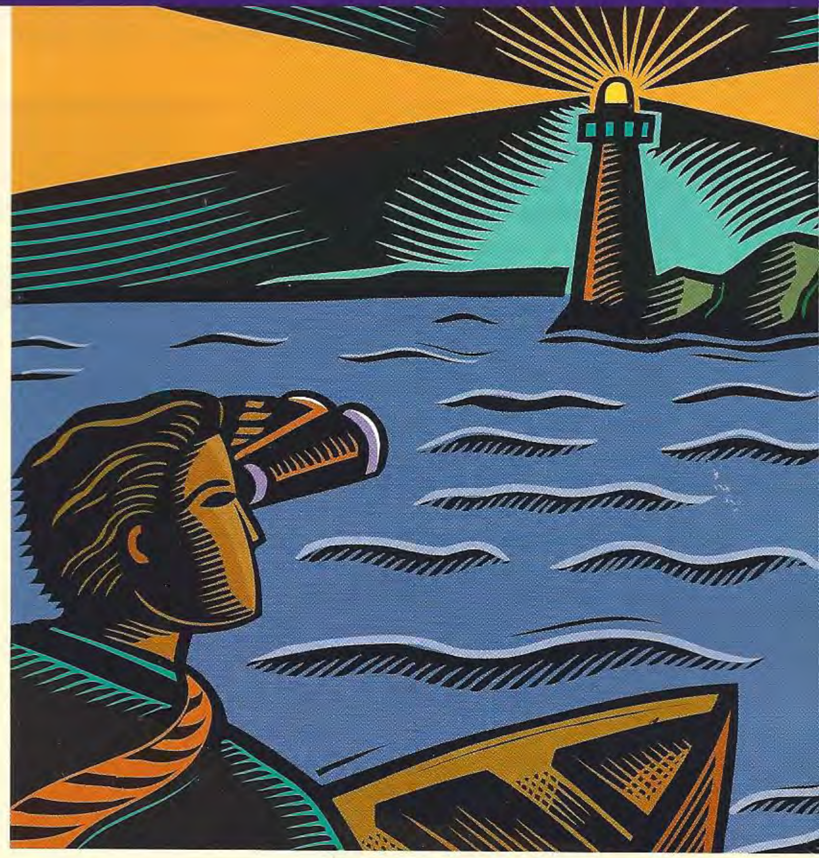
Sound Fiscal Policies Ensure Higher Cost Recovery for Cities



by Bill Statler

Many factors determine your city's fiscal health, but the single most important one is developing and articulating clear fiscal policies *before* a financial crisis hits.

This article explores the power of fiscal policies and discusses some concrete examples of how taking a policy-based approach to fiscal health helped the City of San Luis Obispo close a $7 million general fund budget gap (20 percent of operating expenditures) in FY 2003–04.

Plans Are Good; Policies Are Better

Your city's fiscal health is a lot like your own personal health: It's not what you live for, but it's hard to enjoy your life without it. Cities don't exist to be fiscally healthy; they exist to make our communities better places to live, work and play. However, this requires the fiscal capacity to link community goals with the resources needed to achieve them. Your city's fiscal health is rarely a matter of luck. Like good nutrition and regular exercise, clearly stated financial policies are the best way to ensure your city's long-term fiscal health.

This doesn't mean that a strong local economy isn't a factor; of course it is (just like good genes play an important role in your personal health). But it's not the most critical feature — financial management is.

Long-term financial plans are important for providing general direction. However, plans change over time as actual results replace assumptions. Policies are the north star that guides the preparation of plans, helping make tough decisions easier by telling you what your values are before they are placed under stress by adverse circumstances. You might actually do something else, but they serve as a powerful starting point.

The Power of Policies

In 1996, the San Luis Obispo City Council asked staff to prepare a summary of the city's finances compared with the other cities in the county. Along with a number of financial ratios like revenues and expenditures per capita, we asked the other cities if they had formal minimum general fund reserve policies, and if so, what were they? We also asked how their actual results compared with their policies. As reflected in Figure 1, not all

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cities with policies had the same ones or had fully implemented them. However, those cities with articulated policies were clearly in better financial condition than those without them. Figure 1 graphically illustrates the power of policies.

The City of San Luis Obispo has used formal policies as an integral part of its financial planning and budgeting process for more than 20 years. These policies have served us well in preserving the city's fiscal health, *in good times and bad.*

As shown below, San Luis Obispo's budget and fiscal polices, which are included in our budget document (online at www.slocity.org/finance/policies), cover a broad range of areas. Our user fee policies played an especially important role in helping us balance the 2003–04 budget, where we faced a 20 percent general fund gap without corrective action.

San Luis Obispo's Budget and Fiscal Policy Areas

- Financial Plan Purpose and Organization
- Balanced Budget
- Financial Reporting
- General Revenue Management
- User Fee Cost-Recovery Goals
- Enterprise Fund Fees and Rates
- Revenue Distribution
- Investments
- Appropriations Limits
- Minimum Fund Balance
- Capital Improvement Management
- Capital Financing and Debt Management
- Human Resource Management
- Productivity
- Contracting for Services

Figure 1. 1996 General Reserve Policy Survey: San Luis Obispo County Cities

City	Policy?	If Yes, Description	Actual Reserves
Arroyo Grande	No	—	1 %
Atascadero	No	—	1 %
Grover Beach	Yes	20% of operating	20%
Morro Bay	Yes	27.5% of operating	15%
Paso Robles	Yes	15% of operating	13%
Pismo Beach	No	—	-14%
San Luis Obispo	Yes	20% of operating	21%

Important Note: *This is a "snapshot" picture from 1996; all the cities in the county have since adopted minimum reserve policies and are closely following them.*

User Fee Cost Recovery: Taxes vs. Fees in Financing General Fund Services

When Proposition 218 was adopted in 1996, it created sweeping changes in the way that cities manage and control their revenues. It imposed new requirements for voter approval of all taxes and property-owner approval of most assessments, and many (but not all) fees.

So, along with the fees applied for use of city assets (such as rent for property and franchise fees for rights-of-way), user fees, enterprise fund rates and regulatory fees are some of the few remaining areas of resource discretion available to elected

officials. This includes user charges that are part of the general fund, as well as water and sewer rates, and development impact fees under AB 1600.

But setting user fees is not simply a cost accounting exercise, although having good analytical data is an essential part of the process. It is fundamentally a policy decision by elected officials that determines which of your city's services will be paid from general purpose revenues (primarily taxes) that everyone pays, and which will be funded from user fees. For this reason, the City of San Luis Obispo sets user fees based on a clear policy foundation. We consider the following four factors when determining cost-recovery levels and setting user fees:

1. **Communitywide vs. Special Benefit.** The level of user fee cost recovery should consider the communitywide vs. special service nature of the program or activity. The use of general purpose revenues is appropriate for communitywide services, while user fees are appropriate for services that are of special benefit to easily identified individuals or groups.

2. **Service Recipient vs. Service Driver.** After considering communitywide vs. the special benefit of the service, the concept of service *recipient* vs. service *driver* should also be considered. For example, it could be argued that the applicant for a building permit is not the beneficiary of the city's development review efforts; the community is the primary beneficiary. However, the applicant is the *driver* of development review costs, and as such, cost recovery from the applicant is appropriate.

3. **Effect of Pricing on the Demand for Services.** The level of cost recovery and related pricing of services can significantly affect the demand and subsequent level of services provided. At full or high cost recovery, this has the specific advantage of ensuring that the city is providing services for which there is genuinely a market

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Low Cost-Recovery Factors

Factors that favor low cost-recovery levels — those services that should be funded primarily through general-purpose tax revenues — include the following:

- There is *no* intended relationship between the amount paid and the benefit received. Almost all social service programs fall into this category, because it is *expected* that one group will subsidize another.
- Collecting fees is not cost effective or will significantly impact efficient service delivery.
- There is *no* intent to limit the use of (or entitlement to) the service. Again, most social service programs fit into this category, as well as most public safety (police and fire) emergency response services. Historically, access to neighborhood and community parks would also fit into this category.
- The service is nonrecurring, generally delivered on a "peak demand" or emergency basis, cannot reasonably be planned for on an individual basis and is not readily available from a private sector source. Most public safety services fall into this category.
- Collecting fees would discourage compliance with regulatory requirements and adherence is primarily self-identified; as such, failure to comply could not be readily detected by the city. Many small-scale licenses and permits fall into this category.

High Cost-Recovery Factors

Factors favoring high cost-recovery levels include:

- The service is similar to services provided through the private sector.
- Other private or public sector alternatives could or do exist for the delivery of the service.
- For equity or demand management purposes, it is intended that there be a direct relationship between the amount paid and the level and cost of the service received.
- The use of the service is specifically discouraged. Police response to disturbances or false alarms might fall into this category.
- The service is regulatory in nature, and voluntary compliance is not expected to be the primary method of detecting failure to meet regulatory requirements. Building permit, plan check and subdivision review fees for large projects would fall into this category.

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that is not overly stimulated by artificially low prices. Conversely, high levels of cost recovery will negatively impact the delivery of services to lower income groups. This negative feature is especially pronounced — and works against public policy — if the cost recovery is high for services that are specifically targeted to low-income groups.

4. **Feasibility of Collection and Recovery.** Although a high level of cost recovery may be appropriate for specific services, it may be impractical or too costly to establish a system to identify and charge the user. Accordingly, the feasibility of assessing and collecting charges should also be considered in developing user fees, especially if significant program costs will be financed from that source.

A specific example of how the city implemented these policies is provided in "Real-World Application in San Luis Obispo" on page 19.

Things To Keep in Mind When Evaluating Service Charges

The City of San Luis Obispo uses the following general concepts when evaluating service charges:

- The amount of the fee may not produce revenues that exceed the reasonable cost of providing the service.
- Cost-recovery goals should be based on the total cost of delivering the service, including direct costs, departmental administration costs and organization-wide support costs, such as accounting, personnel, data processing, vehicle maintenance and insurance.
- The method of assessing and collecting fees should be as simple as possible in order to reduce the administrative cost of collection.
- Rate structures should be sensitive to the market for similar services as well as to smaller, infrequent users of the service.
- A unified approach should be used in determining cost-recovery levels for various programs based on the factors discussed above.

Tax-Based Services

The following types of services should have very low cost-recovery goals:

- Delivering public safety emergency response services, such as police patrol services and fire suppression;
- Maintaining and developing public facilities that are provided on a uniform, communitywide basis such as streets, parks and general purpose buildings; and
- Providing social service programs and economic development activities.

In selected circumstances, there may be specific activities within the broad scope of services provided that should have user charges associated with them. However, the primary source of funding for the operation as a whole should be general purpose tax revenues, not user fees.

Fee-Based Services

User fees at some level are appropriate for all other city services. The City of San Luis Obispo set the following user fee cost-recovery goals for recreation and development review services:

- **Recreation programs.** Cost recovery for activities directed at adults should be relatively high, whereas cost recovery for activities directed toward youth and seniors should be relatively low. From this general guideline, the city sets specific cost-recovery goals for each recreation activity. For example, classes, adult athletics and facility rentals should have high cost recovery (defined as 60 to 100 percent); special events and youth track and swim lessons should have "mid-range" cost recovery (30 to 60 percent); and public swim, teen services and senior services should have low cost recovery (up to 30 percent).
- **Development review programs.** For planning, building, engineering and fire development review services, cost recovery should generally be very high. In most instances, the city's cost-recovery goal should be 100 percent. A notable exception is appeal fees. The average appeal costs the city $4,000 to process; however, the fee is $100 to

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Real-World Application in San Luis Obispo

Taking a policy-based approach had very practical results in the City of San Luis Obispo as we struggled to close a $7 million budget gap. As shown in Figure 2, expenditure reductions played the leading role in balancing the budget for 2003–04, accounting for about 74 percent of the overall solution. However, new revenues were also an important part of our strategy, accounting for 15 percent ($1.1 million) of the total (see Figure 3).

Obviously, new revenues as part of the budget process could come only from those revenues subject to the discretion of the city council. Accordingly, we took a close look at our user fees and other fiscal policies to identify opportunities for improved cost recovery.

This policy change occurred only after extensive budget workshops and hearings, which were well publicized and well attended. Most notably, the business and development community did not formally oppose the change, largely due to our "missionary" work in explaining the reasons for the change and the impact on community services (including development review) if it was not made.

As shown in Figure 3, 49 percent of the new revenues ($517,000) came directly from re-evaluating our planning fee cost-recovery policies. Until the 2003–04 budget, the city's policy was to recover 45 percent of most planning-related service costs. (The cost-recovery goal was 100 percent for other development review services, such as building, engineering and fire permits). Most of the other half came from re-evaluating our franchise fee policies.

This reflected the benefit that the community at large receives from this review process. But if the applicant — who drives the need for the city to incur this cost — pays less than the full cost, then general purpose revenues are making up the difference.

Given the fiscal challenges facing us, the practical consequence of this would have been even deeper cuts in services that rely heavily on general purpose revenues, such as police, fire, street maintenance and parks. Moreover, because the general fund was subsidizing such a large portion of planning costs, this would have meant subjecting this service to cost cuts as well, at a time when development activity was at an all-time high.

Faced with these trade-offs, the council unanimously approved moving from 45 percent to 100 percent cost recovery for most planning services. This was consistent with our overall framework in setting cost-recovery goals, which already distinguished between service *recipients* and service *drivers* (see page 17). Moreover, this change also benefited the development community by helping mitigate reductions that might otherwise have been required in our development review services.

Figure 2. Budget Balancing Strategy: Closing the Gap

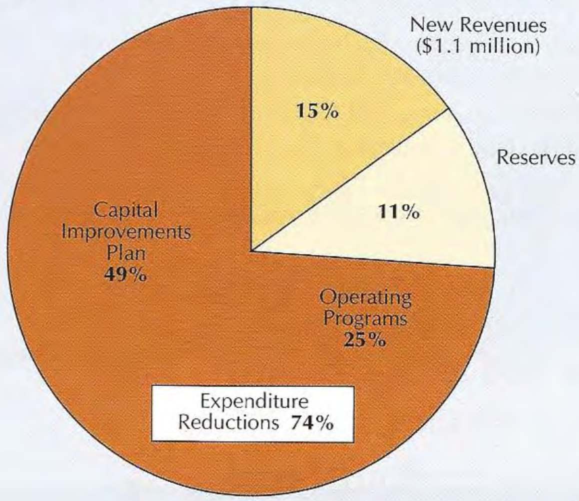
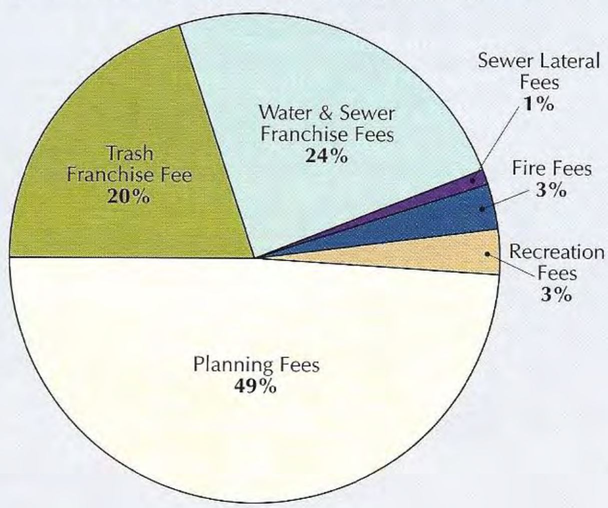


Figure 3. New Revenues by Source: $1.1 Million



Making Comparisons With Other Communities

In setting fees, the City of San Luis Obispo collects and considers information on the amount of fees charged by other communities for similar services. However, our policy is clear that fee surveys should never be the sole or primary criteria in setting city fees, because many factors affect how and why other communities set their own fees. For example:

- What level of cost recovery is their fee intended to achieve compared with our cost-recovery objectives? If our fee is $100 and theirs is $75, perhaps the difference is simply that our cost-recovery goal is 100 percent and theirs is 75 percent.
- What costs have been considered in computing their fees? Our policy is to set fees based on total costs. As such, even if our cost-recovery goals are otherwise the same, perhaps they are considering only direct costs.
- When was the last time their fees were comprehensively evaluated? We adjust our fees on an ongoing basis; perhaps theirs are significantly out of date.
- What level of service do they provide compared with our service or performance standards? Perhaps we simply provide a higher level of service, so our costs — and related fees — are higher.
- Is their rate structure significantly different than ours and what is it intended to achieve? Anyone who has ever tried to compare planning permit fees knows that getting an "apples to apples" comparison is very difficult because every city does it differently.

Ultimately, cities should set their financial management policies based on their unique circumstances, not those of others.

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avoid inappropriately limiting community involvement in the review process. (Until 2003–04, there was no appeal fee at all.)

Staying in Touch With These Tools

In the wake of state budget grabs and the recession of the late 1990s, many cities took a close look at their user fees. But have they been updated on an ongoing basis, and are the policy bases and "analytics" underlying them still valid? To avoid this, San Luis Obispo performs a comprehensive benchmark analysis at least every five years and up-dates fees annually using changes in the U.S. Consumer Price Index in the interim.

If service fees are not assessed where they could be, then general purpose revenues are making up the difference. The direct consequence of this is a lower level of service (and in tough times, deeper cuts) in essential programs that have no significant user fee potential, such as police, fire, streets, libraries and parks.

When should you take a close "re-look" at your current service cost-recovery levels and user fee policies? There are two basic approaches:

- Outside the budget process, where they can be dispassionately viewed on their own analytical merits; or
- As an integral part of the budget process, so that the resource trade-offs between setting user fees at an appropriate level vs. the ability to fund high-priority services are clear.

Either approach can work, but tough decisions may be easier to make and communicate to your community when the real-world benefits are clear and compelling, such as during the budget process when resource decisions are made about what will get done in the coming year (and what won't). This is one of the few remaining areas for local elected officials' judgment.

Five Key Policy Questions To Ask When Setting User Fees

1. **What does it cost the city to provide various services?** Our cost analyses reflect the total cost of services — direct and indirect.
2. **Are these costs reasonable?** Many fee-setting cost studies are criticized as being solely revenue driven: If revenues are not recovering costs, the solution must be to increase revenues. However, the problem may not be that revenues are too low, but that costs are too high. Before considering fee increases, elected officials and members of the community need to be sure that costs are reasonable for the level of service provided.
3. **What are current cost-recovery levels?** The next step is to compare the cost of a service with the revenue it currently generates. For example, a service may cost $100 to deliver, but the related fee is bringing in only $75.
4. **What should the cost-recovery level be?** Obviously, this question can be answered only if there are user fee cost-recovery policies in place. Without this, we don't know if any adjustment to the $75 fee (upward or downward) is warranted. For example, if the policy for the service is 50 percent cost recovery, the fee should be lowered; if it is 90 percent, it should be raised. In short, no matter how well we've technically analyzed what the costs and revenues *are*, knowing this alone does not help us set fees. We also need to know what the cost recovery *should* be.
5. **What fee changes are necessary to implement the city's cost-recovery policies?** Once we know that it costs us $100 to provide a service, that this cost is reasonable, that the current fee recovers only $75 and our policy is 90 percent cost recovery, then setting the fee at $90 becomes an easier decision for policy-makers. However, this approach doesn't mean elected officials are on "auto-pilot" in setting fees; this decision is clearly in the policy arena. If the fee is too high at $90 and all the other criteria have been met, then it must be because the cost-recovery goal at 90 percent is too high. But because the council sets the policy, the council may also amend it.

Your city's fiscal health is rarely a matter of luck. Clearly stated financial policies are the best way to ensure your city's long-term fiscal health.

Policies Are the Foundation of Fiscal Health

Policies are the fundamental foundation for long-term fiscal health. They are an essential component of long-term forecasts and contingency plans. And most importantly, they help frame and articulate your values, which makes doing the right thing easier when tough decisions have to be made. ■

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