Financial sustainability was the main concern for an overwhelming number of respondents to the 2015 GFOA member survey. In fact, respondents raised financial sustainability almost three times more often than the next-biggest issue. Even though this survey was years removed from the 2007 Great Recession, financial sustainability remained top-of-mind for a large portion of GFOA’s membership.

Even without an economic storm like the Great Recession, local governments face a number of financial headwinds that increase the probability of rough budgetary waters ahead:

- **Pensions and Health Care.** Health-care cost increases are still well above inflation and typical government revenue growth, and local governments can assume that this will remain the case.\(^1\) The well-publicized pension funding challenges many local governments face add an additional large expenditure to the ledger.

- **Infrastructure Maintenance and Renewal.** According the American Society of Civil Engineers 2017 report card on American infrastructure, the United States rates a D+ overall and requires $2 trillion in infrastructure investments over 10 years.\(^2\) Not all of that falls on local governments, but it will still create a significant financial burden.

- **Aging Population.** An aging population generates less income, uses more public services, and spends a greater portion of its income on services, rather than taxable goods. This translates into less revenue per citizen.\(^3\)

**A NEW FRAMEWORK**

A popular answer to the financial challenges of local governments is to run government “like a business.” This prescription does offer value; it emphasizes efficiency in service provision and measurement of government performance, for example. But it ignores the fundamental difference between government and business: government is a public organization, and business is private.

In public organizations, decisions require the assent of multiple people, perhaps across different social groups, and the use of resources has to be negotiated among diverse stakeholders. The chief executive of a private company has far greater unilateral decision-making authority than a mayor or city/county manager could ever hope for. Furthermore, businesses have a clear overriding goal: profit. The goals of public organizations are often more ambiguous. For these reasons, the public sector requires a different model of leadership than the private sector.

Also, the design of a government institution empowers people to exert influence over how a government’s resources are used, simply by virtue of being a citizen. When a citizen works together with other citizens who have similar interests, their combined influence can be substantial, including voting public officials out of office. Compare this with a private company, where the individual consumer has relatively little influence over a company’s direction and collective action on the part of consumers is rare.
A more satisfying answer to the challenge of local government financial sustainability must account for these substantial differences in how leadership is exercised and how institutions are designed.

A promising new approach for local governments in the 21st century has its roots in 19th century England. A Victorian economist, William Forster Lloyd, described a situation where a group of farmers had common ownership of a grazing area. An individual farmer had an incentive to send his animals to the common grazing area as much as possible because there was no additional cost for using it, and if he didn’t send his animals, the other farmers’ animals would still graze, thus depriving the farmer’s herd of potential food. The result was that the common area was eventually overgrazed and became barren. This “tragedy of the commons” inspired a line of modern economic research called “common pool resource theory,” which is concerned with how to create sustainable management of commonly owned resources such as grazing lands, fishing stocks, or forests.

A local government budget has important similarities to the commonly owned grazing area. A government and its financial resources are commonly owned by all citizens of the government. Each stakeholder of the government has an incentive to extract resources from the public budget. Stakeholders often find themselves in “competition” with others to get resources and therefore try to get as much as possible, lest they lose the resources to others. The long-term result could look very much like the commonly owned grazing area.

A Holistic Perspective. Common pool resource theory goes beyond budget numbers, addressing the underlying decision-making behaviors and processes that lead to financial health.

Forward-Looking Focus. Because this framework does address the underlying causes of financial sustainability, it should be indicative of future financial health.

Finance as Everyone’s Business. Common pool resource theory recognizes that because everyone is involved in using resources, everyone needs to be involved in sustaining them. This includes elected officials, staff, and citizens and other constituents.

It Works. These strategies and principles have been proven to work in a variety of natural settings. Research has identified similar strategies and principles in local government settings by examining a series of case studies from local governments from across the United States.

LEADERSHIP STRATEGIES

Local government leaders cannot “order” stakeholders to behave in a sustainable way. Instead, they must inspire pride, loyalty, and enthusiasm among stakeholders so that followers will want to help make the organization financially sustainable. Common pool resource theory offers six strategies to help leaders reach this goal:

1. Create open communication among all participants.
2. Help participants to build trustworthy reputations.
3. Convince participants that there are high benefits from collective efforts.
4. Ensure that key stakeholders remain engaged.
5. Build long-time horizons into fiscal planning.
6. Maintain capabilities to reinforce cooperative behavior.
1. Create Open Communication among All Participants. We often expect people to behave selfishly. To test this proposition, researchers ran experiments that gave people the opportunity to advance their own self-interest at the expense of their group’s interest. A surprising number of people choose to help the group, even when they could have personally gained more by opting for a selfish strategy. Even more encouraging is that when participants in the experiment had the opportunity to communicate with one another, especially face-to-face, the likelihood of cooperation increased (even when the participants didn’t like each other!).

One implication here is that local governments should use teams comprising members of different backgrounds to participate in financial decision making. If the process pits one group against another, however, this dynamic sets the stage for one group to view others as adversaries. In this situation, it is only natural for a group to seek to maximize its own share of resources at the expense of others. It is important, therefore, to find ways for participants in financial decision making to work together toward a common goal, even if they have to go outside of their normal group boundaries with, for example, cross-departmental teams.

There are also implications for how governments engage with the public, who often leave a typical local government meeting with a worse opinion of government than when they started. Dissatisfaction occurs if participants do not feel that their views were given an honest and fair hearing. Leaders of public organizations should work to provide effective, meaningful ways for the public to discuss issues with one another and with public officials. For example, the public should be engaged early enough in the decision-making process that their input can have a meaningful impact, and government should make an active effort to recruit stakeholders who will be primarily affected by the decision.

Finally, the parties should seek a joint understanding of the problem before discussing a solution. Reasonable people can disagree, but they are more likely to disagree on a solution when they don’t share a common understanding of the problem.

2. Help Participants Build Trustworthy Reputations. Experimental evidence has shown that when people have reason to trust each other, they are more likely to make decisions that will advance the collective interest of the group — even when they could realize personal gain by making a selfish decision.

This means that when participants in financial decision making trust each other, they are more willing to bear their share of the associated costs. For example, if public officials have developed a reputation for conserving financial resources, it is easier for them to negotiate pension issues with public employee unions. If officials have established reputations for being trustworthy, unions can be confident that short-term sacrifices by their members will not be used to benefit other interest groups instead of helping ensure the availability of resources in the future. But it is unrealistic to expect the members of a decision-making team to make
difficult, collective decisions in the heat of the moment without some preparation. Leaders must prepare participants to trust each other before they ask them to act in the interests of collective well-being. This preparation might include, for example, encouraging departments to work together to solve shared day-to-day operational problems or even just designing workspaces and social events that encourage groups to mingle.

When it comes to making actual decisions, certain behaviors will enhance trust between the parties, while others will undermine or destroy it. For example, when people trust that it is safe to offer information that contradicts views held by a larger group, then teams will function better. Hence, leaders need to model the behaviors that create trust and encourage others in the organization to practice those behaviors.

3. Convince Participants about Benefits from Collective Efforts. Experimental evidence has shown that people are more willing to contribute resources to a common effort if they believe that their contributions will create benefit for themselves. Therefore, leaders need to show financial decision-making participants that individual benefits come from collective action. It may be difficult for benefits to accrue as financial resources, especially in times of scarcity, but research shows that people are powerfully motivated by intrinsic rewards such as serving a purpose greater than themselves or achieving a challenging goal. Research also shows that we tend to believe that others are more motivated by extrinsic rewards (e.g., money) than they actually are. This can lead us to underestimate what others are willing to do for the collective good without monetary incentives. Hence, “benefits” do not necessitate extrinsic rewards, but could encompass intrinsic rewards. Leaders need to set forth an inspiring vision for what collective decision making can do for the organization and how it can get there to show participants the greater purpose they can contribute to and benefit from.

4. Ensure that Key Stakeholders Remain Engaged. Common pool research suggests that if participants can opt out of a decision-making process at relatively low costs and avoid being taken advantage of, this ability encourages other participants to be cooperative. In other words, if participants can simply choose to not play the game instead of being forced to go along with an unfair game, all participants are
encouraged to play fairly. But to keep everyone from dropping out at the first sign of trouble, leaders must encourage key participants to remain engaged in the process of collective problem-solving.

Many stakeholders will not be inclined to routinely participate in local government. Regardless, governments should provide the opportunities for stakeholders to become participants and stay engaged. Leaders not only need to use meeting and communication formats that invite participation, they also need to demonstrate their personal commitment to making stakeholders part of decision making.

Even when leaders do their best to build an engaging process, they will sometimes encounter situations that strain the cohesion of participants. In general terms, leaders can take steps to build the loyalty of participants so that they will stick with the group to make it through hard times. For example, leaders can model collective commitment by giving up something that they value for the good of the group, and by helping participants to recognize their shared goals and interdependencies.

A specific challenge to the cohesion of participants is when one participant cheats or otherwise attempts to gain an unfair advantage at the expense of other participants. If a cheater is perceived to be “getting away with it,” others will become cynical and disengaged. Leaders must counteract cheaters and support fair play.

Finally, though participants will, ideally, stay engaged and loyal, this will not always be the case. Leaders should recognize that when participants leave the decision-making process, it provides a valuable signal that all may not be well. Hence, leaders should make allowances for constructive exits by participants, while taking steps to address the problems that triggered these exits.

5. Build Long-Term Horizons into Fiscal Planning. Researchers have found that, in experimental situations, when participants take a longer-term view on their interactions with other participants, they are more likely to engage in cooperation. Conversely, if the participants take a short-term view, they are more likely to engage in selfish behavior.

Accordingly, financial planning and budgeting are more likely to produce unsustainable choices if participants only focus on the short term. Local government leaders need to develop mechanisms that measure the longer-term impact of annual budget decisions, including those related to labor agreements and infrastructure maintenance. A leading example is long-term forecasting that shows the impact of decisions many years into the future. Long-term plans must also help decision makers accept and deal with uncertainty. For example, decision makers can be presented with plausible scenarios for future revenues and expenditures and then use these scenarios as the basis for developing strategies to remain adaptable to whatever situation eventually does come to pass.

However, because local governments appropriate funds annually, there is a natural bias towards the short term. Additionally, people are often naturally inclined to adopt short-term thinking. Consequently, it is not enough to simply introduce a long-term perspective into planning and budgeting. Local government leaders must also acknowledge short-term pressures and find ways to prevent short-term considerations from overpowering long-term ones.

6. Maintain Capabilities to Reinforce Cooperative Behavior. If a few non-cooperators achieve noticeable successes, others can be convinced not to cooperate either, while notable successes by those who do cooperate may have the opposite effect. Therefore, the decision-making
system must be able to identify and reward those who do cooperate, or sanction those who do not.

The best way to ensure ongoing cooperation is for the participants inside the decision-making system to reinforce the importance of cooperating. Participants who are closest to the decision-making process are in the best place to recognize instances of good or bad behavior from other participants and apply positive or negative reinforcement. For example, people generally prefer to be seen as good members of the group. If leaders can show that most members of the group exhibit sustainable behaviors, the other members of the group will be encouraged to do the same.

External actors can have a role as well. Bond-rating agencies, auditors state agencies, community groups, the media, or even the courts can provide a check against unsustainable decision making, and voters can exercise accountability.

CONCLUSIONS

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. GFOA’s new financial sustainability framework sets forth six specific strategies to help local government leaders do just that. However, leadership alone is not sufficient for financial sustainability. The institution of local government must be designed to consistently produce financially sustainable decisions. The second part of this article, which will be published in the August issue of Government Finance Review, will explore the principles for designing such an institution.

Notes

1. According to “Medical Cost Trend: Behind the Numbers 2017,” published by PWC in June 2016, cost increases will remain similar to recent prior years and may eventually even rise.
2. 2017 Infrastructure Scorecard, American Society of Civil Engineers (http://www.infrastructurereportcard.org).

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5. “Making Public Participation Legal,” compiled by the Working Group on Legal Frameworks for Public Participation, October 2013, references the Knight Foundation’s “Soul of the Community” study.

SHAYNE KAVANAGH is the senior manager of research for GFOA’s Research and Consulting Center in Chicago, Illinois. He can be contacted at skavanagh@gfoa.org.

Credits

This paper is based on research originally performed on behalf of the Lincoln Institute of Land Policy by the following people:

- Shayne Kavanagh, Government Finance Officers Association
- Mark Pisano, University of Southern California Sol Price School of Public Policy
- Shui Yan Tang, University of Southern California Sol Price School of Public Policy
- Michael F. McGrath, National Civic League
- Doug Linkhart, National Civic League
- Monika Hudson, University of San Francisco
- Erik Colon, Government Finance Officers Association

A group of advisors from local governments and universities across North America was integral to this research:

- Mary Bunting, City Manager, City of Hampton, Virginia
- Gregory C. Devereaux, chief executive officer, San Bernardino County, California
- Alfred Tat-Kei Ho, professor, University of Kansas, School of Public Affairs and Administration
- Chris Morrill, executive director, Government Finance Officers Association
- Tina Nabatchi, associate professor, Syracuse University, Maxwell School of Citizenship and Public Affairs
- Ken Rust, chief financial officer, City of Portland, Oregon