timing of slowdowns and even recessions can be anticipated somewhat accurately, their severity and length are much more difficult to forecast. And their impact on local communities varies widely, depending on their cause and on the local economy's link to the broader economic cycle. Consequently, state and local governments risk misestimating revenues whenever their assumptions about the economy's future are inaccurate.[19] A 1987 study of revenue forecasting by the State of California showed that half of its forecasting error was due to inaccurate assumptions about the course of the state's economy and half was due to random statistical error inherent in revenue models.[20]

While revenues fluctuate with the economy, expenditures usually display a countercyclical trend. During economic downturns, demand for government services such as unemployment compensation, education, and police protection may increase. A revenue stabilization reserve enables governments to insulate their spending and taxing policies from the vagaries of the economy.

Two policy issues that a government must resolve when creating a revenue stabilization reserve are the size of the reserve and the way in which it can be tapped. One approach is to set the reserve equal to a percentage of the operating expenditures; another is to set it according to the maximum change in the property tax rate that the government is willing to adopt. In the final analysis, the appropriate size of the reserve depends on the stability of a government's revenue stream and on its political resolve to protect against budget instability.

Most budget policies leave the question of when to tap the reserve to the discretion of the council on the recommendation of the chief executive. Some governments, such as Milwaukee, Wisconsin, require an extraordinary (three-fourths) majority of the council before money can be transferred from the reserve to the operating budget. An alternative approach pegs accessing the reserve to an economic indicator, such as a decline in the gross state product or an increase in the regional unemployment rate. Whatever mechanism is used, the budget policy should specify the benchmark measure, or "trigger point," for accessing the reserve.

Unforeseen contingencies State and local governments also establish contingency reserves to provide funding in case of unforeseen emergencies or disasters. Article X, Section 20, of the Colorado Constitution requires all cities to maintain a restricted reserve in all city funds, which can be tapped only for declared emergencies.[21] A contingency reserve provides a readily available pool of funding to ensure continuation of city operations during an emergency, and it buys time while the city or county assesses the impact of the emergency. Many governments establish a separate contingency reserve in each major fund, such as one for each enterprise fund (water, sewer, sanitation, etc.). In cases where the disaster has a long-term impact, however, as has occurred with Hurricanes Katrina and Sandy, no amount of local contingency funding can provide adequate preparation.

Equipment replacement and building improvements Two other types of reserve that state and local governments use occasionally are for equipment replacement and building improvements. The advantage of an equipment replacement reserve is that money is available for purchasing operating equipment and vehicles as those on hand become obsolete or unusable. Some governments, such as Fort Collins set up a revolving fund that departments can borrow from to replace equipment before the next funding cycle or before the next lease-purchase agreement is approved. Sometimes governments establish a separate reserve that accumulates funds for deferred maintenance, renovations, and repairs to government-owned facilities. Funding for both types of reserve usually comes from surcharges assessed to each department on the basis of its pro rata share of equipment used or building space occupied.

Local governments that pursue a pay-as-you-go policy for capital improvements (discussed in Chapter 11) will likely set up a similar reserve fund to finance new construction, particularly construction for general government activities. Contributions to the reserve may be an annual fee assessed on all general fund activities, a fixed percentage of the annual operating budget, or some combination. Unfortunately, governments that fund their activities using this strategy rarely accumulate sufficient reserves to keep pace with new or replacement construction.

Debt service Lastly, governments establish reserves for debt service payments, usually as a condition of their bond agreements with private investors. Debt service is the annual or semiannual payment of principal and interest that governments must make on outstanding indebtedness. For GO bonds, a debt service fund is created to account for the taxes levied and payments made to service this type of debt. For revenue bonds, separate accounts are created in an enterprise fund to track revenues and payments for debt service. In the case of revenue bonds, reserves of 10–25 percent of the annual debt service payment may be required by a rate covenant in the bond ordinance that protects bondholders against default. The size of the reserve varies, depending on the instability of the revenue stream from the project financed by the bonds. Less frequently, governments may establish a small reserve for their GO payments, but this is usually done more for cash flow purposes than to fulfill a requirement of the bond covenant.

Budget preparation and amendment A budget policy statement should make clear certain critical aspects of budget preparation: the duration of appropriations, the process for amending the budget during the fiscal year, the type and frequency of budget performance reports, and what funds, if any, will be self-supporting.

Duration of appropriation authority For the operating budget, appropriation authority usually lapses at the end of the fiscal year (or biennium for governments on a two-year cycle). Such requirements are often specified in law. Any unspent or unencumbered balances remaining at the end of the year lapse into the fund balance and become available for reappropriation for the next fiscal year. Obviously, department heads have a powerful incentive to spend their full appropriation as they risk having their budgets reduced the next year by an amount equal to the unspent balance. Exceptions to year-end lapsing of authority include appropriations for capital projects, which usually do not lapse until the project is completed, and state and federal grants, which lapse once the grant expires or the grant-funded project is completed.

Amending the budget A budget policy statement should specify the procedures for amending the budget during the fiscal year. Because revenue forecasts must be developed several months before the fiscal year begins, revenue collections may deviate substantially from those on which the budget is based, and the operating budget may need to be amended. In Georgia, as in many state and local governments, revenue forecasts are conservative, leading to a surplus of revenue available for appropriation by the fiscal year's midpoint. Each year the Georgia legislature passes a midyear supplemental appropriation that allocates any revenue surplus to state agencies.[22]

A policy should specify the circumstances under which the legislative body may amend the budget. For example, Fort Collins amends the budget (1) to pay for encumbrances (purchase orders) carried over from the preceding fiscal year; (2) to allocate unanticipated revenues, such as a grant or bond issue; or (3) to allocate reserves where the balances are greater than required by budget policy or where an emergency or unusual circumstance has occurred.[23] Legislatures also amend budgets to transfer money across funds or to retroactively approve a transfer made by the chief executive. Such amendments align the operating budget with the actual levels of spending that are occurring.

Budget status reports A government's budget policy should specify the types of budget status reports to be prepared and their frequency. Governments prepare interim financial reports that compare budgeted with actual amounts of revenues and expenditures to date. These reports, now available in real time with web-based financial management systems, provide decision makers with an important early warning of impending overruns in expenditures or shortfalls in revenues. For governments that rely on legacy data management systems, reports should be prepared quarterly or preferably monthly.

Self-supporting funds Finally, the policy statement for the operating budget should specify which enterprise funds will be self-supporting. In general, enterprise and internal service funds should be self-supporting if (1) the benefits largely accrue to users of the service, (2) collecting a fee from users is administratively feasible, and (3) pricing the service at its full cost will not result in users acting in ways that end up to be more costly than the revenue raised from the charge. For example, charging full cost for residential use of a landfill may increase illegal dumping of trash along roads and in vacant lots. In such cases, subsidizing the service with general tax revenues is more efficient than trying to make it self-supporting.

Fort Collins has the following policy with respect to this issue. The city currently has five enterprise funds: golf, light and power, wastewater, storm drainage, and water. The goal is for all these funds to be self-sufficient—that is, to recover 100 percent of their costs. As a matter of policy, if an activity is unable to adjust its fees over a five-year period so as to achieve self-sufficiency, it will no longer be considered an enterprise fund but will instead be accounted for as part of the general fund.[24]

A related issue concerns the recovery of indirect as well as direct costs by enterprise funds. Indirect costs (or overhead) are the cost of services that are provided to all units of a government, such as the budget office or human resources, but that are not set up as internal service funds. Full cost recovery requires that enterprise funds bear a pro rata share of the cost of these support services. San Luis Obispo, California, states in its policy that its enterprise funds will "fully cover the total direct and indirect costs—including operations, capital outlay, and debt service" of its water, sewer, and parking enterprises.[25]

Assigned responsibilities in the budget process A budget policy should specify the broad outlines of key duties in budget preparation and adoption. For example, it should specify the officer responsible for budget preparation—either the finance officer or, if a separate budget office exists, the budget officer. It should describe in general terms the duties of this officer, such as his or her authority to standardize budget documentation, prepare the budget calendar, and review departmental budget requests for accuracy and conformance to budget guidelines. It should also specify who is responsible for preparing revenue forecasts and the frequency with which such forecasts should be prepared. Finally, the policy should clearly assign responsibility for overseeing the budget's implementation to the chief budget officer. The duties in this phase include preparing and reviewing budget status reports, monitoring revenues, reviewing agency expenditure requests for conformance with the budget, authorizing transfers across accounts or departments, and reviewing requests for supplementary appropriations.

Revenue policies

As with policies governing the operating budget, a revenue policy provides continuity in the procedures and assumptions guiding the funding decisions of government. It also increases the efficiency of deliberations on taxes and service charges by establishing a basis for addressing these sensitive political issues. And such a policy discourages exceptions by making those seeking an exception explain why it should be granted.

Governments typically prepare revenue manuals that provide extensive detail on the legal basis, administration, and yield history of every source of revenue they collect. However, the policies of concern here are those that directly affect funding of the operating and capital budgets: stability of tax rates, use of one-time revenue sources, review of service charges and fees, and collection of delinquent revenues.

Tax rate stability Local leaders can promote revenue stability through a diversified revenue structure. With respect to fluctuations in the property tax rate, a common policy among local governments that have discretion in the property tax rate being levied is to limit increases in the annual levy to the rate of inflation. Since GO bonds are usually repaid with property taxes, local governments often have to increase tax rates to meet annual debt service requirements. In those states that require voter approval to issue GO bonds, governments look to growth in the tax base for the revenue to repay the bonds while holding tax rates constant. Research has found a substitution effect between property taxes levied to repay debt and those levied to fund general government operations, which suggests that as the property taxes dedicated to debt service go up, the latitude for increasing the tax rate for operating purposes goes down.

Use of one-time or temporary revenue Political leaders can easily become lulled into thinking that a temporary revenue windfall, such as a block grant, will continue into the future, and they then use the money for ongoing programs and services. To protect against developing a dependency on one-time or temporary revenue, some governments have a policy of using windfall revenues to finance the purchase of capital assets (equipment, buildings, land) or other nonrecurring purchases. This, too, poses risks if governments defer much-needed capital projects in anticipation of receiving a grant. An alternative strategy is to earmark windfall revenues for deposit in the revenue stabilization account. But in fact it is impossible *not* to develop some dependency on such resources. If the capital item is needed and the one-time revenue windfall is not present, other resources will be used. Ideally, a policy should target transitory revenues to purposes that will minimize the risk of dependency.

midyear for additional budget authority—possibly as a compromise to gain initial approval of a new program or project whose costs are difficult to predict.

Another budget term that has garnered attention in recent years is **sequestration,** which is used to describe a backdoor process for reducing the federal budget by withholding previously appropriated budget authority.[9] The term has found its way into local and state budgeting, too, although most uses are better characterized as impoundment of budget authority. While an impoundment is an executive-level withholding of budget authority, sequestration involves the legislature (Congress) withholding budget authority ex post facto.

The process works as follows. Congress begins its budget process by setting targets for total spending, taxation, deficit, and public debt. The target legislation may include instructions to OMB to withhold (sequester) budget authority should the final appropriations by Congress, passed in thirteen separate bills, exceed the targeted level of spending. Congress then passes appropriation bills granting budget authority to the various federal agencies. Sequestration kicks in if the sum of these appropriations exceeds the target level. Sequestration involves across-the-board cuts to federal programs and is proportionately divided between defense and domestic programs; entitlement programs, such as Social Security and Medicare, are usually excluded. Although sequestration has been mandated on several occasions, Congress had repeatedly chosen to raise the target spending level at the last minute rather than impose across-the-board cuts—until 2013, when for the first time it let stand a sequestration order that had been adopted two years earlier.

Budget reserves

Another tool available for adjusting budget authority during implementation is a budget reserve (also called an economic stabilization fund or rainy day fund), which has been previously set aside for contingencies. In most cases, tapping local budget reserves requires an appropriation by the council. The local government should have in its budget policy a provision on the creation and use of reserves and the conditions under which they can be tapped.

In discussions on the creation of a budget reserve, several issues surface, including why one is needed, how resources for the reserves should be allocated, how large a reserve to maintain, whether a separate fund is needed, and under what circumstances the reserve should be tapped.

Purpose of reserves One reason that local governments establish budget reserves is to create a cushion against the vagaries of the economy. As local governments have increased their dependence on such revenue sources as sales and excise taxes, their budgets have become more vulnerable to economic cycles—particularly the contraction of sales tax revenue during recessions. Thus, as a hedge against revenue shortfalls created by economic cycles, most state and local governments have established rainy day funds.

A second reason that municipal governments have long maintained budget reserves is that the bond-rating agencies place considerable emphasis on the use of a reserve to ensure the timely payment of debt service (principal and interest). Governments that fail to demonstrate such a reserve will certainly suffer a lower bond rating as a result.

Third, local governments maintain budget reserves to manage cash flow. For example, if the fiscal year begins July 1 and property taxes are not due until the following January 1, the government will need cash reserves to cover that six-month lag. If it does not have the cash reserves, it must borrow money in anticipation of the payment of current taxes (using so-called tax anticipation notes) to finance operations during that period.

Finally, local governments maintain reserves for a host of contingencies, including a natural or technological disaster, pending litigation, an unanticipated delay in receiving state or federal aid, or the need to replace a large piece of equipment or a building. Whatever the reason, budget reserves provide an option for cushioning the impact of external events on local government operations.

Allocation, sources, and size of reserves In his discussion of budget reserves, public finance expert Ian J. Allan identifies three methods that governments use to allocate resources to reserve accounts: formula, use of a predetermined portion of operating surpluses, and dedication of revenues from a particular source.[10] State governments in particular dedicate year-end surpluses for their budget stabilization funds, whereas local governments appear to rely more heavily on a formula to determine the appropriate size of the reserves. This may be because of the emphasis that Moody's and Standard & Poor's, the two most influential bond-rating firms, give to formulae: bond-rating firms use a rule of thumb of at least 5 percent of annual operating expenditures.[11] Some governments use from sixty to ninety days of operating expenditures as an acceptable level for reserves. The more unstable a government's revenue base, the larger its reserves should be. Thus, governments that rely on cycle-sensitive revenues, such as sales and excise taxes, should maintain a higher level of reserves in order to ensure a more stable level of budget expenditures.

Location of reserves Lawmakers must decide whether to retain reserves in a separate fund or as an account within an existing fund. The preference among states is to create a separate budget stabilization fund because its purpose can be explicitly defined in law and the procedures for using its financial resources clearly dictated.

One disadvantage of a separate fund is the attention it attracts, especially from the media. It is difficult for lawmakers to explain why a government will ask taxpayers to

Budget reserve accounts in Dallas, Texas

In its financial management policies, the City of Dallas, Texas, specifies five reserve accounts that it will maintain.

The Contingency Reserve provides for unanticipated needs that emerge during the year, such as a new health or public safety need, revenue shortfalls, or opportunities for cost savings. This reserve is maintained at a level ranging from 0.5 percent to 1 percent of the general fund budget.

The second line of defense is an Emergency Reserve, tapped after the Contingency Reserve has been depleted and used for more extraordinary events, such as a disaster or an unexpected liability created by the federal or state government. The Emergency and Contingency Reserves together must be maintained at a level of at least 5 percent of the General Fund operating expenditures.

The city's policy calls for three other reserves for more specialized purposes: The Risk Reserve covers the city's deductible expense for insured losses. The General Fund maintains a liability account that provides a reserve for covering legal claims against the city. The Landfill Closure/Post-Closure Reserve exists to collect funds for the anticipated cost of complying with state and federal requirements to maintain landfills in perpetuity following their closure.

Source: City of Dallas, *Annual Budget for Fiscal Year 2012–2013* (September 2012), 552–556, dallascityhall.com/Budget/adopted_1213/FY13-AdoptedBudgetBook.pdf.