chapter 6

Municipal budgeting and fiscal management

Many people choose to run for political office because they want to make positive change in their community. It quickly becomes apparent that nearly all changes to city policy require changes in the city budget. So to be effective, an elected official must understand the budget process.

The city budget

The city's operating budget is a city's road map throughout the year and one of the main policy actions of the council. The budget serves as:

- A reflection of the city's priorities and policies;
- Legal authority for city officials to incur and pay expenses;
- A system for allocation of funds to different areas; and
- A document that establishes control over how much money may be spent.

In many cities, the budget has evolved from a document composed of a bunch of numbers to one that reflects the city's overall direction. Budgets can include mission statements, goals, and objectives that convey the city's vision to residents. In the budget, elected officials can explain their reasons for allocating resources in the manner they do. It can also be an evaluation tool, comparing commitments made in the previous year's budget with actual accomplishments.

State law dictates some of the major steps in the budget preparation process and in the timing of budget decisions. Be sure you pay attention to these important steps.

MRSC sample budget calendar – Cities and towns

The annual budget preparation procedures and deadlines for cities are found in chapter 35A.33 RCW (code cities) and chapter 35.33 RCW (all other cities and towns except Seattle) and outlined below.

Most of the pre-budget items listed below are recommendations only and are not required by statute. The rest of the items are based on statutory deadlines; cities and towns can take these steps earlier than listed or adopt different deadlines for some of these steps by ordinance or charter. It is recommended that each city and town develop a timeline that best meets its needs, ensures compliance with the statutes, and provides sufficient time to prepare this vital financial plan.

For examples of budget preparation calendars adopted by cities and towns, see MRSC's City and Town Budget Calendars. For a detailed explanation of the budget requirements, as well as some helpful practice tips, see MRSC's City and Town Budget Procedures.

Pre-budget Items Hold council retreat. Update and/or adopt financial policies. Conduct public hearings for capital facility plan updates. Public forums or community outreach (community priorities). Mayor/Manager communicates budget objectives to staff.	**March - August**
Sept 9: Budget request to all department heads. **Sept 9–22:** Department heads prepare estimates of revenues and expenditures. Clerk prepares estimates for debt service and all other estimates. **Sept 23:** Budget estimates from department heads filed with clerk. **Sept 25:** Implicit price deflator calculated (only applies to cities of 10,000+ population)	**September**
Oct 1: Clerk provides estimates filed by department heads to mayor/manager showing complete financial program. **Oct 7:** Mayor/Manager provides council with estimates of revenues from all sources, including estimates prepared by clerk for consideration of setting property tax levy. **Mid-Oct to Mid-Nov (suggested):** Required public hearing on revenue sources including possible increases in property tax.	**October**
Nov 2: Mayor/Manager prepares preliminary budget and budget message. Files with clerk and council. **Nov 1–18:** Publication notice of preliminary budget and final hearing. **Nov 1–25:** Public hearing(s) on preliminary budget. Public hearing on revenue sources for levy setting. **Nov 21:** Copies of budget available to public. **Nov 30:** Property tax levies set by ordinance and filed with the county	**November**
Dec 2: Final budget hearing. **Dec 31:** Budget adoption deadline.	**December**

Staying up to date

Most cities set their budget on an annual basis (or every other year for cities using a biennial budget). Budgets can be affected by new state or federal legislation, voter-approved initiatives, and/or court rulings. MRSC's *Budget Suggestions* publication is released annually to help cities understand legal changes that could affect the city budget. AWC's *Legislative Bulletin* provides ongoing updates about proposed legislation that could also affect city budgets.

Budgeting guidelines for elected officials

1. Adopting the annual budget is generally the most important issue to be addressed. Each city must adopt an annual (or biennial) budget; without doing so, the city cannot expend resources.
2. The budget should reflect the community's priorities, and elected officials should recognize that those priorities change over time.
3. Virtually all small cities engage in "incremental" budgeting. The base tends to be fixed, and annual budgets generally only add or subtract programs and levels of expenditures at the margin.
4. City officials should recognize the interdependence between capital, operations, and maintenance expenditures. New capital expenditures can reduce ongoing expenditures, and failure to properly invest in capital assets can increase ongoing expenditures. Failure of a city to repave thoroughfares can result in increased expenditures for patching and other related costs. It can be dangerous to continually defer necessary capital expenditures.
5. The budget process can be contentious and combative, and in an environment of shrinking revenues, few city officials are fully satisfied with the outcome.
6. Elected officials should avoid using the budget to drive public policy determinations. Such determinations should be established outside of the budgetary process, subject to an open public process, and then implemented in the budget.
7. City resources will never be sufficient to address all of the demands and expectations of residents. Budgeting is about making choices and establishing priorities in an environment of limited fiscal resources.
8. Finally, city officials need to openly communicate with their residents the fiscal limitations of their city and why they're unable to satisfy everyone's expectations.

Financial management

Cities are fiscally accountable to their local taxpayers. Accounting and financial reporting standards ensure consistency among government entities in providing information to residents.

The State Auditor enforces accounting requirements and prescribed reporting. Cities can choose whether to prepare and report financial statements and notes using generally accepted accounting principles (GAAP) or with an other comprehensive basis of accounting (OCBOA) also known as "cash basis," which is further outlined in the State Auditor's *Budgeting, Accounting, and Reporting System (BARS) Manual*. Local governments can choose which method best meets their needs.

The General Accounting Office (GAO) is the federal body that oversees and prescribes the generally accepted accounting practices (GAAP) used by all governmental entities.

Fund accounting, which is unique to government, earmarks revenues and assets, requiring separate recordkeeping for different pots of money. The emphasis is to show a segregation of resources by specific activities.

Funds are independent accounts that represent a portion of a city's activities that cannot be commingled with other accounts. For example, user fees charged to water customers are segregated into a utility fund to clearly illustrate that resources developed by these user fees have not inappropriately subsidized another city function.

Fund types

There are three basic categories of funds. Within each of these categories there are different fund types and revenues.

Reporting requirements

The receipt of timely and accurate financial information is a key component in the financial management system. Several statutes within the RCW (Revised Code of Washington) address the reporting of financial information for local governments. These statutes ensure the accountability of public monies and ensure that financial reports are published to provide all the details of the financial administration of public affairs.

At the end of every fiscal year, the city clerk, treasurer, or other assignee must make a full and detailed statement of receipts and expenditures for the preceding year and a full statement of the city's financial condition. The staff member must also submit a report showing the expenditures against each separate budget appropriation, no less than quarterly, to the council and chief administrative officer (which may be the mayor, the city manager, or the city administrator). The report must also show the receipts from all sources.

The annual financial report provides a summary of all the revenues and expenditures of the city for the fiscal year (January 1 through December 31). The report also includes pertinent financial data regarding the city's outstanding debt, grant expenditures, budget appropriations, and other relevant financial information.

Appropriate oversight and management of these reports is a key component of good financial management. In smaller cities, elected officials can play a key role in ensuring adequate internal controls. Auditing standards reinforce the responsibility of management for oversight and review of the financial reporting process and must be considered during the audit process.

State audit process

In Washington, governmental audits are done by the State Auditor. The audit process assures taxpayers that cities are following accounting rules, standards, and laws. It also provides an opportunity for city officials to evaluate internal controls and make changes in systems as needed.

By law, the State Auditor prescribes a uniform system of accounting and reporting for all cities. Every city is required to submit financial reports covering each fiscal year. The reports must contain:

1. Accurate statements of collections or receipts, all accounts due to the public treasury, and all expenditures;
2. An income and costs statement of public service enterprises owned and operated by a local government;
3. A schedule of the city's debt; and
4. A detailed statement of all revenues and expenditures.

Audits generally consist of several phases:

Entrance conference: This is the first in a series of opportunities to communicate with the audit liaison.

Audit progress meetings and pre-exit conference: These meetings are scheduled as determined by both the city and the auditor. The idea is for the city to be fully aware of all significant matters before the audit report is drafted.

Exit conference: This conference is often attended by the auditor, mayor, city administrator/manager, and elected officials. The conference is held before the final report is issued. Some items that are not significant enough to report will be provided in a management letter or as an exit item (e.g., a recommendation for stronger internal controls). Items such as the audit objectives, areas of improvement, findings, conclusions, and recommendations are all addressed during this meeting.

Final notification of audit report: Once the final audit report is issued, a city is expected to provide a formal response to any findings, conclusions, or recommendations in seven to 30 business days. Elected officials should be aware of all findings and any conclusions or recommendations made.

Plan ahead! Audits can be expensive. They can also involve a lot of staff time in preparing for and working with the auditors. City officials should be aware of their audit schedule and remember to budget for this.

Performance audits

In 2005, Washington voters approved Initiative 900. This initiative mandated that "the State Auditor shall conduct independent, comprehensive performance audits of state government and each of its agencies, accounts, and programs…" These audits include local governments; however, smaller jurisdictions typically do not need to complete a performance audit. This mandate was accompanied by a redirection of a small portion of the state sales tax to defray the added costs of state and local performance audits.

Long-range financial planning

Although city budgets must be completed annually (or every two years if your city has adopted a biennial budget process by ordinance), there is considerable value in longer-range financial planning. It is important to plan for multiyear projects and forecast revenues for a longer period than the coming year.

A strategic plan can help the city council and staff identify future needs. It allows the city to begin preparing for a project before funds are needed. Capital improvement plans are often completed over a five-year period or longer. Since projects such as streets, new utility systems, and city halls often require a great deal of capital spending, it can be helpful to plan for these projects on a long-range basis. Read more about strategic plans in Chapter 4.

Similarly, a strategic plan can help estimate revenues over future years and help to understand the city's tax base. An understanding of revenue trends can help policymakers avoid future disruptions, such as hiring staff in one fiscal year, then laying them off two years later due to declining revenues. It can also help city officials understand and plan for shifting revenue trends, such as an increasing sales tax base or a declining property tax base. Having a realistic outlook of these tax bases and incorporating that understanding into the budget early can help avoid crisis in years to come.

Items that can be helpful in making these long-term financial estimates are:

- City revenue trends over the past ten years
- Construction activity (residential and commercial)
- Property valuation

- Inflation rates
- Utility rates
- School enrollment
- Tourism activity

Planning for major projects

The state's Growth Management Act (GMA) requires communities to plan ahead for infrastructure needs. Planning for capital facilities is a key part of the comprehensive planning process. This required six-year plan allows cities to define acceptable service level standards for residents and businesses, as well as how they plan to pay for these services. Exploring these options together often helps cities in their long-range financial planning efforts. Read more about the GMA in Chapter 10.

General taxing authority

The authority for cities to levy various taxes comes from state law. These laws determine the taxing limits, restrictions, exemptions, and collections. Below are some of the primary revenue sources for cities.

Regular property tax levy

The maximum levy for most cities is $3.375 per thousand dollars of assessed value (AV). Cities with a pre-LEOFF fire pension system can levy an additional $0.225 per thousand dollars AV, resulting in a maximum levy of $3.60 per thousand dollars AV. Cities annexed to fire or library districts have a maximum rate up to $3.60 minus the library and/or fire district/regional fire authority's rate. If a city has a firefighter's pension fund and is annexed to a fire and/or library district, the maximum is $3.825 minus the fire and/or library district rate. Library districts can levy up to $0.50 per thousand dollars AV, and fire districts/regional fire authorities can levy up to $1.50 per thousand dollars AV.

Retail sales and use tax

- Cities are authorized to levy a basic 0.5% sales and use tax plus an optional tax at rates ranging from 0.1% to 0.5%.
- For each portion of the sales and use tax (the basic or optional), the county receives 0.015%. Therefore, the maximum effective rate a city can levy is 0.850%. Other local sales taxes apply with different distribution formulas (e.g., criminal justice).
- Cities that don't levy the optional 0.5% sales tax (that are located within counties that also do not levy the optional 0.5% sales tax) are authorized to levy an additional 0.5% real estate excise tax for general purposes.
- Cities may also levy sales taxes for specific purposes, some by council action and others voter-approved, such as the public safety sales tax or the sales tax for transportation benefit districts.

Business and occupation (B&O) taxes and business licenses

B&O taxes come in three forms:

- Excise taxes levied on different classes of business to raise revenue (general B&O taxes) limited to 0.002% of gross receipts unless grandfathered or voter-approved
- Business license fees with a flat fee
- Business license fees based on the number of employees, type of business, square footage, or some combination thereof

Utility taxes

Taxes can be levied on the gross operating revenues earned by private and public utilities from operations within the boundaries of a city, and by a city's own municipal utilities. Telephone (including cellular and pager services), electric, and natural gas are limited to 6%. Cities may ask voters to approve a rate higher than 6%. There are no restrictions on the tax rates for cable, garbage, water, sewer, and stormwater utilities. Cities cannot, however, tax water and/or sewer services provided by another city or water or sewer district. Cable franchise fees are limited by federal law to 5%.

Other taxes cities have the authority to impose include emergency medical services, real estate excise taxes, hotel-motel taxes, and a gambling tax.

Managing city debt

When city officials decide to build capital projects, they face a number of financing options, including different ways to borrow. Going into debt to finance a large project can make sense and spread the project's financial burden out over many years so future users help pay for the project.

Borrowing can also prevent depletion of a city's reserves. Projects can be built as they are needed, and the benefits can be received sooner without waiting for funds to accumulate.

Long-term borrowing

General obligation bonds are backed by the full faith and credit of the city. There are two types:

- **Councilmanic bonds** are issued by a vote of the city council, backed by general fund revenues when voters have not been asked to pay increased property taxes. These may be used for any city purpose; they do not have to be for capital projects.
- **Unlimited general obligation bonds** must be approved by a 60% majority of voters. This option raises property taxes to pay for projects and is only used for capital purposes.

Revenue bonds finance projects for any city enterprise that is self-supporting (e.g., water/wastewater/golf courses). Payment comes from user fees, so the debt is not backed by the full faith and credit of the city. Investors consider these somewhat less secure than general obligation bonds.

Debt capacity

The amount a city can borrow using general obligation debt and the purposes for which a city can borrow are governed by state laws and the state constitution. A city's debt limitations or debt capacity are subject to two sets of restrictions. First, debt limits set the maximum amount of general obligation debt that a city can have outstanding at any one time. Second, debt limits restrict how much of this capacity can be used for various purposes. There are no debt limits for revenue bonds.

City debt can be used for three purposes:

- General government (both voted and councilmanic capacity)
- Municipally owned water, sewer, or electric facilities (voted debt capacity)
- Providing open space and parks (voted debt capacity)

In certain circumstances, the state will allow cities to access debt through state programs such as the Treasurer's Local Option Capital Asset Lending (LOCAL) program or the Public Works Assistance Account.

Cities can borrow up to 2.5% of assessed property valuation, minus the amount of debt already issued, plus certain net assets available for debt service funds. But just because your city is allowed to borrow a certain amount doesn't always mean those limits should be used to their maximum extent.

Grants and loan opportunities

Many cities seek funding from grants and low-interest loans to augment infrastructure, capital improvement, and economic development activities. Many state agencies offer grant opportunities on a regular basis to cities. However, funding is limited, and competition is great. Foundation and federal grants and loans are another source of potential project revenue for cities.

However, there is no such thing as "free" money. Grant awards require the commitment of human, technical, and often financial resources for successful project management and grant administration. It is important to consider the capacity to effectively manage the activities and requirements of a grant or award before applying, and budget for audit costs and staff time to administer the grant. There are also long-term costs associated with grant-funded projects. Is there existing or new revenue adequate to maintain a program or service once grant funds expire?

Capacity may be enhanced by partnering with other organizations or by contracting out grant management. It can be helpful for a community to have an interlocal agreement that promotes a multi-jurisdictional grant-funded project and fund development for work that crosses municipal boundaries (e.g., telecommunications, floodplain management, open space). Such collaboration may increase the competitiveness of a proposal, the efficiency of program management, and the success of project outcomes.

Know the law

- RCW 35.33 - Budgets in second and third class cities, towns, and first class cities under 300,000
- RCW 35.34 - Biennial budgets
- RCW 35A.33 - Budgets in code cities
- RCW 35A.34 - Biennial budgets for code cities
- RCW 35.27.220 - Annual statement of receipts and expenditures
- RCW 35.33.141 - Quarterly financial statements to council
- RCW 43.09.230 - Local government accounting - Annual reports
- RCW 84.52.043 - Property tax
- RCW 82.14.030(1) - Basic local sales and use tax
- RCW 82.14.030(2) - Optional sales and use tax
- RCW 35A.82.020, RCW 35A.82.050, RCW 35.21.710 - B&O taxes
- RCW 35.21.870 - Utility taxes
- RCW 39.36.020 - Limitation of indebtedness prescribed
- Article VIII, Section 6, Washington State Constitution - Limitations upon municipal indebtedness