



Show Me the Money

BUDGET-CUTTING STRATEGIES FOR CASH-STRAPPED STATES

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Executive Director
Duane Parde

Director of Tax & Fiscal Policy
Chris Atkins

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American Legislative Exchange Council

910 17th Street, N.W., Fifth Floor
Washington, D.C. 20006
(202) 466-3800
(202) 466-3801 fax
www.alec.org

THE MANHATTAN INSTITUTE FOR POLICY RESEARCH

Executive Director of Center for Civic Innovation
Henry Olsen

Author-Senior Fellow
William D. Eggers

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The Manhattan Institute

52 Vanderbilt Avenue, 2nd Floor
New York, N.Y. 10017
(212) 599-7000
(212) 599-3494 fax
www.manhattan-institute.org

Show Me the Money

Budget-Cutting Strategies for Cash-Strapped States

By William D. Eggers

Senior Fellow, Manhattan Institute for Policy Research

It's the most dire situation we've seen in over 20 years. Governors are dealing with unprecedented fiscal pressure. Even as the economy turns around, the state budget forecast will remain stormy since revenue growth lags the recovery by at least 12 to 18 months.¹

—Raymond C. Scheppach, Executive Director, National Governors Association

I. INTRODUCTION

States are facing their worst fiscal crisis in a decade or more. This year's \$40 billion shortfall will almost surely be followed by similarly large deficits next year and tight budgets for years to come.² The causes of the deficits are clear: the recession, September 11, spiraling Medicaid costs, and profligate spending in the mid- and late 1990s.³ Add them all up, and you have the budgetary equivalent of a perfect storm.

If this gives you a strong sense of déjà vu, do not be surprised. We have been through all this before, the last time only a decade ago, during the previous recession. Unfortunately, memories are short. Many states failed to learn one of the most important lessons from previous boom-bust cycles: spending must be contained during growth periods in order to avoid fiscal imbalances when the economy goes south, as it always does eventually.

Faced with constitutional requirements to balance their budgets, policy makers from Honolulu, Hawaii, to Augusta, Maine, are scrambling to find a way out of their budget jams. Here and there, governors and legislatures have displayed courage, but the difficult decisions have mostly been put off until next year, in the vain hope that state coffers will by then contain more cash.

This hope is not likely to be realized. Tax revenues plunged in the first half of 2002. The current fashion of using accounting gimmicks to push this year's expenditures into the future will only make next year even grimmer. The National Association of State Budget Officers (NASBO) and the National Governors Association predict difficult times in the next 12 to 18 months. As hard as it is to fathom, budget problems in fiscal year 2003 might be even worse than they were in fiscal year 2002. "It's worse than anybody expected," said Scott Pattison, NASBO's executive director. "We already knew that [the next fiscal year] was going to be bad, but now it's going to be terrible."⁴

The purpose of this study, however, is not to serve up gloom and doom about state finances; there is already enough of that to go around. Instead, this study seeks to (1) provide proven,

no-nonsense options that policy makers can employ to address the staggering budget shortfalls; and (2) lay out some strategies that go beyond simply plugging budget holes to address needed medium- and long-term reforms in state finances.

II. WHAT ARE STATES DOING TO ADDRESS THEIR BUDGET DEFICITS?

Although states are adopting "kitchen sink" approaches to bring their budgets into balance, one theme clearly stands out in this election year: How *little* can I get away with doing? Everyone is raiding the rainy day fund. Many states are hiking cigarette taxes; some of the same states are also plundering the tobacco settlement money. (Of course, the more cigarette tax hikes reduce demand, the less money the states get in tobacco settlement money.⁵) Another popular strategy is rifling through other portions of the budget—education endowments, transportation funds—hunting for stray money to pay down the deficit.

Big tax hikes are, for the most part, politically untouchable during this heated electoral season. But targeted tax hikes, especially "sin taxes," with their whiff of social engineering, are quite popular. Expect to pay more for your Luckies, your liquor, and your Lotto in many states. Some states are also raising corporate taxes, perhaps wagering that the political appeal of taxing the fat cats will outweigh the economic damage done by having a business-hostile state. Corporations are, predictably, fighting back with threats to withdraw from states that put the bite on too hard. Illinois lost a major gambling-barge contract after it raised casino taxes, creating what the casino company called an "unstable environment."⁶ Of course, states are in the gambling business themselves; some have sought to expand their lotteries, while several others are hoping to add new gambling locations to reap more tax revenue.

Many states have tried some variety of across-the-board spending cuts. Four House members in Alaska formed the Crouching Grouches Caucus to call for such cuts—with a focus on cutting the expenses of the legislature itself—but, as one might expect, self-inflicted surgery is never popular.⁷ Some states have been forced into temporary shutdowns of

major state activities. Missouri, for instance, failed to send out income tax refunds to taxpayers. Indiana Governor Frank O'Bannon vowed to cut education spending, possibly by cutting summer school, alternative schools, programs for gifted students, and full-day kindergarten. Washington governor Gary Lock pledged to eliminate 30 programs and hundreds of state jobs.

The most aggressive budget cutting has been in the Midwest, a region particularly hard hit by the economic downturn. Illinois Governor George Ryan proposed over half a billion dollars in cuts, including closing a medium-security prison, shutting down a mental health center, reducing college scholarships, and paring down state aid to schools. In neighboring Iowa, Governor Tom Vilsak signed a budget that included furloughs for state workers and eliminated or suspended 27 state programs. In Michigan, Governor John Engler cut about \$1 billion in discretionary items, including bilingual education, parenting skills training, and youth violence prevention programs.

The bottom line: some states are making serious spending cuts, but most are not doing much to reduce the medium- and long-term costs of operating government. This objective can be accomplished by reducing the size and scope of government in strategic and imaginative ways, whether by reorganizing or redesigning departments and programs. Absent large tax increases, such steps will soon become unavoidable.

THE SEVEN MOST POPULAR DEFICIT RESPONSES

- 1 Using accounting gimmicks
- 2 Making across-the-board cuts
- 3 "Borrowing" from dedicated funds
- 4 Increasing sin taxes
- 5 Cutting Medicaid
- 6 Drawing on rainy day funds
- 7 Reducing aid to local governments⁸

III. TEN STRATEGIES FOR CUTTING BUDGET DEFICITS

The strategies outlined in this study include short-, medium-, and long-term plans for reducing the cost of government. Some of the short-term measures are imperfect and impolitic and will do little to fix long-term budget imbalances. In many states, however, the severity of the current fiscal situation makes stopgap measures unavoidable.

It is important to remember that no matter how successful state governments are in employing short-term measures to close deficits, the seeds of fiscal crisis will remain. Only by

fundamentally restructuring government will state policy makers be able to contain spending growth and return accountability to state finance. The following ten strategies will help states do both.

1 Go Where the Money Is: Reduce Workforce Costs

One of the most effective short-term cost reduction measures is reducing workforce costs. The reason is simple: state employees' salaries and benefits account for a significant portion of states' costs. Most states will find it almost impossible to balance their budgets without impacting state employees. Fortunately, the innovative use of Web-enabled technology can help to ease the impact of workforce reductions on customer service, while an aging workforce will allow some workforce reduction without massive layoffs.

Recommendations

- **Cap Employment:** Agencies hate full-time equivalent (FTE) employment caps because they restrict their ability to hire new employees. Nevertheless, FTE caps are a proven way to trim workforce costs.⁹
- **Freeze State Hiring:** A number of states, including Illinois and Massachusetts, froze state hiring recently.¹⁰ Although appealingly simple, this approach leaves little room for agencies to adjust their organization to function with a smaller workforce; the budgetary impact is also harder to estimate than with an FTE cap.
- **Reduce the number of government positions:** The most direct way to reduce the size of the state workforce is simply to eliminate government positions outright. In Florida, Governor Jeb Bush has set a goal of reducing the state workforce by 5 percent a year for five years. Through a combination of outsourcing and streamlining, Bush has already cut thousands of permanent and temporary positions from the state payroll. In Missouri, Governor Bob Holden targeted 688 jobs for elimination in his 2002 budget.¹¹
- **Eliminate phantom positions:** When agencies and higher education institutions receive funding for a certain employment level, invariably a percentage of the positions are never filled. Eliminating these positions is a relatively painless way to extract workforce savings from agency budgets. Many of the positions eliminated in Florida fell into this category.¹²
- **Provide incentives for early retirement:** Offering early retirement incentives, such as allowing employees to retire early with full benefits and a severance package, typically results in a large exodus of state workers, thereby reducing the workforce without layoffs. For maximum savings, each agency's funding should be cut by the same amount as the total salaries of retiring employees. The budget bill adopted

by the Wisconsin State Senate in 2002 contains such an early retirement package.¹³ Unfortunately, early retirement packages also carry some potential disadvantages. First, if the severance packages are too generous, they negate potential cost savings. Second, the best and most qualified employees tend to be the first to take the packages, which can hurt program management.

- **Renegotiate labor contracts:** State employee unions sometimes can be persuaded to make contractual concessions during severe budget crises rather than face the prospect of unavoidable layoffs. When former Philadelphia Mayor Edward Rendell first assumed office in 1992, he faced a \$208 million budget shortfall, at the time, the city's worst fiscal crisis since the Great Depression. To reduce costs, he proposed numerous work rule changes and cutbacks in the very generous compensation packages - such as 41 paid vacation days a year - enjoyed by city employees. After holding firm after the unions walked out of their jobs, Rendell was able to extract \$353 million in concessions from the unions over four years.¹⁴ Most attempts to renegotiate contracts, however, are not this successful. Illinois Governor Ryan failed in his attempt to renegotiate union contracts with state employee unions in 2001.¹⁵
- **Reduce retirement costs:** Some analysts question the fairness of asking current state employees to bear all the pain of budget cuts. Most states provide generous pension and health benefits for retired state employees, many of whom embark on lucrative second careers. In the spirit of shared sacrifice, states can realize savings by temporarily freezing cost-of-living adjustments (COLAs) for retirees or requiring them to pay a larger share of their health care insurance premiums, as Governor Lincoln Almond has proposed in Rhode Island.

2 Spread the Pain: Impose Broad-Based Spending Cuts

Across-the-board spending cuts are not the best way to reduce the size and cost of government. They provide little guidance about what services government should deliver or how they should be delivered. Moreover, cutbacks are usually restored as soon as tax revenues begin flowing back into government coffers, meaning long-term cost reductions are not achieved.¹⁶ But for governments needing to quickly identify budget savings—with no time to implement a more strategic process of “rightsizing” and restructuring—across-the-board spending cuts are often a necessary weapon in the budget-balancing arsenal.

Recommendations

- **Make across-the-board budget reductions:** The simplest way to address a budget deficit is to impose across-the-board cuts on all state agency budgets. When not micromanaged, across-the-board cuts allow agencies more flexibility to determine which expenses are essential and which are not. The main problem with this approach is that it penalizes the leanest and most efficient agencies, since they have less fat to cut. Dozens of states enacted across-the-board cuts this year and last, including Iowa, New Jersey, Oklahoma, and Virginia.
- **Freeze spending to prior year's level:** Another simple way to cut spending is to fund agencies at the previous year's level.
- **Freeze COLAs:** Freezing COLAs received by entitlement recipients can save costs in the short term without removing people from program rolls. The freeze can be reversed once the budget picture improves. The only governor to propose a measure of this type in 2002 is John Engler of Michigan, whose budget includes a freeze on Medicaid COLAs.¹⁷

3 Modernize Government: Reform Entitlement Programs

States have no chance to solve their long-term budget problems without getting a handle on the rising cost of entitlements. Next to the recession, the runaway cost of Medicaid—the biggest budget cost driver in most states—is the biggest cause of the current state fiscal crisis. Medicaid now accounts for one-fifth of total state expenditures, second only to education.

For the past two years, Medicaid spending has been growing at a rate of 11.7 percent per year, almost double the 6.4 percent increase in state spending projected for the next fiscal year. The ten-year projections from the Centers for Medicaid and Medicare Services show double-digit cost increases far into the future.¹⁸ States are experimenting with a variety of approaches to reduce Medicaid costs: cutting mental health care; tightening eligibility requirements; reducing payments to providers; lowering drug costs through generic drugs and drug rebates; and reducing coverage for acupuncture, podiatry, dental care, home health care, and chiropractic care. Some of these proposals make sense. Some will even save money. But none of them are likely to have more than a marginal impact on the long-term problem of rising Medicaid costs.

The real problem, as noted in an American Legislative Exchange Council (ALEC) Medicaid study by Richard Teske, lies in Medicaid's defined benefits structure, which fixes benefits and eligibility and makes costs variable—a recipe for skyrocketing costs.¹⁹ An in-depth look at Medicaid's problems and potential

solutions is beyond the scope of this study, but one thing is certain: sustained Medicaid cost control is nearly impossible without structural reform. The most promising reform plans allow consumers to choose among multiple providers; customize benefits according to patients' needs and circumstances; target benefits to the truly needy; and recognize that the Medicaid population consists primarily of three distinct groups—older people, blind and disabled people, and low-income families—each of which needs to be treated differently.²⁰

The large drop in welfare caseloads over the previous six years has meant that Temporary Aid to Needy Families (TANF) costs have not been a major budget driver. However, not all states have embraced welfare change to the same degree: Some evidence suggests that adopting more far-reaching reforms may help some states realize significant savings.

Recommendations

- ***Adopt market-based, consumer-choice Medicaid reform:*** Medicaid consumers should be given vouchers or refundable tax credits to purchase personal insurance through independent brokers from a variety of state-approved plans, including medical savings accounts, fee-for-service plans, and managed care plans. This approach would require changes in federal policy, such as turning Medicaid over to the states. Absent federal legislation, states could still apply for waivers to implement a Medicaid consumer choice pilot, as Tommy Thompson did with welfare reform in Wisconsin.
- ***If comprehensive Medicaid reform is not possible, reduce costs through more targeted approaches:*** A variety of Medicaid cost-cutting options can be undertaken in the absence of full-scale choice-based reform, including implementing home- and community-based alternatives to institutional long-term care, instituting private pharmacy contracts to manage drug consumption, imposing co-payments, contracting for specialized services, eliminating coverage of optional services, using buying pools, and changing the service utilization of existing populations.²¹

One of the most successful Medicaid reforms has been instituting disease state management (DSM) programs for people with chronic diseases such as Alzheimer's, asthma, congestive heart failure, diabetes, and HIV. DSM can reduce costs (e.g., by cutting emergency room visits) and increase care through the use of customized health services, including patient education, technical assistance, and risk management.²²

- ***Adopt a “pay after performance” model for TANF:*** In the years following the passage of the 1996 welfare reform law, no state experienced larger caseload reductions than Wyoming, where the number of people on TANF plummeted 70 percent. The key to Wyoming's success was a “pay after performance” policy, which compels TANF recipients to comply with work requirements and other provisions of their responsibility agreement *before* receiving their monthly grant.²³ Grants are automatically reduced to \$1 for TANF recipients who fail to comply without a legitimate reason. Those who fail to cooperate for two months see their cases closed.

In contrast to this approach, most states try—usually unsuccessfully—to impose sanctions on recipients for noncompliance *after* they receive their monthly grant. When enforced, the sanctions are often too weak to greatly influence behavior. One indication of the magnitude of savings possible from switching to a pay-after-performance model is provided by the Texas comptroller's office, which estimates that Texas could save about \$22 million in general fund revenues by adopting this approach.²⁴

- ***Use technology to reduce fraud, abuse, and overpayments:*** Right now, billions of dollars' worth of welfare and Medicaid benefits go to people who are ineligible for these programs. “Data brokers” and online eligibility systems can help fix this problem by instantly verifying the income and assets of TANF and Medicaid applicants. After years of steep welfare cost increases, the Canadian province of Ontario recently modernized its archaic, error-prone eligibility process. The results have been impressive: the system determined that 17 percent of all welfare recipients were ineligible and another 8 percent were being overpaid. Total cost savings over five years are projected to be \$1 billion.²⁵

ASKING THE RIGHT QUESTIONS

As states scrutinize their budgets in search of savings opportunities, three crucial questions should be asked of all government functions:

- 1 Should government be doing this at all? (If it is something that can be done effectively by the private sector, then the state government should not be wasting resources and energy doing it.)
- 2 How can it be done better and cheaper?
- 3 How can we apply technology to enhance services and cut costs?

4 Turn Capital Assets into Financial Assets: Sell or Lease Government Assets and Enterprises

Over the past two decades, hundreds of billions of dollars' worth of state-owned enterprises and assets have been sold or leased to the private sector worldwide. These assets have included airports, stadiums, ports, utilities, liquor operations, buildings, land, and gas and electric utilities.

The Los Angeles-based Reason Foundation estimates that cities and states own over \$226 billion in infrastructure assets that could be sold to the private sector.²⁶ By selling or leasing state enterprises to private entities, governments can turn dormant physical capital into financial capital, which can be used for more pressing needs such as rebuilding decaying infrastructure, reducing debt, or cutting taxes. State governments can also benefit financially by putting the assets on the tax rolls. A year after Connecticut privatized its off-track betting operation in 1993, it was actually netting more revenues (via a 3.5 percent tax on the company's gross revenues) than it would have been making as owner of the operation.²⁷

State asset sales during the 1990s included the trade sale of the Michigan Accident Fund, the Port Authority of New York and New Jersey's Vista Hotel (at the World Trade Center), state liquor operations, and a number of commercial properties owned by the state of New York. California realized over \$200 million in revenues from the sale of surplus buildings and real estate during the 1990s. Several governors considered or proposed the sale of state-owned airports, insurance funds, turnpikes, and water systems.

Various methods can be employed to carry out such sales, including auctions, negotiated sales, management or employee buyouts, and placement with investors. The nature of the sale determines which method is best. Asset sales must be handled carefully and usually take a year or more to complete.

PRIVATIZATION OPPORTUNITIES

Enterprises: Golf courses, turnpikes, water systems, airports, hospitals, ports, liquor operations, gas and electric utilities, liquor store operations, wastewater treatment plants, waste-to-energy plants, dormitory food service.

Assets: Tax liens, loan portfolios, stadiums.

Real estate: Public housing, hotels, surplus lands and buildings. (Governments at all levels in the United States own property worth at least \$4.5 trillion altogether.)

The largest state privatizations over the past decade have involved the sale of state-run workers' compensation funds. The pioneer in this movement was Michigan, which sold its Accident Fund in 1993 through a public auction process to Blue Cross/Blue Shield of Michigan for \$255 million. One condition of the sale was that Blue Cross/Blue Shield continue to offer small businesses workers' compensation insurance. A.M. Best, a respected insurance rating firm, now rates the privatized Accident Fund's financial condition as excellent. Several years later, Nevada followed Michigan's lead. It privatized its state-run workers' compensation insurance fund and opened the market to private insurers.

Recommendations

- **Direct a special legislative committee or executive branch unit to identify privatization opportunities:** New York State was a leader in selling off state assets and enterprises during the 1990s, including completing the first airport privatization in the country (Stewart National Airport). Instrumental to this success was the creation of a unit within the state's Empire State Development Corporation that was devoted to identifying privatization opportunities and then making the transactions a reality. The privatization unit sold off a golf course, a hotel, New York Coliseum, the Long Island Railroad Freight Division, the 14th Street Armory, and 20 surplus mental health properties. Direct revenues from the sales have amounted to over \$163 million—not to mention the considerable savings of not having to maintain the properties. Any group like this is going to generate bureaucratic and political heat; to succeed, it requires top-level staff with transaction experience, a commitment to privatization, and unwavering support from agency heads and state policy makers, especially the governor.
- **Provide a financial incentive for agencies to turn physical capital into financial capital:** Some agencies are disinclined to sell nonproductive assets, fearing that any savings will only reduce their budget. The easiest way to rectify this situation is to let the agency keep a share of the money earned from the sale, rather than having all proceeds revert to the general fund. Another option is to agree to not reduce an agency's budget by the full amount of the operating savings generated.²⁸
- **Adopt a capital charge system:** Most agencies have little incentive to extract the greatest value from the use of their assets because the capital cost of land, buildings, and other assets is not reflected in their budgets. This can be rectified by assessing a "cost of capital" charge on all assets. A capital charge essentially applies an interest rate to all capital, creating an actual cost for using capital. The charge creates an incentive to balance a capital expenditure against its

usefulness in achieving the agency’s goals because suddenly, the once-invisible costs of land and buildings become very real to agencies that find themselves charged for their use.²⁹

provide a host of services, including day care, recreation, education, mental health, drug treatment, housing, help for people with developmental disabilities, and job training.

REVENUES FROM SELECTED STATE PRIVATIZATIONS OVER THE PAST DECADE

California	Surplus buildings and real estate	\$200M
Michigan	Accident Fund	\$255M
New York	14th Street Armory	\$15M
New York	Long Island Railroad Freight Division	\$28M
New York	Mental health properties	\$62.5M
New York	Radisson Golf Course	\$3.2M
New York	Stewart International Airport	\$35M
Ohio	Liquor stores	\$21M
Virginia	Student loan portfolio	\$62M

Sources: Reason Foundation, New York Empire State Development Corporation

ANNUAL COST SAVINGS ACHIEVED FROM COMPETITIVE GOVERNMENT PROGRAMS

Indianapolis	\$46M
Los Angeles County	\$50M
New York City	\$42M
Philadelphia	\$38M
San Diego County	\$17M
State of Virginia	\$32M

Sources: Individual city and state governments and various Reason Foundation publications

5 Apply Antitrust to Government: Introduce Competition in Service Delivery

Bureaucratic monopolies are bad for taxpayers and public employees. When government bans competition, it communicates a message to public workers that state systems and those who run them are inferior. Competition creates the conditions for increased productivity and new partnerships in which the private sector provides some functions while public employees concentrate on what they do best—and where they are needed most. By opening up public services to competition from private providers, states can realize savings and improve service quality. Private vendors are often able to produce savings through innovation, advanced technology, and a commitment to customer service. Once exposed to competition, public employees will also find ways to reduce their own costs. In Indianapolis, Mayor Stephen Goldsmith bid out more than 70 city services at an average savings of 20 percent.³⁰

For many social, health, and educational services, the best way to realize the benefits of competition is to allow service recipients to choose their own providers. In addition to providing greater freedom, choice-based programs bring consumer pressure to bear, creating incentives for people to shop around for services and for service providers to supply high-quality services at low costs. States now use vouchers to

Recommendations

- **Do a competition review:** Before opening up services to competition, states need to know what is being delivered in-house, what is already being contracted out, and what competitive opportunities exist. Most state governments do not have this information. The legislature should require the executive branch to conduct a comprehensive, government-wide inventory of activities that could be performed by the private sector. One approach is the 1998 Federal Activities Inventory Reform Act, which requires federal agencies to catalog the commercial services they provide and open them to private sector competition. This program has identified more than 900,000 federal positions as being commercial and, therefore, potential competitive opportunities.
- **Mandate that a certain percentage of services be opened up to competition each year:** Simply identifying the functions that can be competed out does little good if agencies fail to do anything with this information. Agencies should be required to compete out a certain percentage of commercial functions each year. At the federal level, President George W. Bush has called on federal agencies to compete at least 5 percent of these positions in 2002, rising to 10 percent next year and increasing as the sourcing potential of more positions is assessed.³¹ The White House expects savings from competitive sourcing to range between 20 and 30 percent.³²

INSTITUTIONALIZING COMPETITION

To ensure that competition is not simply a passing fad, a number of cities and states have established competition councils to institutionalize the concept throughout state government. The two oldest and most prominent are Virginia's Commonwealth Competition Council and the Texas Council on Competitive Government (CCG). Of the two entities, which have each existed for about a decade, the more powerful is the CCG, which can compel state agencies to open functions to competition. CCG projects are also exempt from state procurement laws, a provision that helps to ensure freedom to pursue creative solutions. In all, the CCG has saved the state more than \$65 million since its inception.³³

- ***Incorporate employee incentives into competition programs:***

Agencies or divisions that compete with the private sector to deliver state services should be allowed to distribute a portion of any cost savings that result from winning a competition to the employees who participated in the process.

Indianapolis city employees pocketed tens of millions of dollars from competition savings rewards over the past decade. In response to such incentives, union workers at Indianapolis Fleet Services, the city agency responsible for maintaining and repairing the city's fleet of some 2,500 vehicles, cut their overhead by two-thirds, reduced the number of managers by 75 percent, doubled the productivity of their mechanics, established bonus-pay plans based on performance, and for the first time created customer-evaluation procedures.³⁴

6 Fund Results: Reduce or Eliminate Programs That Perform Poorly

There comes a time when every program must be judged either a success or a failure. Where we find success, we should reward it, repeat it, make it the standard. And where we find failure, we must call it by its name. Government action that fails in its purpose must be reformed or ended.

—Governor George W. Bush (2000)

Governments typically focus on inputs—measuring the quality of a service by the amount of money spent providing it. If crime goes up, police departments receive more money. If student test scores go down, schools are given more cash. Poor outcomes lead to more inputs rather than an improved process.

To reverse these misguided budget incentives, many states implemented performance measurement and budgeting systems during the 1990s. The idea was to spell out the precise outcomes that each department or private vendor is expected to accomplish and at what cost. Rather than funding asphalt, trucks, and employee hours (inputs) or even funding a certain number of repaired potholes (outputs), legislatures would purchase smooth streets (outcomes). Performance standards also can be used to evaluate and reward state employees, enabling managers to tell at a glance whether a certain division is over or under budget, whether its productivity is adequate, and what areas need improvement.

With a few exceptions, performance budgeting has not worked nearly as well in practice as in theory. One of the main stumbling blocks is a legislative reluctance to incorporate performance information into the budgeting process. A recent survey found that nearly all states have a performance measurement system in place but only 21 report that performance information influences the legislature when making policy choices.³⁵ This is unfortunate because, if done correctly, results-based budgeting and management can be a powerful tool for eliminating wasteful government spending. In Washington State, for example, to better assess which programs' funding should be reduced or increased, the state budget office is asking for outcome descriptions to be added to each agency activity. Another promising approach is the program assessment process being developed at the federal level by the Office of Management and Budget (OMB, see box).

PRESIDENT BUSH'S ACCOUNTABILITY BUDGET

President George W. Bush's primary budget reform initiative is to link funding to performance for scores of federal programs. The idea is to get legislators and interest groups to focus less on how much each program's funding has increased over last year's base level, and more on what the program has actually accomplished. The goal, says OMB director Mitch Daniels, the architect of the new budgeting approach, "shouldn't be merely how much, but how well. There are plenty of places to reduce spending when you separate the effective programs from the ineffective programs."

Programs that the OMB rates "ineffective" are slated to get reduced, or axed entirely, while programs rated "effective" will see their budgets boosted. For instance, Bush's budget recommends that the U.S. Department of Agriculture's (USDA's) \$80 million watershed program be shut down. Why? Of the three federal agencies that build dams for farmers—the Federal Emergency Management Agency, the Army Corps of Engineers, and the USDA—the USDA is the worst performer. And dam building for farmers is hardly the only case. There are 48 different federal job training programs, a third of which reside in the Department of Labor.

OMB is also developing uniform evaluation metrics, or "common measures," for scores of cross-cutting, governmentwide functions that are performed by multiple agencies: job training and employment, low-income housing assistance, flood mitigation, and so on. The common measures for evaluating performance will enable OMB and Congress to compare the efficiency and effectiveness of these programs on an apples-to-apples basis.

Job training programs, for example, could be compared on the basis of outcome and efficiency measures like attainment of a job, earnings gains, or total program cost per placement. In a results-based government framework, the least effective and efficient job training programs based on the measures might be consolidated into the high-performing programs or eliminated outright.

Source: William D. Eggers, "The Accountability Budget," *Wall Street Journal*, February 4, 2002.

Recommendations

- **Grade program performance:** The Bush administration's fiscal year 2003 budget contains an OMB scorecard that grades each federal agency on how well it manages its operations. Green dots signify that nearly all management goals had been met; yellow dots, that some had been met; and red dots, that substantial improvement was necessary. In 2002, over 75 percent of the OMB's grades were red dots. Simplistic? Sure, but it got the point across, especially once the president began referring to the grades in budget meetings with his cabinet secretaries and the grades were published in newspapers all over America. A similar approach would help states to engage citizens in the budget process and prod agencies to improve their performance.

- **Buy outcomes from high performers; reduce or eliminate payments to poor performers:** If results-based budgeting is to be more than an academic exercise, there must be rewards for good performance and real consequences for poor performance. Programs that do not work should be reduced, eliminated, restructured, or consolidated into programs that do work. The best way to do this is to develop common evaluation measures for programs performing similar work and then compare performance based on effectiveness and efficiency. After comparing programs' performance, lawmakers can buy outcomes from the high performers and cut payments to the low performers.

Until recently, Texas had two large job training programs located in two different agencies whose functions and clientele overlapped.³⁶ In 2000, several independent performance evaluations of the programs demonstrated conclusively that one of the programs achieved much better results than the other, which was plagued with financial and operational problems.³⁷ Rather than expend significant taxpayer resources trying to "fix" the poor performer, the legislature simply eliminated it, saving the state \$25 million per year.³⁸

- **Adopt performance funding for higher education institutions:** To balance budgets, a number of states are reducing their support to higher education institutions. However, instead of just mindlessly cutting college and university budgets, state legislatures should use this opportunity to rethink their whole approach to higher education. Because much of their funding comes not from state legislatures but from tuition fees, research grants, and endowments, state colleges and universities should be given more freedom to set tuition rates and exempted from various state procurement and personnel regulations.³⁹ Such freedom is necessary for them to thrive in the increasingly competitive marketplace of higher education. In exchange for this freedom, however, legislatures should require greater accountability. Some states, such as

Tennessee, tie a percentage of higher education funding to meeting certain performance measures, such as undergraduate degrees awarded, administrative costs, and use of tenure-track faculty in teaching undergraduates.

7 Change the Incentives: Reward Employees for Saving Money

Most public employees are smart, industrious people who work in ways that are consistent with the incentives and rewards in their workplaces. Unfortunately, traditional compensation systems treat all employees the same, giving workers little incentive to increase efficiency and may even reward inefficiency.

There are a variety of ways to link pay to performance, including performance contracts, performance bonuses, shared savings, gain sharing, and productivity awards. In addition, step-pay raises and COLAs can be eliminated. One of the best strategies to realize budget savings and begin the transition to pay for performance is by providing financial rewards for employees, teams, and divisions for saving money.

Recommendations

- **Establish an employee incentive and gain-sharing program:** Statewide employee incentive and gain-sharing programs do not generally have huge budgetary impacts, but they do help promote a culture of innovation, provide incentives to save money, and achieve some bottom-line cost savings. The Texas Incentive and Productivity Commission, for example, has saved Texas taxpayers more than \$66 million—\$34 for every dollar invested in the commission over the decade. These savings have been generated through a suggestion system and a group incentive pay program; both programs reward state employees who offer creative ideas for improving productivity and saving money.
- **Tie bonuses to meeting budget reduction targets:** Tying employee bonuses directly to their success or failure to meet budgetary targets can provide a powerful incentive for departments to cut costs. The legislature could simply allow, for example, employees of a given agency or division to keep 10 percent of all baseline savings. Already, public works department employees in Portland, Maine, receive between \$100 and \$250 for reducing construction costs by 10 percent or more. In Charlotte, North Carolina, all city employees get a bonus if the budget comes under a certain savings target.

New Zealand has made the most progress in tying pay to performance. “Jobs for life” have been replaced by fixed-term employment contracts. Each year, a performance agreement for the chief executive is developed in parallel with the budget. The agreement states the outputs for

which the chief executive will be held accountable as well as dimensions of the financial performance. At the end of each year, the agreement is reviewed to determine the appropriate action—for example, whether bonuses should be awarded or employment terminated. Typically, at least 10 to 15 percent of each chief executive’s salary depends on performance, and a bonus of up to 20 percent can be earned for superior performance.⁴⁰ In turn, chief executives typically require performance agreements from their senior managers, who do the same for those working under them—creating a pyramid of performance agreements that become powerful levers for driving change downward.

A more radical approach is suggested by Ohio University economist Richard Vedder: tie public officials’ salaries to the size of government. “What if law or constitutional provision permit[ted] the payment of substantial cash bonuses to all legislators, statewide officials, high level political appointees and judges if spending is reduced below 18 percent of personal income?”⁴¹ The answer: spending would almost certainly be reduced.

- **Replace longevity pay with performance pay:** In many states, employees get an extra \$50 or \$100 a month based on nothing other than how many years they have been showing up for work. Such “longevity pay” penalizes some state employees at the expense of others, provides a disincentive for young people who do not necessarily want a career in government, and sends the message that the state cares more about time served than quality of work. Replacing longevity pay with performance bonuses could save money in the short term and, more important, send the message that results are valued most.

8 Get Rational: Reduce Duplication and Overlap

Duplication and overlap in government cost taxpayers billions of dollars. When Mark Forman, the Bush administration’s e-government czar, began looking into duplication and overlap, he found that each of the federal government’s 32 lines of business—ranging from delivering welfare to operating parks—is performed by an average of 19 agencies. Not only is there massive program duplication, but also tremendous redundancy in administrative systems (e.g., the 18 different payroll systems within the federal government).⁴² According to Forman, this kind of duplication at the federal level costs taxpayers at least \$9 billion in redundant information technology (IT) costs alone. At the state level, the Raleigh-based John Locke Foundation found that North Carolina could save at least \$60 million by merging agencies and departments with overlapping functions.⁴³

Higher education is one area often rife with duplication and overlap. In most states, too many colleges and universities are doing too much of the same thing. “There is no need to have 13 Ph.D. programs in history,” an Ohio Senate staffer told *Governing* magazine. “Maybe we’re better served to have two in the state, one in the north and one in the south . . . We want to start to specialize, especially in graduate education.”⁴⁴

Most people accept that duplication and overlap exist. Doing something about them is quite another matter, given the fierce opposition that always accompanies attempts to restructure government. As Steve Kolodney, the former chief information officer of Washington State, rightly notes, “Public institutions have not been created over very many years, simply to lose their identities, their constituencies and all of their traditional purposes.”⁴⁵ Consolidation and rationalization are not easy, but with sufficient political will they are possible.

The first step is to identify the duplication and overlap. The best way to do this is to determine the main lines of business performed by state government—delivering health care, managing assets, incarcerating criminals, offering job training, and so on—and then figure out which agencies provide each service. Typically, when policy makers develop business process maps they discover that multiple agencies are involved in each function or business process.

Recommendations

- **Use results-based budgeting to reduce redundancy:** The least politically explosive and most objective way to push through consolidation and rationalization is to use the performance-based approach described in Strategy 6. If three different agencies, for example, are involved in energy conservation, administrators would first develop common measures of performance for energy conservation and then compare the performance and unit costs of the agency programs. The least efficient and worst-performing programs would be eliminated or merged into the best program.
- **Adopt an enterprise approach to IT spending:** Most governments are spending more than necessary on IT but not spending enough on e-government. Lacking coordination on IT spending, each agency buys its own expensive hardware and software systems. This not only wastes money but typically results in islands of incompatible systems that cannot communicate with each other.

This was the situation Jeb Bush confronted when he became governor of Florida. There were 200 different IT groups, 150 state Web sites, 23 data centers, and no central IT standards or statewide coordination. By centralizing all

IT authority and employees under one State Technology Office, Florida generated large cost savings—over \$11 million in the first year alone—from increased efficiency and economies of scale. In Pennsylvania, the budget office and the chief information officer work together to prevent redundant IT spending by leveraging the budgeting process to force agencies to collaborate on IT systems.

- **Consolidate state data centers:** Governments are also realizing multimillion-dollar savings from shutting down and consolidating large, mainframe-based data centers. In the past few years, New Jersey went from six data centers to one and South Carolina from 11 to one. Pennsylvania outdid both going from 18 data centers to one and saving about \$140 million over five years. “We want to free up both cash and staff resources and to redirect them toward new technologies,” says Curt Haines, a manager for the state’s computer services division.⁴⁶
- **Consolidate some small agencies:** Agencies with fewer than 100 employees often find it difficult to carry out administrative support functions such as accounting and budgeting, purchasing, and human resource administration.⁴⁷ Consolidating entire agencies or the administrative functions of small agencies offers the potential of cost savings and improved performance. In 1996, Michigan consolidated the regulatory functions of the state’s former Departments of Commerce and Labor with those of a number of other agencies to form the Department of Consumer and Industry Services. The consolidation resulted in cost savings, streamlined services, and better customer service.

9 Take the Cost Out: Use Technology to Slash Overhead

The private sector is finally starting to see verifiable cost savings and productivity increases from IT investments. Cisco Systems is netting about \$825 million annually in e-commerce savings, half of that from Web-enabling its supply chain and providing vendors and business partners with integrated ordering tied directly into Cisco’s back-end systems. IBM has claimed even greater savings—\$1 billion annually—from shifting nearly all its business processes to the Web.⁴⁸ Not to be outdone, Oracle’s Larry Ellison says his company is saving a cool \$2 billion a year by moving training and customer service online and using the Web to consolidate databases and information systems. Such savings typically represent permanent reductions in the cost of doing business.

Such savings have so far proven illusory for state governments. There are many reasons: the savings do not come overnight, they are not always easy to identify (they are embedded within processes, activities, and programs), getting to the savings

involves some pain (i.e., some public employees could lose their jobs), and tight budgets mean that huge capital outlays to fund the e-governments of the future are not in the cards.

Despite the obstacles, there are proven ways to extract cost savings from e-government and IT—for governments with the political will to do so. Under the aegis of its EMPOWER Kentucky initiative, Kentucky realized \$140 million a year in cost savings and revenue gains from using technology to reengineer the state's business processes.

TEN WAYS E-GOVERNMENT CAN SAVE STATES MONEY

- 1 Reduced workforce costs
- 2 Higher employee productivity
- 3 Reduced paper costs
- 4 Reduced processing costs
- 5 Better supply chain management
- 6 Better prices on goods and services
- 7 More efficient markets
- 8 Reduced travel and training costs
- 9 Reduced fraud and abuse
- 10 Lower building and property costs

Recommendations

- **Require agencies to procure most goods and services online:** Every year, states spend billions purchasing goods and services, using notoriously inefficient paper-based procurement systems. According to a state of Texas study, governments spend 5.5 percent of procurement budgets simply on processing costs.⁴⁹ If done correctly, moving procurement online can increase competition, speed up transactions, reduce administrative costs and staff time, consolidate purchasing, and drive down prices. To speed the transition from paper-based to digital purchasing, Florida, North Carolina, and a host of other states have mandated that state agencies ditch their archaic paper-based purchasing systems and use enterprise-wide e-procurement platforms.
- **Reduce procurement budgets by 2 to 5 percent to reflect savings from e-procurement:** Several state governments—and scores of private firms—have achieved cost savings by moving purchasing online. Pennsylvania, for example, has saved more than \$13 million in commodity costs since 1999 by conducting online “reverse auctions,” in which sellers compete to offer the lowest prices on commodities or services.⁵⁰ By improving the flow of

information between buyers and sellers, reverse auctions and other forms of e-procurement can make markets more efficient, increase competition among suppliers, and reduce the costs of doing business with buyers. Anticipating economic dividends from online purchasing, in 2001 Virginia reduced each agency's procurement budget by 5 percent.⁵¹

- **Save money by letting customers serve themselves:** Letting customers help themselves via self-service transactions on government portals allows states to reduce costs and improve customer service. Leading private companies are experiencing huge cost savings from shifting millions of customer calls to self-service Web transactions. By moving 35 million customer service calls to a Web-based self-service environment, IBM saved \$750 million in 2000. Every service call handled through ibm.com instead of a customer representative saves between 70 and 90 percent.
The best near-term opportunity for governments to achieve hard cost savings from self-service Web transactions is by digitizing internal functions such as human resources (HR) management. The State of Florida will save \$20 million a year by Web-enabling and outsourcing its HR, payroll, and benefit administration functions now serving 135,000 employees across 30 agencies. Florida's HR outsourcing and technology enhancement initiative will also allow it to reduce the number of employees delivering HR services by 1,000 FTEs.
- **Use technology to cut fraud, waste, and abuse:** Billions of government dollars each year are wasted because of overpayments, false claims, and outright fraud. Neural networks, data mining, and other computer technologies can make it much easier for governments to detect and reduce fraud and erroneous payments. Another promising fraud reduction model is audit recovery programs. A division in the U.S. Department of Defense that makes commodity purchases of about \$4.9 billion a year has recovered \$111 million over the past seven years, and \$24 million last year alone, by using recovery audit techniques.

SAVING MONEY BY WEB-ENABLEMENT

Organization	Process Web-Enabled	Estimated Cost Savings
Cisco Systems	Supply-chain management	\$412.5M
Cisco Systems	Financial Reporting	\$86M ⁵²
DoD Financial & Accounting Service	Reverse Auctions	\$2.1M
DuPont	E-procurement	\$200M ⁵³
Honeywell	Travel booking	\$4M ⁵⁴
IBM	Training	\$395M ⁵⁵
IBM	Customer Service	\$750M ⁵⁶
IBM	E-procurement	\$270M
Oracle	Customer Service	\$550M ⁵⁷
Shell Oil	Knowledge Management	\$200M ⁵⁸
State of Pennsylvania	Reverse Auctions	\$13M ⁵⁹

10 Arm for Battle: Create Cost-Cutting Brigades

When Texas was facing a massive state budget deficit in the early 1990s, then-governor Ann Richards, Comptroller John Sharp, and the state legislature assembled over 100 of the best budget analysts, auditors, and number crunchers in Texas government and gave them a single mission: get us out of this budget crunch! In five months, the team came up with over 1,000 recommendations and identified over \$2.4 billion in budget savings, ending the budget crisis and averting the need to impose a state income tax. The success of the review gave rise to the Texas Performance Review, a biennial review of Texas government that has resulted in \$13.1 billion in savings and gains to state funds since it was launched in 1991.

Every state should have a powerful independent agency that conducts periodic, top-to-bottom reviews of state programs, agencies, and departments and makes recommendations to maintain, eliminate, redesign, or restructure them. There are advantages to establishing such entities:

- They provide a permanent counterweight to the inertia and resistance to change inherent in government.
- They build institutional knowledge. Performance review analysts get to know where all the bodies are buried. Many years of conducting program reviews enables them to go head to head with agencies during legislative testimony and member briefings.
- Legislative committees and state budget offices are easily sidetracked by other priorities and typically lack the dedicated resources needed to lead a transformation initiative.

To be sure, most states already have some kind of performance auditing function in place. These generally fall into three categories: (1) one-time, comprehensive program reviews of the entire state government; (2) regular periodic options reviews of agencies and functions; and (3) sunset commissions.⁶⁰ But in only a handful of states are these entities specifically charged with identifying cost savings opportunities, and in even fewer states do they have enough clout to have much impact on the budget process.

Success requires strong legislative and executive support, first-rate analytical capabilities, the authority to compel agencies to turn over data, and some insulation from parochial political interests. Texas probably has the most robust independent review capabilities of any state. The Texas Performance Review, (now called “e-Texas”) the Texas Sunset Commission, and the 200-person-strong State Auditor’s office all have considerable clout with the Texas state legislators, as well as other powerful state leaders, who are needed to champion their recommendations. The legislative and executive branches take notice when all three forces join together in support of eliminating or restructuring a state program.

RESULTS FROM LEADING STATEWIDE PERFORMANCE REVIEWS/BLUE-RIBBON COMMISSIONS

Review Initiative	Estimated Cost Savings/Cost Avoidance/Revenue Gains
EMPOWER Kentucky (1996–2001)	\$140M (annual)
E-Texas/Texas Performance Review (1991–)	\$13.1B
Illinois Statewide Performance Review (1999–)	Not calculated
New Century Colorado (1999–2000)	\$41–49M ⁶¹
Pennsylvania IMPACT Commission/PRIME (1995–)	\$600M

Recommendations

- **Establish and/or strengthen periodic performance and program reviews:** One-shot performance reviews, whether conducted by blue-ribbon citizen commissions or state employees, are helpful for identifying some cost savings and opportunities for improvement, but without follow-up they will do little to change the culture of government over the long term. States need an ongoing capacity to drive continuous improvement, innovation, and cost savings in government. States without performance review capabilities should establish them; states with such capabilities should look for ways to strengthen them.
- **Establish and/or strengthen sunset review processes:** Nearly half of all states have established a process for regularly assessing and “sunsetting” programs. Unfortunately, in all but a handful of states, the sunset process has little or no impact on budget negotiations, and programs are almost never actually “eliminated.” This has left a general feeling that sunset processes have failed to live up to the expectations of their original backers. But this does not mean that sunset commissions cannot work; they just need the right combination of structure, resources, legislative backing, and executive branch cooperation. Since 1982, for example, the Texas Sunset Commission, a branch of the Texas legislature, has abolished 43 agencies and consolidated another 10, saving the state over \$630 million. Moreover, thanks to the permanent existence of a powerful legislative sunset committee, the bulk of the commission’s recommendations end up becoming law.

IV. Toward a More Stable Fiscal Future

Piling up more debt, using short-term accounting gimmicks, and implementing targeted tax increases might get some states through this year’s budget crisis. However, by pushing today’s costs into tomorrow’s budgets, state lawmakers are just prolonging the misery. Worsening structural imbalances between revenues and expenditures mean that many states can expect hard times throughout the next decade. “States are going to have to rethink how they finance their budgets in the future,” says Claire Cohen, vice chairman of Fitch, a credit-rating agency. “Their problems haven’t ended.”⁶² Some of this decade’s most contentious debates are likely to revolve around proposals to address these problems, whether by broadening the tax base, introducing a state income tax (in those states without one), or trying a variety of other approaches.⁶³

Before contemplating any massive changes in state tax structures, policy makers need to squarely address the expenditure side of the equation by reducing the cost of state government. They should use the fiscal crisis as an opportunity to make needed, albeit politically difficult, reforms to state programs and processes. The dozens of strategies and recommendations outlined here—from reforming entitlement programs to thinning the ranks of state employees—can help not only cut costs but transform state government. What is needed are political leaders willing to make tough decisions and invest their time, staff resources, and, most important, political capital in the difficult task of reforming government.

ABOUT THE AUTHOR

William D. Eggers is a Senior Fellow at the New York–based Manhattan Institute for Policy Research and an appointee of the Office of Management and Budget’s Performance Measurement Advisory Council (PMAC). A nationally recognized expert on government reform, for over a decade he has written and advised policy makers on issues such as government efficiency, e-government, privatization, civil service reform, and government performance. He is the former project director for e-Texas, a state initiative charged with developing recommendations to save tax dollars, increase the use of technology, improve customer service, and inject private sector competition into state services. Mr. Eggers also served as a commissioner for the Texas Incentive and Productivity Commission, a designee on the Texas Council on Competitive Government, and chair of the Government Reform Policy Committee for then-governor George W. Bush during his presidential campaign. He is the 1996 winner of the prestigious Roe Award for leadership and innovation in public policy research. Mr. Eggers is also the coauthor of *Revolution at the Roots: Making Our Government Smaller, Better, and Closer to Home* (Free Press, 1995) for which he was given the 1996 Sir Anthony Fisher International Memorial Award for the book “making the greatest contribution to the understanding of the free economy during the past two years.”

Mr. Eggers can be contacted by e-mail at wdeggers@manhattan-institute.org.

ACKNOWLEDGEMENTS

A number of the ideas presented here were gleaned from several years working for the State of Texas’ e-Texas initiative (formerly called the Texas Performance Review). As such, the author would like to thank Texas Comptroller Carole Keeton Rylander, Deputy Comptroller Billy Hamilton and the staff members of e-Texas for their keen insights into the extremely difficult process of making government less costly and more efficient.

Thanks also to Manhattan Institute research associate, Eve Tushnet, who helped research section II of this study.

Additional Resources and Suggested Reading

“Crisis in State Spending: A Guide for State Legislators,” American Legislative Exchange Council, January 2002, <http://www.alec.org>

“Mid-Year Review of State Budget Policy,” American Legislative Exchange Council, July 2002

Texas Performance Review and e-Texas Reports: <http://www.window.state.tx.us/tpr/tpr.html>
Contact Ruthie Ford, Manager; ph: 512-463-4263,
email: ruthieford@cpa.state.tx

New Century Colorado Report:
http://www.state.co.us/gov_dir/govnr_dir/nccfinalreport.htm

National Association of State Budget Officers (Various Reports): <http://www.nasbo.org/>. Contact: Scott Pattison, Executive Director, 202-624-5382.

State of Illinois Office of Statewide Performance Review:
<http://www.state.il.us/gov/preview/default.cfm>

William Sherman, Vice President, Privatization Group, Empire State Development Corporation, State of New York: ph: 212-803-3680; email: WSHERMAN@empire.state.ny.us.

William D. Eggers and John O’Leary, *Revolution at the Roots: Making Our Government Smaller, Better and Closer to Home*, (New York: Free Press, 1995).

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Footnotes

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The American Legislative Exchange Council's Tax and Fiscal Policy Task Force develops policy to reduce excessive government spending and lower the overall tax burden. Its legislative members have been at the forefront of developing sound, free-market tax and fiscal policy. The Task Force has developed budget reform policies, tax and expenditure limitations; supermajority requirements for tax increases, and dynamic revenue forecasting. Recent task force publications include [Mid-Year Review of State Budget Policy](#) and [Crisis in State Spending: A Guide for State Legislators](#).
www.alec.org

The Manhattan Institute Center for Civic Innovation (CCI) sponsors the publication of books like [The Entrepreneurial City: A How-To Handbook for Urban Innovators](#), which contains brief essays from America's leading mayors explaining how they improved their cities' quality of life; Stephen Goldsmith's [The Twenty-First Century City](#), which provides a blueprint for getting America's cities back in shape; and George Kelling's and Catherine Coles' [Fixing Broken Windows](#), which explores the theory widely created with reducing the rate of crime in New York and other cities. CCI also hosts conferences, publishes studies, and holds luncheon forums where prominent local and national leaders are given opportunities to present their views on critical urban issues. Cities on a Hill, CCI's newsletter, highlights the ongoing work of innovative mayors across the country.
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