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SEVEN KEY ASPECTS OF GOVERNING DURING CRISIS

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

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

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

1. ADDRESS THE PROBLEM, NOT THE SYMPTOMS.

The problem facing states today is unsustainable spending levels, which resulted from state revenue forecasts that did not anticipate the current downturn.[5] Most states have seen revenues fall significantly below projections in the last two years.[6] In virtually all states, spending has increased for the past two decades at a rate that exceeds growth in income plus growth

in residents.[7] According to one calculation, between 2002 and 2007, total revenue to all states' general funds grew by twice the rate of inflation, increasing state revenues by $600 billion.[8] Data from the U.S. Census Bureau show that state and local government revenues increased from $1.32 billion in 2000 to $1.94 billion in 2008, and expenditures increased from $1.27 billion to $2.02 billion over this period.[9] These figures suggest that legislatures largely spent this windfall rather than refunding the surplus to taxpayers.

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

a. Take surplus revenue off the spending table.

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

b. Define and implement responsible budgeting practices.

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

c. Tie spending growth to population or economic growth.

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

2. PRIORITIZE. FOR REAL.

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

3. DEMAND INCREASED PUBLIC SECTOR PRODUCTIVITY.

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

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

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

FIGURE 1: OPTIONS FOR CONSTRAINING GOVERNMENT SPENDING

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

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

4. REFORM THE CIVIL SERVICE.

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

5. REVIEW ALL OPERATIONS.

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

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

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

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

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

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

7. REPEAL BAD IDEAS.

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

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CONCLUSION

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

ENDNOTES

1. National Conference of State Legislatures, State Budget Update: March 2010, http://www.ncsl.org/?tabid=20157.

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

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

4. Eileen Norcross, "State Budget Gimmicks" (working paper, Mercatus Center at George Mason University, forthcoming).

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

6. National Governors Association and National Association of State Budget Officers, *Fiscal Survey of States*.

7. Adrian Summers and Michael Flynn, "Failed States," *Reason*, May 2009, http://reason.com/archives/2009/04/07/failed-states.

8. Ibid.

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

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

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

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

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

14. Authors' calculation based on U.S. Bureau of Labor Statistics Output Per Hour data.

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

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

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

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

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