State and local government finances are sensitive to the broader economy, but the challenges are not just cyclical.

The U.S. Government Accountability Office (GAO) has developed a simulation model for the state and local sector as an entirety, projecting significant, long-term fiscal gaps absent corrective action, due largely to:

- Near-flat revenues as % of GDP
- Healthcare costs (Medicaid, employees, retirees) rising faster than the overall economy
- Pension funding pressures

*In a weaker economy, these structural challenges intensify*

In the Particular: Budget Drivers and Trajectories Can Vary Significantly

- Recognized best practice: 5-10 year long-range financial plan to create a framework for fiscal sustainability
- Typically evaluates key budget drivers and policy parameters through a baseline analysis
- Focuses on recurring revenues and expenditures and structural budget position ("carry forward")
- Assesses and addresses liabilities and long-term needs (e.g. infrastructure, unfunded retiree benefits, tax policy)
- Can be a valuable tool to develop strategies and gain buy-in for bending the curves, closing any gaps, and carving out new resources
- Also the starting point to stress test for recession readiness
Stress Test: Revenues

Cities' largest one-year operating revenue decline in the last recession varied significantly

Detroit's largest one-year revenue decline was 9.03%, just above the 9.0% breakpoint for a "weaker" score on this metric.

Sources: Moody's Investors Service, audited financial statements

Figure 8
Year over Year Change in General Fund Sales, Income and Property Tax Receipts

Sources: Moody's Investors Service, "Strong reserves, financial flexibility position most large US cities to weather a recession;" National League of Cities, "City Fiscal Conditions" (2019)
Stress Test: Operating Expenditures

Total Expenditures = Fixed Costs + [Level of Service * Cost Per Unit of Service]

How would service demands change in a recession?
- Greater demand for social services and safety nets
- Some growth-related service pressures might decline (e.g., building permit inspections)
- Are certain discretionary services and studies likely to go on hold?

How might costs per unit of service change?
- Wage pressures could moderate. How much flexibility (If under collective bargaining, when do contracts expire? Are there reopeners?)? How to evaluate and address?
- Healthcare inflation? Workers’ compensation?
- Are any major contracted services coming up for bid? Is that just a general concern or are there economic sensitivities with pricing?

What are the fixed cost constraints?
- Are they truly fixed? Even if not economically sensitive, are the prospective trends clear?
Stress Test: Fixed Costs and Liabilities

- Declining pension investment returns in a downturn would increase employer contributions (eventually)
  - Impact and timing will depend on multiple factors, for example: dependence on investment returns, assumed rate of return, smoothing method for investment returns, AVR lag to budget year, amortization method (open/closed, level dollar or level % of pay) and period, potentially offsetting changes in payroll growth, etc.

- Other Post-Employment Benefit (OPEB) funding, benefit design and risk exposure

- Debt burden and structure

- Capital Improvement Program (CIP) and related (fleet, equipment) needs

- Other non-debt liabilities, such as:
  - Internal service fund condition
  - Workers’ compensation reserves

- Other fixed costs (e.g. maintenance of effort commitments)?

Source: National Association of State Retirement Administrators (NASRA) Issue Brief (Updated February 2019)
Post-Stress Test: Now What?

- Calibrate and size reserve needs
  - Existing policy
  - Current reserve levels
  - Risk-based resizing based on exposure analysis?

- Establish spending parameters for addressing pent up demands
  - Workforce agreements / policies
  - New services

- Comprehensive Recession Readiness Action Plan to position key budget drivers and reduce overall risk

Figure 8. Median Rainy Day Fund Balance
Fiscal 2000 to Fiscal 2020

Four-Year Wage Cost Growth from a $500 Million Base, 3% Annual Increases vs. Consumer Price Index (CPI)

Sources: National Association of State Budget Officers (NASBO) Fall 2019 Fiscal Survey of the States; CPI growth rates from the Bureau of Labor Statistics, CPI-All Urban current series, 2014 Annual to 2018 Annual, not seasonally adjusted
Recession Readiness Checklist

**Stress Test**
- Develop a baseline long-range forecast
- Identify downturn scenario(s) – moderate, severe
- Analyze revenue volatility – scale and timing for key line items
- Analyze expenditure sensitivity – fixed costs, service demands, unit costs
- Evaluate reserve levels
- Evaluate the condition of internal services funds and any special reserves
- Review capital needs, fleet, and equipment condition
- Assess debt mix and structure with a municipal advisor

**Action Plan for Sustainability**
- Establish future spending parameters
- Calibrate and size reserve needs
- Position revenues sustainably through tax and fee policies and potential adjustments
- Explore rebalancing employee total compensation to improve competitiveness and reduce risk exposure
- Evaluate and develop options to improve efficiency and manage costs
- Invest in productivity improvements (e.g., energy efficiency, fleet renewal, technology)
- Address retiree benefit funding and risk exposure
- Plan for capital program sustainability
- Review debt-financing approach and policies with a municipal advisor
- Ensure that internal services funds and any special reserves are appropriately funded

**Overall Approach**
- Communicate to Build Stakeholder Buy-in