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Trade-off Time:

How Four States Continue to Deliver

EXECUTIVE SUMMARY

The United States is facing the gravest financial crisis in at least a generation. And while all levels of government are affected, the fiscal pain is felt most acutely by states. As we go to press, most states are in recession and facing significant budget shortfalls. The economic downturn is increasing demand for state services at the very time that the revenues that pay for those services are in free fall. The list of problems is familiar to anyone who reads the newspaper. Record job losses are spurring increased demand for safety net programs like food stamps and unemployment compensation. Many states' unemployment trust funds are close to insolvency. Shrinking incomes are projected to increase state Medicaid spending upwards of five percent in Fiscal Year 2009—while overall state general funds are declining.¹ And perhaps most unsettling, no one can predict when the economic situation will begin to improve—or stop getting worse.

States' response to this crisis is critical to the nation's overall economic and fiscal health. Some economists warn that deep state spending cuts in times of crisis can prolong downturns by increasing stresses on citizens. Others warn that raising taxes could stifle economic activity in the private sector. But states that make sound policy decisions will play a vital role in stabilizing the effects of recession and engineering a turnaround that benefits the entire nation now and in the future.



Helping states improve budget practices is a national imperative. *Trade-off Time: How Four States Continue to Deliver* shows how tough economic times can be a crucible forging better decision making and a heightened vigilance to ensure every precious tax dollar delivers maximum value for the public. This report features four states—Indiana, Maryland, Utah and Virginia—that are leaders in measuring the performance of government programs. And by using those measurements to drive smart budget cuts and new spending they are creating the foundation for a better economic and fiscal future.

¹ "The Fiscal Survey of the States," National Association of State Budget Officers, December 2008.

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The process is not an easy one. By publishing this report, The Pew Center on the States (PCS) hopes to give states an edge in these times, by sharing good ideas for tackling the fiscal crisis and calling out efforts that have not been successful.

The Pew Center on the States has followed state government performance for more than a decade, studying good and bad practices and analyzing what works. Our research has shown that results-based budgeting systems can aid states during economic downturns by cutting wasteful spending on programs that are not showing results, and directing resources to programs that evidence has shown to be more effective. Such an approach also can provide lasting benefits, laying the foundation for a leaner, more effective government during the next economic upturn.

Trade-off Time: Tough Choices Made Smarter with Performance-Driven Budgeting

The unfortunate truth is that most states today do not have the tools in place to make well-informed programmatic and budget decisions. There is no way to know how much money states lose to mismanaged or underperforming programs. But those states that have begun to make policy decisions based on data measuring the performance of government, a process called “performance-driven budgeting,” have saved impressive amounts of money—some in very short periods of time. The choices they have made have not been easier, but they have been smarter.

Although individual strategies vary, the states profiled in this report demonstrate common purpose in their approaches to performance-driven budgeting. States that deploy good budget practices:

- Define agency and programmatic missions and goals;
- Establish priorities and assess trade-offs;
- Target reductions with precision;
- Invest in initiatives that yield a return; and
- Institutionalize a culture of results-focused budgeting.

Following the Budget Leaders

Virginia: Using Strategy

The Virginia Performs data system closely monitors the progress of each state agency. Established by former Governor Mark Warner and expanded upon by Governor Tim Kaine to build on the commonwealth's tradition of good governance, Virginia Performs has created a culture of evidence-based decision making that allows Virginia's leaders to systematically tackle the state's budget crisis and increase agency productivity.

Virginia was able to use data from the system to make targeted cuts in corrections, which saved money without affecting public safety. Among other reductions, the Virginia Department of Corrections replaced private food service contracts at several prisons when data showed that the services could be provided more cheaply in-house for a total annual savings of \$851,000.

With an eye toward reducing future crime and social services costs, the governor made the expansion of state-funded prekindergarten a high priority. To determine whether the state's investment in pre-k has led to better school achievement, legislators commissioned an audit to analyze the program's impact. Among other findings, data showed that at-risk children who had participated in state preschool passed kindergarten literacy tests at rates 4 percent to 5 percent higher than those who had not. The study was an important factor in the approval of additional funding for the program.

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The state is also sharpening its calculations of agency productivity, tracking such measures as the cost of issuing a license or processing medical claims online, in-person or through the mail. Not only will the agency be able to track progress towards reducing costs and setting fees at the right level to cover those costs, but it also can help define the most cost-effective way to achieve specific programmatic goals.

Utah: Refocusing on Mission and Metrics

Since 2005, Utah has required more data to inform budget decisions. Using a “balanced scorecard” system developed at Harvard Business School, the state closely monitors performance achieved for every dollar spent. And now, the state requires that any new request for more than \$100,000, or that requires one full-time position, has a specific, measurable goal to justify the request and gauge progress.

As a result, the state is and will continue to be better positioned to identify cuts and demand higher performance for the public. For example, the Governor’s Office of Economic Development recently cut a \$300,000 program to help businesses recruit employees when it could not show measurable success. Most of the savings were returned to the general fund, but a portion was used to fund an online recruitment program to encourage former Utah residents to move back to the state by matching their resumes with 120 companies in the state. The program has generated more than 1,500 new resumes and also connects local businesses to the state’s higher education system graduates.

To achieve even greater savings, Governor Jon Huntsman issued a challenge to reduce state government’s energy use 20 percent by 2015. Meeting the ambitious goal has led many state offices to make a radical change to

four-day work weeks with 10-hour days. In addition to the \$3 million the state expects to save in energy costs, it also estimates that employees will save \$6 million annually in commuting costs. Constituents can access state services before and after their own workdays, traffic is down—and surprisingly, employee sick day and annual leave usage has dropped 9 percent.

Maryland: Leveraging Change Through Data

As mayor of Baltimore, Maryland Governor Martin O’Malley created CitiStat, a data management system that tracks indicators from murder rates to potholes. In its first six years, the program improved city services and generated an estimated \$350 million in savings. It received the Innovations in American Government Award from Harvard University and sparked similar programs around the world.

StateStat, a statewide version of the program, is monitoring 10 major departments, including corrections, health, housing and transportation. Every two weeks, the StateStat team holds a 90-minute meeting where data are dissected and agency heads are grilled on their performance by the governor’s chief of staff and sometimes, by the governor. There is a shared commitment to accountability that helps ensure that every dollar is spent for maximum benefit.

This monitoring of results is making it easier for the state to identify fat to trim and consolidations that achieve savings. For example, the state closed an under-capacity juvenile justice detention facility, saving the state \$1.5 million. Of that money, \$600,000 was transferred to less expensive community-based programs for youth, which use evidence-based family therapy and education programs proven to be more effective than incarceration.

Indiana: Organizing for the Long Term

“Demanding proof that government programs work before spending additional taxpayer money on them must become standard operating procedure,” said Indiana Governor Mitch Daniels, who has been director of the U.S. Office of Management and Budget and an executive at Eli Lilly.

One of his first acts as governor was to create a new state Office of Management and Budget to closely follow the return on investment achieved for every budget item. At first, fewer than half of state programs had any measures of performance, and even fewer were linked to defined goals. Now the state has developed enough data to influence the 2007-2009 biennial budget. For example, the Indiana Department of Child Services was performing poorly on nearly all indicators: child support collection, investigation of abuses and the ratio of case workers to children. To improve the safety of Indiana’s most vulnerable children, state policy makers funded an increase that doubled the number of caseworkers. Although it is too early to declare success, reports of repeat abuse are declining and children appear to be staying protected and safe for longer periods of time.

Close monitoring of results also helped Indiana effectively target budget cuts. For example, a \$600,000-a-year program at the Indiana State Library to give grants to local and county libraries was cut because it did not have an explicit, measurable goal. Another \$900,000 program for “value-added research” at the Indiana State Department of Agriculture was cut because the statutory language was so broad that funding for practically anything could be justified—thus no specific goals could be identified.

Indiana’s fiscal stewardship earned the state’s first AAA rating from Standard & Poor’s in July 2008—a distinction shared by just nine other states. To maintain this momentum through increasingly difficult economic

times, the state is institutionalizing its performance-informed budgeting to maximize every tax dollar by requiring all agencies to submit budgets with clear measurements and goals.

Avoiding the Budget Laggards

The economic meltdown is bringing out the good, the bad and the ugly in state government performance. Our state exemplars contrast with politically gridlocked states such as California, Florida and New York. Since November 2008 New York Governor David Paterson has proposed a series of budget changes to address a rapidly-shifting Fiscal Year 2009-10 budget shortfall currently estimated in excess of \$13 billion. To date, the State Assembly has refused to act, and appears to be offering none of its own solutions.

California, too, is struggling with how to tackle a cumulative FY 2009-10 budget shortfall that could reach more than \$40 billion. The controller’s office warns that the state could run out of money in a matter of months. The state has halted major highway construction projects and the governor ordered furloughs for state employees just before Christmas. The executive and legislative branches again have been stuck since Governor Schwarzenegger vetoed the legislative budget in December 2008.

In a January 2009 special session, Florida’s lawmakers patched a \$2.4 billion dollar hole in the state budget through an almost straight party-line vote that raided trust funds and slashed agency budgets—including a \$466 million cut to education. But the state’s unfortunate confluence of increased home foreclosures, a significant fall in tourism, a rise in unemployment and Medicaid claims, and an increase in both incarceration costs and community college enrollments continues to take its toll. Lawmakers will return to session in March 2009 facing a fresh FY10 shortfall estimated at \$3.3 billion.

Anatomy of a State Budget

Like many American families, responsible state leaders aim to live within their means, recover from mistakes and excessive debt, and plan for long-term goals that position states for success. Although state budgets are more complex than average family budgets, the same principles apply. A budget includes money coming in; money going out in spending for immediate, intermediate and long-term needs; and savings.

States have four broad categories of funds to spend:

General funds, the largest category, come mostly from state taxes, and comprise nearly half of all state spending (44 percent). When budgets are tight, states first look to cut programs financed through the general fund, because this category is the least restricted. But the choices for cutting are difficult. Roughly one-third, or 34 percent of general fund spending supports elementary and secondary education—and another 11 percent supports public higher education. Seventeen percent of state general fund expenditures support state match for the federally supported Medicaid program. More than one-fourth of state general fund expenditures (27 percent) support additional services for some of the states' neediest residents, ranging from the State Children's Health Insurance Program to services for the mentally ill and developmentally disabled, as well as expenditures on such core state functions as state police and employee pensions. State general fund dollars also support corrections (7 percent), public assistance (2 percent) and transportation (less than 1 percent).²

Federal funds, which include grants tied to a specific program like Medicaid or transportation, cover about one-fourth of state spending, or 27 percent.

Restricted state funds, which comprise 25 percent of state spending, come from revenue sources that must be tied to specific functions. For example, a portion of gas tax revenue might be linked to road maintenance through a state's highway trust fund.

Bonds supply about 2 percent of state funding. States issue bonds to pay for capital projects or to generate short-term cash for ongoing expenditures.

The revenue sources for these funds are increasingly volatile and are evaporating rapidly. Personal income taxes often provide the largest portion of state tax revenue, followed by sales taxes. Both are tied closely to the overall health of the economy. Frozen wages and rising unemployment have flattened income and sales tax revenues. These revenue sources simply will not cover the increasing costs of serving public needs.

Although most states have "rainy-day" funds or savings, they seldom comprise more than a few percentage points of their total budgets and are insufficient to address sustained economic downturns. And many states have already dipped into their reserves in response to the unexpected shortfalls that emerged during FY09—leaving little to help with even greater gaps projected for FY10.

When hard economic times hit, demands accelerate for social services, health care, economic and educational programs. In addition to anticipated safety net program needs, states are coming to understand that they have vastly underestimated maintenance costs for their existing roads, bridges and buildings. And as teachers and other public sector workers retire, they begin to draw their state pensions, which have been underfunded in some states, and hurt by the stock market freefall. These problems have been neglected and they have

²"State Expenditure Report 2006," National Association of State Budget Officers, December 2007.

mounted. Ironically, today's crisis is helping decision makers in some states focus on these problems and unite to achieve solutions that serve the public good.

Creating a Road Map— and Using it to Make Tough Decisions

The examples cited here signal an encouraging new era of performance-driven budgeting. It is emerging not a moment too soon. Thirty-nine states now include performance measures in agency budget requests, and 42 states report some level of performance measures online, according to the National Association of State Budget Officers. In addition to using data to measure results and chart progress toward targets, state leaders are deploying the information to manage their agencies and programs. Furthermore, 22 state legislatures reported using performance measures to varying degrees in their budget decision making, according to a 2007 survey of legislative fiscal offices for the IBM Center for The Business of Government.

The four state budget leaders profiled here—Indiana, Maryland, Utah and Virginia—will not avoid all of the severe cuts and the acute strain on their resources, but they will be better positioned to weather bad times. With a more detailed and complete picture of how programs and agencies are serving the public, these states are making cuts that do the least damage and investments that provide the best return and using taxpayer dollars more wisely.

States that succeed in navigating these perilous times will be those that combine short-term strategies to balance their budgets with long-term fiscal and management investments that serve vital public needs and position themselves for the future.

Three Steps States Can Take to Strengthen Decisions and Management

1. Assess Your State's Unique Characteristics to Build a Long-term Strategic Framework.

State leaders must determine their priorities based on the state's demographics, desires and dollars. Reliable economic and revenue projections—although especially difficult in today's uncertain environment—form the foundation for a state's fiscal health.

Armed with a clearer understanding of their fiscal and economic outlook, policy makers can outline broad policy goals of a state with high unemployment that match the needs of people in their state. For example, the immediate goals of a state with high unemployment will be different from those of a state with low unemployment. Similarly, a state with a younger population may focus on educational programs, whereas states with older residents may need to devote more resources to health care. Within its existing constraints, each state must decide what it must do first, and what it can put off. But each state should plan for its long-term fiscal future—not merely react to the current crisis.

2. Refocus Agency Missions and Measures.

Clarifying an agency's mission is critical to understanding the agency's goals and allows policy makers to know what performance outcomes to measure—and how to improve them. In some states, well-intentioned but uncoordinated policy moves have led to a web of overlapping and sometimes conflicting goals that have accumulated throughout years or even decades.

After goals are clear, decision makers can define indicators that tell whether a given program is meeting solid, measurable goals in support of that mission. As the Indiana experience shows, each agency and program should strive to develop outcome measures that chart long-term progress toward goals, with targeted performance levels for each measure.

3. Use the Information to Engage the Public Around New Priorities.

With missions, goals and measures in place, executive and legislative leaders will be in a stronger position to engage one another—and the public—in a focused discussion of difficult fiscal and policy trade-offs. Measuring what really matters in terms of outcomes can significantly improve the quality of policy debates. And making data-driven decisions that are shared with the public in clear, easy-to-understand terms—as Virginia and Washington State are doing—can help bolster the legitimacy of the final resolution.

As each of the four states showcased here demonstrates, a degree of courage and calculated risk is essential to successfully making these important changes. If the goal is to cut a state's energy budget, it will take more than requesting employees to turn off their computers at night. As Utah found, it will require energy audits that link to repair and maintenance of capital assets—and perhaps even changes in service delivery. And some long-term expenditure reduction goals, such as saving money on state purchases of goods and services, may require new investments in information technology and staff capacity to analyze and temper state spending patterns. States may even consider using this period of crisis to rethink and revamp tax and revenue streams to be more stable and fair and avert future crises.

In today's environment, policy makers must say goodbye to the ideas that programs must be funded simply because they always have been and that in a fiscal crisis all new spending is off the table.

A performance-driven approach to budgeting like those demonstrated in these four states puts the public good front and center. This does not mean shirking difficult choices. It means knowing which investments of tax dollars are performing and which ones are not. It means identifying priorities for advancing the public good (health care, education, economic development) and having a budget that matches, as much as possible, those priorities. It is creating a new government culture of accountability and responsible stewardship of precious tax dollars.

The stakes for improving state budgeting could hardly be higher. In their unique roles as fiscal stabilizers and policy innovators, states can help our nation weather the most profound threat to its economy in modern times.