

William C. Statler

Fiscal Policy ■ Financial Planning ■ Analysis ■ Training ■ Organizational Review

Multi-Year Budgeting

The following is based on a “white paper” I prepared when I was the Director of Finance & Information Technology for the City of San Luis Obispo from 1988 to 2010.

The City of San Luis Obispo prepared its first two year Financial Plan in 1983, and it has continued to use it as one of its core tools for planning and budget-making ever since.

The purpose of this “white paper” is to summarize almost thirty of the City’s experience with this approach, including: What are the benefits of multi-year budgets? What are the potential downsides? What are some of the underlying concepts that need to be in place in order to realize these benefits? What should other cities consider in moving to a multi-year budget? And lastly, why does this work for the City of San Luis Obispo?

What are the benefits of multi-year budgets?

The goals identified when the City's first two-year plan was prepared almost thirty years ago continue to be realized:

- Integrate goal-setting and budgetary process.
- Reinforce the commitment to long-term fiscal health by looking beyond a one-year time horizon in our ability to fund operating programs and capital improvements.
- Promote more “orderly spending patterns” – in other words, mitigate against the “use it or lose it” mentality.
- Retain the fiscal control provided by annual budgets.
- Save time and effort in preparing annual budgets.

The following further discusses the key benefits in using a multi-year approach to budgeting:

Linking Goals and Resources. The key to understanding why the City has remained committed to using multi-year budgets is understanding what we believe is the fundamental purpose of the budget process:

Linking what we want to accomplish for the community with the resources necessary to do so.

This means viewing the budgetary process as the primary tool available to the City in identifying the most important things for us to accomplish, and then ensuring that the budget allocates the resources necessary to achieve them.

Accordingly, the City's budget process includes early Council involvement in setting major City goals and priorities as the first major step in preparing the two-year Financial Plan.

Although the specifics vary from year to year, a special Council goal-setting workshop is held at the beginning of the Financial Plan preparation process. Significant staff work does not begin on the budget until after this workshop is completed and the Council has agreed upon the most important, highest priority things for the City to accomplish over the next two years.

The resulting budget instructions from the City Manager to staff in preparing their departmental budgets direct that funding be included in their submittals to accomplish these Council goals. (Discussing the mechanics of how this process works is a topic in itself for another "white paper!")

In addition to identifying major City-wide goals as developed by the Council, the City's Financial Plan also includes comprehensive mission, goal and objective statements for each of the City's 70-plus operating programs along with a full description of program activities.

This planning process occurs within a comprehensive framework of adopted fiscal policies covering a wide range of issues including revenue management, user fee cost recovery goals, enterprise fund fees and rates, investments, capital financing and debt management, productivity, contracting for services, human resources management, fund balance/working capital levels and capital improvement management.

In summary, the City's budget is intended to focus on the key questions of what we do and why, not just how much does it cost and how will it be funded.

In this context, multi-year budgeting makes a great deal of sense. Very few goals and objectives fit into neat one-year increments. As such, a multi-year approach enables the City to better set meaningful objectives with realistic timeframes for completing them. In reflecting this focus on planning and budgeting for accomplishments, the City issues formal reports on an ongoing basis on the status of major goals, objectives and CIP projects as well as issuing interim financial reports.

Mitigating the "Use It or Lose It" Mentality. In addition to reinforcing the City's planning efforts, a multi-year approach also provides for more "structured operations" and "orderly spending patterns." This is a policy euphemism for mitigating the "use it or lose it" mentality that can often exist in managing operating budgets.

Under the City's two-year approach, unspent operating appropriations can be carried over in their entirety into the second year. It isn't automatic—approval by the City Manager is required—but it does offer departments the opportunity to fund worthwhile activities or projects with their operating savings, and to ensure that carry-over funding is available for multi-year objectives and operating activities.

Retaining Fiscal Control. A two-year budget can mean significantly different things to different organizations. In some cities, a two-year budget means adopting a single number that encompasses the entire two-year period, with the operating departments then responsible for allocating their expenditures as they believe appropriate over the two-year period. With this approach, for example, a two year appropriation of \$1 million could have expenditures of \$700,000 the first year and \$300,000 in the second year as determined by the operating department. Another approach is to formally adopt annual budgets for both fiscal years at the same time.

In the City's case, it prepares a Financial Plan that provides for two years of operations along with a four-year capital improvement plan. Under this approach, appropriations continue to be made annually; however, the Financial Plan is the foundation for preparing the budget for the second year. Additionally, as noted above, unexpended operating appropriations from the first year may be carried over for specific purposes into the second year with the approval of the City Manager.

As discussed in greater detail below, the City devotes as much financial and policy attention to the second year of our two-year Financial Plan as the first. This means the budget must balance and make as much fiscal sense in the second year as it does in the first for both operations and capital improvements.

For example, in preparing the 2007-09 Financial Plan, we developed revenue, expenditure (operating, capital and debt service) and changes in fund balance/working capital schedules for both 2007-08 and 2008-09 for all of our funds; and applied our "balanced budget" and minimum fund balance policies to both fiscal years.

It's important to note that the second year of our Financial Plan is not a "wish list;" the City does not include any new programs, personnel or CIP projects in the second year unless it is fully committed to implementing them and to making any revenue adjustments that may be necessary to fund them.

Similar in concept to a mid-year budget review, the second year is used as an opportunity to adjust the Financial Plan as necessary, but it is not intended to be a fundamental reevaluation of our major goals and plans for the balance of the two-year period.

Saving Time and Resources in Preparing the Budget. If the City's approach to budget preparation was primarily a number-crunching exercise, these savings would probably not be significant. However, because of its commitment to using the budget process as a major planning and goal-setting opportunity, the savings with a two-year approach are significant.

Preparing the initial two-year Financial Plan document is an extensive, time-consuming process that involves virtually everyone in the organization, including Council advisory bodies. All of the City's program goals and activities are revisited at this time, and departmental objectives are developed along with Council goals.

Some effort comparisons: preparing the 2005-07 Financial Plan took eleven months and twelve Council workshops, study sessions and public hearings to complete, and resulted in a 402 page document (and two major appendices totaling 516 pages); adopting the 2006-07 budget (second year of the 2005-07 Financial Plan) required just one regular Council meeting (and was considered as just one of many items) and resulted in a 165 page "supplement" document (including supporting documentation).

Maintaining Fiscal Health. Lastly, multi-year budgeting reflects a fundamental commitment to fiscal health by outlining the financial challenges facing the City—not just this year, but in the foreseeable future; and then initiating the next step of developing—and implementing—solutions in meeting these challenges.

Does this mean economic stability is a necessary pre-condition for a realistic multi-year budget?

Before we entered into the very difficult economic environment of the early and mid-1990's—which in California was compounded by hard-hitting cuts by the State to all levels of local government as it struggled with its own very serious budget problems—I would have answered yes to this question.

However, based on the City's experience in putting together the 1993-95 Financial Plan, I believe that taking a multi-year approach is just as important in difficult years as it is in the "good ones." And this belief was reinforced by the very tough budget process we went through in preparing the 2003-05 and 2005-07 Financial Plans.

In the City's case, it assists in making realistic—though tough—decisions about what we can reasonably afford to do in the long run, and eliminates most one-time fixes and "smoke and mirror" approaches to balancing the budget.

In fact, because we knew 1993-95 would be an extremely difficult period for us financially, starting with that Financial Plan, we have extended our forecast period to five years in developing our basic budget balancing strategies in order to ensure that we are in fact making budget decisions that make sense for the foreseeable future. And this longer-term approach was also invaluable in preparing both the 2003-05 and 2005-07 Financial Plans.

Important in the "good times," too. Taking a multi-year approach was also important in preparing the 2007-09 Financial Plan, which reflected a significant improvement in the City's fiscal outlook. (This was largely due to the approval of Measure Y, a ½-cent general purpose City sales tax approved overwhelmingly approved by the voters in November 2006.)

Stated simply, most cities do not get into financial trouble in bad times: the roots most often take hold in the "good times." In preparing the 2007-09 Financial Plan, we worked hard to respond to current community priorities on one hand, while ensuring that the budget made sense for the long run as well. Taking a multi-year approach was a key tool in providing this assurance.

Does this mean making assumptions about the future that may become obsolete before the laser jet ink is even dry? Yes. (Although there are strategies for minimizing this—but this is also the subject of another "white paper.") And isn't there a lot of risk with using this approach? Perhaps.

But what is the alternative if you're serious about assuring your city's long-term fiscal health? Without some idea of the problems you're trying to solve, it is very difficult (if not impossible) to find the right solutions.

Importance of a commitment to a planning approach. What is probably more important than economic stability in making our approach to multi-year budgeting work is some level of political stability. This doesn't mean stability in a policy "agenda" sense, but stability in the commitment by elected officials to using the budget process as a meaningful planning and financial

programming tool. This concern was reflected back when a two-year budget process was first considered by our “pioneers” in their deliberations about what two-year period should be selected:

- The one that immediately follows a Council election?
- Or the one that follows a year later?

In support of the first option is the argument that new Council members should be able to immediately affect City plans, policies and goals for the next two years; in support of the second option is the argument that Council members will be more effective in implementing changes after they are more experienced as Council members and more familiar with city operations.

Because of changes in our election dates since the two year approach was first adopted, we’ve had the opportunity to experience both situations in preparing our two year Financial Plan. The ultimate conclusion? It probably doesn’t matter which two-year period you select *if* the Council is genuinely committed to a policy-based, planning-oriented budget process. (However, there will be more staff work involved in helping new Council members prepare for their first two-year budget, especially if there are three new members, which is possible with the City’s staggered terms and term limits.)

Lessons learned—what should you consider in moving to a two-year budget?

Based on our experience, I think the most important first step for any city that is seriously considering moving towards a two-year budget is to clearly think through the following:

- Most fundamentally, what do you hope to accomplish if you adopt this approach?
- What is your current organizational culture in terms of departmental versus centralized control of the budget? Is this something you want to change?
- Is integrating strategic planning and the budget process a high priority? Do you have a process for this now, and will a multi-year approach improve it?

Once the goals of moving to a two-year budget are identified and agreed upon, the “mechanics” of how to put it together and administer it will follow by simply asking: does this procedure help or hinder accomplishing our goals?

Specifics developed in San Luis Obispo in meeting our goals include:

- **Planning.** We begin the two-year process with Council goal-setting. Their agreed-upon priorities are incorporated into the preliminary budget preparation by the staff. By using a two-year timeframe, we are able to establish reasonable schedules for achieving these goals.
- **Fiscal Health.** We review budget requests and prepare annual operating and capital budgets for both years with equal levels of care and specificity, and make budget decisions based on our financial condition at the end of the second year—not just the first year—of the budget timeframe. And the City doesn’t create “phantom” budget balancing items or defer tough decisions to the second year: any needed expenditure cuts or new revenues have to be real and specified. If an increase in taxes or fees is required to balance the budget, Council approval of the ordinance or resolution implementing this is an integral part of the budget adoption process.

- **Fiscal Control.** The City retains the concept of annual budgets; we do not adopt a single “two-year” number without regard as to which fiscal year there is departmental spending authority. Equally important, we develop revenue and fund balance projections for each fiscal year, and the results must be consistent with adopted fiscal policies.

For example, annual operating expenditures should not exceed operating revenues; and ending fund balance should be at least 20% of operating expenditures.

- **Spending Patterns.** Although the City retains the concept of annual budgets, operating budget savings in the first year are available for carry-over into the second year. However, programming these amounts back into departmental budgets requires City Manager approval. As noted above, it’s not “automatic” (we have developed specific guidelines on how balances are carried-over), but it does provide operating departments with additional funding flexibility using their prior year savings. At the end of the second year, all operating appropriations lapse.
- **Time and Effort.** As discussed above, the City has experienced significant savings in preparing the second year of our two-year document, but virtually all of these savings are attributable to what we want our two-year Financial Plan process to accomplish. The budget for the second year is viewed as a “supplement” to its parent document, and it focuses solely on changes to the adopted Financial Plan; it is not another comprehensive Financial Plan preparation effort.

Summary: Why does this work for us?

Multi-year budgeting works for us because of how we’ve defined the fundamental purpose of our budgetary process:

- Identify the most important things for us to accomplish for our community.
- Establish reasonable timeframes and organizational responsibility for achieving them.
- Allocate the resources necessary for programs and projects to implement them.

Even though the City annually adopts its budget, it takes the two-year nature of our Financial Plan very seriously. In balancing the budget, we are equally concerned with outcomes in the second year (in fact, perhaps even more so) than with projections for the first year.

At an operational level, it works because departmental staff have confidence that operating savings from the first year will be available in the second; and that there is as much commitment to funding any new programs, projects or staffing in the second year as there is in the first. At an elected official level, I think it works because it provides Council members with an effective framework for accomplishing their goals and policy objectives.

Simply stated, it works because the City believes in—and is committed to—the underlying principles that a multi-year approach supports. Without this commitment, the benefits of multi-year budgeting are probably not there.

When I first came to San Luis Obispo in 1988, I have to admit that I was highly skeptical of the real value of a policy-based, multi-year approach to budgeting and financial planning. At best, I

believed it was “frosting on the cake” of what otherwise needed to be a much more basic, meat and potatoes approach to preparing budgets.

After 22 years and the preparation of eleven Financial Plans, it is difficult for me to envision anything more fundamentally necessary for the well-being of a community than identifying where it wants to go and a budget process designed to help it get there.

