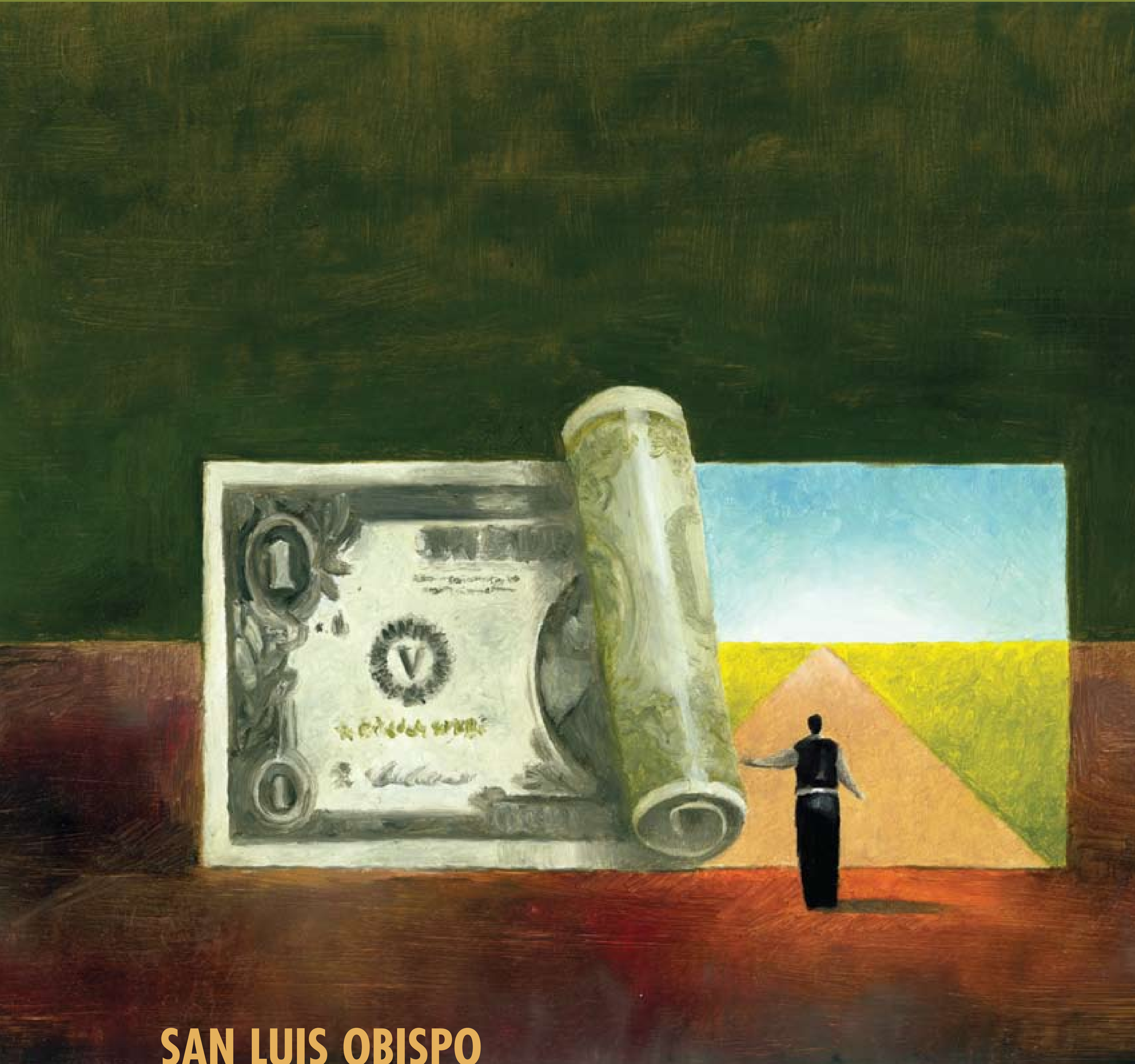


SAN LUIS OBISPO
PLANNING FOR FISCAL RECOVERY

BY BILL STATLER

Most, if not all, government agencies experienced some degree of fiscal distress as a result of the Great Recession. Many communities are now experiencing some level of economic recovery, but experience indicates that the good times (or least better times) ahead will inevitably be followed by bad ones. The City of San Luis Obispo, California, created a fiscal health contingency plan some years ago that has helped it through a number of financial difficulties, including the recent recession. Although this plan was created before the GFOA's 12-step fiscal recovery process (see the sidebar for more information), the city's plan covers the same steps. This proven process can help any organization respond effectively the next time clouds are on the economic horizon.

The purpose of the city's fiscal health contingency plan is to establish a framework and general strategy for responding to adverse fiscal circumstances in both the short and long term.

HOW IT WORKS

The city started working on a plan for addressing fiscal distress in 2001. The economic picture at that point was very bright, but the city manager hadn't forgotten the financial downturn that had happened ten years earlier, when fiscal stress was compounded by deep cuts in state funding. And sure enough, it wasn't long before the plan was implemented, several times — in response to the dotcom meltdown, corporate scandals, and 9/11, and three times since then, in response to state budget cuts, an adverse binding arbitration decision, and, of course, the Great Recession. It would have been difficult for the city to make its way through these periods without having a fiscal contingency plan in place.

The purpose of the city's fiscal health contingency plan is to establish a framework and general strategy for responding to adverse fiscal circumstances in both the short and long term. For this strategy to succeed, employees and the community must be meaningfully involved in the process; the organization must take a policy-based approach to decision making; and the plan must reflect the city's organizational values. The plan functions as a foundation, presenting the principles and values that specific responses will be based on when they are needed.

The plan is not a specific recipe for expenditure cuts or revenue increases — those need to be determined on a case-by-case basis. Preparing detailed cost reduction or revenue options ahead of time creates several problems; for one thing, people don't tend to put enough effort into developing quality solutions if they aren't taking a situation seriously. The other side of that coin is that planners can take the situation too seriously and create needless anxiety by preparing extreme expenditure reductions that aren't necessary at the time and might never be needed. And absent either of these problems, cost cuts and revenue options tend to have a short shelf-life; needs and priorities change over time.

GFOA 12-Step Program

Step 1: Recognize

This closely mirrors Step 1 of the 12-step process. You can't fix a problem if you don't know you have one.

The plan is "triggered" when the city manager determines that the organization faces unfavorable fiscal circumstances, including natural or man-made disasters, cuts in state funding, unexpected large costs, and economic downturns. The plan can also be triggered following two consecutive quarters of adverse fiscal results in the city's top five general fund revenues: sales tax, property tax, transient occupancy tax, utility users tax, and vehicle license fee property tax swap. Adverse results include actual declines in revenues or significant variances from projected revenues. Having a clear definition of when fiscal first aid is needed has been a key factor in the city's ability to take timely action and keep problems from getting even worse.

While the plan focuses on the general fund, the enterprise funds (like water, sewer, and parking) also participate fully because the city is one organization; everyone needs to be on the same page. Enterprise fund participation might be different from general fund participation, however. It is also strategically important to limit enterprise fund rate increases at a time when the city might be considering general fund revenue increases. In fact, rate decreases would be ideal.

GFOA 12-Step Program

Step 2: Mobilization

Organizations "mobilize" by having a strategy in place that spells out clear triggers.

THE KEY ELEMENTS

The city's plan has six main elements:

1. Maintain reserves at policy levels.
2. Follow the city's other key budget and fiscal policies.
3. Closely monitor the city's fiscal condition.
4. Determine whether the challenge is short or long term.
5. Develop options.
6. Implement and monitor results.

1. Minimum Fund Balance, the First Line of Defense in Adverse Circumstances. Maintaining minimum fund balances at policy levels of 20 percent of operating expenditures allows the city to continue operations and projects while responding to short-term problems. It provides a bridge ("breathing room") to addressing longer-term problems while comprehensive response plans are developed. This is especially important if there are limited opportunities for implementing new revenues.

2. Other Key Budget and Fiscal Policies. Along with minimum reserves, following the city's other key budget and fiscal

Setting Reserve Levels

What's the Right Amount?

The GFOA has developed a user-friendly, structured approach to setting minimum reserve targets. It assesses risks based on eight factors:

- Vulnerability to extreme events/public safety concerns.
- Revenue source stability/volatility.
- Expenditure volatility.
- Unfunded liabilities.
- Liquidity (cash flow).
- Dependent funds.
- Growth/new development.
- Unfunded high-priority capital projects.

For more information on the methodology and an easy-to-use spreadsheet, click "General Fund Reserves" at www.gfoa.org/financialpolicies.

The Power of Fiscal Policies

Setting (and then following) clearly articulated fiscal policies is one of the most powerful financial management tools available for preserving long-term financial health. They:

- Help prevent problems from arising in the good times, and respond to bad times when they do occur.
- Establish a strong foundation for long-term fiscal health, the underlying basis for case-by-case decision making.
- Make effective decision making easier by articulating the organization's values before they are put under stress.
- Provide context for what kind of decisions should be made, as a roadmap rather than a straightjacket.
- Provide continuity as elected officials and staff change.

More information about the power of fiscal policies (based on the GFOA publication, *Financial Policies*) is available from the GFOA website at www.gfoa.org/financialpolicies.

policies will help prevent problems to begin with — and keep them from getting bigger when they do happen. These are set forth in the city's budget, and they include: balanced budget (and what this means); annual and interim financial reporting; conservative investment practices; diversified revenues; user fee cost recovery; enterprise funds; capital improvement management; debt financing; fleet replacement; human resources management, contracting for services; and productivity improvements.

3. Fiscal Health Monitoring. In accordance with its budget and fiscal policies, the city has developed and implemented effective ongoing systems for reporting and monitoring its fiscal condition. Interim reporting includes: reliable automated financial management system; online access organization-wide via the network; monthly financial reports; quarterly newsletter (provided electronically to all employees and on the city's website); capital improvement plan project-to-date expenditure report; mid-year budget review; and special reports for sales tax, transient occupancy tax, and cash and investments. Annual reporting entails preparing audited financial statements in accordance with generally accepted accounting principles and GFOA award standards.

GFOA 12-Step Program

Step 3, 4, 5, and 6

This incorporates:

Step 3: Generic Treatments

Step 4: Initial Diagnosis

Step 5: Fiscal First Aid

Step 6: Detailed Diagnosis

4. Assessment: Short- or Long-Term Problem? Different problems require different strategies. In the case of a one-time event or downturn that is not likely to continue indefinitely, "one-time" fixes are appropriate responses for "one-time" problems. But in the case of ongoing downturns in revenues or increases in costs that are systemic, one-time fixes won't work. Instead, new ongoing revenues or ongoing expenditure reductions are required for fiscal sustainability.

If the assessment shows that the problem is short term in nature, the city takes the following actions:

- *Hiring Chill.* Filling vacant regular positions requires approval by the city manager. Department heads must demonstrate that the position is necessary to meet public health, safety, or other high-priority service needs that cannot be temporarily met through contract, overtime, or temporary staffing. The goal is not just creating short-term savings, but also preserving future options if the problem turns out to be ongoing.
- *Travel Chill.* The city limits travel and training and requires approval from the city manager for all travel authorizations.
- *CIP Project Deferrals.* The capital improvement plan review committee identifies projects for possible deferral or deletion.
- *"One-Time" Operating Cost Review.* The budget review team identifies special projects in the operating budget for possible deferral or deletion.
- *Fund Balance.* The city considers allowing fund balances to dip below policy levels.
- *Other.* The city considers other short-term expenditure curtailments, as appropriate.

If the assessment shows that the problem is long term, the city will implement "short-term" actions (following the first rule of holes: When you find yourself in one, stop digging.). Then it will prepare a long-term fiscal forecast to define the problem and prepare options for increasing revenues and reducing expenditures.

GFOA 12-Step Program

Step 7, 8, and 9

This incorporates:

Step 7: Recovery Plan

Step 8: Longer-Term Therapies

Step 9: Long-Term Financial Planning

5. Develop Options. The long-term solution is conceptually simple, since there are only two basic budget-balancing options: increase revenues or reduce expenditures. In the short term, using fund balance is an option. This is not a viable long-term solution, of course; spending reserves is a one-time course of action; it cannot fix a structural imbalance. An exception is using fund balance strategically to reduce future operating costs or increase ongoing revenues.

Meaningful ongoing expenditure reductions require reductions in regular staffing costs — lower staffing levels or reduced compensation — for public safety personnel as well as other employees. For example, in San Luis Obispo, 85 percent of general fund costs are for day-to-day operations, 80 percent of general fund operating costs are for staffing, 90 percent of general fund staffing costs are for regular staffing, and more than 50 percent of general fund staffing costs are for public safety. Also, training becomes even more important with fewer employees; the remaining workforce must be highly skilled and well trained.

Department heads are responsible for crafting operating expenditure reduction options that:

- Are real and "doable."
- Cause the least possible level of service disruption to the community — no game-playing is allowed (such as proposing the least likely reductions).
- Are ongoing.
- Describe how services will be affected.
- Can be accomplished by the city independently (no speculative reductions contingent upon actions by others).
- Can be implemented shortly after adoption (typically three months, but no longer than one year).
- Are net of related revenues from fees or grants.
- Maintain essential facilities, infrastructure, and equipment at reasonable levels — no deferred maintenance posing as genuine cost reductions.
- Include participation from employees throughout their organization — an important organizational value.

Targets for reduction options are generally the same for all departments and are based on percentage reductions from current operating budgets, less significant one-time costs. These targets should be greater than the "gap" identified in the forecast (or the budget-balancing role they have been assigned); this brings to light as many reasonable policy choices as possible, based on priority considerations rather than arbitrary across-the-board decreases. Reductions to operating expenditures are not likely to balance the budget on their own, but identifying how these cuts will affect services is critical to attracting support for new revenues and other mitigation strategies.

There are several important principles to keep in mind when preparing operating expenditure reduction options. Any service reductions should be balanced, and the highest-priority services should be retained. The focus is on retaining frontline core services and reducing the services that have the least impact on the community at large — although the city must preserve its "organizational" infrastructure and keep all appropriate and necessary internal review functions intact. In addition, reductions should be based on service priorities, not vacant positions; attrition should not be the driving strategy in reducing costs. On the other hand, one of the key purposes of the "hiring chill" is to create flexibility in making reductions based on priorities while mitigating the need for lay-offs.

The capital improvement program review committee is responsible for identifying ongoing reduction opportunities. Projects intended to maintain existing infrastructure and facilities generally have higher priority over developing new facilities. Exceptions include projects where there are direct negative impacts on public health and safety if they do not go forward, outstanding contractual commitments, and significant outside resources or related one-time revenues.

Under California's Proposition 218, the council has limited revenue options. Therefore, any new significant revenues would probably require voter approval, and any such election would probably not be held until the next regular municipal election, which is in November of even-numbered years. (There are two exceptions allowing revenue elections to be held at any time: a fiscal emergency declared by unanimous vote of the council, and two-thirds voter approval for earmarked revenues.) Getting voter approval requires time for effective preparation before a revenue measure is placed on the ballot, so this is not a near-term option for balancing the budget.

Nonetheless, options may exist for increased user fees, fines, or use of property — although if these were easy to do, the city would have probably already done them. Employees throughout the organization are encouraged to find ideas for raising revenues, with the understanding that expenditure reductions are likely to play the leading role in balancing the budget.

> The plan is "triggered" when the city manager determines that the organization faces unfavorable fiscal circumstances.

The GFOA's 12 Stages of Financial Recovery

The GFOA's 12-step recovery process (read more at www.gfoa.org/financialrecovery) has three basic stages: bridge, reform, and transform.

Bridge. Getting through the immediate crisis and creating breathing room to make more sustainable reforms. This includes:

- Recognizing that financial distress exists and convincing a critical mass of stakeholders.
- Diagnosing the causes of distress.
- Implementing retrenchment tactics to stabilize the situation.
- Developing a recovery plan.

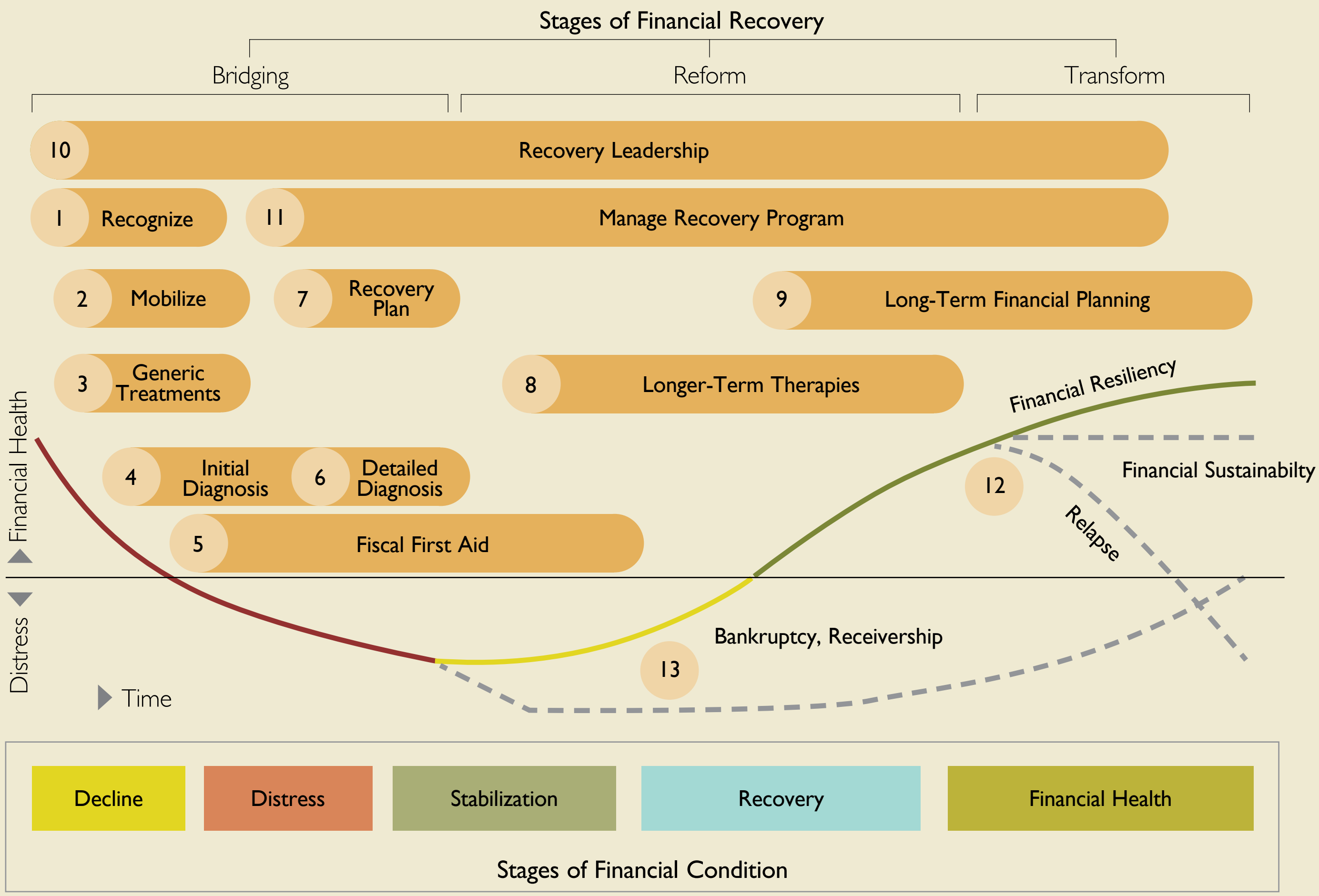
Reform. Carrying out the short-term recovery plan and developing and implementing long-term therapies. This includes:

- Developing long-term financial strategies.
- Starting a formal long-term financial planning process.

Transform. Institutionalizing long-term financial planning. This includes:

- Becoming more resistant to financial distress.
- Becoming more adaptable to a changing environment (developing "financial resiliency").

The following chart outlines the three stages and the underlying 12-step process:



As the chart shows, Step 10 — recovery leadership — transcends the three stages. The chart also recognizes that relapse (Step 13) is a possibility. But diligent application of the 12 steps makes success a likely outcome.

Depending on the reason for the adverse circumstances (and especially if they are driven by state or federal budget actions), the city also works closely with its elected representatives and others (such as the League of California Cities) in mitigating service (and related cost) reductions. The city actively solicits and encourages meaningful participation by key stakeholders in the budget-balancing process, including the organization as a whole, employee associations, and community groups. Doing so requires effective and ongoing communication with these individuals and organizations.

> The long-term solution is conceptually simple, since there are only two basic budget-balancing options: increase revenues or reduce expenditures.

The Budget-Balancing Paradox. Balancing the budget and closing the forecast gap is easy enough if you're just looking at the numbers. But after cutting capital projects, reducing staff, and negotiating and implementing employee concessions, it is difficult to emerge with a vibrant, high-morale, high-productivity organization. It is at this point that the budget-balancing paradox comes into play: At a time when the organization is at its nadir due to downsizing, the resulting smaller organization needs its employees to be even more energized and motivated to perform.

The paradox can only be beaten by communicating honestly with employees and meaningfully engaging them in finding solutions. To use a metaphor from Stephen Covey (author of *The Seven Habits of Highly Effective People*), how we go about this process is an opportunity to make deposits in our credibility bank, not just withdrawals. It's an opportunity both to show our organizational character and values and to build them. Department heads are responsible for encouraging employees to participate meaningfully in the preparation of expenditure reduction and new revenue options. For example, a recent budget process resulted in more than 700 "bright ideas for dark times," most of which were reflected in the city's final budget balancing strategy.

The city strives to identify any likely position reductions that result from its fiscal health contingency plan six months before they're going to be implemented, in order to be straightforward with the affected employees about their employment outlook. This provides transfer opportunities and allows affected employees a reasonable amount of time to make other plans. There are downsides to this approach, which is why many organizations keep force-reduction actions under wraps for as long as possible. However, respect is one of the city's core values, and respecting employees means informing them as soon as possible about city plans that affect them. It also means sharing the hard facts and consequences in a candid and timely way, even if doing so can be painful for the organization.

It is in the city's best interest to keep stakeholders informed. A crucial step for communicating with employees is ongoing face-to-face employee briefings. This requires senior managers to personally tell the city's story over and over, and answer tough questions — a big resource commitment, but one of the most effective ways of maintaining employee trust and confidence. It's also helpful for the city manager and department heads to send ongoing updates via voicemail or e-mail, and periodic newsletters can also provide some control over rumors. Ongoing briefings with employee association leadership is another important step. Communicating with the community works differently. This can be handled via viewpoint articles in the local newspaper and editorial board briefings, news releases, presentations to interested community groups, periodic newsletters and surveys via direct mail or utility billing inserts, website updates, and community forums and workshops. Depending on the circumstances, the city may form an ad hoc advisory community group, carefully considering who should be in the group, when they should become involved in the process, and the role the group should take.

GFOA 12-Step Program

Step 10, 11, and 12

This incorporates:

Step 10: Recovery Leadership

Step 11: Managing the Recovery Program

Step 12: Financial Sustainability

6. Finalize and Implement an Action Plan. With advice from department heads and the budget review team, the city manager is responsible for preparing the recommended action plan. Council approval is required for implementation, and the finance department monitors the plan's results in achieving its goal, quickly reporting any significant deviations to the city manager and council.

This portion of the city's plan dovetails with the last three steps in the GFOA's 12-step process: recovery leadership, managing the recovery program, and financial sustainability.

Recovery Leadership. While depicted as Step 10 in the GFOA model, recovery leadership is not a linear step; it is an essential part of every stage and step of the process. Without it, even the best analytics and plan will fail. Stated simply, the "soft stuff" is the "hard stuff."

Managing the Recovery Program. An important consideration in developing and implementing the 12-step process is identifying the timeframe for fixing the problem and bringing about structural balance: One year? Two years? Five years? San Luis Obispo tends to look at structural balance within the context of its two-year budget timeframe. Real-world constraints might make it difficult to prepare plans that address the problem sooner rather than later, but there are three key reasons for doing so:

- What actually happens is invariably worse than the forecast.
- The solutions are likely to fall short of their goals.
- The sooner you get to the bottom of an issue, the sooner you can begin rebuilding. You can have a five-year rebuilding plan or a five-year "death by a thousand cuts" program.

Financial Sustainability. Financial sustainability is a journey, not a destination. While plans and policies are key elements for success, flexibility and adaptability are our only reliable friends on this journey. Adaptable organizations will have the smoothest ride — although it will still be bumpy.

CONCLUSIONS

The details of process and outcome have changed with the circumstances, but through each financial downturn, the City of San Luis Obispo has succeeded in preserving its long-term fiscal health and organizational vitality. Having a clear strategy in place as the foundation for decision making in tough fiscal times has been a key factor.

BILL STATLER is a consultant and trainer, and the retired director of finance and information technology for the City of San Luis Obispo, California.