Budgeting in an Uncertain Economic and Financial Climate

Presented By:

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PFM's Management and Budget Consulting Practice

- In addition to PFM's Financial Advisory services, our Management and Budget Consulting ("MBC") practice works with municipal and state governments across the country to:
  - Improve the efficiency of day-to-day operations
  - Develop comprehensive strategies to address annual budget pressures
  - Align resources to achieve long-term goals
- We have worked in Tennessee and across the mid-South, assisting local governments with plans and initiatives for fiscal sustainability, and are eager to share what we have learned about budgeting in difficult and uncertain financial climates.

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By Sherry Giewald
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Looming ARPA Cliff

- The American Rescue Plan Act (ARPA) State and Local Fiscal Recovery Funds provided local governments unprecedented one-time funds to support COVID-19 recovery for a variety of eligible uses.
- With key deadlines to obligate funds by December 31, 2024 and spend awarded funds by December 31, 2026, local governments will need to begin to consider how ARPA funded projects and services will be supported going forward.
- This "ARPA Cliff" prompts municipalities to consider:
    - Are all projects positioned to be obligated by December 31, 2024 and spent by December 31, 2026
    - What ARPA funded projects and services are expected to continue beyond December 31, 2026
    - What funding source will be leveraged to support those projects and services
    - How will the municipality fund maintenance and other ongoing costs for one-time construction and infrastructure projects
    - Are funds set aside for final ARPA reporting, compliance, and close out
- Each of these considerations may have a material impact on the short- and long-term budget and financial outlook.

What We Know; What We Don't

What We Know

- The inflation spike has abated, but price growth remains persistent and still above pre-pandemic levels.
- Sales tax revenues are not increasing as predictably as they once did, yet the cost to operate services continues to increase.
- The pandemic shifted work and commerce patterns in many communities that could differentially impact local tax bases where sustained.
- Significant ARPA, IIJA, and IRA resources are available, but many are also time-limited – and recent government shutdown threats highlight the lack of political consensus at the federal level.
- Local governments face structural budget pressures even in good economic times.

What We Don't

- How recent Federal Reserve actions will impact economic indicators.
- How much employment levels and wage pressures might further weaken (or not).
- How work and commerce patterns will continue to evolve "post"-pandemic with what level of impact.
- What future federal infrastructure and program funding might look like.
- When precisely the next recession will hit, how hard, and for how long?

Why is multi-year financial planning particularly important right now?

A multi-year financial plan will help you think through budget position, structural position, and community goals in a quantified, analytical, logical way and communicate your thoughts and priorities to different audiences.

Why do Multi-Year Projections

Strategic	Financial
Helps create a long-view for strategic decision making	Identifies long-term budget issues
Informs policy and operational decisions	Helps evaluate long-term impacts of current decisions
Projects impacts of policy changes in volatile economic environment	Helps understand major revenue and expense budget drivers

Why do Multi-Year Projections

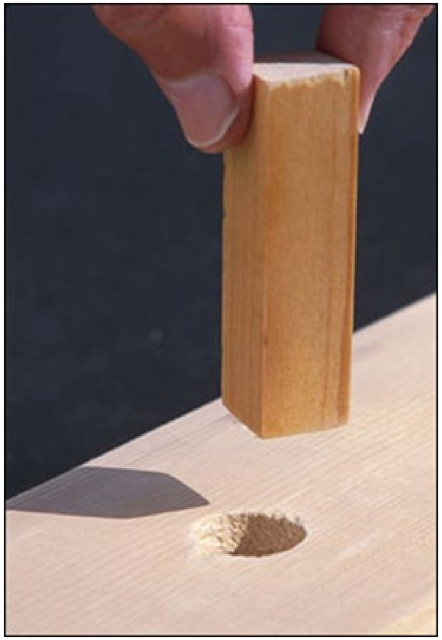
Reason No. 1: Identify possible gaps between revenues and expenditures.

- Many local governments face structural challenges. Property tax revenues are flat, grow by small amounts, or tax rates are capped and there may be limited opportunity for economic development. Meanwhile expenses rise because of pension issues, health insurance costs, energy costs, etc.
- One-year budget cycles are not an ideal way to address systemic challenges:
  - Short-term strategies often yield short-term benefits that expire or may even increase your deficit in out years.
  - Looking exclusively at the short-term limits of public/elected official appreciation and understanding of long-term challenges (e.g., pension, OPEB, debt service).
  - The **options for addressing structural imbalance are much better before cash and current-year budgetary shortfalls arrive**. Multi-year planning allows you to move away from “putting out the next fire.”

Why do Multi-Year Projections

Reason No. 2: It changes the budget conversation.

- Budget processes are often stressful and tense because scarce resources lead to an “us versus them” dynamic between elected officials, department heads, and management, etc.
- Using a multi-year perspective changes the conversation:
  - You can present the challenges to interested parties from a broader perspective and challenge people to think beyond their departmental boundaries.
  - **Revenue projections help you determine what you can afford before you begin processes that will set your expenses for several years** (e.g., issuing debt, citywide employee raises).
  - Multi-year planning allows you to talk about what investments are worth making down the road in addition to what reductions you need now.



Why do Multi-Year Projections

Reason No. 3: It's considered a best practice by GFOA and rating agencies.

"Multi-year planning is a critical exercise. These plans will often have out-year gaps projected which allow governments to work out, in advance, the optimal way to restore fiscal balance."

– Standard & Poor's

"The multiyear plan's value is to anticipate future challenges that may be encountered due to projected revenue and expenditure imbalances. This allows executives and legislators to 'get in front of' potential budget stress, and take corrective action long before budgetary gaps develop into crises."

– Fitch Ratings

"Financial forecasts are at the crux of foresight.

[Use] forecasts to identify the parameters within which to develop and execute strategies, rather than to try to 'predict' the future."

- GFOA, Building a Financially Resilient Government through Long-term Financial Planning

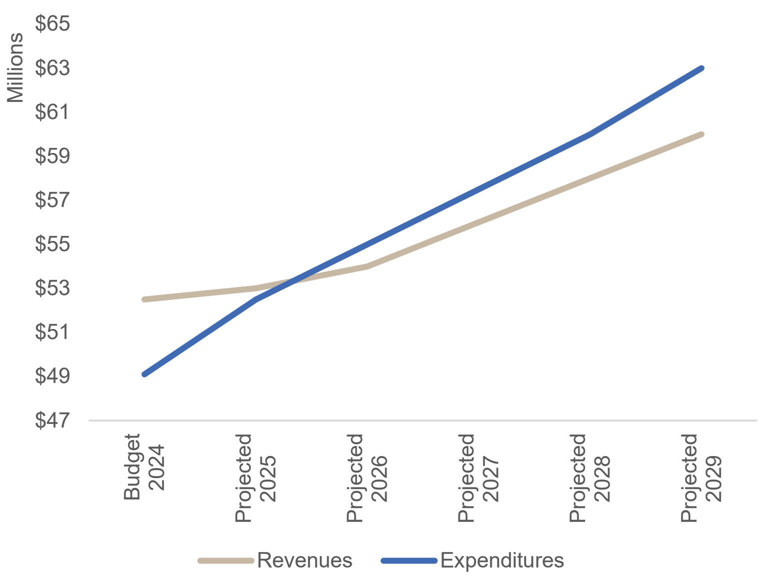
Why Multi-year Financial Planning is Essential in an Uncertain Financial Climate

- During the 2024 legislative sessions, several states, including Tennessee, proposed legislation to impose a limit on increases on property tax rates and/or assessed values.
- In 2024, the State of Alabama limited the year-over-year increase in assessed value to no more than 7.0% for existing property, excluding any improvements or change in ownership.
- In November 2024, Georgia residents will vote on an annual cap on limiting the year-over-year increase in assessed value to no more than 3.0%. A local government may opt out of the cap but must hold a series of meetings and conform to other requirements of transparency.
- Similarly, there was a bill considered (but not passed) in the Tennessee legislature to limit local government's ability to increase real property tax revenues by:
  - Total [property tax] revenue exceeding inflation + 2.0%
  - Total [property tax] revenue exceeding inflation + 6.0% over the preceding three (3) tax years

Developing a Multi-Year Financial Plan

Developing a Baseline Forecast

- A multi-year financial projection is revenues and expenditures over a defined period of time based on a specific sets of assumptions.
- This **baseline projection** is like the diagnosis your doctor gives you after a physical. It reflects your current condition, absent significant changes.
  - For revenues, this means no assumed changes in tax rates, new taxing powers, new grants, large fee increases, or reassessment.
  - For expenditures, this means no assumed new hiring, layoffs or wage increases that deviate from recent trends.
- Ultimately, the baseline is intended to show what the financial results could be with **no corrective action**.



Developing a Baseline Forecast

- To build your projections, growth rates are applied to categorized line-item data to project revenues and expenses in future years. Inputs include:
  - **Historic revenues and expenditures**: PFM usually use 3-5 years to provide a starting point for calculating growth trends.
    - *It's okay if you don't have detailed, consistently organized and formatted data. Start with what you have and what you know.*
  - **Schedules for debt service**, bonds, abatements, leases, grants etc.
  - **Labor costs**, which determine employee salaries and other forms of compensation (including health insurance), along with minimum staffing requirements.
  - **Projected liabilities for pension and other post-employment benefits.**
    - *Ask your actuary or consult your most recent valuation report.*
  - **Statutory provisions**: Do you have a policy that sets a minimum level of reserves you have to maintain? Do you have provisions that restrict the annual growth in tax revenue or tax rates or how the money can be used? Do you have revenues or expenditures that are automatically indexed to something else (CPI, COLA)?

Developing a Baseline Forecast

- Beyond accounting: the baseline projections will help you discuss your entity's goals within the context of its financial resources.
  - **Budget position**: Can we generate sufficient revenues annually to meet all expenditures and not incur deficits?
  - **Structural position**: Are we structurally balanced such that recurring revenues meets recurring expenses, or is our balance predicated on actions that have a short-term benefit? How are the major drivers of financial performance changing? Are they in balance so that we have a stable level of resources? Is our operating margin growing or shrinking?
  - **Community Goals**: Do we want to change where we're spending our limited resources? Will we have the financial resources to deliver desired services over time and respond to changing needs and preferences (investments, reserve levels, tax rates)?
- The baseline projections also should help you identify specific areas for corrective action. Now you can go beyond anecdotal evidence and invest your time and energy where it will make a difference.

Forecast → Financial Plan

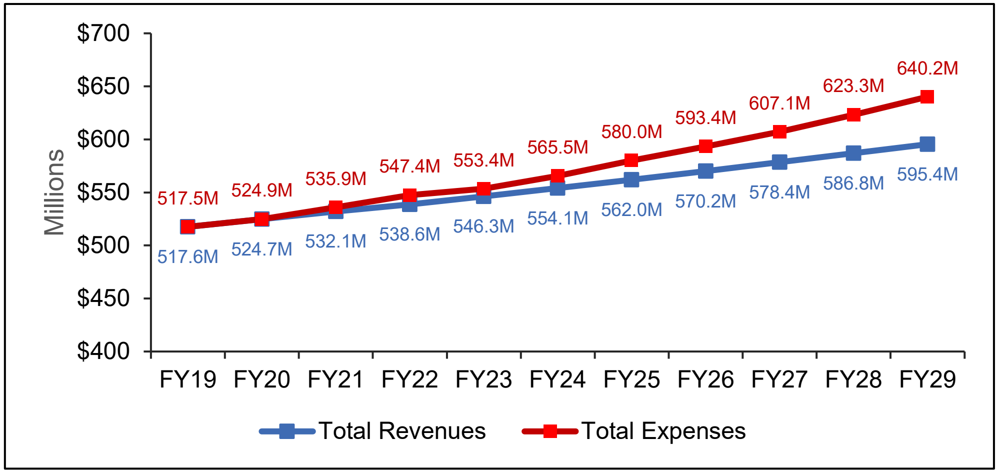
Guiding Questions: Given this baseline assessment and our goals, what kinds of initiatives (on both the expenditure and revenue side) should we pursue, and what is the likely financial impact of those initiatives?

- Many governments struggle to keep their expenses in line with their revenues without raising taxes or cutting services. Your goal is to **develop a menu of options**, with as many quantified as possible, that represent a well-rounded approach to achieving and maintaining balance. Approaches would typically involve some (or all) of the following:
  - Management and productivity initiatives
  - Debt restructuring
  - Cost recovery (fees and service charges)
  - Workforce strategy
  - Program prioritization
  - Tax rate or base changes

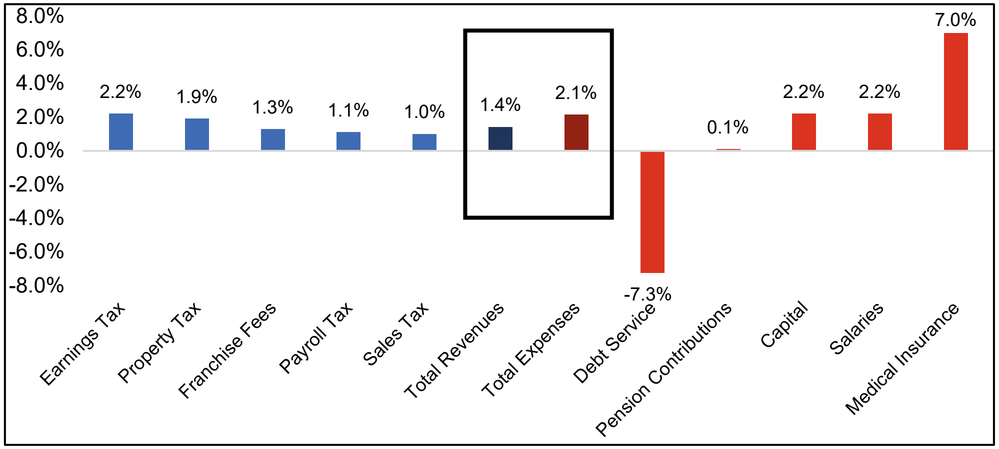
Developing a Multi-Year Financial Plan

- Recognized best practice: 5-10 year **multi-year financial plan** to create a framework for fiscal sustainability.
- Evaluate key budget drivers and policy parameters through a **baseline** analysis.
- Focus on recurring revenues and expenditures and structural budget position ("carry forward").
- Assess and address liabilities and long-term needs (e.g., infrastructure, unfunded retiree benefits, tax policy).
- Develop strategies to bend the curves, close any gaps, and carve out new resources.
- Communicate the plan and gain buy-in from all levels of the organization.

General Fund Projections: FY2019-FY2029 (EXAMPLE)



Projected CAGR for Major Budget Drivers: FY2019-FY2029 (EXAMPLE)



Stress Test

- **Stress test** the plan under alternative economic scenarios; illustrate what could go wrong without preventative measures.
  - Revenue sensitivity
  - Expenditure sensitivity and fixed cost constraints
  - Debt and capital program approach
- Evaluate and forecast key revenue streams under alternative economic scenarios.
- Both the degree of sensitivity to the economy **and** timing of impacts can vary across revenue types based on a range of local factors.
- Examples:
  - Timing of payment
  - Character of the community (e.g., built out or developing)
  - Laws and practices with regard to tax caps and credits
  - Reassessment practices
  - Tax base and industry mix / concentration
  - Exposure to trends in work/commerce location

What scenarios?

- Moderate or "typical" recession?
- Capped property tax growth?
- Multiple scenarios?

Stress Test: Revenues

- Do you (and/or overlapping levels of government) already have forecasting models for major revenue streams driven by economic assumptions?
- What was your experience during prior downturns?
  - Has your community and economic base changed significantly since those prior recessions? Did the pandemic change patterns of work, housing and/or commerce? If so, what do those changes imply for your tax base?
  - Have your tax/fee rates and rate structures changed since your last downturn, and what does that imply?
- Could collection/payment rates decline?
- Will public resistance to otherwise routine rate adjustments (and/or demand for tax breaks) likely intensify during tough times?
- For ARPA, what's left and what is planned? Do you face any ARPA "cliff" ahead?
- With other intergovernmental revenues, how is the fiscal structure for the other levels of government (e.g., state) aligned with the economy in terms of the potential severity and timing of pressures? Are the revenues formulaic or discretionary? What is the history, if any, during prior downturns?

Stress Test: Operating Expenditures

Total Expenditures = Fixed Costs + [Level of Service * Cost Per Unit of Service]

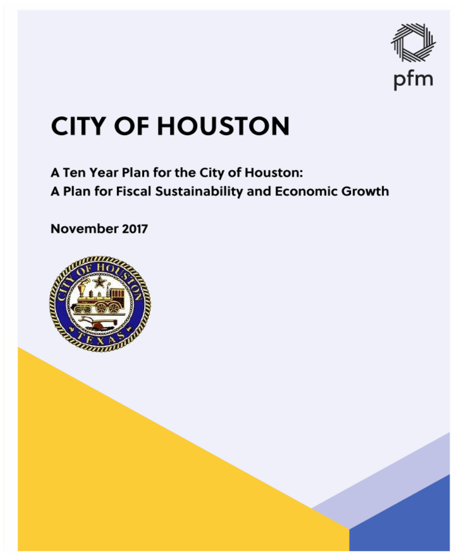
- **What are your fixed costs?**
  - Are they truly fixed? Even if not economically sensitive, are the prospective trends clear?
- **How would your service demands change in a recession?**
  - Greater demand for social services and safety nets
  - Some growth-related service pressures might decline (e.g., building permit inspections)
  - Are certain discretionary services and studies likely to go on hold?
  - Are other new mandates looming (independent of the business cycle)?
- **How might costs per unit of service change?**
  - Are any major contracted services coming up for bid? Is that just a general concern or are there economic sensitivities with the pricing?
  - What is your exposure to different inflationary categories (e.g., energy, construction, general goods and services, healthcare) and what scenarios make sense to analyze?
  - Wage pressures *could* moderate. How much flexibility do you have? How to address and present in a plan?

PFM's Multi-year Financial Plan Engagements

- Baltimore, MD
- **Chattanooga, TN (forecast)**
- Compton, CA
- Dalton, GA
- Danville, VA
- Gary, IN (forecast)
- Hartford, CT
- Houston, TX
- **Memphis, TN**
- Missouri City, TX (forecast)
- Mobile County, AL (forecast
- Norristown, PA
- Pittsburgh, PA
- Providence, RI
- Reading, PA
- Richmond, CA
- Rockford, IL
- Salem, NJ
- Salinas, CA
- Savannah, GA
- Seaside Heights, NJ
- **Shelby County, TN**
- Trenton, NJ
- Youngstown, OH

Case Study: Houston, TX

- In September 2016, the City of Houston engaged PFM develop a Ten-Year Financial Plan, to allow the City to focus on the decisions it needed to make to ensure sustained fiscal balance, while making investments essential to economic competitiveness and quality of life.
- **The Plan identified initiatives with a total savings or new revenue impact of approximately $80 million.** The plan allowed City leadership to make informed decisions to ensure that Danville has sufficient resources to invest in its future.
- The plan combined projections of the City's fiscal future and focus area – reduce violent crime, improve education, and grow the City of Danville – initiatives to articulate a strategic path forward for fiscal and economic growth.
- Combined with a lifting of a revenue cap, the Plan would both close a projected $1.02 billion gap over the ten-year period, provide for wage increases based on inflation, and provide a little more than $1.2 billion for new investments and to address the City's long-term liabilities (e.g. OPEB).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CITY OF HOUSTON

A Ten Year Plan for the City of Houston:
A Plan for Fiscal Sustainability and Economic Growth

November 2017

Questions?

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Thank You!

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