Don't Go It Alone

Pooling Budgetary Risk to Save Money in Your Budget

BY SHAYNE KAVANAGH

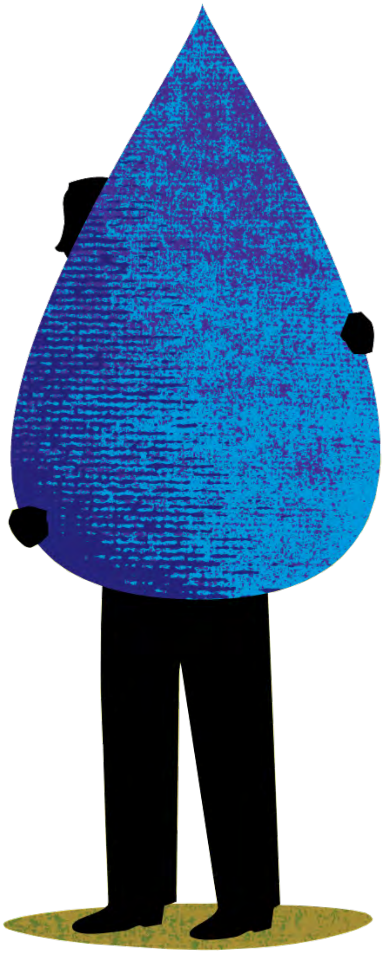
Local governments often join together to pool risk for insurance. Insurance pools save money by aggregating multiple local governments into a larger, more diversified risk pool. Or a government might provide insurance coverage as a central, shared service, which is far cheaper than each department independently contracting with their own insurance providers. This is also a form of risk pooling.

Governments can also save money by pooling budgetary risks across departments. Departments essentially build "insurance" into their budget to account for the possibility of unavoidable and unplanned spending. Some might call this "leeway," or others might call it "padding" or "slack"—but no matter what you call it, it can really add up across all departments. "Padding" is the term this article will use, not as a pejorative, but because its intended role is to soften the blow from unplanned and unavoidable spending. We will also sometimes use "budgetary insurance" as a synonym.

To illustrate the potential for savings, imagine that a local government has ten departments, and each of these departments has a 10 percent chance of incurring $1 million in unplanned and unavoidable expenditures during the year. Each department therefore pads its budget in the amount of $1 million, which means the government is creating $10 million in padding. On average, however, the government as a whole will experience $1 million in unplanned, unavoidable costs (10 departments x 10 percent chance x $1 million). So, the government's $10 million in padding equates to an average of $9 million in additional budget stress because the government has to figure out how to balance its budget at the beginning of the year, including this excess $9 million.[1]

The example gets the point across, but it's simplistic. So, let's examine the problem from another vantage point: the calculation made by the individual department head. When building their budget, the department head has to make some estimate of the potential for unplanned, unavoidable costs during the year, even if informally or intuitively. We'll call this their "best bet"—which will almost invariably be wrong. The actual unplanned, unavoidable expenditures could be some amount less (for instance, it could be zero), or it could be more. But very few rational department heads would budget a level of padding that is less than their best bet. They will budget at least the best-bet amount, and possibly more, to give themselves some leeway. Of course, during the year many departments will experience fewer unplanned, unavoidable expenditures than their best bet.[2] Yet, all departments are probably padding equal to or exceeding their best bet!

Creating a centralized budget contingency to cover unplanned, unavoidable spending makes it possible to pool the risks of each department. This allows the government to eliminate excess padding while still providing sufficient confidence that the organization will be able to cover unplanned, unavoidable expenditures. These potential savings are not hypothetical. San Bernardino County, California, is a larger government (population 2.2 million) that realized between $10 million and $20 million in savings for the county's general fund.[3] The City of San Mateo, California, is a not-so-large government (population 105,000) that saved $1 million.[4] Both governments followed an approach similar to what we will describe in this article.



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Pooling risk in a shared budget contingency is not just a technical problem, though. There is usually no line item labeled "padding" that can simply be eliminated. Departments must be convinced to give up the padding in their budgets in favor of shared, pooled contingency. Therefore, this article will discuss the strategies you can use to lead your government to a pooled contingency.

GETTING TO A POOLED CONTINGENCY—AND GETTING DEPARTMENTS' SUPPORT

A pooled contingency only works if departments support it. Attempting to force departments into it will probably just signal to them that they need to get better at hiding their padding. Getting departments' support starts with why a pooled contingency is a good idea for them and the whole organization.[5] When presenting a new idea, most people tend to start with what the idea is. At best, departments will find these details uninspiring. At worst, they may see it as a move by central authorities to take away a piece of their budget. There are many reasons why departments should support a pooled contingency. Here are two good ones.

1. During a crisis, many people are—rightly—more concerned about exposure to the unexpected than they would be in better times. A pooled contingency gives every department greater assurance against the unexpected, compared to going it alone. Departments already share risk with liability insurance (for example, insurance is handled by a central risk management unit). Why not share risk with the budgetary "insurance" everyone builds into their budget?
2. When every department builds their own "insurance" into their budgets, it is harder to balance the budget across the entire government at the beginning of the year. This causes more stress for everyone, and it may even require departments to reduce services they offer to citizens in order to balance the budget. Even if your government is not experiencing financial distress, a pooled contingency is a more efficient use of public resources. Greater efficiency means that a government can provide better service to the public.

As you think about ways to describe *why* a pooled contingency is a good idea, consider how your audience will react to the term "padding." To some people's ears, suggesting that their budget contains "padding" might sound like an accusation. The examples above use the metaphor of insurance to provide a more neutral tone.

After describing why departments should support this, be prepared with a solid plan for how it will work. The obvious disadvantage of pooled contingency for departments is that they must give up the convenience and control provided by having their own padding. Describing how the contingency will work can give departments confidence that the pooled contingency will be beneficial for them.

Let's start with how the pooled contingency would be accessed by departments. It is worth noting that "pooled contingency" could be an actual pool of money that could be designated as the "contingency." Or it could be virtual, in the form of more room to appropriate extra funds to cover unplanned, unavoidable expenditures across all departments. The City of San Mateo, for example, uses the second approach, simply providing more room to appropriate additional funds during the year, having removed budgetary insurance from the individual departments' budget at the beginning of the year. Neither approach is inherently superior, so a local government can pick whichever one is a better fit for its particular circumstances.

Establish that the pooled contingency is not intended as a way to fund new or expanded programs in the middle of the year. Departments will need assurances that the contingency will not be used as a slush fund for pet projects, for example. Just like a government would not raid a self-insurance fund to pay for new or expanded programs, it should not use the pooled contingency in this way either. The government could adopt a formal policy to give departments confidence that the pooled contingency won't be misused, leaving them without a safety net. A formal policy could also help elected officials understand that some departments might need to access the contingency during the year and, thus, increase their total spending above their original budget. The policy shows that this is part of the local government's financial strategy. GFOA has developed a policy template you can use to get started with your own policy (at gfoa.org/materials/pooled-contingency_template).

Make sure departments know the difference between the pooled contingency and your general fund reserve. Departments probably view the reserve as something that can only be accessed under extraordinary circumstances. A reserve would therefore be a poor substitute for their budget padding.

Show departments clear criteria for how the pooled contingency would be accessed. The two fundamental criteria are that an expenditure is *unplanned* and *unavoidable*. Also, describe how departments can give input to make the case that an expenditure has met these criteria.

To demonstrate that an expenditure was unplanned, departments could show that the assumptions they built into their original budget no longer reflect actual conditions. These assumptions should have been shared with the budget office as part of formulating the budget, so it should be possible to revisit these assumptions to see what developed differently than expected. (Or at least, the assumptions should be documented somewhere.)

What is the difference between a pooled contingency and a reserve?

A *pooled contingency* is a budgetary item that is funded each year at roughly the same level. A pooled contingency is intended for smaller-scale, unplanned and unavoidable expenditures that occur in the normal course of a department's business. A *reserve* is the portion of fund balance that is available for risk mitigation. It is a balance sheet item where the size of the reserve depends on the cumulative effect of surpluses and deficits over the government's history. A reserve is for infrequent, highly consequential events like recessions or natural disasters, where larger amounts of money will be needed to respond.

For example, in the City of San Mateo, the recreation department was hit with an expected increase in utility rates for its facilities and the fire department was hit by a rash of injuries that required more overtime. As part of this discussion, the department should make clear whether their unplanned expenditure will be one-time or on-going. The recreation department's new utility rate is an ongoing expenditure, while the fire department's injuries were bad luck and would not be expected to occur again in the next year. The city's pooled contingency was used to support both departments, but the recreation department included the full cost of the rate increase in the next year's budget. The city council supported using the pooled contingency because the finance officer helped them understand that this was part of a bigger strategy to save money.

To show that an expenditure is unavoidable, the department should demonstrate that it has made a good faith effort to mitigate at least part of the costs in some other way. For example, could they cut some other costs? Could at least part of the new expenditure be avoided by lowering services? Perhaps the pooled contingency would cover part of the amount while the department absorbs some amount. Think of this like an insurance deductible.

Also let departments know who will be involved in making the decision as to whether or not the contingency will be used. One way is to have a collaborative cross-departmental team review requests and make a recommendation to the chief executive. This approach has two main advantages. First, since departments have direct involvement in the decision, they are more likely to consider the process fair. Second, peer review of requests to use the pooled contingency may dissuade a department from making a bad-faith request to use the contingency. The potential for looking bad in front of

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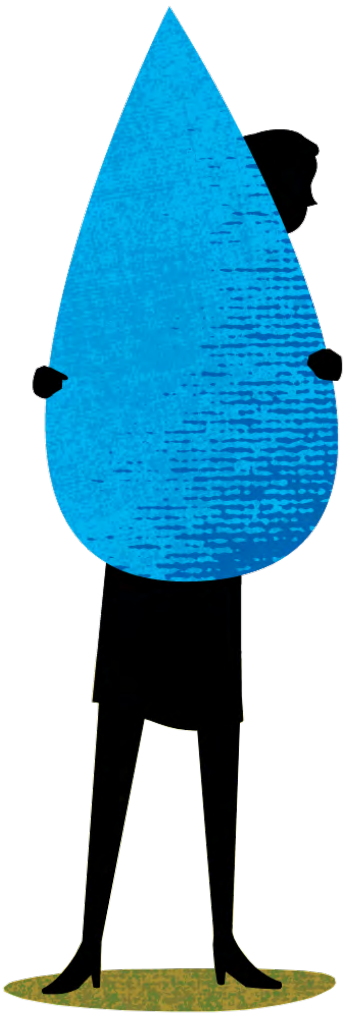


peers would be a powerful deterrent for most people.[6]

A collaborative approach may be more difficult, though, if the government doesn't have a positive history of interdepartmental collaboration to build on. Another way to make the decision, then, is for the budget office to review the evidence and make the decision itself. But for this to work well, departments must trust the budget office to treat them fairly. Describing the criteria for accessing the contingency and the ways in which departments can provide input regarding the decision should help create this trust. One city gave "vouchers" to departments as a tangible symbol of their commitment to help departments cover unplanned or unavoidable expenditures (more on this later). No matter which approach is used, the process needs to be clear and not appear capricious or ad hoc, and department staff need a full explanation of how the decisions will be made.

After departments are convinced that there would be a fair process for accessing the pooled contingency, they must give up their padding or budgetary "insurance" to fund it. The budget office and departments must work together on this. If departments think the information they provide will be used against them, this effort will not go far. They must trust that the pooled contingency is a shared goal that benefits everyone. The budget officers in San Bernardino County and the City of San Mateo actively sought to build trust. You can read about many of the strategies they used in the GFOA report "Building Trust and Open Communications" (at gfoa.org).

For its part, the budget office must trust that the departments will be good partners in building this contingency. This trust will be built on successful collaboration on prior budgets. For example, if budgeting has had an adversarial character in prior years, then it might be difficult for departments to trust the budget office's motives when it comes to pooled contingency. Even when there is trust, the budget office should also verify the budgetary facts, like looking to see where departments consistently underspend certain line items. For example, if the travel line item is underspent every year, then that line item probably contains some padding. The budget office might also look for line items where spending increases rapidly in the final months of the fiscal year. This may reveal where departments are engaging in use-it-or-lose-it spending. These areas might also present potential for funding a pooled contingency. That said, departments will often know best where the proverbial "rabbits-in-the-hat" are located, so the budget office must maintain a collaborative approach.

For example, following the COVID downturn, many governments are cutting back their budgets. All departments should have a role in cutting spending. A pooled contingency would make it easier for departments to reduce their budget

A pooled contingency is not a one-time fix

A pooled contingency is not a one-time budget balancing strategy. It is an ongoing cooperative effort among departments to free up resources for current services. Ideally, a pooled contingency would be accompanied by a habit of taking a close look at department budgets every year to make sure that padding doesn't return in new forms. For example, "one-time" expenditures not infrequently get built into the base budget, so they are budgeted for again the next year. The budget should have a way to identify one-time expenditures and exclude them from the next year's budget.

because they could lower or eliminate padding. Let's consider two examples of how this could be done.

1. A more hands-off approach from the budget office would be to simply give each department a target for reduced spending.[7] The budget office could establish a pooled contingency to complement these spending targets. The pooled contingency would make it easier for departments to reach their targets because they could choose to lower or eliminate padding and rely on the pooled contingency instead. The budget office could suggest where this padding might be found, based on its analysis, but it would ultimately be up to the department to decide how to meet the spending target.

2. A more hands-on approach might involve sitting down with a department to determine what padding can be given up for the pool. This conversation might involve examining the assumptions behind the budget. For example, how many residents does the budget assume will be served? What are the assumed rates for contracted services? What does the department plan to purchase with its budget for commodities? Historical budget-versus-actual spending records could show where budgets are usually too high and, thus, where there is the greatest potential for redirecting resources to a pooled contingency.

The budget office could also recognize and address special circumstances that might hold a department back from giving up padding. For example, sometimes departments that have traditionally been more stretched for resources use padding left over at the end of the year for needed equipment upgrades. If the budget office can establish a more regular and cost-effective equipment replacement schedule, it is a win for the department and the whole organization.

An extra source of padding: vacancy savings

Many governments budget personnel costs conservatively because the consequences of under-budgeting (coming up short) are much worse than over-budgeting (having a surplus at year-end). Often, there is more turnover and/or hiring delays than were assumed in the budget. These vacancy savings from across all departments could be pooled to help fund the budget contingency described in this article.

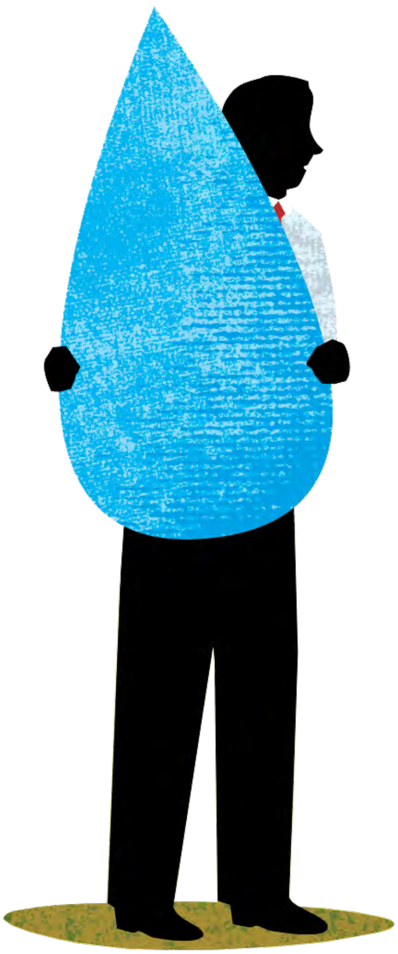
In San Mateo, for example, the city takes a deep dive into each departmental budget to compare the baseline budget (the amount necessary to maintain existing services) to historical actual spending. The city's finance office works collaboratively with each department to set the base budget to a level that *does not* include budgetary insurance for all unplanned, unavoidable expenditures. If an unplanned, unavoidable expenditure occurs, then the department will submit a supplemental budget appropriation to the council for consideration. The finance office and city manager will support reasonable requests because the department acted in good faith to reduce budgetary insurance in its budget.

Once the pooled contingency is in place, the budget office can show departments that it "has their backs" if an unplanned, unavoidable expenditure occurs. For instance, in 2012, San Bernardino County needed to close a large budget gap. As part of this, the CEO and the elected sheriff negotiated a significant budget reduction to the sheriff's department. Part of the deal was that the sheriff would be sure not to go over budget, while the CEO committed to covering the cost of any unplanned, unavoidable expenditures the sheriff might incur. Then, in early 2013, the sheriff's office had to conduct a manhunt for a rogue Los Angeles police officer, which cost hundreds of thousands of dollars. As promised, the CEO encouraged the sheriff to do what was necessary for the safety of the public, while the CEO gathered the funds to cover the extra cost. For his part, the sheriff otherwise remained within the agreed-upon budget. The CEO was able to provide similar assurances to other departments in the county. Knowing that the county would provide a safety net for unforeseen circumstances allowed departments to limit their requests to what they truly needed to meet their service goals for the year. The San Bernardino experience is particularly instructive because the CEO worked with the sheriff. Public safety will often be the largest single department in a city or county, so proving value of a pooled contingency for public safety can be valuable.

Finally, there is the question of what happens to the unused pooled contingency at the end of the year. For example, it could be used to fund a reserve for natural disasters, be applied to for one-time expenses in next year's budget, or simply rolled-over the same purpose. In any event, everyone needs to understand that surplus contingency funds are not a reliable, recurring revenue; they are there for the year when you are unlucky and have to use all or most of the money. Pooled contingency surpluses should not be used to fund recurring expenditures like salaries. Putting surplus pooled contingency toward a non-recurring use that everyone agrees is valuable could help maintain support for the practice.

Do you need help sizing your contingency?

One might ask how big a contingency should be. The governments profiled in this article did not go through a detailed quantitative analysis before using a pooled contingency, so a quantitative analysis of the contingency is probably not needed for many governments. If you feel that a quantitative analysis of the size of a potential pooled contingency would be helpful, however, you can check out GFOA's prototype plug-and-play probabilistic model (at gfoa.org).



AN EXAMPLE

Let's consider a final example that brings together many of the concepts addressed earlier. In one city, the budget office had a discussion with departments about the padding they had in their budgets, "just in case." The budget office started from the position that it was rational for departments to have padding in their budgets. The budget office then guaranteed that if the departments got rid of the padding, the budget office would make them whole on any unplanned, unavoidable costs during the year. Rather than just transferring money into department budgets when an unplanned, unavoidable cost occurred, the budget office would print a voucher that would be redeemable at year's end if the department exceeded their total budget. The budget office found that not many departments actually requested vouchers, and those that did request a voucher never had to redeem them. Let's review the most notable features of this example:

- Padding is framed as "just in case" money. "Just in case" does not have negative connotations, like "padding" might.
- The budget office recognized that padding was a rational action for departments to take.
- The budget office provided assurances that departments would be covered by the pooled contingency and provided a tangible commitment to support departments (the voucher).
- In many cases, departments did not actually need the voucher. This shows that the value of padding is often just psychological comfort. If so, there are opportunities to provide this psychological comfort in other, less expensive ways.

CONCLUSION

A pooled contingency allows departments to pool the risk of unplanned, unavoidable expenditures. This can lead to substantial savings, making it easier for local governments to balance the budget and maintain service levels. Collaboration and trust between the budget office and departments is necessary to get the most from a pooled contingency. This article has described how you can build that trust and build your own pooled contingency.

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1 This basic argument is elaborated in Sam L. Savage and Shayne Kavanagh, "Probability Management in Financial Planning," *Government Finance Review*, February 2014. See section 3 of that article, "Calculating Reserves." Though this section is about reserves, not pooled contingencies, the concepts are transferable.

2 We might assume that department heads' best estimates follow what is known as a bell curve, or normal distribution. This is a very common and reasonable assumption in statistical analysis because many phenomena have been shown to follow a bell curve. If we make this assumption, there is a 50 percent chance that the actual unplanned expenditures will be less than the department's best estimate.

3 Shayne C. Kavanagh and Vincent Reitano, *Financial Foundations for Thriving Communities* (Government Finance Officers Association, 2019).

4 Personal correspondence between Shayne Kavanagh and the city manager of the City of San Mateo.

5 Simon Sinek, *Start With Why: How Great Leaders Inspire Everyone To Take Action* (Penguin, 2011).

6 Kavanagh and Reitano.

7 There are multiple budget methods under which departments could be given spending targets. For example, targets could be aligned with priority areas of spending, or they could be largely uniform. A pooled contingency should take it easier for departments to reach their target regardless of the budget method used.

RESOURCES

Budgetary Pooled Contingency Policy Template
gfoa.org/materials/pooled-contingency-template

"Building Trust and Open Communications"
gfoa.org/materials/building-trust-and-open-communications