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# Municipal Budgeting

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## ABSTRACT

This paper reviews the purpose and methods of the municipal budget process in the context of Ontario municipal practice. The differences in operating and capital budgets and their interaction are discussed. The relationship between accounting systems and budget systems is briefly reviewed, and the steps leading to successful implementation are outlined. A comparison of incremental versus program-based methodology shows that successful management requires the use of elements of both approaches. Most Ontario municipalities are including program-based reviews in their budgetary reforms. The Ontario government is also implementing a benchmarking initiative in cooperation with municipalities which will have implications for future budgetary practice.

**KEYWORDS:** ACCOUNTING METHODS ■ BUDGETING ■ BUDGET PROCESS ■ MUNICIPALITIES ■ MUNICIPAL FINANCE ■ PROVINCIAL-LOCAL

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## MUNICIPAL BUDGETING: A TOPIC OF CONCERN FOR OVER 60 YEARS

Too much importance cannot be attached to the preparation of the budget. No municipality is too small to need such an important forecast and guide. . . . A properly prepared budget will result in the elimination of unnecessary expenditures, increased efficiency in the methods of collecting revenues and preservation of the credit of the municipality.

A budget serves two primary purposes:

- (1) to set out a complete programme with regard to all expenditures of the municipality during the coming year, and the purpose for which they are to be made, and to forecast the revenues from which such expenditures are to be financed;
- (2) to provide a method of controlling expenditure so that a municipality may live within its means.<sup>1</sup>

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## THE PURPOSE OF MUNICIPAL BUDGETS

C.M. Wrenshall, the author of one of the earliest Canadian textbooks on municipal financial administration and accounting, written during the Great Depression, placed municipal budgeting and accounting at the heart of his work. By 1934, over 40 Ontario municipalities and school boards had defaulted on their debt obligations, in part owing to shoddy financial management practices. The provincial government intervened by strengthening the capacity of the Ontario Municipal Board to validate the borrowing bylaws and capital planning of municipalities as well as to supervise the financial affairs of municipalities that were bankrupt. This effort was intended to improve the municipal capacity to use budgeting methodology and to improve the financial administration of municipalities.<sup>2</sup>

Sixty years later, in the spring of 2001, the city of Toronto, faced with the perception of a crisis in fiscal management, recalled the former general manager of the Toronto Transit Commission, David Gunn, for advice on budget making.<sup>3</sup>

Recently, Harry Kitchen has set out the purposes of municipal budgeting, noting that

[m]unicipal budgets should be designed to achieve the following objectives:

- (1) to provide for the management of financial control;
  - (2) to provide information essential for useful and efficient management decisions;
- and
- (3) to improve program and financial planning.<sup>4</sup>

In the context of urban governance reforms and current decentralization initiatives taking place in transition economies, Richard Bird notes the importance of the time horizon and has suggested that “[l]ocal budgeting should take place within the structure of a medium-term expenditure framework, both to ensure the proper financing of investment projects, and to reduce the scope for short-term political manipulation of budgets.”<sup>5</sup>

From these observations, several common themes emerge concerning budgetary principles and the appropriate practices involved in implementing sound budgetary methods. These include accountability, planning and evaluation of expenditure priorities, realistic revenue forecasting, selection of an appropriate time horizon for fiscal planning, and central administrative direction to maintain control of the process.

## WHAT IS THE MUNICIPAL BUDGET?

The budget, at its simplest, is a projection of future revenues and expenditures, whether for an annual or a multiyear period. At a minimum, municipal staff should use it to target and control financial transactions, including investment of surplus funds through the fiscal year or borrowing to meet in-year pressures. Municipal councils can use an adopted budget as a benchmark to control the fiscal operations of the municipality. The annual budget should also be used as a management and planning tool to guide the operations of the municipality. In addition, the budget

process provides an opportunity to review the appropriateness of local tax policies in the context of the capacity of the local assessment base.

### **Operating Budget (Recurrent Budget)**

In providing for the everyday operation of services, municipalities face expenditure obligations on a recurrent basis. Principally these include the salaries and wages of employees; pension contributions; payments to individuals under mandatory cost-shared income redistributive programs; the purchase of services from other agencies, materials and supplies, and short-life equipment; and expenditures on repair and maintenance. Further, there are recurring financial transactions, such as the servicing of long-term debt (principal and interest) and contributions to “reserve funds” established for specific purposes. Current funds may also be transferred to the capital budget for “upfront” financing of a portion of capital projects. In Ontario, municipalities may also establish reserves and in-year budgetary appropriations to fund contingencies or other obligations that may or may not become due or are difficult to estimate precisely.

### **Types of Operating Budgets**

Operating budgets may take several different forms. These have been usefully summarized in the context of the World Bank’s educational programs for local government officials (table 1).<sup>6</sup> Each type or variation of the operating budget provides a different form of information for fiscal decision making. While line-item budgets are used for everyday guidance and for the preparation of departmental operating budgets, many larger municipalities are using performance and program budgeting methodologies to evaluate the efficiency of their service delivery and to evaluate tradeoffs among departmental budgets. Municipal revenues are not generally earmarked on a departmental basis, with the exception of utility operations, funded largely from user fees.

## **THE BUDGET AS A MANAGEMENT TOOL FOR PUBLIC EXPENDITURES**

The municipal budget is essential to the management of a municipality. The customary form of a local municipal budget is a set of documents, divided according to the organizational breakdown of authority within the municipality, usually by operating departments for expenditure items, and including an overall document summarizing the anticipated revenues and the taxation and fee policies being implemented. Total allowable expenditures are usually allocated to each unit/subunit and further divided into line-items of expenditure. Line-item-based budgeting is easily understood; however, it may be inflexible, and it may encourage subterfuge by staff seeking to reallocate funds internally if categories of expenditure are too strictly defined within the operation of a unit.

Under performance and program-based budgeting, expenditures are grouped by individual programs serving major objectives. These methodologies will be discussed further below.

**TABLE 1 Comparison of 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: Michael Schaeffer, *The Budget and Public Sector Performance*, Power Point presentation (Washington, DC: World Bank, March 2000), 21.

In general, the annual budget sets the framework for staff and council to carry out their respective duties regarding expenditure control and forecasting of both revenues and expenditures. The budget may allocate funds on a quarterly basis. This may facilitate financial controls and the auditing process. Quarterly budget allocations must be made in conjunction with aggressive cash flow management.<sup>7</sup>

In larger Ontario municipalities, the initial budget process is followed by regular variance reports on a timely basis. These reports of the progress of expenditures may also be accompanied by regular reports on the returns accruing from investments and the progress of payments related to the capital program being made in-year.

## CAPITAL BUDGET

Capital budgets should be set up on a long term plan: that is, a plan which is to be carried out during a number of years, partly during the current year and partly at certain later periods. Each improvement should be considered as a separate unit and no work should be decided on without taking into account its relation to the balance of the programme from both the financial and physical standpoints. . . .

In order to maintain control over the budget for permanent works, definite plans must be laid and carried out. A haphazard undertaking of expensive works can only result in confusion and in top-heavy financing. In many of the defaulting municipalities much of their trouble has been caused by unwise and unnecessary construction work.<sup>8</sup>

Capital budgeting has been styled as a plan to acquire capital assets. Depending on the services being provided, particularly in multitier local governments, capital budgeting will be affected by various factors including the extent of known deficiencies in hard services such as water, sewer, and roads networks, or in facilities needed to deliver “soft-services” serving existing urbanized areas, and the implications for land-use planning and the extension of urban services. With respect to finances, the state of the capital market in terms of its receptiveness to municipal borrowing or the willingness of council to bear interest costs and the availability of various types of revenues, such as development charges, may also affect the timing of such investments.<sup>9</sup> In multitier governments, coordination of the actual works being contemplated may also affect the timetable for the capital budget; for example, if

the upper tier is responsible for water and sewer services, replacement works are often coordinated with the lower tier's road replacement program.

### **Components of the Capital Budget**

Michael Schaeffer has set out the steps involved in the development of the capital budget:

- Inventory of Capital Assets;
- Developing a Capital Investment Plan (CIP);
- Developing a Multi-Year CIP;
- Developing the Financing Plan; and
- Implementing the Capital Budget.<sup>10</sup>

An inventory of capital assets is a critical piece of information for the operation of municipal services. The inventory can provide information on the capacity of the infrastructure in place and the likely timing of replacement. Accordingly, it can also be an important input into the land-use planning process. The development of a multiyear capital investment plan can provide municipal administrators with several tangible benefits. These include an enhanced ability to program the use of scarce resources and the selection of cost-effective solutions. A multiyear plan can also assist in the development of prudent borrowing and other debt policies, and can enhance revenues by providing guidance on the extent to which surplus funds exist and can be left invested.

A multiyear capital plan should be integrated with a multiyear operating plan to avoid the common failure to provide for future increases in operating and maintenance funding over time. The integration of operational and capital planning can also assist a municipality in avoiding the underutilization or overbuilding of facilities.

The success of the capital budgeting process is highly dependent on public participation, and acceptance of the capital budget is often crucial to its realization. Public acceptance may depend on the degree of urgency involved—as, for example, where water pressure in fire lines is deficient or underground sewers built at the turn of the century have collapsed, creating the conditions for basement backups. Elsewhere, the benefits derived from new subdivision development or commercial and industrial development may facilitate public acceptance. Ratepayers are also likely to be concerned with costs and the resultant impact on existing levels of user fees, taxes, and development charges of system improvements.

The geographic extension of enhanced services or capacity enhancements to existing facilities may also affect land use and land values by opening up the possibility for urban development of rural land or the redevelopment of “underutilized” land in existing urban service areas. Some capital projects may be opposed precisely because of the development that may be enabled.

## INTERRELATIONSHIP BETWEEN BUDGETING AND ACCOUNTING SYSTEMS

While the budget is the heart of municipal resource administration, municipal accounting systems and practices and their subsequent reports are central to the budget-making process.<sup>11</sup>

### Accounting and Financial Reporting

In Ontario municipalities, budgeting and accounting are closely linked. The accounting process is used to generate variance reports, and the budget documents provide the backup documentation for expenditure quantum subject to audit verification. The standardized financial information return that municipalities submit to the province on an annual basis is also used by municipalities as part of their budget planning process, particularly in two-tier systems.

In general, three prominent objectives of financial reporting are identified:

- Financial reporting should assist in fulfilling government's duty to be publicly accountable and should enable users to assess that accountability
- Financial reporting should assist users in evaluating the operating results of the government entity for the year (and, year over year)
- Financial reporting should assist users in assessing the level of services provided by the local municipality and its ability to meet these obligations as they are due.<sup>12</sup>

The Ontario system is based on the modified accrual accounting method. This adopts the same principles and approach as accrual accounting with the exception that depreciation and a return on capital are not included as costs. Instead, interest costs and principal repayments are recovered directly in the year in which they are due through user fees and local taxes. These are generally set to generate revenues in excess of expected operating and maintenance costs and debt service costs. The resulting operating surpluses are transferred to a capital fund to finance ongoing investments or into reserves or reserve funds to finance planned future investments. Because principal repayments are recovered directly each year as chargeable expenses, municipalities are less likely to face cash flow problems. Capital finance does not therefore depend on the flow of funds from a depreciation charge and a return on equity.<sup>13</sup>

### Public Sector Accounting Standards

As of January 1, 2000, local governments in Ontario are required to follow recommendations in the *Public Sector Accounting Handbook* prepared by the Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants (CICA).<sup>14</sup> The *Handbook* recommendations retain the modified accrual basis of accounting and reflect the following objectives:

- provide reliable, understandable, timely, and consistent information that meets the needs of persons for whom the statements are prepared;

- provide an accounting of the full nature and extent of the financial affairs and resources for which local government is responsible;
- demonstrate the accountability of local government for the financial affairs and resources entrusted to it;
- account for the sources, allocation, and uses of financial resources in the period; and
- provide information that shows the state of local government's finances.

Detailed examples of presentation and standards are found in the CICA's *Local Government Financial Reporting*.<sup>15</sup>

## **GENERAL RULES: BUDGETING AND INTERGOVERNMENTAL FINANCE**

Interest in the budget process and expenditure management appears to be related to either real or perceived fiscal crises. The reform of intergovernmental fiscal arrangements in transition economies combined with decentralization initiatives has enhanced interest in the budget process, its transparency to those affected by a national or subnational budget, and the relationship of subnational decisions to the functioning of a national economy. Concomitantly, a normative and analytical literature has evolved which sets out some of the appropriate characteristics that are the hallmarks of an accountable and transparent budget process. This literature also addresses the issue of rules related to expenditure management in the context of intergovernmental fiscal relations.

Confronted with the need to develop new taxation and expenditure control systems, officials in transition economies have sought assistance in the development of appropriate budgetary institutional structures.<sup>16</sup> As part of this effort, various agencies have encouraged the publication of studies pertaining to the transparency of the budget process, the general application of rules and norms, and the issues of budget constraints and discipline in intergovernmental fiscal relations.

Again, some of the motivation can be attributed to perceived crisis settings for decision making, whether the crisis is one of changing revenue sources from asset sales to taxation systems compatible with international norms or coping with the macroeconomic uncertainties of a market-driven international economy.

The concept of crisis and stress is common as well to many of the recent discussions of expenditure management. Premchand styles the third chapter of his widely cited work as "Managing Fiscal Stress," defined as a widening gap between revenues and expenditure pressures.<sup>17</sup>

With respect to the general budget process, Premchand, Kopits and Craig, Kopits and Symansky, and Tanzi and Schuknecht<sup>18</sup> pursue common themes of importance to an effective process, such as the role of transparency, in terms of the availability of information, the existence of rules and norms, and constraints in an intergovernmental context.

In many economies, not just those in transition, municipalities and subnational governments generally have found themselves up against budget constraints and

often a related political constraint. In an intergovernmental context, Bird is categorical on the importance of rules and predictability to enable good decision making:

The budget law must be clear, and it must be enforced. . . .

[I]t is critical to local fiscal discipline that the amount of revenue from intergovernmental transfers be predetermined, and not subject to political re-negotiation during the budgetary year; local governments must *not* be able to depend on central government “bail-outs” of imprudent financial decisions, such as unsustainable borrowing or expenditure increases [emphasis added].<sup>19</sup>

## Rules in Ontario

As Bird and Tassonyi have noted,<sup>20</sup> there are two different worlds in Canada with respect to intergovernmental fiscal relationships: the federal-provincial fiscal relationship, characterized by very soft hierarchical constraints and “negotiated accommodation”; and the provincial-municipal relationship, characterized by strong hierarchical constraints on municipalities’ fiscal decision making. Stemming from the municipal fiscal crisis of the 1930s, Ontario has a well-developed set of rules related to municipal borrowing and accounting. The rules related to municipal involvement in capital markets are being liberalized in the context of changing market conditions and the constraints imposed by lenders.<sup>21</sup> The rules on accounting and audit are also changing with the introduction of a new standard of accounting practice—that is, the implementation of the PSAB’s recommendations for modified accrual accounting in a municipal context.<sup>22</sup>

In terms of fiscal management, Ontario municipalities are not permitted to budget for a surplus or a deficit. Borrowing to cover an operating deficit is not permitted. Any operating surplus or deficit must be taken into account in the following year’s estimates. Municipalities must also adopt their tax policies, including their tax rates, at a single point in time in the year and are precluded from making adjustments to tax rates during their fiscal year. (In Ontario, the calendar year applies.) Expenditure pressures may be affected cyclically or by changing policy with respect to provincial transfers in-year, and the consequences of such changes must be managed within the existing budget and the available revenues.

The timetable and mechanics of the actual budget process and budget methodology are not provincially regulated. In Ontario, as the municipal fiscal year coincides with the calendar year, budget planning in most municipalities is ongoing but is accelerated in the fall in order to meet statutory deadlines for the establishment of tax policy usually applicable in March and April of the new year. Municipalities also seek to finalize their tax bills by early summer to avoid cash flow difficulties.

Most municipalities in the province continue to use an incremental, line-item budget process. However, many have experimented with various forms of program budgeting and have introduced these methods into the annual process of budget making. These differing methods will be summarized later in this paper.

Ontario is the first province to enshrine benchmarking in statute and has initiated a provincial-local process for implementation (discussed below).



## BUDGET PROCESS

### Characteristics of an Effective Budget

- [A]ccurate, periodic, authoritative, timely and transparent<sup>23</sup>
- [A]ccountability, comprehensiveness, constraint, cooperation, honesty, judgment, legitimacy, perception, responsiveness, timeliness, transparency<sup>24</sup>

For a budget to be effective, it must be credible. Credibility is a fragile commodity based on the characteristics identified by the two authors quoted above (Bird and Schaeffer). In Ontario, municipal administrations have sought to make their budget process reflect these characteristics, despite the relative absence of formal rules.

### Characteristics Adversely Affecting Budget Performance

As with any fiscal process, there are practices and pressures that can adversely affect the budget process. Schaeffer has identified “extrabudgetary funds,” “ear-marking,” “unpredictability,” and “unreliable information.”<sup>25</sup> The first two refer to the extent of discretion over funds, whether the use of some funds is independent of the scrutiny of the formal budget process or tied up inflexibly in a reserve fund. The latter two reflect on external and internal information. Unpredictability is most often the hallmark of decisions by senior levels of government to change transfer payment regimes or the conditions or requirements of shared-cost programs or revenue systems.

## BUDGET MAKING AS A CONFLICT RESOLUTION PROCESS<sup>26</sup>

Kitchen<sup>27</sup> identifies four stages in budget making:

1. initial requests at the departmental level,
2. departmental budget requests and development of the revenue constraint,
3. adoption of the budget, and
4. execution of the budget.

He notes:

After frantic pleading by department heads or their delegates, requests may be denied, rearranged or the financial constraint expanded. Ultimately, the chief financial officer arrives at a budget that is then presented to the budget committee of the municipal council.<sup>28</sup>

### Preparation/Planning Stage

Initially, operating departments develop work or service plans. Thus, objectives are stated. It is helpful if these are results oriented, and if desired achievements are measurable within a given time, and related to the overall department goal. These plans should also indicate the relationship of the objectives to performance measures.

In conjunction with the development of departmental objectives and plans, those entrusted with the development of the costing and the coordination of the plans will develop a set of budget instructions and policy guidelines. As well, a budget division may work closely with staff of agencies of the municipality or agencies dependent on the municipality for funding to develop the appropriate requests. In Ontario, agencies that have a statutory right to municipal funding face deadlines in March for the submission of these requests.

### **Integration: The Role of CAO, Treasurer, the Senior Management Team, or a Budgets Division**

Ultimately, the various departmental and agency requests must be made into a coherent budget document for the operational purposes of the municipality. In addition, the available sources of revenue and the capacity of the tax base to bear any additional burdens must be evaluated. This work is usually the responsibility of a budget division within a finance department or the clerk-treasurer in small municipalities.

As part of the budget process, staff of the municipality should review past program performance relative to benchmarks and the stated objectives. An independent forecast of service needs may be commissioned to evaluate whether particular programs are needed. Staff will also seek to measure the relative cost effectiveness of the service delivery mechanisms in place. As well, some municipalities will undertake a process of efficiency analysis to identify least-cost solutions.<sup>29</sup> This process requires that workload data be made available from operating departments to those charged with the responsibility for the central coordination of these efforts.

Finally, the senior management of a municipality must be able to cope with council or citizen-group demands for programs and to judge the merits of spending pressures relative to the fiscal capacity of the tax base and spending pressures that are either mandatory or non-discretionary.

### **Communication/Adoption/Implementation**

A critical component of the budget process is the communication of opportunities for ratepayer input into the policy choices, as well as the outcome of council decisions. The establishment of priorities is often controversial, and obtaining sufficient consensus may entail tradeoffs and compromises. Many municipalities have taken advantage of the Internet to provide more detailed information related to the budget process and have posted the summary documentation on their Web site. This approach represents a significant improvement over reliance on traditional media to disseminate information. The typical budget document also provides an overview of the taxable capacity of the local economy and anticipated pressures from changing economic circumstances in the regional/local economy.

## FINANCIAL MANAGEMENT TECHNIQUES<sup>30</sup>

In order to ensure the successful implementation of the annual budget, municipalities can use this document as the benchmark for the ongoing financial management of the corporation. Monthly or quarterly spending plans can be formulated on the basis of historical experience, and progress of expenditures can be monitored using these in-year plans as a reference. Most councils also require staff to report actual expenditures against detailed budgets.

Timely reports are also essential to allow senior management or a budget division to review and recommend approval of departmental requests to transfer funds between appropriation lines in the budget. Daily monitoring of cash flow and expenditure commitments will enable an aggressive short-term investment program, as well as the smoothing of differences in expenditures and revenues. Such monitoring is also dependent on close supervision of the timing of expected revenues and anticipated and unanticipated expenditures.

Good fiscal management also entails instituting procedures necessary to adjust budgets to reflect changes in revenue availability or changed service requirements.

## BUDGETING METHODOLOGY

### Incrementalism Versus Program-Based Budgeting

[T]he incrementalist approach . . . provides no mechanism for assessing the benefits from existing expenditures and, therefore, no rationale for encouraging local officials to allocate their resources in an efficient manner. . . .

In essence, control budgeting is important but it often creates a narrow and cumbersome financial management system, characterized by paperwork, detail, duplication, complexity, and inflexibility. It also lacks the truly relevant information necessary for proper planning and efficient management of local government activities.<sup>31</sup>

### Rethinking of Budget Design

Budgets in Ontario municipalities have historically been constructed on the basis of line-by-line incrementalism, perhaps reflecting the accounting background of most financial staff and the close relationship of the budget to the audited financial statements required to be submitted to the provincial government after the fiscal year-end. However, many larger municipalities have sought to introduce process and format reforms reflecting more up-to-date thinking about the achievements of goals rather than focusing strictly on cost control. That is not, however, to deny the importance of cost control as a feature of the reformed budget.

Recent Ontario municipal budgeting practices reflect the influence of “newer” methodology that focuses the process on both past and projected expenditures on outputs or goals rather than on costs of inputs. Municipalities have been introducing elements of program-based budgeting (PBB), which targets decisions on budgeted expenditures not solely on the basis of costs but rather on the basis of costs (efficiency) with some notion of returns (effectiveness).<sup>32</sup> As part of ongoing

efforts to control expenditures in a climate of constraints on tax increases, municipalities have also been linking performance measures to the budget process (as discussed below).

### **Program-Based Budgeting**

This part of the paper provides a brief overview of the features of PBB and its precursors. Some of the difficulties in implementing this form of budgeting are also reviewed.

The features of PBB include

- defining objectives and programs to achieve those objectives,
- appropriation by programs,
- use of performance indicators to measure program outputs, and
- use of cost-benefit or other forms of analysis.

Performance budgeting was introduced in the United States at the federal level after the Second World War. Allen and Tommasi provide a summary description of its early evolution:

The first experience with performance budgeting on a wide-scale was launched in 1949 in the United States, following the recommendations of the Hoover Commission. Emphasis was put on full cost measurement, evaluation of workload and reducing unit costs. The focus was on the work to be done, not on the usefulness of the objectives themselves. Performance budgeting was aimed at increasing operational efficiency rather than allocative efficiency. . . . [C]oncerns were raised that the budget did not adequately link policies with programmes. . . .

The Planning Programming Budgeting System (PPBS) was implemented throughout the US government in 1965. PPBS was designed as an instrument for allocating resources among programmes. PPBS processes consisted essentially of three phases. In the planning phase, systems analysis was used to establish the objectives and identify related solutions. At the programming stage, means were reviewed and compared to the solutions identified at the planning stage. Sets of activities were grouped in multi-year programmes, which were appraised and compared. Cost-benefit and cost-effectiveness analyses were then used to compare the various programmes and activities as competing means of achieving a given objective. Finally, the budgeting phase translated these programmes into the annual budget.<sup>33</sup>

PPBS was abandoned after six years of effort. Allen and Tommasi note:

[I]t seems that the goal of reaching a perfect and indisputable rational organisation of government objectives and activities is illusory. A fundamental problem with PPBS was that it neglected the political aspects of the decision-making process. The fact that government objectives and activities are political choices that reflect trade-offs between different value judgements was not sufficiently recognised.<sup>34</sup>

Among the specific problems with the PPBS initiative that have been identified are the breaking of the link between program structure and administrative structure;

the exaggeration of the utility and applicability of economic analysis; and the increase in the volume of work, since officials were charged with preparing both the regular annual budget and the program budget. PPBS required highly trained administrators to conduct the various analyses and studies, and they were in short supply. Moreover, the imposition of the system from above was an unlikely basis of success.<sup>35</sup>

Allen and Tommasi also outline the development of a variation on the PPBS, the development of zero-based budgeting (ZBB). Literally interpreted, ZBB consists of evaluating all programs each year and preparing the budget from scratch, instead of concentrating on budgetary changes at the margin. In practice, most users of a ZBB system did not go so far.

The main features of the system consisted of

- formulating objectives for each agency;
- identifying alternative approaches to achieving the agency objectives;
- identifying alternative funding levels, including a “minimum” level normally below current funding;
- preparing “decision packages,” including budget and performance information; and
- ranking the decision packages against each other.

Because of the extent of effort involved in developing budget estimates from scratch, this initiative has been little used. Ultimately, the PBBS and ZBB initiatives have led to the greater development of economic analysis within governments and the use of tools of policy prioritization.<sup>36</sup>

Despite the failure of early specific initiatives to be fully implemented, the general methods of PBB are in widespread use in governments in the United States and elsewhere. Smith suggests that “PBB may soon be the *de facto* standard for public budgeting.”<sup>37</sup> In his thought-provoking paper, he reviews the sources of vulnerability that may affect the use of PBB. The principal concerns include data integrity and the ease by which this integrity can be knowingly and unwittingly compromised, possible politicization within the bureaucracy and outside the definition of outcomes, and ethics where there may be temptation to falsify results. Smith sees the principal benefit of PBB as a method that focuses on the utility of programs in the context of their own life cycle.<sup>38</sup>

A further issue with any budgeting system is the design of a monitoring process and appropriate reaction to a failure to meet targeted outcomes or to reassess the appropriateness of the targets. Klumbers usefully summarizes this point as follows:

The use of performance indicators and the issue of changing objectives are both related to measuring the performance of tasks necessary for the attainment of objectives. If variances between budgeted and actual performance indicators are not acted upon, if inappropriate indicators are used to measure performance, or if objectives are changed so as to disguise inefficiency and ineffectiveness, then many of the criticisms leveled at PBB are justified. The need for an independent performance audit, in this context, assumes some importance.<sup>39</sup>

Bird notes that demand for more useful budget information should not be confused with the attainment of “better” budget outcomes.<sup>40</sup> In terms of implementing a budget and seeking to introduce the elements of performance-based decision-making, Bird emphasizes the importance of information and flexibility but notes that the risk of fraud is somewhat enhanced:

Allocative efficiency requires that managers receive adequate and accurate information on the effectiveness and social outcomes of the programs for which they are responsible. Operational efficiency may be achieved by allowing line managers significant discretion, within budgetary cash limits, to reallocate funds among inputs, or even across budgetary periods, subject to attaining predefined operational (performance) goals and to complying with appropriate internal and external financial control and audit systems. The emphasis is thus shifted from input controls . . . to output controls . . . an essential step in improving policy outcomes, but [with] some risks.<sup>41</sup>

There is a consensus in the literature that the ideal budget process will yield program results as well as accurate information on costs of service delivery.

## **BENCHMARKING AND PERFORMANCE INDICATORS**

### **Performance Measurement**

The common rationale for the implementation of benchmarking and performance measurement initiatives is that administrators will be better able to control costs, compare processes among similar jurisdictions, maintain standards, and perform interjurisdictional comparisons among sectors of activity. Various indicators can be used at various stages of the benchmarking process. Schaeffer provides a simplified summary of the characteristics of indicators, reproduced in table 2.

One of the difficulties of measurement of municipal effectiveness in service delivery is suggested in this table. While the costs of supply are measurable, the measurement of the appropriate level of demand and its fulfillment at a reasonable level (in terms of infrastructure capacity) is more difficult.<sup>42</sup>

### **Recent Canadian Experience with Performance Measurement**

Many major Canadian cities have initiated performance measurement initiatives at the request of their council. These include the cities of Calgary, Winnipeg, Toronto, Ottawa, Thunder Bay, Burlington, and Guelph, and the Regional Municipalities of York and Peel. As part of an ongoing effort to improve municipal fiscal administration, Ontario has taken the initiative to be the first province to require municipalities to measure and report annually to taxpayers on their performance in service delivery.

The first stage of this effort has been carried out since 1999. Thirty-five performance measures including nine core municipal service areas—garbage, sewage, water, transportation, fire, police, local government, land-use planning, and social services—were analyzed by expert panels in a provincial-municipal cooperative effort.

The minister of municipal affairs and housing has also established an advisory committee with representatives from key municipal stakeholders and the ministry.

**TABLE 2 Performance Indicators**

Type of indicator	Definition	Example
Input indicator	Measure of resources employed	<ul style="list-style-type: none"> <li>■ Equipment needed</li> <li>■ Employees required</li> <li>■ Supplies used</li> </ul>
Output indicator	Quantity of service provided	<ul style="list-style-type: none"> <li>■ Number of projects</li> <li>■ Number of classes</li> <li>■ Number of people served</li> </ul>
Effectiveness/outcome indicator	The degree to which the intended objective of the service is being met	<ul style="list-style-type: none"> <li>■ Percentage increase in employment</li> <li>■ Decrease in crime rate</li> </ul>
Efficiency indicator	Cost per unit of output	<ul style="list-style-type: none"> <li>■ Cost/liter of water delivered by household</li> </ul>

Source: Michael Schaeffer, *The Budget and Public Sector Performance*, Power Point presentation (Washington, DC: World Bank, March 2000), 42.

The committee recommended which measures municipalities would report on in 2001 and 2002. The minister is also establishing a Centre of Municipal Best Practices on Performance Measurement. The Ontario municipal chief administrative officer's CAO's benchmarking initiative has also commissioned a set of methodological studies and an examination of the method to apportion the indirect costs involved in service delivery.<sup>43</sup> The CAO's report stresses the need for an iterative approach, using standardized data collection, and not a superficial approach that ignores the diversity of municipal circumstances and complexities in service delivery.<sup>44</sup>

### **Ontario's Proposed New Municipal Act, 2001**

Bill 111 was adopted on December 11, 2001. Its provisions will take effect in 2003. The new act retains many of the previous rules and provides that municipalities are accountable for their budget processes:

- Municipalities are required to prepare a balanced budget each year, and to provide for any surplus or deficit of the previous year.
- Municipal budgets set out major activities, service levels, related costs, and how best to deliver services. Municipalities are required to discuss and approve their annual budgets in public meetings. Budget documents and staff reports are routinely made public before the political decision-making process begins.
- Municipalities are required to submit an annual financial information return to the Ministry of Municipal Affairs and Housing. The return also includes all local boards within the municipality's jurisdiction.
- The proposed new Municipal Act would also require municipalities to publish their annual audited financial statements 90 days after the audit is completed.

Municipalities are also accountable for the way they deliver services:

- The Municipal Act requires a municipality to provide the minister of municipal affairs and housing with designated information related to the efficiency and effectiveness of the municipality's operations.
- The minister can require municipalities to report these results to taxpayers. A new provision in the proposed Act would require municipalities to report to taxpayers annually on any service delivery improvements, and on any identified barriers to improving service delivery.

## CONCLUSION

This paper has reviewed aspects of the budget process, including some of the recent initiatives that will affect practice in Ontario municipalities and possibly elsewhere. It is appropriate to give the last word to Charles Wrenshaw:

### No Safe Government without Budget Control

Without a proper budget there can be no true economy of expenditure, and without departmental appropriations itemized by administrative unit and object of expenditure, there can be no effective control. Estimates which are used only as a basis for determining the tax rate and not as a basis for itemized appropriations for accounting and administrative control, do not constitute a budget; neither can the determination of a tax rate first, and spreading out the revenues afterwards where council thinks it will do the most good, be the foundation of a real budget, nor can this procedure really control expenditures. Estimates on either of these bases can hardly be more than pious wishes and may be thoroughly deceptive documents, *especially* if the estimates are placed below what council knows is actually required.<sup>45</sup>

## NOTES

- 1 Charles Monck Wrenshall, *Municipal Administration and Accounting* (Toronto: Pitman, 1937), 44-45.
- 2 Richard M. Bird and Almos Tassonyi, "Constraints on Provincial and Municipal Borrowing in Canada: Markets, Rules and Norms" (2001) vol. 44, no. 1 *Canadian Public Administration* 84-109.
- 3 See "Gunn Pushes for Megacity Overhaul," *Toronto Star*, December 6, 2001. Gunn's quoted recommendations to the chief administrative officer include the following: (1) "make the definition of full-time equivalent worker consistent throughout all departments using organizational charts so you know who works for you and what's authorized"; (2) "replace the current practice of base-budget planning with zero-based budgeting"; and (3) "consider the capital budget together with the operating budget in order to judge the implications of the capital program on operating expenditures."
- 4 Harry Kitchen, *Issues in Municipal Financing: Spending, Revenues, Governance, and Administration* (Toronto: Canadian Tax Foundation, forthcoming), chapter 10, "Management Issues Affecting Expenditure Controls."
- 5 Richard M. Bird, "Setting the Stage: Municipal and Intergovernmental Finance," in Mila Freire and Richard Stren, eds., *The Challenge of Urban Government: Policies and Practices* (Washington, DC: World Bank, 2000), 113-28, at 122.
- 6 Michael Schaeffer, *The Budget and Public Sector Performance*, Power Point presentation (Washington, DC: World Bank, March 2000), 21.
- 7 See Kitchen, *supra* note 4.



- 8 Wrenshall, *supra* note 1, at 53.
- 9 The relationship of appropriate funding mechanisms and infrastructure projects is discussed in Almos Tassonyi, "Financing Municipal Infrastructure in Canada's City-Regions," in Paul A.R. Hobson and France St-Hilaire, eds., *Urban Governance and Finance: A Question of Who Does What* (Montreal: Institute for Research on Public Policy, 1997), 171-204.
- 10 Michael Schaeffer, *Municipal Budgeting*, Urban and Local Government Background Series 4 (Washington, DC: World Bank, April 2000), 20-21.
- 11 Kitchen, *supra* note 4.
- 12 Schaeffer, *supra* note 6, at 14.
- 13 Various accounting methods are discussed in Kitchen, *supra* note 4, and in Michael Fortin, Enid Slack, Mike Loudon, and Harry Kitchen, "Financing Water Infrastructure," Issue Paper 14 commissioned by the Walkerton Inquiry (Toronto, May 2001), 93.
- 14 Canadian Institute of Chartered Accountants, Public Sector Accounting Board, *Public Sector Accounting Handbook* (Toronto: CICA, 2000).
- 15 Canadian Institute of Chartered Accountants, Public Sector Accounting Board, *Local Government Financial Reporting* (Toronto: CICA, 2001).
- 16 Akos Szalai, "Budgeting in Hungarian Local Governments" (draft mimeograph, Open Society Institute, Local Government Initiative, Budapest, 2001).
- 17 A. Premchand, *Public Expenditure Management* (Washington, DC: International Monetary Fund, 1993), 53-80.
- 18 See *ibid.*; George Kopits and Jon Craig, *Transparency in Government Operations*, Occasional Paper no. 158 (Washington, DC: International Monetary Fund, 1998); George Kopits and Steven Symansky, *Fiscal Policy Rules*, Occasional Paper no. 162 (Washington, DC: International Monetary Fund, 1998); and Vito Tanzi and Ludger Schuknecht, *Public Spending in the 20th Century: A Global Perspective* (Cambridge, UK: Cambridge University Press, 2000).
- 19 Bird, *supra* note 5, at 122.
- 20 *Supra* note 2, at 84.
- 21 David P. Amborski, *Review of the Regulatory Environment of Municipal Capital Borrowing* (Toronto: Intergovernmental Committee on Urban and Regional Research Press, August 1999).
- 22 See *Local Government Financial Reporting*, *supra* note 15.
- 23 Bird, *supra* note 5, at 122.
- 24 Schaeffer, *supra* note 6, at 39.
- 25 *Ibid.*, at 40.
- 26 The initial perspective on budget making as a conflict-resolution process is articulated in Aaron Wildavsky, *Budgeting: A Comparative Theory of Budgetary Processes* (Boston: Little Brown, 1975).
- 27 Kitchen, *supra* note 4.
- 28 *Ibid.*
- 29 Bish makes the interesting point that municipalities should build excess capacity into their costing exercises as a way to economically deal with differing pressures on staff throughout a year. Robert L. Bish, *Local Government Amalgamations: Discredited Nineteenth-Century Ideals Alive in the Twenty-First*, C.D. Howe Institute Commentary no. 150 (Toronto: C.D. Howe Institute, March 2001), 12.
- 30 See Kitchen, *supra* note 4.
- 31 *Ibid.*
- 32 *Ibid.*

- 33 Richard Allen and Daniel Tommasi, *Managing Public Expenditure: A Reference Book for Transition Countries* (Paris: Organisation for Economic Co-operation and Development, 2001), 132.
- 34 *Ibid.*, at 132-33.
- 35 *Ibid.*, at 133.
- 36 Katherina Peters has written an interesting case study of the introduction of reforms into the budgetary method in Berlin using a game-theory approach. See Katherina Peters, "When Reform Comes into Play: Budgeting as Negotiations Between Administrations," *Schrittenreihe der Forschungsgruppe "Metropolenforschung" des Forschungsschwerpunkts Technik—Arbeit—Umwelt am Wissenschaftszentrum Berlin für Sozialforschung FS II 00-501* (Berlin: Wissenschaftszentrum Berlin für Sozialforschung, 2000).
- 37 James Fielding Smith, "The Benefits and Threats of PBB: An Assessment of Modern Reform" (1999) vol. 19, no. 3 *Public Budgeting & Finance* 4-15, at 4. Ron Kluvers, "An Analysis of Introducing Program Budgeting in Local Government" (2001) vol. 21, no. 2 *Public Budgeting & Finance* 29-45, provides an analysis of PBB in Australia.
- 38 Smith, *supra* note 37, at 14.
- 39 Kluvers, *supra* note 37, at 44.
- 40 Bird, *supra* note 5, at 122.
- 41 *Ibid.*
- 42 Some of these issues are discussed in Z. Hermann, T.M. Horvath, G. Peteri, and G. Ungvari, *Allocation of Local Government Functions: Criteria and Conditions—Analysis and Policy Proposals for Hungary* (Washington, DC: Fiscal Decentralization Initiative for Central and Eastern Europe, 1999).
- 43 See Ontario Municipal CAO's Benchmarking Initiative Steering Committee, *A Summary of Phase 1 and Phase 2 Pilot Projects* (Thorold, ON: Ontario Municipal Benchmarking Project, September 2001) (available on the Web at <http://www.caobenchmarking.ca/docs/OMBIPhase1and2Summary.doc>).
- 44 *Ibid.*, at 7.
- 45 *Supra* note 1, at 56.