

A NEW FRAMEWORK FOR FINANCIAL SUSTAINABILITY

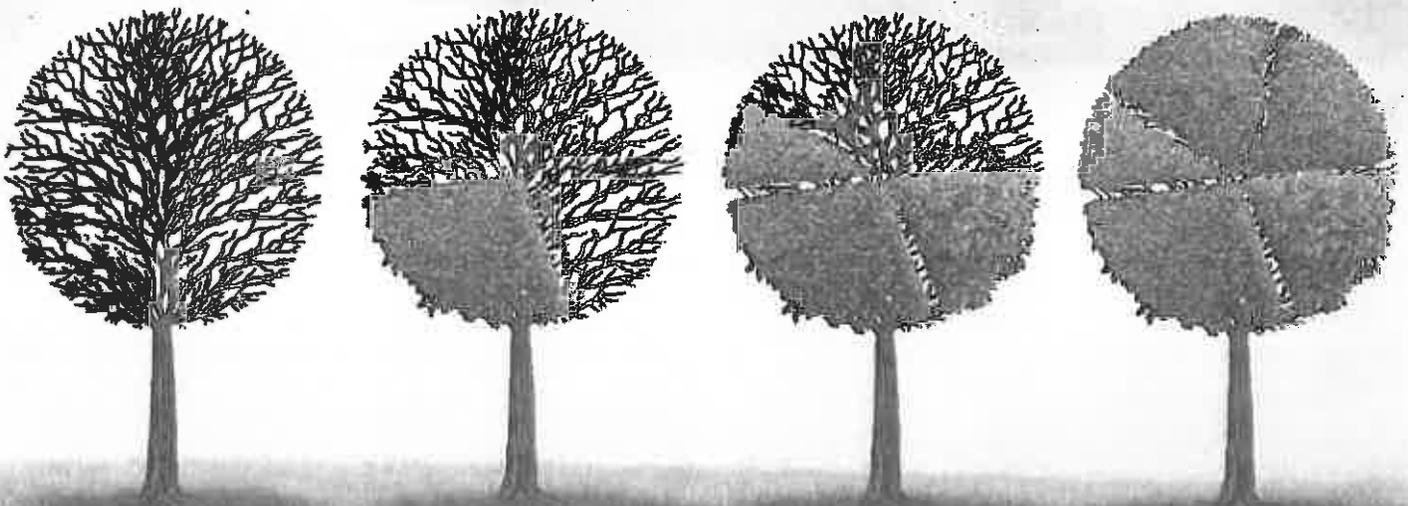
Translating Nobel Prize-winning economics to public finance

By Shayne Kavanagh

For many local governments, financial sustainability seems to be an elusive goal even many years after the Great Recession.¹ In fact, according to a 2015 Government Finance Officers Association (GFOA) member survey, financial sustainability is a perennial concern.

Another economic downturn would be debilitating to local and state government finance and the public services on which people depend. Such concerns become magnified when considering these forces that will add financial pressure for local governments:

- **Aging population.** From 2016 to 2060, the number of Americans age 65 and older is projected to more than double.² An aging population earns less income, uses more public services, and spends a greater portion of its income on non-taxable goods and services (e.g., health care).³
- **Pensions and health-care costs.** Health-care cost increases are still well above typical government revenue growth. Local governments can expect health-care costs to remain a challenge.⁴ The pension funding challenges faced by many local governments add a large expenditure to the budget.
- **Infrastructure maintenance and renewal.** According to the American Society of Civil Engineers, U.S. infrastructure rates a "D+" and requires a \$2 trillion investment over 10 years to bring existing infrastructure into good condition.⁵ Though not all of this required investment falls on local governments, enough of it does to create a significant financial burden.
- **Inequality.** Income and wealth inequalities have grown substantially over the past 30 years.⁶ Since 1980, real wages for the bottom 60 percent of wage earners has been essentially flat.⁷ Local government tax systems



are designed to tax a broad segment of the population, yet a broad segment of the population is experiencing little to no growth in the income from which those taxes are drawn.

Further, as state and federal governments face their own financial challenges, due in part to the trends described above, they may push more responsibilities on to local government and share less revenue. Local governments, for this reason, must find a new way to ensure their ongoing financial health, and thereby ensure their ongoing ability to provide for the health, safety, and welfare of residents.

A New Approach

A promising new approach for local governments in the 21st century has its roots in 19th century England. Victorian economist William Forster Lloyd articu-

A local government budget has important similarities to the commonly owned grazing area. A government and its financial resources are commonly owned by all residents of the government. Each stakeholder of the government has an incentive to extract resources from the public budget.

Stakeholders often find themselves in competition with others to get resources, and therefore, try to get as much as possible in case they lose the resources to others. The long-term result could look much like the commonly owned grazing area.

The Tragedy of the Commons inspired a line of modern economic research called "common pool resource theory," which is concerned with how to create sustainable management of such commonly owned natural resources as grazing lands, fishing

general-purpose cities and counties can use these ideas, too. This is because all local governments, from big to small, from general to specific purpose, are a resource that is commonly owned by the communities that they serve.

Comprehensive System

GFOA's new financial sustainability model is comprehensive. It includes strategies for leaders to inspire pride, loyalty, and enthusiasm so that followers will want to help make the organization financially sustainable.

It also includes design principles for local government institutions, which set the rules of the game for how local government and other, related organizations work together for a sustainable financial future.

The best summarization of GFOA's complete system of financial sustainability

Engaging people in decision making gives them a voice. When people have a voice, they will feel more committed to the success of the organization.

lated an idea that, today, is expressed as this parable:⁴

A group of farmers have common ownership of a grazing area. The individual farmer has the incentive to send his animals to the common grazing area as much as possible. This is because the additional cost to use the grazing area is zero (it is commonly owned) and if he doesn't send his animals, the other farmers' animals still graze, thus depriving the individual farmer's herd of potential food.

All farmers face the same incentive and so all send their animals to the common grazing area. The result is that the common area is eventually overgrazed and becomes barren. This is called "the Tragedy of the Commons."⁵

stocks, or forests. One of the originators of this line of research was Elinor Ostrom, who was awarded a Nobel Prize for her work in 2009.

GFOA, National Civic League, Lincoln Institute of Land Policy, and university researchers have translated common pool resource theory to local government to develop a new model for financial sustainability. Using more than 20 case studies of local governments and feedback from practitioners, Ostrom's Nobel Prize-winning work was translated to public finance.

We found that Ostrom's work can be applied to local governments of different sizes, from Los Angeles County (population more than 10 million) and San Bernardino County, California (population 2.1 million), to the city of Dubuque, Iowa (population 58,500).

Special purpose districts, like schools or water utilities, and

can be found in the concept of "strong reciprocity."⁶ Reciprocity is the practice of exchanging with others for mutual benefit.

Strong reciprocity reinforces mutually beneficial exchange and is essential for the functioning of complex societies and organizations. Strong reciprocity has two features that lead to widespread cooperation.

First, people are conditional cooperators, meaning we will cooperate as long as others do, too. Second, people are altruistic punishers, which means we are willing to punish others for taking advantage of the system—even if applying that punishment will cost us personally.

Strong reciprocity applies to the financial sustainability of a local government. Diverse stakeholders must cooperate to preserve the long-term financial health of a local government, and there must be consequences for taking undue advantage of public resources.

GFOA's framework supports strong reciprocity and thereby, financial sustainability in a local government in five ways (see Figure 1):

1. Establish a long-term vision to give people a reason to cooperate over a sustained period of time.
2. Build trust and open communication to encourage cooperation.
3. Use collective decision making to foster a forum to cooperate.
4. Set rules and ensure they are followed.
5. Treat participants fairly under the rules.

Establish a long-term vision to give people a reason to cooperate over a sustained period of time. A long-term vision helps people understand why it's important to work together. A long-term vision also accentuates the need to fairly distribute the costs and benefits of government services across different generations of residents.

Local government leaders should facilitate the development of a shared vision for the community, including through a strategic planning process. To illustrate, San Bernardino County, California, articulated a vision for the entire county.

The process was inclusive of the municipal governments located within the county as well as a number of nonprofit and private organizations. The vision was to make a real improvement in the lives of community members

by, for example, improving childhood literacy and community health.

These broadly relevant and meaningful indicators made it clear why the county government needed to be sustained, and enlisted other organizations is reaching the vision, thereby reducing the resources required of the county government.

A local government, however, can't be fixated just on the long term. Leaders must also strike a balance between long-term considerations and responding to immediate needs. For example, they might consider merging long-term forecasting with annual budgeting.

Build trust and open communication to encourage cooperation. Open communication allows people to realize their shared interests and to arrive at an understanding of how local government resources can be used for the benefit of all in a community.

Trust is essential if people are going to risk giving up something that benefits them as individuals in order to benefit the entire group. This applies to negotiating budgets across departments and different community groups.

There are local governments, for example, that have found success in using cross-departmental teams to make decisions about how the budget will be allocated, rather than relying on individual departments to submit individual budget requests.

The latter method is essentially a competition between departments that can reinforce the individualist, competitive behaviors that brought tragedy to the commons. The former method asks departments to reach across silos to make decisions in the interest of an entire organization.

Use collective decision making to foster a forum to cooperate. Collective decision making is critical to avoiding a Tragedy of the Commons in local government. Engaging people in decision making gives them a voice. When people have a voice, they will feel more committed to the success of the organization.

Engaging people can also improve the quality of decisions because the decisions will better reflect people's needs. This supports perceptions of legitimacy in how public resources are used. Local governments that have been most successful with public engagement have identified critical capacities.

Financial decision making, for example, is essentially about making trade-offs, where there often is no optimal outcome. Members of the public must, therefore, also make trade-offs, rather than simply advocating for their preferred position.

Even if the trade-offs they are asked to make are simplified over an actual budget, it helps residents better appreciate the perspectives of others and the realities of limited resources.

Figure 1. The Path to Financial Sustainability.



Strong reciprocity reinforces mutually beneficial exchange and is essential for the functioning of complex societies and organizations.

Collective decision making can also take place between local governments. Complex challenges demand more resources than governments have. A local government can join with other organizations to form a network committed to addressing community challenges at a sustainable cost.

Set rules and ensure they are followed. Rules define how decisions are made about public resources and the time horizon that decisions will consider. A financial policy, for example, might define the amount of money a community will keep in its rainy-day fund. Rules must be accompanied by a system that brings transparency to decision making.

A system of monitoring encourages people to operate within the rules and helps them trust that other people are doing the same. People might sometimes be tempted to go outside of the rules, so local government leaders must maintain the ability to reinforce cooperative behavior among people.

Local institutions must be set up to give people the incentive to cooperate. Lighter touch incentives are essential. Terminating a department head that exceeds his budget, for example, is a blunt instrument.

One city created a rule that required department heads who exceeded their budgets to appear before the city's resident budget committee and explain why they exceeded it and then return for the next two months to report on their progress on getting back within budget. The city found that compliance with budgets improved markedly.

Local governments must also be mindful to eliminate incentives that encourage unsustainable behavior.

Departments can often rush to spend out their budgets when the year

ends so as not to lose that funding from their budgets the next year. And so, local governments need to find out where they might actually be encouraging unsustainable behaviors and then change these incentives.

Treat participants fairly under the rules. The perceived fairness of a system is critical to people's decision to support that system. If they feel unfairly treated, they will not be willing to cooperate or respect the rules.

Residents must feel they are getting a beneficial exchange of taxes and fees for public services. More generally, decision-making processes must be regarded as fair and should handle conflicts constructively.

Here are examples: If budget decisions are made based on information that is perceived to be accurate; if a transparent and consistent set of decision-making criteria is applied to everyone equally; if all affected stakeholders are given the opportunity for input; and if decisions that don't work out can later be corrected.

Then people will be more likely to support the decision, even if the decision is not their preferred outcome. These characteristics come from a body of research called procedural justice.

Finally, local government itself must have its decision rights recognized by other levels of government. Local governments must preserve enough independence from state and federal governments to make choices that best fit local conditions.

GFOA has gathered a wealth of case study evidence to show how local governments have put each of these supports in place. It is also pilot testing a program that invites local governments to self-assess the extent to which their financial

decision-making systems exhibit the characteristics of a financially sustainable decision-making system.

Managers can find out about the latest research and how to get access to these materials by contacting the author or visiting <http://gfoa.org/financial-sustainability>. **FMI**

ENDNOTES AND REFERENCES

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