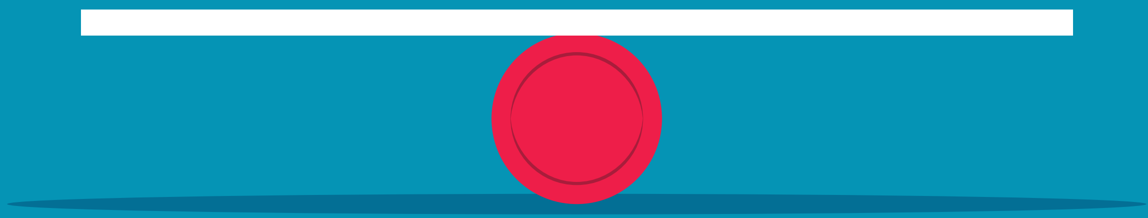
COVER STORY

Structural Budget Balance



Putting the Principle Into Practice

BY KYLE I. JEN AND STEVE WATSON

The world of government finance is filled with arcane terminology and concepts, like horizontal and vertical tax equity, unfunded actuarial accrued liabilities, and arbitrage on tax-exempt bonds, just to name a few. Thankfully, perhaps the most important concept in public finance—structural budget balance—is arguably also the easiest to understand. GFOA's best practice on achieving a structurally balanced budget summarizes the principle as follows:

Most state and local governments are required 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, it could include non-recurring resources such as asset sales or reserves to fund ongoing expenditures, and therefore 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 it's aware of the distinction between satisfying the statutory definition and achieving a true structurally balanced budget.[1]

Not all financial principles translate directly between public finance and personal finance, but structural budget balance does. For example, you shouldn't take on a larger mortgage than you can afford over the full term because you received a one-time compensation bonus that will cover only the first year of the higher payments.

Most government leaders are aware of the principle of structural balance, often summed up as "ongoing expenditures must be supported by ongoing revenues." But how do governments determine what goes into each of those financial categories? Those assumptions and choices will determine the degree to which government budgets are truly "financially sustainable for multiple years into the future." This article builds on GFOA's recent "10 Steps to Achieving a Structurally Balanced Budget"[2] to offer a series of considerations for government finance leaders and elected officials as they work to translate the simple principle of structural balance into the complex financial, operational, and political environments they face.

We focus on two overarching questions, with more specific considerations under the umbrella of each:

- How reliable and clear are the short-term estimates and assumptions underlying the budget?
- Does the budget consistently fund all major long-term liabilities (both hard and soft) of the government?

Budget estimates and assumptions

Unlike most other financial documents produced by governments, budgets are forward looking and, therefore, based entirely on estimates. Physicist Niels Bohr famously said, "Prediction is very difficult, especially if it's about the future!" That statement very much applies to government budgeting. Still, practical steps can be taken to improve reliability and reduce the risk of budget estimates.

Start with revenue

Any thoughtful budget process should start by objectively determining the best estimate of revenue that will be available. The amount of time and analysis needed to produce reliable revenue estimates varies among governments, depending on the number of major revenue sources a government has and the volatility of those sources. (See Exhibit 1.)

Across the most common broad-based tax sources for a state or local general fund budget, property taxes are generally the most stable—although often subject to limitations and other provisions imposed by state law that may complicate the estimating process. Sales and income taxes are more directly and immediately tied to broad economic conditions, so a reasonable economic forecast needs to underlie the estimates for those taxes.

Trends and assumptions for other sources of revenue such as fees, contractual revenue, and intergovernmental support should also be carefully examined each year. It's important to consider how risks across major revenue sources are correlated. For example, an expected reduction in housing sales can negatively affect both property tax collections and real estate transaction fees.

A simple analysis of the ways in which final revenue collections have compared to initial revenue estimates in prior years, including the separation of one-time versus ongoing revenues based on long-term trends, can help identify which revenue sources have been most problematic to project in past years and to help inform efforts to produce better estimates going forward. Most importantly in the context of building a structurally balanced budget, revenue estimates for the government's ongoing operating budget should not include one-time revenue sources such as beginning fund balances, one-time legal settlements, or other windfalls.

Further, government financial statements don't neatly package all the one-time revenues! Sometimes they are hidden within major revenue streams. They could include extraordinary spikes in volatile taxes or the base prior to a tax cut. Separating the ongoing base from the one-time components of prior-year major revenue collections will help governments reduce the risk of overestimating future support for their ongoing operating budgets.

A best practice for eliminating the temptation to overestimate revenues to make the budget balance on paper is the use of a consensus estimating process, like those used by the State of Michigan[3] and City of Detroit,[4] that requires agreement on revenue estimates among multiple economic or fiscal experts, ideally with insulation from political pressure, before the remainder of the budget process occurs. Including multiple perspectives and analyses in the revenue estimating process can improve the quality of the estimates. This kind of process also provides transparency in the assumptions and risks underlying the estimates.

Smaller governments may not have the same access to professional economic expertise, but they can be intentional about making their revenue estimating process as objective as possible. A simple step is to establish and publicly present revenue estimates at the beginning of the annual budget development process, to avoid any temptation to adjust those estimates at the end of the process merely to bring the budget into balance (as opposed to adjustments made based on new data that becomes available).

Once the revenue estimates are set, the remaining budget process must balance to that constraint. Choices to increase ongoing spending in one area must be offset by decreases in ongoing spending in another. This discipline is critical to building sustainable, structurally balanced budgets.

EXHIBIT 1 | Estimating structural surplus or shortfall

Ongoing Revenues
Annual Tax Revenues +
Fees and Charges for Services +
Ongoing Intergovernmental Support +
Other Ongoing Revenues

Less

Ongoing Expenditures
Employee Compensation (including retirement system allocations) +
Other Annual Operating Costs +
Contributions to Debt Service, Capital, and Other Funds +
Ongoing Payments to External Entities +
Other Ongoing Expenditures

Equals

Structural surplus or (shortfall)

The other side of the ledger

While often less well publicized than the revenue estimating process, estimating expenditures has its own nuances. For most (but not all) governments, employee compensation is the largest category of expenditures. This spending is often technically complex, with varying compensation and benefit plans among employee bargaining units and classifications. Modern financial software reduces the manual effort needed to forecast compensation

An annual budget that doesn't appropriately address long-term liabilities on a consistent basis may be structurally balanced on paper but ultimately does not meet the test of supporting "financial sustainability for multiple years into the future."

Why does structural budget balance matter?

The benefits of structural budget balance are manifold. A government that has a structurally balanced budget:

- Won't reduce its reserves in a haphazard manner.
- Will maintain the ability to adjust its budget from year to year in a deliberative manner.
- Will be able to plan over a multiyear period.
- Will be more nimble in responding to an economic downturn or other major fiscal shock.

Further, those who rely on the government's budget, including residents who receive services and external entities that receive ongoing payments (for example, school districts that receive funding from a state government's budget) will be subject to fewer unnecessary fluctuations in service or funding levels.

expenditure, but assumptions behind budgeted amounts should be carefully reviewed each year to make the forecast as reliable as possible.

Other appropriations provided to departments for contractual and other operating costs are generally more discretionary in nature and often subject to internal negotiations with (or dictates to!) departments. Several perspectives can be useful for this category of costs.

The minimum goal should be ensuring that all costs of providing current service levels, including known inflationary pressures, required to operate the department and its programs that can be reasonably anticipated are included in the budget up front. This approach, as opposed to simply assuming the prior year's budget will be sufficient, will help avoid midyear budget increases that could shift the budget into structural shortfall.

Conversely, budgeting for the estimated cost of current services, rather than assuming the prior year's budget should be replicated, will also help minimize excessive "padding" in department budgets. Departments may insist they need that flexibility for unanticipated costs, but governments can use a central contingency pool for such costs instead, with clear guidelines for determining that a cost is truly unavoidable and that all other resources available to a department have been used.[5] Similarly, governments may wish to centrally budget contingency for pending and future collective bargaining, given the timing and negotiated result with each unit are yet to be determined. These strategies will help reduce the risk of departments diverting excess funds toward new ongoing spending outside of the annual budget process.

Vehicle and equipment costs included in operating budgets have generally become more expensive over time, and new technologies like body-worn cameras for law enforcement personnel have become available and widely adopted. Governments should be careful not to classify these purchases as one-time expenditures since most vehicles and equipment will need to be maintained and eventually replaced. We recommend that finance leaders work to build life-cycle replacement costs into annual budgets so departments can manage these purchases over time without having to access financial reserves.

Government general fund budgets may also include regular contributions to proprietary funds that are needed to fund ongoing operations in those funds. Regular analysis of the structural budget outlook for those proprietary funds should be undertaken. A shortfall in a proprietary fund, particularly an internal service fund heavily reliant on general fund contributions, will eventually result in increased general fund expenditures and/or inadequate services being provided.

Other items included in the budget will vary from government to government. Programs driven in part by caseload levels (for example, state Medicaid and public assistance programs and local jail operations) are more difficult to project and require a similar level of analysis and good judgment as revenue estimates do. These types of programs can also be included in consensus estimating processes (as the State of Michigan does). State governments have substantial budgets for payments to external organizations like school districts, local governments, and healthcare providers. Increases in those payments from year to year will always be subject to some level of political negotiation. Analysis should be undertaken to determine if increases in payments are keeping up with inflationary and other cost pressures. If not, the state may end up substantially reducing its investment in the services provided by those organizations over time.

Finally, a key assumption on the expenditure side of the budget is how unspent funds resulting from vacant positions, spending delays, or cost savings at year end are treated. Some governments don't assume any year-end savings in their structural budget calculations and allow those funds to either be carried forward by departments to complete one-time projects or fall back to fund balance. Other governments use a governmentwide assumption regarding personnel savings resulting from vacant positions and operating funds not fully used by departments. A single negative adjustment is included in the original adopted budget, with savings then materializing in individual department budgets over the course of the fiscal year.

If such an assumption is made, it should be cautious in nature, based on historical patterns in spending. And finance leaders should make sure that unspent funds aren't double counted by assuming the lapses to achieve structural balance and allowing departments to carry forward a portion of them. Departmental spending should be monitored monthly or quarterly to determine if assumed year-end savings are on track to materialize.[6]

Funding long-term liabilities

If a government fails to fully budget for its employee compensation and other annual operating costs, the result will be evident to its elected officials and the public very quickly. While failure to budget for debt service costs would certainly have immediate consequences with creditors, failure to appropriately fund other long-term financial needs like unfunded retirement liabilities and capital investments will take longer to have practical implications. That doesn't mean they're not equally important.

An annual budget that doesn't appropriately address long-term liabilities on a consistent basis may be structurally balanced on paper but ultimately does not meet the test of supporting "financial sustainability for multiple years into the future."[7]

Debt service

Budgeting for required debt service payments for the upcoming year should be among the simplest parts of the budget development process. Absent exotic financing arrangements like variable rate debt, annual debt service payment amounts are established for the full term of the borrowing at the onset of the debt financing process.

A government that's facing fiscal challenges may be tempted to refinance its debt to extend the length of the borrowing term and thereby reduce annual debt service payments (a maneuver called "scoop and chuck") to help bring its short-term budget into balance. Governments should have formal debt management policies that establish clear criteria for when refinancing debt can and should be pursued, with debt service schedules generally corresponding to the period during which the asset purchased through the borrowing is being used by the government and its residents.[8]

Retirement liabilities

Thanks to new accounting standards and increased scrutiny from credit rating agencies, the visibility of unfunded liabilities for public pension and retiree healthcare (technically referred to as "other postemployment benefits," or OPEB) as long-term financial liabilities on par with hard debt has risen in recent decades. Elected and appointed officials, however, may not fully understand the technical complexities of how annual contributions to fund those liabilities are determined or how much proposed benefit enhancements could ultimately cost.

Key actuarial assumptions such as the amortization period (and whether it's fixed or rolling), mortality and healthcare cost assumptions, and the assumed rate of investment return all play major factors in the actuarially determined contributions that should be built into a government's annual budget each year (usually spread as a percentage rate across employee payroll). Using assumptions that reduce annual contributions in the

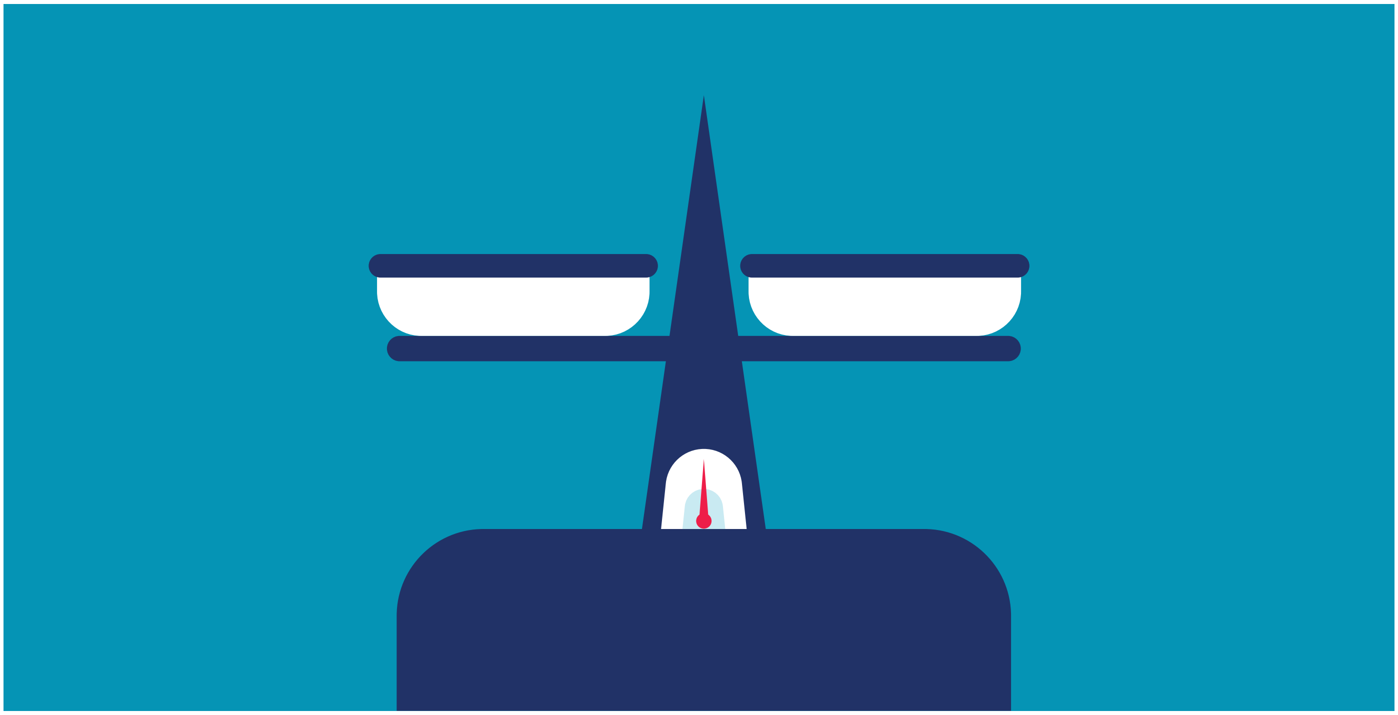
Is this spending really one-time?

Beginning in 2012, as a new governor confronted a large ongoing structural budget shortfall for the State of Michigan, the state began explicitly classifying expenditures as either ongoing or one-time, with one-time spending clearly separated into a "one-time" section in each department's budget. This has value in cases where a cost truly is one-time: for example, a payment for a legal settlement or an allocation to construct a new building (assuming funding has been reserved for ongoing operational and maintenance costs).

In other cases, though, the distinction may be less clear:

- Is a pilot program funded by temporary federal funding really likely to be one-time if it has strong political support?
- Are extra payments to external organizations from one-time surpluses truly being used for one-time purposes by those organizations, to avoid creating a downstream financial or political problem?
- What will the full, ongoing operating costs for a new facility be, beyond the one-time construction costs?

Setting clear internal and external expectations regarding continuation of funding in future years is important. It's also important for leaders to be honest with themselves about whether they're going to be willing to forego continuing one-time expenditures in future years.



short term increases the probability that those contributions will be insufficient to fund the liabilities—particularly if investment markets take a plunge—and that, ultimately, annual contributions included in the budget will have to increase even more down the road.

Retirement system boards should undertake an actuarial experience study every three years to examine their actuarial assumptions.[9] And government leaders should work with those boards to work toward adopting and funding appropriate actuarial assumptions. This process has been underway in many jurisdictions as, for example, the average assumed rate of annual investment return for state retirement systems has been reduced from roughly eight percent to seven percent over the last 20 years.[10]

Capital investment needs

While capital assets are accounted for in government financial statements, the implicit long-term liabilities associated with maintaining, replacing, and potentially expanding those assets are, at best, very bluntly accounted for in those statements. For proprietary funds, depreciation is included in annual budgets. The depreciation amounts may or may not correspond to the actual cost of maintaining and eventually replacing the assets. Accounting standards, meanwhile, do not require that general fund budgets include depreciation, making the process of building in the long-term costs of supporting general fund assets that much more haphazard.

Governments need to regularly assess their capital assets,[11] build realistic capital improvement plans for major capital projects, and, just as importantly, include an appropriate amount of annual funding for routine maintenance projects that don't rise to the level of capital investment. For buildings, this means periodically evaluating facility conditions as comprehensively as possible and using industry standards based on dollars per square foot to establish an ongoing funding pool for building maintenance and upgrades, with clear processes for spending the funds as effectively as possible to prevent higher renovation or construction costs in later years.

In today's operational environment, managing information technology assets and products is as critical, if not more critical, than managing physical assets. A structurally sound budget should include ongoing funding for the purchase and maintenance of a government's portfolio of information technology hardware and software, including the growing need for cybersecurity software and services. A pool of funding available for ongoing software upgrades and implementations can be used to make sure a government doesn't fall behind in using information technology to provide services more effectively.

Transparency about the bottom line

Just as there is a major distinction between a balanced budget that is based on the use of one-time resources and a structurally balanced budget, there's also a distinction to be drawn between a budget that's structurally balanced on paper at the start of the fiscal year and a budget that's likely to result in actual structural balance at the close of the fiscal year.

A budget that results in a shortfall at year's end and requires use of reserves or other one-time measures to resolve the situation after the fact is clearly a problem for a government. Not only are those one-time resources being used in an unplanned manner, the budgets for subsequent years (the first of which the government is already operating in) begin in the hole.

On the other hand, a budget that's likely to result in a substantial unbudgeted year-end surplus—while less concerning from a bottom-line financial perspective—can also be problematic. It deprives policymakers of the ability to potentially fund additional ongoing services that may be important to them and their constituents. And it can lead to a lack of transparency and credibility in the annual budget process for financial decision making.

If a government chooses to adopt conservative budget estimates and assumptions that consistently result in year-end surpluses, we recommend that a clear and transparent process be adopted for how those surpluses are utilized. The simplest option is to require that major one-time investments from financial reserves be considered and approved only through the regular annual budget process. Such a policy goes hand in hand with crafting a thoughtful fund balance policy that considers the questions raised in GFOA's recent series on rethinking reserves.[12]

This may require extra communication and collaboration among separately elected officials for a government to create clarity on long-term financial goals, including risk-based reserves and rainy-day fund targets, and avoid the temptation to divert surplus funds to unaffordable short-term spending purposes.

All government budgets should include a clear and easily understood analysis of the structural budget situation and outlook in its primary budget document. After the City of Detroit's bankruptcy, the city adopted new budget policies based on best practices, [13] including a policy requiring that non-recurring resources be used only for non-recurring expenses such as early debt retirement, pre-funding pension obligations, capital improvements, blight removal, or deposits into the rainy-day fund. The annual budget process is explicitly organized around this policy. The mayor's proposed annual budget and four-year financial plan separately balance recurring and non-recurring resources and expenditures over four years, and the expenditure changes that the city council makes in the final budget are divided into recurring and non-recurring, too. All recurring expenditure increases must be offset by recurring expenditure decreases.

A note on multi-year budgeting

This article has focused on achieving structural budget balance for a single year. Without a clear and realistic picture of how ongoing revenues and expenditures compare for the first year of a budget, a multi-year budget or financial plan has limited value. Once the first-year budget has been solidified, it can serve as the foundation for a multi-year plan that accounts for significant anticipated changes in revenues and spending and provides a roadmap to achieve or maintain structural balance while meeting the government's long-term financial goals.*

While it's impractical to project every line item in the budget over a multi-year period, the plan shouldn't rely on simple trend analysis for subsequent budget years. Assumptions about across-the-board pay increases and other inflationary pressures should be realistic. They can be couched in terms of being for planning purposes only to help manage expectations, recognizing that any upcoming collective bargaining regarding employee compensation can add a major wrinkle to this exercise.

Simply put, a reasonable and informed multi-year budget forecast will quickly reveal whether ongoing revenues are likely to keep pace with ongoing spending. By considering how both external and internal factors will affect the budget—and thinking clearly about long-term financial needs and liabilities—a multi-year view can further strengthen government leaders' confidence that the financial future of their communities is on a sustainable path (or drive financial and operational changes to put it on a sustainable path).

It's important to recognize new costs are more likely to rise in future years than to unexpectedly go down. Therefore, it's unwise to balance budgets for future years to zero, and better to provide a buffer for unexpected negative fiscal impacts. At worst, this will leave room for discretionary ongoing investments in the future.

** "Long-Term Financial Planning," GFOA best practice*

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No budget is perfect, but examining the considerations presented here as transparently as possible and addressing any structural shortfall that emerges in a timely manner will help government leaders avoid being confronted with much larger financial liabilities and challenges down the road.

Conclusion

It's often been said that public budgeting is as much art as it is science. That observation applies even more acutely to building a structurally balanced budget. Questions of economic uncertainty, political strategy and optics, and risk tolerance—none of which have simple, straightforward answers—are inherent in the process.

No budget is perfect, but examining the considerations presented here as transparently as possible and addressing any structural shortfall that emerges in a timely manner will help government leaders avoid being confronted with much larger financial liabilities and challenges down the road. Ultimately, financial reserve levels reported in annual financial reports, along with practical realities like the ability to provide employee pay increases and maintain the facilities and IT systems needed to provide effective services to residents, will tell the story. By taking a continuous improvement approach to developing a financially sustainable budget, governments will be better prepared to keep up with both short-term and long-term funding needs and to responsibly deal with unexpected fiscal shocks.

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