'Rightsizing' your township to respond to tough financial times

The state of Michigan's long-standing budget struggles have dominated policy discussions for most of the decade, but many Michigan local governments—townships included—now face their own "perfect storm" of adverse economic conditions that undermine balanced budgets. Individually, they would pose minor fiscal hurdles, but compounded, the impacts will cause significant financial stress.

A plethora of bad financial news faces township officials, including:

- A chronic state budget structural deficit that precludes state financial support to local government at levels traditionally provided for more than half a century.
- Constitutional and legislatively imposed limitations on the scope of local government revenue sources and property tax limitations.
- Property tax revenues, traditionally resistant to recession, are facing a downturn resulting from a saturated residential market, stagnating population growth, foreclosures that are depressing residential values, and recession-induced declines in personal property tax revenues.
- A global economic transformation that is eroding Michigan's manufacturing—a sector that Michigan relies upon more than any other state. Within manufacturing, the domestic production of automobiles has been particularly hard hit by global competition and changing consumer preferences.
- Budget constraints at the federal government level have restricted domestic funding for local government services.
- Increasing costs related to energy and health care.

NOT ALL LOCALS IMPACTED EQUALLY

These adverse economic conditions will not impact all local governments equally. "Ground zero" will be communities highly reliant on the auto industry for their economic vitality, including communities that have previously been considered relatively affluent. On the other hand, local governments that have more diverse economic bases, including those reliant on agriculture, will likely be spared, and will actually prosper from prevailing agricultural commodity prices, which are supporting relatively high agricultural property values. While it is too early to say with certainty, communities relying on tourism will also likely see some economic challenges resulting from the relatively high cost of gasoline.

Local governments will respond to adverse economic conditions with varying degrees of success, depending on the depth and severity of the current recession; Michigan's success in marketing itself to emerging 21st-century industries; whether energy costs are a bubble to be burst or reflect a long-term disparity between supply and demand; and whether high agricultural commodity prices are sustainable in light of overseas competi-

tion and whether ethanol production continues to drive up commodity demand. Legislative changes that provide to local governments' revenue streams not currently authorized, or that reduce mandated costs, would also improve local governments' ability to withstand these challenges.

Which communities will successfully confront their fiscal challenges, and which will fail? Local governments negatively impacted by economic conditions will successfully respond to adverse economic conditions to varying degrees depending on local political and fiscal conditions, including:

- The presence of effective local political leadership willing and able to build a community consensus to reduce or eliminate programs and services, and/or embrace alternative local government service delivery methods.
- Local support for new local government revenues, including surplus capacity for tax increases and expanded fees for services.
- Public support for major reforms such as consolidation of services or local government mergers.
- Availability of financial reserves.
- The willingness of current employees to embrace wage and fringe benefit concessions, and/or downsizing staffing levels.
- The degree to which a local budget contains nonessential spending or capital investments that can be reduced.
- The extent to which a local government budget is obligated to debt service, current contracts, legacy costs promised to retirees, or other mandated expenditures.

INDICATORS OF FISCAL DISTRESS

Financial crises do not appear overnight. The earlier they are confronted, the less turmoil the township will have to endure. Fund balances are often suggested as the most important indicator of a community's financial health. However, MTA has seen studies of local government fund balances that have badly misinterpreted the implications of the data. For example, using each local government's fiscal year-end balances, researchers have overlooked the crucial differences in cash flows in relation to a local government's fiscal year-end reports.

To be meaningful, fund balances need to be measured at the point in time when they are at their lowest, which is not necessarily at year-end. For townships, the end of November, just prior to beginning the winter tax collection, will yield a more valid picture of financial reserves. A few years ago, a township official contacted MTA in October to report that, while the township had a "balanced" budget, it had no money in the bank and could not pay any bills until it collected some revenue.

Some townships build up their fund balances to pay for anticipated future year expenditures. Consequently, a township could appear to have a very healthy fund balance, maybe even having an amount of money approaching a year's worth of operating expenses. In reality, a big chunk of the money may be intended to replace an old fire truck. The township may have been spending down its fund balance in a free-fall of deficit spending, but is still showing a "safe" level of reserves.

It would be misleading to determine a community's fiscal distress by merely examining a single year's financial data. Dynamic economic impacts require multi-year trend analysis to determine if a single year's performance is an aberration, if a situation is improving, or if a situation is deteriorating. The Government Finance Officers Association (GFOA) recommends the following:

> *A government's Comprehensive Annual Financial Report provides a wealth of data that the government itself and other interested parties can use to analyze the government's financial health. Of course, considering financial data in isolation can lead to inappropriate conclusion—appropriate context is essential for sound interpretation. For state and local governments, trend data of the government itself and comparative data from other governments frequently have provided this context for evaluating current-year financial data.*

(For more GFOA recommendations on evaluating fiscal health, see sidebar on page 22.)

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OTHER FACTORS INDICATING RELATIVE FISCAL HEALTH

Fund balance analysis provides data that documents a township's current fiscal condition, but what can a public official do to glean the township's long-term risk of financial difficulty? To help local government officials evaluate their community's fiscal health, MTA would like to see a database of benchmarks developed by the state. Such a database could include the following components:

- Population: Different benchmarks are likely needed for various-sized communities.
- Population growth: Growing communities tend to have better financial health than stagnating communities.
- Percent of population in poverty: Impacts on the need for special services and revenue capacity.
- Taxable value per capita: Communities with high land values in relation to number of residents will be in a relatively stronger financial position.
- Per capita income: Relates to revenue growth capacity and is the best measure of community prosperity.
- Employment growth and unemployment rate: Needs to be reported regionally as many people do not work in the same community in which they live and pay taxes.

Evaluating fiscal health

The Government Finance Officers Association (GFOA) offers a number of recommendations relative to evaluating fiscal health relative to the amount of township reserves, including:

- The adequacy of unreserved fund balance in the general fund should be assessed based upon a government's own specific circumstances. Nevertheless, GFOA recommends, at a minimum, that general-purpose governments, regardless of size, maintain unreserved fund balance in their general fund of no less than 5 to 15 percent of regular general fund operating revenues, or of no less than one to two months of regular general fund operating expenditures
- A government's particular situation may require levels of unreserved fund balance in the general fund significantly in excess of these recommended minimum levels. Furthermore, such measures should be applied within the context of long-term forecasting, thereby avoiding the risk of placing too much emphasis upon the level of unreserved fund balance in the general fund at any one time.
- Sometimes reserved fund balance includes resources available to finance items that typically would require the use of unreserved fund balance (e.g., a contingency reserve). In that case, such amounts should be included as part of unreserved fund balance for purposes of analysis.
- In practice, levels of fund balance (expressed as a percentage of revenues/expenditures or as a multiple of monthly expenditures) typically are less for larger governments than for smaller governments because of the magnitude of the amounts involved and because the diversification of their revenues and expenditures often results in lower degrees of volatility.
- The predictability of revenues and the volatility of expenditures (i.e., higher levels of unreserved fund balance may be needed if significant revenue sources are subject to unpredictable fluctuations or if operating expenditures are highly volatile).
- The availability of resources in other funds as well as the potential drain upon general fund resources from other funds (i.e., the availability of resources in other funds may reduce the amount of unreserved fund balance needed in the general fund, just as deficits in other funds may require that a higher level of unreserved fund balance be maintained in the general fund).
- Liquidity (i.e., a disparity between when financial resources actually become available to make payments and the average maturity of related liabilities may require that a higher level of resources be maintained).
- Designations (i.e., governments may wish to maintain higher levels of unreserved fund balance to compensate for any portion of unreserved fund balance already designated for a specific purpose).

(From *Appropriate Level of Unreserved Fund Balance in the General Fund 2002*. Available at www.gfoa.org/downloads/budget-appropriate.pdf)

- Millage rate as a ratio of legal limitations: Reflecting taxing capacity in use.
- Long-term debt per capita and in relation to taxable value: Debt capacity in use.
- Local government fiscal effort: Actual revenues collected in relation to potential revenue.
- Local government fiscal capacity: Available resources based on full taxing authority and levying at least an average rate of fees on services.
- Ratio of expenditures related to retirees to total general fund expenditures: Reflects the extent to which current resources are committed to prior year obligations.
- Ratio of multi-year contractual obligations to total general fund expenditures: Reflects amount of budget flexibility.
- Ratio of long-term debt service to total general fund expenditures: Reflects budget flexibility.
- Rate of annual property tax revenue yield decline to total property revenue in past three years: Trend of revenue erosion.
- Ratio of statutory revenue sharing to total revenues: Degree of reliance on state Legislature.
- Ratio of other intergovernmental transfers to total revenues: Degree of reliance on other governmental entities.
- Percentage of businesses with delinquent property taxes: An indicator of potential business failures.
- Percentage of residences with delinquent property taxes: An indicator of future home abandonment or mortgage foreclosures.

MTA is unaware of any credible recommendations, based on data collected either nationwide or originating in Michigan, of tolerable ratios of these or any other benchmarks of local government fiscal health. These triggers need to be developed based on current Michigan experiences or data available from distressed local governments elsewhere. It is also reasonable to assume that no single benchmark, examined in isolation of other factors, can reliably predict or label a community's fiscal distress.

CORRECTING A SHORT-TERM STRUCTURAL DEFICIT

Appropriate strategies to deal with a structural deficit will vary depending on whether local officials believe that the township's fiscal distress is likely short term and self-correcting—or if there has been a permanent change in the historical revenue and expenditure pattern resulting in a non-sustainable allocation of resources.

A short-term budget deficit poses a fairly straight-forward issue: to what extent should the township allow its accumulated fund balance to deteriorate to absorb the shortfall. Rather than tapping into its reserves, the township board can reduce expenditures considered "non-essential" in the short term, such as by curtailing travel, deferring maintenance, limiting professional development opportunities for township staff, or nixing capital outlays. Reducing these kinds of expenditures usually

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causes no permanent harm to the governmental entity in the short term, but the local entity cannot sustain the reductions of these expenditures forever. No local government can expect to produce excellent programs and services using obsolete, unreliable equipment and untrained officials and employees. The short-term savings will eventually be offset by increasing costs of equipment repairs, decision errors and the inevitable replacement of non-working equipment.

Alternately, some township boards may determine that existing accumulated resources exceed minimum prudent levels, and that it would be more appropriate to protect current spending by dipping into reserves. However, this strategy should not be pursued solely to postpone making difficult decisions that must be inevitably faced later. Fund balances are a finite resource that take a long time to accumulate and are very difficult to restore once the financial storm is over. If a township board believes it can use reserves to weather a short-term storm, it should first establish by policy a floor on the amount of reserves it considers to be available to shore up the current spending, and earmark reserves that should be preserved to protect the township from other unforeseen adverse consequences.

RIGHTSIZING INSTEAD OF DOWNSIZING

Faced with impending budget deficits into the foreseeable future, revenues and expenditures must become realigned. Downsizing focuses strictly on the expenditure side of the budget, often by imposing "across-the-board" cuts of a designated percentage that is sufficient to bring expenditures and revenues back into balance.

The "across-the-board" approach often looks appealing to elected officials because it appears to be the politically safest. Cutting all programs and services by the same percentage provides a fig leaf of impartiality and fairness. The problem with across-the-board cuts is that the effects do not fall equally. Departments and programs that have historically enjoyed a budget that supports plenty of non-essential expenditures can absorb the cuts without experiencing a significant impact on service delivery. However, a department that comparatively has little "fat" in its budget gets cut to the bone. Expenditure cuts to revenue-producing programs may have their money-generating abilities compromised.

In a shrinking revenue environment, historical budget allocations may no longer be appropriate given changes in the community's expectations and priorities. In tough times, the township may want some programs protected to a greater extent than others. For example, during the late 1990s and early 2000s, many townships increased the staffing levels of their construction code compliance departments in response to rapid residential growth. With construction now stagnating, it may make more sense to target reductions to programs like building code enforcement and preserve funding to other essential services.

DOING MORE WITH LESS

People running for public office often promise to deliver new programs funded by "eliminating waste." Such promises applied to public entities that have endured years of budget reductions may be wishful thinking, but there may be opportunities to improve local government efficiencies that can help rightsize an imbalanced budget. For larger townships that expend two-thirds or more of their budgets on personnel-related costs, there is a great incentive for both management and employees to think creatively. Collective bargaining agreements may provide impediments to employers acting unilaterally to alter expenditures, so township officials should consult their labor attorneys and be aware of changes they will need to negotiate with their collective bargaining units.

The recent experience of Michigan and its local governments has not found unions eager to make contract concessions to help their employer save money. Nonetheless, both unions and management have a shared interest in finding ways to improve productivity, such as aggressively monitoring and managing absenteeism and overtime, which will simultaneously save jobs and improve the township's bottom line.

Recent studies released by Lansing-based Cobalt Community Research revealed that, compared to the private sector, public employers have been relatively slow to implement or raise health insurance premiums and deductibles. Legacy costs—promises to employees that the governmental entity will continue to pay for their post-retirement health care expenses—will be a major contributor to many local governments' fiscal stress as baby boomers leave the workforce in increasing numbers. Avoiding these types of obligations may not have much impact today but can have positive long-term consequences.

Consolidation as a solution?

Communities must deal with their fiscal issues using strategies that make sense in light of local circumstances. Fortunately, there are a myriad of strategies to raise revenues and cut costs, and the acceptability and efficiency of these strategies will vary by community. Making these choices is what local officials have been elected to do, and there is no reason to presume that they are not up to the task.

Broad-brush solutions have been suggested by state policymakers, including mandating more sharing of local government services and consolidating governmental entities. These strategies may make sense in specific circumstances, but often prove unworkable in many others. Potential savings from joint services have been drastically overstated by some reform advocates, but joint services may be a part of a comprehensive package of steps that township boards may want to pursue. There are potential economies of scale from combining capital-intensive services where high fixed costs can be spread over larger customer bases.

Consolidating services can actually *increase* costs due to higher administrative and oversight costs. Merely combining departments does not decrease costs. Operations must be altered as well, such as closing a fire station, selling duplicative equipment or eliminating positions. Current laws also require all employees to receive the highest compensation received by any of the current employees when combining services.

Several years ago, three local governments in the Upper Peninsula consolidated into a single entity. All were relatively small municipalities sharing adjacent boundaries, and each had few employees. Nonetheless, in spite of the relative simplicity of the merger, the communities took more than five years to work out the details, and this effort required the skilled facilitation of a Michigan State University professor possessing considerable experience in intergovernmental collaboration. It is MTA's understanding that the merger resulted in no immediate cost savings, though some are expected long term. The lesson here is that merging local governments requires considerable time, resources and expertise, and significant cost savings are by no means guaranteed.

The best circumstance for cost savings from either joint services or consolidation result when one or more of the participating entities has surplus capacity to reallocate to a broader service area, which can be preferable to downsizing that function. Consolidating two fiscally weak units of government will likely produce one larger, but nonetheless still fiscally weak, governmental entity. A financially struggling local government may benefit from being consolidated with a stronger entity, but the taxpayers of the stronger entity would likely object to paying the bills of another local government entity. This objection would likely be strongest were one local government's financial difficulties stem from legacy costs incurred years ago, and now the taxpayers of a neighboring entity are expected to cover those costs through higher taxes, loss of local control or the degradation of services.

Technology and energy conservation offer potential savings, but often require spending money in the short term to save money down the road. Automated phone answering systems and computerizing functions that currently involve staff may be part of a government's long-term strategy.

DON'T FORGET THE REVENUE SIDE

Local officials sometimes underestimate the public's support for maintaining existing service levels, even if it means more taxes or higher fees. Without a doubt, the current economy makes asking residents for additional money more difficult. Perceptions of waste, incompetency or frivolity can sink millage increase requests, and voter support for even millage renewals should not be taken for granted. However, a good communication plan that enables voters to understand the causes of the township's financial constraints and the value of the tax-supported services can result in voters agreeing that protecting essential township services is worthy of a millage increase.

There likely will be no "silver bullets" that restore any local government to a strong fiscal position. External funding sources, such as grants, were plentiful decades ago, but today are generally available only for narrow purposes, and ongoing support for existing programs is seldom eligible.

However, township boards may be able to shore up their budgets by tweaking a variety of locally produced revenue streams. Better investment of idle funds may generate more money for the general fund. Relatively low interest rates will not generate a great deal of money through more aggressive investing, but if the township has large sums in non-interest bearing accounts, it may be losing out on a significant opportunity to help its budget situation. Aggressively shopping its investments to multiple financial institutions to obtain better rates on certificates of deposit and commercial paper can improve interest revenue yields without increasing risk.

If the township has not recently examined its fees for services in relation to costs, township officials may be surprised by the extent to which the taxpayers are subsidizing township programs that are enjoyed by a small constituency. Public entities oftentimes do not consider the full costs, including indirect expenditures like accounting, board oversight, facilities and insurance, when considering what it actually costs to operate a program. Cemetery lot sales, recreation programs, township hall rentals and land use permits are often priced well below what it truly costs the township to provide the service. Increasing fees may cause some grumbling from the people who use that program, but the majority of the taxpayers would likely cheer from being relieved of the burden of subsidizing programs from which they do not benefit.

In flush financial times, it makes good political sense to offer programs "free of charge." But, of course, nothing is really free. Taxpayers really pay for everything, whether they use the program or not. Many local governments have found some financial relief by instituting fees for programs and services previously

underwritten by the taxpayers, such as emergency runs, home inspections for residents on vacation, dust control on roads, and aquatic weed eradication. Fees and special assessments are appropriate for programs that have a specific, rather than general benefit.

CUTTING OR ELIMINATING EXISTING PROGRAMS

It is far harder to reduce spending or eliminate a program compared to increasing expenditures. Budgets usually expand incrementally, bit by bit, proportionate to annual revenue increases. But reducing expenditures, to be done efficiently and effectively, must be decisive and strategic. Nicking programs year after year, like the "death from a thousand cuts," undermines productivity, destroys employee morale, and leaves widespread mediocrity throughout the governmental entity.

Rather than reducing all programs to a level of mediocrity, township leaders should consider a re-evaluation of community priorities and targeting expenditures to support what is essential—and eliminating the rest. Instead of cutting line-items, officials should focus on programs and services. This approach requires determining the full cost—including those that are indirect—of every township program and service, including those that are state law mandated. With an eye on the township's expected revenue level, the board makes a list of programs, starting with those that are required, followed by those that the community considers essential, and finishing with programs of declining importance.

Just like a grocery list, the township funds the programs that are within its financial capacity, and eliminates the programs it can no longer afford. The programs that remain should be provided with sufficient financial resources to operate efficiently and effectively. Supporters and constituents of eliminated programs may howl, but adding any programs back in the "funded" list must, of course, result in other programs being dropped.

DON'T GET TOO FAR FROM THE PUBLIC WILL

Elected officials must expect that budget cuts will stir up substantial resistance. Everyone remotely familiar with the democratic process knows how to thwart budget cuts: mobilize supporters and put continuous pressure on public officials until they rescind the cut or the program is restored. Department heads also learn a variety of strategies to protect their programs. Faced with push-back, elected officials can lose their will to act decisively. Budget band-aids, like accounting gimmicks and tapping one-time revenue sources, can stave off tough decisions for awhile. But ultimately there will be a day of reckoning, and the final impacts and political consequences will likely be worse from the failure to act timely and decisively.

Compared to other government entities, township boards have the advantage of being closer to their constituents, enabling a better level of communication between the board and stakeholders. Involving the public through surveys, town meetings and other face-to-face meetings can help build support for the tough decisions ultimately facing the board. Involving other stakeholders, especially employees, can help build buy-in for decisions that everyone wishes the board didn't have to make, but which are essential and in the community's best interest. Stakeholders may also identify and advocate for other strategies and alternatives overlooked or dismissed by board members.

For township officials who see their township as the instrument to deliver essential programs and services consistent with the community's expectations, the mandate to act decisively in the public's best interest can be gut-wrenching. It is seldom popular or easy to discontinue existing programs, especially those involving layoffs of employees. Eliminating jobs requires great empathy and sensitivity. Nonetheless, a united board that reaches its decisions carefully, reasonably and with plenty of public input will survive the inevitable backlash and position the township to move forward to continue providing excellent community services.

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