POLICY BRIEF

from the COMMONWEALTH FOUNDATION

Vol. 23, No. 05
March 2011

Reality-Based Budgeting
Prioritizing Pennsylvania's Spending Plans

MATTHEW J. BROUILLETTE & BOB WILLIAMS

INTRODUCTION: THE NEED FOR A NEW BUDGET PROCESS

Albert Einstein defined insanity as "doing the same thing over and over again and expecting different results." It's time we did things differently.

Pennsylvania state government will tax and spend more than $65 billion this fiscal year. With the loss of federal stimulus money and the exhaustion of all one-time expenditures, the legislature and new governor will soon be forced to reconcile a budget shortfall that could be as large as $5 billion.

Tough decisions will have to be made that impact powerful special interests in popular spending areas like K-12 public schools, higher education, Medicaid, or state employee salaries and benefits (including pensions).

It will be tempting for many legislators to try to address the issue in the usual ways with the usual so-called "solutions:" across-the-board cuts; raids on money in non-general fund accounts; delayed funding of pension obligations; partial contributions to pension funds; and accounting gimmicks, such as delaying payments until the next fiscal year, changing earning assumptions on pensions so less is invested, etc.

Temporary "patches" on state budget gaps will no longer work. Pennsylvania's spending has for a prolonged period of time exceeded state revenues, creating what are called "structural deficits."

The time for legislators to put an end to the structural deficits caused by overspending is now—the longer we delay, the greater we burden future generations of taxpayers. But this will require fundamental reforms to state governments and budget systems. It means tough decisions will have to be made that impact powerful special interests in popular spending areas like K-12 public schools, higher education, Medicaid, or state employee salaries and benefits (including pensions).

The alternative, if legislators are not willing to do the necessary hard work, is to raise taxes. But the state and local tax burden in Pennsylvania is already the 10th highest in the nation—up from 17th highest in 2002. Furthermore, Gov. Tom Corbett has pledged to not raise taxes in the next four years.

PROBLEM: CONVENTIONAL BUDGETING

Budgets drive all policy, which is why debating, writing and approving a state budget is the primary task legislators must accomplish each year. Indeed, it is the only constitutionally required legislative action, and governors and state agencies cannot spend even one dollar without legislative approval.

Many state legislators start the budget process by focusing almost entirely on "inputs" (i.e., how much needs to be allotted to sustain current programs and expenses). They take existing programs, adjust costs for inflation, add caseload increases, splice in a few new initiatives, and call this their baseline budget. This could also be called a "cost-plus" or "iceberg" model, where decades' worth of spending and programs remain unseen and unexamined under the surface while the debate rages year after year over the small part that sticks up above the surface. In this model, the cost, effectiveness and demand for existing programs is rarely considered.

The problems get worse when typical budget debates focus on program intentions, rather than results, and when most of the attention is focused on who spends the money, rather than on who benefits.

Quick fixes may postpone pain for a time, but they don't resolve the deeper, structural problems. And, eventually, there are no more left to try. Which leaves two options: tax more or spend less.

Legislators who use this conventional budget approach become "enablers" for agencies and programs that have outdated or fundamentally flawed designs, and that may even be providing services or spending resources in direct conflict with lawmakers' policy views.

When legislators discover their conventional baseline budget is higher than estimated revenue forecasts, they often focus exclusively on how to fill the budget gaps. Discussion turns toward program cuts, tax increases and accounting gimmicks, until spending lines up with expected revenue.

Addressing long-term disparities in spending and revenue with accounting gimmicks and one-time money sources is a recipe for disaster. Quick fixes may postpone pain for a time, but they don't resolve the deeper, structural problems. And, eventually, there are no more left to try. Which leaves two options: tax more or spend less.

Raising taxes now may very well result in even less revenue to the state due to the negative impact on the economy. More importantly, Gov. Corbett has removed tax increases as an option.

This leaves reductions in spending. However, typical across-the-board program cuts ignore important considerations like efficiency and effectiveness and can hamhandedly hurt the most vulnerable citizens while leaving inefficient or ineffective programs unreformed.

Conventional budgeting never truly considers how to maximize every tax dollar spent. It doesn't analyze the efficiency, effectiveness and necessity of existing state programs and spending. It rarely asks how a service can be improved or purchased differently. It virtually guarantees overspending.

Legislators may be able to get away with this in good economic times, but it is unsustainable in the long-term—which is where they find themselves today. Legislators who procrastinate on hard decisions now are only inviting more difficult decisions in the future. Tough measures now will become even tougher measures later.

Legislators can choose: They can continue to use broken conventional budgeting systems as long as possible, which will result in increasing budget gaps and an increasingly desperate scrambling for short-term "solutions." Or they can recognize the fiscal realities, get a grip on the depth of the problems they face, and do today what will someday be an urgent and unavoidable necessity: restructure their state spending. The choice should be obvious.

SOLUTION: REALITY-BASED BUDGETING

This is the year to resolve Pennsylvania's serious financial crises by changing the budget focus from inputs to outcomes. In other words, legislators and the governor should junk the old conventional model and start designing a reality-based budget from the ground up based on priorities and performance.

These are simple concepts. Priorities are determined by well-defined core functions: What is government responsible for achieving? Performance is the measure of how efficiently and effectively those priorities are delivered What is our return on investment? No legislator should get away with advocating tax increases without first being able to clearly articulate the state's priorities and show how the state is achieving the best possible results at the best possible price with the tax monies they already spend.

Only by clearly identifying the purpose of state government—its core functions—can legislators and the governor deliver essential services to taxpayers in an efficient, cost-effective manner.

How it Works

Reality-based budgeting views all of state government—all of its agencies and functions—as a single enterprise. New proposals are evaluated in the context of all that state government is responsible for doing, and the strategies for achieving the best results are developed with an eye on all of the state's resources. Agencies and services are not sealed in fortified towers where they siphon large portions of state revenue with few questions asked; they are all under one tent where they can be constantly evaluated to ensure they are delivering the highest priorities as efficiently and effectively as possible. Nothing is sacrosanct.

Reality-based budgeting assumes the rules can change and barriers can move in order to maximize results for citizens. It prompts governors and legislators to ask four key questions at the start of each legislative session:

1. What are the core functions of state government?
2. How much money does the state have available to spend?
3. What is the most efficient and effective way to deliver essential services within available funds?
4. How will state government measure its progress and success?

Only by clearly identifying the purpose of state government—its core functions—can legislators and the governor deliver essential services to taxpayers in an efficient, cost-effective manner. This is not an "anti-government" philosophy; rather it ensures that what government is supposed to do, it will do well, at the least cost to taxpayers.

Question #1: What are the core functions of state government?

The first step in responsible budgeting is to determine the purpose of state government, or its core functions, and put them in priority order. We would posit that governments should be limited to protecting life, liberty, and property through the rule of law, while providing oversight of the delivery, and in some cases the production, of certain public goods (e.g., public safety, courts, prisons, etc.). But even those who believe government should play a more expansive role in our lives can and should identify what essential services governments must deliver to citizens and put them in priority order.

The first step in responsible budgeting is to determine the purpose of state government, or its core functions, and put them in priority order.

Doing this will require both time and courage. The process will undoubtedly spark debate between both parties in the legislature, and perhaps all three branches of government. But starting the budgeting process by identifying and prioritizing core government functions is critical.

Once the core functions of government are determined and prioritized, they should serve as a litmus test for the hundreds of departments, boards, commissions, programs and services currently being funded, as well as all future proposals. Departments should be asked to submit their budgets based on delivering one or more of the state's identified core functions. If a department or program is not advancing one of these functions, it should be eliminated.

Question #2: How much money does the state have available to spend?

This is a superbly sensible question to answer before the legislative session even begins, but it is rarely asked even when the budget session is in full swing. By asking the question up front, lawmakers would understand their spending limitations in advance, and then determine whether or not the core functions they've identified can be accomplished within the forecasted revenue.

States should not spend or plan to spend more than the forecasted revenue for the next budget period. Moreover, we recommend legislators designate 2% of the forecasted revenue for a reserve fund, allow this fund to grow to 5% of spending for use on "rainy days," and then return anything in excess of that 5% to taxpayers.

Question #3: What is the most efficient and effective way to deliver essential services within available funds?

Once core functions have been agreed upon and can be accomplished within forecasted revenue, policymakers must go about making sure essential services are delivered as efficiently and effectively as possible without compromising on cost and quality. When legislators have determined that a service or program is a core function of government, they should then decide what level of government should provide it (state, county city, township, borough, etc.), and how competition can be used to control costs and enhance quality.

To make this process functional, agencies must have mission statements, goals, and objectives. These must be categorized as high, medium, or low priority depending on how effectively they accomplish the state's core functions, and they must be held accountable to well-defined performance measures. The agency's budget request should reflect these priorities and measures.

Once agencies have submitted a budget, legislative policy committees should carefully review all agency priorities and budget requests under their jurisdiction to determine whether or not they comply with the core functions of government that have been adopted.

This is when legislators can and should begin to debate the "make or buy" issue. As lawmakers review agency goals and confirm they are core functions, they should consider whether government must actually deliver the services that accomplish those goals, or whether government's duty is simply to ensure the goals are accomplished. It may make the most sense to contract services to private organizations and companies that have already developed the best practices to deliver them as efficiently and effectively as possible.

Essentially, reality-based budgeting changes the budget submission rules. Agency budgets become less about requesting funding, and more about offering to deliver specific results for a specific price.

As legislators separate what functions government must do from what functions government can buy, they shift discussion and debate away from "cuts" and onto "outcomes to be purchased." Essentially, reality-based budgeting changes the budget submission rules. Agency budgets become less about requesting funding, and more about offering to deliver specific results for a specific price. These offers can be evaluated and measured against what is most important to citizens (core functions), and legislators can then buy (fund) the products and services that are most desired with available tax dollars.

Question #4: How will the state measure progress and success?

After identifying the state's core functions, legislatures must determine what it takes to accomplish those core functions. In other words, it must define specific and measurable results to be achieved, as well as benchmarks to measure progress toward those results.

The legislature should begin by requiring each agency to have a mission statement supported by specific goals and objectives that are directly linked to one or more of the state's core functions.

- Agency mission statements should be brief but precise descriptions of the agency's reason for existing—its unique purpose and functions. What is the organization? What does it do? Why? And for whom?

- Agency goals should answer the question: "What do we need to achieve to accomplish our mission?" They should be macro-level, issue-oriented statements of the outcomes the agency will achieve. These define the overall expectations and intentions of the agency.

- Agency objectives break goals down into smaller, more specific pieces. They describe measurable tasks and results the agency is expected to achieve within a given time period.

Once the state and agencies have defined what it looks like to successfully achieve government's core functions, legislators must determine how to measure progress toward those outcomes. Performance indicators are a key tool to make accountability possible by allowing legislators and agencies to answer the question: "Are we making progress toward our goals?"

Agencies should have at least one performance measure (defined outcome) for each major activity they do, whereby immediate and intermediate measures are preferable, though not always necessary. If there isn't a definable outcome, the activity should be eliminated. A good performance measure:

The importance of a careful review of both the core functions of government and the outcome-based measures of success cannot be overstated.

- Shows whether or not the activity is achieving its purpose and contributing to statewide results.
- Is reliable, accurate and verifiable.
- Is understandable and relevant to citizens and stakeholders who may have little or no knowledge of agency operations.
- Is stated in positive terms (i.e., desired results).
- Is connected to challenging but achievable targets.
- Can be obtained at a reasonable cost and effort.

The importance of a careful review of both the core functions of government and the outcome-based measures of success cannot be overstated. Once these are in place, agencies and programs can be prioritized based on how effectively they will help meet the state's goals.

CONCLUSION: RESULTS VS. INTENTIONS

Reality-based budgeting serves citizens well by ensuring government delivers essential services as efficiently and effectively as possible. It maximizes the value of each hard-earned tax dollar, which is an important responsibility of legislators. It protects vulnerable programs from election-year rhetoric. It provides a logical place for legislators in cash-strapped states (i.e., most of them) to begin meaningful debate and restructure spending. It focuses on the results of the legislative and budget process rather than the intentions, as good as they may be.

Moving to reality-based budgeting is not a partisan issue. The Democrat Leadership Council has for years urged its members to embrace outcome-based budgeting:

> That citizens want value for their money is no mystery. We all want as much value as we can get from each dollar we spend—including what we spend on government. The price and value of government are up against the price and value of housing,

> food, clothing, health care, and countless other goods and services that meet people's needs. The price of government is limited, therefore, by the value that citizens want—and get—from government, compared with the value they want and get elsewhere. Government can compete—and stay relevant—only by delivering more value per dollar. But the only way to accomplish this is to reinvent the way we do the public's business. Our public institutions must learn to work harder, but more important, they must learn to work smarter.*

Now is the time to choose: Will Pennsylvania policymakers continue to use broken conventional budgeting systems of focusing on inputs rather than outputs? Or will they start designing a reality-based budget from the ground up based on priorities and performance?

It's really not much of a choice, as sooner or later Harrisburg will be forced to recognize the fiscal realities and restructure their state spending. And if not now, when?

Reality-based budgeting serves citizens well by ensuring government delivers essential services as efficiently and effectively as possible.

* Osborne, David and Peter Hutchinson, "Budgeting For Outcomes," *Blueprint Magazine*, May 7, 2004, www.dlc.org/ndol_ci.cfm?contentid=252574&kaid=125&subid=162

ABOUT THE AUTHORS AND THE COMMONWEALTH FOUNDATION

Matthew J. Brouillette is president and CEO of the Commonwealth Foundation. Bob Williams is Founder and Senior Fellow of the Evergreen Freedom Foundation and the President of State Budget Solutions.

The Commonwealth Foundation is an independent, non-profit research and educational institute. The Commonwealth Foundation works every day to effectively demonstrate the societal benefits of individual liberty, free enterprise, and limited, accountable government so that key decision makers in Pennsylvania embrace them. More information is available at CommonwealthFoundation.org

GUARANTEE OF QUALITY SCHOLARSHIP

The Board of Directors and Staff of the Commonwealth Foundation is dedicated to providing the highest quality and most dependable research on public policy issues in the Keystone State. To this end, the Commonwealth Foundation guarantees that all statements of fact presented in our publications are verifiable, and information attributed to other sources is accurately represented.

Committed to providing Pennsylvanians with reliable information, the Commonwealth Foundation welcomes critical review of its work. If the accuracy of our research is questioned and brought to the Foundation's attention with supporting evidence in writing, the Foundation will respond. If an error exists, the Commonwealth Foundation will issue an errata sheet that will accompany all subsequent distributions of the publication, which constitutes the complete and final remedy under this guarantee.

For additional information or questions on this policy email info@commonwealthfoundation.org