Choosing from Bad Options:

A Practical Guide to Decision-Making in the COVID-19 Crisis

Perspectives | **May 2020**

Following the outbreak of the coronavirus (COVID-19), the Government Finance Officers Association (GFOA) updated its "fiscal first aid" resource center to help government leaders manage the devastating fiscal impact. That update includes two reports on "Balancing the Budget in Bad Times" that describe potential gap-closing initiatives. The first report covers "primary tactics" and the second covers riskier tactics. Members of PFM's Management and Budget Consulting team participated in this process and provided input on how to evaluate budget-closing options.

This article offers practical advice on how to evaluate the effect and efficacy of gap-closing initiatives. It is designed to provide government leaders with a set of questions to ask and factors to consider in determining if, when and how to implement specific initiatives in the face of this crisis.

In considering budget decisions that government leaders will make in response to COVID-19, we really only know one thing with certainty – everything is uncertain. As we write this guide, there are daily changes in projections in the course of the pandemic, a patchwork of reopening strategies that vary widely by state and a range of predictions on the length and depth of the virus' impact on the economy.

That's why careful, thoughtful, rational decision-making around these choices is both essential and incredibly hard. By laying out some questions to ask and factors to consider, we hope to make this painfully difficult process somewhat easier.

GFOA's "primary" techniques take sound, proven financial management practices and explain how they can be especially helpful during financial distress. While a financial crisis can provide an opportunity to push for improvement or refocus staff on existing processes, leaders should not wait for a crisis to use these techniques. Governments should collect tax revenues where due, hold managers accountable for their budget, gain efficiency through centralization or bulk purchases and have the right financial controls and reporting mechanisms in place.

The principles underlying these primary techniques, like transparency, accountability and flexibility, are integral to an effective deficit-closing strategy. For example, if a government is considering a tax increase, the government should ensure it is doing everything it can to collect the taxes already in place, for the sake of equity and maximizing the value of any increase.

The primary techniques are the proverbial "low-hanging fruit" that government leaders often seek out to close budget gaps in good times and bad, and their application needs to be assessed.

But the reality is that even the best projections suggest that most governments will have to go well beyond the primary techniques to address the economic and fiscal challenges resulting from COVID-19. Governments facing a severe drop in revenues, dramatic increases in expenditures, spikes in demand for services and loss of capacity are unlikely to overcome those problems simply by doing the basics well. Leaders will likely have to use some of the tools that GFOA groups in the "caution" or even "extreme caution" categories, depending on the nature of the crisis.

That's why government leaders need to carefully consider the application of gap-closing initiatives. Because the concise answer to whether a particular government should use a particular technique during this particular financial crisis is, "It depends."

The most obvious factor to consider is the size and nature of the projected deficits – how large they are, how quickly they arrive, whether they grow over time or remain constant, and whether they are driven by structural issues exacerbated by a crisis or a unique set of circumstances.

And this will depend greatly on local factors – the government's revenue structure, fiscal and economic conditions before the onset of the COVID-19 pandemic, impacts on major taxpayers and fee payers, impacts on state aid, and the types of areas that the government is responsible for funding, just to name a few.

Still, answering these basic questions – how big is the hole, how fast does it arrive and how does it change over time – will give leaders the context they need to focus on the scale of an appropriate response. Before you plug the hole in the dam, you have to know whether it's the size of a lemon or a limousine.

With the coronavirus crisis, it is impossible to answer these questions with certainty and precision at this point. Even so, a thoughtful preliminary estimate, presented with transparency around the assumptions and a commitment to update as better information becomes available, is better than flying blind. Further, it is important to consider scenarios with even more painful impacts. At the outset, it may be counterproductive to impose severe cuts in anticipation of a "worst-case" scenario if a more moderate outcome is more likely – but is also prudent to begin developing contingencies in case the trajectory of the crisis does take a more difficult turn.

Once you determine the likely size of the deficit – or better yet, outline different scenarios that suggest a range – then you can begin to make some decisions on how best to act. In weighing those decisions, government leaders need to carefully consider a variety of factors. Those outlined in this guide are a "starter's kit" – they are not exhaustive, but provide a floor for the type of analysis that leaders will need to undertake.

Legal Authority

The first criteria for evaluating whether a government should consider using a technique during a financial crisis is whether the government is currently authorized to take action on its own, without a change in state or federal law. Statutory powers vary by state with some governments limited in the types of taxes they can use or the maximum rates they can charge. Other states have legal restrictions around how some forms of employee compensation can be changed, particularly for retired employees. Government leaders should be aware of those limitations.

This should not preclude county and local leaders from seeking changes at the state or federal level of government. As an example of what's possible, the State of Ohio took swift action to change the law governing where local income tax revenues are paid, ensuring that the nexus for tax payments remains the municipality where the business is based, even if its employees work from home during the crisis.

This also should not prevent local leaders from taking a closer look at what enabling legislation or other levels of government actually require. What starts as one person's overstatement or misinterpretation of statutory requirements can evolve into a commonly-held belief in restrictions that are not real.

That said, statutory requirements do exist and, even where it is possible to change them, government leaders should carefully consider the potential time it may take to achieve legislative or regulatory relief or get voter approval via referendum, compared to the immediate needs to close a looming deficit.

RELATED QUESTIONS INCLUDE:

- If we think a law or contract is preventing us from using a particular tactic, have we checked the exact language in the law or contract to make sure the constraint is real?
- If the constraint is real, have we checked with state or federal agencies or the other party to the contract to see if the constraint can be relaxed?
- If the techniques are not currently authorized, what other governments would potentially benefit from expanded authorization and is there a near-term opportunity to collectively lobby for those changes?

Fiscal Impact

Fiscal impact is not the only lens through which deficit-closing techniques should be evaluated, but it is the finance team's responsibility to fully evaluate the techniques from this perspective.

Your team should prepare thoughtful estimates on the potential revenue gains and/or expenditure reductions associated with a technique, using and documenting the best information available at the time. In the event of severe financial distress, techniques that generate minimal or an unknown financial impact can be set aside as lower priorities, particularly where there are clear costs in terms of service quality, employee workload and morale.

Estimated revenue gains from tax or fee increases should account for mitigating factors like a potential increase in delinquent accounts or reduced demand for an associated service, as well as the costs of collection. Measures that reduce expenditures should account for any additional expenditures needed for implementation (increased technology or collection costs, unemployment claims).

Ideally, the estimates should be given on a multi-year basis to provide a sense for whether the financial gains are flat, gradually grow or gradually fall over time. For example, a one-year base salary freeze creates savings in subsequent years when future salary increases are applied to a lower base.

RELATED QUESTIONS INCLUDE:

- What is the projected financial benefit in the first year, factoring in staff time and implementation costs?
- How does the financial impact change over time? Does the revenue increase or expenditure reductions compound? Does the impact drop?
- How certain are we of our projections? If we are highly uncertain, have we considered other, more predictable options? Can we gather more information to increase our certainty?

Service Impact

Many expenditure-reduction techniques in the "caution" or "extreme caution" category will have a cost in terms of the quality or level of services provided. This impact is real, even when it is harder to measure than the financial impact.

To the extent possible, finance leaders should look to data to assess this impact. This will be easier for those governments that already have strong systems that report on levels of service and other key performance indicators. Even where comprehensive data is unavailable, finance leaders should look to basic information – for example, a snapshot of service demands from the prior month may be as valuable as detailed data over the last year, especially when the goal is to use data to assess the impact on services that may have been affected by the COVID-19 crisis.

Finance leaders should also draw on the experience of department leaders and staff in the areas impacted by service cuts. Those employees are most often the best positioned to provide input on how the deficit-closing strategy will affect the government's constituents, including whether the impact will be felt in a small way across a large number of people or more pronounced in a smaller population. Understanding the potential service impact in this way is essential for governments focused on issues related to equity.

Where possible, leaders should collect input from the constituents most likely to be affected. Even in instances where financial needs ultimately outweigh service concerns, it is better to communicate the potential move ahead of time and give those most likely to be impacted a chance to be heard. Your constituents may even identify ways to mitigate the impact of service cuts in a way that still preserves the financial benefit.

It is also important to recognize that, in some cases, a deficit-closing technique's impact may lag when it was implemented. For example, a series of wage freezes or small wage increases may gradually erode a government's ability to retain or recruit personnel in key positions which then reduces that government's ability to provide those services.

Some initiatives may call for significant reductions in service. Government leaders need to carefully consider the varying impacts of service elimination versus reduction: for example, when it may make sense to close one recreation center as opposed to reduced hours for all of them.

Management should also consider how quickly a deficit-closing measure can later be reversed. Tax increases that are not designated for a specific purpose can produce revenue that gets "built into the base," even after the current crisis passes. On the expenditure side, some services can be switched relatively easily from in-house service to outsourcing and back again, while others are harder to reverse once an asset is sold or specialized skills are lost.

RELATED QUESTIONS INCLUDE:

- What is the impact on service levels? How can we measure the impact so that we have quantitative data to supplement what we observe and hear from our department heads and constituents?
- Who are the people most directly impacted by the strategy? Does the strategy impact a large number of people in a small way or a small number of people in a large way? Does it affect particularly vulnerable groups?
- What input can we collect from the impacted population before implementing the strategy? How will we communicate with the impacted population after the deficit-closing techniques take effect?
- How hard will it be to end or reverse the gap-closing strategy after it is enacted?

Implementation Considerations

The financial crisis that hurts a government's fiscal health will also hinder that government's ability to respond to that crisis. Some deficit-closing techniques that score well in terms of maximum financial impact and minimal operational impact may be practically difficult to do with fewer staff, less money available for technology or lower employee morale.

Leaders should consider whether they have the time, staff capacity, technology, information and other resources to effectively implement a particular strategy. For example, some fees may be difficult to implement without adding staff to issue bills, collect cash payments and pursue delinquent accounts. Other fees will be easier to implement where there is already staff and a complementary collection process in place. Selling or leasing an asset may produce a significant financial benefit, but the process may also require an investment of time and professional expertise that is difficult to muster during a crisis.

For each initiative, local leaders also need to understand whether implementation will be limited or complicated by collective bargaining agreements.

A crisis may require a government to renegotiate or modify certain terms under collective bargaining agreements or may trigger the waiver of certain provisions. Nevertheless, local leaders need to carefully consider any changes to employee compensation, work rules or staffing levels to ensure they comply with the government's collective bargaining agreements or policies that set compensation. This includes determining which changes need to be negotiated and for which employees, since that will vary by place.

RELATED QUESTIONS INCLUDE:

- What will we need in terms of staffing, technology or information to use this deficit-closing technique?
- What are the requirements or restrictions under any collective bargaining agreements, memorandums of understanding, arbitration awards or related documents? How do those provisions vary by employee group?
- Are there any foreseeable effects on the morale of employees who are on the front lines of responding to this crisis?
- What good ideas can your employee representatives bring to the table to help sustain services and jobs?

Will it Pass?

Almost all of the strategies set forth as gap-closing techniques will have to be approved by a body of elected or appointed officials, either as stand-alone measures or in the context of an annual budget or budget modifications.

When it comes to budgeting, big reforms are hard to achieve in large part because of political obstacles. That's not a problem. That's democracy. But big reforms often come from either innovation or desperation. In the case of the public sector response to the fiscal challenge created by the COVID-19 crisis, one is essential to avoid the other.

In most cases, government leaders will have to take steps that would otherwise be unthinkable in the normal political context. Nevertheless, it is critical for local leaders – including finance leaders – to understand that the elected and appointed boards that make these decisions do not have an unlimited supply of political capital.

While there can be no sacred cows in the process, clarity as to just how far political will can go is very important. Investing time and effort to develop strategies where it will be almost impossible to win approval diverts resources from other initiatives that may be more politically palatable.

Again, this does not mean that certain strategies should be dismissed simply by saying, "that will never pass." But political consideration has to be both part of how strategies are prioritized and how they are presented.

It makes sense to pursue difficult-to-pass initiatives if local leaders are able to muster the case for them in a way that reflects the extraordinary current conditions. That's why assessing the nature and size of the budget hole is so important, as are the recommended steps designed to gather hard data on the financial and operational impacts of proposed strategies. Doing nothing is not an option, and clearly illustrating the severity of the impact if no tough choices are made is fundamental for galvanizing the will needed to act. Equally as important, fully considering even politically difficult alternatives may make the case for other less draconian steps easier.

RELATED QUESTIONS INCLUDE:

- Is there enough political support for the technique to be approved and implemented?
- Are there steps that can be taken to overcome political opposition in the short-term?
- Have we provided elected officials with the information they need to explain to others why we should use this treatment?
- Would active consideration of the technique make it easier for other politically difficult techniques to be adopted?

Some Tiebreakers

At the end of the day, no matter how thoughtful local leaders are in the face of crisis, these will be incredibly difficult decisions. It will be impossible to thread the needle perfectly and create a list of initiatives that all have maximum financial impact, minimal operational impact and little implementation risk.

There will inevitably be tradeoffs between financial and operational considerations; tradeoffs between steps that are necessary to maintain short-term cash stability and those that work better from a multi-year perspective. The right answer to how to balance those competing needs will depend on the individual community.

Here are a few closing issues to consider as "tiebreakers" when making difficult decisions:

- **Which of these techniques best aligns with our long-term vision?**

  Long-term visions are often ambitious and aspirational, with a focus on what a community would like to be, rather than what it currently is. Financial distress, especially when it is immediate and acute, diverts time, money and attention from efforts that were launched in a different economic environment. Still, some deficit-closing techniques will be better aligned, or at least less detrimental, to those aspirational goals than others. Evaluating your options within the framework of where you want your community to be when this is over remains worthwhile, even if the immediate financial pressures feel overwhelming.

- **How do these techniques compare with those taken by higher or overlapping levels of government?**

  Severe financial distress manifests itself at multiple levels of government simultaneously when governments or public authorities share the same tax base or rely on the same local economy. Shortfalls at the City level may carry over to the school district or County level. Major economic downturns that impact the federal and state governments have a trickledown effect on local governments that varies depending on the level of intergovernmental aid they receive. Leaders at the local level will not be able to make decisions based solely on what is happening elsewhere, but there should be sensitivity to whether other governments will ask the same residents and business to pay higher taxes, fees or utility rates or endure reduced services.

- **How will we know our chosen strategy is working, how will we make adjustments if it isn't and how will we communicate that to others?**

  We previously emphasized the importance of communicating potential changes to the audience most directly impacted by those changes and listening to their input before those changes take effect. That guidance applies whether the impacted audience is a government's own employees, a distinct constituency that relies on a service or the taxpaying public at-large.

  After the action is taken, there should be a clear process for regularly and repeatedly communicating the results, both positive and negative, across the spectrum of financial, operational and strategic concerns that were evaluated in choosing this technique. Iterative progress reports should be candid, concise and clear.

They will be important for highlighting strategies that are working, identifying strategies that aren't and need to be adjusted, and communicating the government's plan to constituents, credit rating agencies, potential business investors, state and federal legislators and others whose support will ultimately be necessary for a successful financial recovery.

To learn more or discuss in greater detail, please contact us:

Gordon Mann | Director
manng@pfm.com | 215.557.1439