To be financially sustainable, a local government needs leadership that can inspire people to look beyond narrow self-interest and participate in decisions that advance the interests of the entire community. The institution of local government must be designed to consistently produce financially sustainable decisions. This article will explore the principles for designing such an institution.

Eight institutional design principles dictate the shape of how local government and related organizations work together to achieve a sustainable financial future. These are:

- Well-defined guidelines.
- Proportional equivalence between benefits and costs.
- Collective choice arrangements.
- Monitoring.
- Graduated sanctions and credible rewards.
- Conflict-resolution mechanisms.
- Minimal recognition of rights.
- Networked enterprises.

**WELL-DEFINED GUIDELINES**

In a local government, it is important to establish parameters that dictate how financial resources will be used and to explain why those parameters are important. For example, financial policies might define the amount of financial reserves that will be kept on hand, why that amount is needed, and the purposes for which reserves can be used. These and other policies define good financial management.

Temporal boundaries must also be recognized. Because local governments legally appropriate and authorize spending annually, the default timeframe of any given decision...
is often conceptualized as a single year. However, many decisions have unambiguous and significant financial impacts on future generations of local leaders and citizens. For example, if the elected body of a jurisdiction approves new debt and pension obligations as part of its annual budget, the impact of these decisions may be relatively minor in the current year, but the effects could be much larger in years to come. Hence, institutional design must encourage participants to look beyond a single year.

**PROPORTIONAL EQUIVALENCE BETWEEN BENEFITS AND COSTS**

When benefits from the resource system are proportional to the distribution of costs, users are more likely to contribute to the system’s sustainability. Put another way, if taxpayers don’t feel that they are getting good value from their contribution to the common pool of financial resources, they will want to reduce their contributions. To establish proportional equivalence between benefits and costs for different groups of stakeholders, local governments are faced with multiple, and potentially competing, responsibilities, including:

- **Civic Responsibility.** Jurisdictions must provide basic services for maintaining the health, safety, and welfare of the community, regardless of an individual resident’s ability to pay.

- **Corporate Responsibility.** Jurisdictions must ensure that basic services are provided at prices that are fair to current and future residents.

- **Fiduciary Duty.** Jurisdictions must ensure that current and future expenditures are justified by benefit-cost calculations and supported by reliable revenue streams. Hence, local governments must think carefully about ways to clarify the relationship between the benefits received by stakeholders and the contributions they make to sustaining local government.

One way to create proportional equivalence between benefits and costs is to link the source of revenues more explicitly to what they pay for. Local governments have historically funded most services through general tax dollars generated from across the community. In an environment of increasing resource scarcity, however, citizens need a more explicit link between what they pay for and what they get in return to help them see the value produced by their contributions to local government. This concept is not totally alien to local government, where there is a long tradition of charging fees to individual constituents for services that benefit them directly (e.g., fees for recreation programs or parking).

Local governments might have opportunities to build on this tradition by thinking about new ways to make the connection between revenue and the precise services they fund. This could include more user fees and other revenue tools such as special service/special assessment areas. For example, San Bernardino County, California, covers one of the largest geographic areas of any county in the United States. In much of the county, snowfall is not a concern, but it is an issue in mountainous parts of the county. In some of these
areas, residents want more frequent snow removal, so the county establishes special taxing districts in those areas to pay for this service. A direct connection is established between what taxpayers pay and what they get.

Another way to clarify the relationship between costs and benefits is to explicitly consider the cost-effectiveness of public services in decision making. The services a local government offers must deliver the maximum benefit for each dollar spent. Without this standard in place, stakeholder groups would find it easier to extract disproportionate benefits for their members at the expense of the larger group. Programs that disproportionately benefit small groups of stakeholders often fail a cost-benefit test. This principle applies equally to operational programs and large capital projects and land-use decisions (which must consider the costs of initial construction and acquisition, as well as the long-term costs the community incurs to operate, maintain, and serve new infrastructure and development.

**COLLECTIVE-CHOICE ARRANGEMENTS**

The best use of any kind of collective resource requires those who use that resource to help design the collective-choice processes; this will ensure that they have a say in how the resource is to be used and managed. When stakeholders are empowered to participate in making and modifying the rules that govern resources, the rules will be more likely to fit the circumstances and be perceived as legitimate.

The best way to enhance stakeholder participation in financial decision making is to strengthen the connection between financial decision making and the choices that stakeholders make in other planning processes. This process is about providing more explicit information to collective-choice arrangements that already exist. Members of the local community often become engaged in planning processes that are implicitly linked to finances (e.g., neighborhood park planning or reviewing a proposed development). Fiscal realities and context — the economic implications of demographic changes, for example — need to be part of these efforts.

At the same time, it’s important to seek out other forms of input from stakeholders. Issues within any planning process are typically resolved by getting insights from those closest to the problem. A structured process for engaging the public allows many stakeholders to weigh in, which establishes a common understanding of the government’s situation and the options for moving forward.

**MONITORING**

Effective monitoring discourages participants from breaking the rules. For example, experiments have shown that participants are more apt to cheat on a test if the lights are dimmed, or if the subjects are simply wearing dark glasses while taking the test. Conversely, they cheat less when there is a cartoon picture of an eye nearby. The point is that people are more prone to dishonest and self-interested behavior when they believe they cannot be seen and their reputations are not on the line.

Local government has often relied on external monitoring, like that provided by bond rating agencies or an external auditor, to provide some assurances of financial integrity — and while these forms of monitoring can be helpful, they have limitations. Most importantly, there is often a long lag

**Proportional Equivalence in Benefit and Costs in Taxes**

The City of Roanoke, Virginia, found itself short of funding for its schools in an anti-tax climate. In response, Roanoke proposed an increase of two percentage points in the city’s meal tax, the proceeds of which would go to public education. A key reason the tax passed is that taxpayers could easily appreciate the connection between their contribution to the community’s finances and the resulting benefit. The tax was also set to sunset after two years, ensuring that the city’s tax base was not locked into inflexible revenue and spending arrangements.
between when the local government makes a decision and when it receives feedback, which makes course corrections more difficult. A government should therefore develop its own capacity for creating regularly available and credible information about its financial performance.

For any monitoring system to work, all involved parties must have some shared understanding of financial terminology and concepts. This doesn’t mean that everyone has to be a finance expert to participate in monitoring financial conditions, but it does mean establishing a baseline level of financial literacy using mutually understood terminology.

**GRADUATED SANCTIONS AND CREDIBLE REWARDS**

Sanctions discourage people from breaking the rules. An effective application of sanctions ensures that no participants can routinely or flagrantly break the rules without suffering consequences. Conversely, rewards can be arranged for those who contribute to maintaining and enforcing rules for using resources.

Without a system of sanctions and rewards, it’s difficult to encourage behaviors that produce sustainable outcomes. Sanctions can include an array of incentives designed to influence behavior, the most severe including things like being fired or receiving a downgrade from a rating agency. But sanctions will work best in a series of graduated steps that start with a light touch and progress in intensity as a behavior increasingly deviates from the established and agreed rules.

Governments have traditionally relied on heavy-handed methods of enforcing compliance with policies (e.g., fines and citations), but researchers have found that more subtle approaches can be more effective. For example, benchmarking information or other commonly accepted best practices can be used to demonstrate that financially sustainable decisions are widely practiced by other governments. This makes it easier for officials to make similar choices. Establishing clear norms of behavior is subtle but effective — when it is expected that financially sustainable choices will be made, people tend to monitor themselves because they don’t want to risk drawing the ire of their peers.

**CONFLICT-RESOLUTION MECHANISMS**

Decisions about how a government’s fiscal resources are used are subject to dispute, and conflicts that are allowed to escalate can undermine general trust in the system. Practicing constructive conflict-resolution methods means that conflict becomes a way to solve problems, not exacerbate them.

The best way to avoid destructive conflict is to prevent it from happening in the first place. Research shows that if participants in a decision-making process believe that the process was fair, they are more likely to support the decision, even if the decision is not in their own interest. But disagreements will sometimes run deeper and be so intractable that conflict is unavoidable. In these cases, having structured mechanisms to help parties resolve disagreements constructively can help the organization move forward.

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**Creating Networked Enterprises**

As part of its journey towards financial sustainability, San Bernardino County, California, initiated county-wide strategic planning that involved county officials, officials from the 24 cities in the county, officials from regional planning agencies, civic leaders, business leaders, and more. This diverse group worked together to develop joint solutions to complex problems such as housing and public health. The county has even taken steps to nurture new civic groups by helping them with grant-seeking and initial administrative set-up. The goal is to create strong civic partners the county can count on when it needs them.
MINIMUM RECOGNITION OF RIGHTS

People who use a common resource are generally the best judges of how to allocate benefits and responsibilities among themselves. It is, however, more difficult for local participants to uphold their local rules if they are not recognized by external government authorities, as disgruntled participants may seek the help of external authorities to invalidate the local rules. These efforts can also lead to unsustainable use of the resource when external authorities seek to impose uniform rules on communities that have different circumstances.

Accordingly, local governments are in the best position to craft strategies to support their own long-term financial sustainability. However, state and federal government policies often create fiscal stresses for local governments, especially in the form of unfunded mandates, which create obligations for local governments without providing the revenue to support them. Local governments should proactively look for ways to mitigate unfunded mandates and other restrictions that prevent the best alignment of local resources with local needs.

Grants also impose obligations on local governments, and though there is some supporting revenue stream here, it isn’t usually enough to cover the full cost of the grant. Hence, local governments need to put systems in place to ensure that grants don’t commit the government to unsustainable cost obligations or to over-expansion into low-priority service areas.

In some cases, local governments may have the opportunity to fundamentally alter the nature of their relationships with the state government through mechanisms like home rule, charter changes, or referendums. These changes might provide more latitude for the government to improve its financial position. Increased power can, however, lead to bigger missteps.

NETWORKED ENTERPRISES

Collective-action problems can’t always be solved within the boundaries of a single jurisdiction. Multiple organizations (public, private, and nonprofit) may be needed to address these issues at different scales (i.e., a system of networked enterprises).

As a fundamental part of institutional design, governments need to consider how they develop and maintain relationships with outside organizations that can help the government meet public service demands at a sustainable cost.

Sanctions and Traffic Controls

Traffic enforcement is a metaphor for the ideal role of sanctions. The vast majority of people observe traffic rules because of social norms. However, without sanctions for flagrant or repeat violators, the traffic system would likely descend into chaos.
Local governments must be intentional about managing the relationships that are crucial to financial health. These relationships will be different for each local government and might change over time. For example, a school district might have important relationships with overlapping cities whose land use policies greatly affect the district’s tax base. Or local institutions of higher education might be important partners in helping high school students become college ready.

Developing networked relationships requires governments to develop organizational structures that connect resources with the service providers that create the best value. Too much centralization can lead to a lack of responsiveness to local and changing conditions. Too much decentralization can work against a coordinated response to large, strategic issues and erode economies of scale. Hence, local governments should develop organizational structures that provide centralized leadership and coordination for the issues that demand it, but with decentralized features that allow for responsiveness and agility, and for the movement of resources to where they will create the best value.

WHERE TO FROM HERE?

GFOA developed a “Framework for Financial Sustainability” that provides more details about leadership strategies and institutional design principles, including specific implementation tactics to help public managers put the framework into practice. GFOA has also developed a financial sustainability index that allows governments to assess the extent to which they embody these leadership strategies and institutional design principles.

GFOA will convene a group of city and county governments to be the “early adopters” of the financial sustainability framework. Over the next year or so, this group will use the self-assessment tool and work with GFOA to advance the financial management practices for their governments, shaping the direction that GFOA’s financial sustainability project will take in the future.

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