

Revenue and Expenditure Forecasting

A financial forecast, or multi-year revenue and expenditure forecast, is a useful management and policy making tool that allows a municipality to evaluate the impact of various government decisions over time. Since policy choices often affect the town's financial condition for years to come, it is beneficial to analyze the associated fiscal impacts over a multi-year period. For example,

- What is the impact of a multi-year collective bargaining agreement?
- What is the impact of financing a new school and what impact will the debt service have on the tax rate?
- How much will a proposed development add to the tax levy and what are the associated added service costs?
- What is the impact of moving solid waste disposal to a full cost recovery basis over the next three years?

Financial forecasting provides an effective approach to evaluating these and other policy choices being considered by a municipality.

A forecast can also serve as an early warning system to detect a future gap between revenues and expenditures. While it cannot insulate a community from all forms of fiscal surprises, analyzing its financial picture in this type of comprehensive and structured manner will reduce the risk of overlooking key information. Detecting problems early gives management more time to consider corrective action. Assuming that the forecast is done with spreadsheet software, it is a simple matter to hold all the other components of the forecast constant and isolate the impact of various policy solutions on the bottom line.

It is important to recognize that forecasting is more of an art than an exact science. A simple, common sense approach may be just as useful and accurate as an intricate econometric model. While beginning a revenue and expenditure forecast can be a daunting task given the complex interactions of numerous variables, it is more manageable if you follow the guidelines below.

1. While you can choose a longer period, accuracy will decline rapidly as you move beyond five years. Of course, much of the focus should be to project revenues accurately in the first forecast year. These numbers provide a starting point in the annual budget debate and can be used to develop budget guidelines to assist department heads in preparing their appropriation requests.
2. **The forecast need not be as detailed as the annual budget.** The forecast should be presented at a summary level with revenues and expenditures broken into

manageable components. For example, expenditures can be summarized as school expenditures, municipal departmental expenditures, employee benefits, debt service, reserves, state and county charges and other amounts to be raised. Revenues can be consolidated into tax levy, state aid, local receipts and available funds. Subsidiary worksheets, with the necessary detail you need for accuracy, can be created with totals that tie to your summary worksheets. Presenting the forecast at the summary level makes it easier to understand and helps readers distinguish the forecasting document from the recommended budget. As a general rule, we advise communities to organize revenue categories, as a summary or subsidiary worksheet, to match the Tax Recap sheet.

3. **The forecast is more useful if the numbers are accompanied by written assumptions detailing how numbers were arrived at.** Realistic assumptions play a large role in ensuring a credible forecast. Credibility is important because other officials and citizens must believe that the forecast is a sound and reasonable portrayal of a municipality's fiscal condition. Otherwise, the forecast has little use in the budget planning process.
4. **A reliable forecast is the product of accurate historical data and up-to-date information from many different sources.** To coordinate the gathering of financial data necessary to complete a forecast, it is best that one knowledgeable person lead the process. This individual could be the manager/administrator, finance director, accountant, or a finance committee member in a town, or a chief financial officer or auditor in a city. Ultimately, the person that emerges depends on your community's form of government. Due to the myriad variables that can impact fiscal condition, however, a credible forecast requires the input and cooperation of all finance officers. By enlisting their support and utilizing their expertise, forecasting becomes a valuable team building exercise, where meetings held initially to gather data for a forecast can evolve into more widespread efforts to improve financial operations. Work on a forecast should begin in October or early November and end in December, so that conclusions can be incorporated into budget guidelines for department managers.
5. **For forecasting revenues, a moderately conservative approach should be used.** Upon review of historical information, conservative assumptions should be made about dollar or percentage adjustments to the current year's revenues in order to arrive at projections for the first forecast year. The same analysis should be made for each successive year in the forecast. As new information becomes available or circumstances change, the forecast is revised. With this approach, if projected revenues increase (e.g., Governor's budget, new growth, user fees, and free cash), then a corresponding expenditure increase may be made to the recommended operating or capital budget. Alternatively, the potential revenue gain could be

diverted to reserves, or left unexpended and allowed to close at year-end to free cash.

6. **For forecasting expenditures, an approach should be determined.** In forecasting expenditures, a community has the option of developing a maintenance (level service) budget, a level funded budget, or costs can be adjusted (across the board or by department) by a specified percentage increase or decrease.

By “maintenance budget,” we mean projecting what it costs to maintain the current level of staffing and mix of services into the future. In this approach, it is also helpful to assume that all current laws and regulations remain in effect during the forecast period. Negotiated collective bargaining cost increases, salary step increases and longevity pay can all be projected to the year a contract ends. Possible personnel costs associated with future contracts should not be included because the purpose of the forecast is to determine what revenue is left after the maintenance budget is funded. Because of contractual obligations and the impact of inflation on expenses, a maintenance budget will almost always be greater than the prior year appropriation.

A “level funded” budget appropriates the same amount of money to each municipal department and is tantamount to a budget cut from the prior year appropriation. Even under level funding, however, increases in mandated costs and other fixed expenses must be covered, usually at the expense of the general government operating budget.

In either case, remaining funds can be used for “discretionary spending” such as future collective bargaining settlements, capital purchases, new staff, expanded services, or set aside as reserves.

With a current and credible forecast, officials and citizens will be able to evaluate the fiscal impact of any contemplated spending choices or revenue raising options.