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How to Lose \$5.2 Million in Your Operational Budget and Still Make It Balance

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Abstract

Some cities experience exponential growth. Some cities experience operating budget shortfalls. Significantly few cities experience both simultaneously and are still able to balance their budgets for the upcoming fiscal year. This is the predicament a small municipality found itself in as it was forced to face unimaginable challenges at the beginning of fiscal year 2022. The operational budget shortfall could happen to any municipality and may have even happened to yours.

This article will explore what happened, how it was discovered, what was done to balance the budget, and what measures were put in place to prevent this from happening in the future. To understand how this happened, you will need to first understand the process that was being used, how the operational budget was presented to the city council, and some of the “tricks” that were used to veil actual representations.

Introduction and History

To better understand the situation, the history as to where the city was financially and how they got to the point of being \$5.2 million in deficit will be reviewed. With the completion of the Grand Parkway toll road and having two exits into our city, Dayton was at the cusp of exponential growth. With approximately 12,000 new homes being developed, Dayton’s population was going to explode from 9,000 to 45,000 within just a few years. The City borrowed \$18 million to finance an internet fiber service that would be provided as a city utility, just like water and sewer. There were two industrial parks that had just completed construction, and multi-million dollar businesses were vying for space to expand their locales. Fast food restaurants were popping up left and right. Things couldn’t get much better for Dayton and, at the time, the city administration could only see dollar signs.

Enter budget season. The adopted local government budget is the ultimate control on financial management, and, when properly executed, can provide a valuable resource for all stakeholders while providing for efficient and effective management and operations. However, in practice, counties and cities often throw together a line-item budget at the last minute, resulting in a budget that is often misunderstood, provides no operational guidance, causes an unreasonable amount of budget transfers and budget amendments, and provides no useful information regarding outcomes and performance measurement. In essence, the local government budget is typically more an event than a process.¹ This was the procedure we were using to present our operational budget to our city council. Between our former City Manager and former Finance Director, instead of explaining the budget and going over where revenues were coming from, how rates were affected, and what the internet fiber project would do if it failed, they provided the city council

with charts, graphs, and a very vague feasibility study to support the internet fiber project. Trusting that the City Manager and Finance Director had the City of Dayton’s best interest at heart, the city council approved everything without a question asked. So what happened?

The Problems We Found

I interviewed our current Finance Director, Calyn Wesson, to ask her how we got to the point of being \$5.2 million short in our operational budget. She explained what she thought had happened and how the former administration failed. “I ran an Income Statement for the City’s Water & Sewer Fund and did a quick trend analysis. It showed that we were not going to come close to meeting our budget for revenues,” she said, as is shown in Figure 1 below. Wesson then explained her discovery process:

I then ran a balance sheet for the same fund and our cash balance was negative. The same reports for the General Fund showed we had very low cash. I was alarmed so I started to run the same reports for prior years. You could see the General Fund was depleting its account that housed the ‘reserve requirement.’ In addition, I started to see that each year the Water & Sewer Fund was increasing its budget for water and sewer; however, it was never being met.²

Figure 1: City of Dayton, Budgeted versus Actual Revenues

	19/20		20/21		21/22	
	Budget	Actual	Budget	Actual	Budget	Projection
Water	2,434,700	1,855,828	2,806,038	1,970,451	3,281,168	1,949,369
Sewer	2,129,900	1,837,534	2,386,800	1,888,748	2,776,373	1,929,412
Total	4,564,600	3,693,362	5,192,838	3,859,199	6,057,541	3,878,781

By rounding the numbers, in 19/20, actual revenue was \$3.7 million when the budget was \$4.6 million, meaning a shortfall of \$900 thousand. However, the revenue budget was increased to \$5.2 million for the next year. Again, there was a shortfall between the increased budget and actual revenue (\$3.9 million) of around \$1.3 million. Despite this, there was another budget increase to almost \$6.1 million in 21/22. My first projections showed we would only bring in roughly \$3.9 million; a shortfall of \$2.2 million.

It did not make sense to me that we would budget such increases without a significant rate increase or almost doubling our billable accounts, neither of which occurred. The only recent rate increase I found was about 1%, which would not come close to explaining why so much was budgeted in revenue. What was found, though, was the Water & Sewer debt payments and the transfers out to the General Fund continued to grow each year. Without anything to support such a substantial increase in budgeted revenues, it appears that revenues were being inflated to make the budget work. The City’s expenses were increasing each year; therefore, the revenues needed to increase as well. Each year the City was absorbing the increase in costs which depleted all the cash reserves. Inflation impacts purchases made by the City and not just residents. The City’s largest source of revenue is property tax. Other revenues include: sales tax, franchise tax, court revenue, water, sewer, and solid waste. There are more sources of income, however, none as material as the ones listed above.

In addition to the \$2.2 million budget shortfall in 21/22 as shown in Figure 1, we discovered we were short \$2 million in our General Fund Reserves and negative \$1 million in the Water & Sewer Fund. All this combined led to the loss of \$5.2 million. These actions did not happen overnight; this was a combination of several factors that led up to this budget shortfall.

We believe that a monthly review of the Income Statement could have helped. Part of the month end process we use includes a monthly report to City Council. When we review the report, our Finance Director does a quick trend analysis on revenue as well as expenditures. There must be knowledge of your funds and accounts because not all revenue and expenditures are equal amounts each month; some are cyclical. If the Finance Director sees that we are not trending in the right direction, she will investigate further.

We do, however, think poor financial management was a contributing factor. Based on what we have seen, it appears that the budget was forced to work by inflating revenues, even though revenues hadn't increased. The City Council might have identified this, however, it is the Finance Director's responsibility to be the subject matter expert on these items in addition to having the fiduciary responsibility to look out for the city. Some of the spending that we have seen would be normal if the City was in a better financial situation.

Along with the operational budget shortfall, we discovered that the internet fiber project was doomed from the beginning. After researching the feasibility study provided by the contractor, it was realized that even if every single person in the city were to get onto the fiber, it wouldn't pay back the \$18 million we had borrowed to supply it. There was no way we could make this work and pay back the debt, much less consider it a revenue source.

Based on all of these issues, we were not eligible to go out for more debt or bonds. We would be lucky to balance the budget, much less anything else.

How We Fixed It, Made It Better, and Made It Balance

Once we discovered our budget shortfall, we immediately stopped all purchases across all departments unless immediately necessary. We canceled all training unless it was crucial to day-to-day operations, and we terminated all of our contractors such as grant managers, engineers, and the internet fiber crews. This saved us over \$500,000.00.

We closed the community pool, saving over \$200,000 in operational and maintenance costs. One of the more unfortunate decisions we made was to lay off over 20 employees and eliminate "extra," or non-priority, positions. This provided savings of approximately \$500,000 in salaries and benefits. With these savings, we were able to help the employees we kept with their retirement and benefits package.

The City Council and City Manager know our greatest assets are our people. The employees of the City of Dayton have been through a lot in the past several years. Updating our retirement benefits was very costly, however, it was the right thing to do for the employees. It is also necessary to recruit new staff because the benefits package we changed to is almost standard for every other city. We reduced the Health Savings Account (HAS) contribution because it was excessive, and we felt the employees were better off having the funds redirected to their retirement.

Another hard decision that had to be made was to raise the water rates. The rates had only been increased 1% since 2020. The water rates were raised by 8% and will continue to increase by 8% each year over the next eight years, which is still in line with the state rate. It was an extremely unpopular decision with our citizens, but it provided revenue that was desperately needed. Raising the rates gave us an additional \$1 million in revenue.

A couple of items contributed to the City being able to present a balanced budget. A main contributor was the American Rescue Plan Act (ARPA) funding. When the spending restrictions were loosened and cities were able to deposit them into their General Funds for general use, we capitalized on that. We were able to put \$1.8 million in ARPA funding back into our General Fund.

Because some of the ARPA funds had already been allocated, we had to get our Economic Development Corporation to give the city a grant for those expenditures so we could deposit all the ARPA funds into the General Fund. Fortunately, the Economic Development Corporation granted the city the funds. In addition, staff was cut, spending was redirected, water and sewer rates were increased, and we took advantage of a large fund balance sitting in the I&S (interest & sinking) funds. We also skipped \$500,000 in debt issuance for 2022. All of this combined led us to make up for the \$5.2 million budget shortfall and balance our budget.

We used the excess fund balance to pay this year's debt payment that the Water & Sewer fund would typically pay. Because of this change, the Water & Sewer fund had excess cash that was used to bring its cash level back to positive as well as transfer to the General Fund. Sustaining this going forward will be very important. Next year will be a challenging year because the General Fund will not receive such a large transfer in from the Water & Sewer fund as it will be making the debt payments that year. Expenses will have to be scrutinized and rates for city services will need to continue to increase.³

Measures Put in Place Moving Forward

To prevent this from happening in the future, protective measures were put in place and implemented. We have enhanced our purchasing procedures: requisitions for expenditures greater than \$500 must be entered and approved prior to purchasing. This approval process goes through the department head, the accounting manager, and the Finance Director. This helps ensure all parties are aware of the expenditure, it is being coded correctly, and it is within budget. In addition, department heads are required to sign off on all invoices less than \$500.

Accountability is being placed on the department heads for their budgets. In addition, at month end, Accounting runs a report to monitor accounts and ensure none are over budget. If any are over budget, the department is emailed, and a budget transfer must be requested.

The department heads build almost a zero-based budget where they must prove out all of their requests and provide support, if necessary. Too often, organizations tend to expect results from budgetary control and fail to recognize that most problems of budgeting are behavioral.

Where there is cause for dysfunctional behavior, pressures are created leading to mistrust, hostility, and actions detrimental to the long-term prospects of an organization. Thus, every budgeting system must be tailor-made, and its success should be measured by the extent to which it provides the necessary motivation for individuals to make their maximum contribution to the achievement of organization goals.⁴

Based on this observation, the City currently uses the Theory Y budget system. This process emphasizes that the governing body sets the goals and direction for the entire budget, and once it has been done, steps back to leave staff to the task of figuring how to meet the goals with the available resources and then to hold the staff accountable for the outcomes.⁵

We also prepare a monthly finance packet to send to the City Council that is thoroughly discussed during Council meetings so that the Council is aware of what is going on with the finances of their City. This packet includes a listing of all checks printed for the month, a budget versus actual on all active funds, a snapshot of the debt, the required investment report, and a

property tax reconciliation, as this is the largest source of revenue for the City. There are plans to add another section to give the Council an update on all grant funds.

While our financial portfolio is not exceptional, it continues to improve with time. We were able to balance the budget and actually have two months of reserves in our General Fund. Just as the shortfall didn't happen overnight, the solution will not happen overnight. We will continue to strive for financial excellence and do what we need to do to get back on track.

Conclusion

In conclusion, several factors led to this operational budget shortfall. This situation could have been avoided if we had paid attention and participated in the budget process. When only one or two persons oversees your budget and making the decisions, it is harder to stand up and say, "I don't think this is right." Speaking up and being strong may prevent financial situations like this from occurring. If something does not make sense, ask questions about it. If it does not look right, get clarification and do not be afraid to ask "why?" It is your budget, and you will be the one who is accountable for it in the end. Get involved, take charge, stand up for what you believe to be right, and if you are wrong in the end, apologize, and know that at least you were diligent in your budget process.

Notes

¹ Tony Sims, "Leadership Through Budgeting: Controlling Taxes and Increasing Services." *Certified Public Manager® Applied Research* 3, no. 1 (2022): 1.

² Calyn Wesson, City of Dayton Finance Director, In-person interview September 20, 2022.

³ Ibid.

⁴ Moolchand Raghunandan, Narendra Ramgulam, and Koshina Raghunandan-Mohammed, "Examining the Behavioral Aspects of Budgeting with Particular Emphasis on Public Sector/Service Budgets," *International Journal of Business and Social Science*, 3, no.14 (2012).

⁵ Scott Douglas Lazenby, *The Human Side of Budgeting: Budget Games & How to End Them* (Sandy, OR: Erehwon Press, 2013).