Financial Sustainability:
Mutual Trust for Communitywide Benefit

Maintaining the financial capacity to provide quality services is a concern for all local governments. This is especially true in a time of immediate cost pressures, like pension and infrastructure, and resource constraints, like reduced financial support from state and federal governments and public aversion to higher taxes. Further, an aging population uses more in public services and pays less in taxes, which means local governments will be facing fiscal pressures for years to come. Failure to take on these challenges in a systematic and thoughtful way could endanger the financial sustainability of our communities and, with it, their health, safety, and welfare.

A promising approach to financial sustainability has its roots a phenomenon called “the tragedy of the commons.” In this hypothetical scenario, a group of farmers has common ownership of a grazing area. An individual farmer has an incentive to send his herd to the common grazing area as much as possible because there is no additional cost for using it, and if he doesn’t send his animals, the other farmers’ animals will still graze, thus depriving the farmer’s herd of potential food. As a result, the common area is overgrazed and becomes barren. The tragedy of the commons inspired a line of Nobel Prize-winning economic research called “common pool resource theory,” which is concerned with how to create sustainable management of commonly owned resources such as grazing lands, fishing stocks, or forests.

The Tragedy of the Commons

BEFORE | **AFTER**

When indviduals within a shared resource system act independently, they work against the common good of all users, thereby depleting that resource through their individual actions.

A local government budget has important similarities to the "commons." A government and its financial resources are commonly owned by all citizens. Each government stakeholder 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, lest they lose the resources to others. The long-term result could look very much like the commonly owned grazing area.

Over the last few years, GFOA, the National Civic League, researchers at the University of Southern California and University of San Francisco, and the Lincoln Institute of Land Policy have worked together to translate the lessons from common pool resource theory to public finance. We believe the potential of the framework is great for several reasons.

The Tragedy of Local Government?

Local governments face problems that require cooperation. The "tragedy of the commons" could occur, for example, if infrastructure maintenance is deferred in favor of meeting the demands for compensation increases from labor unions. However, the tragedy can be avoided by creating a decision system that promotes trust and mutual gain for all parties.

- **A holistic perspective.** Common pool resource theory goes beyond budget numbers. It addresses the decision making behaviors and processes that lead to financial sustainability.
- **Forward looking.** Because this framework addresses the underlying causes of financial sustainability, it should be indicative of future financial health.
- **Makes finance everyone's business.** Because everyone is involved in using resources, everyone needs to be involved in sustaining them. This includes elected officials, staff, and citizens.
- **It works!** The framework has been proven to work in a variety of natural settings, and we have found similar proof in local government by examining case studies from across the United States. (See the example below and a more detailed example in Appendix 1.)

The Journey toward Financial Sustainability in San Bernardino County, California

San Bernardino County was facing massive long-term fiscal deficits. To improve financial sustainability, the county pursed three major strategies: 1) increase coherence of county government; 2) strengthen budgeting and financial planning; and 3) develop a countywide strategic plan with the close collaboration of the community. This would reduce fragmentation of county government which had contributed to wasteful duplication of services and competing directions for county staff. It would also help the county take a long-term view of its resources. For example, the county developed 10-year forecasts, prompting a change to employee compensation policies. Finally, the strategic plan highlighted the shared interest of all stakeholders in having a financially sustainable county government and made it clear why financial sustainability matters. It also highlighted opportunities for county government to work with private firms, non-profits, and other local governments to address community problems jointly and more efficiently.

Two Ingredients for Sustainability: Leadership and Institutional Design

The financial sustainability framework has two major ingredients. First are "Leadership Strategies." Local government leaders cannot order people to behave in a sustainable way. Instead, they must inspire pride, loyalty, and enthusiasm so followers will want to help make the organization financially sustainable. The six leadership strategies contained in the framework do just that.

1. **Help participants build trustworthy reputations.** Trust is essential if people are going to risk suffering a loss to their individual well-being in order to advance the group's well-being.
2. **Create open communication among all participants.** Open, especially face-to-face, communication increases the probability of reaching sustainable outcomes.
3. **Convince participants that collective efforts yield important benefits.** If people see that they can gain from cooperation, they are more likely to engage in it.
4. **Ensure that key stakeholders remain engaged.** People must remain constructive participants in decision making for the system to last.

5. **Build long-time horizons into fiscal planning.** Short-term perspectives produce short-term decisions.
6. **Maintain capabilities to reinforce cooperative behavior.** If people are allowed to subvert the collective good for individual gain, the system will fall apart.

The second ingredient is institutional design principles. These are the rules of the game for how local government and other related organizations work together for a sustainable financial future. The eight Institutional design principles provide the context in which the leadership strategies operate.

1. **Well-defined boundaries.** The default boundary of financial decision making is the single fiscal year. A sustainable institution considers the impact of decisions beyond just one year.
2. **Proportional equivalence between benefits and costs.** When constituents can better appreciate the value they receive for their taxes and fees, they will more willing to financially support government.
3. **Collective choice arrangements.** Government must have the capacity to regularly engage a diverse group of citizens in making choices about their community.
4. **Monitoring.** Effective monitoring discourages people from breaking the rules.
5. **Graduated sanctions and credible rewards.** Sanctions deter participants from breaking the rules. Rewards can be given to those who contribute sustainable resource use.
6. **Conflict-resolution mechanisms.** Decisions regarding a government's fiscal resources are subject to dispute. Rapid and low-cost conflict-resolution helps prevent escalation of destructive conflicts.
7. **Minimal recognition of rights.** Local governments need to preserve enough independence from state and federal government to make choices that best fit local conditions.
8. **Networked enterprises.** Local government often can't solve complex community challenges by itself. It must join with others to form a network of enterprises committed to addressing the challenges for a sustainable cost.

How You Can Use This New Framework for Financial Sustainability

GFOA has developed two documents to help local government leaders use this framework. The first document describes the framework in detail, and address the following for each leadership strategy and institutional design principle:

- **Basis in evidence.** The hard proof that the strategy or design principle works. The evidence comes from scientific studies of how common pool resource systems can be sustainable.
- **Implications for decision making.** The evidence is translated into guidelines for making sustainable decisions in local government public finance.
- **Research-proven tactics for public officials/managers.** These are specific actions that public officials or managers can take to make more financially sustainable decisions.

The second document is a self-assessment tool that invites governments to evaluate the extent to which they exhibit the leadership strategies and institutional design principles. This starts a conversation about what it means to be financially sustainable and how everyone can work better together protect long-term financial health and, with it, the health, safety, and welfare of the community.

Where to Next?

GFOA is convening a group of local governments from across North America to be the first apply this framework and to form the core of a new movement within GFOA to advance financial sustainability. The members of this group will conduct the financial sustainability self-assessment, and then they will take action to improve their financial sustainability. To learn how to join this group, visit gfoa.org/financial-sustainability-resource-center.

Appendix 1 — The Journey to Financial Sustainability in the City of Baltimore, Maryland

Beginning in 2011, Baltimore, Maryland found itself facing annual multi-million dollar financial shortfalls equal to about 17% of its discretionary resources. After trying budget reductions to close the gaps — including eliminating 240 positions; increasing hotel, energy, and telecom taxes; and reducing capital projects, maintenance, and recreational programs — the city's mayor and budget director decided there had to be a better way to solve the crisis. Since one of the causes of Baltimore's woes was a shrinking population, the city embarked on a long-term financial planning process christened "Change to Grow," with the intent of adding 10,000 new families to Baltimore over a period of 10 years.

The process used to develop long-term fiscal strategies required that city departments and members of the public work together. The city formed three "guidance committees" were formed, the membership of which crossed many stakeholder groups. The committees had substantive roles in decision making. Two committees were charged with providing direction on two of the city's most important challenges, the cost of employee health benefits and pensions. The third committee provided direction on the ten-year plan as a whole.

When municipalities develop a long-term financial plan, they often focus on a three-year or five-year time horizon. However, the mayor and the finance team knew that the city's biggest challenges, like declining population, a stagnating tax base, deteriorating capital infrastructure, and growing liabilities for employee pensions could not be adequately addressed over five years. A ten-year horizon was needed to effect meaningful change. Further, a longer time horizon would allow the city to better assess the potential of strategies that might not make a big difference within a few years, but could have major positive impacts down the road. A ten-year window would also de-emphasize the long-term plan as a response to the city's recent severe financial crises and emphasize the plan as a means of long-term transformation of the city's fiscal fortunes.

The city developed long-term forecasts that made the best use of technical methods and the on-the-ground knowledge of city staff and other knowledgeable parties. Baseline, pessimistic, and optimistic scenarios were created with an eye toward understanding what plausible versions of the future might look like, based on different forecast outcomes. A combination of public, nonprofit, and private sector participants were asked to use this information as the basis for answering various "what if" questions about the city's financial future. This helped broaden people's perspective of what was possible, leading to more imaginative financial strategies.

The city's approach allowed all stakeholders to understand how factors such as pension and health-care costs and a declining tax base would impact Baltimore over the long term and under different economic conditions. Providing this data to the collective decision making body — elected officials, union leaders, city employees, the larger community, media, and special interest groups — created the foundation for the tough conversations needed to change the city's financial trajectory. For example, the cost of employee and retiree health benefits was a serious concern because of both its overall size and its high rate of growth. The city's previous efforts to contain these costs mostly involved making marginal changes to cost-sharing ratios with plan participants, or changes that affected only retirees, such as dividing potential pharmaceutical purchases into pricing tiers in order to steer participants toward generic and preferred brands. After the scenario analysis, the participants in "Change to Grow" were willing to consider changes that affected active employees and that required negotiations with employee unions due to the scale of the change proposed. For instance, a 20% co-pay for drugs was proposed for all plan participants — double the co-pay for retirees and an entirely new cost for active employees. They also approved a variety of other strategies to make Baltimore more economically dynamic and to improve city government, such as infrastructure investments, tax reform, and making city services more efficient.

This case illustrates how Baltimore officials were able to use their new-found financial knowledge to build community confidence and trust in their leadership. As a result, collective public support was generated to reduce costs and expand the general municipal tax base.

Connections to the Financial Sustainability Framework

Leadership Strategies

1. Help participants to build trustworthy reputations. The mayor and finance department were candid about the city's financial position and used scenarios to help make financial information more accessible to people. Face-to-face collaboration on the guidance committees also helped build trust between participants.

2. Create open communication among all participants. Baltimore's mayor led the financial planning process and used a variety of methods to communicate the city's financial condition to stakeholders. For example, long-term forecasts were made publicly available, and Baltimore actively engaged with the local media to distribute financial information.

3. Convince stakeholders that collective efforts can yield benefits. The "Change to Grow" goal of adding 10,000 families to Baltimore in 10 years would revitalize the city and cast planning in a positive light, not just as a way to survive the latest crisis.

4. Ensure that key participant remain engaged. "Change to Grow" was a highly collaborative endeavor. The city council, dozens of city department and division managers and professionals, and members of the public were all engaged. At the center of this engagement strategy were the guidance committees, which were substantive participants in decision making.

5. Build long-term horizons into fiscal planning. The city took a 10-year perspective on its plan so that it could adequately address the city's biggest challenges, like declining population, a stagnating tax base, deteriorating capital infrastructure, and growing liabilities for employee pensions.

Institutional Design Principle (IDP)

2 Ensure proportional equivalence between benefits and costs. Baltimore took a balanced approach improving its revenue income and controlling its costs. It did not over-burden the public or any particular stakeholder group.

3 Make collective choice arrangements. A broad cross-section of stakeholders participated in making the hard financial decisions. Also, pursuing a broad range of strategies to improve financial health broadened the relevance of the financial planning process.

4 Focus on monitoring and decision making. Scenario analysis helped stakeholders who were not financial experts get a better sense of Baltimore's financial situation and, therefore, be informed participants in decision making.

8 Network enterprises. Building a financial plan incorporated representatives from academia and the nonprofit and private sectors. This resulted in a higher quality plan with a larger base of support.

Government Finance Officers Association

203 North LaSalle Street, Suite 2700
Chicago, IL 60601-1210
312-977-9700 | 312-977-4806 FAX | www.gfoa.org