MUNICIPAL FINANCE

4

BACKGROUND SERIES

Municipal Budgeting

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Acronyms

A/P	Accounts Payable
B/S	Balance Sheet
CIP	Capital Investment Plan
FASB	Financial Accounting Standards Board
GAAP	Generally Accepted Accounting Principles
GAAFR	Governmental Accounting, Auditing, and Financial Reporting
GASB	Government Accounting Standards Board
GO	General Obligation Bond
I/S	Income Statement
O&M	Operations and Maintenance
WB	World Bank

I. INTRODUCTION

1.01 The focus of this paper is to outline the role of budgeting as a critical tool of local government finance and to provide guidelines to strengthen local public finances in improving the financial management and creditworthiness of local government entities[1]. Adequate and appropriate procedural norms are important in any financial management system. But substantive outcomes are what is key in any policy system. Budgeting and financial management procedures are simply the accounting manifestation of public policy. In particular, proper public financial management must: adequately control the total level of revenue and expenditure; appropriately allocate public resources among sectors and programs; and, ensure that governmental institutions operate as efficiently as possible.

1.02 An essential first step is to put sound budgetary and financial procedures into place. Local budgets must be comprehensive, accurate, periodic authoritative, timely and transparent. A strong budgeting and financial system along these lines satisfies several essential requirements of good government: i) it establishes the basis for financial control; and, ii) it provides accurate, uniform, and timely financial information.

1.03 This toolkit provides practical guidance to municipal finance managers on how to implement prudent, service oriented budgeting practices. This municipal budgeting section is organized into several sections including: accounting and auditing; the municipal budget; municipal revenues; pubic expenditures; the capital budget and investment planning; and budget performance information and measurement.

II. ACCOUNTING AND AUDITING[2]

2.01 Public managers often view accounting and audit processes as cumbersome and time consuming tasks. However, efficient and effective municipal accounting and auditing practices are essential to managing municipal current and future budgets, and making local municipal finances increasingly transparent to the local constituency. This section is organized around five primary topics:

- Standards for municipal accounting and financial reporting;
- Financial reporting practices;

[1] The author(s) of the *Municipal Budget Toolkit* would like to acknowledge the contributions to the understanding of municipal financial management by James McMaster et al, *Urban Financial Management - A Training Manual,* 1994 published by the Economic Development Institute of the World Bank and the UN Centre for Human Settlements. The *Municipal Budget and Financial Management Toolkit* does not seek to replicate the training manual, merely to build upon some of the knowledge presented in the manual in a few key areas – municipal accounting, performance/program based budgeting, and linking the capital and operating budgets with performance based outcome(s) as a primary objective.

[2] See Appendix A: "Twelve Accounting Principles."

- Auditing standards and practices;
- Accrual and cash reporting; and,
- Service cost information.

A. Standards for Municipal Accounting and Financial Reporting

2.02 Internationally, accounting and financial reporting standards are often established by independent standards setting authorities or boards. In the United States, for example, the Financial Accounting Standards Board (FASB) and the Government Accounting Standards Board (GASB) establish the financial reporting standards for the private and public sectors, respectively. Many countries have established Public Accounting Plans.

2.03 Accurate municipal accounting systems provide the tools and techniques necessary for public sector managers to assemble, analyze, and report financial data such that it may be used for planning, decision making and cost and budget control. The purpose of accounting is to provide financial information which is accurate, complete, timely and in a form that is understandable to users. An accounting system consists of an integrated structure of source documents, journals, ledgers and procedures used to determine the financial position of the municipality. The accounting process involves the composite activity of recording, summarizing, analyzing and interpreting financial transactions. The four primary inputs to the accounting and financial reporting structure include:

- Source documents and forms including invoices, receipts and details of all financial transactions.
- Journals which provide summary lists all transactions in a chronological order.
- Ledgers which are based upon the summary tools in journals and show the balance in any revenue, expenditure, or other account. General and subsidiary ledgers are generally used to provide different levels of financial detail.
- Procedures and controls include the forms and instructions for classifying, recording and reporting financial transactions in source documents, journals, and ledgers.

2.04 The primary focus of local municipal accounting is in general on cash flows and increasing transparency and accountability to the local constituency rather than on profit or loss reporting. Evolving from this basic difference between private sector and public sector are the following general practices in public sector accounting:

- Fund accounting should be used to insure legal compliance with restrictions on the use of revenues and to enhance sound financial administration of diverse governmental operations.

- Fixed asset accounts should be maintained separately from current assets. All tangible fixed assets should be depreciated.

- Long-term general obligation bonds should be recorded in a separate group of accounts as obligations of the entire governmental unit. Revenue bonds are obligations of specific funds and should be recorded as such[3].

- Basis of accounting are methods used for matching revenues and expenditures over a specific time period. On a *cash basis*, revenues are recorded when cash is received and expenditures are recorded when cash payments are actually completed. On a *full accrual basis*, revenues are recorded when earned and expenses are recorded when liability is incurred. The *modified accrual basis* records expenditures when liability is incurred but does not record most revenues until cash is received.[4] And, lastly,

- Financial reports should be issued regularly and an annual report covering all funds and operations should be published.

B. Basic Considerations of Accounts and Budgets

2.05 The most observable feature of governmental accounting differing from business or personal accounting is the use by local governments of what is known as the fund system. In conventional accounting, all monies customarily go into one account from which all expenses are paid, and a single set of accounts suffices to disclose all pertinent transactions and all needed details of financial condition. The legal restrictions on the use of government monies and on the purposes of governmental expenditure make the co-mingling of monies an obstacle to a clear demonstration of compliance. Some taxes or other revenues are segregated into separate, distinct funds or accounts, from which payments for the permitted purpose are made.

C. Types of Funds

2.06 Municipal governments are required to account for the receipt and expenditure for all funds received on behalf of the jurisdiction. These financial records are subdivided into several funds. As defined by Generally Accepted Accounting Principles (GAAP), a fund is a set of interrelated accounts which

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[3] Robert A. Reny, "Municipal Accounting," in Jack Rabin et a., editors, *Budget Management* (Athens, Georgia: Carl Vinson Institute of Government, 1983), p. 128.

[4] Exceptions may be made for revenues that are clearly measurable and available such as property taxes. Capital project accounts should be maintained on a full accrual basis whereas general fund and other revenue funds can be recorded on a conservative modified accrual basis. Cash basis accounting, though still widely used, is not desirable since it is easy to manipulate and gives a less than complete portrait of the local financial condition.

record assets (revenues) and liabilities (expenditures/obligations) related to a specific purpose[5]. There are three basic types of funds used in municipal financing practices: i) governmental; ii) proprietary; and, iii) fiduciary. Table 5, below defines the funds and their respective subcategories.

Table 5
Government Funds

Fund	Definition
1. Governmental Funds	
General Fund	▪ Consists of general revenue sources such as taxes, fines, licenses and fees. The general fund is usually the largest municipal fund.
Special Revenue Fund	▪ Consists of resources that are restricted for special purposes. Examples include· Transportation Trust Fund or State and Federal Grants
Debt Service Fund	▪ Consists of resources used to repay long-term general obligation debt (general obligation bonds)
Capital Project Funds	▪ Consists of resources restricted for construction and acquisition of capital facilities.
Special Assessment Funds	▪ Consists of resources received from special charges or fees levied on persons that benefit from a particular capital improvement project
2. Proprietary Funds	▪ Proprietary funds account for records of operations.
Enterprise Fund	▪ Contain financial records of self supporting operations (Water and Sewer Fund)
Internal Service Fund	▪ Account for the financing of goods or services provided by one department or agency to other departments or government agencies on a cost reimbursement basis. (i.e. building maintenance).
3. Fiduciary Fund	▪ Account for assets held by a governmental unit in a trustee capacity. (Law Enforcement Fund)

Source Riley, Susan L , and Peter W Colby 1991 *Practical Government Budgeting* State University Press

[5] *"Number and Classification of Funds"* 1982. in *How Your Government Can Apply GAAP* Cleveland, Ohio: Ernst and Whinney. P. 52.

On June 11, 1999 U.S. government accounting regulators approved sweeping new bookkeeping rules that will require municipalities to disclose more detail about how they spend taxpayer money. Municipalities will be required to disclose in their annual reports details about the full cost of providing government services, such as fire protection, and water and sewerage services. Numerous municipalities will also have to disclose for the first time, the cost of their infrastructure assets, such as bridges and roads. This requirement includes infrastructure assets that are 25 years or older.

The rule, approved by the Government Accounting Standards Board, takes effect for state and local governments with $100 million or more in annual revenue for fiscal years beginning after June 15, 2001. Municipalities with annual revenue ranging between $10 million must adhere to the new standard for fiscal years beginning after June 15, 2002. Many states and municipalities however, can still mask their fiscal problems because they do not have laws on their books requiring them to follow GASB rules.

Underwriters are increasingly demanding that municipalities provide audited statements in accordance with these rules in order to issue bonds. Bond underwriters report that many municipalities report their financial numbers on a strictly cash basis with little double-entry bookkeeping. For example many states now issue bonds to finance bridges and other big projects, but don't show these assets on their balance sheets. Poor accounting rules have let governments hid ballooning debt by dispersing red ink in a number of entries on the balance sheet, making it difficult to track.

Such problems were behind Miami's budget collapse in fiscal 1996. At the time, faced with a burgeoning $70 million budget deficit, Miami was masking its problems by spreading its deficit over a number of entries in the balance sheet. The new GASB reporting model will make these kinds of situations more transparent to the public.

Source Wall Street Journal, Friday, June 11, 1999 P A4

D. Accrual and Cash Reporting

2.07 Many municipalities report events primarily on a cash accounting basis. That is, municipalities recognize expenses only as paid for and recognize income only as received. Many users of municipal financial reports look for internationally accepted accrual reporting as more revealing to the financial condition. Accrual reporting recognizes expenses incurred during the year, even if the expenses were not paid for and links the annual financial statement directly with changes in assets and liabilities in the municipalities financial position.

E. Cash Accounting

2.08 The simplest of all accounting procedures is to record cash transactions: how much is received; how much is paid out; and, how much is on hand at the bank. In effect, revenues and transfers are not recorded in accounts until cash is received, and expenditures (or expenses in proprietary funds) and transfers out are recorded only when cash is disbursed. The cash basis is not recommended by GAAP because it usually gives a misleading picture of municipal accounts. For example, cash received as a loan would be illustrated as revenue on the operating statement but not as a liability on the balance sheet. To correct for this kind of transaction, most cash accounting systems recognize not only cash, but also other assets and liabilities arising through prior cash transactions. The accounting correction however, does not alter the fact that at any point in time, outstanding obligations, in the form of contracts or purchase orders issued, are not reflected in the accounting records. Consequently, the available balance is overstated. This can lead to unwise local municipal expenditures and potential budget overspending[6].

F. Accrual Accounting

2.09 In order to understand what is actually happening in the municipal accounts, there must also be records which relate revenues and expenditures not to the time in which the cash is received or the disbursement made, but to the period for whose benefit the transaction occurs. Financial recording according to the benefit period, instead of the period in which cash moves, is known as accruing (accrual accounting). Under an accrual system, revenues are recorded when the charge is effective not when the cash is received[7]. Expenditures are recorded when the obligation is incurred, irrespective of when the disbursement is made[8].

2.10 Accrued revenues are usually expended on the assumption that the cash owing will be received. In fact, there may be loses. Taxpayers may dispute

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[6] All accounting systems must include such cash records, but cash journals and ledgers by themselves do not constitute accounting or budgeting systems. This is because cash records do not indicate the time period to which a given transaction relates. The cash from receipt of a prior year receivable cannot be distinguished from receipt of a revenue due for the first time, nor can disbursement on an expenditure account incurred this year be distinguished from a liability held over unpaid from the prior year.

[7] Obviously, there are relatively few revenues which can be accrued in the technical sense – property taxes, some franchise taxes, some fiscal aid. Revenues not susceptible to accrual are in practice booked as cash received. It is important that accurate distinction be made between current year, prior year, and future year transactions.

[8] The accrual basis is applied somewhat differently in proprietary funds (full accrual) than in governmental funds (modified accrual) because expenses are being measured in proprietary funds while expenditures are the focus in government funds. In brief, an expense is an amount of resources used up during the accounting period. Specifically, an expenditure is an amount of cash spent, or to be spent during an accounting period. Since governmental funds do not account for capital and debt (they are accounted for in fixed asset and long term debt account groups), expenditures, not expenses are measured. In contrast to government funds, the concern in proprietary funds is with net income. Full accrual accounting is used to record revenues when earned and expenses when incurred. In other words, expenses are recorded when a liability is incurred regardless of when an actual payment is made.

the amount owed, and the terms of grants and other transfer payments may be changed after the local government has already budgeted and spent the money. Likewise, expenditures when originally recorded may be over or under the amounts finally determined to be due. Contingencies should be provided for by means of reserves (contingency) accounts against ultimate losses and unrecorded liabilities[9].

2.11 There are two primary problems in municipal government finance. One is where the appropriations authorized by the local government are exceeded. The other is that revenues accrued and already spent during the year due may not be received, so that the local government is left with payables for which it has no offsetting assets. Expenditures can be contained by means of an encumbrance system. In other words, some expenditures are made according to schedules that permit ready determination of amounts and times (e.g. debt service, payroll).
The solution to the revenue problem is to prohibit expenditure of revenues unless and until the cash has been collected and is in hand. In some jurisdictions, this has been attempted by making public officials personally liable for expenditures incurred in excess of the cash received to make the payments.

2.12 A system that restricts expenditures to actual cash collections is called *cash basis budgeting.* Under this system, the budget anticipation of revenues is based on the cash collections reasonably likely to be realized, not on the revenue to accrue from taxes. Where the accrued revenue budget anticipates the revenues expected to be ultimately realized, the cash basis budget anticipates the revenue to be received in cash in the budget year. Under this system, receivables ordinarily are unencumbered and represent cash revenues for the year received.

2.13 Since the accounts must follow the budget, cash-basis budgeting requires that revenues be handled on the books similarly as in the budget. Under cash basis budgeting, revenues are accounted on a cash basis. This is only partially correct. It is misleading to assume that cash basis budgeting implies failure to account for receivables and to observe the distinctions between, past, current and future transactions. Under cash basis budgeting, receivables are accrued on the ledgers just as under accrued revenue budgeting, but only the cash collections are taken into current year revenues.

G. Financial Reporting Practices

2.14 There are three prominent objectives of financial reporting as promulgated by the Government Accounting Standards Board (GASB). These

[9] There are two means of establishing reserve accounts. One is to set-up these accounts at the beginning of the fiscal year, when the budget anticipations and appropriations are entered as controls for the budgetary accounts. The other is to establish or adjust reserves during, at the end, or after the close of the fiscal year.

objectives provide a good basis for evaluating local municipal government financial reporting practices.

1. Financial reporting should assist in fulfilling government's duty to be publicly accountable and should enable users to access that accountability[10]. This means that municipal financial reporting practices should provide information to determine whether current year revenues are sufficient to pay for the current years expenditures (or, financial services)[11].

2. Financial reporting should assist users in evaluating the operating results of the government entity for the year. Municipal financial reporting should provide information about the sources and uses of financial resources and about how the governmental entity financed its activities and met its cash requirements. Financial reporting should also provide information necessary to determine whether the jurisdiction's financial position improved or deteriorated as a result of the current year's operations.[12]

3. Financial reporting should assist users in assessing the level of services that can be provided by the local municipality and its ability to meet these obligations as they are due. This means that financial reporting should provide information about the financial position and condition of the local government, about the physical and non-financial resources that have useful lives that extend beyond the current year fiscal year.[13]

2.15 All municipalities should present a basic balance sheet and income statement. In addition, it would strengthen the usefulness of financial reporting if municipalities also present standardized general purpose summary financial statements.

H. Auditing Standards and Practices

2.16 Financial reporting must faithfully represent the financial condition and debt position of municipalities to be useful. Auditing is the systematic process of verifying the reliability of financial reports and the appropriateness of the underlying financial activities. By definition an audit is an examination of systems, procedures, programs and financial data. The end product of an audit is a report issued by an independent auditor describing how well a municipal

[10] Robert A. Reny, "Municipal Accounting," in Jack Rabin et al, editors, *Budget Management* (Athens, Georgia: Carl Vinson Institute of Government, 1983). P. 120.

[11] Municipal financial reporting should reveal whether resources were obtained and used in accordance with the entity's legally adopted budget, demonstrate compliance with other finance-related legal or contractual requirements, and should provide information to assist users in assessing public sector service efforts, costs and accomplishments.

[12] Ibid. p. 120.

[13] Ibid. p. 120.

government's financial statements describe its financial conditions and the results of its operations[14].

I. Service Cost Information

2.17 Financial statements can provide much of the information that municipal authorities need to assess the efficiency of local service delivery or that outside observers need in order to compare the costs of service delivery in one municipality with another (see performance indicators, below). In effect, service cost information becomes a fundamental management tool. Similarly, financial statements and balance sheets can and should be used to report the condition of municipal infrastructure facilities and the backlog of capital investment needs. Financial reports based on an accrual basis should examine the condition, serviceability, value, and depreciation of the municipality's capital assets.

III. THE MUNICIPAL BUDGET

3.01 In contrast with accounting records which are retrospective, a budget is generally a projection of future revenues and expenditures. At a minimum, a budget is used to control financial transactions. However, in addition to controlling financial transactions, a budget should also be used as a management and planning tool. Work load and service goal objectives are objectives are included in the budget document.

3.02 Because governments allocate services, budgets are needed to plan for and control the receipt and expenditure of monies to meet these ends. Each government's budgetary process is affected by numerous variables (e.g., the law; intergovernmental transfers; governmental structure; the regional and national economies; the nature of the service provided; and the personalities of the principal actors). These factors heavily influence the budget process and budgetary outcomes.

A. The Recurrent Budget

3.03 A traditional form of budgeting consists of separate estimates of recurrent revenue and expenditures and capital spending. The recurrent budget is concerned with the regular operation of services, including salaries, pension contributions, the purchase of short-life equipment, the costs of routine repair and maintenance, and the servicing of long-term debt (principal and interest). The capital budget is largely concerned with the creation of long-term assets (roads, pipes, schools, water treatment plants).

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[14] There are three principal types of audit: compliance audit; management audit; and, program audit. A compliance audit determines if the municipality has acted according to the applicable federal, state and local laws, regulations policies and procedures. A management audit determines if the municipality is performing in an economical and efficient manner, identifies problems, and makes recommendations for improvements. A program audit determines whether the intended results of a local government activity is being achieved.

3.04 In the traditional form of budgeting, regular revenues including own-source taxes, fees are credited to the recurrent budget. The only revenues that are credited to the capital budget are loans or grants that are specifically targeted for the development of capital projects or receipts from the sale of capital assets (e.g., land, buildings).

3.05 There are some unclear areas between capital and recurrent expenditure. Debt service is sometimes shown as capital expenditure as opposed to recurrent operating expenses. Debt service should be included in the recurrent budget if it is a charge against a recurrent tax or grant revenues. Vehicles and equipment (e.g., computers, printers) with medium-term useful life appear can appear in either the capital or operating budget.

B. Types of Operating Budgets

3.06 Three types of operating (recurrent) budgets are described in Table 1, below, including: i) the line item budget; ii) the performance budget; and, iii) the program budget. A budget may be a combination of more than one budget type. Normally, government budgets are planned and approved on a detailed line-item basis. However, actually spending may be controlled and managed on a broader less detailed level. Each type of operating budget, however, differs in the way in which funds are allocated for expenditures and in the orientation of the budget: control, management efficiency, or planning.

Table 1
Types of Operating Budgets

Budget Type	Characteristics	Criteria
Line-Item	▪ Expenditures and revenues are related to commodities	▪ Control
Performance	▪ Expenditures and revenues are related to workload	▪ Management Efficiency
Program	▪ Expenditures and revenues are related to public goals	▪ Planning/Impact

Source. The Urban Institute *Program Budgeting* 1999 and, Riley, Susan L , and Peter W Colby. 1991 *Practical Government Budgeting* State University Press.

C. Line-Item Budget

3.07 The line-item budget is a financial document that lists how much the local municipality will spend on every item that it uses. Cost categories include personal services, operating expenses, and capital outlay. These cost outlays are often further detailed in object codes. For example, personnel expenses can be further separated into salaries, retirement, and health insurance costs. Operating expenses can be subdivided to include such items as office supplies, printing, and utility costs. The cost category capital outlay includes office equipment, furniture and vehicles.

3.08 The primary orientation of a line-item budget is that of expenditure control and accountability. The line-item budget is relatively easy to prepare and illustrates how much money is appropriated to specific cost categories. While the simplest budget to prepare, the line-item budget does not provide any information regarding activities and functions of a program, department, or municipality. An example of a line-item budget is illustrate in Table 2, below. The line-item budget assists municipal officials in understanding how much they are spending on salaries, supplies, and maintenance, but does not reveal how much is being spent on the actual delivery of services. In order to determine the cost of service delivery, expenditures must be re-arranged into programs or activities.

Table 2
Example of a Line Item Budget
FY98-99 Expenditures

Item	Amount
01 Personal Services	$100,000
02 Supplies	$20,000
03 Insurance	$10,000
Subtotal	$130,000

D. Performance Budget

3.09 A performance budget allocates money to various programs within an organization but also details the service level on which the budget is predicated. The service level is identified by the use of performance measures. In addition to controlling costs, the primary orientation of the performance budget is that of improving the internal management of the program. A performance budget is illustrated as follows:

Table 3
Example of a Performance Budget
FY98-99

Road Maintenance Performance Measures	Amount
Paving Roads	
Miles to pave: 10 miles	
Cost per mile. $400,000 per mile	
Subtotal cost	$4,000,000
Resurfacing Roads	
Miles to resurface· 5 Miles	
Cost per mile: $150,000	
Subtotal cost	$750,000
TOTAL ROAD MAINTENANCE COSTS	$4,750,000

3.10 The primary advantage of the performance based budget is that it illustrates both the activities and service levels of local government. The relative service levels and funds spent on different activities show where the municipal priorities lie. In addition to providing information in assessing the quantity, quality, and productivity of the municipal budget, the performance budget also provides sufficient information for municipal officials to decide if the priorities are correct.

E. Program Budget

3.11 The program budget differs from the traditional line-item approach to preparing, reviewing, and presenting the budget. Rather than focusing on what the local municipality buys, a program budget allocates money to major program areas, focusing on the expected results of services and activities to be carried out. Program areas often utilized by government entities include public safety, public works, human services, leisure services, and general government. The emphasis of program project's is on the attainment of long-term local community goals.

3.12 Program areas are generally related to an organization's goals and often cross organizational lines. For example, public safety is considered to be a single program concern. Notwithstanding, public safety includes two separate program activities - fire and police protection.

3.13 The primary point of reference of program budgeting is that it allows municipal leaders to plan a budget in a manner that allows for improved decision making regarding the organization's goals. In a program budget, revenues and expenditures are linked to multi-year community goals and objectives. A program budget identifies the anticipated results and outputs of these investments. A program budget is illustrated in Table 4, below.

Table 4
Example of a Program Budget
FY98-99

Program		Amount
Public Safety		
Fire Protection		$2,000,000
Police Protection		$2,000,000
Subtotal		$4,000,000
Leisure Services		
Parks and Recreation		$1,000,000
Library Services		$1,000,000
Subtotal		$2,000,000
	TOTAL	$6,000,000

3.14 Both the program and performance budget use indicators to measure financial and operational performance, but the budgets have a different focus. A performance budget emphasizes management efficiency, whereas a program budget emphasizes the benefits that the local community gains from municipal expenditures.

The benefits of using program budgeting as a primary operating budget tool includes:

- Financial data are presented in a transparent format.

- Encourages a more coordinated and efficient government administration. And,

- Focuses the budget on the communities priorities and financial capabilities.

3.15 Ideally, a performance budget has measurable service objectives in terms of unit costs. In reality, the quality and reliability of performance information is sometimes not dependable.[15]

IV. MUNICIPAL REVENUES

4.01 Local municipal governments have two primary sources of revenue. The first are revenues that they collect themselves including local taxes, service charges, fees and licenses, rental income from buildings and facilities, interest income on municipal investments, as well as income from sales of municipal assets. The other major source of revenues include central government transfers and grants. In some countries, provincial governments or states may also provide transfers or grants to local municipal governments. Increasingly, central and provincial (or state) governments are reducing intergovernmental transfers and grants to local jurisdictions. As a result, it is essential for local municipal governments to review their level of financial self-sufficiency and to accelerate the growth of their own-source revenues.

A. User Charges

4.02 For efficiency reasons, charges should be levied on the direct recipients of public service benefits. The appropriate policy is to charge the correct (marginal cost) price. Water supply, sewerage, parking, toll roads, recreational facilities, and refuse collection are frequently the subject of municipal user charges. The common rationale when imposing service charges, include[16]:

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[15] Services are sometimes difficult to effectively measure or quantify. Further, local governments may not have sufficient staff to ensure that the performance data is accurate. Despite these obstacles, many services do lend themselves to evaluation that can be related to the budget including: water quality; sewerage; and, garbage disposal.

[16] McMaster, James. 1994. *Urban Financial Management A Training Manual.* The World Bank, Washington, D.C. , pg. 2.

- To recover costs so as to minimize the burdens to be placed on taxation (cost recovery);

- To maximize revenues, hoping to realize profits (charging what the market will bear); and,

- To control user demand[17].

4.03 The issue and experience of service charges in developed and developing countries is not a simple one. The prices charged seldom reflect economic efficiency rationale. The potential for improved user charge finance as a means of financing local government remains more potential than reality. In practice, the most important decisions in local government finance in most countries inevitably concern the design and implementation of local taxes and intergovernmental transfers[18].

B. Local (Own-Source) Taxes

4.04 In general, central governments set the taxation rules and generally take the best-yielding taxes for their own use. Local municipal governments do not have sufficient access to tax sources that would free them from dependence on intergovernmental transfers. Local municipal governments utilize three basic forms of local taxation: i) property tax; ii) local income tax; and, iii) taxes on expenditures.

Property Tax

4.05 Taxes on land and buildings are the most common form of direct revenue for local municipal governments. The ad valorem tax, or the property tax, is usually local government's largest single revenue source. Property tax revenues are normally general purpose revenues contributing to a broad range of municipal services, particularly physical infrastructure such as roads and drainage.

Income Tax

4.06 The principal alternative to property taxes found in many countries is some form of income tax. The local income tax is generally levied as a supplement to national income taxes. Income taxes are charges levied by a local jurisdiction against the income or wealth of a person or corporation. Since property taxes can be pushed only so far, if more local own-source revenue is

[17] Controlling user demand often applies to parking control and residential/industrial water use.
[18] The cost-of-service provision is at the center of questions regarding user charges. The present forms of municipal budgets, with inadequate cost-accounting treatment, do not readily lend themselves to efficient cost-of-service analysis. A move to program based budget structures combined with appropriate cost accounting techniques would greatly assist the issue of proper service charging.

desired, it makes sense to utilize a supplementary local income tax, particularly in large urban areas[19].

Other Local Own-Source Revenues

4.07 This category of local government revenues comprises a broad list of local sales taxes, royalties, entertainment taxes, licenses and permits, and vehicle taxes. These taxes are generally describes as indirect taxes because they are usually passed on by the payer to the end user. Indirect taxes can be described as follows:

- Licenses and Permits – include revenues derived from the issuance of local licenses and permits such as building permits, motor vehicle licenses, and other permit fees.

- Charges for Services – include the receipt of revenues stemming from such sources such as zoning fees, legal aid fees, and, water and sewerage charges.

- Fines and Forfeitures – include revenues received from fines and penalties imposed for the commission of statutory offenses, violations, and for neglect of official duties. Library fines and any other court fines are included in this revenue category.

- Miscellaneous Revenues – includes all revenue not categorized in any of the above revenue categories. Interest income, receipt from the sale of surplus equipment, rental income from public property, are examples of municipal miscellaneous revenue.

- Non-Revenues – are funds received by the government that are not new additions to assets of the government as a whole. These revenues include inter-fund transfers, bond/loan proceeds, and appropriated fund balances.

Intergovernmental Transfers

4.08 Regardless of what revenue sources are made available to local municipal governments, transfers from central to local governments will undoubtedly continue to constitute a important feature of local government finance. Intergovernmental revenues account for all revenues received from federal, state, or other local government sources in such forms as grants or shared revenues.

[19] If a national government sets out a strategy to maximize local government financial independence, experience suggests that it must provide the local government with access to national tax bases. Piggybacking a local income tax on the national income tax is a viable way to expand local own source revenue and to retain an element of national accountability.

4.09 There are a wide variety of structures for intergovernmental transfers. Some government transfers give local municipal governments a specified portion of the national tax revenues. Other national governments distribute funds not be formula, but through annual appropriations approved by the national legislature. A third variation of intergovernmental transfers is when central governments provide funds under specific categorical programs that can be used for specific types of projects. Good transfers should in principle be both transparent and predictable.

V. PUBLIC EXPENDITURES

5.01 The primary purpose of appropriations, and the accompanying expenditures, are classified by character, by function, by activity and by object. In brief,

- *Character* applies to the fiscal period. Appropriations, or expenditures chiefly incurred for the current period, are termed current expenses or expenses. Expenditures on account of prior years are usually represented by provisions for bad debt retirement, write-offs of uncollectibles, re-appropriation of surplus, prior deficits and adjustments of reserves. Deferred expenditures represent transactions of future benefit. They include the setting aside of funds for capital improvements, and other capital outlays, prepayments, and establishment of reserves for uncollected or uncollectible current period revenues.

- *Function* designates the stated purpose of the expenditure. For example, health and sanitation and public safety.

- *Activity* designates the work done and is the first subdivision of function. For example, garbage collection might be a subcategory of health and sanitation.

- *Object* designates the kind of goods and services whose acquisition is authorized by an appropriation. One classification scheme, for example, divides expenditures among operation, maintenance, interest, and other charges.

5.02 The customary form of local municipal budget is normally divided according to organizational breakdown of authority so that the amount allocated to each unit or subunit, is further divided into line-items by object of expenditure. Under more performance based budgeting, expenditures are grouped by programs serving major objectives to which a number of operating units contribute.

5.03 Since expenditures are accrued under both accrual budgeting and cash basis budgeting systems, there is no significant difference in the way appropriations are handled under either system. Reserve requirements are, however, calculated in different ways. There is also some evidence that maintenance of reserves and re-appropriations for prior years' deficits tend to be more carefully handled under a cash basis budgeting than under accrual budgeting.

5.04 Under accrual budgeting, reserves against revenue losses are for ultimate uncollectibles, while re-appropriations for prior years' deficits are for the accrued revenue deficiency. Both kinds of accruals are likely to be smaller than their cash basis accounting and budgeting counterparts. A general fund can accumulate a sizeable cumulative cash deficit and still have an accrued revenue surplus. Therefore, reserve and deficiency appropriations must be carefully handled under accrual budgeting if fund liquidity is to be maintained. Under cash basis budgeting, the focus is always on the cash position.

5.05 The provision for future years' benefits is primarily in appropriations for capital outlays, or capital improvements. It is generally agreed that the current year's contribution from current revenues to the capital improvement funds must be appropriated in the annual operating budget. Current account and capital improvement account should be kept separate in the budget (as in the ledgers).

A. Expenditure Control

5.06 Municipalities should closely monitor and control budget expenditures to minimize the potential of expenditure overruns (revenue shortfalls). Leaving budget overruns unchecked over the course of a fiscal year can greatly exacerbate their negative effects. Since municipalities have slightly more control over expenditures than revenues, they should closely control and monitor outlays.

5.07 Allocating funds to operating departments or sectors on a quarterly basis during the budget year can help municipal finance managers control expenditures[20]. It also enables the detection of budget overspending in a timely manner and prevents any fiscal gap from widening to the point where it becomes difficult to close. Quarterly allocations of funds also can foster more accurate operating department planning and more prudent use of quarterly budget projections in the planning phase.

5.08 To be effective, quarterly budget allocations must be made in conjunction with an aggressive cash flow management program and should be based on the analyses of at a minimum monthly reports measuring actual expenditures against budget forecast[21]. Expenditure control and cash flow management must be integrated through the use of at least monthly reports which can the following non-exclusive information list: i) actual expenditures; ii) budgeted expenditures; iii) comparison of expenditures as a percent (%) of the budget; and iv) unpaid expenditures. Comparing budgeted to actual

[20] Quarterly budget allocation is one method only for controlling (monitoring) expenditures. This method does present problems with respect to the execution of the capital budget.
[21] Cash budget information can be in real time while the budget account usual implies that the data can be presented in the following month.

expenditures on a at least a monthly and quarterly basis helps managers take prompt actions to curb overspending.

B. Forecasting Operating Results

5.09 Local government finances are somewhat disadvantaged, compared to national government or even private business finances. Unlike national governments which control money and credit, local municipal governments cannot inflate tax yields by inflating the economy. Further, unlike private business, local municipal governments cannot discontinue activities whose costs become unattractive. Because of these factors, local municipal government budgets should be examined for their conservative characteristics. The budget pressures likely to be revealed may, in general, tend to unbalance the budget, rather than produce surpluses. In forecasting local municipal government operating budgets, realistic questions concern what can go wrong and what has been done within the budget framework to prevent anything from going wrong.

5.10 There are a number of ways in which a local municipal government budget can be strengthened. Foremost is the conservative estimation of both revenues and expenditures. This means that in estimating revenues, real best estimates are used without straining to raise revenue estimates to avoid tax increases or having to consider appropriation cuts. Similarly, appropriations should be fixed at levels determined by the best estimates of available work, services, and price levels for the year. Budgets predicated on inflated revenue estimates and shaved appropriations may be only narrowly balanced under the best of conditions and are readily unbalanced by external pressures.

VI. THE CAPITAL BUDGET AND INVESTMENT PLANNING

6.01 The capital budget is largely concerned with the creation of long-term assets (roads, pipes, schools, water treatment plants). The capital budget details the local government's long-term capital improvement needs. Governments commonly establish a uniform and organized multi-year (5-year) capital investment plan (CIP) to outline the public facilities, infrastructure, and land purchases that the jurisdiction intends to implement during a multi-year period given the availability of funds.

A. Components of the Capital Budget

6.02 The capital budget process is usually a multi-step process, including:

- Inventory of Capital Assets;
- Developing a Capital Investment Plan (CIP);
- Developing a Multi-Year CIP;
- Developing the Financing Plan; and,

- Implementing the Capital Budget.

6.03 A central element of the capital budget and the multi-year capital investment plan is the financial analysis aimed at minimizing the financial effect of investment project(s) on the local budget, while maximizing the impact or returns of the project in addressing the community's needs. The capital budget process is not only a management tool for guiding the expenditure of public resources over an extended period of time, but also represents a commitment by the local government to provide its community with the desired and required level of service.

B. Inventory of Capital Assets

6.04 Many local municipalities do not have an adequate up-to-date inventory of existing capital infrastructure facilities including the date of construction, cost, and current conditions. Further, many local municipalities do not have ongoing programs for regularly examining the quality and level of service provided by the infrastructure facility (e.g. water/sewer lines, treatment plants, roads, sanitary landfills, public buildings). The first step in the development of a capital budget is to inventory and provide an assessment of the current condition of all infrastructure facilities.

6.05 A systematic process for capital investment planning can be built around a very simple information base that confers the need for new or replacement infrastructure. Table 6, provides a sample format that could be utilized to complete a preliminary assessment of a jurisdiction's existing facilities.

Table 6
Capital Facilities Inventory

FACILITY	BUILT OR ACQUIRED	CONDITION	COVERAGE	USE	SIZE / QUANTITY	REPLACE-MENT COST
Fire Station	1986	Good		Moderate		$2.3 million
Water Treatment Facility	1956	Poor	25%	Heavy	50,000 liters/day	$6.7 million

6.06 The inventory and condition of the infrastructure will facilitate the tasks of local government in determining the need for renewal, replacement, expansion, and even retirement of current inventory. The current level of services usually provides the platform for determining future investment spending. For example, the water system may provide direct household connections to 65% of the population and have water loss rates of 40%. In the above example, a local government may determine a middle ground between investing in resources to reduce the water loss rate or using the community's investment resources for extending water service coverage. More detailed analyses of the level and quality of service should be carried out as part of specific capital project analysis. However, at a preliminary review stage, it may only be necessary to use a few indicators of level of service or coverage levels to make decisions whether to extend or upgrade coverage of an infrastructure network. From this existing inventory of investment needs, the municipality can examine the areas of greatest need with respect to existing infrastructure programs and can add potential capital investment projects.

C. Developing a Capital Investment Plan

6.07 Decisions used to undertake capital investment are motivated by several criteria, including:

- Degree of urgency of the project;
- Benefits derived from the project;
- Cost and financial impact of the project; and,
- Acceptability to the local constituency.

6.08 In developing the capital investment plan, it is important to establish goals for the level and quantity of service in terms of measurable indicators. For example, a local jurisdiction may have water service coverage for 60% of its citizens. The highest priority of the community may be to extend the water coverage to 100% of the community by the year 2010.

6.09 The use of service goals as a motivational instrument underpinning the investment plan enables jurisdictions to determine whether infrastructure should be replaced, upgraded/extended, or whether entirely new investment should be undertaken. The development of a multi-year investment plan usually begins with the inventory of existing assets, and the service provided with these existing assets, and compares this inventory and level of service provided to the jurisdictions desired service goals. The output at this stage is a list of capital investment projects required to meet the jurisdiction's service goals and a preliminary priority list of when those projects should be started and completed to meet those goals.

D. Developing a Multi-Year CIP

6.10 Based on preliminary project cost estimates and the time schedule established by technical studies, the initial priority list of projects may have to be re-prioritized, and revised annually to establish a preliminary multi-year "rolling" investment plan[22]. This multi-year plan establishes the time schedule and costs for all capital investment projects under consideration. The plan should include

[22] The multi-year investment plan should be for a minimum of 5-years and be revised annually.

total additional costs to complete these projects beyond the 5-year recommended period.

6.11 The benefits of multi-year horizon capital investment plan includes:

- Assisting the jurisdiction in programming scarce financial resources.
- Allowing the jurisdiction the opportunity to select alternative (cost-effective) solutions.
- Allowing the jurisdiction to engage in prudent borrowing and other public debt policies.

E. Developing the Financing Plan

6.12 In financial planning, the local municipality must investigate the financing options and the fiscal feasibility of funding the various project requests. The most critical stage of the capital investment program consists of conducting detailed financial analysis of the municipality's capacity and ability to undertake the investment program. The number of public improvements that a local government can finance generally depends on the following non-exclusive list:

- The level of recurring future operating expenditures;
- The cost recovery elements for individual projects and the potential for the public investment to be revenue generating;
- The availability of cost sharing by different tiers of government (or public private partnerships); and,
- Debt structures and instruments (debt-carrying capacity).

F. Implications for Recurring Expenditures

6.13 A detailed analysis of increased investment spending on current and future operating expenditures is a cornerstone in the development of the capital budget. Even without any additional capital spending, recurrent operating expenditures may be accelerating quickly such that it may be inappropriate to engage in additional capital spending until expenditures are brought under control. In addition, all current account transfers including a separate identification of costs to be transferred to the current operating budget including project design costs, future operation and maintenance spending, and all financing charges must be integrated into the future recurrent expenditure account.

6.14 For each operating agency responsible for the operation and maintenance (O&M) of the capital infrastructure, the necessity of additional current and future expenditures to maintain the new capital facilities should be identified so that the impact on the department (and, jurisdiction) budget can be identified. The eventual impact on the recurrent expenditure budget may significantly influence the decision whether to move forward on certain capital investment projects or not. One of the most common and substantial failures of capital planning and budgeting has been the failure to provide for O&M, with the result that newly built capital facilities are allowed to deteriorate, or in extreme cases, go unutilized because the operating agency refuses to absorb the budgetary burden of operations. No project should be approved unless O&M costs have been estimated and the line agency responsible for operations has confirmed that it both accepts the cost estimates and is willing to assume O&M obligations.

6.15 Repair and replacement investment, in contrast, often is designed to generate operating savings by installing new facilities that are less costly to maintain or by substituting one-time repairs for annual maintenance. Such savings to the annual operating budget should also be included at the time of project preparation. The O&M costs or saving associated with a project not only need to be recognized in calculating the consequences of the investment budget for the recurrent budget, but should be a factor in project selection.

G. Cost Recovery and Revenue Generating Elements For Capital Projects

6.16 The basic approach to capital investment planning assumes that all capital investment projects can be rank-ordered in terms of priority. Starting from the top of the priority list, municipal officials can work their way down the list until they exhaust the financing resources available to their jurisdiction. The reality of most capital investment budgets deviates from the above approach.

6.17 Many investment projects are fully or partially financed from dedicated revenue sources. Further, a municipality's general funds are free to be allocated as local authorities prefer. The remainder of the capital budget consists of projects financed by specific (dedicated/restricted) grants or international funding sources which are restricted to certain purposes[23]. Properly designed, a system of dedicated user fees, benefit charges and benefit-related taxes can greatly enhance the efficiency of local capital allocation[24].

6.18 At this stage of the capital/investment budget process, capital programming is an iterative process. No revenue constraint is completely fixed. Confronted with pressing community investment demands, local government authorities have the option of relaxing the capital budget constraint by raising additional public revenues, borrowing capital funds, or re-allocating funds from the operating budget to the investment budget. In approaching revenue mobilization for capital spending:

[23] Examples include revenues from water tariffs which must be used for water system improvement.

[24] The earmarking of general revenues from particular kinds of capital investment projects may bias sectoral investment choices, thereby impeding the capital budget, project priority-setting process.

- The first priority is to collect revenues that are due from the existing tax structure.

- User fee levels should be increased such that they cover the incremental costs of service delivery.

- Through consultation with citizens – the local jurisdiction should be given an indication of how much investment the community is willing to finance.

H. Implementing the Capital Budget

6.19 In the final implementation stage, final development and adoption of the capital budget occurs. The multi-year capital investment plan should include the following components:

- All relevant project/investment cost details including construction and financing costs (and, any other costs attributed to project development);

- The annual capital cost disbursement schedule including direct construction payments but all principal/interest repayment for debt financing[25]; and,

- All current account transfers including a separate identification of costs to be transferred to the current operating budget including: project design costs; future operation and maintenance spending; and all fees and interest charges required for successful project development[26].

6.20 At this final stage of development, the completed capital budget should have the full cost implications for all proposed projects; the annual capital costs (or annual financial value) of all proposed investment projects; and, the current budget implications of each project. For the local legislative body and constituency, the capital budget is an important management tool in that it:

- Allows the local jurisdiction and constituency to be better informed on the need for short- and long-term capital expenditures; and,

- Allows the local jurisdiction and constituency to consider and make more informed recommendations with respect to future capital spending.

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[25] An alternative to incorporating debt service (interest plus principal) into the multi-year capital budget, is to include only a summary line item for total project amortization rather than a case-by-case amortization or debt service schedule.

[26] The decision to include all fees and interest charges as a transfer to the re-current budget or as a capital expenditure depends on the accounting approach pursued. In many consolidated financial statements' interest and principal are considered as capital costs. Alternatively, many jurisdictions consider interest as a recurrent cost and principal as capital expenditure. There is no rule-of-thumb as to which is the preeminent approach. Preference, however, is generally expressed for carrying interest into the (re)current operating budget rather than as a capital expenditure. The rational for this is that principal represents the actual investment cost whereas interest and associated fees represent the costs associated with a particular method of financing.

6.21 The normal procedure for the implementation of the investment plan is that the jurisdiction adopts the capital budget, incorporating it as a separate feature of the total annual municipal budget. The remaining years of the program are accepted by resolution, subject to annual revision and authorization. It is essential that when the municipality adopts a multi-year capital spending project/program, that the expenditure accrue as a future liability. In other words, this capital spending should be accounted for on the municipal balance sheet as *expenditures committed for future years.*

VII. BUDGET PERFORMANCE INFORMATION AND MEASUREMENT

7.01 Recent attention to public management reform and the role of performance based budgeting is not new. Australia and New Zealand, for example, have developed very extensive performance based budgets and processes. A full explanation of these reforms is beyond the scope of this section, but the major characteristics of these reforms particularly as they relate to performance indicators in budget systems are worth documenting. Campos and Pradhan (1996) reviewed the reforms in Australia and new Zealand in some detail and list the following shared principles related to budget reforms and the institutionalization of performance standards in budgets:

- Budget transparency is key. In Australia, for example, there is a requirement for three-year forward estimates and for reporting of budgetary versus actual budgetary allocations.

- Decentralization of operating functions. In many instances, there has been a substantial devolution of management functions to operating-line agencies to perform their tasks. Under a practice known as portfolio budgeting, line agencies are given the responsibility for setting priorities, identifying spending and savings measures necessary to meet aggregate fiscal targets which are set at the center.

- Each municipality is committed to particular fiscal targets and institutes measures that enforce the achievement of these targets.

7.02 As illustrated in Campos and Pradhan (1996), the primary difference between the Australia and New Zealand performance based budget frameworks is a tradeoff between a focus on outputs and a focus on outcomes. For example, in New Zealand, the focus is on technical efficiency in the delivery of outputs, whereas in Australia the focus is on outcomes (i.e., the impact of outputs on beneficiaries)[27].

7.03 The reason(s) for the diverse paths are largely due to the underlying conditions previous to the reforms. In New Zealand, the pre-reform state was

[27] Campos, Ed and Sanjay Pradhan. P. 29. *The Impact of Budgetary Institutions on Expenditure Outcomes. Binding Governments to Fiscal Performance.* 1996. The World Bank.

swollen and characterized by substantial budget overspending. Thus, an important output of the reforms was the substantial privatization of public sector services. In New Zealand, performance is based on formal accountability mechanisms and sanctions.[28] Australia was not perceived to have a significantly distended public sector. Notwithstanding, there was a significant desire to identify budgetary savings. As a result, operating line agencies were given significant discretion to identify and implement management processes to meet specific savings targets. The budget process has evolved into one where political leaders set strategic priorities. Operating line managers are then given considerable discretion to manage their own agencies and programs to achieve the intended outcomes. In the Australian system there are no formal output based contracts. Public accountability is achieved through performance reporting and evaluations.

A. The Municipal Management Plan

7.04 Modernizing municipal budgeting practices implies a shift away from control orientation and budgeting inputs to focus on outcomes (results) and accomplishments. Municipal budgeting is such a complex process that budgets are usually a combination of line-item, program or performance budgets. The primary objective is to make the budget process more efficient and effective irrespective of the type of budget. One of the tools used to achieve this is the management plan. The municipal management plan should illustrate the issues confronting the various departments and line-agencies, and, should clearly state the mayor's and municipal council's direction.

7.05 Municipal management planning includes the formulation of long-term objectives and short term goals, priority setting, elaboration of plans, and control and supervision of budget execution from a qualitative as well as quantitative perspective. The municipal management plan should include:

- Mission statement;
- Description;
- Accomplishments and Achievements;
- Goals;
- Objectives; and,
- Performance Indicators.

7.06 The local government must define its own local requirements and develop strategies to meet its goals and objectives within the confines of national laws and policies. Municipal operational line managers should be held

[28] Ibid. p. 30.

accountable for delivery of service and program performance. In effect, when the municipality develops its management (strategic) plan it must focus on results of its activities through performance management. This requires knowing the real cost of providing a service, the demand for the service, and the results achieved by the service.

B. The Budget and Public Sector Performance

7.07 Performance information is primarily a management, transparency and financial accountability tool rather than a mere budgetary instrument. Effective and efficient service delivery requires performance management.[29] In performance management, the municipality establishes service objectives and monitors performance towards the attainment of those objectives.

7.08 How can it be determined that a local government's budget system is supportive of performance. A listing of characteristics of an effective budget has been offered by Meyers (1996).

[29] Performance management implies the planning, monitoring, and measuring of service performance.

Table 7
Characteristics of an Effective Budget

Term	Characteristic
Accountability	▪ Detailed controls should be established which have the goal of ensuring that policy directives are carried out by managers, contractors and all concerned parties.
Comprehensiveness	▪ Includes all uses of government's financial resources
Constraint	▪ Contains limitations on the amount of money that need be acquired by government
Cooperation	▪ Budgeting should exist in harmony with other decision processes and should not be dominant.
Honesty	▪ Contains unbiased projections
Judgement	▪ Encourages participants to seek the most effect at the least costs
Legitimacy	▪ The budget process should reserve important decisions to legally appropriate authorities
Perception	▪ Considers both near- and long-term
Responsiveness	▪ The budget must adopt policies that match public preferences
Timeliness	▪ A budget process should complete regular tasks when expected
Transparency	▪ The budget and budget procedures should be understood by participants and outside stakeholders.

Source Meyers, Roy T , 1996. *Is There a Key to the Normative Budgeting Lock,* The World Bank, Washington, D C

7.09 Some of these characteristics for an effective budget relate primarily to the process of budget prioritization (comprehensiveness, perception). Whereas other characteristics are related almost exclusively to operational efficiency (cooperation, timeliness). These standards, however, do not in general align themselves to clean separations.

7.10 Of all the characteristics of budget systems in many local economies that conspire against performance, perhaps the most crucial are shown in Table 8, below.

Table 8
Characteristics That Adversely Impact Budget Performance

Term	Characteristic
Extrabudgetary Funds	▪ Extrabudgetary funds do not force tradeoffs between competing priorities. Extrabudgetary funds generally circumvent central controls, thereby violating the comprehensiveness standard
Earmarked Funds (Earmarking)	▪ Earmarked funds are dedicated to particular uses or purposes. Agencies with earmarked funds may have little or no incentive to economize Earmarking may impede the government's ability to be flexible in managing its budget or in allocating resources.
Unpredictability	▪ Inaccurate budget estimates, arbitrary budget cuts, and non-timely fund disbursements will create substantial budget unpredictability.
Unreliable Information	▪ Inaccurate and unreliable information will conspire against enhancing budget performance.

Source. Meyers, Roy T , 1996 *Is There a Key to the Normative Budgeting Lock,* The World Bank, Washington, D C

7.11 In order for an enabling environment to take place, it is important to diagnose the flows in the current budget system and to develop a strategy for correcting potential flaws. For example, developing methodologies to more accurately predict future financial flows and bringing more activities into the budget will contribute to better operational performance.

C. Performance Measurement

7.12 Local government performance is of primary concern to every citizen in the community because there is an expectation that all local government resources are to be used efficiently in providing the highest level of public services. In turn, the local government has the responsibility to ensure that the programs that it provides meet their stated objectives and are cost effective. By measuring the level, efficiency, and outcome of a program's efforts, performance indicators can guide local government resource allocation decisions and communicate to the community the goals, objectives and effectiveness of public programs.

7.13 Nayyer-Stone (1999) considered four primary types of performance indicators: input, output, outcome, and efficiency. Table 9, below, defines the four primary types of performance indicators. In general, input indicators address the amount of resources used in providing a service, whereas output indicators describe the activities undertaken in providing a service. An advantage in using input/output performance measures is that the data is more readily available and they are generally easier to define. However, input/output indicators only provide limited insight into the question of whether the program is achieving the goals for which it was designed.

7.14 Outcome/effectiveness indicators are used to evaluate the quality and effectiveness of public services. Outcome/effectiveness indicators are generally measured in terms of the number of people served and the quality of the service delivered. For example, a relevant outcome indicator is the number of crimes committed per capita. Outcome indicators provide an indication of how effectively community services are provided. Outcome/effectiveness indicators are sometimes difficult to use due to the inability to determine a direct correlation between the service provided and the results measured, and they are generally time consuming measurement techniques.

Table 9
Performance Indicators

Type of Indicator	Definition	Example
Input Indicator	Measure of Resources Employed	▪ Equipment Needed ▪ Employees Required ▪ Supplies Used
Output Indicator	Quantity of Service Provided	▪ Number of projects ▪ Number of classes ▪ Number of people served
Effectiveness/outcome Indicator	The degree to which the intended objection of the service is being met.	▪ Percentage increase in employment ▪ Decrease in crime rate
Efficiency Indicator	Cost per unit of output	▪ Cost/liter of water delivered by household

Source Adapted from Harry P Hatry, 1977, *How Effective are your Community Services?* Washington, D.C. The Urban Institute

7.15 A final type of indicator is efficiency, which relates inputs to units of output or outcome. For example, the cost per liter of water delivered to a household, or cost per ton of garbage collected. When efficiency indicators are used over time, they provide evidence of productivity trends. A detailed description and analysis of municipal financial indicators is provided in Appendix B.

D. Use of Performance Measures

7.16 Performance measures can be used in several ways, including:

- Controlling costs – enabling municipal managers to identify costs which are much higher or lower than average and determine why these differences exist.

- Comparing processes – analyzing performance of a services performed with a particular technology, approach or procedure.

- Maintaining standards – monitoring service performance against established performance targets or benchmarks.

- Comparing sectors – comparing costs of public-service sector delivery to costs of private-sector delivery of the same type of service.

VIII. CONCLUSION

The principal overarching themes in budget reform over the past decade have been budget restraint and performance. Improvement of a budget system should be seen as part of an integrated strategy of better public sector reform. The budget system may need to be reformed to create an enabling environment for performance – providing for greater transparency, accountability, flexibility, and predictability. At the same time, accounting systems may need to be revised so that they can provide real cost information by program, and can support the accountability that is necessary for improved performance.

Appendix A: Twelve Accounting Principles

Many local governments follow generally accepted accounting principles (GAAP) as set out by the Governmental Accounting Standards Board (GASB). The National Committee on Governmental Accounting (NCGA) revised the Governmental Accounting, Auditing and Financial Reporting (GAAFR) under what is known as Statement No. 1. The *Twelve Accounting Principles* under statement number 1 are as follows[30]:

Accounting and Reporting Capabilities

1. A governmental accounting system must make it possible both: (a) to present fairly and with full disclosure the financial position and results of financial operations of the funds and account groups of the governmental unit in conformity with generally accepted accounting principles; and, (b) to determine and demonstrate compliance with finance-related legal and contractual provisions.

Fund Accounting Systems

2. Governmental accounting systems should be organized and operated on a fund basis. A fund is defined as a fiscal accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations.

Types of Funds

3. The following types of funds should be used by state and local governments:

Governmental Funds

(1) The General Fund – to account for all financial resources except those required to be accounted for in another fund.
(2) Special Reserve Funds – to account for the proceeds of specific revenue sources (other than special assessments, expendable trusts, or for major capital projects) that are legally restricted to expenditure for specified purposes.
(3) Capital Project Funds – to account for financial resources to be used for the acquisition or construction of major capital facilities (other than those financed by proprietary funds, Special Assessment Funds, and Trust Funds).
(4) Debt Service Funds – to account for the accumulation of resources for, and the payment of, general long-term debt principal and interest.
(5) Special Assessment Funds – to account for the financing of public improvements or services deemed to benefit the properties against which special assessments are levied.

Proprietary Funds

(6) Enterprise Funds – to account for operations (a) that are financed and operated in a manner similar to private business enterprises – where the intent of the governing body is that the costs

[30] Government Finance Officers Association, governmental Accounting and Financial Reporting (Chicago: GFOA, 1980).

(expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges; or (b) where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.

(7) Internal Service Funds – to account for the financing of goods or services provided by one department or agency to other departments or agencies of the governmental unit, or to other governmental units, on a cost-reimbursement basis.

Fiduciary Funds

(8) Trust and Agency Funds – to account for assets held by a governmental unit in a trustee capacity or as an agent for individuals, private organizations, other governmental units, and/or other funds. These include (a) Expendable Trust Funds, (b) Nonexpendable Trust Funds, (c) Pension Trust Funds, and (d) Agency Funds.

Number of Funds

4. Governmental units should establish and maintain those funds required by law and sound financial administration. Only the minimum number of funds consistent with legal and operating requirements should be established, however, since unnecessary funds result in inflexibility, undue complexity, and inefficient financial administration.

Accounting For Fixed Assets and Long Term Liabilities

5. A clear distinction should be made between (a) fund fixed assets and general fixed assets and (b) fund long-term liabilities and general long-term debt.

i. Fixed assets related to specific proprietary funds or Trust Funds should be accounted for through those funds. All other fixed assets of a governmental unit should be accounted for through the General Fixed Assets Account Group.
ii. Long-term liabilities of proprietary funds, Special Assessment Funds, and Trust Funds should be accounted for through those funds. All other unmatured general long-term liabilities of the governmental unit should be accounted for through the General Long Term Debt Account Group.

Valuation of Fixed Assets

6. Fixed assets should be accounted for at cost or, if the cost is not practicably determinable, at estimated cost. Donated fixed assets should be recorded at their estimated fair value at the time received.

Depreciation of Fixed Assets

7. a. Depreciation of general fixed assets should not be recorded in the accounts of governmental funds. Depreciation of general fixed assets may be recorded in cost accounting systems or calculated for cost finding analyses; and accumulated depreciation may be recorded in the General Fixed Assets Account Group.

b. Depreciation of fixed assets accounted for in a proprietary fund should be recorded in the accounts of that fund. Depreciation is also recognized in those Trust Funds where expenses, net income, and/or capital maintenance are measured.

Accrual Basis in Governmental Accounting

8. The modified accrual or accrual basis of accounting, as appropriate, should be utilized in measuring financial position and operating results.
a) Governmental fund revenues and expenditures should be recognized on the modified accrual basis. Revenues should be recognized in the accounting period in which they become available and measurable. Expenditures should be recognized in the accounting period in which the fund liability is incurred, if measurable, except for unmatured interest on general long-term debt and on special assessment indebtedness secured by interest bearing special levies, which should be recognized when due.
b) Proprietary fund revenues and expenditures should be recognized on the accrual basis. Revenues should be recognized in the accounting period in which they are earned and become measurable; expenses should be recognized in the period incurred, if measurable.
c) Fiduciary fund revenues and expenses or expenditures (as appropriate) should be recognized on the basis consistent with the fund's accounting measurement objective. Nonexpendable Trust and Pension Trust Funds should be accounted for on the accrual basis; Expendable Trust Funds should be account for on the modified accrual basis. Agency Fund assets and liabilities should be accounted for on the modified accrual basis.
d) Transfers should be recognized in the accounting period in which the interfund receivable and payable arise.

Budgeting, Budgetary Control, and Budgetary Reporting

9. a. An annual budget(s) should be adopted by every governmental unit.
b. The accounting system should provide the basis for appropriate budgetary control.
c. Budgetary comparisons should be included in the appropriate financial statements and schedules for governmental funds for which an annual budget has been adopted.

Transfer, Revenue, Expenditure and Expense Account Classifications

10. a. Interfund transfers and proceeds of general long-term debt issues should be classified separately from fund revenues and expenditures or expenses.
b. Governmental fund revenues should be classified by fund and source. Expenditures should be classified by fund, function (or program) organization unit, activity, character, and principal classes of objects.
c. Proprietary fund revenues and expenses should be classified in essentially the same manner as those of similar business organizations, functions, or activities.

Common Terminology and Classification

11. A common terminology and classification should be used consistently throughout the budget, the accounts, and the financial reports of each fund.

Interim and Annual Financial Reports

12. a. Appropriate interim financial statements and reports of financial position, operating results, and other pertinent information should be prepared to facilitate management control of financial operations, legislative oversight, and where necessary or desired, for external reporting purposes.
b. A comprehensive annual financial report covering all funds and account groups of the governmental unit – including appropriate combined, combining, and individual fund statements;

notes to the financial statements; schedules; narrative explanations; and statistical tables – should be prepared and published.

c. General purpose financial statements may be issued separately from the comprehensive annual financial report. Such statements should include the basic financial statements and notes to the financial statements that are essential to fair presentation of financial position and operation results (and changes in financial position of proprietary funds and similar Trust Funds).

Appendix B: Municipal Financial Indicators

This section explains the concept and structure of municipal financial performance indicators. Indicators express the financial information of a municipality as a ratio or percent obtained by dividing by one set of financial data or another. For example, an indicator can express net operating results as a percent of recurring revenue. Financial performance indicators are a useful tool for comparing financial information of one municipality over a multi-year period. Financial indicators also make it possible to compare one municipality to another. It is the ability to provide comparison over time that makes performance indicators a useful financial tool.

Municipal Financial Indicators

The indicators used in municipal financial analysis methodology are grouped into several categories that look at revenues, expenditures, net operating results, actual to budget results, relative growth, annual debt service, liquidity and outstanding debt. The calculation of these indicators use the basic data include in the standard municipal income and expense balance sheet reports. Further, non-financial information such as number of municipal employees, population, and number of households may also be used in municipal financial analysis.

Table 10, below, provides a list of financial indicators and how they can be used in municipal financial analysis. The indicators are compared against benchmarks. A benchmark is a target of performance which is based on an industry standard or in the absence of a standard, on proven historical trends or comparative data. The benchmarks do not represent absolute global (or World-wide) standards but rather provide an relative indication of the financial strength of the municipality[31].

[31] The Finance Manager should use only a smaller subset of the illustrative ratios indicated in Table 10. Further, it should be noted that there is no single framework of financial benchmarks. Table 10 is an illustrative examples of benchmarks, but do not represent any globally accepted standards.

Table 10
Municipal Financial Characteristics

Indicator	Benchmark - Strong	Benchmark - Weak
Revenues		
Recurring Revenue/Total Revenue	> 65%	< 50%
Local Revenues/Recurring Revenues	> 33%	< 25%
State Operating Subsidies / Recurring Revenues	< 33%	> 50%
Proceeds from Asset Sales / Total Revenues	< 2%	> 5%
Expenditures		
Total Expenditures Per Capita	N/a	N/a
Operating Expenditures Per Capita	N/a	N/a
Operating Expenditures / Total Expenditures	N/a	N/a
Capital Investments / Total Expenditures	N/a	N/a
Net Results		
Total Expenditures / Total Revenues	<95%	> 100%
Operating Expenditures / Recurring Revenues	< 95%	> 100%
Actual to Budget Performance		
Actual Recurring Revenues / Budgeted Recurring Revenues	< 110%	> 125%
Actual Operating Expenditures / Budgeted Expenditures	< 110%	> 125%
Actual Capital Investments / Budget Capital Investments	< 110%	> 125%
Relative Growth		
Change in Recurring Revenues / Change in Total Revenues	> 100%	< 100%
Change in Operating Expenditures / Change in Recurring Revenues	< 100%	> 100%
Liquidity		
Notes and Accounts Payable (a/p) / Recurring Revenues	N/a	N/a
Short Term Assets / Short Term Liabilities	> 100%	< 100%
Overall Surplus / Recurring Revenues	> 5%	< 0%
Outstanding Debt		
Long Term Debt / Total Assets	N/a	N/a
Long Term Debt / Population	N/a	N/a
Annual Debt Service		
Total Annual Debt Service / Recurring Revenues	< 5%	> 15%
Interest Payments / Recurring Revenues	< 5%	> 10%
Total Annual Debt Service / Cash & Short Term Financial Assets	<60%	> 75%

Source. Abrahams, Mark , and Francis Conway, et al *Credit Finance Analysis Handbook for Municipalities in the Czech Republic* 1996. Washington, D C The Urban Institute And, ICMA 1994 *Evaluating Financial Conditions – A Handbook for Local Governments* Washington, D C

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