



MONITORING FINANCIAL DECISIONS

The City of Tempe and a Key to Financial Sustainability

BY SHAYNE KAVANAGH

This article is part of an ongoing series about financial sustainability, based on GFOA's new financial sustainability framework. You can learn more about the framework at www.gfoa.org/financialsustainability.

Municipal financial sustainability depends on everyone, in every department, following the same rules and guidelines, such as financial policies and budgeted spending limitations. But it doesn't always work that way; there are always temptations to break the rules to gain an advantage.

Research shows that people are more prone to dishonest and self-interested behavior when they feel that they're out of sight, and their reputations aren't on the line. For example, in one experiment, test-takers cheated more when the lights were dimmed¹ and less when there was a cartoon image of an eye nearby.² Hence, to minimize any temptation to break rules, governments should create conditions where decision makers feel that their actions will be closely watched.

Unfortunately, creating a feeling of internal transparency in government finance isn't as simple as installing stronger light bulbs or eye-themed art on the walls. Local governments must develop a capacity to monitor their financial decisions and the impact of those decisions.

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This article examines the systems created by the City of Tempe, Arizona, along three dimensions: the financial big picture, the operating budget details, and the details of the capital budget.

THE BIG PICTURE OF TEMPE'S FINANCES

It's easy for public finance discussions to get bogged down in details, but to understand if the organization is truly financially sustainable, big-picture perspective is needed. At the same time, public finances are complex, and the jargon used in managing the details can prevent some public officials from understanding what it means to be financially sustainable, much less monitor sustainability.

Understanding and monitoring the big picture demands terminology that all parties can understand and a shared concept of what financial sustainability looks like.

In Tempe, the big picture starts with the city's reserve policy, which calls for maintaining unreserved general fund balances equal to between 20 and 30 percent of general fund revenues, and to project an unreserved fund balance within those same boundaries over a five-year forecast period.

This is a formal policy adopted by Tempe's city council. The target range was arrived at via negotiation among public officials. Other cities set their own reserve targets by considering their risks (e.g., economic dislocation, extreme events) and sizing the reserve accordingly.³

THE GOLDEN CONE OF PROSPERITY

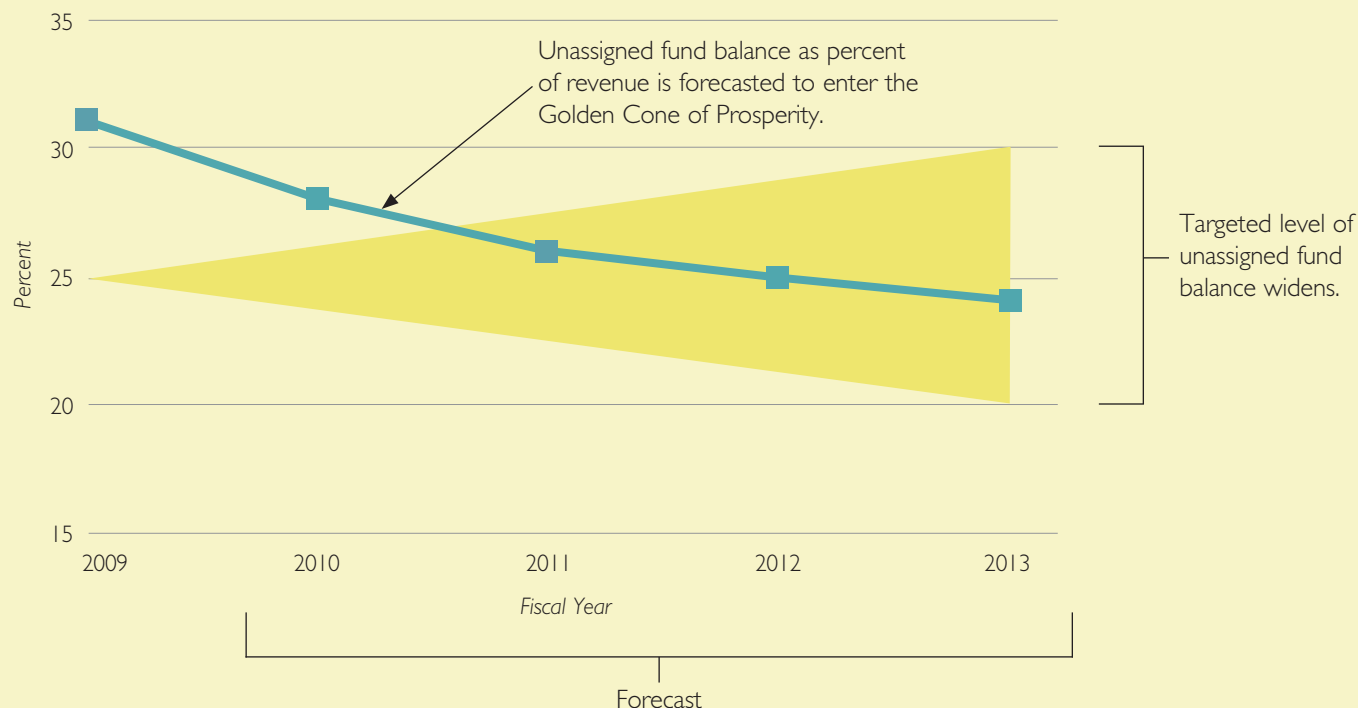
In 2009, city policy called for an unassigned fund balance equal to 25 percent of general fund revenues. However, the city had maintained fund balances of more than 30 percent, which caused some to question why the city wasn't in alignment with the policy and if the city had too much fund balance.

The council and staff agreed to change the goal for unassigned fund balance to between 20 and 30 percent of revenue, a range that would provide more management discretion. They also agreed to bring the fund balance into this new target range. To ensure an orderly transition, the new targets and fund balance level would be phased in over several years.

The staff developed a presentation of the city's revenue forecast and called it the "Golden Cone of Prosperity." Exhibit 1 shows the presentation, with the yellow cone representing how the range of desired fund balance widens over the forecast horizon. The black line represents the actual fund balance gradually entering the cone.

The Golden Cone of Prosperity's design and name made it memorable. As of 2017, Tempe staff still present the Golden Cone twice a year to help public officials understand the big picture and where Tempe's balance fund stands — a testament to the communicative power of the Golden Cone. Staff members are transparent about the assumptions behind the forecasts and strive to be as objective as possible in their forecast, which they believe has been crucial to the credibility of the presentation.

Exhibit I: Tempe's Golden Cone of Prosperity in 2009



The general fund reserve policy and the long-range forecast are also part of Tempe's "Long-Range Financial Capacity Study." The study, which provides a comprehensive review of the city's long-term financial position, is reviewed by the city council and staff before the annual budget process, providing big-picture context for budget decision making.

Another crucial part of the big picture in Tempe is its city council's five strategic priorities, which include "Financial Stability and Vitality." Elevating financial sustainability to the level of a city council goal encourages public officials to remain mindful about being good stewards of the city's financial future. The city has developed iconography for the five strategic priorities to visually evoke the underlying ideals in reports and presentations.

Finally, each of the strategic priorities has associated performance measures. For example, one of the measures for "Financial Sustainability and

Vitality" is remaining within the city's general fund reserve target range.

THE DETAILS OF THE OPERATING BUDGET

While an understanding of the big picture is essential, the operating budget is where many decisions are made. These decisions are not made in isolation. If one person breaks the rules to gain an advantage, others might do the same. Tempe leaders have structured their process to create an even playing field, where everyone knows the rules and all decision making is transparent. That starts with basic departmental budget allocation.

Like many cities, Tempe's budget process is largely incremental. Next year's budget is similar to that of the prior year, with changes made around the margins. In a typical incremental budget process, revenue increases are used to expand departmental budgets. Departments seek to capture some

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part of this expanded revenue, and once they have it, those funds become part of their permanent budget, funded in successive years.

An incremental system can encourage unhealthy competition for resources among departments as they scramble to capture funds and build them into their permanent budget to insulate themselves from future competition. Attempts to game the system can arise, such as obtaining funds for a special one-time project one year, then keeping the budget in successive years. Expenditures can increase to unsustainable levels. At worst, some of these expenditures may no longer be relevant to the community's needs.

Tempe avoids these problems by dividing budgets into “base budget” and “supplementals.” The base budget forms the majority of a department's funding and usually remains the same year to year. Supplementals are any additional funding sought by a department. For example, a special one-time project would be considered supplemental and would be removed from a department's budget the following year.

Supplementals could include a service enhancement the department hopes will eventually become part of the base budget. For example, the fire department might request a supplement to pilot-test a “low-acuity response team,” which is a less intensive, less expensive response team that might be more appropriate for many of the medical calls the department receives.

All supplemental requests are reviewed annually by the city's management team, which includes department heads, and are scored according to criteria that include:

- Advancing a city council strategic priority.
- Addressing a pressing safety or health concern.
- Generating future cost savings.

This way, each department sees which supplementals are funded and why, counteracting any perceptions that a department is employing less than forthright means of securing funding.

Building the budget involves allocating costs from internal services to operating departments. The credibility of the rules

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governing the budget process could be reduced if the allocation method is perceived as unfair and operating departments believe that they are unjustifiably carrying the costs of internal service departments.

Tempe allocates charges based on reasonable indicators of a department's actual use of services. For example, the motor pool tracks time and expenses for servicing each department's vehicles, and departments are charged accordingly. Workers' compensation insurance is charged based on a department's claims experience. Information technology is charged based on a department's hardware and software usage. These transparent metrics allow departments

to easily understand the basis for the charges.

Tempe also holds employee forums that allow workers to ask questions about the budget. The forums help employees grasp the forces that affect budget decisions, including salaries. A leadership development program offers workshops to employees who want a deeper understanding of the budget, beyond the forums.

FIRM BUDGETARY CONTROLS

Once the budget is adopted, Tempe tightly controls against the budget amount. Each department's budget is divided into two parts for the purposes of control: the personnel budget, and everything else. These controls are built into the city's financial management information system so departments are automatically prevented from exceeding their budgets.

Despite these controls, the city could encounter trouble if a department spends its entire budget too soon. To counter this, Tempe produces quarterly reports to monitor performance and identify where spending (or revenue) threatens to deviate from the annual forecast.

The standard for where a department or revenue should stand relative to its budget is determined by historical patterns. For example, a department that provides the same level of service all year should spend about 25 percent of its budget each quarter. Revenue with significant seasonal variation, like sales taxes over the Christmas shopping season, might

be monitored against standards that anticipate this variation.

Tempe classifies the performance of major revenues and department expenditures against their historical performance with color-coded variance categories. “Positive” (green) signifies being within 2 percent of goals, or better. “Watch” (yellow) is underperformance of 2 to 5 percent. “Negative” is underperformance of more than 5 percent. Finance staff members produce a summary like the one shown in Exhibit 2. A detailed half-page analysis is provided for each revenue and department, showing the numbers behind the color ratings and a short explanation of the situation.

This approach creates a common and easily understood standard for evaluating city expenditures, as compared to the budget throughout the year. The report is given to the city council and city management team and made available to the public online.

Negative ratings can generate a lot of interest, so the detailed reports are important for answering questions. In some cases, negative variations are the result of underperformance, but in other cases they are the result of bookkeeping idiosyncrasies (e.g., delayed revenue). Staff members, prepared to discuss both cases, preserve the credibility of the quarterly review.

While quarterly reporting has proven sufficient for most revenues and expenditures, there is one exception: sales tax, which demands more attention due to volume and volatility. Tempe produces monthly sales tax reports that compare current sales tax performance to previous years, month by month.

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The report breaks down performance by segments of sales tax producers. The city also makes detailed spending information on each department available, but this is limited to the city’s intranet and isn’t published as a report. Few Tempe public officials are interested in the detailed departmental spending records, but the information is available if it is needed.

CAPITAL PLANNING

Tempe has a five-year capital improvement plan. The first year becomes the capital budget. Several policies maintain the sustainability of the capital plan, most notably policies that limit the maximum debt the city will incur.

Tempe uses a scoring system to decide which projects to green light, with criteria that address issues such as whether a project preserves or expands Tempe’s existing capital stock, and how a project aligns with the city council’s strategic priorities. This system ensures that everyone is judged by similar criteria, and everyone knows what those criteria are.

The color-coded classification system shows how projects fare in the evaluation:

- Green means it will go forward.
- Yellow means maybe, depending on funding availability.
- Red means no go.

The chart below shows how Tempe would use general obligation bond funding over five years. Specifically, it shows the extent to which a project promotes asset preservation versus system expansion, and whether a project is immediately necessary for public health and safety, or if it is discretionary. The bubble size corresponds to the project cost, and users can mouse over a bubble to learn more detail. (See Exhibit 3.) For example, the \$14.6 million yellow bubble on the left represents a public safety training facility.

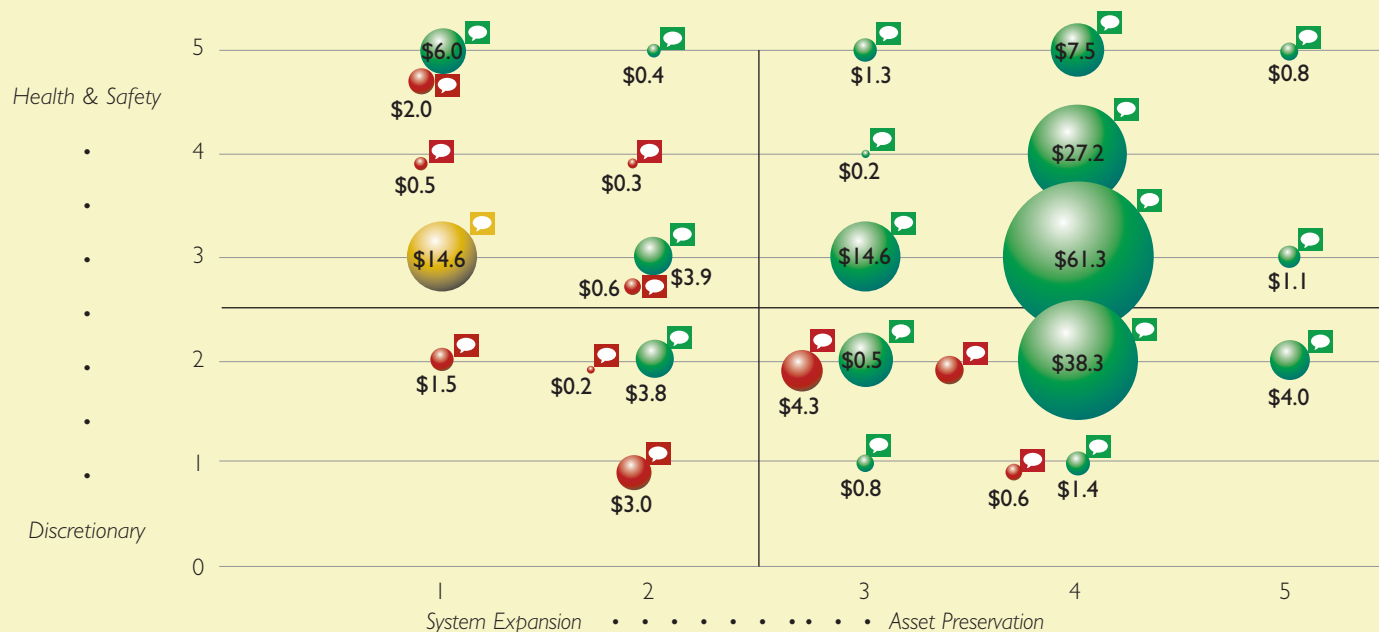
CONCLUSIONS

The City of Tempe illustrates how a local government can create a system to monitor the process of financial decision making, and the outcomes of those decisions. For example, the criteria and ranking system used to evaluate budget supplements and capital projects promote a sense of fairness in the decision-making process. The Golden Cone of Prosperity and

Exhibit 2: Summary of Revenues and Expenditures against Their Historical Performance

General Fund Revenue	Rating
All General Fund	Positive
Sales Tax	Negative
Property Tax	Positive
Bed Tax	Negative
Franchise Fees	Watch
Intergovernmental	Positive

Exhibit 3: Prioritization of General Obligation Bond-Funded Projects in Tempe



the quarterly financial reports show how city agencies operate within the agreed-upon boundaries, both in the big picture and in the details. Staying within boundaries is a decision-making outcome that is essential for financial sustainability.

Creating such a monitoring system in a local government encourages everyone involved with financial decision making to operate within their budget, and it helps build trust that their government colleagues are doing the same. Otherwise, some participants may feel encouraged to seek advantages for themselves and their constituencies. Other departments may start trying to complete, eventually leading to financial distress when the boundaries of financial sustainability are no longer respected.

Finally, Tempe's experience illustrates that a monitoring system doesn't have to be labor-intensive or overbearing. For example, the Golden Cone of Prosperity is simple, straightforward, and used year after year. Budget controls are automated by the city's financial management information system. The quarterly report color-coding system encourages departments to self-monitor — no one wants to explain a red score to the city council.

Transparent metrics
allow departments
to easily understand
the basis for the charges.

If some aspect of monitoring has proven too burdensome, Tempe has modified or discontinued it. The city has also looked for improvements such as building an electronic dashboard of performance measures for the city council's strategic priorities and better articulating the degree of uncertainty in its forecasts. This shows that monitoring is an evolving activity where government finance officers can balance the cost of the monitoring system against the benefit it produces while encouraging financial sustainable decision making. ■

Notes

1. Zhong, Chen-Bo, Vanessa Bohns, and Francesca Gino, "Good Lamps Are the Best Police: Darkness Increases Dishonesty and Self-Interested Behavior," *Psychological Science* 21, 2010.
2. Azim Shariff, and Ara Norenzayan, "God Is Watching You: Priming God Concepts Increases Prosocial Behavior in an Anonymous Economic Game," *Psychological Science* 18, 2007.
3. Shayne Kavanagh, "A Risk-Based Analysis of General Fund Reserve Requirements: A Case Study of Colorado Springs," Government Finance Officers Association, 2013.

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