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ELEVEN IDEAS FOR STATE LEGISLATURES IN 2011

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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 (TEs) on their books, yet few states have controlled spending effectively. While TEs 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 downturns 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 non-vested 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.

ENDNOTES

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