

## Part 4

# Conclusions and Recommendations

For the five years immediately preceding the economic downturn, states experienced both robust revenue growth and steady increases in overall spending. Their total spending far outpaced inflation. In fact, states collectively spent hundreds of billions more than was necessary to maintain programs at 2002 levels, after accounting for population growth and inflation. As this period coincided with falling unemployment and a generally strong economy, it is not unreasonable to ask how states could have justified such a large increase in spending.

There is no industry today that expects its costs to increase every year at more than the rate of inflation. Such a business model is unsustainable in today's globalized economy. Every industry and company is under constant pressure to trim costs and streamline service delivery to compete in the free market. Economic downturns provide an extra incentive to do this and generally help set the stage for a robust recovery. State governments shouldn't be immune to this. Instead of seeking a temporary bailout from the federal government, states should roll up their sleeves and put their own fiscal house in order. No function, program or agency should be considered sacred, and each merits rigorous review and evaluation to determine whether it is achieving its mission, delivering services in a cost-effective manner and, ultimately, whether it merits continuation or not.

Let's put this another way. After 2007 we were clearly experiencing an economic downturn. If the states had merely maintained their existing programs in between economic downturns, they would have been able to deliver a \$1 trillion tax cut at the end of 2007 to help the economy recover quickly. Imagine the impact that would have had.

It is beyond the scope of this paper to explore the myriad of program-level and agency-level reform options to drive cost reductions and efficiency improvements in state government. Rather, the recommendations that follow focus on implementing systemic, proven reforms designed to drive large, enterprise-wide changes across state government to help keep the costs of government—and the taxpayer burden—in check. The following reforms are explained in more detail in the next section:

- Reform #1: Adopt an Effective State Spending/Revenue Limit
- Reform #2: Employ Outcome-Based Budgeting
- Reform #3: Adopt a Sunset Review Process for State Agencies, Boards and Commissions

- Reform #4: Utilize Non-Partisan Revenue Forecasts and an Independent Certification of the Budget
- Reform #5: Create a Statewide Real Property Inventory and Take Advantage of Asset Sale and Lease Opportunities
- Reform #6: Expand the Use of Privatization and Competitive Contracting
- Reform #7: Establish a State Privatization and Efficiency Council
- Reform #8: Implement Public-Private Partnerships to Finance Transportation Infrastructure
- Reform #9: Enact School Empowerment and Student-Based Budgeting Reforms
- Reform 10: Reinvent Higher Education Systems

### **Reform #1: Adopt an Effective State Spending/Revenue Limit**

Many states have attempted to curtail spending (or, more accurately, spending growth) with mixed success. In fact, 45 states currently maintain some sort of spending limit, combined with rainy day funds. The effectiveness of the spending restraints and the size of the rainy day funds vary greatly, however.

One of the most successful checks on government spending has been the Taxpayer Bill of Rights (TABOR), adopted by Colorado taxpayers in 1992. Although TABOR is often referred to as a spending limit, it is actually a limit on the revenues the state may collect, and thus serves as a de facto spending limit. TABOR caps the growth in state tax revenues at the combined growth rates of inflation and population. Any amount collected above this limit must be returned to the taxpayers through refunds, temporary tax credits, or any other “reasonable means.” The limit is calculated based on the previous year’s allowable revenues or actual revenues, whichever is lower.

The state exceeded the revenue limit for the first time in FY 1997–98 and continued to exceed it in many of the intervening years. Since 1997, Colorado has returned over \$3.2 billion to taxpayers, and while other states grappled with their fiscal woes in the 2001–2002 recession, Colorado enjoyed a balanced budget and still managed to issue \$927 million in tax refunds.

Increases above the tax revenue limit may only be obtained by approval of the voters in a referendum, giving the system a degree of flexibility. Since TABOR’s inception, several such referenda have been offered to the voters. Two such measures to pass include Amendment 23, which required education spending to increase at a certain rate regardless of state revenues, and Referendum A, which directed \$44 million from the TABOR surplus toward property tax relief for qualified seniors. Both measures passed in the 2000 election. Amendment 23 was fundamentally incompatible with TABOR’s revenue limits, and soon created budget problems.

Despite the fiscal responsibility and economic growth it had helped create, TABOR was blamed for the budget problems by various interests that sought to increase government spending, while the problems fostered by Amendment 23's spending mandates were ignored. Unfortunately, voters chose to side with increased spending over fiscal restraint, and TABOR was temporarily suspended for five years by Referendum C in 2005. If not for Referendum C's suspension of TABOR between 2005 and 2010, it is estimated that taxpayers would have had nearly \$3.6 billion returned to them during that period.<sup>6</sup>

TABOR went back into effect at the start of fiscal year 2010–11 on July 1, 2010. However, Referendum C permanently changed the calculation of the TABOR revenue limit such that it can no longer adjust downward when actual revenues are less than the allowable limit. Thus, spending can now only “ratchet up,” not down—the revenue limit will no longer be reset in the event of declining state revenues. It is estimated that under the new Referendum C revenue limit, Colorado will keep over \$748 million in fiscal year 2010–11 that would have otherwise been refunded under the original TABOR provisions.<sup>7</sup>

In addition to the TABOR revenue limit, Colorado does have a spending limit as well. The Arveschoug-Bird limit, put in place in 1991, restricts general fund appropriations growth to 6% per year. Exceptions are made for federal mandates, court orders, Medicaid overexpenditures, and transfers to the state's Capital Construction Fund. According to State Treasurer Mike Coffman, “if the state collects tax revenues that exceed the Arveschoug-Bird limit but that are less than the total TABOR revenue limit ... that money is normally spent on transportation and capital construction projects.”

Although the “6% limit” was merely a statute, a specific provision of TABOR prohibits the state (and local governments) from weakening any spending limitations that existed at the time of TABOR's inception, including Arveschoug-Bird. Thus, the 6% limit has become “constitutionalized.”

Overall, TABOR has had a strong and positive impact on the Colorado economy. In the words of University of Colorado economics professor Dr. Barry Poulson, “Colorado has achieved unprecedented growth over the past decade due to a favorable business climate.”<sup>8</sup> By helping to keep tax rates low and stable, TABOR has allowed taxpayers and business owners to invest more of their earnings into the economy, spurring further growth. Colorado's favorable business climate and economic growth are evidenced by the following:

- Colorado's 60% growth in per capita disposable income during the 1990s ranked first among all states.
- During this period, Colorado's population grew an average of 2.3% per year—the third-highest growth rate in the country. The number of full-time jobs increased 43%, from 1,655,000 jobs in 1990 to 2,363,000 jobs in 2000. What is more, most of the jobs created during the economic expansion were not for low-skilled work, but rather for relatively high-paying positions.

- Between 1995 and 2000, Colorado’s 51% growth in gross state product was the second-fastest in the nation.

In addition, TABOR made the budgeting process more transparent. This allowed taxpayers to become more informed and have a stronger and more direct say as to what their tax dollars were buying. If taxpayers felt legislators were not adequately funding a program that truly needed funding, they could agree to set aside a special allotment for that purpose through the referendum process.

Since, under the TABOR system, any funds for such a program will be taken from revenues collected over the limit—revenues that would otherwise be returned to the taxpayers—taxpayers can make the funding priority decisions that legislators are unable, or unwilling, to make. The crucial point is that, under TABOR, excess tax collections are rightly recognized as property of the taxpayers, not the legislators. This implies that, when deciding whether or not spending (and thus, taxes) should be increased to pay for programs not covered under the TABOR limits, Colorado taxpayers can more easily factor in the costs of programs, and not simply focus on the benefits heralded by legislators or special interest groups, since the money to pay for such programs will be coming from their own tax refunds. Without such a check on the power of the purse, all tax dollars will be spent, regardless of whether or not the state collected too much money in the first place.

Despite its many attractive features, however, TABOR is not flawless. The main drawback is that Colorado lacks an effective “rainy-day fund” to resort to in times of economic hardship. While the state does maintain very limited emergency reserve funds, “it does not currently have a device in place to smooth government revenues and expenditures over the business cycle,” according to Dr. Poulson. This is not so much a criticism of TABOR itself as it is the tax collection system as a whole, but it nonetheless deserves comment.

TABOR may be able to limit the amount that the state can collect, and thus spend, but it cannot prevent legislators from spending the maximum amount of tax dollars from the general fund and dipping into reserves not subject to the TABOR limit. Thus, while the pot may be smaller to begin with, lack of fiscal discipline will still cause it to be depleted, leaving little or nothing in reserve for use in the event of an emergency. Indeed, this has proven to be the case in Colorado. In the words of former Colorado State Treasurer Mike Coffman, “The problem is a legislature that spends to its legal limits in good times and is reluctant to set aside any of that money for the tough ones. What we need to do is ensure a balance that restrains government growth in prosperous times and permits the state to meet the needs of its citizens when times get tough.”<sup>9</sup>

In addition to the lack of a rainy-day fund, TABOR has been weakened by the practice of pre-spending the surplus. In 1998, legislation passed that allowed the state to recognize the TABOR surplus obligation in the year after the money is realized instead of in the year in which revenue comes in the door. Thus, the surplus is treated as an asset in the year it occurs and a liability the subsequent year. According to the Colorado Office of State Planning and Budgeting:

*Beginning in 1998, the state did not restrict the TABOR surplus revenue in the year it occurred. Rather the legislature, through House Bill 98-1414, obligated the TABOR refund from the next year's revenues. This pre-spending of the TABOR revenues in FY 1998–99 allowed \$468.3 million in spending for capital construction and highways. If the TABOR surplus had been restricted in the year it was realized, only \$287 million would have been available for capital and highway expenditures in FY 1998–99.<sup>10</sup>*

This raises a potential cash flow problem if the TABOR surplus is less than that of the preceding year or if an economic downturn causes revenues to come in under projections. In addition, permanent tax relief in the full amount of the surplus is now much more difficult, as the prior year's TABOR surplus must be incurred in the current year. If a similar measure is to be employed in other states, efforts must be made to avoid these dilutive effects and accounting gimmicks.

Limitations on revenues and/or spending would serve to prevent budget crises like the current one not only by enforcing fiscal discipline, but by fostering economic growth as well. Measures like TABOR create a favorable business climate by keeping tax burdens low, thus drawing increased investment to the state and encouraging small business and job growth. This incentive is a crucial prerequisite of a thriving economy.

In light of this, states should adopt the following:

- ***TABOR Revenue Limit:*** Establish a revenue limit to impose discipline on spending, as well as on taxes.
- ***Tax Rebate/Revenue Reserve Fund:*** Critics of TABOR point out that should the state spend exactly to the revenue limit each year, it might be possible that a year of falling revenue would produce a deficit. As a result, a TABOR measure should be designed to keep a running balance of up to 30% of the revenue over-collection accumulated during the previous five-year cycle. As a result, a maximum of 70% of over-collected revenues could be automatically rebated to the taxpayer, while provisions would be made for the retention of over-collections to meet the 30% reserve.
- ***Strong Spending Limit, with Spending Ratchet:*** Adopt a strong spending limit and a spending ratchet formula for setting the spending limit each year. A spending ratchet technique focuses on actual spending instead of prior spending limits by re-setting the base year at the previous year's spending level. Thus, spending limits can be reduced and, once reduced, must grow from the lower base level.
- ***“Balanced Budget Trigger”:*** Adopt a mid-year Automatic Spending Reconciliation—thus providing another way to correct for any intentional or accidental inflation of revenues. The “trigger” would adjust discretionary spending levels to achieve a balanced budget based on a program's proportion in the budget. This would make balancing the budget automatic and shield politicians from making the difficult votes of reducing spending on popular programs. Should the legislature actually want to craft its own package of reductions and take a formal vote, it certainly could. However, to ensure gridlock does not prevent the balancing of the budget, an automatic “trigger” would be necessary.

### ***Additional Resources***

Barry W. Poulson, *Colorado's Taxpayer Bill of Rights (TABOR) Amendment: An Experiment in Direct Democracy*, Americans for Prosperity Foundation, 2009.

Barry W. Poulson, *What Is at Stake in the Current Battle over Colorado's Tax and Spending Limits?*, Issue Backgrounder, Independence Institute, March 2009, [http://www.i2i.org/articles/IB\\_2009\\_C\\_a.pdf](http://www.i2i.org/articles/IB_2009_C_a.pdf).

Geoffrey F. Segal and Adam B. Summers, *The Sky Isn't Falling: Proven Strategies for Budget Reconciliation*, Americans for Prosperity Foundation and Reason Foundation, October 2005, <http://reason.org/news/show/127597.html>.

## **Reform #2: Employ Outcome-Based Budgeting**

The adoption of a priority or outcome-based budgeting system would help state policymakers to more easily identify the governmental activities most important to taxpayers and to make difficult trade-off and cost-benefit decisions. It would also result in the provision of better, more efficient state government services while protecting taxpayers and maintaining fiscal responsibility.

There are surely some functions that state government can stop providing, but unfortunately the traditional budgeting process fails to facilitate this sort of downsizing. Traditional state budgeting focuses only on the increase to a base budget, and rarely are the “big picture” questions asked—in essence, the budget is on autopilot. The logic of autopilot budgeting is simple—that in order to maintain current service levels, agencies need to spend what they did last year plus an increase to account for inflation and population increases. Put simply, this moves the discussion to the margins of spending—the annual spending increase requests from agencies. Unfortunately, the other 90 to 95% of spending is left out of the debate and seldom is analyzed for its relative merits. In fact, it is generally assumed that the activities should continue to receive funding. Put simply, the traditional budgeting process effectively establishes a default position that state government will just continue to expand over time, representing an unsustainable approach to state fiscal management.

Several states (and more cities and counties) are changing their views about government budgeting. *Priority or outcome-based spending* treats spending as an investment—the type and amount of investment should change yearly as results, performance and needs change. Budgeting this way shifts the focus on the investments and what can be accomplished with available resources—when resources run out, spending stops. Using this model, deficits are nearly impossible.

States need to follow the lead of Washington State, Iowa and others (see Table 22) and begin shifting to an outcome-based budgeting system, also known as Budgeting for Outcomes (BFO), in which policymakers and the public collaboratively rank programs according to how cost-effective they are at achieving the results citizens want. The state government then goes down the list, funds

the most important programs first, “buying down” with available revenues until it runs out of money. This ensures that vital services are being funded before less-critical ones, and services not deemed of greater importance are reduced or eliminated. Kitchen table budgeting works this way, and there is no reason the state should not do the same.

<b>Table 29: Jurisdictions That Have Used Budgeting for Outcomes</b>	
<b>States</b>	<b>Counties</b>
Washington Iowa South Carolina Michigan Louisiana Dept. of Culture, Recreation and Tourism	Snohomish, WA Multnomah, OR Mesa County, CO Polk County, FL Larimer County, CO Coconino County, AZ
<b>Cities</b>	<b>School Districts</b>
Azusa, CA Spokane, WA Dallas, TX Ft. Collins, CO Northglenn, CO Redmond, WA Eugene, OR Savannah, GA Baltimore, MD Tacoma Metro Parks, WA	Jefferson County, CO Billings, MT

Source: David Osborne, *The Next California Budget: Buying Results Citizens Want at a Price They Are Willing to Pay*, Policy Study 380, Reason Foundation, April 2010, p. 2.

### ***Washington State—Priorities of Government Budgeting Model***

Budgeting for Outcomes was first employed by Governor Gary Locke in the State of Washington in 2002 and was called the Priorities of Government (POG) model. At the time, Washington was facing a potential \$2.4 billion budget shortfall (approximately 10–15% of the size of the general fund operating budget). Significant changes were needed to plug the hole in the budget. In an effort to make the most of limited resources and ensure that the most important governmental functions were properly funded, the Locke administration called for a top-to-bottom evaluation of what services the government provided and how.

The Public Strategies Group, led by author, reform expert and consultant David Osborne (who led Vice President Al Gore’s “Reinventing Government” initiative at the federal level under the Clinton administration), developed the POG approach with the Locke administration as a central means of closing the budget deficit. The administration identified a set of ten key results that citizens expect from government:

- Improve student achievement in elementary, middle and high schools.
- Improve the quality and productivity of our workforce.

- Improve the value of post-secondary learning.
- Improve the health of Washington citizens.
- Improve the security of Washington’s vulnerable children and adults.
- Improve the economic vitality of business and individuals.
- Improve statewide mobility of people, goods, information and energy.
- Improve the safety of people and property.
- Improve the quality of Washington’s natural resources.
- Improve cultural and recreational opportunities throughout the state.

“Result teams” were formed to analyze government activities in each of the ten result areas. In Washington, result teams are comprised of six to eight subject-matter experts from state agencies, and are led by the Office of Financial Management. These teams analyzed and ranked government activities according to how well they achieved the desired outcomes as outlined in the ten governmental goals. The result teams were aided by a 10-member “guidance team” comprised of leaders of the public, private and nonprofit sectors. The guidance team was tasked with overseeing the prioritization process and reviewing the work of the result teams.

In order to aid in the decision-making process, result teams were each given a dollar allocation to serve as an upper spending limit for their purchase plans. Washington reached several key conclusions regarding the allocation limit:

- The prioritization process is often more meaningful when the allocation is less than the amount currently spent in that area.
- A dollar constraint encourages creativity, keeps proposals grounded in financial reality, and forces people to articulate priorities and choices.<sup>11</sup>

The priority rankings established by the result teams were then used to develop the 2003–05 biennial executive budget proposal. Activities were funded from the top of the list down until the spending limit was reached. Figure 1 offers an illustrative example of some of the spending priorities that were established.

The POG model is still used in Washington State today under the current administration, demonstrating the longevity of the approach and its resilience to changes in leadership.

### ***Why Budgeting for Outcomes Works***

Across-the-board cuts are generally ill-advised—they treat and affect the highest performing and most important services equally with low performing and less important services. By focusing on performance and priorities, policymakers can target their cuts—ridding taxpayers of poor-performing, non-essential and non-core services.

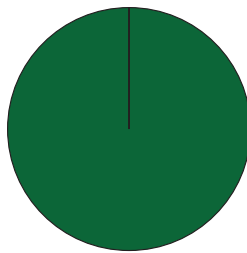


Since politicians, special interests and bureaucrats often focus on narrow interests and spending priorities, ignoring the larger picture and the sacrifices necessary to accommodate those desires, perhaps the greatest benefit of BFO is simply making budgetary priority and trade-off decisions clear to all. As a U.S. Government Accountability Office report of innovative state performance budgeting efforts noted:

*One Washington legislator said that [BFO] provided decision makers with proposed priorities in a clear and easily understood format that encouraged constructive debate. . . . Legislative officials said that the greatest contribution of [BFO] was that it provides a strong, clear means of communicating budgetary trade-offs to both decision makers and the public.<sup>12</sup>*

**Figure 25: Washington State POG Example**

**Funded Priorities:**



**\$24 Billion**  
(GF-8 & Health Services)

**Purchased: \$24 Billion (GF-8 and Health Services Account)**

- \$10.2 billion K-12 education for 1,000,000 students
- \$2.7 billion Higher education for 215,000 students
- \$3.7 billion Health care for 979,000 children and needy people
- \$3.8 billion Protecting vulnerable children, adults and families
- \$1.4 billion Public safety, including prison for 15,500
- \$125 million Economic development
- \$310 million Natural resources and parks
- \$133 million Legislature
- \$82 million Judicial
- \$369 million Government operations
- \$1.3 billion Debt service on capital projects
- \$55 million Pension contributions
- \$344 million Reserves (GF-9=\$214m, Health Services=\$78m, ERF=\$67m)

**Unfunded Priorities:**



**\$2.4 Billion**  
(GF-8 & Health Services)

**Reductions: \$2.4 Billion (GF-8 and Health Services Account)**

- \$109 million Lower costs in higher education
- \$221 million Future class size reduction
- \$112 million K-12 programs beyond basic education
- \$112 million Revised sentences for 1,200 non-violent and drug offenders
- \$187 million Lower-priority programs for vulnerable children and adults
- \$389 million Future expansion of Basic Health Plan
- \$277 million Health coverage for 58,000 adults now on Basic Health Plan
- \$774 million Pay increases benefits for state-funded employees, pension savings
- \$122 million Consolidation and staff reductions of 2,600 FTE

Source: Washington State Office of Financial Management.

The BFO approach to budgeting has several other advantages over the traditional incremental “line-item” approach:

- BFO focuses on achieving results and developing statewide strategies for realizing goals, instead of focusing narrowly on agency “silos.”
- BFO illustrates not only which programs are cut, but which programs are funded.
- BFO presents trade-offs and cost-benefit decisions in a way that is clear and easy for decision makers and citizens alike to understand.
- BFO makes performance information more relevant and useful to budget decisions.
- BFO allows decision makers to reward programs and activities that best serve state goals and helps reduce waste by identifying ineffective and duplicative programs and services.
- BFO helps identify statutory limitations that are obstructing more effective service delivery.

Adopting a BFO approach would be a major step for states toward bringing sanity and fiscal sustainability to the budget process. It integrates strategic planning, zero-based budgeting and performance-based budgeting in a workable, common-sense system that has been replicated in numerous state and local governments. Policymakers would be well advised to begin implementing a similar transformation in the budgeting process to ensure that taxpayer dollars are spent with maximum effectiveness and that the trade-offs among different categories of spending—especially in a budget crisis—are made clear and explicit.

### ***Additional Resources***

David Osborne, *The Next California Budget: Buying Results Citizens Want at a Price They Are Willing to Pay*, Policy Study 380, Reason Foundation, April 2010.

David Osborne and Peter Hutchinson, *The Price of Government: Getting the Results We Need in an Age of Permanent Fiscal Crisis*, (New York, NY: Basic Books, 2004).

Washington State Office of Financial Management website, “Priorities of Government,” <http://www.ofm.wa.gov/budget/pog/>.

## **Reform #3: Adopt a Sunset Review Process for State Agencies, Boards and Commissions**

Once created, government agencies or programs are rarely reevaluated to see if circumstances—or agency performance itself—justify their continued existence. Naturally, this promotes government “sprawl” and spiraling public sector costs. In the absence of any mechanism to continually prune away at government, it is typically far more difficult to shut down an agency or program than it is to create it in the first place.

Luckily such mechanisms exist, one of the more powerful being the use of a sunset review commission. Texas offers a powerful example of what a functional, effective sunset commission can achieve. The Texas legislature established a 12-member Sunset Advisory Commission in 1977 to conduct regular assessments of over 150 state agencies to determine: (a) if each agency is still needed, and (b) identify and eliminate waste, duplication and inefficiency in state government.

The fiscal impact of Commission recommendations over time has been impressive. Since the sunset process began in 1978, 58 state agencies have been abolished and another 12 agencies have been consolidated. Based on reviews conducted between 1982 and 2009, the Commission estimates a potential 27-year revenue savings of approximately \$783.7 million through the sunset process, compared with expenditures of \$28.6 million for the Commission.<sup>13</sup> Hence, for every dollar spent on the sunset process, Texas taxpayers have received \$27 in return.

Each sunset review must include a recommendation to either abolish or continue the agency, and it may include additional recommendations for policy changes, efficiency improvements and the like. Notably, the Texas legislature has approved a large majority of the recommendations of the Sunset Commission over time. If the Commission recommends continuation of an agency, the Commission must provide draft legislation to the legislature to continue for up to 12 years and correct other problems identified during the sunset review.

Under the Texas system, an agency is automatically abolished unless the legislature passes a continuation bill. If an agency is abolished, the state's Sunset Act provides for a one-year "wind-down" period to conclude its operations and transfer all property and records to an appropriate state agency.

States should create a similar, permanent sunset review commission to recommend ways the state can cut costs, reduce waste and improve efficiency and service levels. This commission should review 20% of state programs each year, assess the importance of each agency's functions, and recommend the elimination or consolidation of unneeded or outdated programs.

Not only could a sunset review commission identify duplicative services and programs that have outlived their purpose, it could also help the legislature identify low-priority programs which the state may wish to fund during the luxury of good economic times, but are not imperative—and therefore not justified—in times of fiscal distress. With many states facing budget deficits and the prospects for ongoing fiscal challenges in a sluggish economy, state legislators and governors should take this opportunity to implement a strong sunset review process to reevaluate the government's core functions and responsibilities and streamline the state.

### ***Additional Resources***

Texas Sunset Advisory Commission, <http://www.sunset.state.tx.us/>.

Texas Sunset Advisory Commission, *Guide to the Sunset Process*, December 2009, <http://www.sunset.state.tx.us/guide.pdf>.

## Reform #4: Utilize Non-Partisan Revenue Forecasts and an Independent Certification of the Budget

The current budgeting process allows much room for discretion in revenue projections, creating the opportunity for unrealistic projections to serve as the foundation for state spending. Two interrelated reforms can help to address this problem: (1) have a nonpartisan revenue forecast council that meets quarterly and publishes an official state revenue forecast, and (2) have an independent, third-party certification of the budget.

Using non-partisan revenue forecasts—which should account for all taxes, fees and charges by state government—can help eliminate the bureaucratic tendency to rely on higher-end revenue estimates just to balance the budget. States should also require the state treasurer (or a similar comptroller or state auditor position) to certify the budget, which would help to ensure that the budget relies on realistic revenue forecasts. Further, this approach creates a political incentive for accurate budgeting since the comptroller’s professional credibility (and potential political future) is on the line.

The Texas State Constitution gives the comptroller in that state the authority to certify the state’s budget. In advance of each regular legislative session, the comptroller prepares and submits to the governor and legislature a statement under oath showing the financial condition of the state treasury at the close of the last fiscal period and an estimate of the probable receipts and disbursements for the current fiscal year. The statement also contains an itemized estimate of the anticipated revenue based on the laws then in effect from all sources, showing the fund accounts to be credited during the succeeding biennium.

Except in the case of emergency or imperative necessity and with a four-fifths vote in each house, *no appropriation in excess of the cash and anticipated revenue of the funds from which such appropriation is to be made is considered valid*. No bill containing an appropriation can be considered as passed or be sent to the governor for consideration until and unless the comptroller certifies that the amount appropriated is within the amount estimated to be available in the affected funds.

Policymakers should close the current gap in their budgeting processes by adopting provisions similar to Texas’s. Giving the state’s chief financial officer the ability to prevent unrealistic budgets from being adopted until they match expected revenues would be an important step at tightening and strengthening the state’s system of fiscal controls to keep the price of government in check.

### ***Additional Resources***

State of Texas, Senate Research Center, *Budget 101: A Guide to the State Budget Process in Texas*, January 2005, [http://www.senate.state.tx.us/SRC/pdf/Budget101\\_2005.pdf](http://www.senate.state.tx.us/SRC/pdf/Budget101_2005.pdf).

Texas State Constitution, Article 3, Sec. 49a., “Financial Statement and Estimate by Comptroller of Public Accounts; Limitation of Appropriations.”

## Reform #5: Create a Statewide Real Property Inventory and Take Advantage of Asset Sale and Lease Opportunities

How much land does each state own, and how many assets are held by each state? These seem like basic questions that would have simple answers, but many states and counties do not have the kind of basic property and asset data that a well-run business or responsible family relies on to manage its finances. With millions of acres and thousands of assets in government portfolios, officials should take steps to identify what they own, determine whether government or private ownership is the most effective, and streamline the efficient disposal of all unneeded real property.

A real property inventory (RPI) is simply a written record of what land and assets a government owns. Real property assets are typically immovable property, such as office buildings, warehouses, heavy equipment or bridges. Governments can also track additional property, like vehicles, in a comprehensive inventory. Inventories can be built in many different ways, but whatever the shape an RPI takes, the end product should be able to answer five questions:

- What do we own?
- Where is what we own located?
- What is the condition of what we own?
- What is the value of what we own?
- What is the best use of what we own?

Real property inventories have a wide range of applications and value. The process of developing and maintaining an inventory allows government officials to assess their costs in managing property to find ways of being more efficient with taxpayer money. Inventories can even help monitor the effectiveness of spending projects and provide data to economic crisis early warning systems. There are additional non-financial benefits, such as legal compliance and mapping systems for emergency response units. Last, a comprehensive list of land and assets, up-to-date with their current use, allows a governing entity to assess what property it might be able to lease or divest to generate upfront cash in times of economic crisis.

The two most common and effective ways of extracting value from government assets are asset divestiture (the outright sale of government land or assets) and asset leases (long-term leases of public assets to private sector investor-operators). Government asset sales and leases can take a variety of forms. In some cases, government entities sell real property outright, in either an “as is” or “entitled” state (having secured necessary zoning approval). In other cases, these transactions are established as a long-term lease agreement or concession, particularly for revenue-generating enterprises like a golf course, toll road or parking facility. In other cases, such as government-owned buildings, approaches include sale-leasebacks, where the private sector purchases the property for a fixed price and agrees to lease back the facility to the government entity for an agreed-upon period of time. Importantly, the government entity can receive a lump-sum cash payment in all three scenarios.

A thorough centralized inventory of all state-owned real property and assets is a critical first step that will form the basis for planning, maintenance and operational decisions moving forward. Such a database can be used to generate benchmarking data to inform property management decisions and provide documented institutional memory in the face of changes in personnel.

The first step a state must take is to conduct an “inventory of inventories” to find out what the state already knows it owns. This survey project would involve coordinating various state agencies and creating common metrics to record ownership data to provide a benchmark for what next steps in the inventory process should be.

Afterward the governor should commission a review to categorize all state-owned property and move toward asset divestiture and realignment opportunities. Within existing staff, a position should be identified within the Department of Administrative Services (or similar department) to be directly accountable for overseeing this portfolio and given the necessary authority to exercise those duties on an ongoing basis. Ongoing support for asset inventory maintenance is key, as the state will benefit most from a dynamic database that it can add to and subtract property data from over time.

Upon completion of the asset inventory, the governor should commission a review to categorize all state-owned property as: (1) property currently serving a critical function (state courthouses and public safety facilities would be examples) and thus are unlikely candidates for sale or divestiture; (2) real estate that is unused, underutilized or not linked to concrete program goals; (3) revenue-generating assets that offer significant lease opportunities; or (4) non-critical assets that are not supporting an inherently governmental function (such as public golf courses) for which both sale or lease are viable options.

After the commission categorizes all state-owned property, the following steps should be taken:

1. Assemble a procurement team to prioritize asset lease opportunities. This team—appointed by the governor and composed of budget, policy, financial and legal experts—would conduct a rigorous assessment of potential asset lease opportunities and identify a recommended set of top-tier assets to advance toward privatization or public-private partnerships.
2. Incentivize quick identification and disposal. State officials should develop a system to disburse some portion of the proceeds from real property and asset sales to programs and departments, providing an incentive for those departments to participate in the divestiture process. Agencies that identify assets for divestiture should benefit from those sales. For example, the department that operated the surplus property (Parks, etc.) should be given a “commission” for helping identify unneeded property—perhaps 10% of proceeds—which could be used for needed capital upgrades or other purposes. As it stands, in many states departments have few incentives to seek divestiture opportunities because they receive none of the benefits of surplus sales.

3. Contract with the private sector to conduct a market-value disposal of surplus property. Such opportunities include partnering with local private real estate brokers. Additionally, rather than conducting its own live auctions, the state can employ readily available online auction markets for the disposal of property. Whereas live auctions require a physical presence and severely limit participation, online auctions are global in their reach and participation.

The recent experience of states and local governments demonstrates the opportunities and potential of asset divestiture initiatives. For example, using technology and analysis systems developed by the vendor ARCHIBUS to manage state property, the state of Missouri saved \$3 million directly through the consolidation of state facilities and an additional \$10 million in annual savings from improved billing, space utilization, work order and lease management.

Georgia offers another powerful example of success using this process. In 2004, Georgia Governor Sonny Perdue realized each state agency was handling its own space management without cross-agency coordination, resulting in inefficient facility use and little or no opportunity for comprehensive management of real estate assets. He created the Governor's Commission for a New Georgia by executive order, one aspect of which was to develop a statewide land inventory.

When the state set out to inventory its property it found many cases of gross mismanagement of public resources. Using its state Building, Land & Lease Inventory of Property (BLLIP), Georgia identified several properties that were not being put to their full use. In one case, underused properties were consolidated into the Douglasville One Stop Shop, a collocation project of three state agencies.<sup>14</sup> This project resulted in:

- A cost savings totaling \$150,000 annually (maintenance, security, etc.);
- An additional 18,000 square feet of office space;
- \$22 million revenue to the state by selling surplus property (easily identifiable through
- BLLIP); and
- \$1.1 million saved in 2006 through renegotiation and consolidation of leases that will save an estimated \$20.5 million through 2012.

BLLIP also identified two properties in close proximity of each other that could be consolidated, saving Georgia \$102 million over ten years.

The fiscal benefits Georgia attained did not come from passive management but intentional pursuit of efficiency. Lonice Barrett, director of implementation for the governor's commission, says, "Now we can ask why an agency is doing one thing with one property while another agency is doing something else with a similar property. We found examples where an agency had two buildings in one office park and were paying different rates for the two offices."<sup>15</sup>

Every state would similarly benefit from taking comprehensive steps toward being a better steward of the land it owns and streamlining the efficient transfer of all unnecessary or under-used real property. This would improve proper asset management, encourage economic growth, and generate—instead of consuming—tax dollars.

### ***Additional Resources***

Anthony Randazzo and John Palatiello, *Knowing What You Own: An Efficient Government How-To Guide for Managing State and Local Property Inventories*, Policy Study 383, Reason Foundation, June 2010, <http://reason.org/news/show/managing-state-local-property>.

John Palatiello, *What's in the Government's Attic?*, Policy Brief 33, Reason Foundation, December 2004, <http://reason.org/news/show/whats-in-the-governments-attic>.

Committee on Transportation and Infrastructure, *Sitting on Our Assets: The Federal Government's Misuse of Taxpayer-Owned Assets*, U.S. House of Representatives, October, 2010, [http://mica.house.gov/UploadedFiles/FINAL\\_REPORT\\_Sitting\\_On\\_Our\\_Assets.pdf](http://mica.house.gov/UploadedFiles/FINAL_REPORT_Sitting_On_Our_Assets.pdf)

## **Reform #6: Expand the Use of Privatization and Competitive Contracting**

*“It is better for the public to procure at the market whatever the market can supply; because there it is by competition kept up in its quality, and reduced to its minimum price.”*

— Thomas Jefferson, 1808

Though there are many causes of states’ current fiscal woes, one contributing factor is that over the years governments at all levels have expanded into hundreds of activities that are commercial in nature. Many of these are support functions that service the bureaucracy. However, most of these functions are not inherent or unique to government; in fact, they can be found in the Yellow Pages in towns all over America. This trend should concern those who believe that government should be focused on performing its core functions well and should not be in competition with its own citizens to perform non-core functions. In many areas of government service delivery, state and local governments are literally cutting into the business of business.

In fact, public encroachment on commercial activity has been positively identified in many states. Policymakers can reasonably assume that thousands of state employees are engaged in activities that are commercial in nature and could be delivered by private sector firms at a lower cost and higher level of quality. Identifying areas where the private sector can perform government functions more efficiently and at a lower cost can be an important part of the budget solution, not only cutting costs, but providing corporate tax revenue to state coffers.

The term “privatization” refers to a broad array of strategies that governments increasingly employ to take advantage of the capabilities of the private sector and thereby provide better value for the



public. It covers a spectrum ranging from a simple outsourcing contract—for example, contracting a private landscaping firm to mow the lawn around public buildings—to sales of government properties and to complex, joint public-private ventures to deliver assets (such as toll roads, bridges and public buildings) that are government-owned but are financed, built and operated by the private sector under long-term leases.

Policymakers and government administrators turn to privatization to achieve a number of different goals:

- **Cost Savings:** A Reason Foundation review of over 100 privatization studies found that cost savings ranged between 5 and 50% depending upon the scope and type of service; cost savings through privatization typically average between 10 and 25%, according to Reason Foundation experts.<sup>16</sup> As perhaps the most impressive example at the statewide level, Florida used privatization competitive sourcing more than 130 times during the eight-year tenure of former Governor Jeb Bush, saving more than \$550 million in actual dollars and preventing an estimated \$1 billion in additional costs (see the discussion in “Reform #7: Establish a State Privatization and Efficiency Council” below).
- **Access to Expertise:** Contracting gives governments access to expertise they do not have in-house on an as-needed basis. It is cheaper to retain architects, engineers and lawyers on an as-needed basis than to hire them as full-time employees.
- **Better Quality:** Competition brings out the best in competitors, whether it is in sports or in the business of providing public services. Bidders have incentives to offer the best possible combination of price and service quality to beat their rivals.
- **Improved Risk Management:** Contractors, rather than the government, are responsible for cost overruns, strikes, delays and other risks.<sup>17</sup>
- **Innovation:** Competition to win and retain contracts spurs the discovery of new, cutting-edge solutions. Without competition, even top-notch employees may stop looking for ways to improve how they meet customers’ needs.
- **Meeting Peak Demand:** The cost of providing a public service can be raised considerably by the capital and manpower needed to satisfy demand at peak periods, even though those peaks may last only for a few hours a day, a few days a week or a few months a year. Contracting allows governments to obtain additional help when it is needed so that services are uninterrupted for residents.
- **Timeliness:** “Time is money” if you are a contractor footing the bill, or if your contract with the city or state includes penalties for delays. Contractors can recruit additional workers or provide performance bonuses to meet or beat deadlines, options that often are unavailable to in-house staff.

All of these goals can be bundled under the banner of “performance.” Using privatization to achieve a combination of cost savings and improvements in quality, innovation, speed, expertise and innovation is key to achieving higher performance in government service delivery.

Because every state government uses privatization to some degree—and in a myriad of ways—comprehensive studies of state-level use of privatization are difficult to produce and are rarely compiled. The most recent, comprehensive state-level privatization trend survey released by the Council of State Governments (CSG) in 2003 found that the amount of privatization largely remained the same or increased slightly across the states between 1998 and 2002. When asked about the primary motivations for privatization, a majority of state budget directors cited cost savings, while agency heads ranked a lack of personnel or expertise as the number one reason for privatization. The CSG survey also noted that privatization trends will likely continue in state agencies, with nearly half of surveyed officials responding that privatization in their state or agency was likely to increase and the other half responding it would remain the same.

While there are literally dozens of state services and government activities for which privatization could be applied, some of the most often privatized at the state-level include:

- Highway design and maintenance
- Building repair and maintenance
- Vehicle fleet operations, maintenance and ownership
- Information technology
- Administrative support services (e.g., human resources, payroll, accounting, mail, printing, etc.)
- Risk management (e.g., claims processing, loss prevention services)
- Facilities financing, operations and maintenance
- Park operations and maintenance
- Corrections and mental health (facility operations and management, health care, medical and food services)
- Core infrastructure (roads/transit, water, etc.)
- Engineering services
- Welfare-to-work programs
- Child care, child welfare and adoption programs
- Juvenile rehabilitation
- Environmental lab analysis

The success of any privatization initiative will depend on a variety of factors, but two stand out:

- ***Performance-based contracts***: The legal foundation of a privatization initiative is a contract that spells out all of the responsibilities and performance expectations that the government partner will require of the contractor. No detail is too small. Failure to meet the performance standards specified in the contract should expose the contractor to financial penalties, and in the worst-case scenario, termination of the contract.

- ***Strong contract monitoring and oversight:*** Government does not walk away after signing a contract; in fact, in many ways the process—and an ongoing partnership with the contractor—is just beginning. Policymakers and administrators should develop strong oversight, monitoring and assessment protocols before entering into a contract to ensure compliance and performance, and should then follow through on full implementation. Monitoring should focus on quantifiable measures and achieving results, not on process.

People are by nature resistant to change. Privatization is a disruptive process in that it requires transformational change—a change in thinking among career civil servants and among appointees who are mastering new responsibilities. The significant budget cuts that states must make cannot be achieved through small tweaks in the status quo, but rather they demand a fundamental change in the way officials view state government operation. To help keep states' budgets in check and promote efficiency in government, it is critical to eliminate wasteful, non-essential government functions by continually challenging state entities to identify and focus on their core functions and competencies. Privatization and competitive contracting are vital tools in this process that involve looking at everything government agencies do and determining whether private firms could do the same things more efficiently and effectively. Additionally, minimizing government competition with businesses will help states retain (and grow) private sector jobs and increase state revenue by shifting tax-exempt properties and activities to the taxable sector.

#### ***Additional Resources***

Leonard Gilroy and Adrian Moore, *Ten Principles of Privatization*, Legislative Principles Series No. 7, Heartland Institute, July 2010, [http://www.heartland.org/custom/semod\\_policybot/pdf/27946.pdf](http://www.heartland.org/custom/semod_policybot/pdf/27946.pdf).

Leonard Gilroy, *Streamlining Government through Privatization and Public-Private Partnerships*, Testimony before the New Jersey Privatization Task Force, April 7, 2010.

E.S. Savas, *Privatization and Public-Private Partnerships* (New York, NY: Chatham House Publishers, 2000).

*Annual Privatization Report 2010*, Reason Foundation, <http://www.reason.org/apr2010>.

### **Reform #7: Establish a State Privatization and Efficiency Council**

As discussed in the previous section, policymakers should embrace privatization and the competitive contracting of government services to drive service delivery improvements and better value for each taxpayer dollar spent. A key lesson learned from global experience in privatization is that it works best when governments develop a centralized, independent decision-making body to manage privatization and government efficiency initiatives.

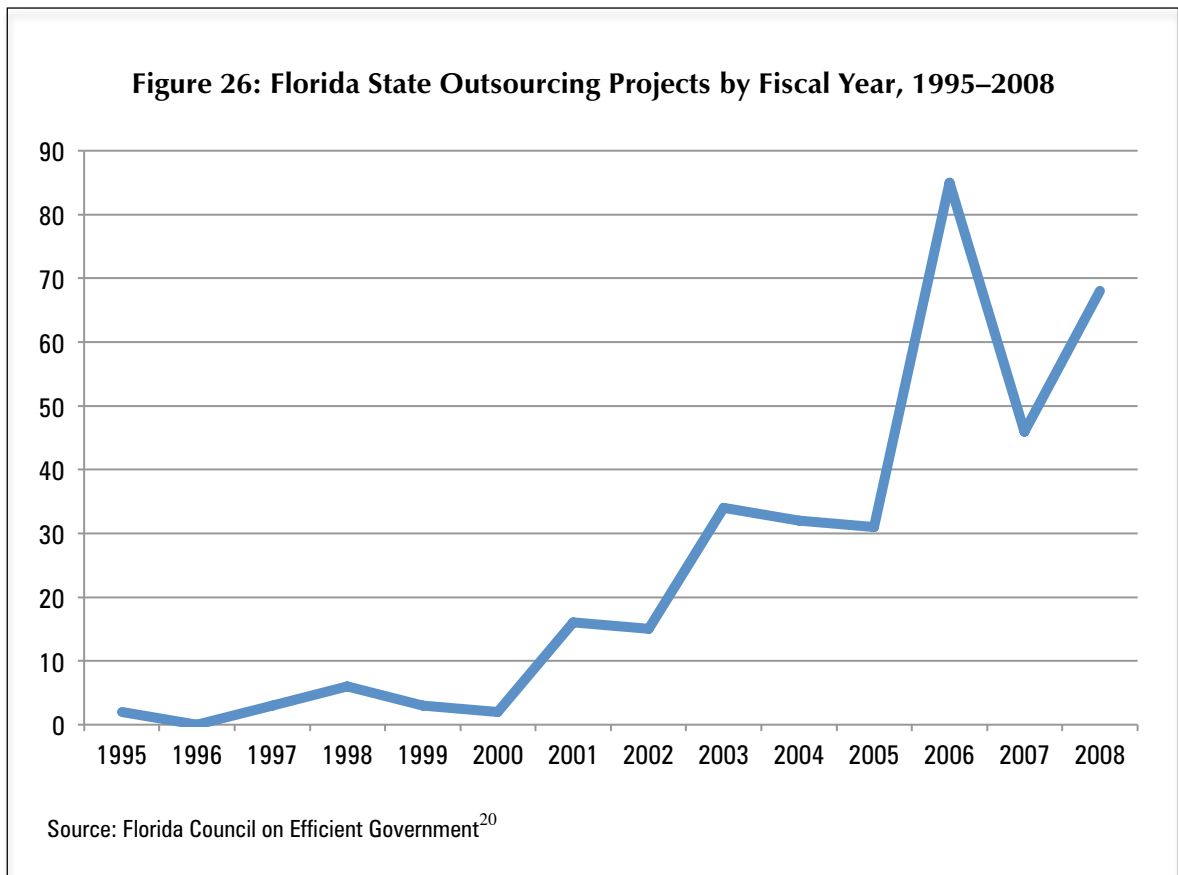
States should follow the lead of innovative states like Florida by creating a Council on Efficient Government designed to serve as the enterprise-wide gateway for best business practices in competitive contracting and to standardize how the state identifies and conducts competition initiatives (i.e., a state “center of excellence” in procurement).

Florida’s Council on Efficient Government was developed in 2004 during former Governor Jeb Bush’s tenure and was a key component of a strategy that ultimately helped his administration realize over \$550 million in cost savings through over 130 privatization and competition initiatives. When many other states were raising taxes, these initiatives helped Florida shed almost \$20 billion in taxes during Bush’s term.

Midway through his term, some of Bush’s major privatization successes became overshadowed by the media spotlight on a few major outsourcing projects that experienced difficulties in implementation. Recognizing the need to improve (a) state procurement and (b) the state’s ability to monitor the procurements, Governor Bush signed an executive order in March of 2004 directing the Department of Management Services to create a “center of excellence” authorized to conduct a statewide evaluation of Florida’s competitive sourcing efforts. The new Center for Efficient Government (subsequently codified by the legislature as the Council on Efficient Government) was empowered to “identify opportunities for additional [competition] initiatives, and oversee execution of future [competition] projects.”

The CEG’s mission is “to promote fair and transparent best business practices in government in order to foster accountability, competition, efficiency and innovation in the way state agencies serve Florida’s citizens.” It serves as the enterprise-wide gateway for best business practices in competitive sourcing and standardizes how the state identifies opportunities, conducts competitions, and awards and manages contracts for government services. Perhaps its most important responsibility is the preparation of business case evaluations of proposed privatization initiatives *before deciding whether or not to proceed* in order to help managers and policymakers thoroughly evaluate an initiative’s merits from the outset.

Prior to 2001, Florida had a total of 16 outsourced projects reported by state agencies. From 2001 to 2006, the state initiated an average of 37 projects annually (see Figure 23). In FY 2008, state agencies identified 551 projects being outsourced with a lifetime value of over \$8 billion.<sup>18</sup> Notably, the CEG was initially created in 2004, which coincides with the tremendous ramp-up in state privatization. Since Bush’s departure, the CEG is still humming along. In 2009 alone, the Council evaluated 23 new business cases for potential agency outsourcing projects with a cumulative value of more than \$225 million, identifying more than \$31 million in projected savings to the state.<sup>19</sup>



A similar center of excellence should be established in every state and given the responsibility to:

- Develop a standardized, enterprise-wide process for identifying and implementing competitive sourcing;
- Assist agencies in developing business cases for any proposed privatization initiative—before procurement—that clearly outline the rationale for the initiative (cost savings, service quality improvements, changing antiquated business practices, etc.);
- Develop rules instituting performance-based contracting and business case development as requirements for state procurements;
- Disseminate lessons learned and best practices in competitive sourcing across state government;
- Conduct an annual or biannual inventory of all functions and activities performed by state government, distinguishing between inherently government and commercial activities;
- Create a uniform cost accounting model to facilitate “apples-to-apples” cost comparisons between public and private sector service provision (critical to ensure a level public-private playing field);
- Review and take action on complaints regarding inappropriate government competition with the private sector.

With widespread state fiscal crises deepening across the country, other state policymakers are increasingly looking to the example set by Florida and the other states that have pioneered this privatization “center of excellence” concept as they struggle to close large budget deficits. For example, in December 2009 Louisiana’s Commission on Streamlining Government (established by Governor Bobby Jindal) released a set of 238 government downsizing recommendations—including a recommendation for a “center of excellence” in privatization, as well as over a dozen specific privatization proposals—that are estimated to save over \$1 billion.

Similarly, the New Jersey Privatization Task Force established in 2010 by Governor Chris Christie has recommended that the governor announce as an administration priority that achieving efficiency through private sector competition become standard policy for all state agencies. To that end, the Task Force recommended that the Christie administration establish a centralized privatization entity for the state that would fulfill functions similar to Florida’s CEG.

Having a Florida-style Council on Efficient Government in place would facilitate the regular, wholesale review of state government activities with an eye toward right-sizing government through competition and privatization. But, at the same time, it recognizes that successful privatization requires a high standard of due diligence in contracting. Hence, the Council would be responsible for establishing a standardized method for procuring and managing contracts in order to maximize accountability, transparency and competition, and deliver the best value for taxpayers.

Altogether, a sound privatization policy framework is essential to maximizing cost savings and value for money in the delivery of state services. Experience from Florida, Virginia and Utah—which have each implemented versions of the procurement “center of excellence” concept—also suggests that this approach has increased the public’s confidence and mitigated perceptions of impropriety, a common public perception and concern with any privatization initiative. Further, having a dedicated unit manage the process on an enterprise-wide scale ensures that the benefits of lessons learned and best practices are shared among agencies.

### ***Additional Resources***

Leonard Gilroy and Adrian Moore, *Ten Principles of Privatization*, Legislative Principles Series No. 7, Heartland Institute, July 2010, [http://www.heartland.org/custom/semod\\_policybot/pdf/27946.pdf](http://www.heartland.org/custom/semod_policybot/pdf/27946.pdf).

Leonard Gilroy, *State Competitive Government Commission: A Tool for 'Right-Sizing' Kansas Government*, Reason Foundation testimony to the Kansas House Appropriations Committee, January 27, 2010, <http://reason.org/news/show/state-competitive-government-c>.

Henry Garrigo, “Look Before You Leap Into Privatization: Florida’s Council on Efficient Government Sets a New Standard in Transparency, Due Diligence in Privatization and Contracting

Decisions,” interview in Leonard Gilroy (editor), *Innovators in Action 2009*, Reason Foundation, January 2010, <http://reason.org/news/show/innovators-in-action-2009>.

Florida Council on Efficient Government, *Annual Report 2009*, <http://dms.myflorida.com/index.php/content/download/63973/274570/version/1/file/Annual+Report+2009.pdf>.

## **Reform #8: Implement Public-Private Partnerships to Finance Transportation Infrastructure**

The current “perfect storm” of growing budget deficits, declining tax revenues and a sluggish economy has placed severe stress on state budgets, prompting policymakers to seek new solutions to maintain and expand their transportation facilities and other infrastructure assets. Many states find themselves at the convergence of two intersecting trends that demand attention. First, growing transportation needs are outstripping available capacity, and second, the need for maintenance and renovation of existing systems is eating up available financial resources. A failure to address these twin challenges will lead to even greater congestion in various forms and lowered reliability of service in the future. By any measure, these realities impact states’ economic competitiveness and their citizens’ quality of life.

Forward thinking states like Virginia, Florida, Texas and Arizona are increasingly looking to supplement dwindling “traditional” transportation revenues (federal grants, fuel taxes, vehicle fees, etc.) with private sector investment through public-private partnerships (PPPs). PPPs are just one tool in the box, but many states have left this promising and valuable option available to policymakers relatively untapped.

PPPs are contracts formed between public agencies and private companies that facilitate greater private sector participation in the delivery of transportation assets and services. PPPs offer a way to leverage private capital and expertise to provide a public service, and states are increasingly using them to deliver needed new transportation capacity while stretching limited taxpayer dollars. Although often thought of simply as “private toll roads,” transportation PPPs actually allow for many options to finance, construct and/or maintain new and enhanced transportation facilities. PPPs come in many forms, including the development of new infrastructure, the maintenance of existing infrastructure, and the operation of existing services. PPPs are never going to completely replace the traditional means of funding transportation, but they are a very promising method in which to augment traditional transportation revenue sources and provide more transportation project delivery options and cost savings to taxpayers.

Workable legislation is generally needed to entice private sector investment, but some states currently lack broad enabling legislation for these partnerships. The reality is that transportation projects are going to states like Virginia, Florida and Georgia that have created a solid legal foundation for PPPs—where the law facilitates PPPs and where private investment and

participation is welcomed and embraced. The modern use of public-private partnerships in the transportation arena in the United States originated over 15 years ago with California's enactment of AB 680 and adoption by the Commonwealth of Virginia of its Public-Private Transportation Act of 1995. Since the passage of these two enabling statutes, over half of the states have now adopted legislation authorizing the use of PPPs for the design, construction, financing, and operation and maintenance of transportation facilities.

Today, PPP toll projects are currently in operation or in development in states like California, Florida, Texas and Virginia. Since the beginning of 2009, Florida reached financial close on two Miami-Fort Lauderdale area PPP toll projects totaling over \$2 billion in value, and Texas reached financial close on two PPP megaprojects in the Dallas area accounting for over \$6 billion in investment. These are vital, congestion-busting projects that could not have advanced without private financing. Until state policymakers embrace PPPs and pass a workable enabling law to facilitate them, other states will continue to reap the benefits of an improved economy and business climate.

PPPs, when implemented properly and carefully, can benefit both the state and its citizens. Policymakers would then no longer be forced to choose between increasing costs to taxpayers or reducing services to motorists. Opportunities for PPPs exist in many important facets of transportation, including constructing new highways, building new bridges, and maintaining and operating state and local roads through competitive contracting. In fact, PPPs may offer a viable means of financing some large-scale capital improvement projects that currently lack a funding source.

Embracing PPPs could help states address their looming transportation funding shortfalls in order to keep people and goods—and, ultimately, their state economies—moving forward.

### ***Additional Resources***

Shirley Ybarra and Leonard Gilroy, *The Role for Public-Private Partnerships in Modernizing and Expanding Nebraska's Transportation System*, Platte Institute for Economic Research, December 2010, [http://www.platteinstitute.org/docLib/20091208\\_NE\\_Transportation\\_Study\\_-\\_FINAL.pdf](http://www.platteinstitute.org/docLib/20091208_NE_Transportation_Study_-_FINAL.pdf).

Leonard Gilroy, Robert Poole, Peter Samuel and Geoffrey F. Segal, *Building New Roads Through Public-Private Partnerships: Frequently Asked Questions*, Reason Foundation, March 2007, <http://reason.org/news/show/1002866.html>.

National Surface Transportation Infrastructure Financing Commission, *Paying Our Way: A New Framework for Transportation Finance*, Final Report, February 26, 2009, [www.tinyurl.com/y18xzv1](http://www.tinyurl.com/y18xzv1).



## Reform #9: Enact School Empowerment and Student-Based Budgeting Reforms

States should create one simple funding mechanism that distributes federal, state and local funding based on a “student-based budgeting” financing system that would include one base allocation equalized across the schools within a district and additional weighted funds for students with additional needs, including characteristics such as special education, poverty or English learners. Using student-based budgeting’s decentralized system, education funds are attached to each student and the students can take that money directly to the public school of their choice.

This process would make school finance simpler and more equitable, and bring significant cost savings by reducing central office costs and redirecting some of this savings to increase per-pupil funding allocations in the classroom. In addition, states should require the funding to follow students down to the school level and allow principals discretion over school budgets.

Key student-based budgeting principles that improve educational outcomes as well as the transparency and accountability of schools include:

1. Funding follows the child to the public school of his choice;
2. Per student funding varies based on a child’s educational needs, with special education students and others receiving larger amounts;
3. Funding arrives at individual schools in real dollars, not in numbers of teaching positions, staffing ratios, or as salary averages.

In addition, one of the most important factors in the success of schools is decentralized decision-making. Principals should have autonomy over their budgets and hiring teachers. This local flexibility allows principals to tailor their schools to best fit the needs of their students.

At least 15 school districts and the state of Hawaii have moved to this system of student-based budgeting and autonomous schools. The results from districts using student-based funding are promising. For example, prior to 2008, less than half of Hartford, Connecticut’s education money made it to the classroom. Now, under student-based budgeting, over 70% makes it to the classroom. Hartford School District achieved this goal with a 20% reduction of central office expenses, including the reduction of over 40 district-level positions.

In 2008, Baltimore City Schools faced a \$76.9 million budget shortfall. Superintendent Andres Alonso instituted student-based budgeting. He identified \$165 million in budget cuts at the central office to eliminate the deficit and redistributed approximately \$88 million in central office funds to the schools. By the 2010 school year, Alonso cut 489 non-essential teaching jobs from the central office, redirecting 80% of the district’s operating budget to individual schools.

In California, student-based budgeting has successfully offered every public school autonomy in two urban school districts. San Francisco changed to a student-based budgeting system in 2002 and the district has outperformed the comparable large school districts on the California Standards

Tests for seven straight years. A greater percentage of San Francisco Unified students graduate from high school than almost any other large urban public school system in the country. And across the Bay, Oakland has produced the largest four-year gain among large urban districts on California's standardized tests since implementing a form of student-based budgeting in 2004.

***The New York City Model.*** One case that is particularly relevant is the New York City example because it shows that it is possible to offer schools charter-like autonomy and take student-based budgeting to scale, and demonstrates that this could be taken to scale across an entire state.

Beginning in 2007–08, the New York City Department of Education began empowering all public schools, so that educational decisions happen in schools, where the people closest to students decide what will help students succeed. In New York, public school empowerment is built on the Empowerment Schools initiative pilot. In the 2006–07 school year, 332 New York City public schools took on greater decision-making power and resources in exchange for accepting accountability for results. These “Empowerment Schools” worked under performance agreements, committing to high levels of student achievement with clear consequences for failure. In exchange for this commitment, principals and their teams had the freedom to design educational strategies tailored to their students. These schools have hand-picked their support teams, hired additional teachers, implemented creative schedules, designed tailored assessments, invested in professional development, and purchased both internal and external services that meet their needs and their students' needs. Initial results are promising, with more than 85% of empowerment schools meeting the performance targets set by the Department of Education.

Following on that success, beginning in the 2007–08 school year, all New York public schools were empowered, giving their principals and their teams broader discretion over allocating resources, choosing their staffs and creating programming for their students.

Schools also have increased resources because of the Department's new student-based budgeting system called “Fair Student Funding.” The New York City program is based on simple principles:

- School budgeting should fund students fairly and adequately, while preserving stability at all schools.
- Different students have different educational needs, and funding levels should reflect those needs as well as possible.
- School leaders, not central offices, are best positioned to decide how to improve achievement.
- School budgets should be as transparent as possible so that funding decisions are visible for all to see and evaluate.

In keeping with these principles:

- Money follows each student to the public school that he or she attends.
- Each student receives funding based on grade level.
- Students also may receive additional dollars based on need.

- Principals have greater flexibility about how to spend money on teachers and other investments—along with greater responsibility for dollars and greater accountability for results.
- Key funding decisions are based on clear, public criteria.

**Why it Works.** Student-based budgeting works because it generally includes every public school in a school district, education corporation or geographic area. It changes the culture of the public school system.

Everyone becomes focused on student outcomes because families have legitimate choices within the public school system. If an assigned, or neighborhood, school is not meeting a child’s needs, that child can move to another school within the district and take his funding with him.

Every school in a state or a district becomes a school of choice and the funding system gives individuals, particularly school administrators, the autonomy to make local decisions. This autonomy is granted based on the contractual obligation that principals will meet state and district standards for student performance. It is a system-wide reform that allows parents the right of exit to the best performing schools and gives every school an incentive to change practices to attract and retain families from their communities.

**The Way Ahead for States.** Specific reforms states need to make include:

- The state-level funding formula should be changed so that the money follows the child to the school level rather than the district level.
- The state should implement school-level budgets so that school funding is transparent and equitable at the school level rather than the district level.
- Schools should receive revenue in the same way that the district receives revenue, on a per-pupil basis reflecting the enrollment at a school and the individual characteristics of students at each school.
- Principals must be able to make decisions about how to spend resources in terms of staffing and programs. The more “unlocked” dollars a principal controls, the more autonomy that principal has over designing the school to meet the needs of the students in the school. The state should require districts to place the majority of their operating budget, between 70 and 90%, into a school-level allocation to offer principals more autonomy and more real decision-making power.

### **Additional Resources**

Lisa Snell, *Weighted Student Formula Yearbook 2009*, Reason Foundation, April 30, 2009, <http://reason.org/news/show/weighted-student-formula-yearb>.

Lisa Snell, *Fix the City Schools: Moving All Schools to Charter-Like Autonomy*, Reason Foundation, Policy Brief 87, March 2010, [http://reason.org/files/pb87\\_fix\\_schools\\_charters.pdf](http://reason.org/files/pb87_fix_schools_charters.pdf).

## Reform #10: Reinvent Higher Education Systems

The rising costs of higher education are a policy challenge even in good economic times. However, given that higher education spending typically ranks among the top state spending categories (with health care, K-12 education and corrections), the current fiscal malaise in the states is shining a spotlight on this important category of state spending.

States' ability to compete in the 21<sup>st</sup> century, knowledge-based economy demands that public higher education institutions more efficiently and effectively educate larger numbers of their citizens in what is likely to become an increasingly constrained budget environment. Yet, colleges and university systems are complex enterprises both from an operational and public policy perspective, and there are no silver bullet solutions for streamlining and modernizing higher education systems.

The need to tackle large-scale systemic reforms has prompted some governors to create post-secondary education reform commissions in recent years. In 2009, Louisiana Governor Bobby Jindal created the Postsecondary Education Review Commission to recommend to the Board of Regents and the legislature the most efficient and effective ways for the state to educate citizens in the context of the state's ongoing financial challenges. The Commission issued its final report in February 2010, outlining 22 substantive system reforms to modernize higher education in Louisiana. Similarly, in March 2010 Virginia Governor Bob McDonnell issued an executive order creating the Governor's Commission on Higher Education Reform, Innovation and Investment, which will focus on crafting a sustainable higher education funding model to systematically move Virginia toward higher levels of educational attainment and economic competitiveness over the next 15 years.

While a commission or task force may be necessary to explore the depth and finer details of system-wide spending—and would be an important first step—there is no need to wait to get started on the difficult work of higher education reform. The following sections discuss three key reforms that policymakers can use to begin the process of larger, system-wide reinvention in higher education.

***Provide higher education grants directly to students, not universities:*** Just as local school districts are beginning to discover the benefits of “backpack”-based funding models (see previous section) that foster choice and competition among schools, similar lessons can be applied at the level of state higher education systems. Instead of lump-sum appropriations to public institutions, policymakers should consider reforming the funding model to distribute funds directly to students in the form of grants, and let the universities compete for their business.

Having to compete for students would create strong incentives for state higher education institutions to control their own costs, keep tuition rates in check and develop innovative educational offerings. Otherwise, if they fail to keep up with competing institutions—public or private—universities risk losing students and the education dollars they bring.

In 2005, Colorado created the College Opportunity Fund, the first statewide higher education grant system adopted in the nation.<sup>21</sup> Rather than making lump-sum payments to its public undergraduate institutions, funding goes directly to state undergraduates in the form of stipends. Like the federal Pell Grant program, students can use their grants at any in-state, public or private college or university of their choice.

A 2006 study by the Arizona-based Goldwater Institute recommended this approach for Arizona.<sup>22</sup> The study found that the \$1.3 billion in operating funds (excluding capital and construction expenses) that had been allocated annually to public colleges and universities in Arizona via state and local lump-sum funding could have instead been used to give every projected resident student an \$8,000 grant annually to attend a four-year institution (or \$5,000 annually to attend a two-year college).

Notably, this would have left intact \$2.4 billion in annual revenue Arizona public institutions were receiving from tuition and fees and other revenue (e.g., local, state and federal grants for capital and special projects, private gifts and grants, and endowment and auxiliary revenue). Also, the study finds that tying operating funding directly to students and indexing grant amounts to inflation would have saved an estimated \$768 million annually over the state's lump-sum funding system, which does not account for student counts or inflation.

***Privatize university support, administrative and commercial functions:*** Public institutions of higher education are similar to state governments as a whole in one important way—they tend to grow into large bureaucracies that expand into non-core, commercial functions and activities over time, rather than strategically using privatization and competitive contracting to deliver efficiencies and cost savings.

Privatization can typically lower the costs of service delivery by 10 to 25%. Some privatization opportunities at universities include:

- Facility maintenance;
- Landscaping and grounds maintenance;
- Security operations;
- Parking operations and maintenance;
- Transit services;
- Administrative support functions (e.g., information systems, accounting, payroll services, human resources, etc.); and
- Bookstores

Savings and operational changes can be significant, as two recent examples illustrate. In July 2010, the final report of the New Jersey Privatization Task Force estimated that colleges and universities in the Garden State could save approximately \$27.4 million annually through the outsourcing of a variety of facility maintenance functions. Also, the University of Alaska-Fairbanks announced

plans in 2010 to contract out the management of its bookstore to Follett Bookstores, the largest national college bookstore operator, citing high operating costs and Internet book downloads as impediments to a sustainable in-house operation. The privatization will return textbooks to the bookstore, improve the online store, and provide new services and a wider array of merchandise.

***Embrace innovative finance and public-private partnerships (PPPs) for capital projects:*** State universities invest a tremendous amount of capital into new and expanded facilities—academic buildings, administrative complexes, dormitories and the like—but increasing fiscal pressures are making it increasingly difficult to do so. State university systems across the country are beginning to look beyond traditional tax-exempt financing (e.g., bonds, etc.) toward more innovative procurement models that bring private sector capital and expertise to bear on the financing of university facilities (see earlier discussion on PPPs in transportation).

At first glance, it may seem that tax-exempt financing would always present a more compelling option for public universities, as compared to taxable, private sector financing models that incur a higher cost of capital. However this analysis ignores some important points.

First, financing costs usually only account for roughly 25% of total project costs, and a 1–2% differential in tax-exempt versus private costs of capital will only translate to 5% of total project cost, leaving 95% of the remaining project costs presenting opportunities for cost savings and other efficiencies brought by PPPs.<sup>23</sup> Further, PPPs can deliver 15 to 30% life cycle cost savings for operations and maintenance and can be used to deliver projects significantly faster than under typical public procurement methods.<sup>24</sup> Oftentimes, thorough project analysis will reveal that the benefits of PPPs far outweigh the limited benefits of tax-exempt public financing.

A recent sampling of innovative PPP arrangements in higher education include:

- The University of California-Davis is using a PPP to deliver its West Village project, a 130-acre project that will provide 343 housing units, 1,980 student beds in apartment housing and 42,500 square feet of retail in a mixed-use development. The university will receive income from both the lease payments for apartments and retail uses and payments by resident faculty in the housing units. Using a PPP allowed the university to leverage its small, direct investment of \$11 million into a viable \$280 million project.<sup>25</sup>
- In March 2010, Florida Atlantic University (FAU) announced a PPP for a new \$123 million, on-campus student housing community on its Boca Raton campus. Under the PPP, Balfour Beatty Campus Solutions and Capstone Development Corporation will oversee the development and management of the 1,216-bed student residential project, Innovation Village Apartments, which will also include mixed retail and office uses. Though this project is being financed through a combination of tax-exempt and Build America bonds issued by The FAU Finance Corporation, partner Balfour Beatty Capital has invested in the project by purchasing \$3.4 million of tax-exempt bonds.

- Northern Illinois University's board of trustees approved a plan in early 2010 to develop a new, state-of-the-art on-campus housing complex to attract more students, and have agreed to pursue a PPP model to deliver it. Under the plan, a private concessionaire would finance and construct the complex, which would then be managed by the university.

Given these and other experiences from public higher education systems across the country, public universities should evaluate all planned capital projects—and all future projects—regarding their potential viability for a PPP financing model to realize better value for money in the delivery of facilities and infrastructure over traditional procurement methods.

### ***Additional Resources***

Vicki E. Murray, Ph.D., *10 Questions State Legislators Should Ask About Higher Education*, American Legislative Exchange Council, [http://www.alec.org/am/pdf/education/10questions/10Questions\\_full.pdf](http://www.alec.org/am/pdf/education/10questions/10Questions_full.pdf).

Vicki E. Murray, Ph.D., *Cash for College: Bringing Free-market Reform to Higher Education*, Goldwater Institute Policy Report #208, March 2006, <http://www.goldwaterinstitute.org/article/1648>

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Leonard Gilroy, Laura J. Davis, Sarah F. Anzia and Geoffrey Segal, *Privatizing University Housing*, Reason Foundation Policy Study No. 356, January 2007, <http://reason.org/news/show/privatizing-university-housing>.