NAVIGATING THE FISCAL CRISIS:

Tested Strategies for Local Leaders

A White Paper prepared for ICMA by the Alliance for Innovation

White Paper

Navigating the Fiscal Crisis:

Tested Strategies for Local Leaders

Prepared for the

International City/County Management Association

By

Alliance for Innovation

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January 2009

Executive Summary

Navigating the Fiscal Crisis: Tested Strategies for Local Leaders

A White Paper from the Alliance for Innovation commissioned by the International City/County Management Association (ICMA)

The developing fiscal crisis that city and county governments face calls for extraordinary action by local officials at all levels of government. However, there are lessons to be learned from research on previous downturns and what is known about how organizations achieve excellence and deal with adversity. ICMA commissioned this White Paper by researchers in the Academic Network of the Alliance for Innovation in order to better understand the nature of this fiscal crisis and what steps managers can take to pursue economic recovery. Key findings in the research address the following areas:

This economic crisis is deeper and more severe than what we have experienced in the past 50 years. While some U.S. regions and localities are experiencing the downturn differently, for the first time in the postwar era, all levels of government are impacted with dramatic revenue reductions simultaneously. In addition, this economy has all sectors of the private economy also in a tailspin. Events have already reached crisis levels in some cities and counties, and some say that "we are just at the end of the beginning" of dealing with the crisis. Still, local governments in other parts of the country are just starting to see how the crisis will affect their communities. These governments can learn from past experience with cutbacks and the response of cities and counties already on the frontlines of the crisis.

There are lessons to be learned from past stimulus programs. First and foremost is timing. Only one stimulus package – that of 2001 – was actually approved before the recession had officially ended. In addition, we know that:

- Tax cuts have less impact than cash grant to localities
- Capital project support has a greater impact than operating expenditure support
- Higher level government project and block grants speed recovery in comparison to formula grants

Local leaders can turn crisis into opportunity, if the organization is well managed and takes the long view. Cutbacks, if actions are delayed or reactive, can result in retrenchment and arbitrary cuts. The process, however, can be proactive and focus on advancing the organization's core mission. Local leaders can use hard times to pursue organizational change or shed outmoded business practices that might seem too risky when all economic indicators are positive.

There are local strategies that will contribute to economic recovery and will avoid doing more harm. These actions are not necessarily intuitive and require careful assessment and strategic choice. Local governments are important economic agents. In tough times, local governments should try to serve their residents and stimulate their economies by 1) increasing revenues or drawing down reserves, in order to maintain spending 2) expanding or accelerating local capital projects – especially those with low long term operating costs. Local officials should lead inclusively and encourage creativity and engagement at all levels of the organization and the community. The governments that can take these steps toward renewal in a time of adversity will be better positioned to achieve higher levels of performance when the crisis ends.

Navigating the Fiscal Crisis: Tested Strategies for Local Leaders brings *must have* research and recommendations to localities when it is most needed. The White Paper is only the first step in a vital yearlong project for ICMA and the Alliance for Innovation.

- A web-based "wiki-blog" has been established for local government staff to share ideas on how to weather the economic crisis. Go to www.Transformgov.org – click on the Fiscal Crisis icon.

- A monitoring project has been established to watch a dozen localities, to determine what actions they take to cope with plummeting revenues and community distress over the coming year.

- Regional meetings and national learning events will be scheduled throughout the year to explore specific dimensions of the crisis, such as tightening of the public capital markets, impacts on pension funds and actions for implementation of a federal stimulus program, if approved.

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Navigating the Fiscal Crisis: Tested Strategies for Local Leaders

Essays and Contributors

Overview, Gerald J. Miller and James H. Svara, Arizona State University

New England: State and Local Revenue Systems and Vulnerability to Recession, Doug Snow, Suffolk University

New York, New Jersey, Connecticut, Delaware, and the Philadelphia Region, Helisse Levine, Long Island University, Brooklyn, New York

Fiscal Conditions of Local and Regional Governments in Seven Midwestern States: Ohio, Indiana, Michigan, Illinois, Wisconsin, Iowa, & Kentucky, Donijo Robbins, PhD, Grand Valley State University

Fiscal Crisis in Federal Reserve Districts 9 and 10 "Plains States", John R. Bartle, University of Nebraska, Omaha

Fiscal Conditions in Cities bordering the Mississippi River and Texas: Dallas and St. Louis Federal Reserve District Cities Revenue Outlook, Gerald J. Miller, Arizona State University

The Fiscal Crisis and Cities in the West, Rex Facer, Brigham Young University

Effect of the Economic Downturn in the Fifth and Sixth Federal Reserve Districts – The Southeast, Charles K. Coe, North Carolina State University

Coping with Foreclosures, J. Edwin Benton, University of South Florida

The impact of financial market crisis on local government borrowing and pension costs, Jun Peng, University of Arizona

Human Resource Management Lessons from Past Fiscal Crises, Joe Cayer, Arizona State University

How Have Previous Fiscal Stress Periods Aggravated or Abated Urban Problems?, Rebecca Hendrick, University of Illinois at Chicago

Coping with Fiscal Stress, Jonathan Justice, University of Delaware

Organizational Resilience and Crises Confronting Cities, Janet Denhardt and Robert Denhardt, Arizona State University

Local Level Fiscal Sustainability and Strategies, Jeff Chapman, Arizona State University

Innovation in Hard Times is Essential, Yet Often Most Difficult, Michael T. Peddle, Northern Illinois University

Cutback Management in the Context of Innovation, James H. Svara, Arizona State University

Socially Responsible Supply Management: Thinking Global in Local Government Purchasing during a Fiscal Crisis, Thomas J. Catlaw, Arizona State University

Can local government leaders formulate strategies that will actually – rather than hopefully – stimulate their local economies? Has history any record of such successes?, Justin Marlowe, University of Kansas

Fiscal Stimulus versus Economic Base Development, Jeff Chapman, Arizona State University

Navigating the Fiscal Crisis: Tested Strategies for Local Leaders

Overview

Gerald J. Miller and James H. Svara

The developing fiscal crisis facing city and county governments calls for extraordinary actions by local officials. Fortunately, research on organizations' responses to previous downturns and other adversities provides important lessons for today's managers. A cadre of researchers in the Academic Network of the Alliance for Innovation prepared this white paper for the International City/County Managers Association (ICMA). It is intended to help local government managers understand the nature of this fiscal crisis and the steps they can take to support economic recovery. The paper answers five questions:

- What are the dimensions of the current crisis? What defines it?
- What has worked in previous fiscal cutback efforts?
- What characterizes organizations that cope better with fiscal stress than others?
- Why is innovation in hard times so critical yet how can positive actions be taken?
- How can local government actions contribute to the economic recovery?

This introduction to *Navigating the Fiscal Crisis* concludes with guiding principles for local government action.

As of January 2009, estimates indicate that no state, much less the nation, has reached the bottom of the economic cycle. However, events have already reached crisis levels in some cities and counties. For example, one Arizona city manager who has dealt with declining revenues for nearly two years tells his community that the measures taken so far are simply "the end of the beginning." Local governments in other parts of the country are just starting to see how the crisis will affect their communities. All signals point to challenges getting worse in many more communities before the nation's fiscal health improves. *Navigating the Fiscal Crisis* is meant less as a history lesson of how cities survived the 2007-2008 recession and more as a set of suggestions for coping with the recession as it continues in 2009 and beyond.

Fiscal Dimensions of the Economic Crisis

This is deeper and different than anything we've seen in the past 50 years.

All local governments face uncertainties and risks in the current recession, and many will experience severe challenges with local government finances because of the slowdowns among major economic drivers. The downturn in economic activity and rising unemployment reduce revenues and increase demands on the social safety net. But states' economic problems differ across the country. Regional assessments of conditions have been made by Doug Snow, Helisse Levine, Donijo Robbins, Charlie Coe, Rex Facer, John Bartle, and Jerry Miller.

- Problems in the automobile and financial services industries primarily affect Michigan, New York, New Jersey, Connecticut, and Delaware.
- States, which depend heavily on sales taxes and development-related revenues such as Arizona, California, Florida, and Nevada, have felt the sting of slumps in spending and home construction.
- Local governments with substantial transfers from state government—most counties and cities in 19 states—may experience reductions in this fiscal year and 2010 since revenue shortfalls of more than seven percent of the operating budget are expected in 13 states (2009) and 21 states, respectively. (See figure 1) Counties are likely to be even more significantly impacted by state budget problems since they received a third of their total revenue from state sources compared to an average state share of 19 percent in cities.

- Manufacturing states in America's heartland have seen high demands for exports collapse. Now, the pipeline is empty due to slowed economies in Asia and Europe.
- States that draw heavily on agricultural, energy, and mining tax bases such as Iowa, Kentucky, North Dakota, South Dakota, Oklahoma, Wyoming, Montana, Kansas, and Utah have experienced relatively mild effects of the crisis but if energy prices decline, this may not continue to be true.
- Greater reliance on property tax provides a buffer from declining revenues for some entities because of the delay in reassessing property values. However, the property tax revenues that increased in 2007 are expected to decline for 2008 and drop even more in the future.

Figure 1. Potential Municipal Vulnerability to Projected Decline in State Government Resources

			Most Vulnerable
City government dependence on state revenue high (19%+)	Alaska Mississippi New Hampshire Wyoming	Maine Michigan New Mexico Massachusetts Nevada Pennsylvania	Arizona New York Rhode Island Wisconsin Illinois Maryland Virginia Connecticut New Jersey
City government dependence on state revenue medium (7 to 18%)	Idaho Montana Nebraska North Dakota Arkansas Oregon Iowa	Tennessee Ohio Indiana	California Florida Louisiana Minnesota North Carolina
City government dependence on state revenue low (Less than 7%)	Kentucky Oklahoma Missouri South Dakota Texas West Virginia	Colorado Delaware Georgia South Carolina Alabama	Utah Washington Vermont Kansas Hawaii
Least vulnerable	***State budget gap low (Less than 5%)***	***State budget gap medium (5-14%)***	***State budget gap high (15% +)***

Sources: City percent of revenues from state government. Source: *Finances of Municipal and Township Governments: 2002* (2002 Census of Governments, issued April, 2005); State budget gap based on projected deficit in 2009 and 2010. Source: Center on Budget Policies and Priorities http://www.cbpp.org/9-8-08sfp.htm (accessed January, 2009)

The recession is spreading beyond housing, automobiles, manufacturing, and financial services to affect all areas of the economy, and it is global in scope. This fiscal crisis is the first in the postwar period in which local, state, and federal governments have reported shortfalls in all major revenues— sales, income tax, and capital-property—at the same time.

The National League of Cities reported that there is typically an 18-24 month lag between the change in economic conditions and the impact on municipal revenue collections.[1] Thus, some governments are affected now by reduced revenues, while others will experience intense pressures in the near future. According to economic forecasts, 2010 and 2011 will be even tougher on local government fiscal health than 2009. Of 17 large counties surveyed by the National Association of Counties, 47% anticipate a budget shortfall in the current fiscal year, and 59% expect a shortfall in the next fiscal year.[2] Federal stimulus spending may offset some of this coming loss in revenue, although most of the funding is likely to support public works projects, tax relief, and aid individuals in need, rather than restoring losses in operating budgets. For most local governments, it is time to prepare for coping with and moving beyond these tough times.

Foreclosure

The U.S. housing foreclosure crisis persists, and according to housing and banking experts, the foreclosure problem will become bigger. While the drivers of the crisis are complex, we know several things drawing on the assessment by Ed Benton. First, the factors responsible for it predate and largely triggered the current economic downturn. Second, the recession likely will lead to another wave of foreclosures of a different nature and magnitude. Foreclosures began with subprime mortgages—those made to borrowers with a sketchy credit history or who provided limited documentation of their income or assets. The foreclosures now, contrary to similar past periods, are on higher-end properties, resulting in more severe bank losses. A third wave of foreclosures is likely to follow and conform to traditional patterns—foreclosures among those who live from paycheck to paycheck. The states with the highest foreclosure rates (in order of magnitude) are Nevada, Florida, Arizona, California, Colorado, Michigan, Ohio, and Georgia. (See figure 2) These eight states along with eight others with rates over 1.5% account for almost four-fifths of all housing units in foreclosure in the country.

The impact of foreclosures varies greatly across localities. Some jurisdictions have few foreclosures, but more than 250 local governments had problems substantial enough to receive direct Neighborhood Stabilization Program (NSP) funding from the U.S. Department of Housing and Urban Development (HUD)—with additional dollars going to statewide programs—to deal with the impact of already empty properties. When foreclosures are concentrated, property assessments decrease, and local governments' property tax collections are reduced. Sales taxes have slumped in part due to lower consumer spending brought on by the heavy debt load households assumed with home equity loans and second mortgages. Simply put, some local governments can expect to see what were once stable property tax dollars and robust sales tax revenues shrink, and become increasingly unreliable.

On the spending side, foreclosed properties often result in public health issues, crime, and other social problems. Previously middle income families who had foreclosed mortgages must deal with forced relocation and even homelessness. As a result, they face humiliating, unfamiliar problems and the prospect of being in cash- and asset-poor circumstances for some years. With no place else to turn, local government leaders are compelled to deal both with foreclosed properties and dislocated families.

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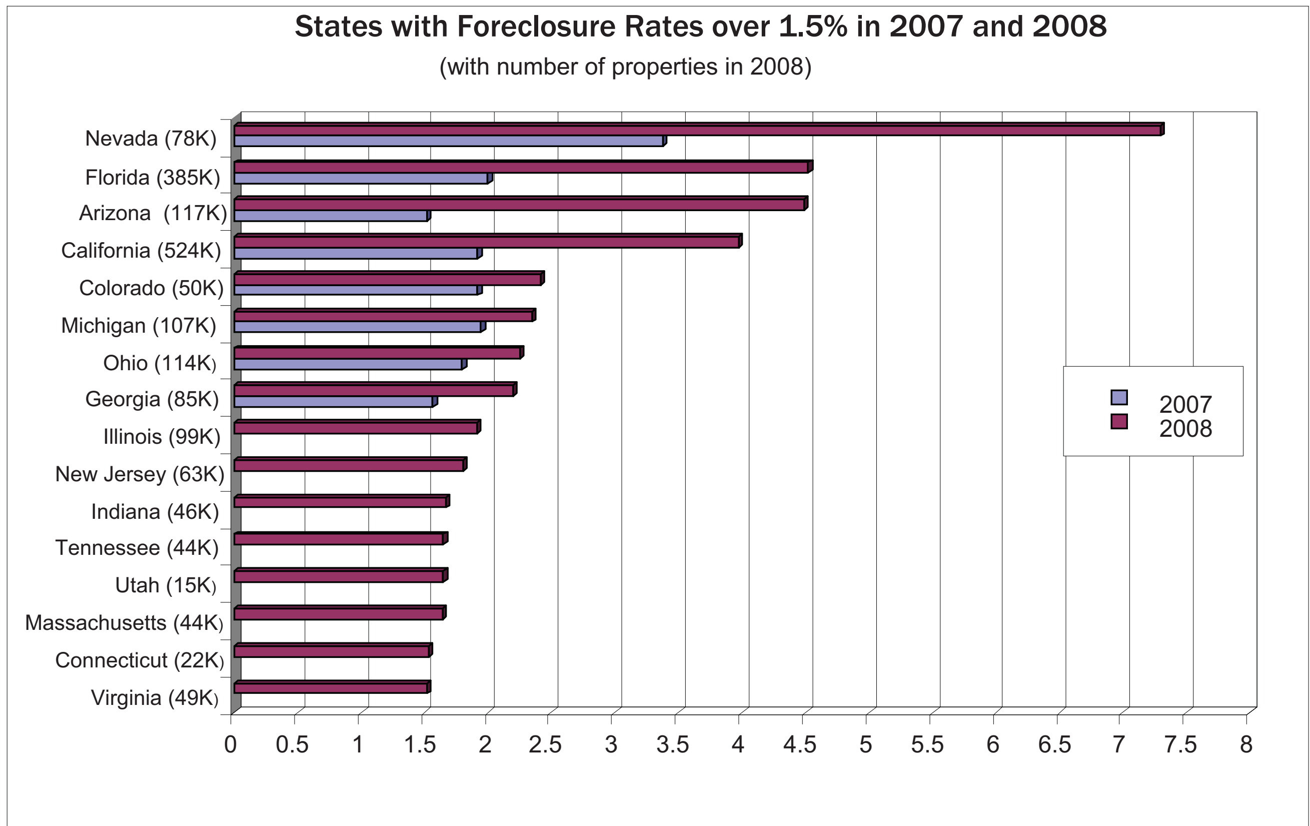
[1] Hoene, Christopher W. & Pagano, Michael A. (September, 2008) , City Fiscal Conditions in 2008. Research Brief on America's Cities, Issue 2008-2. Retrieved 9-20-2008, from www.nlc.org Washington, D.C

[2] Taylor, Charles (2008, October 27) Many urban counties hurt by economic downturn. County News-National Association of Counties. Retrieved December 15, 2008 from http://www.naco.org/CountyNewsTemplate.cfm?template=/ContentManagement/ContentDisplay.cfm&ContentID=29131

Figure 2. Foreclosure Rates and Properties



Source: http://www.realtytrac.com, U.S. Foreclosure Market Data by State for 2007 and 2008

<u>What and how credit market problems have threatened existing local government borrowing and how stock market problems affect pensions</u>

While the twin economic and financial market crises dealt a severe blow to state and local government finance on the revenue side, they also have a direct impact on state and local governments' spending side. Two areas of government spending under pressure now or in the near future as a result of the financial market meltdown: government borrowing cost, and public pension benefit cost according to Jun Peng.

<u>Government borrowing cost</u>

State and local governments rely on borrowing in the municipal bond market to finance all sorts of capital projects. This market has been severely disrupted by the financial crisis, which leads to a disruption in capital financing and substantial increase in borrowing cost. The subprime mortgage crisis and particularly Lehman Brothers' filing for bankruptcy in September of 2008 had a direct impact on the municipal market. All major bond insurers, which previously insured close to half of all new municipal issues prior to the disruption, were downgraded below AAA rating due to their financial loss related to mortgage debt and lowered the overall credit quality of the municipal bond market. The decrease was further exacerbated by Lehman Brothers' filing, which led to a credit market freeze. This credit freeze had two severe consequences for the municipal bond market. First it led to "flight to quality," meaning investors put faith

only in the federal government's ultra safe treasury securities and demand a high risk premium on all other debt securities, including municipal debt. Second, to raise capital, some large traditional institutional buyers of municipal debt, such as property and casualty insurers and hedge funds, became net sellers of municipal debt. The combination of flight to quality and decrease in demand for municipal debt led to a sharp increase in the cost of credit for municipal borrowing.

For much of 2008 until early September, the interest rate in the municipal market remained relatively stable in the five percentage point range, as measured by the Bond Buyer Index for 40 municipal bonds. However, since Lehman Brothers' bankruptcy filing from the week of September 12 through the week of October 17, the average weekly Bond Buyer Index shot up from 5.34 percent to 6.69 percent, a level that has not been seen for almost a decade. The spread between the municipal yield and the 10-year Treasury note also shows the flight to quality. Since mid-September, the spread has widened considerably, a reflection of the extra risk premium on the municipal bonds. This extra risk premium is also shown among municipal debt of different credit quality. For example, on December 31, 2008, the yield on 10-year, triple-A rated municipal bond was 3.52% whereas the yield on single-A rated, 10-year municipal bond was 4.95%[3] In comparison, the average monthly spread between these two ratings was only 0.3 percent from the turn of the century through September of 2008.

This spike in yield makes it much more costly to borrow. For the three months of September, October and November in 2008, municipal bond issuance was down 31.2 percent compared to the same period last year, although the reduction was less in November (down 22 percent) than in October. In some cases, the government issuer had to borrow less than they originally planned so that the debt service could be fit into the budget. In other extreme cases, the issuer had to cancel the issue entirely and wait until interest rates come down sometime in the future.[4] This has put a severe drag on the financing of capital projects. In the past, even in difficult times, state and local governments could depend on debt financing to replace all or part of the pay-as-you-go financing for capital projects to realize budget savings. This strategy is more difficult to implement this time around.

Since the Federal Reserve reduced the federal funds rate to almost zero percent in mid-December, 2008, the yield on the municipal debt has also come down somewhat, as can be seen from figure 3. The yield decreased from 6.49 percent just before the Federal Reserve decision to 5.96 percent by the end of 2008. Whether the yield will continue to decrease in 2009 depends on a few factors. The most important is the length and depth of the economic recession, which will determine the confidence of investors (i.e. the size of risk premium demanded on municipal debt). A second factor will be the overall credit quality of municipal issuers, which is affected by the overall revenue and budget situation. Another factor that potentially influences the municipal bond market is the Obama administration's stimulus plan for state and local governments. The impact will depend on the size and makeup of the federal aid to state and local governments.

In all, the credit market problems influence the allocation of funds. Cities and counties except for those with the best credit ratings probably will not be able to borrow through traditional bond issues. Those localities with the best credit ratings will find traditional borrowing easier. If officials have difficulty

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[3] Herman, Jack and Seymour, Dan (December 2009). Munis Cap Tumultuous Year with Quiet Day. Retrieved on January 2009 from www.bondbuyer.com

[4] Aneiro, Michael (2008, November 19) Cities and States Feel the Squeeze. *Wall Street Journal*. Retrieved November 28, 2008 from www.online.wsj.com and Gogoi, Pallavi. Cities, Schools Delay Projects in Tough Climate for Muni Bonds. *USA Today*. Retrieved November 19, 2008 from usatoday.com

reaching a consensus quickly on how to resolve their budget problems, that may doom traditional borrowing until the credit market problems get resolved. Disagreement or delay in local action sends a negative signal to the credit market. The alternatives to traditional borrowing for either short term cash management or long-term capital projects are pay-as-you-go financing, unusual sources often at higher than expected rates, IOUs for short term cash management as in California, or delay in proceeding with capital improvements.

Pensions

The financial crisis also hit public pension plans hard. At the end of the third quarter of 2007, state and local pension plans collectively held assets worth $3.26 trillion, but the value of assets dropped to $2.75 trillion by the end of the third quarter in 2008. How will this loss affect state and local government pension contributions? Two factors make the impact somewhat difficult to predict. First, pension contributions depend on how the stock market performs over the next six months, since most pension plans' fiscal year ends on June 30. Given the volatility in the current market, it is difficult to tell. The second factor is the smoothing technique used by pension plans in valuing assets. To avoid the volatility in asset value, plans use a multi-year smoothing technique to phase in asset gains or losses. What this means is that the pension funding ratio, which averaged 86 percent for large state pension plans in 2007, will not see a substantial drop next year, and state and local governments will also not see an immediate, substantial increase in pension contributions. However, if the stock market does not see any noticeable improvement, and as the losses are phased in over the next few years, pension contribution will continue to go up in the near future. Since this increase, no matter how small it is in the beginning, happens at a time when government revenue is also shrinking, it nonetheless will add severe strain to state and local government financial health.

Due to the market losses and the expected increase in employer pension contributions, some states may reduce pension benefits for new employees by creating a new tier. So far, New York state has already proposed establishing a new tier that will require new employees to work longer and retire later to receive full pension benefits. More such proposals can be expected in the future.

What Local Governments Have Done in Past Crises

"Lessons learned" call for strategic, targeted actions.

Cities and counties usually combine revenue increases, cuts in spending, and cutbacks on capital projects to neutralize a fiscal crisis. In the past, delaying action has been the typical response in hopes that the cutbacks are only a temporary slowdown.

"Cutback management," the well-known body of work to come out of the financially stressful 1970s, is a method for coping with fiscal turbulence, as summarized by Barbara Lewkowitz. Charles Levine, the person most closely associated with the concept, observed cities being challenged by escalating periods of resource scarcity and foresaw the necessity for public sector contraction. Levine emphasized that management needed to maintain credibility, civility, and consensus. He dismissed any alarmist mentality; he felt that cool, rational actions would preserve necessary municipal services and help the community understand the scope of the problem. To him, "orderly retrenchment," or a managed organizational response, creates the necessary flexibility to handle fiscal stress and loosen the rigidity of municipal budgets.

Levine advised elected officials and managers to:

1. Recognize or predict impending decline. Such factors as shifts in demographic patterns, economic behavior, community social attitudes, or political power bases will force cutbacks.
2. Educate the public about necessary reductions and engage in thoughtful cutback management. Despite the belief that someone—even someone as imaginary as the tooth fairy—will appear miraculously to take the painful tooth of budgetary cutbacks from under the pillow and replace it with enough new, shiny quarters to fund an entire mouthful of new programs, Levine argued that leaders could manage perceptions and increase public understanding of fiscal stress. Educating the public includes such things as preparing reports, fact sheets, and briefings, being specific about the community's resources and essential local government services, and encouraging as much community input as possible.
3. Refrain from moving money around for short-run expediencies or deferring maintenance. Leaders should prioritize programs and target budget cuts.

More specifically, fiscal stress management research appeared with lessons for dealing with human resources and related problems. In human resource terms, Joe Cayer reports that cities and counties often:

- Freeze hiring.
- Freeze or reduce pay.
- Reduce work hours with subsequent reduction in pay.
- Eliminate positions which may require laying-off employees if there are not other vacant positions for which they are qualified.
- Provide incentives for early retirement.
- Use volunteers.

Research reveals that fiscal cutback techniques have important differences, especially as they may be used in state and local governments compared to the federal government. Increasing a tax has a greater impact in speeding economic recovery than cutting expenditures. Financial controls applied across the organization from the top have more unintentional than intentional consequences. Across the board cuts do not distinguish essential from less important activities or the impact of proportional cuts on programs of different scales. This type of cut confuses the purposes of local government activities among stakeholders. Without a rational, understandable basis for cutting spending, across the board cuts encourage politicking for budget restoration by inspiring competition among programs, their allies, and local government stakeholders. Hiring freezes weaken organization performance more than targeted layoffs. Pay freezes can be implemented most easily and are perceived as fair by employees. Reducing work hours with subsequent reduction in pay has less impact on employee morale than pay reductions.

Past fiscal stimulus programs—such as higher level governments help lower government level leaders to solve their fiscal problems—have had various designs. Some have proven to be more effective in speeding economic recovery than others. For example:

- Tax cuts have less impact on economic recovery than do cash grants to governments.
- Capital project support has greater impact than support for operating expenditures.
- Support for capital projects that have low operating costs have a greater impact than capital projects with high operating costs.
- Higher level government project and block grants speed economic recovery in comparison to formula grants and various forms of subsidies for lower level governments.

Timing is an important aspect of a stimulus program. As indicated in Figure 3, none of the stimulus programs passed by Congress in the post-war period were approved before the end of the recession, except that in 2001.

Figure 3. Use and Timing of Dollars for Selected Stimulus Packages in Recessionary and Non-Recessionary Periods

Appropriated in Legislation	Adjusted to 2008 Dollars	Legislation Name-*Use of funding*	Beginning of Recession	End of Recession	Stimulus Legislation Enacted
$394M	$2.8B	Area Redevelopment Act	Apr. 1960	Feb. 1961	May 1961, Sep. 1962
$900M	$6.3B	Public Works Acceleration Act	NA	NA	1962
$6B	$22.4B	Local Public Works, Capital Development and Investment Act *to states and substates levels*	Nov. 1973	Mar. 1975	July 1976, May 1977
$9B	19.2B	Emergency Jobs Appropriations Act *86% for public works, remainder to public service functions*	Jul. 1981	Nov. 1982	Jan. 1983, Mar. 1983
$32B (over 10 years)	$5B annually by 2008	Taxpayer Relief Act of 1997 *Empowerment zones created*	Jul. 1990	Mar. 1991	Dec. 1991, Apr. 1993
$1.35 Trillion in Tax Reductions	Over 10 years	Economic Growth and Tax Relief Reconciliation Act of 2001 *Tax Cuts-one time rebate*	Mar. 2001	Nov. 2001	Jun. 2001
$350B in Tax Reductions and limited spending	Over 10 years	Jobs and Growth Tax Relief Reconciliation Act of 2003 S.1054 *20B for states over two years-no city funding*	NA	NA	May 14, 2003

Source: Data from CRS Report titled *Economic Slowdown: Issues and Policies*, retrieved November 26, 2008

A crucial choice in stimulus package design is how funds will be distributed. Three considerations reinforce providing a substantial portion of such funds directly to local governments. First, beyond increased benefits to individuals in need, the greatest multipliers from fiscal actions come from infrastructure spending. Second, most infrastructure is built and maintained by local governments. Third, there are losses from overhead expenses and goal displacement when grants must pass through another body to get to the recipient.[5] Direct allocations to local governments offer advantages in speed, simplicity, flexibility, and accountability.[6] Fourth, local governments can integrate these projects with ongoing efforts to advance sustainability, quality of life, and neighborhood revitalization.[7]

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[5] These losses trade off against the gains from planning and coordination possible when development grants go through some regional or state body for review. Beam, D.R. and Conlan, T.J. (2002), Grants, in L.M. Salamon (Ed.) assisted by O.V. Elliott, The Tools of Governments: A Guide to the New Governance (pp.340-380) Oxford; New York : Oxford University Press

[6] ICMA, NACO, NLC, Research Brief, Transition Presentation to incoming President, Retrieved December 2008 from www.icma.org

[7] Peirce, Neal. (2008, November 30). In An Epic Fiscal Storm, New Strategies Sprout. Washington Post Writers Group. Retrieved December 1, 2008, from http://citiwire.net/post/437/

Effective management of a fiscal crisis depends on the type of economic crisis. Cyclical periods of deficit correspond to average-length recessions as localities experienced them in the early 1990s and 2000s. Most recessions permit short-term adjustments to events and a return to the status quo. Structural deficits arise from fundamental demographic, social, and economic changes in the community that permanently unbalance recurring expenditures and revenues. Structural deficits can materialize from isolated events, such as the loss of a large employer, or from a widely experienced, deep recession, illustrated by the local fiscal effects of poor global competitiveness among U. S. automakers and financial services firms.

Overall, fiscal crises disrupt metropolitan economies, argues Rebecca Hendrick. Central cities, areas within them, and inner-ring suburban local governments with more urban problems are likely to become worse off during a fiscal crisis. Urban problems include concentrated poverty, unemployment, and crime and low business activity. In the current period, some new suburbs on the fringe of metropolitan areas have been particularly susceptible to foreclosures or suspended development. Economic development efforts pursued independently by individual governments can aggravate urban problems when a local government has fewer assets to leverage. Such assets include infrastructure, workforce capabilities, and educational institutions. Coordinated development, often found by researchers to be the product of institutions created by a higher level government such as states for cities, reduce competition between poor and rich jurisdictions and help reduce some of competition's costly by-products, including sprawl.

Characteristics of Organizations That Cope Well With Fiscal stress

Leadership, resiliency, and a long view are needed.

Given the crisis, well-managed organizations capable of dealing with events before, during, and after a crisis are those that are able to adapt, bounce back, and sustain essential activities with reasonably accessible revenues.

Fiscal health reflects the adaptation of a local government's revenues and expenditures to the resources and constraints provided by its environment. Jonathan Justice found that adaptation takes place over the long term of several business cycles and in the short term within a cycle. Adaptation positions a local government to sustain a politically and economically appropriate level and mix of services throughout the business cycle. In turn, the locality can accumulate sufficient reserves as revenues cycle up to take the organization through normal downturns without disruptive cutbacks or revenue increases.

Long-term adaptation tactics, according to Jonathan Justice and Jeff Chapman, include:

- Avoiding excessive commitments to fixed expenses such as debt service and unfunded post-employment liabilities, being flexible and efficient in spending choices,
- Trying to diversify revenue sources so that they are fairly stable and may be controlled locally across economic cycles.
- Engaging in long-term financial planning.
- Maintaining reserves adequate to deal with abrupt, temporary shocks,
- Using charges for services and a land value tax as a benefit tax for local government capital improvements.
- Working to educate stakeholders about their jurisdiction's financial situation and the need for fiscal planning and prudence.

Short-term coping tactics include moving promptly to rein in controllable expenses and adjusting the revenue mix and tax rates to the extent permitted by law and by other constraints. Local governments

should look for opportunities to improve productivity and financial management practices, consider shedding activities that can be appropriately divested or eliminated, explore introducing or increasing charges for services that can appropriately and feasibly be priced, enacting temporary tax increases, and secure special assessments for certain capital improvements. Adaptation may require major reductions in services, often made after zero-based reviews of service mixes and levels or by other methods of ranking priorities among services. Jefferson County, Colorado used an intensive assessment by staff to identify service priorities, and Queen Creek, Arizona took advantage of a management retreat to identify core services followed up by council discussion and acceptance. Cities and counties have used participatory techniques to manage cutbacks, increasing the visibility of existing services, exploiting the varieties and depth of knowledge among residents, bolstering residents' willingness to share the risks of the cutbacks, and improving the political acceptability of the cutbacks.

What organizations are most likely to respond constructively when faced with adversity? Natural disasters, terror attacks, and fiscal crises have increased curiosity about how some organizations recover even though they have been stressed to the breaking point. Janet Denhardt and Robert Denhardt refer to resilience as a more flexible and greater ability to adapt to future challenges. They and other researchers argue that it is the practice of everyday resilience in responding to myriad daily stresses that best equip organizations to handle catastrophic and unexpected challenges. Organizational resilience increases as managers build the capacity to adapt.

Organizations that emphasize power relationships and reliance on authority, rules, and procedures may limit the capacity of leaders to change followers' frames of reference. Instead, flexible practices are recommended that permit an organization to shift from one make up to another and back again in the same way that a soccer or basketball team will flip from offensive to defensive alignments. For example, Glendale, Arizona, after stressing cross-training and job sharing for years, found that staff members were prepared for new responsibilities that result from downsizing and reorganization.

Resilient local government organizations pursue "bricolage." In construction, it means using whatever materials are at hand and in budgeting it means doing what's necessary with what's at hand. By distinguishing the essential from the "just good to do," local managers decide what's necessary to do. By choosing balanced revenues, setting realistic tax rates, and assessing the cost-effectiveness of tax gifts as recruitment tools for firms for economic development, local leaders determine what's at hand. Bricolage permits fiscal sustainability. Fiscal sustainability strategies build the capability of a government to meet consistently its financial responsibilities, in the short term by adjusting spending to revenues and revenues to spending, and in the long term by protecting future generations' fiscal abilities.

Positive Actions in Hard Times
Opportunity can rise out of crisis.

Managers also recognize that well-managed organizations can find ways to make constructive changes with positive long-term impacts even in the midst of a fiscal crisis. Jim Svara argues that organizations will use hard times as the occasion for introducing change, and these actions can approximate the process of innovation. The destructive aspects of retrenchment with the loss of good people and programs make it hard to look at a cutback period as a time of innovation. Such periods, however, are characterized by widespread change, and the experience of innovation can contribute to understanding how creativity can be a positive force even if it comes from cutbacks. Innovations include approaches that are new, original, and cutting edge and also changes adopted from other organizations with the intention of improving processes or results. These actions are new to the organization and a departure from previous practice but not necessarily original.

Mike Peddle writes, "Innovation in hard times is essential, yet … most difficult …." Routine solutions,

experience has taught, no longer work. Through past fiscal crises, successful innovations have included financing public facilities through lease arrangements, sales of public facilities naming rights, joint development by local governments and for-profit entities, and developer-financed infrastructure. These approaches have become accepted practice. Successful financial innovations have tended to be those that allocate or reallocate the costs of public services and infrastructure to their beneficiaries rather than the general public.

Nevertheless, popular perceptions hold that a fiscal crisis is not the time for risky ventures. In tough times, there is less of a margin for error if an idea fails, and stakeholders prefer safe bets when resources are scarce for governments, businesses, and households. Safe bets are often provided by solutions popularly thought to be sound but are found to fail when tried. Innovations are often restricted to governments that have resources, while those that need it most are the least likely to undertake it.

So, what conditions encourage innovation and constructive approaches to dealing with cutbacks? Advance preparation and strong organizational capacity before a cutback occurs are important factors in why some organizations succeed and others decline. For example, choosing to discontinue programs that depart from core values or achieve only marginal results presumes that core values are clearly identified and results can be measured. This does not mean, however, that the ability to cope is predetermined and beyond the control of leaders. The positive qualities of well-run organizations provide an inventory for managers to use in taking stock of their own capabilities. They also provide a guide to organization building to prepare not only for the next crisis but also for more successful organizational performance in “normal” conditions. For example, Washoe County, Nevada, started a citizen involvement process during the downturn in 2003 that has been an asset for identifying priorities before the current crisis started.

Other actions that have been taken or systems established in advance include:

- Understanding community values and establishing priorities to guide choice of programs and services.
- Establishing an early-warning system to discern which trends and factors will affect strategy and timing.
- Implementing a strategy for increasing fiscal sustainability.
- Defining key service delivery areas and using performance indicators to measure results. Rigorous analysis determines whether programs are working. If cuts are needed, the government can identify relative program and service effectiveness.

Local government managers must display fair and forward-looking leadership that supports the policy making by elected officials and empowers and engages staff to contribute to finding solutions. As for fiscal and managerial tactics that facilitate innovation, nine actions offer a variety of measures for responding in the short term and long term to fiscal problems and to the opportunity for innovation. (See Figure 4)

Actions by Local Government Leaders for Economic Recovery
Intelligent public investment can reap rewards.

City and county managers have the responsibility to promote organizational adaptability and steer through the fiscal crisis successfully. A larger question is whether local government leaders can contribute to economic recovery and avoid making matters worse or dampening recovery efforts.

Figure 4. Actions to Promote Constructive Change

- ✓ Cut quickly; avoid delay
- ✓ Take a long-term view
- ✓ Focus on core mission, purpose and highest priorities
- ✓ Invest in innovation and continuous improvement
- ✓ Manage revenues as carefully as expenditures
- ✓ Examine and improve organizational design and processes
- ✓ Foster stewardship and cost containment
- ✓ Create a sense of inevitability, devise a workable schedule, and stick with it.
- ✓ Commit to communicating with all stakeholders.

With a large number of employees paid regularly and substantial purchases of goods and services, local governments are important economic agents. In a fiscal crisis, what, if anything, can local government leaders do to stimulate their economies? Justin Marlowe points out that the answer, according to public finance theorists, is local governments can accomplish little on their own. The actions they take, however, could exacerbate problems if they make cuts in ways that accelerate rather than counter the shrinkage of the local economy.

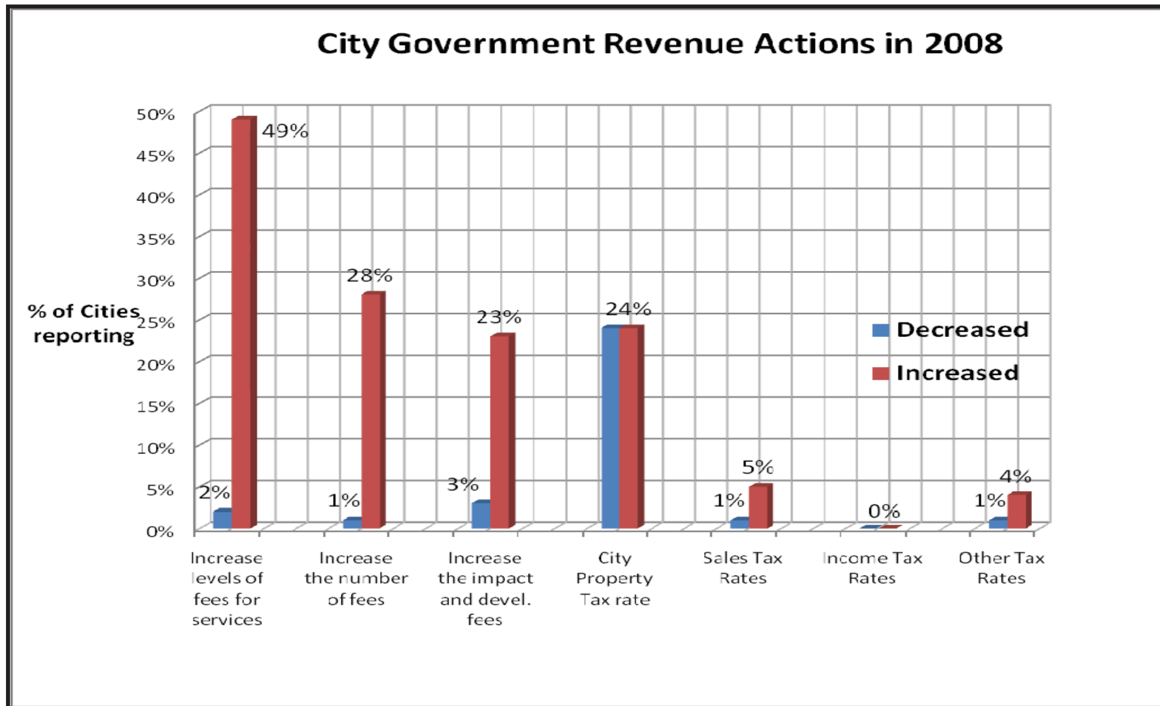
Leaders can mildly stimulate their local economies with several strategies: 1) increasing revenues or drawing down financial reserves to maintain or increase local government expenditures; and 2) expanding or accelerating local capital projects. In the current crisis as in previous situations, many cities are maintaining expenditure levels primarily by increasing charges, but also by adjusting taxes and other revenues when possible. (See figure 5). Furthermore, many local governments have accumulated financial reserves, ranging from 30-50 percent of their annual expenditures. Research shows that it is helpful to use reserves to prop up spending when revenues decline and make local government fiscal decisions less counterproductive to economic stimulation. The positive effect of public spending is especially strong for public facilities and services that have a direct relationship to business and industry, including roads, bridges, storm water treatment, and other basic infrastructure. Present circumstances resemble the ideal conditions for local economic stimulus through capital improvements, and the federal stimulus package may provide the funding that is not available at the local level.

A third possible strategy would be for local leaders to emulate Congress by reducing local tax rates to encourage spending. Realistically, stimulus works differently at the local level. Reducing taxes has less impact on local consumer spending than maintaining programs and expenditure levels. The evidence suggests local consumer spending does not get a boost so much as savings, which enters a large pool distributed globally rather than locally.

Marlowe concludes that, ironically, the best option for local governments asked to do something to stimulate their local economies is to maintain current expenditure levels and expand capital improvements if local revenues, reserves, interest rates, and federal grant funds make it possible. This course of action, Jeff Chapman notes, is not typical. Commonly, he says, the state and local response to a change in

economic activity tends to make downturns and upturns more extreme. However, nearly all of the economics literature estimates that cutting expenditures hurts the local economic recovery more than raising taxes.

Figure 5



Michael A. Pagano and Christopher W. Hoene, "City Fiscal Conditions in 2008," *National League of Cities*

Economic development efforts can generate jobs and tax revenues during a recession. While fiscal economic development incentives do not work all that well, according to research estimates, to attract investment to a particular state, these incentives do become powerful at the local level after a developer has decided to move to a particular region. In particular, they may be more important during a recession; the private sector firm might be more sensitive to the impacts of the incentives because its profit margins may be smaller. The incentives, however, do not have to be solely in cash. Factors besides fiscal incentives do matter in economic development, and some may have a bigger impact than tax gifts. For example, local community assets including infrastructure, a skilled workforce, and educational institutions matter to private sector firms in location and expansion decisions, as do factors with less direct impact, from the process of getting project approvals to the local government's credit worthiness in the municipal bond market. A period of resource scarcity is an appropriate time for jurisdictions in a region to share incentives and benefits instead of pursuing new development as a zero-sum game.

Chapman contrasts fiscal stimulus with economic development. Developing the economic base must be considered more of a long-run play, involving careful planning, multiple analyses of many variables, and minimal expectations of quick payoff. State and local fiscal stimulus differs due to its emphasis on immediate effects.

Conclusion

The current crisis forces local government leaders to face new challenges.

In this fiscal crisis so far, there is evidence that local government leaders have pursued a number different goals with a variety of strategies and tactics. In general, the cutbacks have forced either proactive or reactive changes. Proactive efforts have aimed to create longer-term effectiveness, efficiency, and stability. The result is a positive difference for the organization compared to conditions that existed before the fiscal crisis began or that would have resulted from arbitrary actions. In contrast, reactive efforts respond to events and aim to maintain the status quo until it is possible to restore the organization as it was before the fiscal crisis began. The reactive approach often involves across the board cuts, ignoring differences in importance and priority, failure to deal with the fundamental sources of inefficiency and instability, denial of fiscal sustainability problems, and an organization-wide sense that simply weathering the storm is appropriate.

The severity of the fiscal crisis a city or county faces does not determine which approach managers encourage their organizations to take. Some are overwhelmed by deep and successive reductions in resources. Other see a crisis as an opportunity for constructively shaping changes when declining resources make it impossible to continue business as usual.

Important guiding principles, some of which are counter-intuitive, are clear from this research review:

- Insofar as possible, maintain spending rather than cutting revenues and eliminating even more programs and services. In particular, do not trim capital projects with limited impact on the operational budget.
- In making budget reductions, avoid across the board cuts that take funds away from higher priority programs and services along with those with lower priority.
- If reducing positions, avoid eliminating only vacant positions that either randomly distribute vacancies or leave high turnover agencies severely understaffed.
- Lead inclusively and encourage creativity and engagement at all levels of the organization rather than tightening controls and making top-down decisions.
- Draw on the organization and the community's ideas and support, and use the crisis to identify how the organization can be strengthened.

In this economic downturn, lessons from past downturns, research, and practice show that we know what works and what does not to cope with the crisis and position local government organizations for strong, long-term development and change. Local governments should make cuts in strategic, programmed ways and look for ways to improve the organization while making changes forced by reduced resources. Leaders can positively resize or restructure their organizations. Local governments better serve their residents and do more to counter the downturn by offering sound programs and services than by reducing revenues and cutting services indiscriminately. The governments that can take these steps toward renewal in a time of adversity will be better positioned to achieve higher levels of performance when the crisis ends.