Smart Planning
During an Upturn
BY DREW CORBETT

One of the most important things we can provide our communities, in terms of services, is consistency. Economic cycles make consistency hard to achieve, however, as downturns can reduce the resources that are available for providing services. As a result, strategic resource management during an upturn in the economy is essential.

It can be tempting to add or enhance services during an upturn, but doing so without adequate analysis can create unsustainable spending patterns and require your jurisdiction to reduce those services in the future. Taking advantage of an upturn to strategically assess your agency's capacity to increase existing service levels and/or add new services can help create the consistency we seek in terms of service delivery, and it makes for a more financially sustainable and resilient organization.

Economic upturns provide six key strategic assessment areas that will allow your agency to determine if it has the capacity needed to sustainably increase service levels and/or add services, or if investments in other areas would be a more prudent use of resources. Services also need to be prioritized once the jurisdiction determines that it has capacity for an increase, and barriers to success (and ways to overcome them) need to be considered.

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THE SIX ASSESSMENT AREAS

1. **Revenue Sustainability.** During periods of economic expansion, when revenue growth is robust, carefully consider what is driving that growth and whether it is sustainable. Much of this analysis should focus on the jurisdiction's major tax revenues and how volatile they are. More volatile revenue sources that move with the economy (e.g., hotel taxes) cannot necessarily be counted on to provide capacity for enhancing services or adding new services because they may decline during the next economic downturn. When assessing volatile revenues, governments should also consider growth above the sustainable baseline for future use as part of a stabilization reserve (which will be discussed in more detail later in this article).

   On the other hand, if the growth is from a less volatile revenue source, it may be more sustainable through the next downturn. All revenue sources need to be analyzed carefully, particularly those the government deems sustainable through economic fluctuations, as these are the jurisdiction's potential sources of capacity for enhancing or adding services.

2. **Expenditure Growth.** Once revenue sustainability has been evaluated, the next area of assessment is how well the jurisdiction's projected growth in expenditures aligns with projected growth in revenue. The foundation for this assessment is a good long-term financial plan that factors in known increases in the government's expenditure baseline and makes sound assumptions for expenditure components for which the exact increase may not be known.

   Since personnel costs are such a large portion of most general funds, these growth components must be projected accurately before a jurisdiction can determine whether it truly has capacity to enhance service levels. Salary increases that are made to offset the negative effect of a recession (as well as increases in pension, medical, and retiree medical costs) — especially if they exceed historical norms — will usually consume any capacity created by growth in sustainable revenue sources over time. It is therefore imperative for organizations to not just consider the affordability of compensation increases in the short-term (during an upturn), but also in the mid- and long-term.

3. **Reserve Levels.** An assessment of reserve levels includes several factors. Initially, the assessment should determine whether reserves are at policy levels or, if there's no formal reserve policy in place, if they are at best-practice levels. GFOA recommends having at least two months of operating expenditures available as unrestricted fund balance. That recommendation, however, comes with a caveat, which is that the amount an individual government should keep in reserve is a function of the risk of revenue volatility in that particular organization. The recommended minimum of two months' operating expenditures is a great

policy-level reserve for a jurisdiction with stable revenues that don't fluctuate greatly during economic cycles. If, on the other hand, a government is heavily dependent on revenues that can fluctuate greatly during downturns (e.g., communities that are heavily dependent on tourism), reserve levels will need to be higher if the jurisdiction is going to be able to sustain services during a downturn.

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If a jurisdiction's reserves are at minimum policy levels, an economic upturn is a great time to assess whether increasing the level of reserves available to stabilize service levels during economic fluctuations is a good option. With reserves at a minimum level, a government may be able to withstand the shock of an economic downturn; however, it may not be resilient enough to provide consistent service levels year after year. Even in good economic times, revenues can fluctuate for a variety of reasons. If reserves are kept at a minimum policy level, the organization may end up spending unsustainably during these good times, only then to have to cut back during the next downturn.

This cycle of adding and cutting is by no means ideal. During an upturn, when revenues are in good shape, governments have an opportunity to use all or a portion of revenues that exceed the sustainable baseline to increase reserves over minimum policy amounts, with the objective of stabilizing service levels the next time revenues fall below their sustainable baseline. This idea of a stabilization fund sets expenditures at the sustainable revenue baseline, with revenues above the baseline amount going into the stabilization fund instead of being used to increase service levels. This allows service levels to be maintained when revenues fall below the sustainable baseline, creating a consistent service level for the community.

4. **Infrastructure.** The next area of assessment during an upturn is infrastructure — that is, how well it has been maintained over the years and whether maintenance has been deferred. A high-visibility example is roads and streets. When service cuts are being considered during an economic downturn, it is always tempting to defer street maintenance. In the short term, this may be less painful than making reductions in other areas, but this shortcut comes at a price. Deferring infrastructure maintenance significantly increases costs, and the longer the deferral goes on, the more the costs increase. Governments that did defer maintenance during an economic downturn need to address vulnerable areas and infrastructure needs during upturns. Doing so helps ensure that infrastructure is maintained properly and, importantly, in the most cost-effective manner, allowing for the most effective allocation of resources across all government priorities.

5. **Unfunded Liabilities.** Increased scrutiny of pensions and retiree medical benefits has forced agencies to focus more on how they will pay for them, now and in the future. There seems to be no end to the increase in costs for providing these benefits, and governments are using more and more of their operating resources to fund them — leaving fewer resources for everything else. A significant component of this cost is the interest expense

portion of the unfunded liability. During an upturn in the economy, a jurisdiction should therefore analyze its unfunded liability and determine whether resources should be allocated to addressing this liability more aggressively.

This increased funding could be accomplished in a number of ways, including paying more than the required contribution to the pension fund, creating an irrevocable pension trust to set aside additional money aside outside of the pension fund, and/or paying into a retiree medical trust. While all of these options entail some degree of risk — especially the risk of losing access to those funds if they are needed for other purposes — using excess resources to address unfunded liabilities during an upturn has some significant benefits, including reducing the unfunded liability and increasing investment return potential. Because there is risk involved, these options may not work for all jurisdictions, but all governments should, at the very least, assess the situation and be aware of the tradeoffs a "pay-as-you-go" approach entails, as opposed to more aggressively addressing these liabilities.

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6. **Service-Level Deficiencies.** The most challenging assessment area is probably identifying and addressing service-level deficiencies, particularly as they relate to community preferences. Most operating departments can point to areas in which services are not being provided at the optimal level, and thus can make a valid argument supporting a service-level deficiency—but this doesn't necessarily mean that resources should be dedicated to that service when there is capacity. Because there will always be organization-wide competition for excess capacity, all areas where services are not being provided at the optimal level must be assessed carefully, taking the community's preferences into account, as well as the degree to which those preferences are aligned with the service level.

In some cases, the optimal level of service may not be what the community wants, especially if attaining this state means that the government won't be able to offer more of another valued service, or a new service that the public also wants. For example, using resources to increase the service capacity of a community facility only makes sense to the extent there is excess demand for that facility, even if it means the continued sub-optimal use of the facility. This may not make sense at first glance, but this sort of compromise is an important consideration in the context of allocating limited resources and providing the community with the services it most desires. The return on investment of available capacity, both in terms of possible financial return from investing in cost-recovery services and the non-financial return of increasing the government's ability to meet the community's needs, is an important component in the prioritization process when resources are available.

PRIORITIZING

Having analyzed the six areas of assessment and determined that the government has capacity, how do you prioritize? Are there service-level deficiencies to be addressed? Do you want to enhance existing service levels? Do you want to add new services? With the likely answer to those questions being "all of the above," you will face hard decisions in determining where the government's limited resources should be allocated. Just as the assessment areas focused on making the best investments with the jurisdiction's funds, allocating additional resources among competing priorities should be focused on making the best investments.

The service areas that provide the best return on investment are the ones that should be prioritized. A good way to make this comparison among competing priorities is to analyze the outcome expected from the additional resources being requested. The requests that will provide the most impact at the lowest cost constitute the best investments for your agency, but it can be difficult to remove subjectivity from the assessment process in order to ensure that the assumed outcome is actually feasible. A great way to make the assessment more objective is to use performance metrics, which are an effective way to establish the relationship between the level of resources provided and what outcome can be achieved at that level.

OVERCOMING BARRIERS TO SUCCESS

Being a finance director during an upturn can actually be more challenging than the same job during a downturn. Fiscal discipline is perhaps most difficult to achieve when times are good. With a seemingly endless list of new initiatives and demands for more services and/or better service levels, the pressure to increase spending levels can be intense during the good times. This can be especially difficult if this pressure is driven by an agency's governing body. Some suggestions are not going to be as politically attractive as adding new services would be, especially to the extent those services are beneficial to a large portion of the community. But adding any service might lead to unsustainable spending patterns if the jurisdiction has failed to assess its long-term capacity.

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Another challenge, especially during an upturn that has followed a severe downturn like the Great Recession, is the pressure from employee associations to increase wages and compensation, especially if concessions were made during the downturn. While investing in your workforce is not a bad thing, the sustainability of these compensation increases must be considered to ensure that what the government can afford now will remain affordable in the future.

The challenges to establishing and maintaining a sustainable and resilient agency during the good times are not insurmountable. One key strategy is to have a good long-term planning model. This helps ensure that decisions are evaluated for their impact both now and in the future, and it also spotlights the ongoing effects of current spending decisions and whether they will be sustainable over the long term. Another key step is having strong financial policies for items such as reserve levels, compensation, infrastructure maintenance, and one-time revenues. These can be powerful tools in guiding decision making and easing some of the external pressures.

Overall, economic upturns represent a tremendous opportunity for governments, but how that opportunity is defined may differ within the organization. Departments that have had to cut service levels over the years may define opportunity as the potential to restore service levels, but the definition of opportunity for a finance professional should be much different. For the finance professional, the economic upturn is the ideal time to critically assess the long-term financial health, sustainability, and resiliency of the entire organization, and work to make any changes needed to ensure its long-term ability to withstand economic cycles.

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