

CAPITAL BUDGETING STRATEGIES IN GOOD TIMES . . . AND BAD

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This study, drawing upon interviews with officials from 33 communities across the state, explores the opportunity for improving capital budgeting among municipal governments. The results illustrate the dramatic changes underway in capital budgeting in the wake of the Great Recession and the State of Illinois' deepening fiscal crisis while highlighting practices and strategies now being used. By reviewing exemplary examples from throughout the state, the study offers practical guidance for municipalities seeking to improve this form of budgeting in good times and bad.

INTRODUCTION

Capital budgeting is widely recognized as being vital to effective and efficient municipal services. During good economic times, this can be challenging, but manageable. During bad times, however, the challenge can seem overwhelming. This raises several important questions: How do municipalities meet capital needs in times of fiscal stress or uncertainty? What types of “best practices” should local leaders follow to overcome the obstacles associated with this type of budgeting?

To help answer these questions, this study pursues two objectives. First, it illuminates the capital budgeting problems that have become pervasive among municipalities in the state. Second, it shares insights from the professionals who continuously deal with this problem to help others grapple with this often-neglected issue.

The principle methodology used to meet these objectives involves evaluating the results of key informant interviews. Over a six-year period, 44 municipal government officials from 33 municipalities in the state took part in structured interviews. (See Figure 1 for a map showing the locations of these communities.) Eight officials were interviewed in the spring or summer of 2010 and the remaining 36 were interviewed this past summer.

Among those interviewed were mayors, village and city managers, and budget and finance officials. This information is supplemented with descriptions of “best practices” obtained from publications by the Government Finance

Officers Association (GFOA) and the International City/County Management Association (ICMA).

FIGURE 1
State Map Highlighting Municipalities Interviewed



These results are summarized in four sections below. The first section broadly examines the major capital budgeting challenges facing municipalities reported by the respondents. The second section evaluates how the Great Recession and the state's fiscal situation have affected the budgeting process. The third section considers the capital budgeting strategies that municipalities are using. Together, the results show that—despite persistent problems—many municipalities are responding vigorously to generate the capital they need.

MAJOR CAPITAL BUDGETING CHALLENGES

Insufficient revenue to meet capital needs is, not surprisingly, widely regarded as the largest capital budgeting challenge facing Illinois communities. The causes of the insufficient revenue include resistance to tax increases, backlogs in capital maintenance, the high costs of capital projects, and competing demands for the use of municipal revenues.

When asked about insufficient revenue, some of the municipal officials described the struggle to raise taxes or user charges in their communities. “People want services but they don’t want to pay for them,” noted a former Moline official. Several people reported that property taxes are already high, primarily due to school district taxes, which hinders the ability of the municipal government to raise taxes.

Other government representatives indicated they are currently coping with the problems caused by past underinvestment in capital infrastructure. Many officials cited a decrease in the ability of their municipalities to keep up with capital needs during the Great Recession, while others stated that their backlog dates to pre-recession years.

A related issue voiced quite often is the age and condition of the existing infrastructure and the high price of capital replacement. “Our aging infrastructure is outdated and creates issues during very heavy rains,” asserted a representative of Forest Park. Several others commented on the high price of equipment, such as a ladder fire truck which they said costs about \$1 million.

Another factor that contributes to the lack of sufficient revenue for capital is the need to finance other costs such as salary increases, employee health care, pensions, and federal and state mandates. “The growth in police and fire pension contributions have resulted in less funds for capital, which is one of the first things we cut,” noted a current Moline official. “The city’s police and

fire pension contributions have increased from \$2.5 million in 2006 to \$8.9 million in 2017.”

That sentiment was echoed in other interviews. “We transfer funds from the general fund at year-end to be used for capital,” noted a Barrington representative. “As unfunded mandates increase, less is available for capital.” The interviewees expressed concerns about various mandates from state and federal governments, such as dispatch consolidation, Americans with Disabilities Act requirements, prevailing wage rate provisions, proposed new water testing requirements, and Freedom of Information Act requirements.

THE IMPACT OF THE GREAT RECESSION

The Great Recession only lasted officially from 2008-09, but its effects were felt for much longer, resulting in significant declines in revenues or sluggish growth. This had a major impact on the ability of municipalities to finance capital maintenance and to replace aging infrastructure, equipment, and fleets. Capital spending often was deferred as communities struggled to maintain services and pay staff.

Among the municipalities that were especially hit hard was Joliet. “Our revenues dipped for about five years,” recalled a representative from that community. “We were constantly cutting and freezing positions and eliminating positions through attrition. In 2007 we received more revenue than we are receiving now. We stopped doing capital for a while. Our casino revenue went from \$36 million to \$18 million now. Some revenues are coming back, such as those associated with our warehouse district.”

The troubles could also be seen in Decatur. “The city finished in the black but equipment was not replaced, infrastructure projects were deferred, and cash reserves were depleted,” remembered a representative from that community. There were also troubles in Bloomington as one official stated that the city faced serious financial issues in 2008, including negative fund balances in the general fund, the capital improvement fund, the vehicle replacement fund, and others. The official stated the city’s overall cash reserves dropped to an equivalent of about 30 days of operations. However, over a period of four to five years, the city has replenished its reserves to over \$15 million.

Municipalities recognize the trajectory of their growth may have been permanently changed by the Great Recession. Some are experiencing rising sales tax and property tax revenues and have now surpassed pre-recession

revenue levels, while others have not experienced a full recovery and must adjust plans accordingly.

IMPACT OF THE STATE GOVERNMENT FISCAL PROBLEMS

The far-reaching effects of the fiscal problems facing the State of Illinois was another pervasive theme. During 2015, there was a delay in state funding to municipalities for motor fuel taxes, casino and video gaming taxes, use taxes, and 911 surcharges on phone bills. Plus, Governor Bruce Rauner proposed that the state should cut the income tax revenues that are shared with local governments by 50%, which drew harsh backlash from communities.

The results of the state budget impasse were mixed. Most of the interviewees said their communities had sufficient cash reserves to withstand the delay in the receipt of state revenues. Some municipalities delayed capital projects until the state funds were released. Many of the interviewees said their communities are still waiting to receive state grants they were awarded during the past couple of years. Some projects have been put on hold while others have continued with the local government fronting the state funds. Some officials noted that the state fiscal situation and uncertainty make it harder to attract new businesses to Illinois.

As a result of the future uncertainty in state revenues, some municipalities are taking a more conservative approach to budgeting, such as cutting departmental budgets or increasing fund balances. A Champaign official said “increasing the fund balance will give us time to make well-thought-out decisions.” That sentiment was echoed by an official from Naperville. “We are focusing more on what we need to do to be strong and proactive,” the western suburb representative said. “We have adopted a goal to pay down our debt and be less reliant on borrowing. We passed a 0.5% home rule sales tax but left capacity to go higher if we need to.” In West Chicago an official stated, “If the state cuts our revenues, we would redirect revenue for capital purposes to operations.”

MUNICIPAL CAPITAL BUDGETING PRACTICES & STRATEGIES

This section addresses capital budgeting practices and strategies that are being used by municipal governments in the state (see Table 1 and Table 2 for notable examples). These approaches can help municipalities plan for the future, involve and communicate with the public, and identify funding sources for capital projects.

TABLE 1
Examples of Capital Budgeting Practices

<p>CHAMPAIGN: Prepare a multi-year capital improvement plan</p>	<p>Champaign uses a collaborative approach to develop its 10-year CIP. Teams of staff review and make recommendations on capital projects within their assigned funds (e.g., transportation, economic development). The Capital Improvement Review Team, which includes the planning and development director, finance director, public works director, neighborhood services director and a deputy city manager, manages the process and prepares staff’s recommendations for city council consideration.</p>
<p>SPRINGFIELD: Establish revenue sources dedicated to capital</p>	<p>Springfield has several revenue sources dedicated to capital, including a 0.25% home rule sales tax, a portion of the hotel/motel tax, and video gambling revenues. In 2013, the city implemented an additional 0.5% home rule sales tax to support an \$87 million general obligation bond issue for roads and sidewalks.</p>
<p>MOLINE: Create capital replacement funds</p>	<p>Moline administers a fleet services fund (an internal service fund), which the city uses to purchase vehicles, trucks, and heavy equipment. The departments that use the fleet pay a fee, which covers the costs of operations, maintenance, and replacement. The recommended 2017 budget that has been submitted to the city council also includes a new facility replacement fund.</p>
<p>RANTOUL: Maintain a capital reserve fund</p>	<p>Rantoul has a corporate reserve fund which it uses for special projects, such as repairs to facilities or for grant-funded projects that require a local match. The fund receives funding from a transfer from the general fund when its fund balance is more than 30% of annual expenditures.</p>

1. DEVELOP A CAPITAL IMPROVEMENT PLAN THAT INCLUDES PROJECT PRIORITIZATION

An important part of capital budgeting is the identification and prioritization of capital projects. Best practice calls for the creation of an integrated multi-year capital improvement plan (CIP), which includes a list of capital projects for each year, along with the estimated costs and funding sources for each project (Marlowe, Rivenbark, & Vogt, 2009). Typically the first year of the CIP is adopted as the capital budget.

An integrated CIP has multiple benefits. It can be used to align capital investments with a community’s comprehensive plan and facilitate coordination among departments. A CIP can identify in advance the need for debt-financing or the accumulation of cash reserves, as well as opportunities for grants. It also can serve as a means to communicate with the public. A

TABLE 2
Examples of Capital Budgeting Strategies

<p>WEST CHICAGO: Tie capital plans to the community's strategic plan</p>	<p>The City of West Chicago over a period of nine months engaged residents in the development of the West Chicago Strategic Plan. This plan identifies community priorities, strategic objectives, and action items, including high-priority capital investments.</p>
<p>KEWANEE: Solicit input from stakeholders</p>	<p>Kewanee distributed a survey to help identify residential priorities. An official explained, <i>"We are targeting the alignment of resources with customer needs. The citizens want us to place our emphasis on streets, sidewalks, and stormwater."</i></p>
<p>BLOOMINGTON: Communicate with the public</p>	<p>Bloomington officials go into quadrants of the city to discuss how the CIP addresses neighborhood needs, what projects in the plan are the most relevant to that quadrant, and how the projects will be financed. Following approval of the CIP, city officials plan to continue to communicate with neighborhoods and others about major construction activities.</p>

Highland Park official stated the CIP helps make the public aware of the total amount of infrastructure investment and provides a description of each project that will be undertaken.

Most CIPs span for five to six years, although some Illinois municipalities have longer plans. For example, the City of Naperville has a 20-year plan and the Village of Barrington has a 25-year plan. "Five years is not sufficient for large projects with respect to infrastructure planning as well as financial planning," noted an official from Champaign, which has a 10-year capital improvement plan.

Some governments have experienced challenges in implementing their CIPs. During the Great Recession, some municipalities funded essential projects and deferred others. An official from Rantoul surmised that the projects in the out years are often a wish list, with projects being deemed negotiable.

It is hard to forecast the availability of federal or state funding for street projects, but, "we still want to keep those projects listed as needs," according to a Plainfield representative. Several of the officials who were interviewed said that their municipalities have multi-year master plans for particular functions, such as water and sewer, but do not have an integrated plan that includes all functions.

“In the past we put together of a list of things we would like to do and thumbnail estimates of costs without a true plan to coordinate water, sewer, or streets,” noted a Kewanee representative. “We lacked transparency – no one had the ability to see when a street would be fixed. There was no accountability – we didn’t say what we would do and so it was hard to hold us accountable. We would fix something and then later do the related sub infrastructure. Now we are putting together a five-year CIP to improve the process.”

The preparation of the CIP consists of three major stages: (1) the development of proposed capital projects, (2) the review and prioritization of capital projects and an analysis of the municipality’s ability to finance those projects, and (3) the review and approval of the CIP by the municipal legislative body.

Typically, professional staff plays the lead role in proposing capital projects. They may respond to mandates or needs identified by the public or elected officials and also conduct their own professional analysis. For existing assets, staff may consider the age of the asset, its repair history, its condition, and the need for a replacement. For new assets, staff may take into account the community’s development patterns and the capacity of existing infrastructure, as well as capital projects that are needed to support the community’s comprehensive plan or strategic plan. The staff then prepares a description of each of the proposed projects, along with the estimated costs and funding sources. In some municipalities, the staff is asked to rank the proposed capital projects within their respective departments.

The next major step is to review the departmental requests, prioritize projects, and assess the ability of the municipality to finance projects. This usually is the responsibility of the city/village manager or the mayor in consultation with the finance official and other key staff, such as the public works director. Some municipalities use special committees to assist in the process. For example, the City of Lombard has a public works committee, which includes eight residents and one village trustee as chair, which reviews the CIP and provides input regarding priorities. In West Chicago, 50% of the city council members serve on an infrastructure committee that compiles the five-year CIP.

Some municipal officials stressed the value of using technology to assist in the capital planning process. “Our capital planning software allows us to input different versions of a project and see the overall impact,” noted a Champaign official. “This helps us determine whether we can afford the project or need to make revisions.” Several other officials commented on the value of using geographic information systems (GIS) to assist in capital planning.

Following the preparation of the CIP, the municipal legislative body is responsible for the review and approval of the CIP and for the adoption of the capital budget (typically the first year of the CIP).² Professional staff will help educate the elected officials about the proposed CIP through presentations, meetings, or tours and by providing maps, pictures, and information sheets about the proposed projects. Most of the officials interviewed for this study indicated that the legislative body for the most part adopts the CIP as proposed by staff; however, some elected officials may make additions or revisions to specific projects that have the most direct impact on their constituents. Some municipalities have workshops or meetings with elected officials early in the capital planning process to obtain input about their priorities, which can help lessen the changes that are needed later in the process.

2. INVOLVE THE PUBLIC IN MEANINGFUL DISCUSSIONS ABOUT LONG-RANGE GOALS

Municipalities can also solicit input from the public during the development of the capital plan. This can help ensure the plan reflects the priorities of the community and can help educate people about capital needs and the importance of capital funding. Participation can also help avoid public discontent after the completion of a project (Canally and Casey, 2007). GFOA recommends that governments develop a communications plan prior to any major capital program (GFOA, 2014A).

The opportunity for public input during the capital budgeting process is different for each community. Most, if not all, municipalities have one or more public meetings or hearings on the municipal budget, including the capital budget. Some officials said that the public rarely becomes involved unless there is a particular issue that concerns them, such as flooding. Other officials said they receive input from neighborhood or interest groups, citizen boards and commissions, or other committees. For example, Chatham has a parks committee, made up of residents, that provides input on park priorities. Rockford has a separate capital allocation by ward in which each city council member puts together a neighborhood road improvement plan for his or her ward, with assistance from staff and input from residents.

Some municipalities make a concerted effort to communicate with the public. For example, the City of Bloomington has been conducting public outreach and education prior to the city council's final vote on a new five-year CIP. "We want the public's support for financial solutions needed to address existing and future needs," explained a Bloomington official. "As our primary

stakeholders and owners, we want the public to understand what our capital needs are and how our plan impacts them and the community's economic development . . . Without their support, we cannot be as aggressive as we need to be regarding investing in capital infrastructure . . . Public support helps our elected officials have the will and ability to address the community's capital needs at a policy level . . . When we updated the comprehensive plan, the word we most frequently heard from the public was infrastructure, due in no small part to our efforts to raise the public's awareness of infrastructure issues."

Municipal governments use a variety of means to communicate with the public. For example, Highland Park conducts neighborhood meetings jointly with its government partners, makes extensive use of social media such as Facebook and Twitter, distributes a monthly hard copy and electronic newsletter, and releases weekly electronic news blasts. Other municipalities use approaches such as hosting strategic planning public meetings (Plainfield), focus groups (Geneva), and neighborhood/ward meetings (Springfield); offering tours of city streets and hiring a Latino ombudsperson to interact with the public (West Chicago); posting short videos about stormwater management on the village's website, along with information about a stormwater advisory referendum, and including a comparison of costs of two potential revenue sources (Downers Grove); placing an information insert into the local newspaper six times per year including one insert that solicits requests for capital projects (Carbondale); speaking to community groups (East Peoria); and surveying residents (Geneva, Kewanee, and Lombard).

3. ESTABLISH A DEDICATED REVENUE SOURCE

Municipalities use a variety of revenue sources to finance capital projects, with the most common being property taxes, sales taxes, and water and sewer charges. Some governments use debt, while others seek to minimize the use of debt. Still, many interviewees stressed the importance of having one or more revenue sources specifically dedicated to capital. "We have a constant dialogue about the importance of keeping dedicated revenues," acknowledged a Springfield official. "People can see the projects and see that we are doing what we said we would do . . . The revenues are dedicated by ordinance, which could be changed, but it makes it more difficult to use those funds elsewhere."

One of the most frequently used dedicated revenues is the sales tax. A local sales tax can generate significant revenue, depending on the level of retail activity in a jurisdiction. However, sales tax revenues also can be sensitive to

downturns in the economy, as was seen during the Great Recession. Non-home rule municipalities have to obtain voter approval for a sales tax and are limited to a maximum rate of 1.0%; however, home rule municipalities can initiate a sales tax without a voter referendum and are not subject to a legal limit on the rate. Several interviewees indicated that they would like to see the state lower the home rule population threshold to 5,000 (it currently is 25,000).

Some non-home rule communities have had successful referendums. For example, Forest Park initiated a 0.5% sales tax in 2005 and added another 0.5% in 2014. “This was the only way to get streets and alleys done,” according to a local official. “It is paid largely by people coming to town to shop at a big box store and the auto dealers.”

Rockford also has had successful non-home rule sales tax referendums. “Our non-home rule sales tax has to be approved every five years,” noted a Rockford official. “The community recently approved it for the third time. We first pitched it with a five-year CIP, which allowed people to understand how the money would be spent. During the first reauthorization, we provided a document that said here is what we said we would do and here’s what we did. People can see that it is doing a lot of good. We also emphasized that out-of-town patrons of shops and restaurants should help pay for the roads that they use.”

Historically, many municipalities have used a portion of the water and sewer fees for capital purposes. GFOA recommends that governments adopt formal policies on charges and fees, including what types of factors should be considered when establishing the charges (e.g., affordability, inflation) and whether the government seeks to recover the full costs of providing the service. GFOA also recommends the charges should be reviewed and updated periodically (GFOA, 2014B).

Officials described various challenges associated with water or sewer fees. One official said that water and sewer fees in his municipality have been kept artificially low. An official from Geneva said that the city’s water fund had been struggling due to water conservation, which prompted the city to revise the rate structure. The water rate was previously based on consumption, but it now includes a monthly fee and a consumption charge. In a couple of cities, the city council voted for annual incremental increases in fees to avoid the resistance that is associated with large increases.

Stormwater management has become increasingly important in some municipalities. Downers Grove has instituted a stormwater utility fee, along

with a plan for investing in stormwater capital improvements. There has been some discussion about whether the charge should be replaced with property tax revenues. Another official said that his community discussed a stormwater fee but that the city council decided not to put it in place due to concerns that large retailers with lots of impervious surfaces might leave the community.

Some municipalities have decided to use their state-shared motor fuel tax revenues solely for capital, while others use it for operations or both capital and operations. Some home rule municipalities have imposed a separate local motor fuel tax to fund capital projects. Among the officials interviewed for this study, the local MFT rate ranged from two to five cents.

Other revenue sources that were identified by some interviewees as being dedicated to capital included telecommunications taxes, food and beverage taxes, utility taxes, video gambling revenue, casino revenue, fire/ambulance fees, and dispatch service fees.

4. ESTABLISH CAPITAL REPLACEMENT FUNDS

Some municipalities use a capital replacement fund for fleet and equipment. A typical structure is for the departments that use the fleet and equipment to pay a fee that is designed to generate funds for the maintenance and future replacement of the vehicle or equipment. This system is often operated through an internal service fund, which is used to accumulate the funds. Capital replacement funds also can be used for other types of capital, such as information technology or facilities.

A capital replacement fund represents a systematic way for a government to save for the future replacement of capital assets. Charging a fee for the use of the asset also helps identify the true cost of services provided by the operating departments. However, several officials said their governments had difficulties managing the replacement funds during the Great Recession. The government spent some of the capital funds for other purposes or deferred contributions to the fund in order to pay for operating expenditures.

5. GRADUALLY BUILD UP CAPITAL RESERVES TO EASE THE BURDEN OF NEEDED FUTURE INVESTMENTS

Some municipalities build cash reserves to be used for capital purposes. This can be a more conservative approach than financing through debt. However, in some cases, the size of a capital project or the emergency nature of a project may necessitate borrowing for at least a portion of the project costs (Marlowe,

Rivenbark, & Vogt, 2009). Also, like capital replacement funds, capital reserve funds may be vulnerable during economic downturns.

Capital reserves are typically set up as a separate fund and are specified to be used for a particular project, type of function (e.g., transportation), or for capital in general. For example, Lombard has separate reserve funds for fleet, technology, and facilities. Several officials said their municipality has been setting aside funds for a major water or sewer project. An official from Sterling said that the city has been putting \$400,000 to \$500,000 per year into the sewer fund for the future replacement of a sewer plant. He added the city now has about \$10 million of the estimated \$30 million costs and will likely use bonds for the remainder. The City of West Chicago, for another example, has been saving funds for a water tower.

CONCLUSION

Municipal officials must balance the need for capital funding with operational needs and a desire to keep taxes and user charges at reasonable levels. Such a “balancing act”, however, is more difficult in the wake of the Great Recession and the worsening fiscal situation of the State of Illinois.

Collectively, however, municipal governments in the state have made considerable progress in adopting strategies to deal with looming capital-investment deficits. This includes adopting such “best practices” as the creation of integrated multi-year capital improvement plans and seeking input from and educating the public. Municipal officials also are implementing new funding strategies, such as designating particular revenues for capital and establishing capital replacement funds and capital reserves.

The uncertainty facing the state government nonetheless heightens the need for municipal officials to be prudent in their budgeting. Local governments need to be fiscally solvent, which includes the ability to pay bills as they become due, but they also need to demonstrate “service solvency,” i.e., the ability to provide the level and quality of services needed to ensure the general health and welfare of the community (Groves, Godsey, & Shulman, 1981).

A notable trend in budgeting is placing more emphasis on results rather than focusing primarily on the size of monetary allocations (Osborne and Hutchinson, 2004). Ideally, that would be done through a community planning process that results in a comprehensive plan that develops the community’s vision for the future and a strategic plan that identifies goals and strategies.

Those plans can be used to guide the development of a multi-year integrated capital improvement plan (GFOA, 2008).

The planning process also needs to include the development of financial policies, which can promote long-term and strategic thinking (GFOA, 2015). Capital budgeting strategies can address items such as the definition of capital, how capital will be financed (including when debt is allowed and what levels of debt are allowable), and key provisions of the capital planning and budgeting process.

Moline stands out for having a financial plan that addresses these issues (Table 3). The city maintains a 90-day undesignated fund balance reserve in the General Fund to ensure an adequate cash flow cushion against the volatility in local sales tax revenues. It seeks to increase the annual growth of expenditures in the CIP in accordance with the consumer price index.

Maintain Undesignated Fund Balance	Establish and maintain a 90-day undesignated fund balance reserve in the General Fund to ensure an adequate cash flow cushion against the volatility of the amount of local sales tax revenues generated from retail sales caused by uncontrollable state and national economic conditions.
Fund Capital Improvements	Provided that the 90-day fund balance target is satisfied, use any excess or unexpected revenues to fund capital improvements, particularly street and alley improvements as a priority. Such revenues shall not be expended on personnel or other operating costs.
Increase Expenditures Proportionately with CPI	Increase the annual growth of expenditures in the Capital Improvement Program by the same increase as the consumer price index. This will ensure the continued re-investment of municipal funds into public infrastructure needs.
Assess Financial Health by Condition of Capital Assets	Recognize the condition of the city’s capital assets, particularly the quality of its streets, alleys, water mains, sanitary sewer lines and storm water drainage systems as an indicator of whether the city’s financial health is improving or deteriorating.

Source: City of Moline 2016 Annual Budget, <http://www.moline.il.us/DocumentCenter/View/3731> (accessed September 26)

Through enhanced capital planning, continual communication with elected officials and the public, and the development of prudent financial policies, municipal governments can chart a course to meet their capital-investment needs during both good times and bad.

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¹ The 2010 municipalities were selected based on a convenience sample and the 2016 interviewees were selected based on a random sample of Illinois municipalities with populations of 5,000 or more. The random sample was supplemented with additional interviews to obtain more regional representation.

² Some Illinois municipalities do not have a multi-year CIP. In those communities, the elected officials will vote on proposed capital projects for the upcoming fiscal year.

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Capital budgeting has its effect in a long time span. It also affects companies future cost & growth. Involvement of a Large Number of Funds. Since a good project can turn bad if expenditures aren't carefully controlled or monitored, this step is a crucial benefit of the capital budgeting process. Transfer of Information. The time that project starts off as an idea, it is accepted or rejected; numerous decisions have to be made at a various level of authority. Capital budgeting involves two important decisions at once: a financial decision and an investment decision. By taking the project, the business has agreed to make a financial commitment to a project, and that involves own set of risk. Project delay, cost overruns & regulatory restriction that can all delay & increase the cost of the project. Capital budgeting, which is also called "investment appraisal," is the planning process used to determine which of an organization's long term investments such as new machinery, replacement machinery, new plants, new products, and research development projects are worth pursuing. It is to budget for major capital investments or expenditures. Major Methods. Many formal methods are used in capital budgeting, including the techniques as followed: Net present value. Internal rate of return. Translating Strategy into Targets and Budgets. There are four dimensions to consider when translating high-level strategy, such as mission, vision, and goals, into budgets. Objectives are basically your goals, e.g., increasing the amount each customer spends at your retail store. Then, you develop one or more strategies to achieve your goals. Capital budgets are typically requests for purchases of large assets such as property, equipment, or IT systems that create major demands on an organization's cash flow. The purposes of capital budgets are to allocate funds, control risks in decision-making, and set priorities. 3. Cash budget. Cash budgets tie the other two budgets together and take into account the timing of payments and the timing of receipt of cash from revenues. The capital budget is a key instrument in implementing organizational strategies. Capital budgeting involves comparing and evaluating alternative projects within a budgetary framework. A variety of criteria are applied by managers and accountants to evaluate the feasibility of alternative projects. Although financial criteria are used to assess virtually all projects, today more firms are also using nonfinancial criteria. Capital Budgeting and the Capital Asset Pricing Model. 323. i Capital Budgeting and the Capital Asset Pricing Model. 33 1. flows give a good approximation to asset values derived from rigorous analysis of equilibrium market values. We have uncovered no evidence that conventional valuation models are unsafe for management consumption. IV. GOODNEWS AND BADNEWS. The bad news is that the real determinants of beta are more complicated than is generally suspected. Beta depends on the link between cash flow forecast errors and forecast errors for the market return. It depends on asset life, the growth trend in the cash flows, and on the pattern of expected cash flows over time.17 It depends on the procedure by which investors forecast asset cash flows.