

Budget Process and Philosophy

Beginning with the 2014-15 fiscal year, we adopted a budget management system that gives the managers of the general fund departments the same budget authority and responsibility as the managers of the enterprise and special revenue funds. In the case of enterprise funds (e.g., water) or special revenue funds (e.g., streets), the manager is confronted by the discipline of a balanced budget. Expenditures can never exceed available resources, and the manager has to be creative in finding new sources of revenue and in cutting costs. The number and level of positions, the cost of union contracts, and interest earnings on invested cash are all important factors in managing the budget. There is no “spend it or lose it” incentive, because spending in one fiscal year directly reduces the beginning balance in the following fiscal year.

In order to enlist the managers of general fund programs in a similar role in managing the city’s financial resources, we made the following changes:

1. Allocation of General Revenues to Major Programs. While many general fund departments generate some revenue, they are also dependent on general taxes and fees (for example, property taxes and franchise fees). But in a typical budget, it’s hard to determine the level of this support. Lake Oswego’s budget shows explicitly the dollar amount of general revenues allocated to each program. These amounts reflect the priorities the City Council has placed on funding city services, and they are consistent with the results of citizen surveys on services. Public safety (police and fire) make up, by far, the largest allocation of general revenues. This is followed by parks maintenance, transfers to the street fund, and library—all services that are strongly supported by Lake Oswego residents.

These allocations are ultimately decided by the City Council. Setting these targets in the budget is as much art as it is science. For 2015-16 and 2016-17, we started with the allocations approved by the City Council in the 2014-15 budget, and multiplied these amounts by the projected growth in general revenues (around 3.5% for 2015-16). The exception was Planning and Building Services, which based on Council priorities, received no increase (the department has offset this by the elimination of one position and through growth in permit fee revenue).

2. Carryover Savings. As noted above, managers of enterprise and special revenue funds have a strong incentive to reduce expenses, since any savings during the fiscal year adds to the next year’s beginning balance, which in turn provides more flexibility in funding one-time expenses such as equipment or capital improvements.

Beginning with the 2014-15 Budget, we instituted a similar incentive for general fund program managers, by allowing them to carry over savings (and department revenues that exceed projections) as a beginning balance for the department. These balances must be used in ways that are consistent with Council priorities, and can’t be used for ongoing commitments such as staff costs.

For 2015-16, several General Fund Departments are using their beginning balances to help fund small projects and capital equipment and vehicle replacements without requesting additional allocations of

general revenues. For example, the Parks & Recreation Department will be using their beginning balance to make repairs to the Roehr Park dolphin and Westlake pathway, and construct a fit spot at Foothills Park. The Police Department is carrying over funds for remaining expenses related to the upgrade of the Computer Automated Dispatch System. And the Planning Department will be using a portion of their savings to implement an online land use permitting software program.

In the City Manager's Office, staff vacancies and a reorganization of positions has resulted in savings that will become very useful should a private-public partnership for constructing a fiber to the home broadband network in Lake Oswego becomes a reality. We've set aside \$200,000 of the department's contingency as a resource for any expenses the city may potentially incur as part of the initial stages of the project.

3. Departmental Contingency Accounts. All general fund programs in every city include contingency amounts, but they are hidden in the form of padded line items. With the state law's fixation on appropriations (rather than actual spending), and sanctions for going over budget, the rules of the game require line item padding as an insurance policy.

In Lake Oswego's budget, we are more open about this, and have encouraged department managers to set aside some portion of their beginning balance in a contingency budget. They can't spend directly out of this account, but it serves as a buffer for higher than expected costs in other line items. And of course, if the contingency account isn't needed in the current fiscal year, it carries forward into the next year.

Well-managed cities that have combined a carryover savings program with departmental contingency accounts have found they are more resilient to outside shocks to the financial environment. For example, planning departments are better able to weather the inevitable cycles in construction activity, and departments with facilities like the library or adult community center are better equipped to deal with a failure of the HVAC system.

4. Responsibility for Personnel Costs. One could argue that the cost of employees is outside the control of operating managers. Salaries are set by union contracts (approved by the City Council) or by a citywide classification system. Pension costs are set by the state. Healthcare costs are also set by union contracts or through citywide policies.

But in the long run, operating managers do determine personnel costs: they set the number and level of positions in their departments. And to the extent the managers involve their staff members in financial management, the cost of collective bargaining agreements is not an abstract concept, but a real cost that reduces the ability to add positions or replace equipment.

Typically, the central budget office in a city "gives" the general fund departments their personnel budgets, based on the current number and level of authorized positions. In our budget process, we instead give the general fund managers their share of general revenues and let them to figure out how to allocate it. The finance department does share projections of the salary and benefit costs for each current employee, but the department head have to add them, one by one, into the budget. This process is more than symbolic: it emphasizes that operating managers are responsible for *all* the costs

of providing service, including staff costs. There is no budget “request” process: once departments receive their target (i.e., their allocation of general revenues), they are on their own in figuring out how to balance the budget.

5. Internal Fees for Service. To be able to provide city services, we have to account for money, recruit staff and process the payroll, provide legal advice, maintain buildings, operate a computer network, and provide other internal support services. These costs have always been explicit in the enterprise and special revenue funds. But they have been hidden from sight in the general fund programs.

The City of Lake Oswego uses a sophisticated cost accounting model—developed and updated by an independent expert—to allocate internal service costs to the various city departments. The model includes an allocation of costs to general fund programs, such as police and library service, but since most of the expenses are also accounted for in general fund units (HR, IT, finance, etc.), there is no need to transfer these amounts between funds, so they haven’t been shown separately. Beginning with the 2014-15 budget, we now show these amounts as a real component of the cost of general fund services.

In some cases, these costs are significant. The internal service fee for the police department totals about \$1.8 million. But the department is a heavy user of computers in the dispatch center and patrol cars, occupies most of a floor in city hall, and has the largest payroll of any city department. It makes sense that it accounts for a large share of support service costs. The overhead rate is still less than 15%, lower than that of most university programs, or a typical allowance in federal grant programs. The overhead rate is lower for departments that aren’t such a major consumer of computer and other services (e.g., 11% for the adult community center).

By fully expensing these costs, we are able to show corresponding revenue for the support service departments, so like their direct service peers, these programs become self-balancing accounts. The direct service departments are the customers of the support service departments, and the fees represent the cost of internal “contracts” for service.

To emphasize this relationship, the first step in the budget preparation process is to compute the fees for each program. The managers of the support service departments then present their budgets (and fee amounts) to a “tribunal” of the direct service departments. To their credit, the support service managers have been very willing to do so, and welcome suggestions that could result in savings in their operations. They have a strong customer service ethic, and see their role as supporting the folks who provide the direct services to our citizens.

Managing the Bottom Line

These changes affect how the budget is drafted and shown, but the final appropriations set by the City Council will look the same as in past years: a total appropriation (spending limit) for each program in the general fund, and appropriations by categories of expense in the other funds.

Where it really matters is in how the budgets are *managed*. Enterprise and special revenue fund managers have always had to manage the bottom line: regardless of estimates and projections (the budget), actual spending can’t exceed total available resources. The same is now true for the managers

of general fund programs. Actual expenses (including internal service fees) can't exceed resources (including beginning balance and the fixed allocation of general revenues). If carryover savings are less than projected, or if departmental revenues come in below projections, the manager will have to offset this on the expense side. On the other hand, if, for example, the response to recreation offerings is greater than anticipated, resulting in additional revenue, the parks director can add courses and contractors.

Dual Balancing Processes—Operating Budgets and Fund Balance

A financial policy that has served Lake Oswego well is to avoid using one-time resources (e.g., beginning balances) to fund ongoing costs, such as staff salaries. An exception is the use of a "rainy day" fund to get through a recession or emergency, since that is exactly what the fund is for.

In the general fund, this policy requires two balancing processes. The allocation of general revenues, noted above, uses only ongoing revenues such as property tax and franchise fees. This source, along with (ongoing) departmental revenues, fully funds the ongoing cost of general fund services.

The second balancing process involves the allocation of the beginning general fund balance. A large part of it is set aside first as the city's operating reserve; by policy, 30% of general fund operating costs. The remainder is either set aside in other reserves (e.g. future equipment replacement), or appropriated for one-time expenses. The amounts involved can be sizeable, and the final allocation is one of the most critical decisions for the Budget Committee and City Council. For the 2015-16 Budget, the Budget Committee directed a sizable portion of available fund balance in the General Fund towards the replacement of the Public Works Operations Facility.

Budget Information Improvements

To save costs and make budget information more widely available, we have moved from a printed budget document to web-based budget information. An innovation in 2014-15 is the creation of an interactive budget dashboard that allows operating managers and citizens an at-a-glance overview of all city financial performance, with the ability to drill down to more detailed data. We are currently working on producing a dashboard of key performance indicators for city programs, updated at least quarterly, and real-time tracking of multi-year capital projects, showing the total project budget and the amount spent to date (across fiscal years).