As they struggle to balance their revenue-deprived budgets, state and local governments should look beyond mere cost-cutting measures to structural solutions that not only foster budgetary balance, but also enhance service delivery.

Finding Opportunities in Fiscal Stress: How to Balance Your Budget and Improve Performance

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State and local governments are experiencing the worst fiscal stress in more than a decade. As they struggle to balance their budgets, these governments have two choices: they can either resort to the traditional medicine (i.e., service reductions, cost cutting, layoffs, tax increases, or some combination thereof) or use the opportunity to make permanent changes to the way they operate. Advocating the latter approach, this article identifies an array of strategies governments can use to simultaneously balance their budgets and improve their performance.

First Things First

As they set out to balance their budgets, governments need to carefully consider three important factors: (1) cyclical versus structural deficits, (2) the price of government, and (3) results. By determining the true nature of budget problems, setting the desired price of government, and deciding on what results are to be achieved with available revenues at the beginning of the process, governments can radically improve the end product. In this section, we discuss how each of these factors contributes to long-term financial stability and enhanced performance.

Cyclical Versus Structural Deficits

Confronted by budget deficits, governments must first determine whether the problem is cyclical (short-term) or structural (long-term). Cyclical deficits are typically caused by temporary economic downturns, whereas structural deficits are caused by long-term gaps between projected revenue growth and the estimated cost of government-funded services. Budget deficits may include both cyclical and structural components, as is the case for many governments currently experiencing fiscal stress.

Many jurisdictions accumulated "rainy day funds" over the last decade to help them through short-term budget difficulties. Some of these jurisdictions are now using these reserves and a host of other short-term fixes to plug budget holes. However, the use of one-time money in the face of structural imbalance only postpones the problem, and is ultimately a recipe for fiscal disaster.

In order to select the most appropriate balancing strategy, governments need to understand the true dimensions of the problem (i.e., whether it is cyclical or structural in nature). This requires effective long-term financial planning based on credible short- and long-term forecasts of both revenues and expenditures. To identify structural gaps before they become a serious problem, these forecasts should extend at least four years out.

If estimated revenues are adequate to meet estimated expenditures over the long-term, governments can safely use reserves or other stop-gap measures to meet short-term needs and remain fiscally sound. If, however, revenues are not expected to keep pace with expenditures—as is often the case—governments will have to make permanent, fundamental changes to their revenues, expenditures, or both. Once these changes have been implemented, governments can use reserves to meet whatever short-term needs remain or to facilitate a more gradual transition to long-term solutions.

Although a gradual transition to structural balance creates less disruption to government operations, delaying the solution can exacerbate budget deficits. Changes in revenue structures and spending take hold gradually over time, so the earlier they are implemented, the earlier structural balance can be achieved. Governments need to be clear about the implications of their budget-balancing decisions. Public managers and elected officials should ask themselves what impact their budget-balancing decisions will have on future budget cycles, whether budget-balancing measures are sustainable, and how long it will take to achieve structural balance if a short-term strategy is used as a transition to solving a long-term problem.

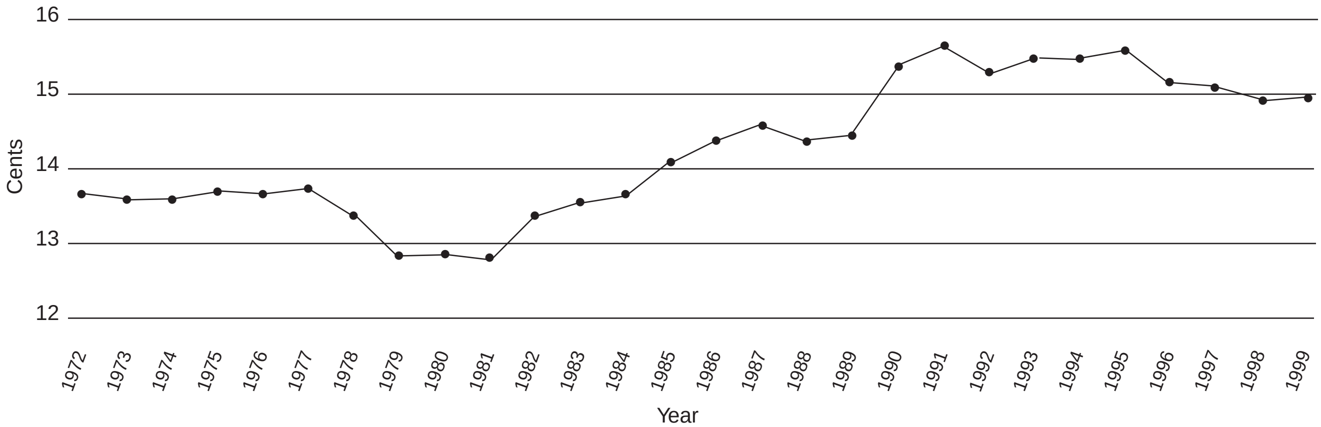
The Price of Government

Consumers demand maximum value for the price they pay for goods and services, and government is no exception. Citizens constantly assess the relationship between value and price as they judge the performance of their governments. Unfortunately, this kind of assessment does not always surface during the budget deliberation process. Instead, most government managers and observers focus on the cost of government, obscuring the relationship between price and value. Setting the price of government is the first step in determining total revenue; that is, local or "own source" revenues plus intergovernmental revenues. Quantifying total revenue at the beginning of the budget process is a reversal of the usual approach of asking how much will be needed to fund budgetary costs.

The price of government is the amount citizens pay in local taxes, fees, and charges from each dollar of personal income. The average

Exhibit 1

PRICE OF U.S. STATE AND LOCAL GOVERNMENT
(Measured by the amount paid to government for every dollar of personal income)



national price of state and local government was relatively stable from 1970 through 1990. It peaked following the recession of the early 1990s, and hovered around that level through the decade. Exhibit 1 plots the average price of state and local government in the United States between 1972 and 1999. Although nationwide averages are interesting, each state and locality has its own unique pattern. Still, it is useful to know how the current price of government compares to historical averages and how governments in the same area compare to each other. It is also helpful to understand why the price of government may have changed.

There is no one "right" price of government. Indeed, each jurisdiction approaches this issue differently. Arriving at political agreement on the desired price of government early in the budget process, however, is a crucial step in managing today's fiscal challenges. By setting a long-term goal for the price of government, public leaders can establish the fiscal context for current and future budgetary decisions. Price setting in the public sector involves the following actions: analyzing historical trends in the price of government, making assumptions about the future direction of personal income, preparing reliable revenue projections, and making policy decisions regarding those revenues for which the government has discretionary control. Once the price of government is established, total revenues can then be determined by adding non-local sources.

Results

Generally speaking, public budgeting is overly focused on costs. Public accounting systems, for example, have literally thousands of cost codes. With relative ease, government accountants can report on the whereabouts of every penny of public money. Although this kind of accountability for public funds is an important objective of financial reporting, it provides little, if any, information about the results of government spending. If governments cannot show that they are delivering desired outcomes with tax dollars, citizens are justified in asking why government is collecting and spending their money at all.

Government can effectively "purchase" results by first determining what citizens want and then allocating the resources necessary to produce the desired outcomes. Individual units of government, such as departments or agencies, must then be held accountable for achieving those outcomes. Linking revenues to results is the essence of results-based budgeting, which is a dramatic departure from the traditional cost-based approach. Results-based budgeting shifts the focus from inputs (dollars, number of employees, equipment, etc.) to outcomes. As such, it requires that public managers and elected officials play by a whole new set of "rules." Exhibit 2 compares the rules of the old game (cost-based budgeting) to the rules of the new game (results-based budgeting).

Strategies for Cutting Costs and Improving Performance

Having determined the nature of their budgetary problems, agreed upon the appropriate price of government (and thus total revenue), and allocated revenue to achieve desired results, governments are prepared to implement specific strategies that will simultaneously reduce their costs and improve their performance. These are not Band-Aid fixes, but rather long-term solutions designed to achieve structural budgetary balance and deliver high-quality services as efficiently as possible. Eight of these strategies are discussed below.

Clear the Decks

Governments can reduce budgets and/or create a funding source to improve performance by eliminating programs or activities that are not central to the government's core purposes or that are no longer valuable to citizens. Although eliminating programs or activities almost always disrupts operations, such action usually frees up resources that can be invested to achieve outcomes that matter most to citizens. Perhaps the most visible example of successful deck clearing is the Defense Department's base closing effort. Similar challenges have confronted school districts with excess space and agencies with outdated programs. Several years ago, the Minnesota Public School District developed a systematic process for identifying and eliminating unnecessary programs and activities, thereby freeing up resources for other priorities. The district essentially divested itself of existing programs to invest in new, mission-critical ones.

Consolidate

Used properly, consolidation offers the potential for cost savings and improved service delivery. But because consolidation also can disrupt operations to the point of actually increasing costs or

Exhibit 2

COST-BASED BUDGETING VERSUS RESULTS-BASED BUDGETING

	Cost-Based Budgeting	Results-Based Budgeting
Starting point	Last year's costs.	This year's price, a fixed number based on the price of government. Also, agency or department results and performance targets.
Focus	Adding to and subtracting from last year's budget.	Spending what is available to get the best results possible.
Additions	This year's inflationary increases plus costs or enhancements.	None—the price is given.
Subtractions	"Cuts" from what was expected, including additions.	None—the price is given.
Purpose of the budget submission	To justify perceived needs and specify the associated costs of those needs.	To articulate the plan for achieving desired results at the specified price.
The budget analyst's role	To find inflated costs and unnecessary needs; probe how work is performed; and push for more productive approaches.	To validate the ability of service providers to produce desired results; shop for alternative providers that can produce better results for the same price; create choices for decision makers.
The elected official's role	To decide what to cut (i.e., to find the "hidden" costs).	To choose which results to "buy" from the various service providers.
Incentives for managers	Inflate costs as a cushion against inevitable cuts in funding.	Produce results that really matter, demonstrating the connection between resources and results.

undermining services, governments should carefully plan any proposed consolidation effort. The types of consolidation most likely to produce savings or improve performance include the consolidation of missions, funding streams, policy direction, service provision, supervisory layers, information access, and back-room activities.

When separate organizations are combined, they often bring with them their various missions. The result is a lack of focus, if not outright conflict between missions. Consolidation works best when the resulting organization has a clear, focused mission and a set of clear, limited performance targets.

The consolidation of funding streams is far more powerful than the consolidation of organizations. Categorical funding inevitably results in categorical, compartmentalized organizations. Consolidate funding, focus it on clear, high-priority outcomes, and use it to purchase those priority outcomes from whatever organizations can best produce them.

Most government organizations have both policy (steering) responsibilities and operating (rowing) responsibilities. Steering functions focus on doing the right things, while rowing functions focus on doing those things right. By separating these roles, governments can better perform both of them. Once separated, steering can be consolidated to ensure that the policymaking process is integrated and mutually reinforcing across government. Operating organizations that perform similar kinds of work (e.g., revenue collection) are also good candidates for consolidation.

Consolidating organizational layers is another way to save money and improve service delivery. One Minnesota county, for example, has eight layers of management between the elected county board and the front-line employees. These layers may have been necessary when communication was cumbersome and employees poorly educated, but this justification no longer exists given today's technology and workforce.

Much of what government does involves the collection and processing of information. Accessing this information, however, is often cumbersome and expensive for those both inside and outside of the organization. Technology offers the potential to consolidate access to information.

Many organizations share common back-room functions, such as customer service, purchasing, and data storage. Although these activities vary from department to department, they often can be consolidated into a centralized "back room" to more effectively support citizen service.

Make Services Accountable to their Customers

The value of any given product or service is best determined by those who use them. Today's consumers expect alternatives for the many products and services they purchase. Providing choices to customers creates competition among service providers and establishes accountability to customers. Perhaps the best example of this is school choice. When faced with the possibility of losing students—and money—to neighboring schools, administrators suddenly begin to pay very close attention to what parents want, and strive to deliver the desired results.

Another way to enhance accountability is to post service standards, offering a rebate or some other form of redress for failure to live up to those standards. A good example of the effectiveness of service standards is the passport application process. If you do not receive your passport on time, you get your money back. The result: delighted customers who get passports much faster than they ever thought possible.

Governments also can create value by making it possible for customers to serve themselves through e-government. Web-based services give customers control over the time and convenience of the services they desire. By offering online renewal of commercial fishing permits, for example, the National Oceanic and Atmospheric

Administration reduced the waiting time for permits to just two days from 30 days. By posting the results of restaurant inspections on the Internet, New York City and other jurisdictions have simultaneously provided a valuable new service to citizens and improved compliance. There are numerous other examples of how the Internet has helped governments of all sizes save operating costs and enhance service delivery.

Create Consequences for Performance

When there are no consequences for performance, either for the organization itself or for individuals within the organization, performance is likely to be less than optimal. Enterprise management establishes consequences by requiring service organizations to "earn" their budgets, often in competition with private providers. Suddenly, survival depends on how well they please their customers and at what price. Many governments have turned their internal services (i.e., maintenance, printing, training, data processing, etc.) into competitive enterprises. The Edmonton School District, the City of Milwaukee, the State of Minnesota, even Australia and the United Kingdom have used this approach.

"Gainsharing" can be an effective strategy to improve performance and cut costs. Managers at the Seattle area's wastewater treatment operation agreed to let employees keep half of the savings they generated for the department. Over a four-year period, savings totaled $2.5 million, with no reduction in service levels or effluent quality.

Managed competition uses competitive contracting to make public agencies compete with other agencies or private firms to serve public needs. Competition unleashes the creative potential of employees, because performance is directly linked to consequences. Indianapolis has used managed competition to improve services and lower costs by an average of 25 percent. Similarly, the Milwaukee area's wastewater treatment agency used the same strategy to cut plant and field operating costs by more than 30 percent.

Performance management requires government agencies to set performance targets and then measure and report results against those targets. This strategy focuses attention on what matters most—results. Governments can enhance their performance management systems by rewarding good performance and penalizing poor performance. Because developing an effective performance management system often requires several years and substantial resources, governments that are under immediate fiscal pressure may opt for the aforementioned strategies, which offer faster results and greater savings.

Offer Flexibility in Exchange for Accountability

In exchange for the new forms of accountability described thus far, governments should offer managers the flexibility to determine the best methods for delivering desired outcomes. Holding managers accountable for performance while simultaneously tying their hands with red tape is a set up for failure. Alternatively, flexibility without accountability is an open invitation for chaos. A flexible performance agreement is one way to ensure both accountability and flexibility. These written agreements articulate the oversight organization's expectations, the service organization's goals and freedoms, how performance will be reported, and how that information will be used to trigger consequences, either positive or negative.

Reform Internal Systems to Improve Performance Externally

All organizations have internal systems for accounting, auditing, budgeting, personnel, and procurement. Unfortunately, the procedural, rules-driven messages these systems send to workers are usually much more compelling than managerial exhortations for improvement. Consequently, lasting improvements in performance require better internal systems.

Although reforming entrenched internal systems is much easier said than done, many governments have successfully met this challenge. Milwaukee's purchasing department, for example, reduced its staff by nearly two-thirds and its budget by more than 55 percent by simplifying processes, pushing authority out to departments, and using technology. A short-term alternative to reforming internal systems is to empower a panel of "bureaucracy busters" to grant selective relief from rules that get in the way of results or add needlessly to costs. Such action can improve results and lower costs, while building the case for system reform.

Cut the Cost of Mistrust

The main purpose of 20 to 30 percent of all government spending is to control the other 70 to 80 percent. This is based on the belief that if given the opportunity, many people will lie, cheat, and steal. Such mistrust is not only expensive, but it also can be detrimental to performance. Montgomery County, Maryland, found that 90 percent of the activity in its accounts payable unit was dedicated to the payment of small-dollar invoices, which accounted for only 10 percent of total purchases. Acting on this information, the county authorized departments to pay invoices up to $5,000 rather than sending them to accounts payable. This simple measure resulted in a 50 percent reduction in accounts payable staff.

Maximize Return on Capital Investments

Increases in debt-funded capital spending can be popular in times of tight operating budgets. For a small increase in debt service, governments can launch relatively large expenditures for roads, bridges, buildings, and technology. Among the top priorities for capital should be investments intended specifically to make services better, faster, and cheaper.

Conclusion

The urgent need to balance budgets in a time of fiscal stress creates a choice for finance and budget professionals. They can either follow the traditional path of cutting services and using short-term solutions, or they can take advantage of the situation to focus on outcomes that citizens really want. Doing so requires a combination of courage, creativity, and good ideas. This article described a range of strategies governments can employ to shift their focus from inputs to outcomes and to achieve structural balance. That these strategies already have worked in many jurisdictions should encourage others to follow suit.

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