The Big Reset

State Government After the Great Recession

The states are facing a protracted budget crisis, like none seen in the last 30 years, and perhaps not seen since the Great Depression. The long climb toward recovery of state fiscal health has not yet begun, and this has prompted urgent efforts to redesign and downsize government. In some instances, this has given states an opportunity to enact needed changes that have been avoided during prosperous times. But in other cases, it has prompted hard choices on the best way to "cut to the bone" while doing the least harm to state competitiveness and quality of life.

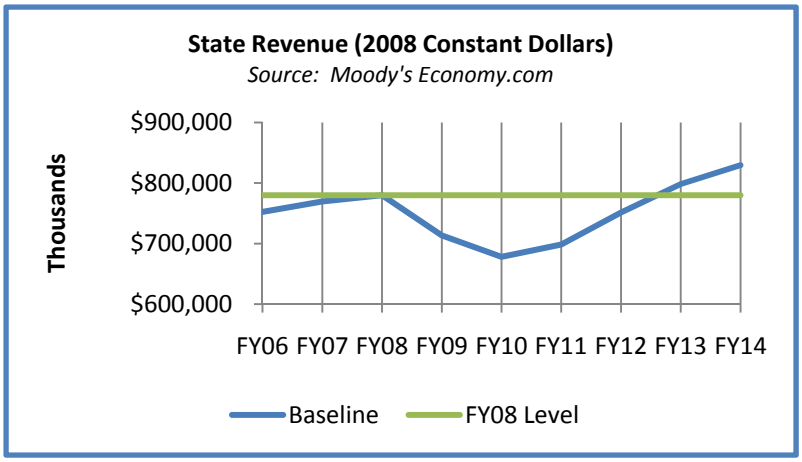
This paper examines some of the efforts states are undertaking to redesign government to meet the new austere realities and presents some of the ideas suggested for tackling the toughest issues. Many states are taking a hard look at the core services they provide and asking tough questions on what is essential and what can be made more efficient. Areas being examined include K-12 and higher education funding, corrections programs, state workforce size and costs, and government processes that cross all departments.

Governors, legislators, and citizens all need to be engaged in these efforts to redesign state government. It is a topic that will dominate the agendas of states for the next several years, and likely lead to some profound changes in how state government operates and what services it provides.

The Economic Headwinds Facing States

The "Great Recession" may have ended in August 2009, but states will take years to step back from the brink. State economies will recover eventually, but state fiscal wounds will mend slowly. Indeed, state revenues (in real terms) may not reach 2008 levels until late in fiscal 2012, at the earliest. Moreover, with the cost of services continuing to rise and investments in infrastructure and pensions largely deferred, state budgets may not fully recover until near the end of the decade. This raises the specter of a "lost decade" for states in terms of fiscal health, severely testing public expectations over what states can and cannot provide.

Unfortunately, this downturn does not resemble a normal business-cycle recession, and a typical strong recovery (such as those of earlier recessions) is unlikely. The conditions that led to the downturn—real estate bubbles, overleveraged consumers, risky debt instruments, and a near collapse of the financial system—have created long-run repercussions. The recession has left scars on consumers, entrepreneurs, and businesses and they will re-enter the marketplace slowly and with caution. Credit will remain tight and job growth



constrained. The recovery signs seen today in the United States and other developed countries are fragile, and depend largely on public spending. Without it, the recession likely would continue.

Despite the damage done, the U.S. economy (and most others) eventually will recover. However, a new question has emerged—what will the "new normal" look like? The post-recession economy may look very different in terms of leading and lagging sectors, concentration of industries, trade patterns and quantity, and countries of influence. Many workers will face new challenges to maintain or grow their income and pressures to learn new skills that match available jobs. The U.S. and many other countries will enter the next 15 to 20 years burdened by substantial public debt, possibly leading to higher interest rates, higher taxes, and tighter credit. Finally, American consumers—having lost substantial wealth—may not revive their spending spree, which helped drive the U.S. and many other economies before the recession.

All of these factors portend a decade of growth much slower than experienced in the previous 30 years. Most troubling is the continuing weakness in employment. At the end of 2009, 15.3 million workers were unemployed (40 percent were out of a job more than six months) and the official unemployment rate stood at 10 percent. Almost 7.5 million jobs were lost during the recession, and it will take years to reverse those losses. It will take even longer to create the jobs needed to reach a pre-recession unemployment rate of 5 percent—a level that many consider as representing "full" employment.

In tandem with lost jobs, state revenue and state spending has sharply declined, and will take years for state budgets to recover. From 1979 through 2007, state tax revenues grew at an average rate of 6.5 percent each quarter from the year before, with only a single quarter of negative growth. But recently, this trend has been reversed. Starting in the fourth quarter of 2008 through the third quarter of 2009, state tax revenues declined an average of 10.7 percent each quarter, with no indication at the start of 2010 that the bottom has been reached.

Not surprisingly, state expenditures have followed a similar but less volatile course until just recently. For a long period, between 1979 and 2007, state spending grew at an average rate of 6.5 percent each year. Only once did it decline—in 1983—by less than 1 percent. In contrast, fiscal 2009 general fund expenditures declined 3.4 percent from fiscal 2008 levels and enacted budgets for fiscal 2010 show a 5.4 percent decrease from 2009. These decreases in general fund expenditures represent the largest declines recorded in the last 30 years from surveys conducted by the National Association of State Budget Officers.

Challenges to Growth

Growing protectionism—Nations around the world may restrict trade and capital flows to protect their economies. Imports may face greater scrutiny over product safety and environmental standards. Imports to the U.S. may cost more, and exports may face barriers.

More government oversight and market participation—Governments around the world may play a stronger role in regulating businesses and financial transactions. State ownership of foreign oil and gas industries will increase in many parts of the world, helping keep prices high.

A tough environment for entrepreneurs—Concerns over risk will restrict credit availability to new and unproven businesses. Private angel and venture capital will be in short supply. Entrepreneurs, who face an uncertain regulatory environment, also will be cautious. Job creation, powered by start-ups, will be slow.

Government pressure to increase revenue—The federal government will face strong pressure to reduce its debt-to-GDP ratio in the next decade, which will rise to levels not seen since World War II. States, too, may need to raise revenues to meet basic services, rebuild infrastructure, and meet federal mandates. Whether through user fees, taxes, or both, citizens will likely be asked to pay more for government programs.

Dislocated workers will require substantial retraining—The post-recession economy will continue to place an emphasis on skills and education, just as it did before the recession. Many workers who lost their jobs will need substantial retraining to reenter the workforce. The regions quickest to recover will be those with the most proficient and educated workers.

A chastened consumer—A substantial amount of wealth in the United States and world has been destroyed and likely will take decades to be rebuilt. People with jobs will need to focus on saving for retirement, and a slow housing recovery will continue to suppress consumer borrowing and spending. Consumer spending, responsible for about half the growth in past recoveries, will be constrained.

Many states have tried to fill a portion of this gap by increasing fees and taxes. For fiscal 2010, states enacted tax and fee increases of $23.9 billion yet still needed to cut expenditures by $55.7 billion to balance their budgets. As the cost of government services grows and revenue falls or eventually rises at an anemic pace, the gap will widen. The problem is exacerbated by the fact that most states with sales taxes only cover sales of tangible goods. By not including services in the tax base, a large portion of the economy is ignored, making manufactured goods carry an increasing tax burden.

While a reformed tax system might spread costs over a broader base, in practical terms states recognize that increasing taxes can only go so far in eliminating current budget gaps before economic growth is hindered. The only other solution, therefore, is to structurally transform government so that it costs less to operate. This is where most policy attention is focused today. As a result, we may see dramatic changes in the size, structure, and responsibilities of state government over the next decade.

At the same time, states still will want to grow their economies and compete globally. They will want to help businesses prosper in this new environment, produce an educated and skilled workforce, and provide other essential services to sustain competitiveness. These goals will be tested by the new fiscal realities.

So how must state government adjust to meet the new challenges? Already governors are grappling with this issue. Almost every state has an internal process underway to examine how to cut costs, and several states have created formal task forces or commissions to look at cost-savings and streamlining. Most efforts start by exploring the traditional tools of budget cutting: targeted and across-the-board program cuts, reductions to local aid, layoffs, benefit cuts, furloughs, and salary reductions. In today's environment, however, states quickly find that these options do not shift the cost curve sufficiently, and they must look at actions that change the way government does business.

Additional steps that are being considered or undertaken today include:

- Selling state assets (such as surplus equipment and state office buildings);
- Consolidating data centers and IT functions;
- Coordinating purchases across agencies;
- Consolidating state real estate management into one entity and conducting a review of real estate holdings and leasing arrangement; and
- Reorganizing and combining agencies.

The above actions usually require several months to complete and may require legislative action. Thus, the savings that result will not be immediate. But even these steps—while important and necessary—may not be enough to restore long-term fiscal health in many states. As a result, more fundamental changes to state government should be considered.

Redesigning State Government for the New Normal

The business of redesigning state government is not new. Since the 1980's, governors have launched a significant number of initiatives to improve the quality and value of government, eliminate waste, and improve efficiency. Some of these were spurred by economic downturns, but many were born from concerns over the growing size and complexity of state government over the last 30 years. During that time, states have had to significantly expand responsibilities in

areas such as education, homeland security, health care, and social services, and this has forced government to grow and costs to rise.

The fiscal crisis brought on by the Great Recession has brought a new urgency to government reform efforts. It has prompted a return to questioning what are the core services of state government and how much are we willing to pay for them.

This paper begins to explore how to answer these questions. It draws from meetings with government efficiency and reform experts, discussions with policy leaders, and reviews of past and current streamlining efforts. The body of work in this area is large and already some overarching advice has emerged that can be applied to the situation today:

- First, the current fiscal situation presents an opportunity to propose major changes in state government that might not have been entertained in the past. The dire circumstances can help drive agency restructuring and reorganization, changes to pensions and benefits, redesign of service delivery models, and elimination of certain programs deemed ineffective.

- Second, veteran political observers emphasize that achieving major change require time and political commitment. Major changes will need to involve state legislators, the private sector, outside groups, and citizens. Governors must pick those actions that promise the greatest return on the investment of their political capital.

- Third, it is important to address structural changes that permanently lower the cost curve in the future. Temporary cost reductions that must be paid back later will not yield long-term structural savings. On the other hand, changes that eliminate programs or permanently alter entitlements—like Medicaid or retiree benefits—can lower expenditures in the long-term.

- Fourth, consider elimination of certain services, not just reduction. It may be better to do nothing in an area, than do it poorly and leave open the potential for future program growth.

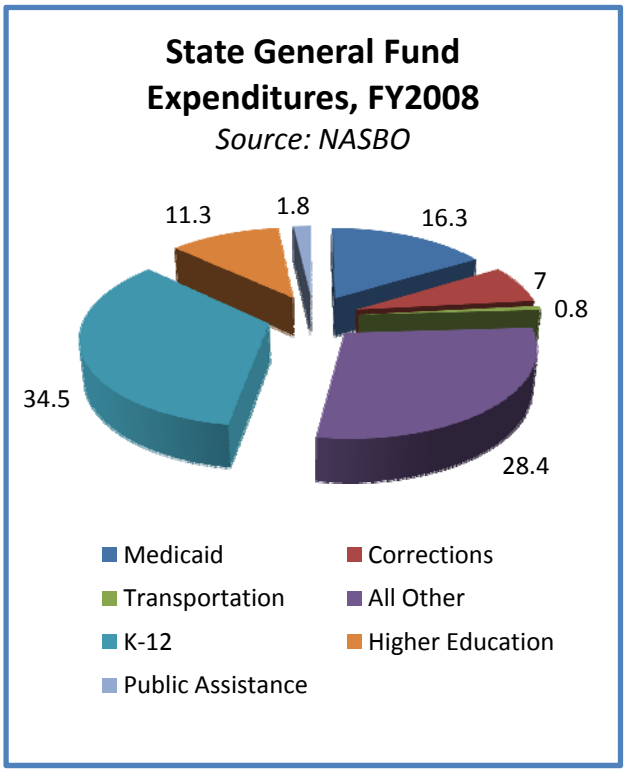
- Fifth, reorganization saves money only if it consolidates functions, combines support activities, and improves productivity. Keeping departments and their functions separate and "siloed" within a new agency will not save money.

- Sixth, optimize the technology state government already has. Consolidate data centers and processes (like payroll), integrate and share services across agencies, use common platforms, aggregate multi-agency purchasing, and require employees to fully take advantage of the technology available to them to do their job. Also, consider how technology can be used to deliver services more efficiently and cheaply.

These rules should apply to the overall review of state government and the examination of individual core services.

Reexamining Core Services

The hard work for states (and their citizens) is to decide whether the current budget priorities reflect the right mix and emphasis, and then determine whether there are major restructuring and cost saving opportunities within each area. Today, states in total spend approximately 35 percent of their general fund on K-12 education, 16.3 percent on Medicaid, 11.3 percent on higher education, 7 percent on corrections, and about 28 percent on "all other" items, which include state employee salary and benefits, public safety, environment, and parks and recreation. In fiscal 2009, state general fund expenditures totaled about $664 billion.[1]



When federal funds and other state resources (like bond revenue and trust funds) are added to state general fund expenditures, the distribution of spending among the categories changes. Medicaid rises to 21 percent of the total budget and transportation grows to about 8 percent. Most other categories shrink in comparison. The addition of federal funds and other state revenue raises the total state expenditures to approximately $1.6 trillion (fiscal 2009).

How states allocate their funds reflects, to a large extent, the priorities chosen by the state. States can cut costs either by deemphasizing certain areas or finding ways to provide the same service more efficiently. Both will need to be examined in this environment. Some options are examined below.

Corrections

Experts believe that the corrections system offers many options for savings in most state budgets. Other than Medicaid, the corrections system represents the fastest growing category in state budgets.

Because staffing accounts for 75 to 80 percent of corrections costs, reducing the prison population and closing facilities can yield substantial returns. However, this requires policy action to achieve three goals: reduce the number of people who enter prison, increase the number who leave prison without jeopardizing the community, and lowering the number who reoffend and return.

To achieve these goals, states must review and reform sentencing guidelines (to lower the number of non-violent offenders who enter prison), improve and expand prisoner re-entry programs (to increase post-prison success), and initiate enhanced community parole and probation oversight (to lower reoffending). This may require some additional resources, but these should be more than offset by the shuttering of prison capacity. These same actions also can lower the long-term costs to society and government by turning more prisoners into productive citizens.

The Vera Institute of Justice reports that Michigan plans to close three prisons and five prison camps to save $118 million annually. New York plans to close three minimum security camps and parts of seven more facilities to save over $50 million in FY 2010 and 2011. Many other states are freezing prison capacity to save money. However, all of these actions require other reforms to be in place for them to succeed.

Improving community supervision is an important component. This may require more staff to supervise released inmates, but better oversight can yield net savings by lowering the rate of re-incarceration. For example, technical violations of parole account for more than one-third of prison admissions, sometimes returning the individual to complete the original sentence. An alternative is a graduated response policy that involves closer supervision and swift, but appropriate, sanctions for early minor violations, such as failing to report. Sanctions can include home detention, short stays in county jail, or community service. By using this approach, experience has shown that parolees better adhere to their conditions of release and are more successful in completing their sentence outside prison walls.

Corrections Facts

- The average annual operating cost per state inmate in 2005 was $23,876. Nationwide, costs ranged from $13,009 to $44,860.
- Capital expenses for a medium security prison cost approximately $65,000 per bed.
- Prison operations consume about 77 of state correctional costs.
- Health care accounts for about 10 percent of correctional spending.
- The prison population that is over 50 years old is expected to grow to one-third in 2010. The average cost for an older prisoner is approximately $70,000.

Source: PEW Center on the States, "One in 100: Behind Bars in America 2008". Washington, D.C.

Reentry programs and facilities also can reduce recidivism and thus save money. These programs provide services both before and after release in areas such as substance abuse and treatment, vocational training, job placement, housing placement, and other family services. Even though re-entry programs require resources, the net effect is to lower corrections spending by eliminating the need for beds.

Finally, other cost-saving options are being explored by states, often focusing on health care expenditures. For example, many states are creating new release conditions for geriatric and chronically-ill inmates who may be low-risk offenders but require expensive health care while in prison. The Vera Institute reports that, in 2008, at least seven states established medical or geriatric parole or expanded existing programs. These programs not only eliminate the cost of a prison bed, but allow medical costs to be shifted to Medicare and/or Medicaid (states pick up 100 percent of health care costs when inmates are incarcerated).

K-12 Education

Elementary and secondary (K–12) education is the largest component of state spending when all state costs are totaled nationwide, though each state's share varies. In fiscal 2008, state funding for K-12 totaled $323.9 billion, which included state general funds (73.2 percent), federal funds (14 percent), other state funds (11.8 percent), and bonds (1.1 percent). Local governments provided an additional amount equal to about 90 percent of the state share.

Despite the fact of its size in state budgets, K-12 education spending usually is last to face the budget ax. This partly is because K-12 education is an important component of each state's economic future and a top priority for most voters. But it is also because states have little control over how education money is spent at the local level. Thus, state cuts do not necessarily generate policy responses that improve efficiency.

Nevertheless, in fiscal 2010, 30 states made program area cuts in K-12. Most of these involved allowing class size to increase (by raising student-to-teacher ratios in funding formulas), reducing administrative staff allocations, and cutting funds for teacher preparation and training. In addition, many states have cut aid for school construction; funding for pre-k, early childhood, and kindergarten programs; and subsidies for textbook purchases.

Unfortunately, because the K-12 system is locally controlled and decentralized, states have had difficulty getting districts to act strategically and restructure in light of current or anticipated challenges. For example, it has been notoriously difficult for states to get districts to combine services, consolidate schools or districts, share technology, or coordinate purchasing. Instead, most aid cuts must be absorbed district-by-district.

Because of the dire budget outlook over the next few years—and the loss of federal education stimulus funds after September 2010—states and K-12 districts will need to be more aggressive in streamlining services and exploring cost-reduction options that don't jeopardize student achievement. Underutilized schools should be considered for closure and districts with small numbers of pupils should be consolidated, which has been shown to save costs (as much as 20 percent).[2] Statewide, all districts should consider merging services, purchasing, and outsourcing functions where it is advantageous. Textbook use should be standardized across districts and greater use of online resources should be encouraged, including the use of online courses for students as well as teacher professional development. Even the benefit and retirement system for new teachers should be examined. Often, this system is more generous than that of state employees' and does not play the role it once did in attracting new teachers, who may not want to spend a lifetime in the profession.

To move forward in some of these areas, governors may find it beneficial to establish an advisory body or commission to examine certain policy options. For example, Governor Barbour in Mississippi recently established the Commission on Education Structure to study the best way to go about consolidation the state's 152 districts. The commission is a mixture of legislators, education specialists, business leaders, and other stakeholders.

Maine School District Consolidation

Maine Governor Baldacci proposed and the Legislature enacted a school district consolidation program in June 2007 that requires smaller school districts to reorganize into larger, more efficient units with the goal of merging back-office operations. The original proposal called for Maine's 260 school districts to be consolidated into 26 districts by November, 2008. The Legislature amended the proposal, changing the goal to 80 districts, with a projected savings of $36.5 million. On November 3, 2009 Maine voters defeated a referendum (by 59% to 41%) that would have repealed the law. In the first four months after enactment, some districts in consolidation reported savings as high as $2 million by coordinating purchases and merging administrative functions.

Higher Education

Postsecondary education represents the third largest expenditure in most state budgets. On average, postsecondary education receives between 11 percent and 12 percent of state general funds. In times of fiscal stress, however, postsecondary funding typically gets cut. The current environment is no different: despite federal stimulus dollars that have filled some shortfalls, 30 states made program cuts to postsecondary education in fiscal 2010.[3]

When states cut postsecondary education, more costs often are shifted to the student. However, this has been occurring even when states have increased funding. State support for public higher

education rose steadily over the last three decades (see figure), but total costs per student rose even faster. As a result, tuition costs have risen over 500 percent from 1983 to 2008.

At the same time, degree attainment is falling. While other countries are seeing a rise in degree attainment, younger generations in the U.S. are achieving fewer degrees than their predecessors. In 2006, only 37 percent of the U.S. adults ages 25-64 had an associate's degree or higher, while the best performing countries averaged 55 percent of their adult workforce holding at least an associate's degree.[4] In addition, only about 36 percent of today's U.S. freshman entering college complete their bachelor's within four years; half never graduate.

Postsecondary Cost Trends 1983 to 2008

- State support to public institutions grew from $22.8 billion to $77.1 billion (a 238 percent increase).
- Total educational revenues (tuition plus state) grew from $26.3 billion to $115.5 billion (339 percent increase)
- Over the same period, average tuition at all four-year public institutions rose from $1,031 to $5,940 (a 506 percent increase).
- Over the same period, general inflation rose 88 percent (GDP deflator).
- In 1983, tuition accounted for 20.2 percent of student educational costs; in 2008, the tuition share grew to 33 percent.

This is unfortunate because higher education remains critical to state prosperity. Not only do educated workers have greater career mobility and higher wages, a state's overall per capita income is strongly associated with the proportion of adults holding postsecondary degrees or credentials.[5] At the national level, research shows that a 1 percent increase in the postsecondary education completion rate raises real GDP per worker by 0.1 percent.[6]

In addition, more employers are demanding a higher skilled workforce that requires at least a postsecondary credential or two-year degree. Seventy-four percent of U.S. jobs by 2014 will require a postsecondary certificate or degree, according to one estimate[7].

Nevertheless, these tough budget times essentially assure that states will continue to cut or freeze higher education spending. As a result—without policy changes at the university level—more costs will be passed on through tuition increases, and fewer families will be able to pay for college. For these reasons, states must now use the substantial subsidy they provide to higher education to make the system more productive and affordable before it is too late.

The first step is to demand greater results for state dollars and shift from funding enrollments to funding degree attainment. Several states—including Florida, Indiana, Ohio, Texas, and Washington—are or have proposed basing a portion of their funding on course and degree completion. When Ohio started funding schools based on their ability to graduate students, the median time-to-degree went from 4.7 years in 1999 to 4.3 years in 2003, holding steady through 2007. Florida community colleges increased degree completion by 43 percent from 1996 to 2007 using a similar approach.[8] England goes even further. The U.K. distributes public funds to universities based on how well they fulfill national goals of improving quality, expanding access, enhancing research, and contributing to the economy.[9] Although this is a national system, it may serve as a good model for states interested in restructuring their funding processes

States also must encourage their colleges to employ strategies that reduce student educational costs and make degree attainment faster and cheaper. Such approaches include:

- **Limit the number of credit hours required for a degree in state schools.** Studies over the last 20 years have found a tendency for degree programs to increase the number of

credit hours required for a diploma—the so-called "Credit Creep" phenomenon. In their report, *Good Policy, Good Practice*, the National Center for Public Policy and Higher Education and the National Center for Higher Education Management Systems recommend establishing a limit of 120 student credit hours on all degree requirements, except for educationally justifiable reasons.[10]

- **Create articulation agreements among institutions.** Articulation agreements allow students to transfer courses from one institution to another without penalty. When colleges do not honor transfer credits, students pay the price by having to retake courses. In Florida, for example, most community college graduates that have met general education requirements are guaranteed admission into the upper division of a state university.[11]

- **Allow and encourage dual enrollment.** Dual enrollment allows high school students who are ready to enroll in college-level courses for credit. For example, the University of Missouri allows qualified high school students to enroll in university-level courses while paying only 50 percent of the normal tuition.

- **Stop or reduce funding for non-productive majors.** For example, Ohio and Virginia use productivity reviews to identify underutilized majors and shift funding away from such programs as necessary. Illinois uses a data system it created on program productivity to help the state's Board of Higher Education make informed decisions about program elimination.[12]

- **Encourage greater use of technology to deliver course content and improve outcomes.** Many courses can be reengineered to make use of online instruction and even testing, particularly large, introductory courses that involve lectures on basic concepts. Universities should explore transitioning some of their core course to an online environment. Online, competency-based learning has proven to be effective, producing outcomes equal to or better than traditional instruction. For example, the Western Governors University, founded by the governors of 19 U.S. states, delivers all of its courses online (with mentoring support). Students learn at their own paces, demonstrate competencies through online tests, and receive accredited degrees at about half the cost of brick and mortar schools.

- **Make data on college cost and performance readily available.** Governors can post data on state college costs and performance online and distribute this information to high school students to improve the transparency of the higher education system. Armed with such information, parents and students can make informed choices about college based on cost and quality. The **Texas** Higher Education Coordinating Board operates a Web site, www.txhighereddata.org, to provide access to data, statistics, reports, and other information related to the cost and quality of postsecondary education in the state.

Finally, states also can urge universities to share services, coordinate purchases, and develop consortia to better utilize campuses and facilities. In 2007, the NGA Center published a report, *A Compact for Postsecondary Education*, which recommended that governors, university presidents, Boards of Regents, and legislative leaders hammer out an agreement that establishes productivity goals for the postsecondary system in exchange for state commitments to budget stability and enhanced autonomy. The recommendations of that report may have increased relevance today.

Public Employee Benefits

Salaries and benefits for state employees—together with unfunded liabilities related to state retiree health care and pensions—represent a substantial cost to states. Moreover, it is a cost that is growing at a rate that cannot be sustained. To have any hope of achieving fiscal health in the future, states will need to redesign their benefit systems.

Salaries and benefits for state employees account for around 30 percent of the state general fund. Benefits account for more than a third of that cost, meaning that about 10 percent of state general fund expenditures now go to benefits for currently employed workers.

In addition, states face large future costs to cover the health and pension benefits for retirees. In 2007, the Pew Center on the States estimated that state retiree benefits over the period 2006 to 2036 could total $2.73 trillion, including $381 billion for healthcare and non-pension benefits.[13]

A large portion of the pension costs should be covered by state pension funds, but these have likely deteriorated during the recession. Few states, however, have put aside funds for retiree health benefits. The Pew Center estimates that 97 percent of retiree health care and non-pension benefits remains unfunded. This presents a substantial future liability for state budgets.

For many years, state and local governments have been increasing the benefit portion of employee compensation at a greater rate than the wage portion. Much of the reasoning behind this was the belief that state government salaries could not compete with the private sector. As a result, benefits for state employees gradually became more generous than those in the private sector while state salaries lagged. Today, the average compensation for state and local employees exceeds that of private workers. And, by using benefits as a compensation equalizer, states have placed long-term liabilities on their balance sheets. States would be in much better financial shape now had they adopted competitive salaries years ago and provided a benefit package much closer in value to the private sector.

Public vs. Private Compensation

- $39.83—average hourly compensation (wage and benefits) for state and local employees. Average hourly wage was $26.24.
- $27.49—average hourly compensation for private industry employees. Average hourly wage was $19.45. (Compensation was higher for managers, $48.91, and lower for services workers, $13.65.)
- $4.43—state and local health benefits pay per hour.
- $2.01—private industry health benefits pay per hour.
- $3.23—state and local retirement and savings pay per hour.
- $0.94—private industry retirement and savings pay per hour.

Source: "Employer Costs for Employee compensation—September 2009", Bureau of Labor Statistics, U.S. DOL, December 9, 2009.

There are three types of general benefits that should be reviewed to identify opportunities for savings:

- Health care benefits for current state employees;
- Health care benefits for retirees; and
- Pension benefits and rules.

Health Benefits for Current Employees

All 50 states provide health insurance coverage to most of their employees. In 2009, the average cost for an individual policy was $502.43, with the state paying about $447.79 (89 percent) and

the individual paying about $56.52 (11 percent).[14] In 2009, 14 states paid 100 percent of the premium costs for a basic or standard health plan for individual state employees.

States have only two options to reduce health care costs: shift more costs to the consumer or reduce the cost of the plan. Most states are looking at both.

Many states are shifting more costs to the consumer through premium increases, surcharges, and higher co-insurance. For example, several state insurance plans have started imposing a $25 monthly surcharge for smokers. Alabama considered such a fee on workers with a body mass index of 35 or higher, but has since offered discounts if they enroll in a weight-loss program. Florida imposes a $30 monthly "spousal surcharge" for members whose spouse is eligible through his or her non-state employer but declines coverage. Another strategy is to raise coinsurance so employees share in increasing costs automatically; this is more effective than simply raising co-payments.

Charging Retirees for Health Care Benefits

Many states provide health benefits to retirees at little or no cost. That may be changing. In 2009, for example, New Hampshire began withholding from retirement benefits a charge of $65 per month for retired state employees under the age of 65 who are covered by retired employee health insurance ($130 for covered retiree and spouse).

States also are attempting to control plan costs. The most effective strategies include:

- **Enhancing wellness programs.** Many states are finding cost benefits for providing wellness programs that address certain key cost drivers, such as smoking and obesity.

- **Improving case management to target specific diseases and keep patients on appropriate therapies.** High-value targets include diabetes and cardiovascular disease. Closely monitoring patient care and follow-through for these conditions can lower their costs.

- **Pooling insurance with other state entities.** A number of states are opening their health insurance plans to teachers, professors, and local governments to create a larger, more potent purchasing pool. Thirty states allow it, but more should consider encouraging it or making it a requirement if possible.

Health Care Benefits for Retirees

Virtually all states provide some type of retiree health benefit plan thought these plans differ across states. Retiree costs vary—from paying full premium to paying no premium to somewhere in between. Most state retiree health costs are on a pay-as-you-go basis from general revenues and very few have set aside funds to cover future liabilities. Because most states are unwilling to raise general fund revenues to cover retiree health care costs, states are actively pursuing a variety of cost-containment strategies.

In general—unlike pensions—states have a great deal of flexibility in altering the funding and generosity of health benefits for retirees, although they may face some restrictions due to collective bargaining agreements. Changes that have either been implemented or are under consideration include:

- Requiring the retiree pay a greater portion of the premium;
- Increasing the deductibles, co-pays, or co-insurance rates;

- Increasing the number of years required to be vested in the health benefits;
- Eliminating drug coverage for Medicare eligible retirees;
- Terminating coverage at age 65;
- Increasing the age at which retirement health care is available; and
- Introducing a catastrophic plan plus a retiree medical savings account.

To date, it appears no state has decided to cease offering health care benefits to future retirees. However, it is likely that more costs will be shifted to retirees to cover the health care benefits provided by the state.

Pension Changes

Because of legal restrictions, most changes to employee pension plans are directed at new hires. State law generally prohibits reductions in the benefit package given to existing employees.

Starting in 2008, many states began making changes to their pension plans to reduce future costs. The most common types of changes are:

- **Alter the benefit calculation and eligibility rules to lower payments and delay the start year of drawdown**. A number of states have altered the benefit calculation to lower the annual payment to the retiree. For example, Nevada capped the last two years of salary increases that could be used to calculate benefits and Georgia prohibited post-retirement benefit increases for newly-hired employees. Rhode Island and several other states raised the retirement age to 62.

- **Increase employee contribution rates.** Several states have increased rates for both new and existing employees.

- **Create a defined contribution or hybrid plan for new employees.** Georgia recently created a hybrid retirement plan for state employees. The "Georgia State Employees' Pension and Savings Plan" provides a defined benefit plan and 401(k) defined contribution plan for new hires on and after January 1, 2009, and an opt-in to those employees enrolled in the traditional plan. Only Alaska and Michigan use a defined contribution plan as their primary plan. A few states offer it as an option. In addition, Georgia, Indiana, and Oregon offer hybrids.

Other Budget Categories for Consideration

There are many other budget categories that states can review for potential savings. A detailed look at these categories is beyond the scope of this paper; however, those often considered include:

Public health care programs (Medicaid and children's health insurance program). Unfortunately, reducing the cost of care in these programs is difficult because they operate within the current U.S. health care system, which is relatively inefficient. Some states have been experimenting with care management strategies, which show some promise in holding down cost growth. However, the fact remains that in the short term the only available option for cutting costs is to reduce benefits and/or enrollment. Over the long-term, the introduction of electronic health records coupled with quality initiatives and payment reform may be able to bring some cost-containment to these programs.

Transportation infrastructure. For many years, state and federal budgets have not been able to keep up with transportation needs. At the state level, interest has been growing in using public-private partnerships to build new capacity and recoup costs via user fees (tolls). Some states and localities also have considered establishing congestion or "vehicle miles traveled" fees, but these have only been implemented as pilots thus far. In time, it is likely that user fees (like tolls) will grow in prevalence to support construction of new capacity.

Parks and recreational programs. States will need to consider raising user fees to support parks and recreational programs. The fees should be designed to cover the costs of operating these programs and should assume very little support from general revenues. In many instances, current state fees are far below those charged at comparable private campgrounds and for similar recreational programs.

Social services programs. In most cases, states are focusing on making the programs as efficient as possible so they provide the greatest value to the client and the state. One area of emphasis is insuring that all social programs closely coordinate with workforce training and job placement services.

Creating a Government Review Process

A good government review process must be tailored to the needs and culture of the state; yet, all processes need certain elements to be successful. A recent report from the Deloitte Public Leadership Institute, *Government Reform's Next Wave: Redesigning Government to Meet the Challenges of the 21st Century*, contained an examination of major federal and state reform initiatives since World War II.[15] Lessons learned from that study, along with those from our own analyses, offer some useful tips when creating a state performance review:

- **Provide a reasonable time-frame to complete the work.** A good commission should take approximately 9 to 12 months to complete its analysis and provide recommendations. A shorter timeframe often includes only quick fixes and recommendations requiring further analysis.

- **Enlist support from as many key**

Texas Performance Review

In late 1990 and early 1991, Texas was struggling to balance its budget and maintain its current level of services without taking the unpopular step of imposing a state income tax. To avert disaster, the Texas Legislature passed a bill requiring the Legislative Budget Board to conduct an audit of state agencies and their activities. The goal of the Texas Performance Review (TPR) was to cut fat out of the next state budget. Completed in just 140 days, the TPR made 975 recommendations that were slated to save the state more than $5 billion. Legislators approved two-thirds of the recommendations, resulting in savings or revenue gains that totaled $2.4 billion for the 1992–1993 state budget.

The TPR was given ample professional staff and a budget to support its work The TPR held nine hearings, attended by state officials, state employees and the general public, to explain the process and take recommendations. The review also created a hotline for state workers and other citizens who wanted to make suggestions, giving these groups a sense of ownership in the results. The TPR had strong legislative involvement, since the legislature had to pass a separate law in order to implement each recommendation. Finally, the TPR report was written so citizens could easily understand the issues and recommendations.

TPR produced an annual report until 2003. In 2003, the comptroller's office identified savings and additional revenue of nearly $3.65 billion for the next biennium. Recommendations ranged from bringing agency staff and management ratios in line with those found in the private sector to completely eliminating certain state agencies.

stakeholders as possible, including the legislature and the entire executive branch. Commissions that do not involve the legislature or key executive branch managers often fail because the recommendations lack an implementation strategy for passing new legislation or enacting policy changes. In addition to legislators, the private sector, outside groups, and the general public need to be engaged in the process.

- **Engage civil servants in the process.** In any government reform effort, the perspectives of civil servants are essential. Civil servants often are in the best position to suggest how certain process changes can yield savings and they are eager to provide ideas. Bringing them in as part of the team utilizes their inside knowledge and encourages their buy-in to the process.

- **Provide sufficient resources and assign professional staff to analyze options, convene forums, and draft findings and recommendations.** Staff must be knowledgeable and sufficient in numbers to prepare budget estimates and an implementation strategy, which may include draft legislation.

- **Create a deadline for receiving recommendations.** A solid deadline creates a sense of urgency, keeping participants focused on their task. A deadline also encourages participation of outside experts, who typically prefer a limited time commitment.

- **Choose a manageable scope for the review and focus on a few well-recognized challenges.** Create subgroups to look at specific core functions. Also, create a separate subgroup to look at government-wide savings and efficiency opportunities.

- **Consider benchmarking the state to surrounding states to provide a helpful starting point.** What is the state's cost of government per capita and how does it compare to its neighbors? How many workers does the state employ per capita? Determine how these and other measures compare to your region and identify reasons for differences.

- **Develop a communications plan to explain the initiative to the public, elicit their feedback, and enlist their support.** The public needs to understand why certain services are being cutback and how government is spending its revenue. The process should encourage citizens to engage in the debate. For example, a number of states have created Web sites or hotlines to solicit citizen feedback.

Conclusion

The current fiscal crisis has spawned a new round of state performance reviews, many of which will yield profound changes in the services state government delivers. This period of government downsizing and streamlining may be a protracted one, ending only when state budget health is restored. The delicate balance will be maintaining those services that help the state prosper, while eliminating those that produce the least value.

This paper was prepared by John Thomasian of the National Governors Association Center for Best Practices, 202-624-5300, jthomasian@nga.org

[1] National Association of State Budget Officers, *State Expenditure Report*, (Washington, DC: 2009), http://nasbo.org/Publications/StateExpenditureReport/tabid/79/Default.aspx.

[2] William Duncombe and John Yinger, "Does School District Consolidation Cut Costs?" *Working Paper No. 33*, (Syracuse, New York: Center for Policy Research, Maxwell School of Citizenship and Public Affairs, Syracuse University, 2001).

[3] National Association of State Budget Officers, *The Fiscal Survey of the States*, (Washington, DC: The National Governors Association and National Association of State Budget Officers, December 2009).

[4] "Linking Higher Education with Workforce and Economic Development," presentation by the National Center for Higher Education Management Systems, April 2009.

[5] U.S. Census Bureau, *Decennial Census' and American Community Survey*, (Washington, DC: Census Bureau, 2005).

[6] Ray Uhalde, Jeff Strohl, and Zamira Simkins, *America in the Global Economy*, (Washington, DC: National Center on Education and the Economy, December 2006).

[7] [7] *Linking Higher Education with Workforce and Economic Development.* A presentation by the National Center for Higher Education Management Systems, April 2009.

[8] Brenda Albright, "Tipsheet on Performance Funding," (Boston: Lumina Foundation, August 2009), http://www.makingopportunityaffordable.org/sites/default/files/resources/TipsheetonPerformanceFunding.pdf.

[9] Higher Education Funding Council of England, "About Us – Mission," HEFCE, http://www.hefce.ac.uk/aboutus/mission.htm (accessed March 20, 2007).

[10] Patrick Callan et al., *Good Policy, Good Practice: Improving Outcomes and Productivity in Higher Education: A Guide for Policymakers*, (The National Center for Public Policy and Higher Education and The National Center for Higher Education Management Systems, November 2007), http://www.highereducation.org/reports/Policy_Practice/GPGP.pdf.

[11] Travis Reindl, *Hitting Home: Quality, Cost, and Access Challenges Confronting Higher Education Today* (Indianapolis, IN: Lumina Foundation for Education, Inc., Making Opportunity Affordable, 2007), 5. Available at: <http://www.makingopportunityaffordable.org/wp-content/file_uploads/Hitting_Home_030107.pdf>.

[12] Reindl, *Hitting Home*, 6.

[13] Pew Center on the States, *Promises with a Price: Public Sector Retirement Benefits*, (Washington, DC: Pew Center on the States, July 2007), http://www.pewtrusts.org/news_room_detail.aspx?id=32368.

[14] National Conference of State Legislatures, "State Employee Health Benefits—2009," Web page, http://www.ncsl.org/IssuesResearch/Health/StateEmployeeHealthBenefits2009EditionNCSL/tabid/14345/Default.aspx.

[15] William Eggers et al, *Government Reform's Next Wave: Redesigning Government to Meet the Challenges of the 21st Century*, (Washington, DC: Deloitte, April 14, 2009), http://www.deloitte.com/view/en_US/us/Industries/US-State-Government-Public-Sector/article/025fbf2733101210VgnVCM100000ba42f00aRCRD.htm.