Forecasting can be a powerful tool that informs financial decision-making, but financial forecasts are surprisingly ineffective in influencing decision makers. What steps can be taken, then, to make forecasts more meaningful to the people who need them?

The answer lies in the power of the organizational milieu — especially procedures, policies, and institutional identity — to shape the decisions we make. A simple thought experiment illustrates the power of milieu in public financial management to shape financial choices in local governments. Exhibit 1 invites you to consider two hypothetical cities, imaginatively named A and B. Assuming both cities face similar socio-economic conditions and are run in similar ways, which one do you think will make better use of forecast information and make consistently better choices?

The hypothetical cities above imply that governments need to focus on three key areas: financial policies, budgeting practices, and strategic planning. Establishing a solid foundation of policies, procedures, and goals makes

<table>
<thead>
<tr>
<th>Exhibit 1: A Tale of Two Hypothetical Cities</th>
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<tr>
<td><strong>City A</strong></td>
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<tr>
<td>Financial policies are maintained in writing so that everyone knows the standards of good financial management and the guidelines for decision making.</td>
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<tr>
<td>Officials are regularly provided with survey data and other objective indicators of citizens’ views.</td>
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<tr>
<td>Good decisions are captured by, for example, embedding them into stories that become part of the culture.</td>
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<tr>
<td>A set of goals has been agreed upon.</td>
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<tr>
<td>The budget process asks officials to consider how all available revenues can be used to best achieve the community’s goals and priorities.</td>
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<tr>
<td>A strategic financial planning process asks officials to think about long-term financial sustainability.</td>
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it easier to evaluate forecasts in light of existing protocols and institutional objectives, and is therefore necessary in building an organizational milieu that readily incorporates forecasts into the decision-making process.

**ESTABLISH FINANCIAL POLICIES**

How can public managers create an environment that supports using financial forecasts to make decisions? Financial policies are a good place to start. Financial policies establish local standards for acceptable and unacceptable courses of financial action, guidelines under which the government can operate, and a standard against which the government’s fiscal performance can be judged. Financial policies provide details to back up the principles, without crossing the line into administrative procedure. Types of financial policies that are especially important for creating a good environment for using forecasts in decision making include:

- **Reserves.** A reserve is the portion of fund balance (or working capital, in an enterprise fund) that is put aside as a hedge against risk. A reserve policy establishes the desired level of fund balance to maintain as a hedge — for example, the policy might require the government to maintain reserves equal to at least 17 percent of its regular operating revenue. A reserve policy implies the need for good forecasting to predict whether reserves will remain at desired levels, given future revenues and spending.

- **Structurally Balanced Budget.** Many local governments are subject to state laws that require a “balanced budget,” where sources of funds equal uses of funds. But if non-recurring sources such as asset sales or use of fund balance are used to pay for recurring uses of funds (e.g., employee salaries), then the budget is not truly balanced — the government will eventually run out of non-recurring sources and be left with a deficit. A policy on maintaining true structural balance requires recurring expenditures to be covered by recurring revenues. Determining whether true structural balance can be expected into the future requires a forecast.

The most important financial decisions are made during the budgeting process, so the very design of this process should encourage the use of forecasting information.

- **Non-Recurring and Volatile Revenue Policies.** This policy commits the government to using non-recurring revenues for non-recurring expenditures in order to avoid creating structural imbalance. This policy can be extended to include volatile revenues (i.e., a recurring revenue, the yield of which varies significantly from year to year). If a government were to budget recurring expenditures equal to the income from volatile revenue during a peak in the revenue’s performance, a structural deficit would result when the revenue comes down from its peak. A policy commits the government to treating extraordinary income from volatile revenue similarly to the way it would treat non-recurring revenues. Revenue forecasting and analysis is needed to identify which revenue sources qualify as “volatile,” and when revenue yields are within normal ranges and when they are extraordinary.

- **Long-Term Financial Planning.** This policy commits officials to considering the long-term implications of decisions made today in order to ensure that the short-term benefits of a decision are not outweighed by long-term disadvantages. Naturally, long-term forecasting is required to gain insight into the implications of these decisions.

**DESIGN BETTER BUDGETING PROTOCOLS**

The most important financial decisions are made during the budgeting process, so the very design of this process should encourage the use of forecasting information. Less traditional budgeting formats tend to encourage better use of forecasting. Traditional budgeting formats are characterized by an emphasis on controlling spending through detailed line items; inputs into public services (i.e., staffing, materials) rather than the outcomes; and incremental decision-making wherein the government starts the budget with last year’s expenditures and adjusts them up or down at the margins as required, given assumed revenue growth or contraction. Conversely, governments that have budgets that incorporate a planning orientation, take program performance into account when allocating resources, and take an explicit, structured approach to weighing competing potential uses of resources are more likely to get value out of revenue forecasts.
The traditional, incremental budget process tends to emphasize expenditures, as that is where the budget discussion begins: What did we spend last year? An alternative approach to budgeting starts by asking what resources are available, and it may even engage public officials in a discussion on whether tax and fee levels are appropriate, given the service demands of the public. This difference in approach, although subtle, emphasizes revenue forecasts as a tool for revealing the level of resources available as the starting point for budget discussions. Budgeting methods like target-based budgeting, priority-based budgeting, and budgeting for outcomes ask decision makers to “go shopping” for programs or services that will do the most to further the organization’s objectives. The forecast defines how much is available to go shopping with.

**DEVELOP A STRATEGIC PLAN**

Developing a strategic vision for the community is a powerful opportunity to create an environment that supports forecasting. GFOA has long advocated for local governments to undertake long-term financial planning, which combines financial forecasting with financial strategizing to identify future challenges and opportunities, causes of financial imbalances, and strategies to secure financial sustainability.

Cognitive science helps elucidate the relationship between strategic planning and forecasting through its dual process theory — that we each have two mental processes for making decisions, called System 1 and System 2. System 1 works intuitively, reflexively, and quickly. System 2 works rationally, deliberatively, and more slowly. Humans inherently use System 1 most often because it requires less biological energy to use.

**Identity Formation.** How can the “intuitive” side of decision making be used to support the use of forecasts? Political science research would suggest the answer can be found in the identity model of decision making. According to this theory, people take shortcuts and make decisions consistent with what they believe someone like themselves would do in a similar situation. This explains why voters sometimes vote against their rational self-interest (e.g., a millionaire who sees herself as a progressive person voting for a candidate who might raise their taxes to pay for social services).

Decision makers’ identities can affect their inclination to use and support forecasts in decision making. For example, in the City of Boulder, Colorado, the community has a strong interest in the sustainability of the natural environment. As such, the city government has a vision for making Boulder more environmentally sustainable and develops strategies and plans accordingly. Decisions are made through the lens of sustainability, and the city’s leaders have expanded this “sustainability” identity to include “financial sustainability.” Hence, decision makers in Boulder are more likely to inquire about what forecasts say about the long-term sustainability of city decisions. This shortcut strategy is applicable to any organization, regardless of its identity. Any clear and compelling strategic plan to provide better services to the community, along with the realization that money is needed to achieve that vision, can form the basis for an identity that supports forecasting.

**Rational Decision Making.** More rationally driven decision making can also help connect forecasting with long-term strategic plans. Forecasts can inject reality into long-term planning by highlighting resource constraints, thus encouraging decision makers to weigh the relative importance of long-term goals and identify those that are most important.

**CONCLUSIONS**

Financial forecasts have an important potential to improve decision making, but the decision making environment must be designed to unlock this potential. Hence, finance officers should design financial policies, the budget, and long-term financial plans that encourage decision makers to induct forecasts into their deliberations.

**Notes**


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