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AN EXAMINATION OF THE RELATIONSHIP BETWEEN THE MUNICIPAL STRATEGIC PLAN AND THE CAPITAL BUDGET AND ITS EFFECT ON FINANCIAL PERFORMANCE

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ABSTRACT. Strategic planning in all sectors of government is currently experiencing greater use. Strategic planning in the federal government, for example, is now mandated and the emphasis is on "managing for results" (Roberts, 2000). At the same time, capital budgeting in all sectors of government is also receiving greater attention because of the recognition of greater need for attention to funding infrastructure. In this study, the relationship between the municipal strategic plan and the capital budget and their effect on financial performance is examined. Based on the analysis, the strategic plan, when connected to the capital budget, was found to have a statistically significant effect on selected aspects of municipal financial performance. The findings for practitioners indicate that strategic planning and capital budgeting are a major influence on financial performance and that the combination of capital budgeting and strategic planning constitutes a strategic decision-making process.

INTRODUCTION

Governments, especially municipal governments, are faced with increased financial stress. Financial stress is defined as a decline in the economic vitality of the municipality, which results in the loss of financial flexibility and independence and the postponement or deferral of municipal infrastructure costs into the future. Along with increased financial stress, citizens and consumers are asking questions concerning the role and delivery of government services. Clearly, they are asking for

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evidence of the effectiveness of those services. One potential public management approach to reducing financial stress and including citizens and consumers' input into service delivery priorities is the use of strategic planning. A number of authors have argued that the government uses of strategic planning benefits the public organization (Beckett-Camarata, 1998; Bryson, 1995; Streib & Poister, 1990). Yet, little hard evidence exists linking strategic planning to either capital budgeting or public sector financial performance. What little indication there is usually focuses exclusively on either the relationship of strategic planning to the operating budget process or to economic development. "Capital budgeting is an important component of the local budgeting and planning process." (Forrester, 1993, p. 85) And, until recently, most of the literature on capital budgeting has been limited to case studies that consider technical issues, and does not address the relationship between the strategic plan and the capital budget. This article, which examines the connection between the strategic plan and capital budget and their effect on financial performance, is part of a growing literature that has recently received attention. This emphasis has evolved from the recent recognition that public sector performance indicators are credible measures of goal achievement (Newcomer, 1997).

Existing literature suggests that strategic planning is an important factor in influencing organizational performance (Ansoff & McDonnell, 1990; Pitts, 1984). A strategic planning-capital budget-financial performance model is presented. For municipal managers, the long-term result of implementing this model will be their increased ability to (1) manage the strategic planning process, (2) better manage the capital budget process, and (3) recognize the positive effect of systematically connecting the strategic plan and the capital budget on selected financial performance measures, especially financial performance outcome indicators. Nunn maintains that municipalities may not plan systematically for infrastructure [capital] budgeting (Nunn, 1991).

The model used in this article uses Ansoff and McDonnell's (1990) strategic success hypothesis to test the relationship between strategic planning and capital budgeting and its effect on financial performance. This model begins with an explanation of the limited research on the use of municipal strategic planning and on capital budgeting.

CURRENT RESEARCH

Although the relationship between municipal strategic planning, the capital budget and financial performance outcomes has not yet been studied directly, indirect evidence has suggested the relationship. Streib and Poister (1990) expanded the scope of municipal strategic planning research to cities in the United States. They examined (1) the extent to which strategic planning is used by cities, (2) management perceptions of strategic planning effectiveness, (3) the application of strategic planning and (4) the process necessary to successfully implement strategic planning. Their study concluded that the use of strategic planning does not vary significantly by city size or form of government (Streib & Poister, 1990). Their findings show that cities have the capability to compile information necessary to complete a strategic plan. They also found that municipal strategic planning was seen as an effective management tool. Streib and Poister (1990) noted that the high levels of use of other management tools, e.g., information technology, coupled with the use of strategic planning, indicated both a level of expertise and a thorough and competent attempt to use strategic planning effectively (Streib & Poister, 1990, p. 38). Further, their study determined that a successful approach to strategic plan implementation was to tie strategic planning directly to the budget process, while maintaining normal performance monitoring. "Evidence exists that suggests that city governments in America have developed a great deal of expertise in the use of a variety of management tools, many of which would provide essential information for strategic planning activities" (Streib & Poister, 1990, p.37). Their research found 63 percent of the survey respondents used strategic planning; however, only 26 percent of respondents in their study used strategic planning citywide.

More recently, Poister and Streib (1999, p. 313) concluded that . . . those who are responsible for strategic management must ensure that budgeting and financial management systems, performance management, and other administrative processes are designed to facilitate the implementation of strategic plans and to reinforce the focus on strategy throughout the governmental unit."

Some research suggests that strategic planning influences the budget process. For example, Pratt (1990), examined the relationship between strategic planning and the budget process in a public university environment. Drawing on data collected from interviews with sixty-nine senior managers in five public universities, three regional offices and five central state agencies, Pratt (1990) established an association between strategic planning and the budget process in public universities and other public institutions of higher education. The connection was found between an individual institution's strategies for documenting resource requirements in the strategic plan and state resource allocation. This study also found that at the institutional level, strategic planning and budgeting were largely rational and closely linked. Budgeting in Pratt's study included both operating and capital budgets.

WHAT IS MUNICIPAL STRATEGIC PLANNING

Just what constitutes municipal strategic planning? To answer this question, strategic planning is described in terms of the document used as the basis for implementing the strategic plan. According to Poister and Streib (1999, p. 309), "In the ongoing rush of activities, competing demands for attention, and the press of day-to-day decisions, focusing on a viable and responsive strategic agenda as the central source of direction, initiatives and priorities is of fundamental importance." In addition, with greater emphasis being placed on strategic planning for public organizations, it is becoming more important for financial performance planning to be tied to strategic plans (Beckett-Camarata, 1998).

Strategic planning is defined in this article as an ongoing, future-directed, change and action-oriented managerial planning process. A strategic plan is defined as a written document which includes: (1) a schedule/time-frame, (2) a mission statement, (3) an environmental analysis/assessment, (4) organizational goals and objectives, (5) organizational action plans, (6) a planning horizon of more than one year, (7) outcome evaluation criteria, (8) a financial plan, and (9) the period of time the strategic plan covers.

Capital Budget

Capital budgeting is based on planning and economic theory (Forrester, 1993) and to the extent that a municipality uses the capital budget, it should be guided by a strategic plan (Matson, 1976). About 81 percent of municipalities with a population greater than 75,000 had a legally required capital budget and 71 percent separated their capital budget from their operating budget (Forrester, 1993). The importance of the capital budget to sound financial management is likely to increase in the future as resource constraints and demands for services continue to rise simultaneously (Reed & Swain, 1997) along with the introduction of Governmental Accounting Standards Board (GASB) Statement 34. GASB 34 brings a new era in capital (infrastructure) accounting and reporting by requiring that all state and local governments report the cost of their capital assets in the statement of net assets. Unless a municipality adopts the modified approach, it must report depreciation expense for infrastructure assets in its government wide statement of activities. Prior to GASB 34, most local governments opted not to report their investment in capital assets because they believe the information to be of limited value for stewardship or management decision-making purpose (GASB, 2001, Appendix B, Part I.)

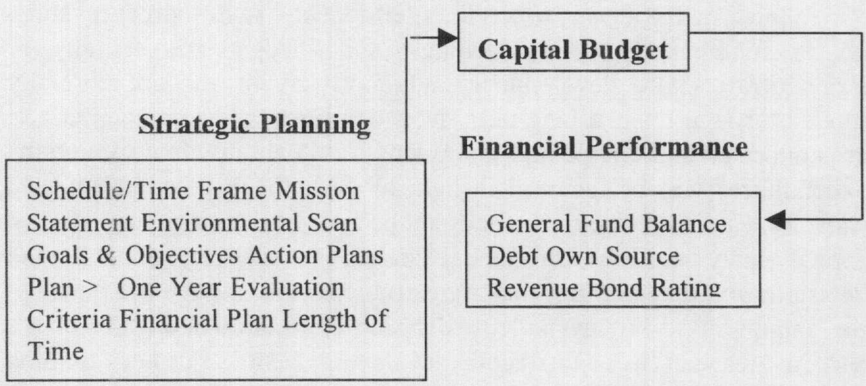
Capital budgeting is an important public policy and management decision-making tool. Yet, research on capital budgeting is scarce and there is little empirical research on capital budgeting perhaps because definitions and use of capital budgets are not uniformly accepted (Lee & Johnson, 1998). Sekwat (1994) conducted a national survey of U.S. county governments to find out their use of a capital budget. He found that 40.2 percent of county governments in his survey use a separate capital budget. Lynch, Lynch and Omdal (1997) found strong support for the use of separate capital budgets in their study of Louisiana cities.

Capital budgets can affect long-term debt, own source revenue, general fund balance and bond rating. Capital budgets are generally for large infrastructure development and improvement and are normally funded through bonded long-term debt. Further, when capital budgets are connected to strategic plans, any long-term debt required to fund the expenditures will be incurred in light of the municipal long-term debt capacity. Capital budgets are important because of the magnitude of most capital outlay decisions. Substantial funding is at stake in capital budget decisions and the decisions that a government makes shape the future of the community. For example, a decision to locate a new school in a certain area can speed up economic development. Further, funding capital budgets commits resources into the future and affects the long-term spending of a community. When a municipality makes a financial commitment, the impact of that decision can be felt for 30 to 40 years (Vogt, 1983).

This articles examines (1) whether the strategic plan and capital budget influence general fund balance, (2) whether the strategic plan and capital budget influence long-term debt, (3) whether the strategic plan and capital budget influence own source revenue (4) whether the strategic plan and the capital budget influence bond rating, (5) whether the effect the strategic plan had on long-term debt, own source revenue, general fund balance, bond rating, capital budget.

A model of the relationship between the strategic plan, the capital budget and financial performance is presented in Figure 1. The model elements are based on a review of the literature and input from a panel of municipal managers. The model is adapted from Ansoff and McDonnell's (1990) strategic success hypothesis. A hypothesized relationship between the strategic plan, the capital budget and financial performance outcomes in the public sector has not been tested prior to this research. The purpose of the model is to frame the hypothesized relationships between the elements comprising the strategic plan and financial performance for discussion and examination.

FIGURE 1
Preliminary Strategic Planning-Capital Budget-Financial Performance Model



The first group of elements in the model represents the strategic plan. Pitts (1984) found, for example, that the use of strategic plan elements influences the performance of not-for-profit hospitals in Virginia. The Strategic Plan elements in Figure 1 were adapted from Pratt's study. The strategic plan elements in the preliminary model (Figure 1) above include the elements, which taken together, define the Strategic Plan. The Strategic plan is the independent variable.

The second group of elements represents the outcome measures of Financial Performance. The dependent variable is financial performance, which is measured by bond rating (Moody's bond rating), long-term debt (debt per capita), general fund balance (total general fund revenue less total general fund expenditure per capita) and own source revenue per capita (i.e., intergovernmental transfers, property taxes, charges and miscellaneous taxes). The financial measures were selected because they reflect financial and economic quality differences in local governments. In the case of bond ratings, these differences are reflected in the published bond ratings (Ziebell & Rivers, 1992). The quality differences of published bond ratings are commensurate with the way financial indicators such as (1) return on earnings, (2) return on investment and (3) earnings per share reflect financial and economic quality differences in for-profit organizations. Capital budget expenditures are included in the model as the control variable because capital budget expenditures can affect long-term debt, own source revenue, general fund balance and bond rating. Capital budget expenditures are generally made for large infrastructure development and improvement and are generally funded through bonded long-term debt. When capital budget expenditures are planned, any long-term debt required to fund the expenditures will be incurred in light of the municipal long-term debt capacity.

METHODOLOGY

Data for the study were gathered from three hundred and sixty-three of the 432 municipalities with populations between 75,000 and 150,000 International City/County Management Association (ICMA) members. All 363 (84 percent) of the 432 municipalities were selected for the study. Although the choice of municipalities in this population range was arbitrary, there were some interesting characteristics of this population that made studying this group appealing. For example, municipalities with a population of 75,000 to 150,000 throughout the United States generally have rated general obligation bonds (Ziebell & Rivers, 1992). In addition, municipalities with larger populations (greater than 150,000) and municipals with smaller populations (less than 75,000) were not chosen for inclusion in this study because some limited municipal strategic planning research has already been conducted previously on this size municipalities. In addition, municipalities with smaller populations generally do not have rated bond issues.

Of the 432, 363 municipalities were chosen for the sample size because data were available and that number would provide for sufficient cases for analysis. In order to examine the effect of municipal planning in concert with capital budgeting in influencing financial outcomes, this study used a Mixed-Method Design, consisting of survey research and secondary data.

Data for the study were gathered from a survey mailed in May of 1997 to city managers, county administrators and/or mayors, and finance officers of cities with a population between 75,000 and 150,000 as identified by the International City/County Management Association. Municipalities in this population range are likely to use capital budgeting and are economically and politically diverse enough to reflect what is occurring in the field. Selected indicators of the strategic plan and financial performance were used in this study. Indicators were specified in the operational definitions (see Appendix A). The use of strategic planning is measured using a survey. The survey instruments used reflected those in the literature on public and private strategic planning. Jordan (1990), Streib and Poister (1990), Ansoff and McDonnell (1990), Seasons (1989), and Pitts (1984) included specific but focused measures of performance in their strategic planning research. The questionnaires contained selected items that measure aspects of the strategic plan, capital budget and financial performance. Those measures were examined by using two survey instruments, a mail questionnaire and a telephone questionnaire and an analysis of municipal financial data. A survey regarding strategic planning use was used because the information was not available from other sources. The response rate to the mail survey was 97 (30 percent). The results of the mail survey to city managers and mayors pertaining to capital budgets and strategic planning are reported in this article.

Capital budgets and financial performance are measured using quantitative measures from the U.S. Census. Existing indicators in the literature and operational definitions were used. Appendix B provides a summary of definitions for each element.

The responding municipalities were analyzed using four financial performance measures: own source revenue (OSR), general fund balance (GFB), long-term debt (LTD) and bond rating (BR). Annual data on population, own source revenue, general fund balance and long-term debt were obtained from the U.S. Census, City/County Government Finances and merged with the survey data. Bond rating data was obtained from Moody's Municipals.

The population was defined as managers of political subdivisions within which a municipal corporation has been established to provide general administration for a specific population concentration in a defined area. This includes all active governmental units officially designated as cities and counties (U.S. Census, City Government Finances, 1991-1992). Organized county governments are found throughout the United States except in Connecticut, Rhode Island, the District of Columbia and limited portions of other states (U.S. Bureau of Census, 1995).

All municipalities participating in the study had to have financial data published in the U.S. Census City/County Finances for the period 1984-1992, and have a Moody's Municipal Bond Rating for that period. The extended time period selected for study was chosen to accommodate the effects of interim environmental changes and to average out performance over time. Using U.S. Census data provided consistency in reported data. Selection of the local governments for this study was limited to those municipalities whose financial data was readily available for the time period studied and reported in a consistent format, such as the U.S. Census data.

FINDINGS

Does the strategic plan and capital budget influence general fund balance? As shown in Table 1, strategic planning did not have a significant effect on general fund balance. However, when capital expenditures were included in the model, strategic planning significantly influenced general fund balance. The addition of population change to the model did not have an effect on the general fund balance.

TABLE 1
General Fund Balance

Model Summary	ANOVA		Coefficient		
Variables: Independent	R^2	Adj.R^2	F	Significant F Change	Beta
Strategic Plan	.04	.03	3.25	.08	.20
Capital Budget	.31	.29	17.16	.08	.53

Does the strategic plan and capital budget influence long-term debt? As shown in Table 2, strategic planning did not have a significant effect on long- term debt. However, when capital expenditures were included in the model, strategic planning significantly influenced long-term debt. The addition of population change to the model did not have an effect on long-term debt.

TABLE 2
Long Term Debt

Model Summary	ANOVA		Coefficient		
Variables: Independent	R^2	Adj. R^2	F	Sig. F Change	Beta
Strategic Plan	.007	.006	.54	.47	.098
Capital Budget	.17	.150	8.02	.00	.398

Does the strategic plan and capital budget influence own source revenue? As shown in Table 3, strategic planning did not have a significant effect on own source revenue. However, when capital expenditures were included in the model, strategic planning significantly influenced own source revenue. The addition of population change to the model did not have an effect on own source revenue.

TABLE 3
Own Source Revenue

Model Summary	ANOVA		Coefficient		
Variables: Independent	R^2	Adj.R^2	F	Sig. F Change	Beta
Strategic Plan	.004	.008	.34	.56	.56
Capital Budget	.14	.12	6.40	.001	.003

As shown in Table 4, strategic planning did not have a significant effect on bond rating. When capital expenditures were included in the model, strategic planning did not significantly influence bond rating. The addition of capital expenditures or population change to the model did not have an effect on bond rating.

What effect has your strategic plan had on municipalities' financial performance? As shown in Table 5, the strategic plan was reported to have the most positive effect on the capital budget and the

TABLE 4
Bond Rating

Model Summary	ANOVA		Coefficient		
Variables: Independent	R^2	Adj.R^2	F	Sig. F Change	Beta
Strategic Plan	.012	.012	1.085	.300	-.109
Capital Budget	.012	.012	.562	.822	-.115

TABLE 5
Effect of Strategic Planning on Financial Performance
(In Percent of Responders)

What effect has your strategic plan had on your:			
	No Effect	Negative Effect	Positive Effect
Long-term debt	44	2	54
Own source revenue	48	0	52
General fund balance	38	0	62
Bond rating	49	0	51
Capital budget	26	0	74

general fund balance while respondents recognize that the Strategic Planning processes affect financial performance.

RESULTS

Cases with missing quantitative data for strategic planning were eliminated from the sample. All analyses were based on responses from the 97 municipalities. The results of the hypothesis tests were the same whether pairwise or listwise deletion of missing data was used. Listwise deletion (N=9), a more conservation approach to handling the missing data was used.

The use of a strategic plan did not have a significant effect on long-term debt per capita, bond rating, general fund revenue balance per capita or own source revenue per capita at the 0.05 level of significance. When the capital budget was included as a predictor, use of a strategic plan significantly influenced all financial performance measures except bond rating. Further analysis of the significant F change and the beta coefficients for long-term debt per capita, own source revenue per capita and general fund revenue balance per capita indicates that capital budget is responsible for the preponderance of the change. Analyses of the adjusted R^2 score further supports these conclusions.

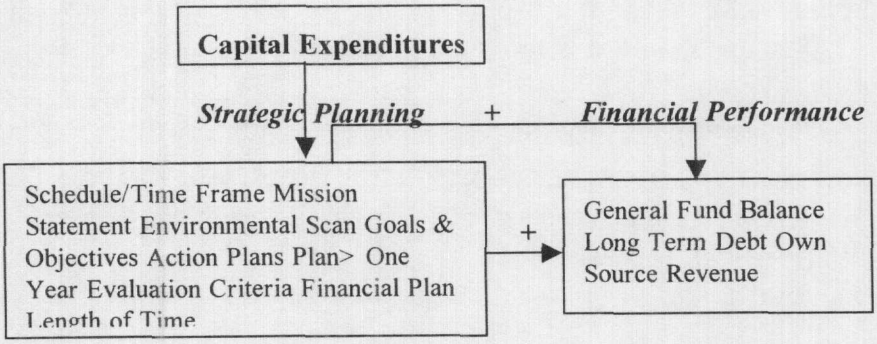
DISCUSSION

The capital budget is normally guided by a formal plan. The results provide evidence to support combined use of a strategic plan and capital budget. Of particular importance is the finding that a strategic plan has a statistically significant effect on financial performance when used with the capital budget. If municipal managers include key stakeholders up front in the planning process, they are more likely to have the support and buy-in of those agencies in critical community issues. Seventy-four percent of the respondents indicated they felt the Strategic plan had a positive effect on the capital budget. Capital improvements planning established the basis for a municipality's strategic financial plan, its capital budget. The capital budget is typically located within a municipality's capital improvements plan (the first year of the capital improvements plan). The data suggests that the capital budget is perceived to be one of the key connections between municipal financial planning and its financial performance. Yet, it is paradoxical that the municipal manager is highly involved in preparing the strategic plan and less concerned with capital improvements planning. It does appear from the interviews and financial reports that strategic management of certain financial variables, general fund balance per capita and long-term debt per capita, can be accomplished through connecting capital budgets to strategic plans.

Evidence suggests that municipal strategic planning is used with capital budgeting. It appears that municipal managers use planning for strategy implementation and that strategic planning and capital improvement planning can be used jointly. This finding also supports the combination of strategic planning and other planning types reported by Forrester. In his study of the use of planning by cities with a population greater than 75,000 he found that strategic planning and other planning types are not mutually exclusive, but rather can be successfully blended (Forrester, 1993, p. 94).

There are several important findings, which have been incorporated into the Strategic Planning-Financial Performance Model (See Figure 1). The findings are complex and reflect the complicated nature of strategic planning. Since Strategic Planning was found to have a statistically significant effect on Own Source Revenue, Debt and General fund Balance when capital expenditures were included in the analysis, this finding is especially important for local government managers and citizens since strategic planning and capital expenditures together affect debt and by implication, tax rate. This finding is particularly useful for local government managers in reducing financial stress caused by eroding property tax bases, rising expectations about local government services, and dynamic changes in the American economy. Some local governments have been successful in using strategic planning to deal with these circumstances, but it is apparent from the findings that strategic planning must be linked to the capital budget if it is to impact financial performance.

FIGURE 2
Strategic Planning-Financial Performance Model



CONCLUSION AND IMPLICATIONS

Findings from this research suggest that very careful attention needs to be paid to connecting the strategic plan to the capital budget as a tool for municipal managers to influence long-term debt and general fund balance. Having a written strategic plan, with attention given to its content, is also important for managing outcomes. Connecting capital budgeting to strategic planning and including performance measurement are critical in developing sound financial management practices.

The findings for practitioners indicate that the use of strategic planning and capital budgeting is a major influence on financial performance and that the combination of a capital budget and a strategic plan constitutes a strategic decision-making process. Since the operating and capital budgets are separate in the majority of municipalities (Forrester, 1993), capital budget expenditures are not reflected in operating budgets as such. Thus, the case can be made that capital budgets are long-term financial plans that are implemented over several fiscal years. This challenges the findings of others (Forrester, 1993) who found that capital budgets have more of a short-term focus.

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APPENDIX A
Construct Definitions

Construct	**Definition**	**Operationalization**
Strategic Planning	Ongoing, future directed change and action oriented managerial planning process which results in written document	Presence of elements
Strategic Planning Elements		
Schedule/Time Frame	A regular planning cycle	Existence of recurring plan review/update
Mission Statement	Declaration of Org. Purpose	Existence of statement of purpose
Environmental Scan	Monitoring stakeholders & Political, Economic, Sociological/Technological Trends	Existence of SWOT list
Goals and Objectives	Statements which clarify each goal	Existence of written goal statements

APPENDIX A (Continued)

Action Plan	Specific steps outlined for implementing the plan	Existence of written implementation steps
Plan > 1 Year	Implementation schedule which has key dates greater than 1 year	Existence of schedule with appropriate dates
Evaluation Criteria	Standards for Evaluation	Written standards in place
Financial Plan	Resource Allocation Plan	Existence of written financial allocation
Time on Strategic Planning	Extent to which municipal manager is working on strategic plan	Actual time which is spent on long-term strategy planning
Financial Performance	Strategies to achieve defined municipal strategic financial goals and objectives.	
Bond Rating	Moody's Bond Rating	Moody's Bond Rating
Debt Per Capita	Ratio of long-term debt to population	Existence of Debt
Own Source Revenue Per Capita	Local revenue sources	Local source revnue
General Fund Balance Per Capita	Total general fund revenue less total general fund expenditure	GF Balance

APPENDIX B
Operational Measures- Sources and Reliabilities

Construct	Scale	Items	Reliabilities
Schedule/Timeframe	New	1	.93
Mission Statement	Planning Documents (Pitts, 1984)	1	.93
Environmental Scan	Adapted Planning Documents Scale (Pitts, 1984)	1	.94
Goals & Objectives	Adapted Planning Documents Scale (Pitts, 1984)	1	.92
Action Plan	New	1	.93

APPENDIX B (Continued)

Plan > 1 Year	New	1	.93
Evaluation Criteria	New	1	.93
Financial Plan	Adapted Planning Documents Scale (Pitts, 1984)	1	.93
Time on Strategic Planning	New	1	.93