

A forecast of projected revenues and expenditures is a useful management and policymaking tool that enables a municipality to evaluate the impact of various government decisions over time. Since policy decisions often affect financial conditions for years to come, it is beneficial to analyze their associated fiscal impacts over a multiyear period, as in the following examples:

- What is the impact of a multiyear collective bargaining agreement?
- What is the impact of financing a new school, and how will its debt service affect the tax rate?
- How much will a proposed development add to the tax levy, and what will be its added service costs?
- What is the impact of moving solid waste disposal to a full cost recovery basis over the next three years?
- What is the impact of various health insurance cost savings options?

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

It is best practice to present a financial forecast early in the budget process. As a result, the financial management team will be aware of any potential challenges in the immediate or upcoming fiscal year, as the forecast can serve as an early warning system to detect future gaps between revenues and expenditures. Although it cannot insulate a community from all potential surprises, analyzing the financial picture in this comprehensive and structured manner reduces the risk of overlooking key information. Detecting problems early gives management more time to consider corrective actions. Assuming the forecast is done with spreadsheet software, it is a simple matter to hold all the other components of the forecast constant and isolate in turn the impact of various potential policy decisions on the bottom line.

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

1. **While you may choose a longer period, accuracy declines rapidly as you move beyond five years.** Of course, much of the focus should be on projecting 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 additional detail needed for accuracy can be created with totals that tie to the summary worksheets. Presenting the forecast at a summary level makes it easier to understand and helps readers distinguish the forecast document from the recommended budget. As a general rule, we advise communities to organize the revenue categories in summary or subsidiary worksheets to match up with the Tax Recap sheet.
3. **The forecast is more useful if written assumptions accompany the numbers to detail how they were arrived at.** Realistic assumptions are key to ensuring a credible forecast. Credibility is important because other officials and citizens must believe the forecast is a sound and reasonable portrayal of a municipality's fiscal condition. Otherwise, it 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 sources.** To coordinate the financial data gathering needed to complete a forecast, it is best that one knowledgeable person lead the process. Depending on the form of government, this individual could be the manager/administrator, finance director, accountant, finance committee member in a town, or chief financial officer or auditor in a city. Since myriad variables can impact fiscal conditions, however, a credible forecast requires cooperation and input from all finance officers. With their support and expertise, forecasting becomes a valuable team building exercise, whereby meetings initially held to gather forecasting data can evolve into more general efforts to improve financial operations. Forecasting work should begin in October or early November and end in December so that conclusions can be incorporated into budget guidelines for department managers.
5. **Use a moderately conservative approach when forecasting revenues.** Upon review of historical data, conservative assumptions should be made about dollar or percentage adjustments to the current year's revenues to arrive at projections for the first forecast year. And 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 due to certain factors (e.g., Governor's budget, new growth, user fees, 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 to free cash at year-end.

6. **For forecasting expenditures, decide on a particular approach.** In forecasting expenditures, a community can opt to develop a maintenance (level service) budget or a level-funded budget, or it can specify percentages to increase or decrease costs (either across the board or by department).

By a maintenance budget, we mean projecting the costs needed to maintain the current level of staffing and services into the future. In this approach, it is helpful to assume 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 that each contract will end. Possible personnel costs associated with future contracts should not be included because the forecast's purpose is to determine what revenue is left after the maintenance budget is funded.

A maintenance budget will almost always be greater than the prior-year appropriation due to contractual obligations and inflation's impact on expenses. A level-funded budget, which repeats the same appropriation given to each municipal department for the new year, is tantamount to a budget cut from the prior-year for the same reasons. However, even a level-funded budget must cover increases in mandated costs and other fixed expenses, usually at the expense of the general government operating budget. In either case, any remaining funds can be used for "discretionary spending" (capital purchases, new staff, expanded services) or set aside as reserves.