2013

STATE POLICY GUIDE

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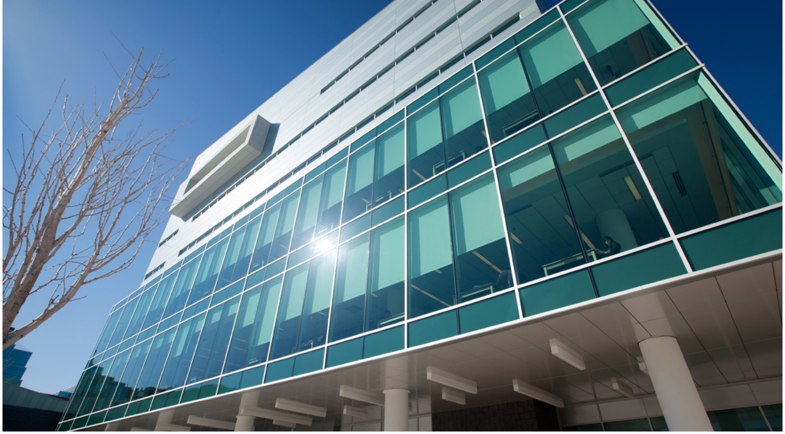

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The Mercatus State Policy Guide is intended to summarize and condense the best research available on the most relevant topics. It's a starting point for discussion, not a comprehensive overview of economic policy.

Each statement is supported by academic research, with links provided in the endnotes. Mercatus scholars are available to further explain the results of their studies.

We hope the guide will prove to be a valuable tool in your economic policy research.

HOW TO CONTROL SPENDING

Research Findings

Strict balanced budget requirements should prevent annual deficits and accumulated debt.

- A strict balanced budget requirement (1) requires actual—as opposed to prospective—balance, (2) prohibits a deficit to be carried over to the next year, and (3) has an independently elected authority evaluate the budget.
- On average, states with strict balanced budget requirements spend less than other states—nearly $200 per capita per year.[1]

The item-reduction veto is an important tool for governors.

- Instead of forcing governors to either accept or reject a spending item outright, the item-reduction veto allows the governor to reduce the amount appropriated.

- Implementing an item-reduction veto can be expected to reduce spending by over $450 per person annually.[2]

A supermajority requirement will limit tax increases.

- States with a supermajority requirement to pass any tax increase reduce spending on average by over $100 per capita each year.[3]

Separate tax and spending committees in state legislatures reduce the funding of pet projects.

- If a committee has jurisdiction over taxing but not spending, its members—unable to steer spending projects toward their constituencies—will have an incentive to keep tax rates competitive because they will not have a way to cater to voters on the spending side.
- States with separate tax and spending committees spend over $1,000 less per capita annually.[4]

Binding tax and expenditure limits restrict spending increases.

- Tax and expenditure limits (TELs) are constitutional or statutory limits on state spending that forbid legislators from growing expenditures above a certain rate.
- The most effective TELs are codified constitutionally, restrict per capita spending to increasing only with inflation, refund excess surplus revenues to taxpayers, and require a high bar for an override.[5]

Temporary federal grants often increase long-term state spending.

- When states accept temporary federal aid to create or expand a public program today, they will inevitably be forced to either cut the program or raise state and local taxes to cover its costs when federal aid ends.
- In practice, temporary federal grants today tend to result in higher state and local taxes tomorrow. For each dollar of federal aid that states receive, they can be expected to raise taxes between 33 and 42 cents to cover program costs. Localities can be expected to raise taxes and fees by 23 to 46 cents for each dollar of federal aid they receive.[6]

Budget gimmicks can mask the true cost of government and allow legislators to avoid difficult decisions.

- States can make budgeting processes less susceptible to frequently used fiscal evasion tactics.
- Tactics include inserting loopholes into balanced budget requirements, pushing forward payroll dates, deferring tax refunds, and having weak tax and expenditure limits that allow spending to increase faster than inflation and population growth.[7]

Policy Challenges

- While most states are no longer facing the level of budget shortfalls that they saw over the last few years, 21 of the 50 states still expect lower revenues in 2013 than they had before the crisis began in 2008.[8]

- States rely on grants from the federal government for nearly one-third of their entire budgets. Given the likelihood of federal spending cuts in the future, states cannot and should not count on federal support to balance their budgets indefinitely.[9]

- State budgets will face unprecedented pressure from rising Medicaid and government employee pension costs in the near future.[10]

- Medicaid is now the most expensive item in state general fund budgets, with nearly a quarter of every budget dollar going toward the program.[11]

- The biggest driver of state debt is the unfunded liabilities of government employee pension plans. As of 2012, states had enough assets to cover only 41 percent of promised pension benefits. That left an unfunded liability of $4.6 trillion, using market valuation.[12]

- Of the 50 states, 49 have some form of legal requirement to balance their budget. State governments—at least in principle—are prohibited from running annual deficits and accumulating debt. But legislators in many states have disregarded the spirit of these balanced budget requirements and sought loopholes for continued deficit spending.[13]

Policy Proposals

- Reform the budgeting process by instituting strict balanced budget requirements, thus preventing the use of gimmicks that circumvent rules meant to control spending and protect taxpayers.
- Empower the governor to reduce spending, and give voters the option to introduce binding tax and expenditure limits that restrict spending growth.
- Create institutional reforms that have been proven to control spending. Examples include requiring a supermajority to pass a tax increase and separating the legislative committees responsible for taxes and for spending.
- Remember that federal aid comes with strings attached and that increased federal grants will eventually result in larger government programs and higher state taxes.

HOW TO FIX PENSIONS

Research Findings

Accurate accounting methods can reveal the true cost of pension plans.

- Current government accounting standards result in US public pension plans understating the value of pensions promised to workers. The result is that state plans are more deeply underfunded than state policymakers report.[14]
- To accurately represent pension obligations, states should be using the risk-free discount rate of the 15-year treasury bond. Instead, states typically use the expected rate of return on their investments. This practice gives states and municipalities a pretext to make insufficient annual contributions to their pension funds—kicking the can to future generations and setting the stage for a debt crisis.[15]
- In order to develop an accurate understanding of their state's long-term fiscal health, policymakers should require pension authorities to measure and report on pension liabilities based on the market value of these liabilities. This practice would properly account for the guaranteed nature of state pensions.[16]

Moving from defined benefit plans to defined contribution plans makes public-sector compensation comparable to private-sector compensation.

- Most state and local governments in the United States offer only defined benefit (DB) pension plans to their workers. Under a DB plan, the employer promises employees regular pension payments over the workers' retirement years.
- In these public-sector DB plans, the investment risk is borne by taxpayers, since the employer's payment is guaranteed regardless of the rate of return that the pension funds earn. When investment returns are insufficient to cover the benefits promised under DB plans, states and municipalities must provide the difference—by raising taxes or cutting spending on other items in the budget.[17]
- Transitioning government employees from defined benefit to defined contribution (DC) retirement plans takes decisions about future pension benefits out of the hands of politicians and empowers workers with more choices concerning their retirement investments. Additionally, a DC plan allows public employees the flexibility to take their retirement benefits with them if they want to leave a job before pension vesting.[18]

Some states have instituted best practices to control employee pensions.

- In **Rhode Island**, the governor and legislature took the first serious step toward pension reform in 2011 by enacting the Rhode Island Retirement Security Act. This legislation immediately reduced unfunded liability by $3 billion by raising the retirement age, creating a hybrid defined benefit–defined contribution plan, and suspending the cost-of-living adjustment.[19]
- **New Jersey** took small first steps in 2010 with reforms that increase funding and reduce benefits for newly hired public employees. The state should continue to reform by offering new hires the same DC plan currently used by public university employees.[20]

- The **Pennsylvania** legislature is debating a shift to DC plans for future employees, which would be critical for long-term sustainability for state finances. However, the state will impose transition costs and will not mitigate the cost of benefits for existing employees on DB plans.[21]

Some states have taken dangerous steps to deal with unfunded liabilities.

- In **Delaware**, the realization that unfunded liabilities are growing has led officials to invest pension funds into riskier assets. This is a dangerous trend that puts both retirees and taxpayers at substantial risk. Such an action is an unsuitable substitute for serious structural reform.[22]

Policy Challenges

- The unfunded liabilities of government employee pension plans are the biggest driver of massive state debt.[23]
- State officials have promised an estimated $4.6 trillion to current and future retirees that are not backed by pension fund assets, which is the unfunded liability.[24]
- Pension costs do not appear as line items in budgets today, and many policymakers make spending decisions that do not take these future costs into account.[25]
- Current accounting methods drastically underestimate future retiree costs. These methods assume that pension fund portfolios will grow at rates that are unrealistically optimistic (nearly 10 percent per year in some instances) whereas guaranteed benefits should be valued at the risk-free rate.[26]

- Most state and local governments still enroll their employees in DB pension programs, a system that has long been abandoned by the private sector, in part because it limits retirement options for workers.[27]

- DB programs force taxpayers to assume all of the risk for future government employee benefits. If the pension fund cannot fulfill all of the benefits, taxpayers must make up the difference.[28]

Policy Proposals

- Measure unfunded pension liabilities with market valuation. This is the first step to take in any meaningful pension reform.
- Transition government employees to DC plans, which are the standard for workers outside the public sector. DC plans give employees more control over their retirement benefits while also sparing taxpayers from bearing the risk associated with unfunded pension liabilities.
- Study Rhode Island's pension reforms. This state's public employees have the choice to segue into hybrid plans that include elements of both DB and DC plans.
- Consider other structural changes that would address pension costs, including changing the cost-of-living adjustment formula and raising the number of years employees must work before being vested in their pension plan.

HOW TO CONTROL HEALTHCARE COST

Research Findings

From a practical perspective, it is unlikely that the federal government will make the full amount of Medicaid payments now scheduled under law.

- State governments that choose to expand Medicaid are at risk that the federal government will reduce Medicaid spending, leaving states to either assume these costs or cut benefits.[29]

Federal grants impose large costs in the form of future increases in state and local taxes.

- When states accept federal aid to create or expand public programs such as Medicaid today, they inevitably must decide whether to cut the program or to find additional revenue—often through tax hikes—when federal aid ends.
- State taxes will rise between 33 and 42 cents for every dollar in federal grants received today.[30]

Medicaid reforms that encourage preventive care and discourage emergency room visits can benefit both patients and taxpayers.

- Nonemergency visits to emergency rooms by Medicaid patients are one of the largest cost drivers of the program. Treatment in the ER is significantly more expensive than the same treatment delivered by a primary care physician outside of a hospital setting.[31]
- West Virginia ran a trial program that incentivized Medicaid patients with enhanced plan benefits if they signed a pledge to use the ER only in actual emergencies. This reform saw moderate reductions in unnecessary ER visits within certain demographics.[32]

The 1996 federal welfare reform, which replaced federal matching grants with block grants to states, serves as a guide to block granting Medicaid to the states.

- Block grants enabled policy experiments in the "laboratory of the states" that yielded benefits to the nation as a whole.[33]
- Block grants generate an incentive for states to be more innovative and efficient in using tax dollars.[34]
- In lieu of block grants for Medicaid, states should take full advantage of the opportunity to experiment under waiver programs. Most of the innovative state programs that encourage welfare-to-work transitions were initiated under waiver programs begun before the 1996 welfare reform.[35]

Policy Challenges

- Of total state spending in fiscal 2011, 23.6 percent went to Medicaid, the single largest portion of total state spending.[36]
- Medicaid is jointly funded by the federal government and state governments. Most Medicaid enrollees (about 7 in 10) are low-income, but the program also covers benefits for long-term senior care and disabled Americans.[37]
- The quality of care under Medicaid is inferior to that provided under private insurance. The reason is that many doctors choose not to accept Medicaid patients because reimbursement rates are so low.[38]
- With the dramatic expansion of Medicaid under the new healthcare law (the Patient Protection and Affordable Care Act, or ACA), the program will consume even more of state budgets in the future.[39]
- State policymakers face a choice under the Affordable Care Act: expand Medicaid coverage with temporary federal grants or maintain existing Medicaid systems.[40]

Policy Proposals

- Do not treat federal grants for Medicaid as free money. Each dollar of federal grants leads to future tax increases of 33 to 42 cents.[41]
- Budget with the assumption that the federal government will not be able to keep its promises for future Medicaid funding.

- Seek waivers to give states more flexibility to tailor Medicaid programs for each state's populations.
- Emphasize preventive care for patients, and create incentives for patients to avoid using the emergency room for nonemergency situations.

HOW TO STREAMLINE GOVERNMENT

Research Findings

Productivity dividends are one way to reward increased performance and discourage inefficiency.

- States typically use 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.[42]
- 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 fewer resources.[43]

The civil service must be brought into the 21st century.

- In most states, the terms and conditions of government employment are based on an industrial-era model of public sector production. In today's knowledge economy, this model is outdated.[44]
- A 21st century civil service would base pay and performance requirements on private-sector labor market equivalence.[45]

Independent streamlining commissions provide a way to test new ideas.

- Streamlining commissions can offer state governments useful tools for shrinking the cost of government while limiting cuts to the goods and services that state government is in the best position to provide.[46]
- States will be well served by carefully designed commissions that have clear and realistic missions. They should seek policy recommendations from a highly qualified commission, with as little influence from special interests as possible.[47]

Robust transparency laws ensure that government performance data is easily accessible.

- Transparency in government provides an incentive for decision-makers to act in a spirit of compliance.
- State governments can develop technological solutions to ensure that all reporting required by law is completed and made immediately available to the public. The most effective states have built websites that contain vast but easily searchable information regarding budgeting, performance criteria, and regulatory procedures.[48]

Policy Challenges

- During the recent economic downturn, states have faced difficult trade-offs as demand for public services has increased in the face of lower state revenue. Increasing taxes is both politically unacceptable and economically unsound, so state policymakers must find innovative solutions to maintain government services, given fewer resources. As short-term state budgets gradually recover, long-term debt obligations and unfunded pension liabilities indicate that difficult budget decisions are here to stay.
- Too many elected officials measure the success of government programs by how much is spent on them, regardless of whether or not they achieve desirable results for taxpayers.
- The civil service still operates on 20th century terms and conditions that are completely unsuitable for a 21st century knowledge-based economy.
- We take for granted that productivity will increase gradually over time in the private sector, but the opposite is true for the public-sector labor force. Incremental budgeting allocates more and more to state agencies over time just to achieve the same result.
- Many citizens have no way of learning how their tax dollars are being spent and how efficiently their public services perform.

Policy Proposals

- Demand productivity dividends. The public-sector labor force should become more efficient over time, so we should spend less next year than we do this year to obtain the same services (accounting for inflation, of course).
- Create government streamlining commissions. They can be a way to test innovations on a small scale to determine whether they will work for constituents.
- Pass transparency laws that give the public online access to the spending and performance records of government entities. The capability of the public to easily examine and review the full performance and financial statements of government entities leads to confidence and trust in the public sector.
- Implement private-sector standards for the public-sector workforce, including pay and benefits that are based on performance.

HOW TO EVALUATE REGULATIONS

Research Findings

Before designing a regulation, regulators should define the problem the regulation is supposed to address.

- Regulations should only be used to address widespread and systemic problems.[49]
- Many problems are not systemic, but anecdotal, in which case the best course of action is not to regulate.[50]

Once a problem has been identified, regulators should consider a wide range of alternatives before selecting a course of action.

- In some cases, the best solution may involve regulatory intervention, but in other cases, such intervention may actually cause more harm than good.[51]

- Understanding the baseline, which is a projection of what is likely to happen in the future in the absence of new regulation, allows state agencies to evaluate whether regulation will change a projected trend.[52]
- Some alternatives may involve additional government action even if they do not involve restrictive new regulations.[53]

Regulation cannot be expected to have beneficial effects unless a significant, systemic problem exists that can be alleviated by changing the rules of the game.

- There are three types of systemic problems that regulation can address: market failures, government failures, and overriding social needs.[54]
- Remedying the first two types of failures improves economic efficiency, that is, it allows either markets or government to produce the mix of goods and services that consumers value most highly.[55]
- The third type of problem, an overriding social need, usually involves some aspect of fairness or justice that may or may not have an explicit efficiency rationale.[56]

Policy Challenges

- Regulations are implemented with the stated intent of ensuring that markets operate fairly, information flows freely, and hazards to safety and health are minimized. However, many regulations yield unwanted and unintended consequences, sometimes even exacerbating the very problems that they were meant to correct.[57]

Policy Proposal

- Make a measured analysis of the problem at hand and consider all possible options before enacting additions and modifications to the regulatory code.

HOW TO DEVELOP COMPETITIVE TAX POLICIES

Research Findings

If states "bribe" companies to relocate, eventually those states will have to "bribe" them again to stay.

- States should instead work to create a tax and regulatory climate that allows all firms to compete and does not offer any special or one-off regulations to individual firms.[58]

High personal income tax rates compel productive workers to migrate to other states.

- States lose households to more tax-friendly states by (1) lowering the high-income threshold so as to capture more households, (2) increasing high-income tax rates, and (3) increasing property tax rates.[59]

Dedicated tax streams tend to result in larger government but do little to increase funding for their intended target.

- Tax revenues are called dedicated when a specific type of tax (often an excise tax) is automatically earmarked for a particular category of expenditure (education spending, health spending, etc.).
- The majority of dedicated tax revenues are ineffective at increasing spending on their targeted category, but instead increase overall expenditures.[60]

Sin taxes on items such as cigarettes and alcohol can be an effective means of raising revenue, but they come with dangerous unintended consequences.

- Sin taxes are inherently regressive. Low-income consumers, who have the fewest alternatives available to them, will shoulder the heaviest tax burdens.[61]

Policy Challenges

- Many states offer targeted tax breaks to individual firms or particular sectors in order to lure business and create jobs in their states. But once states “bribe” companies to relocate, they will eventually have to “bribe” companies to keep them from leaving.
- Dedicated tax revenues, in which all revenues from a particular source (such as gasoline taxes) can only be spent on one category (such as education or transportation), tend to be ineffective in increasing spending in the intended areas.

Policy Proposals

- Set competitive personal and business tax rates that treat all parties equally. This practice is a better way to compete than targeted tax breaks.
- Avoid dedicated tax revenues. If a spending item is deemed sufficiently important, legislators should find a way to pay for it from the general fund.
- Lower sin taxes to ease the burden on low-income consumers.

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