TEN STRATEGIES FOR CUTTING STATE BUDGET DEFICITS

by William D. Eggers

State governments are facing their worst fiscal crisis in a decade or more. This year's $40 billion shortfall will almost surely be followed by similarly large deficits next year and tight budgets for years to come. The causes of the deficits are clear: the recession, September 11, spiraling Medicaid costs, and profligate spending in the mid- and late 1990s. Add them all up, and you have the budgetary equivalent of a perfect storm. Although states are adopting "kitchen sink" approaches to bring their budgets into balance, one theme clearly stands out in this election year: How little can I get away with doing? Everyone is raiding the rainy day fund. Many states are hiking cigarette taxes; some of the same states are also plundering the tobacco settlement money. (Of course, the more cigarette tax hikes reduce demand, the less money the states get in tobacco settlement money.)

Another popular strategy is rifling through other portions of the budget—education endowments, transportation funds—hunting for stray money to pay down the deficit.

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

1. Go Where the Money Is: Reduce Workforce Costs

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

2. Spread the Pain: Impose Broad-Based Spending Cuts

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

3. Modernize Government: Reform Entitlement Programs

States have no chance to solve their long-term budget problems without getting a handle on the rising cost of entitlements. Next to the recession, the runaway cost of Medicaid—the biggest budget cost driver in most states—is the biggest cause of the current state fiscal crisis. Medicaid now accounts for one-fifth of total state expenditures, second only to education. For the past two years, Medicaid spending has been growing at a rate of 11.7 percent per year, almost double the 6.4 percent increase in state spending projected for the next fiscal year. The ten-year projections from the Centers for Medicaid and Medicare Services show double-digit cost increases far into the future. The real problem, as noted in an

American Legislative Exchange Council (ALEC) Medicaid study by Richard Teske, lies in Medicaid's defined benefits structure, which fixes benefits and eligibility and makes costs variable—a recipe for skyrocketing costs. The most promising reform plans allow consumers to choose among multiple providers; customize benefits according to patients' needs and circumstances; target benefits to the truly needy; and recognize that the Medicaid population consists primarily of three distinct groups—older people, blind and disabled people, and low income families—each of which needs to be treated differently.

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

Over the past two decades, hundreds of billions of dollars' worth of state-owned enterprises and assets have been sold or leased to the private sector worldwide. These assets have included airports, stadiums, ports, utilities, liquor operations, buildings, land, and gas and electric utilities. The Reason Foundation estimates that cities and states own over $226 billion in infrastructure assets that could be sold to the private sector. By selling or leasing state enterprises to private entities, governments can turn dormant physical capital into financial capital, which can be used for more pressing needs such as rebuilding decaying infrastructure, reducing debt, or cutting taxes.

5. Apply Antitrust to Government: Introduce Competition in Service Delivery

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

6. Fund Results: Reduce or Eliminate Programs That Perform Poorly

Governments typically focus on inputs—measuring the quality of a service by the amount of money spent providing it. If crime goes up, police departments receive more money. If student test scores go down, schools are given more cash. Poor outcomes lead to more inputs rather than an improved process. To reverse these misguided budget incentives, many states implemented performance measurement and budgeting systems during the 1990s. The idea was to spell out the precise outcomes that each department or private vendor is expected to accomplish and at what cost. Rather than funding asphalt, trucks, and employee hours (inputs) or even funding a certain number of repaired potholes (outputs), legislatures would purchase smooth streets (outcomes).

7. Change the Incentives: Reward Employees for Saving Money

Most public employees are smart, industrious people who work in ways that are consistent with the incentives and rewards in their workplaces. Unfortunately, traditional compensation systems treat all employees the same, giving workers little incentive to increase efficiency and may even reward inefficiency. There are a variety of ways to link pay to performance, including performance contracts, performance bonuses, shared savings, gain sharing, and productivity awards. In addition, step-pay raises and COLAs can be eliminated. One of the best strategies to realize budget savings and begin the transition to pay for performance is by providing financial rewards for employees, teams, and divisions for saving money.

8. Get Rational: Reduce Duplication and Overlap

Duplication and overlap in government cost taxpayers billions of dollars. When Mark Forman, the Bush administration's e-government czar, began looking into duplication and overlap, he found that each of the federal government's 32 lines of business—ranging from delivering welfare to operating parks—is performed by an average of 19 agencies. At the state level, the John Locke Foundation found that North Carolina could save at least $60 million by merging agencies and departments with overlapping functions. The first step in solving this problem is to identify the duplication and overlap. The best way to do this is to determine the main lines of business performed by state government—delivering health care, managing assets, incarcerating criminals, offering job training, and so on—and then figure out which agencies provide each service. Typically, when policy makers develop business process maps they discover that multiple agencies are involved in each function or business process.

9. Take the Cost Out: Use Technology to Slash Overhead

The private sector is finally starting to see verifiable cost savings and productivity increases from IT investments. For example, Cisco Systems is netting about $825 million annually in e-commerce savings, half of that from Web-enabling its supply chain and providing vendors and business partners with integrated ordering tied directly into Cisco's back-end systems. Such savings typically represent permanent reductions in the cost of doing business. There are proven ways to extract cost savings from e-government and IT—for governments with the political will to do so. Under the aegis of its EMPOWER Kentucky initiative, Kentucky realized $140 million a year in cost savings and revenue gains from using technology to reengineer the state's business processes.

10. Arm for Battle: Create Cost-Cutting Brigades

When Texas was facing a massive state budget deficit in the early 1990s, then-governor Ann Richards, Comptroller John Sharp, and the state legislature assembled over 100 of the best budget analysts, auditors, and number crunchers in Texas government and gave them a single mission: get us out of this budget crunch! In five months, the team came up with over 1,000 recommendations and identified over $2.4 billion in budget savings, ending the budget crisis and averting the need to impose a state income tax. The success of the review gave rise to the Texas Performance Review, a biennial review of Texas government that has resulted in $13.1 billion in savings and gains to state funds since it was launched in 1991. Every state should have a powerful independent agency that conducts periodic, top-to-bottom reviews of state programs, agencies, and departments and makes recommendations to maintain, eliminate, redesign, or restructure them. Success requires strong legislative and executive support, first-rate analytical capabilities, the authority to compel agencies to turn over data, and some insulation from parochial political interests.

Piling up more debt, using short-term accounting gimmicks, and implementing targeted tax increases might get some states through this year's budget crisis. However, by pushing today's costs into tomorrow's budgets, state lawmakers are just prolonging the misery. Before contemplating any massive changes in state tax structures, policy makers need to squarely address the expenditure side of the equation by reducing the cost of state government. They should use the fiscal crisis as an opportunity to make needed, albeit politically difficult, reforms to state programs and processes. The strategies and recommendations outlined here can help not only cut costs but transform state government. What is needed are political leaders willing to make tough decisions and invest their time, staff resources, and, most important, political capital in the difficult task of reforming government.

William D. Eggers is a senior fellow at the Manhattan Institute for Policy Research. This article is an abridged version of *Show Me The Money: Budget-Cutting Strategies for Cash-Strapped States,* published jointly by the American Legislative Exchange Council and available at http://www.alec.org and http://www.manhattan-institute.org.