The Florida Senate

COMMITTEE MEETING EXPANDED AGENDA

BUDGET SUBCOMMITTEE ON GENERAL GOVERNMENT APPROPRIATIONS
Senator Hays, Chair
Senator Benacquisto, Vice Chair

MEETING DATE: Wednesday, February 16, 2011
TIME: 8:00 —10:15 a.m.
PLACE: *James E. "Jim" King, Jr., Committee Room,* 401 Senate Office Building

MEMBERS: Senator Hays, Chair; Senator Benacquisto, Vice Chair; Senators Bullard, Diaz de la Portilla, Hill, Jones, and Latvala

TAB	BILL NO. and INTRODUCER	BILL DESCRIPTION and SENATE COMMITTEE ACTIONS	COMMITTEE ACTION
1	Agency Presentations of Schedule VIIIB Reduction Proposals for Fiscal Year 2011-12: Dept. of Agriculture and Consumer Services Dept. of Business and Professional Regulation Dept. of Environmental Protection Dept. of Financial Services Office of Financial Regulation Office of Insurance Regulation Dept. of Lottery Dept. of Management Services Division of Administrative Hearings Florida Commission on Human Relations Public Employees Relations Commission Southwood Shared Resource Center Public Service Commission		
2	Presentation on State Spending and Budgeting by the Mercatus Center, George Mason University		
	Budget Workshop		

Department of Environmental Protection
FY 2011-12 Schedule VIII-B Reduction Proposals

15% Target Amount: $2,513,375 GR; $49,848,927 TF

Row #	Issue	FTE	General Revenue	Trust Fund	Description
1	Realign General Revenue And Permit Fee Trust Fund Positions To Federal Grants Trust Fund -Regulatory Programs - Deduct	(29.00)	(1,766,390)	(290,181)	Shifts funding of 29 FTE positions from General Revenue and Permit Fee Trust Fund to Federal Grants Trust Fund. Statutory change required to expand authorized use of service fee. General Revenue and Permit Fee Trust Fund
2	Realign General Revenue And Permit Fee Trust Fund Positions To Federal Grants Trust Fund - Regulatory Programs - Add	29.00	0	2,056,571	See above. Federal Grants Trust Fund
3	Rent Reduction - Administrative Services	0.00	0	(58,549)	Reduces rental costs from consolidation of staff and office space. Administrative Trust Fund
4	Outsourcing - Office Of Greenways And Trails	0.00	0	(272,615)	Eliminates the outsourcing labor for mowing contracts (except for Inglis and Kirkpatrick Dam for safety reasons), burning contracts and the Department of Corrections Inmate Labor contract. Conservation & Recreation Lands Trust Fund
5	Operating Budget - Chief Of Staff	0.00	0	(274,069)	Reduces expense funding in Executive Offices. Administrative Trust Fund
6	Operating Budget - Office Of The Deputy Secretary For Policy And Planning	(1.00)	0	(38,660)	Eliminates 1 FTE vacant position. Administrative Trust Fund
7	Restructure Budget Entities And Reduce Budget Office	(1.00)	0	(43,271)	Reduces 1 FTE position in Budget and Planning and consolidates certain budget entities. Administrative Trust Fund
8	Water Supply Restoration Program - Water Well And Hazardous Waste Cleanup Components - Water Resources	0.00	0	(1,600,000)	Eliminates the program that provides well construction subsidies to citizens who must drill wells in delineated areas and reduces contract funds for certain sampling of private wells and their maintenance requirements. Water Quality Assurance Trust Fund and Inland Protection Trust Fund
9	Restoration Projects - Greenways And Trails	0.00	0	(101,342)	Reduces restoration projects along Cross Florida Greenway. Conservation & Recreation Lands Trust Fund
10	Other Personal Services - Office Of Greenways And Trails	0.00	0	(77,470)	Eliminates 3 - 4 OPS positions which provide operation and maintenance support for land management. Land Acquisition Trust Fund
11	Funding And Staff For State Road Forty Visitor Center - Office Of Greenways And Trails	0.00	0	(33,683)	Eliminates 1 OPS position for the State Road 40 Visitor Center which operates through a partnership with the U.S. Forestry Service. Land Acquisition Trust Fund
12	Office Of Ecosystem Projects Coordination - Office Of The Secretary	0.00	0	(36,575)	Reduces expense funding related to implementation of South Florida restoration projects. Administrative Trust Fund
13	Transfer To Institute Of Food And Agriculture Sciences - Lakewatch - Environmental Assessment And Restoration	0.00	0	(275,000)	Eliminates the pass-through funds to the University of Florida Institute of Food and Agriculture Sciences for the volunteer citizen lake monitoring program known as Lakewatch. Internal Improvement Trust Fund
14	Ground Water Monitoring Network - Environmental Assessment And Restoration	0.00	0	(800,000)	Reduces the Groundwater Quality Monitoring Network by approximately 50 percent and eliminates 10 OPS positions resulting in the elimination of the "status network component" within the groundwater monitoring program. Water Quality Assurance Trust Fund
15	Funding And Staff For Campgrounds - Office Of Greenways And Trails	0.00	0	(281,872)	Eliminates the funding and 14 OPS positions for all Office of Greenways (OFT) managed campgrounds (two in Marion County and one in Putnam County) resulting in OGT pursuing private sector vendors to fund and operate the campgrounds. Land Acquisition Trust Fund and Conservation & Recreation Lands Trust Fund
16	Florida Springs Initiative Funding - Environmental Assessment And Restoration	0.00	0	(514,271)	Eliminates the balance of OPS budget in the Land Acquisition Trust Fund associated with the Florida Springs Initiative. Land Acquisition Trust Fund
17	Florida Natural Areas Inventory - State Lands	0.00	0	(197,947)	Reduces funds to cover contracts for scientific and technical services in land acquisition and land management activities. Conservation & Recreation Lands Trust Fund

Department of Environmental Protection
FY 2011-12 Schedule VIII-B Reduction Proposals

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Row #	Issue	FTE	General Revenue	Trust Fund	Description
18	Ambient Monitoring For Local Programs - Air Resources	0.00	0	(600,000)	Reduces OPS funds to eliminate the Ambient Monitoring grants to seven approved local air pollution control programs. Air Pollution Control Trust Fund
19	Operating Budget - Office Of Intergovernmental Programs	(1.00)	0	(101,724)	Eliminates the funding for 1 FTE position and reduces expenses in the Office of Intergovernmental Programs. Administrative Trust Fund
20	Funding and Staff For Water Control Structures - Office Of Greenways And Trails	(1.00)	0	(229,383)	Eliminates the funding for 1 FTE position and 1 OPS position for the Water Control Structures in which position responsibilities will be transferred to the appropriate Water Management District. Land Acquisition Trust Fund
21	National Ocean Survey Advisor Program - State Lands	(2.00)	0	(163,159)	Eliminates $84,000 for the National Ocean Survey resulting in the Division of State Lands (DSL) losing the matching funds from the federal government as well as cooperative grant funded programs; eliminates 2 FTE positions that support grants; eliminates 8 grant funded OPS positions; and eliminates 2 National Oceanic and Atmospheric Administration employees stationed within the DSL. Internal Improvement Trust Fund
22	Operating Budget - State Lands	(8.00)	0	(1,445,784)	Reduces operational funding, OPS staff and 3 FTE positions that support the land administration functions of the Division of State Lands. Internal Improvement Trust Fund and Conservation & Recreation Lands Trust Fund
23	Florida Recreation Development Assistance Program (Frdap) Administration - State Parks	(5.00)	0	(267,010)	Eliminates 5 FTE positions associated with managing FRDAP grants. Funding for this program has been virtually non-existent for two years and all remaining grants will expire by June 30, 2011. Land Acquisition Trust Fund
24	Merge Office Of Greenways And Trails Into Division Of Recreation And Parks	(16.00)	0	(1,078,292)	Eliminates 16 FTE positions in the Office of Greenways and Trails by merging into the Division of Recreation and Parks. Land Acquisition Trust Fund
25	Revert **Non-Recurring** Prior Year GR and Ecosystem Mgt/Rest TF Appropriations for Local Water Restoration Projects.	0.00		(43,524,381)	Reverts unexpended prior year fixed capital outlay appropriations for certain Local Water Restoration Projects and transfers the resulting fund balances to General Revenue. This proposal was requested by the Department as part of its 5% reduction (Schedule 8B1) submission. The Governor included these reversions at an amount of $41,538,575.
VIII-B REDUCTIONS NOT INCLUDED IN GOVERNOR'S BUDGET RECOMMENDATIONS					
26	Shift Funding From General Revenue To Ecosystems Management And Restoration Trust Fund - Water Resource Management - Deduct	(4.00)	(301,668)	0	Shifts funding of 4 FTE positions from General Revenue to Ecosystems Management and Restoration Trust Fund. General Revenue
27	Shift Funding From General Revenue To Ecosystems Management And Restoration Trust Fund - Water Resource Management - Add	4.00	0	301,668	See above. Ecosystems Management and Restoration Trust Fund
28	Stewardship Funds - State Lands	0.00	0	(150,000)	Reduces State Land Stewardship appropriation by 33 percent. Internal Improvement Trust Fund
29	Equipment Management Contract - Underground Storage Tank Cleanup - Waste Management	0.00	0	(670,000)	Eliminates an equipment contract used to manage the hundreds of contamination remediation systems that the preapproval program uses to clean up petroleum contaminated sites. Inland Protection Trust Fund
30	Staff Augmentation Contracts - Underground Storage Tank Cleanup - Waste Management	0.00	0	(2,600,000)	Eliminates the two contracted cleanup teams (WRS Infrastructure & Environment, Inc. and Ecology & Environment, Inc.), which are no longer necessary and will be absorbed by four in-house teams. Inland Protection Trust Fund
31	Transfer To Department Of Community Affairs / Florida Community Trust - Recreation And Parks	0.00	0	(181,602)	Reduces the transfer of funds by 15 percent to the Department of Community Affairs which administers the Florida Communities Trust two state land acquisition grant programs. Land Acquisition Trust Fund

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Row #	Issue	FTE	General Revenue	Trust Fund	Description
32	Water Management District Permitting Assistance For Water Wells - Water Resources	0.00	0	(100,000)	Eliminates funding assistance to Water Management Districts (NWFWMD - $60,000 and SRWMD - $40,000) to permit private drinking wells in delineated areas. Water Management Lands Trust Fund
33	Title V Program Contracts For Local Governments - Air Resources	0.00	0	(2,237,012)	Reduces OPS funds to eliminate the Title V grants to seven approved local air pollution control programs. Air Pollution Control Trust Fund
34	Storage Tank Compliance Verification - Waste Management	0.00	0	(6,400,000)	Reduces storage tank compliance verification inspections throughout the state and reduces frequency of inspections. Inland Protection Trust Fund
35	Local Government Cleanup Contracting - Waste Management	0.00	0	(6,000,000)	Reduces local government cleanup contracting in which counties perform oversight and monitoring activities to bring a petroleum contamination cleanup site to closure. Inland Protection Trust Fund
36	Transfers To Other State Agencies For Land Management - State Lands	0.00	0	(4,914,524)	Reduces funds by 15 percent for land management purposes that are transferred to other land managing agencies and eliminates the Endangered or Threatened Native Floria Conservation Grants Program within the Department of Agriculture and Consumer Services. Conservation & Recreation Lands Trust Fund
37	Transfer To Fish And Wildlife Conservation Commission - Law Enforcement	0.00	0	(1,679,586)	Reduces pass-through funds to the Florida Fish and Wildlife Conservation Commission. Coastal Protection Trust Fund
38	Payment In Lieu Of Taxes (PILT) - State Lands	0.00	0	(204,000)	Reduces payment in lieu of taxes funding by 15% resulting in the eligible counties and local governments receiving prorated payments based on $1.1 million instead of $1.3 million. Conservation & Recreation Lands Trust Fund
39	Geological Data Management Staffing - Florida Geology Survey	(1.00)	0	(66,161)	Eliminates 1 FTE position which will be absorbed by current staff. Minerals Trust Fund
40	District Education and Training Program - State Park System	(5.00)	0	(237,130)	Eliminates 5 FTE positions (1 FTE position at each of the 5 park districts) which provide education and training for district personnel and shifts training to headquarters staff. State Park Trust Fund
41	Bureau Of Design And Construction - Recreation And Parks	(5.00)	0	(300,602)	Eliminates 5 FTE positions as a result of reduced fixed capital outlay funding from previous years. State Park Trust Fund
42	Operating Budget - Office Of Inspector General	(3.00)	0	(311,946)	Eliminates 3 FTE positions in the Office of Inspector General; reduces OPS funding; expense funding; and funding in the Petroleum Cleanup Audits special category. Administrative Trust Fund and Inland Protection Trust Fund
43	Transfer Non-State Owned Parks To Owner - State Park System	(5.00)	0	(351,044)	Eliminates 5 FTE positions as a result of the transfer of three non-state owned parks to their owners. State Park Trust Fund
44	Coastal Research Program - Florida Geological Survey	(3.00)	0	(186,078)	Eliminates 3 FTE positions which would eliminate the Florida Geological Survey Coastal Research Program and reduces operating capital outlay and expense funding. Minerals Trust Fund and Water Quality Assurance Trust Fund
45	Geological And Geotechnical Data Acquisition Program - Florida Geological Survey	(3.00)	0	(155,606)	Eliminates 3 FTE positions and 1 OPS position which supports the geologic research program; reduces operating capital outlay funding; and expense funding. Minerals Trust Fund and Water Quality Assurance Trust Fund
46	Park Operated Concessions Programs - State Park System	(24.50)	0	(3,515,225)	Eliminates 24.5 FTE positions as a result of proposing to outsource concession programs at five state parks and headquarters to private vendors. State Park Trust Fund
47	Law Enforcement Operational Funding - Bureau Of Environmental Investigations	(13.00)	0	(870,919)	Eliminates 13 law enforcement agent positions in Environmental Investigations. Coastal Protection Trust Fund, Inland Protection Trust Fund and Solid Waste Management Trust Fund

Department of Environmental Protection
FY 2011-12 Schedule VIII-B Reduction Proposals

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Row #	Issue	FTE	General Revenue	Trust Fund	Description
48	National Estuarine Research Reserves And Florida Aquatic Preserves Program - Coastal And Aquatic Managed Areas	(13.00)	0	(1,002,703)	Eliminates 13 FTE positions and 9.5 OPS positions as a result of proposing to close six aquatic preserve offices. Land Acquisition Trust Fund
49	Law Enforcement Operational Funding - Emergency Response	(4.00)	0	(555,105)	Eliminates 4 FTE positions in Emergency Response and reduces special category contingency funding. Coastal Protection Trust Fund and Inland Protection Trust Fund
50	Law Enforcement Operational Funding - Bureau Of Park Police	(17.00)	0	(1,010,714)	Eliminates 17 FTE law enforcement positions which provide Park Police. Land Acquisition Trust Fund
51	Tallahassee And Sebring Regulatory District Branch Offices	(19.00)	(140,045)	(837,231)	Eliminates 19 FTE positions as a result of proposing to close the Sebring and Tallahassee regulatory district branch offices. Administrative Trust Fund, Air Pollution Control Trust Fund, Ecosystem Management & Restoration Trust Fund, Inland Protection Trust Fund, Internal Improvement Trust Fund, Land Acquisition Trust Fund, Permit Fee Trust Fund and Water Quality Assurance Trust Fund
52	Park Closures - State Park System	(22.00)	0	(6,480,644)	Eliminates 22 FTE positions and OPS funding as a result of proposing to close 53 "day use only" state parks with the lowest attendance (fewer than 60,000 visitors per year) thereby reducing park system revenue by $911,179 and park visitation by 1,099,650 based on FY 2009-10 data. State Park Trust Fund and Conservation & Recreation Lands Trust Fund
		(172.50)	**(2,208,103)**	**(90,964,831)**	

Florida Commission on Human Relations

Resolving discrimination allegations faster, better, and less costly for businesses and the state of Florida

Presented by:

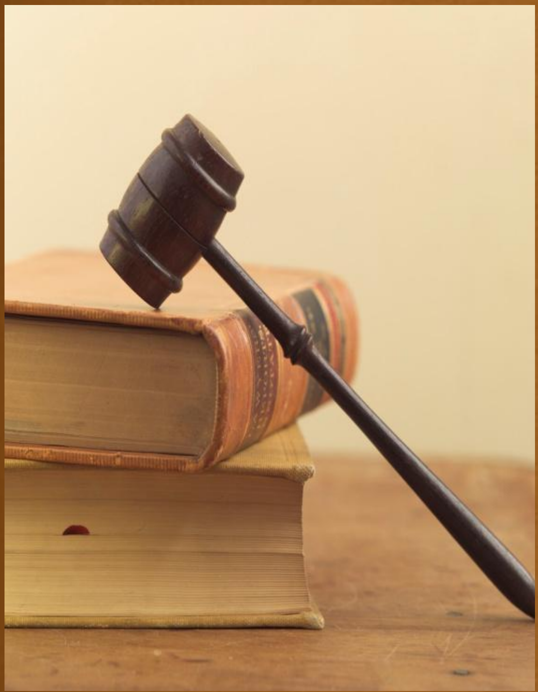
Michelle Wilson, Budget Officer

CORE FUNCTION OF STATE GOVERNMENT

"We, the people of the State of Florida, being grateful to Almighty God for our constitutional liberty, in order to secure its benefits, perfect our government, insure domestic tranquility, maintain public order, and **guarantee equal civil and political rights to all**, do ordain and establish this constitution." *Article I, Section 2 of the Florida Constitution*

Protecting people's RIGHTS is a CORE FUNCTION of Florida state government. Florida's Constitution: Section 2, Article I states that … *No person shall be deprived of any right because of race, religion, national origin, or physical disability*.

AUTHORITY TO RESOLVE DISCRIMINATION ALLEGATIONS



- Florida Civil Rights Act and Florida Fair Housing Act (Chapter 760); Whistle-blower Retaliation for State Employees (s. 12.31895, F.S.)

- Areas Protected by Statute: Race, color, religion, sex, national origin, age, disability, marital status, familial status, retaliation

- Strategic Goals: Help businesses and the state avoid costly discrimination lawsuits and attract the best and brightest talent to Florida's workforce

FLORIDA COMMISSION ON HUMAN RELATIONS

FCHR

ACCOUNTABILITY MEASURES

- Assisted over 400 businesses avoid paying more than $51 million in litigation costs
- Issued 2,825 "no cause" determinations within 180 days
- Investigated, mediated and closed over 3K cases during FY 09-10
- Processed over 13K inquiries during FY 09-10
- Resolved cases within 180 days by 86% during FY 09-10
- Rate of Return: 344% (since 2006)

FISCAL YEAR 2010-11

- **53.5 FTE's**
- **General Revenue: $3,209,824**
- **Trust Fund: $1,176,955**
- **Funds Transferred to Other State Entities:**
  - **$802,572 - DOAH (administrative hearing services)**
  - **$55,630 - Risk Management Insurance**
  - **$22,714 - DMS (personnel services)**
  - **$43,896 - State Technology Office**
  - **$924,812 transferred to other agencies**

MEASURES TAKEN TO REDUCE BURDEN ON TAX PAYER

- 27% FTE Reduction
- Renegotiated private lease twice
- Renegotiated Copier leases
- Reduced Cell Phone Usage
- Reduced office supply purchases
- Reduced paper usage
- Eliminated subscriptions
- Reduced Technology Costs
- Reduced Postage
- Reduced non-essential travel costs
- Flattened management structure

FY 11-12 REDUCTION PROPOSAL

- #1: Trust Fund Revenue - $5,100
- #2: Reduce OPS Funding - $21,002 General Revenue
- #3: Eliminate Expense Budget - $52,670 General Revenue
- #4: Fund shift a position from the General Revenue Fund to the Operating Trust Fund - $52,562
- #5: Eliminate 5 Positions - $254,269

Target Reduction Amount (15%)

GR $350,737

TF $5,100

IMPACT OF SEVERE BUDGET CUTS

- Significant reductions will paralyze FCHR and decrease the number of cases resolved within 180 days

- The State of Florida and businesses would have to concede to the Federal Equal Employment Opportunity Commission to resolve cases

- Continued negative impact to Risk Management Trust Fund

Questions

Contact: Derick Daniel, Executive Director

(850) 488-7082

Website: http://fchr.state.fl.us

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SOUTHWOOD SHARED RESOURCE CENTER

Schedule VIII-B Reductions

FY 2011/12

TIER III FACILITY™
State of Florida
SSRC
November 18, 2008
UPTIME INSTITUTE CERTIFIED

Reduction of Trust Fund in Operational Categories

- These are projected reductions across all funding categories resulting from proposed consolidation and standardization efforts, a computing on demand concept, removal of the graphics service, deletion of one staff augmentation position, reduced operating plans and a shift of base budget indirect costs to future customers.

- Working Capital Trust Fund Budget $21,440,480
- 15% Target $3,216,072
- Identified Reductions Total $3,216,072

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Mainframe Software Consolidation

- Mainframe software is currently being reviewed for consolidation and may net a savings of $700,000. Mainframe software currently costs over $4 m. Very optimistic estimates anticipate savings up to 18%. If any one mainframe customer balks at the consolidation or if estimated savings from software vendors is unrealized then these savings could dramatically reduce to less than $400,000.

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Minimal Operating Plan

- This savings projection of $611,600 represents a minimal operating budget. The risk would be the inability to absorb new unplanned service costs, emergency or equipment replacement (refresh) costs to maintain production, and infrastructure investments to support consolidation and standardization initiatives.

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Delete Graphics Section

- This savings of $163,305 is result of transferring the Graphics Department from the SSRC to Executive Order of the Governor (EOG).

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Delete Staff Augmentation Position

- This saving of $161,700 is the result of elimination of one Oracle Data Base Administrator contractor position.

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Shift of Indirect Costs

- This estimated cost shift of $300,000 is the result of indirect costs shifting from current base budget customers to new customer agencies Department of Corrections (DOC) & Department of Transportation (DOT) costs. This estimate could vary greatly depending on costs and utilizations brought into the SSRC by these new customers.

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Utility Computing Initiative

- This estimated savings of up to $600,000 may result from the implementation of utility (capacity on demand) computing. The estimate is based on 1,500 servers including current managed systems, Shared Transitional Service (STS), DOC and DOT servers with a reduced operating cost savings per server of $400. This utility computing concept is in its initial development stage. Therefore, there are numerous unknown design and implementation time factors, vendor pricing and costs. This optimistic estimate could be negatively impacted by the final design, pricing and costs.

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Distributed Systems Infrastructure Consolidation

- This estimated savings of up to $679,467 may result from the implementation of data center wide consolidation of hardware and software across Windows, Oracle, Storage (Storage-Across-Network (SAN)) and Backup production platforms. Each of these platforms could realize over $100,000 in savings through consolidation and standardization. These savings would be contingent upon cooperation by the affected agencies and their ability to modify production applications to run in the standardized environment if needed. Additionally, in order to realize these future savings an up-front investment to build the standardized infrastructure for these disparate systems would be required.

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Bridging the gap between academic ideas and real-world problems, Mercatus brings scholarly research to bear on policy questions, acquaints scholars with the real-world complexities of market and political processes, and trains graduate students in how sound economics offers solutions to society's most pressing problems. For over a decade, we have shared how academic knowledge addresses current issues in seminars, lectures, courses, and consultations for policy makers, opinion shapers, and the public.

SEVERAL PROGRAMS AT MERCATUS CONSIDER CONTEMPORARY ISSUES.

The Spending and Budget Initiative draws on a team of university economists and policy practitioners with diverse expertise in government spending and budget reform, assembled to provide policy makers an honest understanding of budgets, spending, deficits, and debt and how these issues relate to economic growth and progress.

The Technology Policy Program works within the university setting to improve the state of knowledge and debate about the regulation of the Internet and high technology.

The Financial Markets Working Group draws on Mercatus's long-standing expertise in economic and regulatory analysis to conduct research on the causes and potential solutions to the economic downturn, offer productive ideas to address the serious problems in financial markets, and encourage a sustainable economic recovery.

The Regulatory Studies Program works to improve the state of knowledge about regulations and their effects on society, market-based alternatives that achieve regulatory goals, and the overall performance of the regulatory process.

Located on George Mason University's Arlington campus, the Mercatus Center is a 501(c)(3) tax-exempt organization.

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MERCATUS ON POLICY

SEVEN KEY ASPECTS OF GOVERNING DURING CRISIS

By Maurice McTigue
and Daniel M. Rothschild

MERCATUS CENTER
George Mason University

As of March 2010, 49 states faced budget deficits totaling $174.1 billion for the current fiscal year, with higher deficits on the horizon.[1] Largely due to federal stimulus dollars, mid-year spending reductions, and some creative accounting gimmicks, states technically complied with their constitutional requirements to balance their budgets in 2009–2010. [2] These options however will likely not all be available for the next fiscal year.[3] Moreover, many of these accounting practices are of dubious ethical and accounting value and only serve to postpone dealing with current problems at a higher future cost.[4]

This paper presents a toolkit of seven ideas and procedures for state policy makers to evaluate budget shortfalls and find opportunities for reform. Drawing on domestic and international experiences, we believe the current gap between revenues and expenditures presents policy makers with an opportunity to reevaluate the functions and business practices of their state governments, not only to survive the current economic downturn, but in order to thrive in its aftermath.

Policy makers should shift their focus from addressing symptoms—the disparity between revenues and expenditures—to ameliorating underlying problems. States must seek permanent solutions that will encourage economic growth and bear dividends today and into the future, making their states more economically competitive, employment-rich, and better able to weather future fiscal storms.

1. ADDRESS THE PROBLEM, NOT THE SYMPTOMS.

The problem facing states today is unsustainable spending levels, which resulted from state revenue forecasts that did not anticipate the current downturn.[5] Most states have seen revenues fall significantly below projections in the last two years.[6] In virtually all states, spending has increased for the past two decades at a rate that exceeds growth in income plus growth in residents.[7] According to one calculation, between 2002 and 2007, total revenue to all states' general funds grew by twice the rate of inflation, increasing state revenues by $600 billion.[8] Data from the U.S. Census Bureau show that state and local government revenues increased from $1.32 billion in 2000 to $1.94 billion in 2008, and expenditures increased from $1.27 billion to $2.02 billion over this period.[9] These figures suggest that legislatures largely spent this windfall rather than refunding the surplus to taxpayers.

> Because the budget deficits they face are caused by spending and not by revenue decllines, states must constrain spending in the future.

Because the budget deficits they face are caused by spending and not by revenue declines, states must constrain spending in the future. There are three ways states can achieve this fiscal objective.

a. Take surplus revenue off the spending table.

State spending has grown significantly over the last decade, with many states adding or expanding various spending programs with insufficient attention to whether these hikes are sustainable. Legislative devices like Oregon's "Kicker Law" that send surplus revenue to taxpayers or a rainy day fund may be an effective way to help keep spending on a sustainable trajectory.[10]

b. Define and implement responsible budgeting practices.

Legislators should quantify what responsible budgeting looks like so that the public can hold them accountable. Rules that define responsible budgeting give the public a yardstick against which to judge their legislators' spending behavior. Texas's constitutional Tax and Expenditure Limitation (TEL), for example, prohibits expenditure growth in excess of growth in per capita income.[11]

c. Tie spending growth to population or economic growth.

Policy makers should consider enacting tax and expenditure limitations that tie spending increases to the rate of inflation plus population growth, keeping expenditure constant in real terms on a per capita basis, unless overridden by voters.[12] Alternatively, policy makers may choose to link spending to gross state product (GSP) growth or some other measure outside their direct control.

2. PRIORITIZE. FOR REAL.

Ranking government expenditure in order of priority would dramatically improve the debate over which activities get more or less funding in a given budget. David Osborne and Peter Hutchins, in their book *The Price of Government: Getting the Results We Need in an Age of Permanent Fiscal Crisis*, stress the importance of holding revenues fixed and determining what services governments can buy for that price.[13] We would take this a step further and recommend that states find ways to restrain spending growth when revenue increases.

3. DEMAND INCREASED PUBLIC SECTOR PRODUCTIVITY.

Most states begin their budgeting processes by assuming that every department, division, agency, and office should start with the previous year's budget and add some additional funds; this is commonly known as "incremental budgeting." This practice neither rewards effective performance nor discourages inefficiency. A prerequisite for an item to appear in a budget request should be evidence of the scale and value of the previous year's outcomes.

One way states can adopt this rule is by implementing productivity dividends. Pioneered by New Zealand in the 1980s, productivity dividends assume that, just as the labor productivity of the private sector increases over time, so should the labor productivity of the public sector.

For example, output per labor hour in the non-farm U.S. private sector increased by about 2.17 percent per year between 1988 and 2008.[14] This means that the average worker in 2008 was producing about 54 percent more output than she was in 1998 per hour worked. To implement a productivity dividend then, a government reduces budgets automatically by a small

FIGURE 1: OPTIONS FOR CONSTRAINING GOVERNMENT SPENDING

Goal	Description
Hold growth rates constant.	Tie spending growth to economic growth as measured by gross state product.
Have a zero percent growth rate.	Tie spending to inflation and population growth, holding it constant on a real per capita basis.
Reduce absolute spending.	Demand productivity gains, requiring agencies to hold results constant while reducing inputs.

amount every year—around 2 percent in nominal terms—and requires agencies to produce the same results with their slightly smaller budgets.

4. REFORM THE CIVIL SERVICE.

Policy makers should consider modernizing state civil services. In most states, the terms and conditions of government employment are based on an industrial-era model of public sector production. In the 21st-century knowledge economy, this model is outdated. Decreasing the hundreds or even thousands of overly specific job descriptions, relaxing the rigid pay bands, and reforming the inflexible hiring and dismissal procedures would improve the quality of management and productivity in government while shrinking its expenses. A "21st-century civil service" would base pay and performance requirements on private sector labor-market equivalence.

5. REVIEW ALL OPERATIONS.

A critical review of all the operation and programs funded by a state can uncover economies of scale, obsolete programs where costs exceed benefits, and opportunities to streamline state operations. That is, such a review could find opportunities to prioritize, rationalize, economize, and privatize.[15]

In 2009, Louisiana created a Commission on Streamlining Government, which issued in January 2010 a report with 238 specific recommendations that if enacted would save the state hundreds of millions of dollars.[16] That work contributed to the governor proposing a budget for fiscal year 2010–11 that was 19 percent under that passed for fiscal year 2009–10.[17] In addition, there are now 89 bills in the legislature arising from this commission's recommendations designed to improve the way the state of Louisiana does business and to provide better services and value to taxpayers and citizens.[18]

6. DELIVER GOODS AND SERVICES, NOT FAVORS AND HANDOUTS.

Governments have a duty to taxpayers to buy goods and services from the best providers. In some cases it may be best for states to provide goods and services directly, while in others it may make more sense for states to contract with private providers or to provide citizens with vouchers for certain goods or services that they can spend as they choose in the marketplace.

For instance, there may be no good reason for each department in a state to have its own legal department, accounting service, purchasing unit, payroll function, and data collection and storage facility. In many cases, some departments could easily purchase these services from other departments within the state, creating cost and efficiency gains.

Policy makers should differentiate between desired benefits and methods of delivery; the one does not equate with the other. For example, just because state governments pay to maintain roads does not mean that it's necessary for them to own the machinery required for filling potholes or to pay the people involved in maintenance directly. It may (or may not) be better value for taxpayers to contract with outside firms to build and maintain roads. Policy makers should maintain a philosophy of buying goods and services from the best providers.

7. REPEAL BAD IDEAS.

Not infrequently, interest groups oppose policy innovations on the premise that existing laws forbid implementation. Policy makers should remember that they can repeal laws in favor of new and better ideas. Simply because a statute enshrines a policy does not mean that the policy cannot be improved. Every field of study and practice from medicine to engineering constantly refines its methodologies and techniques; law and public policy should be no different. Policy makers should not be constrained by current policies just because they are the current policies.

Every field of study and practice from medicine to engineering constantly refines its methodologies and techniques; law and public policy should be no different.

CONCLUSION

States are facing severe budget shortfalls, and at the time of this writing, it appears likely they will get worse before they get better. Legislatures nationwide are in a tight spot. But if states reevaluate their functions and business practices in the process of closing the gap between expenditures and revenues, they will be well-positioned to thrive in the future and avoid the hangovers of overspending.

ENDNOTES

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2. All states except Vermont are required by their laws or constitutions to balance their budgets for each fiscal year.

3. Fiscal gimmickry included pushing state payrolls off by 24–72 hours to book them in another fiscal year, accelerating income tax payments, delaying checks due to citizens for tax refunds, withholding payments to vendors, forcing local governments to loan money to the state treasury, diverting fees collected for one purpose to another unrelated function, and refinancing state debts in ways that will increase taxpayer liabilities over the long term.

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5. For more information, see National Governors Association and National Association of State Budget Officers, *Fiscal Survey of States, Fall 2009*, http://tinyurl.com/fss-f09; National Association of State Budget Officers, *State Expenditure Report 2008* (2009), http://tinyurl.com/ser08.

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8. Ibid.

9. Authors' calculations based on U.S. Census Bureau, *Statistical Abstract of the United States 2010*, table 418, State and Local Governments—Summary of Finances, http://www.census.gov/compendia/statab/cats/state_local_govt_finances_employment.html. These figures are in nominal terms; that is, they have not been adjusted for inflation.

10. Oregon Constitution, art. IX § 14 (added November 2000).

11. Texas Constitution, art. VIII § 22(a) (added November 1978).

12. For more on the different types of tax and expenditure limitations, see Emily Washington and Frederic Sautet, *Tax and Expenditure Limits for Long-Run Fiscal Stability*, Mercatus on Policy no. 61 (Arlington, VA: Mercatus Center at George Mason University, 2009); Eileen Norcross and Emily Washington, "Tax and Expenditure Limitations—A Survey," forthcoming.

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15. A Mercatus on Policy addressing best practices for streamlining commissions is forthcoming.

16. The commission's reports are available at http://senate.legis.state.la.us/streamline/c_reports.htm.

17. Bobby Jindal, *Governor's Executive Budget, Fiscal Year 2010–11*, http://www.doa.louisiana.gov/opb/pub/FY11/FY11ExecutiveBudget.pdf.

18. In May 2009, Virginia Governor Bob McDonnell announced the formation of a similar commission for that state, on which one of the authors (McTigue) serves as a member.

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MERCATUS ON POLICY

ELEVEN IDEAS FOR STATE LEGISLATURES IN 2011

By Daniel Rothschild

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ACROSS THE COUNTRY, state legislatures and governors are looking for opportunities to reduce spending and fill revenue holes as state budget deficits totaled some $191 billion and $130 billion in the 2010 and 2011 fiscal years, respectively.[1] States should seize this opportunity and go beyond merely duct-taping together a budget that limps across the fiscal-year finish line. They should explore opportunities for fundamental reform of state spending, budget, and management practices. Below are eleven bold reform ideas that could help states balance their 2012 budgets and avoid boom-and-bust budgeting cycles in the future.

1. Assess your future liabilities accurately.

For decades, states have understated their liabilities by assuming unrealistic returns, in many cases exceeding 8 percent annually.[2] These assumptions were unrealistic when they were made and led to legislatures making impossible promises to state workers about their future benefits. Nationally, state and local pension funds are underfunded by an estimated $3 trillion.[3]

In order to develop an accurate understanding of the states' long-term fiscal health, policy makers should require pension authorities to measure and report on pension liabilities based on the market value of liabilities (MVL), which properly account for the guaranteed nature of state pensions. Accurately evaluating the situation is a critical first step for assessing future obligations.

2. Control your spending through meaningful tax and expenditure limits.

Twenty-seven states have tax and expenditure limitations (TELs) on their books, yet few states have controlled spending effectively. While TELs may be ineffective or even encourage spending growth in higher-income states, many states would benefit from having TELs that would tie spending growth strictly to the rate of inflation plus population growth.[4] While there is no one-size-fits-all model, if a state does decide institute a TEL, it should codify the TEL constitutionally, focus the TEL on spending rather than revenue, refund excess surplus revenues to taxpayers, and require a high bar for override.

3. Institute an item-reduction veto.

Many states have line-item vetoes, which allow governors to veto specific lines in spending bills. But few policy makers are familiar with the item-reduction veto, which allows governors to reduce spending on particular programs. Instead of forcing the governor to either accept or reject a spending item outright, the item- reduction veto allows the governor to reduce the amount appropriated.[5] Historically, the presence of an item-reduction veto has reduced per-capita state spending by an average of 14 percent.[6]

4. Use purchase agreements rather than blind appropriation.

New Zealand introduced purchase agreements in the 1990s to increase transparency and accountability.[7] These agreements stipulate in detail the outputs the government is purchasing in terms of price, quantity, quality, and timeliness, allowing policy makers and the public to better see the link (or lack thereof) between expenditures and desirable results. For instance, one could see how many miles of road at what quality were built over what period.

By linking funding decisions to actual results, policy makers get a better idea of the relationship between appropriations and desirable results. This is true accountability as opposed to traditional appropriation, which defines accountability by whether the government spent the money as policy makers intended—not whether the money achieved the desired ends.

5. Demand productivity dividends.

States typically use what is commonly known as "incremental budgeting" to allocate funding, giving an agency or department the same budget it had the year before plus some additional funds. This practice neither rewards increased performance nor discourages inefficient practices.

States that want increased public-sector productivity should consider implementing productivity dividends.[8] Pioneered by New Zealand in the 1980s, productivity dividends assume that public-sector labor productivity, like private-sector labor productivity, should increase gradually over time. Thus, the government *reduces* nominal budgets by a small amount—perhaps around 2 percent—requiring agencies to produce the same results with smaller output (exempting transfer payments).

6. Eschew "temporary" federal grants.

For the last two years, states have relied extensively on temporary federal funding to plug their budget gaps. The American Recovery and Reinvestment Act (ARRA, also known as the economic stimulus) provided $212 billion to state and local governments.[9] But temporary federal aid to states prompts both state and local governments to increase taxes when federal funds dry up. According to recent research, each dollar of aid prompts future state sales tax increases of 33 to 42 cents and local government tax and fee increases of 23 to 46 cents.[10] In other words, temporary federal grants today lead to tax increases tomorrow.

Moreover, the strings that come attached to federal funds undermine state sovereignty and the concept of states as policy laboratories. State reliance on federal bailouts undermines federalism by allowing Congress effective control over state spending.[11]

7. Review operations through an independent commission.

When independent commission review the operations, programs, and policies of state governments, they often help identify opportunities for streamlining operations, eliminating ineffective programs, and refocusing state governments on their critical core missions. Such commissions work best when they have clear goals, a reasonable timeframe, a parsimonious but well-selected membership, and the support of the executive branch.[12]

A group of experts and seasoned practitioners from the public sector, nonprofits, and the business community can solicit suggestions from state employees, vendors, academics, and the public at large and make research-based recommendations for opportunities to reduce costs and refocus the state government on its critical core missions.

8. Make unemployment benefits work for workers.

Unfortunately, when the unemployed are most in need of help, governments have the least revenue to spare. The current recession has been no exception, revealing significant problems with the unemployment insurance programs of many states, the chief problem being that in many states these programs are approaching insolvency.

States that want to provide a real safety net for workers during economic downtimes should consider, with federal consent, revising their unemployment insurance programs to create private unemployment savings accounts.[13] Workers and employers would contribute to these accounts, which workers would draw down during unemployment or family and medical leave. Young or long-term unemployed workers with depleted unemployment savings accounts would be eligible for loans. In addition to empowering workers, these accounts would reduce

11 IDEAS FOR STATE LEGISLATURES IN 2011 CHECKLIST

- ☑ Assess your future liabilities accurately.
- ☑ Control your spending through meaningful tax and expenditure limits.
- ☑ Institute an item-reduction veto.
- ☑ Use purchase agreements rather than blind appropriation.
- ☑ Demand productivity dividends.
- ☑ Eschew "temporary" federal grants.
- ☑ Review operations through an independent commission.
- ☑ Make unemployment benefits work for workers.
- ☑ Allow innovative sub-local governance.
- ☑ Stop using fiscal evasion.
- ☑ Reform your public pensions.

states' fiscal liabilities during economic downturns, provide more certainty and fairness, and reduce the unintentional perverse incentives of current unemployment policies.[14]

9. Allow innovative sub-local governance.

States organize local governments in a number of different ways due to size, population patterns, tradition, and other factors, but few states allow significant sub-local government organization. However, sub-local governments may be more responsive to neighborhood needs and wants, and they may be able to provide public services more efficiently than city or county governments.[15] The most common such organization is the business improvement district (BID), but urban scholars have suggested extending the idea to residential improvement districts (RIDs) and other innovative patterns of local government.[16] States could poll county and local governments about whether such innovations might be appropriate and, if so, what legislative changes would be required.

10. Stop using fiscal evasion.

For decades, but especially over the last two years, states have resorted to fiscal gamesmanship to make unbalanced budgets appear to be prudent.[17] This not only causes taxpayers to believe that the costs of government services are much lower than they actually are, but it creates unseen and unknown fiscal liabilities for future legislatures and taxpayers. This "fiscal evasion"—including school-aid cuts, tax and pension holidays, delayed tax refunds, and delayed vendor payments—encourages and enables boom-and-bust budgeting.

11. Reform your public pensions.

Nationally, state and local pensions are underfunded by as much as $3 trillion—a figure some three times as high as total explicit state debt.[18] Almost all state and local governments provide defined benefit plans, while few such plans exist in the private sector.

States should reform their pension systems, enrolling all nonvested workers in defined contribution plans.[19] This change would not only clarify the liabilities of retirement plans, but it would also give state workers more freedom to change jobs and move between the public and private sectors since they can roll over contributions between jobs.

In addition, states with heavily unfunded pension liabilities should consider increasing employee contributions, reducing future benefit accumulation, reducing cost of living adjustments (COLAs), and raising retirement ages. Failure to do so puts off the day of reckoning for underfunded plans and ultimately makes fixing the problem more costly.

CONCLUSION

In this time of plummeting revenues and uncertain futures, legislatures face the daunting task of keeping their states running, paying obligations to vendors and workers, maintaining a social safety net, and making good on promises to retirees. States are not entirely the victims of a declining economy however. Much of today's pain is a hangover from spending binges over the last two decades.

The hair of the dog—in the form of increased spending—is not the cure for this hangover. To ease current and avoid future pain, states need to reform not just their 2012 budgets, but their spending processes going forward by employing innovative policies and focusing state governments on their core purposes and capabilities. Only then can they ensure that their long-run spending and revenues are sustainable and that they can fulfill the promises made to taxpayers and public-sector employees today and in the future.

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10. Ibid.

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13. Eileen Norcross and Emily Washington, "The Costs and Consequences of Unemployment Benefits on the States," *Mercatus On Policy* 67 (January 2010).

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MERCATUS ON POLICY

SPENDING RESTRAINT IN FLORIDA

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Following the economic collapse of 2008, almost every state in the Union faced a significant budget shortfall. Florida was no exception. Yawning budget gaps plagued the state budget in 2009 and 2010.[1] Though the recession was the proximate cause of the gaps, decades of overspending spawned Florida's fiscal woes. Furthermore, the predicament was avoidable. If Florida had held spending constant for the last 20 years while adjusting for inflation and population growth, it would have avoided its 2009 budget gap. Moreover, the state can avoid future budgetary problems by restraining the growth of spending, permitting Floridians greater economic freedom, and adopting stronger balanced-budget requirements.

BUDGET GAPS

In 2009, Florida faced a $5.7 billion budget shortfall, equal to 22 percent of its General Fund.[2] As soon as the state closed that gap, however, another emerged in 2010. In order to close the gaps, Florida enacted a number of emergency measures, including fee increases, tax hikes, and spending reductions. For instance, the state increased new car registration fees by 35 percent, raised its cigarette tax by $1 per pack, increased its tax on real property transfers, and decreased spending on transportation and corrections.[3] Each of these decisions created hardship for Floridians as they encountered unanticipated costs and reduced services.

The recession was the proximate cause of Florida's budget gaps and its citizens' pain. When the economy contracted in late 2008 and 2009, state revenue fell precipitously. At the same time, demand for the state's welfare services increased, generating the nation's 11th-largest budget gap in 2009. But the recession was not the only cause for this gap. Though all states experienced the recession, not all states encountered large gaps. Recent research indicates that the following policies in particular contributed to large budget gaps:

- Growth in per capita spending during the decades preceding the recession.[4]
- Low levels of economic freedom, characterized by onerous regulation or burdensome government activity.
- Weak balanced budget requirements.[5]

All three of these policies contributed to Florida's gap.

Spending Growth

In 1987, Florida spent $2,666 per citizen.[6] In 2007—the year before the recession—the state spent $3,772 per citizen.[7] Thus, even after adjusting for inflation, the state increased per capita spending 41 percent over 20 years. This might not have been a problem if the state's economy had grown as quickly, but it didn't. Over the same period, inflation-adjusted per capita personal income increased only 32 percent. Growth in state government spending therefore outpaced growth in state income by nearly 30 percent. Because the state relies on the private sector for its revenue, such a spending path is unsustainable. If, however, Florida had maintained its inflation-adjusted per capita spending level of 1987, it would have avoided its 2009 budget gap.

Economic Freedom

People are said to enjoy economic freedom when their persons and property are protected by the rule of law and when they are permitted personal choice, voluntary exchange with others, and freedom to compete in markets.[8] Political scientists William Ruger and Jason Sorens have developed a measure of each state's level of economic freedom.[9] Taking into account factors such as state spending, regulation, and tax policies, Sorens and Ruger rank Florida the 22nd-most economically free state in the Union.

As with limited spending growth, econometric tests show that Sorens and Ruger's measure of economic freedom is associated with smaller budget gaps.[10] If Florida exhibited the same level of economic freedom as the freest states (such as South Dakota, New Hampshire and Colorado), its 2009 budget gap would have been 37 to 47 percent smaller.[11]

Strict Balanced-Budget Requirements

A number of researchers have investigated the stringency of state balanced-budget requirements.[12] These requirements can be more or less strict depending on whether they apply to proposed or enacted spending, whether they permit deficits to be carried over to the next year, and whether an independently elected high court evaluates the legislature's compliance with these requirements. While Florida meets the first two criteria, its Supreme Court members are politically appointed, resulting in less-strict state balanced-budget requirements.[13] Research shows that states with balanced-budget requirements such as Florida's tend to have budget gaps that are 35 to 45 percent larger than states with stronger balanced-budget requirements.[14]

THE PROBLEM OF OVERSPENDING

Florida can close its budget gap in the short run by raising taxes or cutting expenses. However, the state cannot solve its long-term budgetary problems merely by raising taxes.

First, taxes are economically costly. In a review of the literature, economist Timothy Bartik found that, according to the median estimate, a 10 percent increase in state taxation is associated with a 3 percent reduction in business activity such as employment, firm births, and investment.[15] Thus, a state that raises taxes to close its deficit substitutes one problem for another.

Moreover, a number of studies suggest that tax increases lead to further spending increases.[16] This is because government spending tends to adjust to whatever resources are available. Thus, if a state addresses its budget gap by raising revenues, it often increases total expenditures in the years that follow. And because expenditure increases eventually result in larger budget gaps, attempts to rectify revenue shortfalls with tax increases may be self-defeating.[17]

Lastly, as noted above, Florida spending has outpaced private-sector growth for several decades. Even if the state were to continually raise taxes enough to keep pace with spending growth, this is not a sustainable solution. Prudent fiscal reform must address the persistent problem of overspending.

MECHANISMS TO LIMIT SPENDING

As Florida policy makers search for mechanisms to rein in spending, they have several options. Studies have shown that a number of institutions can limit state spending.[18] One option is a supermajority vote requirement for all tax increases. Florida currently requires a supermajority vote in the legislature to raise its corporate income tax. If the state applied this requirement to all tax increases (as ten states currently do), it would provide a powerful restraint on future spending increases.[19]

An executive line-item reduction veto is another option. This type of veto—present in 12 states—permits the governor to write in a lower spending amount for particular items in the budget.[20] In contrast with the more-conventional veto power in which the governor must veto an entire item if he objects to its cost, the line-item reduction veto has been shown to be a significant tool in limiting spending.

Strict balanced-budget requirements (as described above) are another option. Recent research has shown that these too can be a significant break on spending.

Certain tax and expenditure limitations can also limit state spending. In the next section, we explore one such limit in detail.

TAX AND EXPENDITURE LIMITATIONS

A TAX AND expenditure limitation (TEL) is a formal rule that limits state spending or revenue growth by formula. Thirty states (including Florida) operate under such rules, but the structures of their TELs vary considerably.[21] Many, such as Florida's, are based on growth in state income. Florida's rule limits state revenue growth to the average growth rate of state personal income over the previous five years.[22]

Florida illustrates the problem of an income-based limit: When state income is rapidly expanding—as during a housing boom—the limit is not limiting. It simply grows with the rate of income. In contrast, one of the most restrictive TELs limits spending growth to the sum of inflation and population growth.[23] In other words, it holds real per capita spending constant over time.

Figure 1 displays Florida's budget path under such a TEL. The dark blue line depicts Florida's actual spending path. The dashed light-blue line shows the upper limit to Florida's spending if it had been restrained in 1987 to grow no faster than the sum of inflation and population growth. The solid light-blue line is an estimate of what Florida would have spent under such a limit, assuming that spending would have fallen during years in which actual spending fell.

In 2009, Florida spent approximately $66 billion. If the state had maintained its real 1987 per capita spending level, however, its 2009 budget would have been $46 billion. The difference would have easily been enough to avoid Florida's $6 billion budget gap.[24] Additionally, if many other states had adopted a similar TEL they would have avoided their budget woes as well.[25]

CONCLUSION

LIKE NEARLY EVERY state in the Union, Florida faced unprecedentedly large budget gaps in both 2009 and 2010. In response, the state cut budgets, raised taxes, and hiked fees. Though these responses closed the budget gaps (for now), they caused much hardship and failed to address the fundamental problem of excessive government spending.

Future budget gaps could be mitigated or avoided altogether if the state were to adopt a more-stringent balanced-budget requirement, permit its citizens greater economic freedom, and/or take serious steps to limit the growth in state spending.

There are a number of reforms that would help Florida limit spending: a line-item reduction veto, a supermajority requirement for all tax increases, a strict balanced-budget requirement, or a formal tax and expenditure limitation. In this paper, we analyzed the impact of an expenditure limit that would permit state spending to grow no faster than the sum of inflation and population growth. If the state had adopted and adhered to such a measure in 1987, it would have avoided its entire 2009 budget gap.

ENDNOTES

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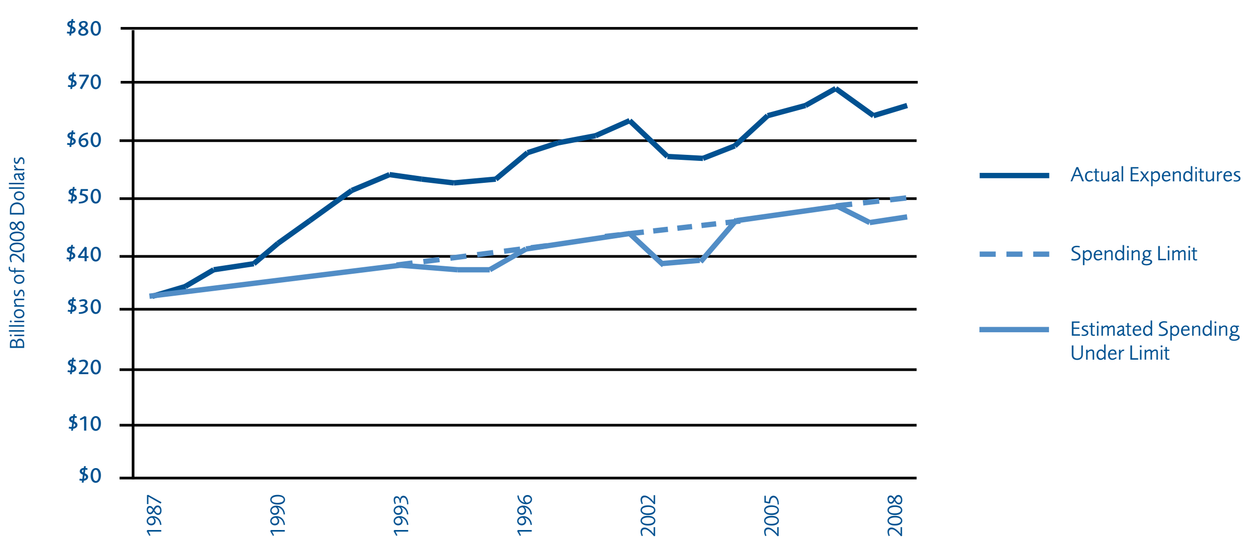
2. Elizabeth McNichol, Phil Oliff, and Nicholas Johnson, "Recession Continues to Batter State Budgets; State Responses Could Slow Recovery,"

FIGURE 1: FLORIDA'S ACTUAL AND ALTERNATIVE SPENDING



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23. Alaska, Colorado, Nevada, Utah, and Washington have such a TEL. Colorado has currently suspended its TEL, however, and Utah exempts large portions of its budget from the limit. Waisanen, *State Tax and Expenditure Limits*.

24. It is not likely that revenue would have actually followed its same course. If the state had spent less on, say, Medicaid, then the federal government would have sent fewer matching dollars to the state. On the other hand, less spending might mean less crowding-out of private activity, expanding the tax base and, with it, revenues. Whatever the net effect, we assume that revenue would have remained constant as a simple analytical illustration of the impact of spending restraint, holding all other factors constant.

25. Mitchell, "State Budget Gaps and State Budget Growth."

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COMMENTS ON PRIVATIZATION TO THE FLORIDA SENATE GENERAL GOVERNMENT APPROPRIATIONS SUBCOMMITTEE

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Vice President and Distinguished Visiting Scholar

Privatization is a general term used to describe government activity or government assets that are being moved to the private sector. This paper deals with some of the economic and political risks that are inherent in the process of selling or contracting public processes to the private sector. The appendix describes the different processes that might fall under the description of privatization.

Much of the criticism of privatization around the world stems from the absence of a robust system of management and oversight of the privatization process. I base these comments on my experience as the minister inside the New Zealand cabinet who was responsible for all privatization.

PRIVATIZATION OVERSIGHT UNIT

I recommend:

- A privatization unit should be created.
- The privatization unit will have full responsibility for all privatizations, regardless of which department controls the assets or the services being privatized.
- The privatization unit should be located inside one of the administration's control agencies, such as the Department of Administration or similar agency.
- The unit should be comprised of people with the necessary technical skills and the appropriate experience in the marketplace to be aware of the potential pitfalls of privatizing. If necessary, these people should be hired from outside the government workforce.
- The unit should be answerable to the secretary/commissioner and the governor and provide them with the advice necessary to make the best decisions possible.
- The final decision on whether to proceed with the privatization should be based on a recommendation made by the secretary/commissioner to the governor. (Note: This might mean including the decision in the budget, the passing of a law through the legislature, or it might be done administratively.)
- It is wise for the commissioner and the governor to be at arms length from the negotiating process. The privatization unit's staff should do the actual negotiating, but always ad referendum to the secretary/commissioner, who should be keeping the governor informed. The secretary/commissioner and the governor should act on the advice of this unit.
- Appropriate paper trails should be kept through the whole process.

PRIVATIZATION PROCESS

A proposal to embark on a privatization should immediately and automatically initiate an economic analysis. This process is designed to determine whether the proposal is viable and which form of privatization will produce the greatest benefit.

- The privatization unit should be involved in this initial process and should have oversight of all subsequent processes.

- The depth of the analysis required will differ according to the proposal for privatization. If the proposal is to outsource certain services or acquisitions, then the analysis can be a straight cost-benefit analysis. However, if the privatization involves the sale of a state asset, then a full scoping study of the proposal and the asset concerned should be initiated.

- It is important that each privatization initiative develops an appropriate communication strategy and that the secretary/commissioner is satisfied with that strategy.

- The writing of contracts and other related legal documents is a specialized legal skill, and the privatization unit should use the best ones available. This will probably mean using private-sector law firms with significant commercial experience.

- The privatization plan must deal with the disclosure requirements and see that these requirements are fully met at all times.

- The privatization plan must detail the contract monitoring process, detail the required ongoing disclosures, and guarantee that the conditions of the contract are met.

- The management of contracts requires specialist skills. The privatization unit should be charged with holding the contract management to a high standard. (Note: Most problems that occur after a privatization are due to inadequate management of the contract after signing the final documents.)

- Every condition placed on a privatization has a cost. The condition will either diminish the value of the asset to be sold or add to the cost of the service to be delivered. Therefore conditions and constraints placed on a privatization need to be considered carefully against these costs.

APPENDIX

Privatization. This process transfers ownership of assets from the public sector to the private sector normally through sale, but sometimes through negotiation or restricted-access sale. A number of recent innovations have seen this process evolve to more of a long-term lease 20, 30 or 100 years, after which the assets revert to public ownership (e.g. roads, the radio spectrum, forests, prisons, banks, insurance companies, and other businesses).

Outsourcing. This process subjects services that were previously delivered inside government organizations to competition from private-sector bidders. This is normally done by contract, which may be for a single year or multiple years. An innovation in this process is allowing the public-sector organization to bid for those services as well, but before being allowed to bid, the public-sector organization must set up a separate commercial profit center. This profit center would be required to conform to all of the rules and regulations that its private-sector competitor is required to meet (e.g. supply of consumables, cleaning services, repairs and maintenance, professional services, accounting, legal services, health services, human resources management, etc.).

Public-Private Partnerships. This process attracts private-sector capital to provide facilities, often buildings, but also roads, bridges, recreational areas, and parks. These sometimes are combined operations where the private sector provides the residential facility and management of those facilities and the government provides technical or governmental services. Examples include prisons, where government may provide custodial staff, and the private sector may provide facilities, and hospitals, where the private sector would provide buildings, plants, maintenance, and cafeteria services, and the state would employ health-services staff (e.g. nurses, doctors, and psychiatrists).

Internal Markets. This is a process where one government department may supply services to another government department under a contractual arrangement. For this process to work, it needs to be strictly business-based in its operation with full costing of services by the delivering organization and specification of quantity, quality, and timeliness by the purchasing organization. The contracts need to be professionally written, professionally managed, and enforceable in a court of law.

State-Owned Enterprises. This process is designed to bring private-sector managerial skills and efficiency to operations that are destined to stay in government ownership. This structure is often used for activities that are natural monopolies. The enterprise is structured in an identical way to a private-sector corporation, is managed by a private-sector board of directors chosen for their competency, who serve fixed terms on the board. The government's role is that of a shareholder and the administration and legislature are unable to interfere in the day-to-day operation of the corporation. The corporation pays taxes, pays dividends to its shareholders, and is required by law to be profitable. The government may have an ongoing business relationship with this organization, in which case it would buy goods and services by contract. If the government requires the organization to undertake any activity that is seen by the board of directors as uneconomic, then the government must pay a fee to the corporation equal to the difference between the rate of return on that activity and what would be an economic rate of return. (e.g. airports, shipping ports, water systems, irrigation schemes, navigations services, research organizations, etc.).

Competitive Contracting. This is a process where the government may purchase a variety of different services by letting competitive bids for contracts that specify the service to be delivered. These may be as varied as vehicle safety inspections, park maintenance, pothole repair, the provision of technology or technical equipment, meal delivery, buildings maintenance, the provision of vehicles, plant repair and maintenance, etc.

For these processes and procedures to be successful, there are a number of principles that must be adhered to:

- The process must be open, transparent, fair, and the contracts enforceable.

- The procedures around contracting require high levels of skill and credibility. This includes the writing of contracts, particularly the specification of service to be delivered, and the managing of the contracts to ensure that the goods and services specified in the contracts are delivered, on time, within budget, and with acceptable levels of public satisfaction.

- The process of privatization needs to be designed so that it is totally untainted by any hints of preference, privilege, or corruption. It must be designed to maximize the benefit to the taxpayer, and the results of the transaction must be public.

- The process in every case should be designed so that those in political office are kept informed but at arms length from the transactions, so that accusations of preferential treatment or political patronage can be eliminated. This is best achieved by a process that appoints a private-sector sale manager.

- As much as possible, the special requirements that the government has in each sale should be outlined in the bidding documents and then enshrined in the final sale-and-purchase agreement. This means that disputes are subject to contract law which provides much greater certainty than the use of administrative law. For example, it is possible to write into a final sale-and-purchase agreement the environmental outcomes that the government wishes to protect; the quality of service that the government requires when dealing with citizen; the compliance with laws, bylaws, and administrative orders; and the geographical availability of services.

APPLYING FULL-COST RECOVERY IN GOVERNMENT BUDGETS

Hon Maurice McTigue
Vice President and Distinguished Visiting Scholar

When governments make decisions requiring a certain procedure, license, permit, or authorization, then the next logical decision should be how this service or process will be funded. There are basically two choices for funding: the taxpayer or the user/consumer of the service. Theoretically the decision should be based on who benefits. If the new activity is entirely a public good, then it is the taxpayer who should pay. When it is a private benefit, then the user/consumer should pay. On other occasions, the cost might be apportioned between the two when there is both a public and private good. Ultimately it is a political decision to determine the means of funding the activity. Often at the time of making the original decision, there are vested interests at work trying to move the cost to the taxpayer. It is a quite legitimate budget practice to test these decisions from time to time and, as a matter of equity, to shift the cost from the taxpayer to the user or vice-versa.

In analyses I have done over the years, I have made a large number of recommendations that certain goods and services should be subjected to "full-cost recovery." I use the term "full-cost recovery" very deliberately because I wish to make a distinction between the concept of "cost" and the concept of "fees." The concept of "cost" includes all of the expenses that were incurred in providing the service or goods but absent any profit or reward. The concept of "fees" is best compared to the standard practice of lawyers, accountants, architects, doctors, or engineers who charge us for their services through a schedule of "fees," and these are clearly inclusive of both the costs incurred and reward. For the public to accept this process of "cost recovery" then, they need to believe that there is no reward or profit in the costs they have to pay for these government services. The credibility of this process is entirely dependent on the level of transparency and authentication that is used in calculating the costs imposed.

There are many activities for which the users and consumers of those services should pay. As the public will view the process of determining who should pay for what with understandable cynicism, I have also outlined a set of criteria that should apply to "full-cost recovery" so that the decisions made are open, transparent, and consistent.

HOW SHOULD COST RECOVERY WORK?

First Principle

This process is a recovery of costs only so government agencies must not be allowed to recover any more than the exact cost of the service or good provided. *If they recover in excess of the actual cost, then the funds must be returned to the payers, otherwise that excess is a tax. Government agencies do not have taxing authority*.

The Procedure

- The governor issues an executive order stating that agencies are required to recover the cost of designated services but are forbidden from recovering money in excess of the cost of services.

- The executive order lays out the criteria for setting the amounts for cost recovery, and all charges existing and new would be subject to these criteria. (The elements of the criteria follow, but this is not an exhaustive list. Other criteria might be added according to the requirements of the governor's office.)

- The executive order makes it clear that the governor's budget and the decisions of the legislature determine what activities of agencies are to be funded by cost recovery. That same process determines whether it will be full-cost recovery (100 percent), proportional recovery (75 percent), or some other amount.

- The advice of the accounting profession is sought to specify the process to be used and the elements of the agencies operation that may be included in cost recovery.

- The data and information used, as well as the process employed to calculate the specific charge, must be prominently displayed on the agency's website in a readily accessible manner and in a user-friendly format.

- The charge, when determined, must be subjected to audit and the audit report must be placed online and linked to the charge concerned. The audit report must include an assessment of what proportion of cost this charge represents (e.g. 90 percent, 100 percent, 105 percent).

- The executive order states that if an agency overcharges customers, it must return the excess that has been collected. (This requirement probably needs some minimum rules attached to it, e.g. the over charge exceeds 1 percent or $5, so as to avoid dealing in ridiculously small amounts.)

- The executive order also defines what activities are subjected to cost recovery.

EXAMPLES OF COST RECOVERY: IS IT A PUBLIC GOOD, A PRIVATE BENEFIT, OR A PORTION OF EACH?

- The FDIC is funded by levies and charges imposed on banks to carry out its mandate of insuring the deposits of all depositors up to a certain limit. The banks make the payment, but in the end all bank customers pay (even though this process is invisible). The taxpayers do not pay because the benefit is clearly to the depositors.

- Vehicle drivers and owners pay for licenses, safety inspections, and vehicle registrations. While it could be argued that the public benefits from safety inspections, clearly drivers and the owners benefit the most, so they pay.

- Airline safety gives the greatest benefit to passengers, so airport security is funded almost entirely by them.

- A building permit is a private benefit, so the owner pays.

- Policing is a public benefit, so taxpayers pay.

- The military is a public benefit, so taxpayers pay.

- Prosecution of criminals is a public benefit, so taxpayers pay.

- Border protection is a public benefit, so taxpayers pay.

- Environmental pollution and damage are public problems, so the polluters and/or the taxpayers pay.

- Controlling an outbreak of hoof & mouth disease is a public benefit, so taxpayers pay.

- Weight and measure inspections are costs of doing business, so businesses pay.

- A license to be a hairdresser is a cost of doing business, so the business pays.

- A license to use chemicals is a cost of doing business, so the business pays.

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MERCATUS ON POLICY

GETTING AN ACCURATE PICTURE OF STATE PENSION LIABILITIES

By Eileen Norcross

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State governments have reported unfunded pension liabilities—the difference between what plans have promised to pay public workers and the assets set aside to pay out these benefits—of $452 billion as of June 2009.[1] Estimates place the shortfall in local plans at an additional $190 billion.[2] These reported figures, however, severely underestimate the pension obligations governments owe to public workers. To measure pension obligations accurately, state and local governments must institutionalize the correct measurement of pension liabilities: the market value of liabilities (MVL), which properly accounts for the guaranteed nature of public pension benefits.

Recognizing the unsustainable future of current public pension plans, many state legislatures are considering pension reform. Unfortunately, most proposed reforms are insufficient to fill the funding gap because government accounting standards continue to underestimate the true debt.

CALCULATING PENSION LIABILITIES

Governments hire actuarial firms to perform annual valuations of their pension plans. These Comprehensive Annual Financial Reports (CAFRs) include information about plan assets, plan liabilities, and the level of plan funding.

Employee and employer contributions and the return on those contributions when invested, together finance plan benefits.[3] To assess the funded status of the plan, a process known as discounting makes plan liabilities that occur years or even decades in the future comparable to the assets held by the plan today. Discounting takes a future dollar value and backs out the interest to generate a "present value." The present value of plan liabilities can then be compared to the current value of plan assets to determine the overall funding health of the program.

In determining what interest (or discount) rate to use, actuaries rely on the Government Accounting Standards Board (GASB) Ruling 25[4] and Actuarial Standards of Practice (ASOP) 27.[5] These rules state that a pension liability may be discounted using the annual interest rate the plan's assets are expected to return. On average, state governments have assumed an annual rate of return of 7.97 percent on plan assets, with individual plan returns varying from a low of around 7 percent to a high of around 8.5 percent.

Current pension reporting calculates the value of pension liabilities based on what the assets are expected to return when invested. This approach sounds reasonable, but in fact it runs contrary to economic theory and the practice of financial markets.

The problem is that public pension liabilities are practically riskless, guaranteed by legal precedents and state constitutions, yet the assets held by pension plans are highly risky. This mismatch systematically understates the value of pension liabilities and overstates plans' funding levels.

The valuation that does not understate the value of pension liabilities is the standard used by private pension plans, the market value of the liabilities (MVL). The MVL discounts future liabilities at an interest rate that matches their risks and represents the amount a private insurance company would demand to issue annuities to cover all the benefits owed by a plan. Market valuation reveals the shortfall in state plans is over $3 trillion and the shortfall in local plans is $574 billion.[6]

PENSION MISMANAGEMENT

This approach implies that a public pension benefit—a government debt that represents a guaranteed payment to a worker— can be secured by investing in risky assets without any accounting for the cost of investment risk. As a result, the pension liabilities reported in government accounts appear smaller than they actually are. This has led to at least three consequent mistakes in how plans have been managed by governments.

Governments set too little aside to fund future benefits. Because they systematically underestimate the liability, governments have also underestimated the Annual Required Contribution (ARC), or the amount set aside today by employees and the employer to fund the liability in the future.

Pension portfolios have shifted toward riskier assets in order to discount their liabilities at higher interest rates. In the 1980s, equities constituted 40 percent of public pension fund investments; by 2007, they comprised 70 percent.[7] In addition, rising shares of pension assets are now dedicated to even riskier "alternative investments" such as private equity and hedge funds. As a result of the market decline of 2008, pension plan portfolios lost an estimated $1 trillion.[8]

FINDING THE MARKET VALUE OF THE LIABILITY BASED ON THE REPORTED ACTUARIAL VALUE OF THE ASSETS, LIABILITIES, AND ASSUMED INTEREST RATE FOUND IN THE PENSION PLAN'S CAFR

Example: New Jersey Teachers Pension Annuity Fund (TPAF) (Data taken from the Comprehensive Audited Financial Statement Report for FY 2010.)[1]

As Reported:

Actuarial Value of Assets (AVA): $34,838,211,259

Actuarial Accrued Liabilities (AAL): $54,576,061,024

Unfunded Accrued Liability = (AVA – AAL) = $19,737,849,765

Funding Ratio = (AVA ÷ AAL) = 63%

Actuarial Assumption: Interest Rate = 8.25%

To arrive at the Market Value of the Liability based on the information provided, first calculate the Future Value of the Liability by compounding the AAL 15 years forward based on the plan's assumed interest rate (r = 8.25%). Fifteen years represents the approximate midpoint of pension plans' future benefit obligations. Then discount this Future Value back to the Present Value based on the risk-free rate (r = 3.5%). We choose the yield on 15-year Treasury bonds.[2]

Formula to find the Future Value:

$$FV = AAL \times (1 + r)^{15}$$

$$= \$53{,}418{,}328{,}576 \times (1 + 0.0825)^{15} = \$179{,}234{,}151{,}014$$

Formula to Discount the Future Value of the reported liability back to the Present Value is based on the risk-free discount rate.

Formula to find the Present Value of the MVL:

$$PV = FV \div (1 + r)^{15}$$

$$MVL = \$179{,}234{,}151{,}014 \div (1 + 0.035)^{15} = \$106{,}983{,}183{,}277$$

Market Value Unfunded Liability = AAL – MVL = $72,144,972,018

Funded Ratio based on the Market Value = AVA ÷ MVL = 33%

1. See State of New Jersey Division of Pensions and Benefits, Financial Statements and Schedules *(June 30, 2010), 25, http://www.state.nj.us/treasury/pensions/pdf/financial/2010divisioncombined.pdf.*

2. See Eileen Norcross and Andrew Biggs, "The Crisis in Public Sector Pension Plans: A Blueprint for Reform in New Jersey," (working paper, Mercatus Center at George Mason University, July 2010). We choose the 15-year yield on Treasury bonds because it has been shown that the mid-point of a public pension's stream of future benefit payments is approximately 15 years in the future. In other words, a lump-sum payment 15 years hence can be treated as an approximation of the annual benefit liability owed by the plan. See M. Barton Waring, "Liability-relative investing," Journal of Portfolio Management *30, no. 4 (2008).*

Basing the discount rate on expected asset returns gives plans the illusory appearance of full funding in years when investment returns are robust.[9] Operating under this false assumption has led some governments to adjust their budgeting behavior, deferring contributions to pension systems and granting generous benefit enhancements.

POLICY RECOMMENDATION: INSTITUTIONALIZE ACCURATE PENSION ACCOUNTING

As a result of this mismanagement and underfunding, many plans are due to run out of assets to pay beneficiaries in the next 15 to 20 years.[10] Realizing this and recognizing the recent downturn in the market, several states have started to reform their pension plans by adjusting their discount rates downward from the 8-percent to the 7-percent range. However, this downward adjustment is still based on the same incorrect logic—anticipated returns for assets—and sidesteps the fundamental measurement error used to value pension liabilities. [11]

To fix the systematic underestimation of pension liabilities, governments should legally require that actuarial firms hired to value state and local pension plans calculate the MVL based on the return on U.S. Treasury securities and use this to determine what the plan owes to retirees over the 30-year time horizon (which includes calculating what this requires annually in their CAFR reports).[12] Only when states have an accurate accounting of what they owe their workers over a 30-year period can pension reforms be fully successful in stabilizing pension systems, government budgets, and protecting taxpayers.

> To fix the systematic underestimation of pension liabilities, governments should legally require that actuarial firms hired to value state and local pension plans calculate the MVL based on the return of U.S. Treasury securities.

ENDNOTES

1. "The The Trillion Dollar Gap: Underfunded state retirement systems and the roads to reform," The Pew Center on the States, February 2010, 2–3.

2. Robert Novy-Marx and Joshua Rauh, "The Crisis in Local Government Pensions in the United States" (working paper, Northwestern University, 2010).

3. The actuarial valuation of assets is based on a process called "smoothing" which averages returns, typically over a five-year period. This means that a downturn in returns is not fully recognized at once, but incorporated over the period. Andrew Biggs notes, "while the market value of assets (the amount for which the plan's assets could be sold at the time the valuation is made) is a preferable figure, in most cases actuarial assets are at least an unbiased measure: it as likely to understate the market value of the plan assets as it is to overstate it." See *The Market Value of Public-Sector Pension Deficits*, Retirement Policy Outlook no. 1 (Washington, DC: American Enterprise Institute for Public Policy Research, April 2010), 2.

4. Government Accounting Standards Board, "Summaries and Status—Summary of Statement no. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*," November 1994, http://www.gasb.org/cs/ContentServer?c=Pronouncement_C&pagename=GASB%2FPronouncement_C%2FGASBSummaryPage&cid=1176156677465.

5. Actuarial Standards Board, *Selection of Economic Assumptions for Measuring Pension Obligations*, Actuarial Standard of Practice no. 27, September 2007, http://www.actuarialstandardsboard.org/pdf/asops/asop027_109.pdf.

6. Alicia Munnell and Mauricio Soto, *State and Local Pensions are Different from Private Plans*, State and Local Pension Plans no. 1 (Chestnut Hill, MA: Center for Retirement Research at Boston College, 2007).

7. Alicia Munnell, Kelly Haverstick, and Jean-Pierre Aubry, *Why Does Funding Status Vary Among State and Local Plans?* State and Local Pension Plans no. 6 (Chestnut Hill, MA: Center for Retirement Research at Boston College, 2008).

8. Andrew Biggs, *The Market Value of Public-Sector Pension Deficits*.

9. Joshua Rauh, *Are State Public Pensions Sustainable? Why the Federal Government Should Worry About State Pension Liabilities* (Evanston, IL: Northwestern University Department of Finance, 2010), 26.

10. Economists agree on a precept called "the law of one price," which holds that two assets that produce the same stream of payments should sell for the same price. The discount rate chosen should match as closely as possible the timing, amount and probability of payment of the liability being valued. While no market assets match pension liabilities perfectly, many analysts have concluded that the probability of default on accrued pension liabilities is roughly equivalent to that on U.S. Treasury securities. Thus the yield on Treasury bonds is likely the most appropriate discount rate to apply in calculating the size of pension liabilities.

11. There is precedent for this practice. In 2007, New York City's actuary, Robert North, performed a market valuation of the New York City's Employees' Retirement System (NYCERS) and calculated the MVL based on Treasury securities. Jeremy Gold and Gordon Latter, "Making the Case for the Marking Public Plan Liabilities to Market" (working paper, Pension Finance Institute, 2008), 63.

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