Full Appropriations Council on Education & Economic Development

Tuesday, February 16, 2010
1:00 PM – 4:00 PM
212 Knott Building

Council Meeting Packet

Larry Cretul
Speaker

David Rivera
Chair

The Florida House of Representatives

Full Appropriations Council on Education & Economic Development
Full Appropriations Council on General Government & Health Care

Larry Cretul
Speaker

David Rivera
Chair

Meeting Agenda
Tuesday, February 16, 2010
212 Knott Building
1:00 PM – 4:00 PM

I. Call to order/Roll Call

II. Opening Remarks by Chair Rivera

III. Presentation "Improving the Budget Process in Florida:

Lessons from the 50 states and Abroad" by The Honorable Maurice P. McTigue, Vice President and Distinguished Visiting Fellow, Mercatus Center at George Mason University and Eileen C. Norcross, Senior Research Fellow, Mercatus Center at George Mason University.

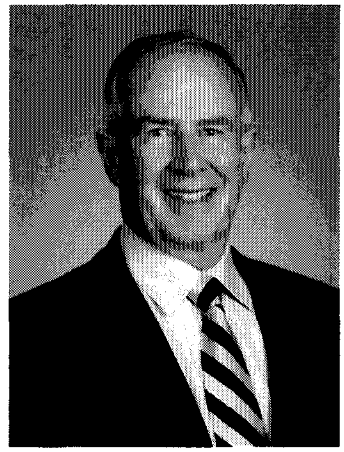
IV. Presentation on Options for modifying the Florida Retirement System to reduce costs by the Office of Program Policy Analysis and Government Accountability

V. Closing Remarks and Adjournment

Testimony of
Hon. Maurice McTigue

MERCATUS CENTER

George Mason University



The Honorable Maurice McTigue joined the Mercatus Center in 1997 as a distinguished visiting scholar following an illustrious career as a New Zealand Member of Parliament, Cabinet Minister and Ambassador. Prior to his arrival in the United States, Mr. McTigue led an ambitious and extremely successful effort to restructure New Zealand's public sector and to revitalize its stagnant economy in the 1984-94 period. He entered the New Zealand Parliament in 1985 and served as the National Party's Junior Whip. As Spokesman for Works, Irrigation, Transport and Fisheries, Mr. McTigue was closely involved in the deregulation of labor markets, deregulation of the transportation industry, and restructuring of the fishing industry through the creation of conservation incentives. In 1990, Mr. McTigue was appointed Minister of Employment and Associate Minister of Finance, holding primary financial responsibility for student loans, school funding, public transit, occupational licensing, and the restructuring of employment programs.

In 1991, Mr. McTigue accepted the positions of Minister of State Owned Enterprises, Minister of Railways, and Minister of Works and Development, and assumed Chairmanship of the Cabinet's powerful Expenditure Control Committee. In each ministry, he applied results-based criteria to help clarify the organization's mission, analyze performance, and prioritize activities accordingly. In 1993, Mr. McTigue was appointed Minister of Labour and Minister of Immigration, continuing the application of results-based principles to employment law, occupational safety and health regulations, and immigration. In April 1994, he moved to Canada as New Zealand's Ambassador; concurrently, he served as non-residential High Commissioner to Jamaica, Barbados, Trinidad and Tobago, and Guyana.

In a ceremony at Buckingham Palace in 1999, Queen Elizabeth II bestowed upon Mr. McTigue the prestigious Queen's Service Order, in recognition of his public service. This is one of the highest honors attainable for civil service in New Zealand.

As director of the Government Accountability Project at Mercatus, Mr. McTigue is sharing the lessons of his practical experience with policy makers in the United States. He works with officials in the Administration, members of Congress, officials from over 23 federal agencies and state governments on applying the principles of transparency and accountability in the public sector. In 2003, he was appointed to the Office of Personnel Management Senior Review Committee, formed to make recommendations for new Human Resources systems at the then newly created Department of Homeland Security. Mr. McTigue has provided extensive strategic-level advice to the Office of Management and Budget on a wide range of management issues, including the development of a results-based program assessment tool. He frequently speaks at conferences on performance issues and testifies before congressional committees on issues of government reform.

MERCATUS CENTER
George Mason University

Testimony of

Hon. Maurice McTigue, QSO[1]

Distinguished Visiting Fellow and Vice President
Mercatus Center at George Mason University

Before the
Full Appropriations Council on Education and Economic Development and the
Full Appropriations Council on General Government and Health Care of the
Florida House of Representatives

February 16, 2010

Thinking Differently About Budgeting

Government conducts its business through the allocation of funds to public or private delivery organizations. However, it is exactly the concept of allocation that is an inherent weakness in the traditional budget process. The problem is that an allocation is only that: an amount of money to be spent on identified issues or activities. Missing is any identification of what the money is supposed to achieve. Without clear expectations of results, neither elected officials nor the public have a good idea whether or not progress is being made on policy goals. There is no accountability as to whether the allocated money reduced poverty by an acceptable amount, increased literacy satisfactorily, or improved economic activity.

Essentially, the process is one big "faith-based initiative," distributing money and hoping for results. It is certainly frustrating for new legislators to find that their best intentions are thwarted by an incomprehensible budget process. They discover there is no clear vision of what government intends to achieve in the next year, five years, or decade. Even more troublesome, there is no record of achievements from the last year, five years, or the last decade. The records show where money was spent but evidence of what was achieved is elusive at best.

What if this could be reversed and it was possible for legislators to know, for example, precisely how much the government is spending on poverty and when it will be a problem of the past? What if the records showed the progress made to date on the issue and not just the amount of money spent on it? What if lawmakers could identify how much the government planned to spend on economic development in terms of which programs would be funded and what each program would contribute to economic growth? In these scenarios, legislators are in the ideal position to assess past performance and make informed funding decisions based on past successes or failures.

[1] The views expressed in this testimony are solely my own and are not official positions of the Mercatus Center or of George Mason University.

They can ask: Do we need to do more or less to solve this problem? If the results are not what we want, do we need to use a different approach or can we fix the existing programs? In these situations, lawmakers have the tools they need to do the job for which they were elected.

During a time of fiscal pressure across government and a climate of renewed emphasis on accountability, "faith-based budgeting" is inadequate. Instead, we need to be able to create situations like those above. Decision makers are eager to discover innovative ways to manage revenues and expenditures. The good news is that this can be done; in fact, some state and national governments are taking the lead. They have discovered that the most valuable tools in this process are greater transparency and a clear focus on producing results that improve the public benefit. The results speak for themselves: declining and disappearing deficits, more efficient allocation of resources, and high approval ratings from citizens who are happy to reward their politicians for improved accountability. Here I will discuss some of the guiding principles for developing clear and accountable budgets, and we will see how various governments have implemented these principles on a practical level. These examples may need to be adapted to apply to unique situations but there is no reason to let minor obstacles stand in the way of greater transparency and increased public confidence in the electoral system.

Getting What You Pay For

In order to have a transparent budget process, it is essential to clarify what you are getting for what you are paying. Governments usually know precisely how much they are spending and on what they are spending that money. But the evidence of what they expect to get in return is often poorly articulated or even totally unknown. Lack of clarity about expectations at the time of appropriation means that holding people accountable for the results produced is almost impossible. This deficit of results information means that we may be continually reinvesting money into activities that are not delivering the results we expect. We spend money on education because we believe it is good to teach children to read, write, and develop other skills. However, we should also know how many children actually learned to read, write, and compute through the programs government bought. We should know that fewer people are homeless as a result of programs aimed at reducing poverty. We should be able to ask and answer several questions:

- Is this satisfactory progress?
- Do we want greater progress?
- Should we look for more effective tools to make progress?

Purchasing Versus Allocating

One way to do this is to start thinking about government spending in terms of a purchase.

The idea of purchasing something immediately implies an exchange of value. The concept is

Inputs – Costs of producing outputs.
Outputs – Goods, services, or activities produced by an agency to achieve an outcome.
Outcomes – The desired results.

quite familiar in daily life; in fact, everything in our economic lives is governed by purchase. In contrast, very few things are governed by grants, gifts, or allocations. It is the reverse with the way government traditionally operates. Very little government activity is analogous to a purchase; the existing appropriation process stops short of indicating what is expected in return for the money spent. However, the new mechanisms used by some governments, namely New Zealand, Australia, and Great Britain, to allow for a much more tangible link between dollars spent and results produced are built on the idea of a purchase, the exchange of money for some clearly defined benefit.

Some governments have defined this benefit as an outcome; others have defined it as the purchase of certain outputs designed to achieve the desired outcome. Regardless of the form used, the process of government purchase provides a very clear expectation of what is to be produced with the money spent. A purchase agreement[2] extends the appropriation process by linking funding decisions to the purchase of specific goods and services designed to produce clearly defined results. Accountability is built-in; stated expectations can easily be compared with final results. Satisfactory performance can only be claimed if those results match the original intent described in the purchase agreement. By comparison, a traditional appropriation is an allocation of money to spend on a particular issue, in which the only basis for accountability is whether or not the money was spent accordingly. Satisfactory performance can be claimed by a delivery organization even if the results are disappointing or unknown. A

Examples of New Zealand Purchase Agreements

(These are based on actual purchase agreements but have been dramatically condensed for the purposes of this publication.)

The Ministry for Employment
Mission: To improve the employability of people currently out of work.
The Contract: During this fiscal year, the Ministry will place into work 150,000 unemployed people. Of that 150,000 people, 56% must be long-term unemployed; 25% must be Maori; 14% must be people with disabilities; 7% must be people with acute social problems or from low socio-economic areas. The services of the Ministry must be reasonably accessible throughout the country, but priority in access and resources must be concentrated in the areas of greatest need.
Cost: $60 million

The Reserve Bank
Mission: To maintain price stability.
Contract: The governor is to contain inflation within a range of zero to two percent. Failure to maintain these targets requires the resignation of the governor, which the Government may or may not accept, at its discretion.
Cost: To be determined

The Inland Revenue Service (IRS)
Taxpayer Audit Description: This output involves the audit of all Classes of taxpayers, with emphasis on high risk non-compliers.
Outcome: Revenue is collected to help fund the work of the New Zealand Government according to law and in the most effective and efficient manner.
Contract: 137,000 investigations and verification checks
58,000 GST audits and checks
20,000 payroll audits
Tax assessed per dollar spent
$14.00 per investigation
$4.00 per verification
$6.00 per GST audit
$5.00 per payroll audit
All audits and checks must meet 100% of the standards and timeframes outlined in the National Quality Statements.
Cost: $117.430 million

[2] Term used in New Zealand, which first introduced purchase agreements in the early 1990's. Since then, there has been significant evolution of the process based upon local experience and observing the initiatives of other countries. This text draws on examples from the early part of the New Zealand experience.

purchase agreement defines exactly what is being purchased, at what price, and with what expected result.

This new procedure does not replace the established appropriation process. The appropriation process, developed to meet the constitutional requirement for the legislature's authorization of the expenditure of public funds, must continue. "Purchase agreements" simply extend the appropriation process further by converting the appropriated funds into specific contracts with delivery organizations to purchase outputs in order to achieve successful outcomes.

Purchase agreements were introduced in the budgeting process in New Zealand in the early 1990's as contractual undertakings between the minister of a government agency and the chief executive of a government department or private corporation. They were implemented to increase transparency regarding the government's plans for making progress on policy initiatives. New Zealand recognized that their existing appropriation process, like that of many other governments, was adept at directing funds but pretty abysmal at producing measurable results. The bottom line in the public sector had to be demonstrable public benefit; therefore, the process had to spell out what benefit was expected from each allocation. To achieve this specificity, the government became a purchaser of goods and services from a variety of providers.

Maximizing the Public Benefit in New Zealand

When I became Minister of Labor, I inherited thirty-four programs designed to put people back into work and reduce unemployment. The existing measures of success were the number of people involved in the programs and how much they liked participating. The most important measure was overlooked; namely, how good are these programs at getting people back to work? When we asked this question, we learned that only four of the 34 programs did this well.

The only responsible thing to do was to stop putting resources into the thirty unsuccessful programs and concentrate on the four programs that were making a real difference.

The result? Those four programs were able to put 300% more people back into work than before, at 40% less than the previous cost.

New Zealand purchase agreements stipulate in considerable detail the outputs the government is buying, expressed in terms of price, quantity, quality, availability, and timeliness. The agreement also estimates what the impact of these outputs will be on the desired outcome. For example: homelessness will be reduced by ten percent; inflation will be contained at between zero and two percent; the risk of successful terrorist action will be diminished by sixty percent.

The negotiations on purchase agreements take place while the budget is being prepared. These involve simultaneous discussions between the department's minister and chief executive about which outputs should be purchased and between the minister and the

Portfolio Budget Statements in Australia

In Australia's budget process, agencies identify and report to Parliament and the public of their plans for allocating resources to government outcomes for the coming budget year through Portfolio Budget Statements. These documents specify appropriations by outcomes, and outputs according to which agency in that portfolio is responsible for producing them. The details of the Portfolio Budget Statements inform Parliament and the public of the purpose of each item proposed in the appropriation bills. They are an important tool for holding the executive branch accountable to the Parliament.

Treasury on the level of funding available to purchase those outputs. Because the purchase agreements are available to legislative committees at least in draft form during appropriation debates, it is very clear what results the appropriation will buy, as well as what the consequences will be for changing budget recommendations. After the budget has been approved, the purchase agreements will be adjusted according to the legislature's decisions. Less funding means that either the quantity or quality of the outputs will be lower than they would have been under the proposed funding level; purchase agreements will be altered to reflect this. The purchased outputs can be any goods or services that an agency produces for external use, including policy advice, assessment of grants, payment of benefits, licensing, inspection, publishing, or revenue collection. They do not all have to be provided by government agencies; purchase agreements may be contracted with the private sector as well.

Once signed, the purchase agreement is a legally binding public document. The department is required to do only what is specified in the agreement. Therefore, the legislature cannot ask the department to take on additional activities during the year, unless it is prepared to grant extra resources or cancel some current purchases and reallocate the funds. This prevents departments from being saddled with unfunded mandates or held accountable for producing outputs that received no funding. The intent of purchase agreements is to provide maximum transparency and maximum accountability.

With the clarity that a purchase agreement provides, a very strong basis for accountability exists. The outcome the government intends to achieve and how the agency plans to achieve it are apparent to both policymakers and the public. Good or poor performance is immediately identifiable. The minister of the department is held accountable for the government's policy decisions, while the chief executive is responsible for the delivery of the services as stated in the purchase agreement. Failure to deliver the outputs indicated in the agreement is grounds for dismissal of the chief executive. On the other hand, if the agency fully delivers the contract but the desired outcome (public benefit) does not materialize, the policymakers are responsible. They bought the wrong goods and services and can be held accountable by the public, which is now equipped to evaluate the performance of their government. New Zealand is not the only country to experiment with tools that clearly demonstrate how the public benefits from government expenditures. Great Britain and Australia have also developed transparent mechanisms that accomplish the same things: increased accountability for government expenditures and greater clarity about government progress.

Public Service Agreements in Great Britain

Great Britain's public service agreements (PSAs) are three-year agreements between the main departments and the Treasury. Their purpose is to indicate what results the public can expect from each government expenditure. Each PSA lays out the department's "high-level aim," its objectives under that aim, and key outcome-based performance measures.

Putting the Public Benefit First

Much of what is said about budget reform revolves around saving money, which translates into budget cuts somewhere, anywhere, or everywhere. Focusing on reductions means spending time and energy determining which programs can go without creating too much upheaval. Hard political sells are avoided, whether or not the programs actually work. Instead of concentrating only on saving money, the real emphasis should be on using money effectively. This means putting the public benefit first and foremost when considering budget reforms. After all, the citizens and taxpayers are the primary government stakeholders. Every decision should be held up to the standard of whether or not it increases the public benefit in a tangible way. This means that decision makers need to know if government programs are producing the best results or if they are hampering the creation of the maximum public benefit. How can elected officials make informed budget decisions without knowing this?

Unfortunately for all of us, the most common barometer for measuring political commitment to progress on societal issues is whether more or less money is spent on them. The budgeting process takes for granted that increased public benefit will follow the expenditure of additional monies, therefore little formulation of intended outcomes or accountability for actual results produced is considered. But dollars spent do not equal evidence of success. A good case study is a simple examination of the U.S. food stamp program. In 2005, we were spending 31 times the amount we spent at the program's inception in 1969, in constant dollars. Yet far more people receive food stamps now than in 1969. In terms of population growth, the disparity is even more worrisome. While those on the food stamp rolls in 1969 represented about 1% of the total population, today the number is closer to 8% of the total population. Is this evidence of success? It makes one wonder what we are trying to achieve with this program, because the logical outcome, i.e., erasing hunger, does not seem to be materializing. It is hard to believe that this is the best we can do, but as long as we are unaware or inattentive to whether programs are living up to expectations, maybe it is.

We should not be judging how much our elected leaders care about an issue by measuring increases or decreases in the money they spend, but instead we should be measuring the difference they make. This difference should be expressed in terms of public benefit. Measures of progress should be accounted for by demonstrating that the public benefit has improved or deteriorated. After all, we the public want to know if more people have jobs as a result of government action or if more children have achieved a reading age equal to their biological age. In other words, the public interest is in the outcome.

Acceptance of this thesis means that we should look at government programs as tools designed to produce public benefit. If improved government programs are created then old or obsolete programs should be retired in favor of that activity that will produce the maximum public good. Programs should not be allowed to develop the mantra of an institution deserving of preservation in their own right but should constantly be evaluated against all other activities directed at that public benefit with only the best surviving.

Officials should clearly articulate throughout the budget process what progress they intend to make on each issue and then be held accountable for the end results. In fact, until government organizations know what is expected of them and are held responsible for meeting or exceeding expectations, satisfactory progress is unlikely to occur. While it can be difficult to measure government progress in some areas, it is not impossible. A statutory purchasing process similar to those outlined above is a good start, but more must be done to fully implement accountability into the budget process.

Budgeting for Outcomes: David Osborne's Steps

Another method that has been successfully implemented in the states of Washington and Iowa, the cities of Azusa and Los Angeles in California, and the city of Spokane is David Osborne's "Budgeting for Outcomes Process." The steps are straightforward and easily adaptable to local situations:

1) Set the price of government. How much are citizens willing to pay for the results they want from their government?
2) Set the priorities of government. Define the results that matter most to the citizens.
3) Set the price of each priority. Total revenue divided among the priority outcomes according to their relative value.
4) Develop purchasing plan for each priority. Which factors/activities matter most for delivering a certain result?
5) Solicit offers from providers to deliver the desired results. Who can deliver the most results for the money?
6) Buy from the best providers, until the funds are used up. This is the budget.
7) Draw up performance agreements with the providers. This builds accountability into the budget.

The results of this process in the localities that are applying it are a compelling endorsement. In Washington, the new way of doing things was widely accepted by both the public and the legislature, even though it involved making hard choices.

The savings are adding up too: Iowa saved $35 million annually in its Department of Transportation alone, by reorganizing to focus on maximizing results.

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

Maximizing Public Benefit

Government should be buying goods and services from the best providers, and if it does not, there will almost certainly be benefit foregone. Some public benefit that would have otherwise existed has been lost forever because the most effective and efficient way to produce that good was not identified. This is not only a monetary loss, but also a social loss. The consequence of public benefit being foregone is that some people remain unemployed, illiterate, or hungry.

The way to spot the best providers is to introduce competition into the public sector. Competition is a marvelous force constantly at work in the marketplace; the effect is that the products and services we use are getting better and cheaper all the time. (Just think of the cellular phone today versus the cellular phone of 1985.)

Creating Internal Markets in Government

Competition fosters creativity and discovery, continuously providing better value for the same dollar. This innovative process can be introduced in the public sector, to the advantage of both citizens and elected officials.

Governments can use competition as a reliable tool for ensuring that results are being achieved instead of special interests being served. Implementing competition in the public sector means purchasing goods and services from the best providers only, not any and all providers.

Results-oriented analysis singles out the programs that are producing the best results and rewards that achievement.

Why not require all departments to bid out to other departments the provision of:

- **Legal services,**
- **Payroll,**
- **Accounting,**
- **Human resources services,**
- **Data collection,**
- **Data entry,**
- **Website management,**
- **Purchasing, and**
- **Contract management?**

Competition is proven to be the best mechanism to achieve best quality, best price, and best service.

Competing Activities Within Programs

To accomplish optimal performance, all activities that claim to have a beneficial impact on a certain goal should be compared. Those with the greatest impact should be rewarded with continued funding, while those that cannot meet that level of achievement lose their funding. Alternatively, based on convincing evidence that a program that has not performed as well as it should to date can reach the desired level, conditional funding might be given for another year.

Study of Vocational Training Programs in the United States

This was a Mercatus study in the year 2000 of federal vocations training programs in the United States.

- Purpose: to aid people into work
- Forty-five activities were identified
- Twelve departments involved
- Various ranges of success in placing people into work
- Total cost: $8.2 billion
- Cost per person placed into work: between $270 and $29,000
- Total of 2.8 million people into jobs
- Using the 3 most effective programs, there would be 14.2 million people into jobs
- Status quo means 11.4 million people don't get jobs (benefit forgone)
- Maintaining current public benefit of 2.8 million into work with the most effective programs would free up $6 billion to be spent on other priorities.

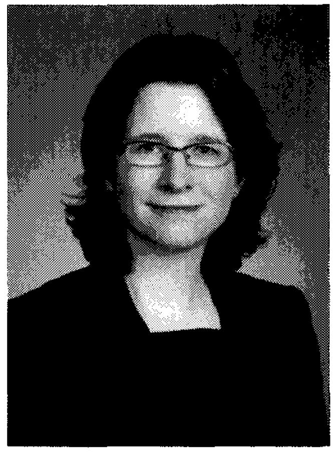
Conclusions

Dramatic improvements in budgeting outcomes are possible. There are plenty of processes and procedures available to follow. The greatest barrier to progress is the fear of change itself.

Budgeting for Results Checklist

_ Know what public benefit each appropriation is supposed to produce.
_ Allocate funding based on a clear measure of the public benefit that will be produced.
_ Insist on measures that tell you if that public benefit is being created.
_ Review performance to see if it is meeting expectations.
_ Use performance reviews to influence the next year's funding decisions.
_ Conduct the whole process with the greatest possible transparency so that expectations of what is to be delivered, and possible future improvements are apparent to all.

Testimony of
Eileen C. Norcross



Eileen Norcross is a senior research fellow with the Social Change Project and the lead researcher on the State and Local Policy Project. Her work focuses on the question of how societies sustain prosperity and the role civil society plays in supporting economic resiliency. Her areas of research include fiscal federalism and institutions, state and local governments, and economic development.

She has testified before Congress on a variety of topics including the Community Development Block Grant (CDBG) program, and the use of technology to monitor stimulus funding. A co-founder of the web site StimulusWatch.org with fellow Mercatus scholar Jerry Brito, she is also interested in the impact of technology on social change.

She blogs on state and local issues at neighborhoodeffects.mercatus.org.

Before joining Mercatus, Ms. Norcross was the 2001-2002 Warren Brookes Fellow in Journalism at the Competitive Enterprise Institute in Washington, DC. Previously, Ms. Norcross worked for KPMG as a consultant with their transfer pricing division and as a research analyst with Thompson Financial Securities Data.

A native of New Jersey, Ms. Norcross earned her Masters in Economics from Rutgers University in 1996. She graduated summa cum laude from Rutgers University in 1993 with a Bachelor of Arts degree in Economics and U.S. History.

Her most recent research includes a case study of New Jersey's current fiscal and economic crisis entitled *Institutions Matter: Can New Jersey Reverse Course*, co-authored with Mercatus colleague Frederic Sautet. Other research includes: *The Community Development Block Grant: Does it Work?*; *The Road Home: Helping Homeowners in the Gulf Post-Katrina*, coauthored with Anthony Skriba; and *From BIDs to RIDs: Creating Residential Improvement Districts*, co-authored by Robert Nelson and Kyle McKenzie. She has co-authored several Mercatus On Policy briefs covering tax incentive policy in New Orleans and the American Recovery and Reinvestment Act of 2009.

Her work has been cited in numerous media outlets, and her op-eds have appeared in the *Wall Street Journal*, the *Washington Times*, *Forbes*, and the *New Jersey Star-Ledger*.

MERCATUS CENTER
George Mason University

Testimony of

Eileen C. Norcross[1]

Senior Research Fellow
Mercatus Center at George Mason University

Before the
Full Appropriations Council on Education and Economic Development and the
Full Appropriations Council on General Government and Health Care of the
Florida House of Representatives

February 16, 2010

Thank you for inviting me to testify today on Florida's budget and the outlook for the state's future. Florida, like the rest of the nation, is weathering a deep and sustained recession.

As of today, the state faces a budget gap of at least $3 billion. Last year's $66.5 billion budget was balanced through a combination of quick fixes, including $2.2 billion in tax hikes, $5 billion in federal stimulus dollars, and $1 billion in cuts.

This year's $69 billion proposed budget takes a flawed approach: Expanding spending by relying on uncertain stimulus funds, pushing Florida closer to what Scott Pattison of the National Association of State Budget Officers calls "the stimulus cliff."

When federal funds recede, unless Florida institutes meaningful spending reforms, budgetary gaps will reappear. The choices Florida's government makes today are vital to Florida's future.

To bring Florida back to fiscal stability requires looking at how the state arrived at this point, while ensuring the state avoids the pitfalls responsible for the bankruptcy scenarios facing California, New York, and New Jersey. In these states, ever-escalating taxation to pay for out of control spending has produced a significant out-migration of people over the last decade.

I have spent the last several years studying the relationship between appropriations and policy implementation on the federal and state levels. And for the last 18 months, I've studied the fiscal collapse of New Jersey and the factors that brought it to its current crisis.

If Florida wishes to avoid the same fate it is imperative that the legislature get its fiscal house in order and not delay tough decisions until it's too late. This is what New Jersey did, and it is

[1] The views expressed in this testimony are solely my own and are not official positions of the Mercatus Center or of George Mason University.

currently reaping the whirlwind of legislative malpractice, judicial interference with the appropriations process, and a tax structure that the non-partisan Tax Foundation calls the worst in the country.

As you know, the areas of greatest budgetary concern for Florida are the growth in spending in health care, transportation, and education. All three of these deserve careful study by the legislature. Today, I will focus on the relationship between fiscal policy and education.

Education

As you know, Florida's spending on education has risen steadily over the past 15 years. The question I'd like to frame my remarks around is: "Why does spending appear uncontrollable?"

For an answer I will discuss Florida's fiscal situation from the perspective of the fiscal "rules of the game." That is, the rules under which the state budgets and sets policy. These include the school funding formula and the revenue cap.

In 1973 the Florida legislature pre-empted the wave of educational funding equity litigation rolling through the states, creating the Florida Education Financing Program (FEFP). The goal was to equitably distribute state resources to Florida's 67 school districts.

The formula sets a base amount of funding for Florida's schools and then factors in a cost-of-living differential and other factors for each district. From this, state determines the "required local effort," or the amount the locality must collect on its own, which is based on property values and a required tax rate.

To receive state funds, school districts must levy the local property tax rate set by the Legislature. Districts with higher property values generate more funding than districts with low property values. Districts with low property values receive more state funding. Districts with high property values receive less.

This sets up a problematic relationship. Education is locally-delivered good but its financing is determined by the state. Through this formula, the state determines the local property tax. State and local revenue streams are co-mingled and redistributed.

The result of this approach is that fiscal accountability is blurred by the weakened relationship between the taxpayers and school districts.

The Tax Swap

The housing boom produced a period of double-digit growth in property tax valuations without reductions in property tax rates. This increased property tax burden led the state to consider alternative means to fund Florida's schools, proposing in 2008 Amendment Five, or the Tax Swap Amendment.

This amendment would have eliminated school property taxes and offset those revenues with a state-levied source such as an increase in the sales tax.

The amendment did not make the ballot.

It is important to review why this proposal would not have worked and how close Florida came to making the same fatal error New Jersey did 34 years ago.

In 1976, the New Jersey Supreme Court ruled in the first of a series of decision known as the *Abbott* decisions that state could not rely on the property tax alone to fund schools. The court ordered the state to find supplemental revenues. This set the stage for the takeover of the legislature's constitutional power of appropriations by the courts. The result is one of the highest rates of per-pupil spending in the country and an education system that in many urban areas graduates less than one out of every eight high school freshmen.

The New Jersey legislature complied with the *Abbott* rulings by creating a nearly flat income tax constitutionally dedicating all of the revenues to "indirect property tax relief."

Nearly 78 percent of the state's "Property Tax Relief Fund" is now spent on schools. The school portion is nearly equally split between 31 court-designated "poor districts" and the remainder of New Jersey's 605 school districts. A small portion of the fund is spent on providing homestead rebates and municipal aid.

The fund has failed on all counts. Today it is a leading driver of New Jersey's fiscal crisis, its ever-increasing income tax rates, and the outmigration of businesses and citizens.

Property taxes have risen in New Jersey every year since 1978, a mere two years after the first *Abbott* decision. Since 1976, the court has continued to issue more rulings. The most significant in 1997 mandated that poor districts spend as much per pupil as the wealthiest districts in the state. The result is one of the most progressive income taxes in the nation, with eight brackets and a top rate of 10.75 percent on those earning over a million dollars a year.

In spite of these massive transfers, outcomes in the *Abbott* districts remain abysmal. Since 1998, Camden has received $2.8 billion for its schools, with close to $24,000 spent per pupil per year. Last year, 18 percent of Camden's eighth graders scored proficient in math.

A tax swap, or any similar divorcing of education consumers from education producers, would put Florida on a similar path. There are fundamental flaws in dedicating more state revenue to providing a local good.

Replacing local revenues with state revenues does nothing to prevent property taxes from rising. In fact, the replacement of revenues may stimulate greater local spending. As more funding comes from the state, there is less "fiscal visibility" and accountability for how funds are spent on the local level.

Comingling and redistributing state and locally levied resources creates greater opacity for taxpayers, for the parents of schoolchildren, and for the state government. Accountability for spending and outcomes becomes obscured as the source of funding, and the place where spending takes place is separated, a concept known in economics as "fiscal illusion." Taxpayers have a blurred picture of the true cost of funding education and are less likely to police such spending on the local level. The state government receives an incomplete picture of how those funds are being stewarded. And the local level loses its autonomy and flexibility in setting its fiscal policy and delivering educational outcomes.

In considering how to fund its schools Florida should adopt principles that give more, not less, autonomy to the localities to levy taxes to provide education. As funding is centralized, accountability on the local level is weakened. In other words, it's important that Florida maintain as much link between taxation and outcomes as possible.

Revenue Limit

Another fiscal rule I would like to touch upon is Florida's revenue limit.

Spending in Florida has continued to climb beyond what can currently be supported by state revenues, because the rules meant to constrain excessive spending are ineffective.

In 1994, Florida instituted a revenue cap. This cap increases each year according to the average annual growth rate in Florida personal income over the previous five years.

In effect, the revenue cap places no limit on spending. Appropriations are tied to growing incomes. When economic growth is robust, spending grows rapidly. Only own-source revenues are included (therefore federal funds are excluded), further weakening the cap.

In other words, this revenue cap has no teeth.

It is the fiscal equivalent of belonging to a gym but never going inside. It gives legislators a false sense of fiscal discipline, but does nothing to produce a disciplined budget. Reliance on this cap is a key reason that Florida is in its current fiscal position. To extend my metaphor, it's like using a gym membership that's never exercised as an excuse to eat dessert – night after night.

Florida should consider an effective spending rule. One such rule would cap spending to the sum of population growth and inflation.

Recommendations

I do not want to tell you that Florida's fiscal picture is as dire as those facing other states, such as New Jersey, New York, and California. But at the same time, you are facing a significant gap between expenditures and revenues, and there is no choice but to close it.

The decisions that you as legislators make today will have ramifications for decades to come, just as New Jersey's poor fiscal decisions in the 1970s set the stage for one of the worst fiscal disasters in American state history. Florida's situation is not so dire that it cannot be fixed with the right policies. The decisions the state makes today will determine whether the state will remain competitive in the future. Florida can stay on track if it adheres to some basic principles in how it thinks about taxation, spending, and budgeting.

I have two key recommendations.

First, apply the principles of decentralization in education financing. Education is a local good. It is consumed and provided on the local level. When funding for schools moves further from this level, accountability is weakened. Fiscal opacity is built into the system. The best way to bring down costs in education, while increasing fiscal transparency is to continue to introduce competition, and pursue policies that provide more autonomy to local government, rather than less.

Florida's education landscape should be kept free from fiscal and regulatory obstacles that might limit flexibility and responsiveness in delivering a variety of educational goods.
Florida has been a leader in this area through its voucher programs and commitment to charter schools.

The perverse outcomes of the *Abbott* decisions in New Jersey fiscally centralized the provision of education, tying together the state's income tax and property tax regimes. This design is a leading driver in the state's fiscal and economic downward spiral as school costs skyrocketed and competition has been nearly shut out of the system.

On that note, it is worth mentioning the importance of the courts in setting this fiscal and educational climate. The New Jersey Constitution requires that students receive a "thorough and efficient" education. This language formed the basis of the court's multiple *Abbott* decisions.

Constitutional language is subject to a wide range of interpretations. Florida experienced this in 1998 when the state's Constitution was amended to include the "uniformity" clause, which mandates, "a uniform, efficient, safe, secure and high quality system of free public schools...." The court's interpretation of this clause became the centerpiece of the 2006 Florida Supreme Court ruling that overturned the A+ voucher program.

Secondly, Florida should consider implementing an effective spending limit. The current revenue cap is ineffective. Indeed, it is worse than ineffective because it merely provides cover for poor long-term budgeting practices. Florida should consider a limit with teeth that would tie spending increases to the combined annual growth in population and inflation. That would prevent future legislatures from having to make tough choices now facing this body.

Under such a cap, in cases where the state would like to spend beyond the cap, it must seek permission to override the cap from taxpayers. When revenues exceed the cap, these can be dedicated to a Budget Stabilization fund, up to a limit, with the remainder rebated to taxpayers.

Local governments should also be given the opportunity to institute similar spending limits if they choose.

Effectively designed spending limits with competition in the provision of education will have the combined effect of increasing accountability in school spending, lowering costs, improving outcomes, and enhancing prosperity for Florida's residents and economy.

Thank you for inviting me to testify, and I look forward to taking your questions.

OPPAGA Presentation

Changes to the Florida Retirement System Could Reduce Costs

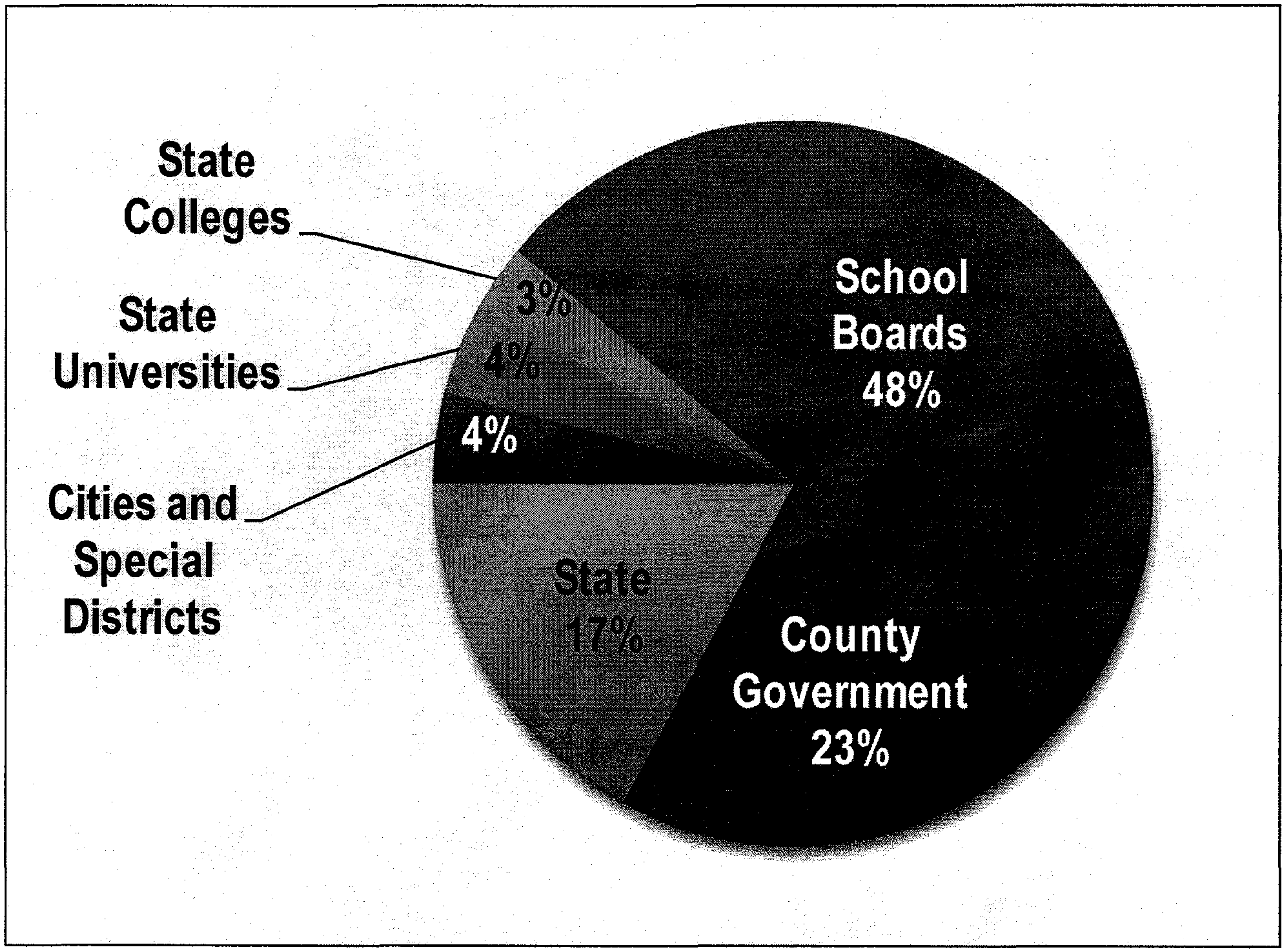
Full Appropriations Council on Education & Economic Development

February 16, 2010

Overview

- FRS includes both state and local government employees
- System costs will substantially increase
- FRS's two plans have differing advantages
- There are options to reduce FRS costs
  - Changing membership classes
  - Changing contribution levels
  - Shifting to defined contribution plan
  - Modifying DROP

Most FRS Members Are Local Government Employees



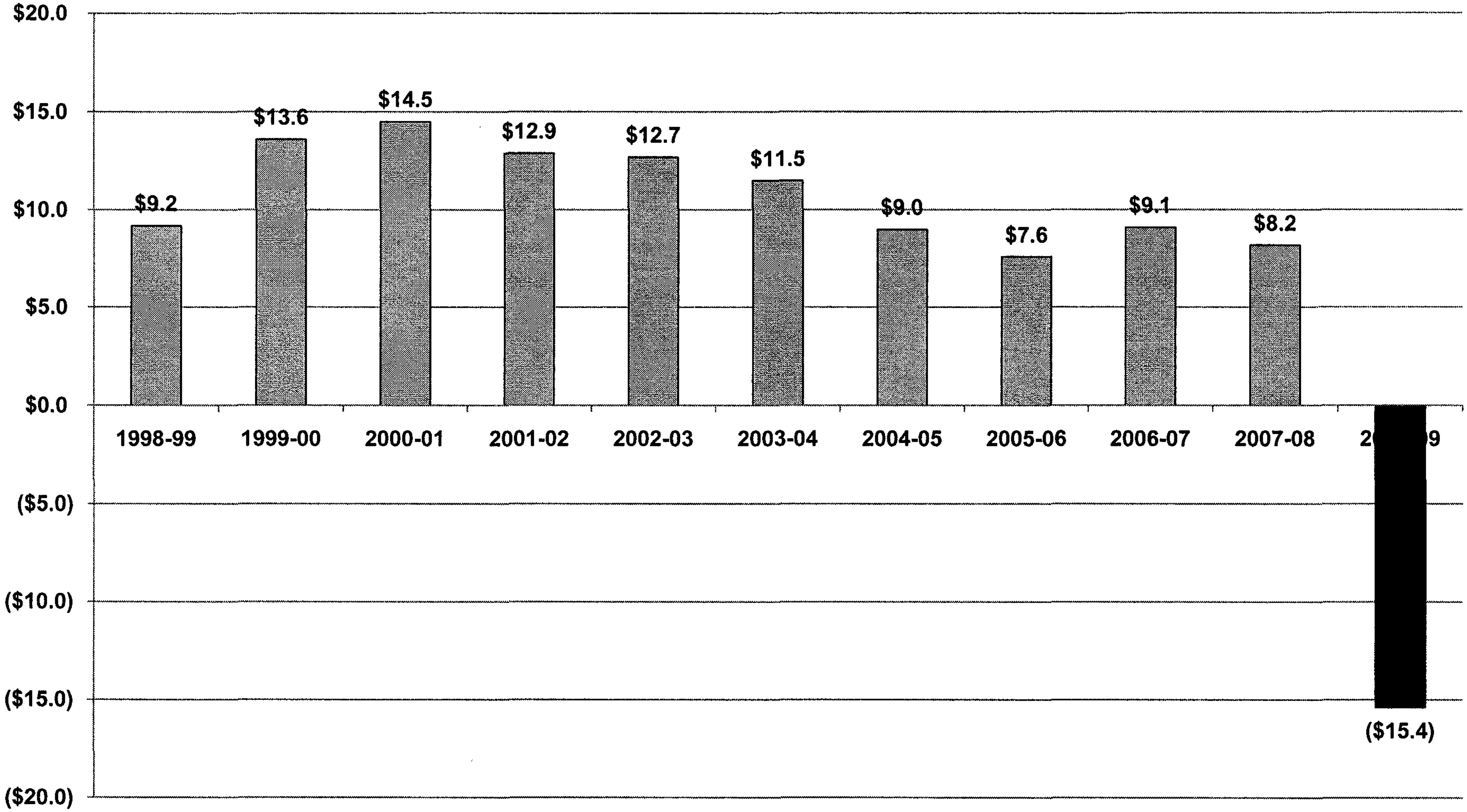
FRS Has Two Plans

- Pension Plan – provides a defined benefit payment to retirees
- Investment Plan – provides a defined contribution to employees' individual investment account; payments to retirees will vary based on investment performance

FRS Pension Plan as of 6/30/09

- 572,887 participants, 288,216 retiree annuitants
- $99 billion in net assets
- Major investment loss in FY 2008-09 (-19%) some losses have been recovered
- $15.3 billion actuarial deficit – 88.5% funding ratio

Pension Plan Had a Surplus but Now Has a Deficit



FRS Investment Plan as of 6/30/09

- 95,529 participants -- 21,139 retirees
- $4 billion in net assets – (down $297 million for year)

FRS Benefit Formula Has Not Changed

Years of Service	X	Accrual Rate	X	Average Final Compensation	=	Annual Pension Benefit

Accrual rate is the percentage value awarded for each year of creditable service

Average Final Compensation was the average of the five best years of the last ten years of service

FRS Class Structure Has Changed
Initial (1970) Structure

	Regular	**Special Risk**
Vesting	10 Years	10 Years
Normal Retirement	Age 62 with 10 Years of Service or 35 Years of Service	Age 55 with 10 Years of Service or 25 Years of Service
Accrual Rate	1.6% - 1.68%	2%
Employee Contribution Rate	4%	6%

FRS Has Evolved Significantly

- 1970: Created as Contributory System with 2 Classes
- 1972: Elected State Officers' Class added
- 1975: Employee contributions eliminated for Regular and Special Risk Class employees
- 1981: Non-contributory for all classes
- 1982: Special Risk Administrative Support added

FRS Has Evolved Significantly
(continued)

- 1986: Senior Management Service Class added
- 1998: Deferred Retirement Option Program (DROP)
- 2002: Investment Plan created
- Other benefits enhanced over time
  - Vesting periods reduced
  - Expanded classes, increased accrual rates, added in-line of duty disability benefits

Current Accrual Rates Vary

- Regular: 1.6% - 1.68%
- Special Risk: 3%
- Special Risk Administrative Support: 1.6% - 1.68%
- Senior Management: 2%
- Elected Officers'
  - Judicial: 3.3%
  - Legislature/Cabinet/Attorneys: 3%
  - County: 3%

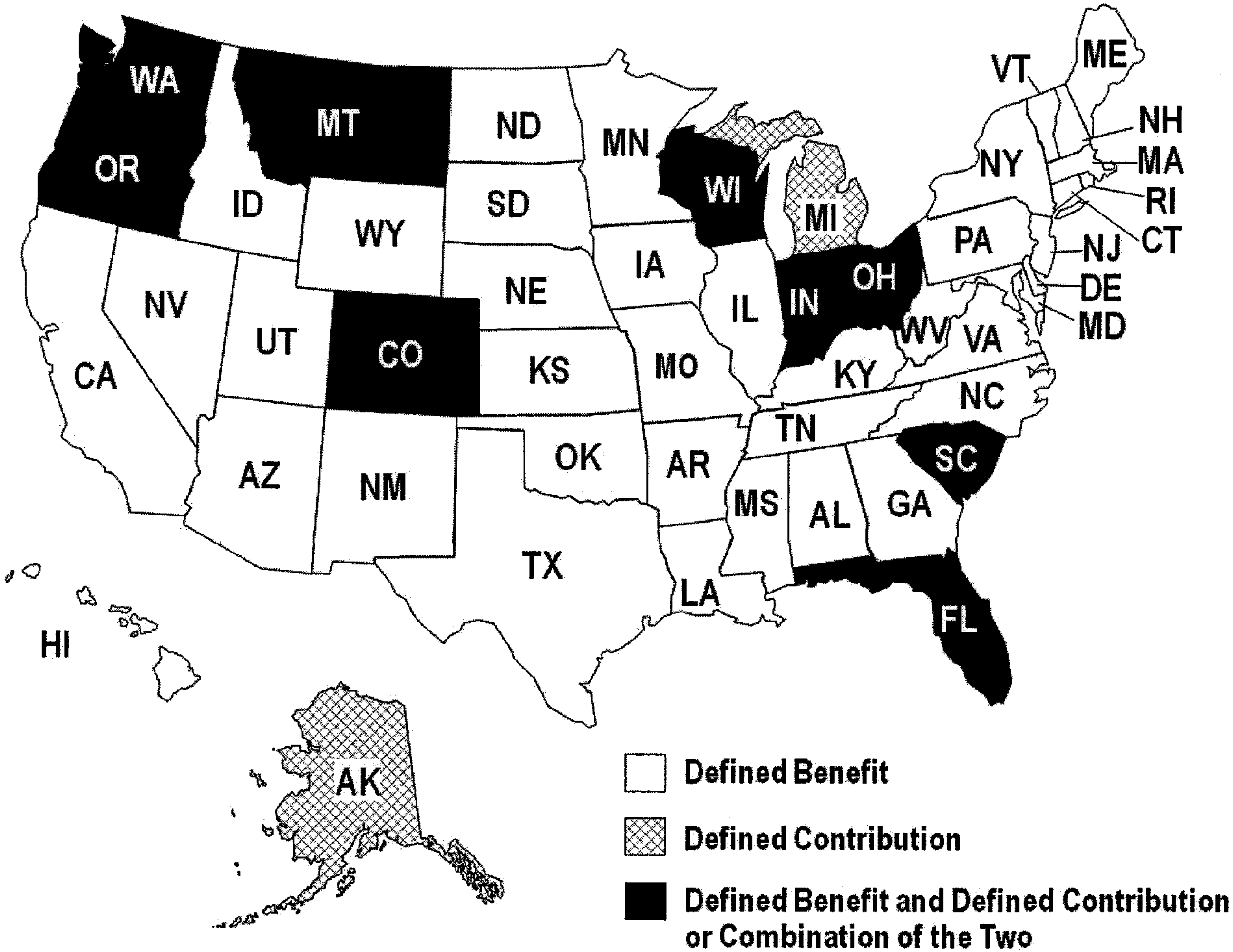
Average Benefits Vary By Class

Class	Average Initial Benefit for Retirees in Fiscal Year 2007-08
Regular	$9,248
Special Risk	$24,230
Special Risk Administrative Support	$26,274
Elected Officers	$21,027
Senior Management	$28,993

FRS Is Similar to Systems Offered by Other States

- All have multiple classes
- 45 require Regular Class contributions
  - 5% contribution rate
  - 2% accrual rate
- 43 require Special Risk contributions
  - 7.5% contribution rate
  - 2.5% accrual rate
  - 10 states have accrual rates of 3% or higher; 9 are contributory
- Senior Management Service Class is Rare

Most States Offer Only One Plan



The Two Plans Have Differing Advantages

- Defined Contribution Plans
  - Predictable costs
  - No need for actuarial studies
  - Shifts investment risk to employee, who may attain higher (or lower) benefits
  - Benefits are portable and have shorter vesting period
  - Favored by non-career employees

The Two Plans Have Differing Advantages

- Defined Benefit Plans
  - Typically have higher investment returns
  - Typically have lower investment costs
  - May achieve surpluses that can defray costs
  - Favored by career employees

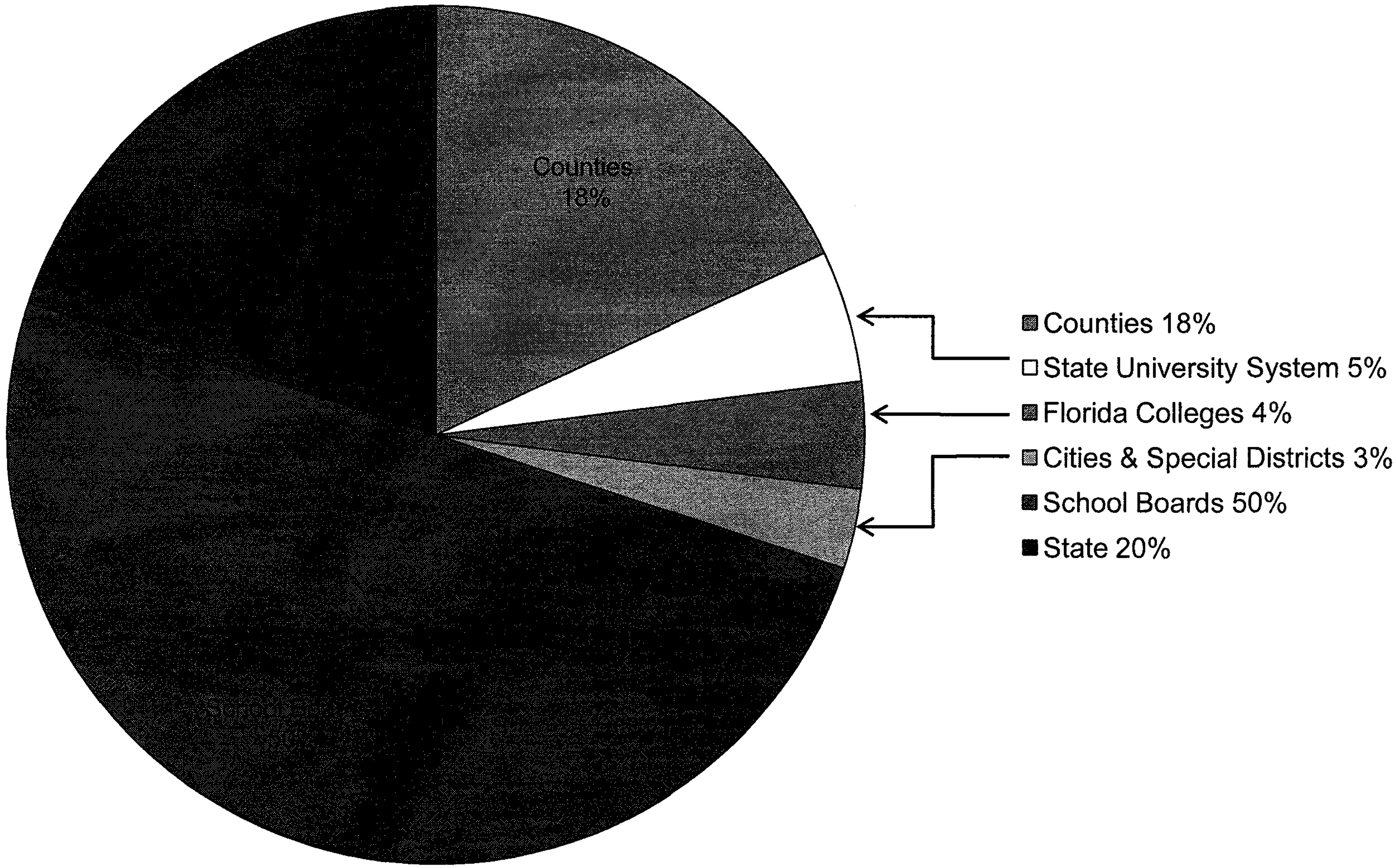
DROP Was Created in 1998

- **Purpose not articulated; two schools of thought:**
  - **Encourage higher paid employees to retire**
  - **Retain skilled employees**
- **Allows members to retire and continue working**
  - **5 Years: Most members**
  - **8 Years: K-12 Instructional Personnel**
- **Pension benefits accumulate in the FRS Trust fund**
  - **Earn 6.5% interest + 3% COLA**
- **Members must terminate FRS employment after completing DROP**

Recent Legislation Changed DROP

- Members who retire or exit DROP after July 1, 2010
  - Cannot be reemployed by an FRS employer within 6 months
  - Are ineligible to earn additional pension benefits
  - Elected officials may only earn interest on their accounts for the specified DROP period, even if their term of office extends beyond the expiration date.

Most DROP Participants Are Local Government Employees



Cost Reduction Options

Option – Offer Only the Defined Contribution Plan

- FRS costs would have been $183 million lower if all employees hired since July 1, 2002 had been in Defined Contribution Plan
- However, closing Pension Plan would increase its contribution rate
- Actuarial study of costs now being done

Option – Reduce Retirement Classes

For example, FRS initially included only two classes. Reinstating initial design would save $359 million

	Class 1	Class 2
Class Criteria	Can complete 30-year career without endangering self, coworkers, or public	Cannot complete 30-year career without endangering self, coworkers, or public
Normal Retirement	Age 62 with 10 Years of Service or 35 Years of Service	Age 55 with 10 Years of Service or 25 Years of Service
Accrual Rate	1.6% to 1.68%	2%
Membership	20% of current Special Risk and all Regular, Senior Management, Elected Officers' Class members	80% of current Special Risk members

Option - Revisit Special Risk Class Membership

- Number of employee classes in Special Risk Class has substantially increased overtime
- For example, could restrict Special Risk membership to only law enforcement officers, Firefighters, and Corrections officers
- Would save $83 million

Option – Modify Accrual Rates

- For example, could reinstate accrual rates that were used when FRS was created in 1970

Class	Current Accrual Rate	Original Accrual Rate
Regular	1.6% - 1.68%	1.6% - 1.68%
Elected Officers'	3% – 3.3%	1.6% - 1.68%
Senior Management	2%	1.6% - 1.68%
Special Risk	3%	2%
Special Risk Administrative	1.6% - 1.68%	1.6% - 1.68%

- Would saves $327 million

Option – Require Employees to Contribute to System

- Each 1% contribution would generate $275 million
- Would not reduce employer contributions on a dollar-for dollar basis
  - Employee contributions are refundable
  - 70% of FRS employees leave prior to meeting the 6-year vesting requirement

Option – Modify DROP

- **DROP cost $41.7 million in FY 2008-09**
- **Costs vary by membership class**
  - **Regular Class = .09%**
  - **Special Risk = .46%**
  - **Special Risk Administrative Support = -.04%**
  - **Senior Management Service Class = .04%**
  - **Elected Officers' Class = .06% to .35%**
- Has been funded through blended rate that shifts costs among employers

DROP Shifts Cost to Regular Class Employers

FRS Fiscal Year 2010-11 Blended Rates

	Regular	Senior Management	Special Risk	Special Risk Administrative Support	Judicial	L/A/C	Counties
Rates	11.66%	21.56%	28.57%	27.21%	32.27%	32.08%	37.36%
DROP	20.07%	20.07%	20.07%	20.07%	20.07%	20.07%	20.07%
Difference	+8.41%	-1.49%	-8.5%	-7.14%	-12.2%	-12.01%	-17.29%

Many States Implement Drop Differently

- At least 12 other states offer DROP
  - Four offer DROP to all members
  - Six limit to Special Risk only
  - Six provide a guaranteed interest rate (typically lower)
  - Four provide COLAs
  - Six allow members to defer enrollment after meeting eligibility requirements

Options for Modifying DROP

- Define purpose
- Fund by membership class
- Standardize requirements
- Base interest rate on current economic conditions
- Eliminate DROP – potential annual savings of $41 million

Modify Health Insurance Subsidy

- Currently, Pension Plan annuitants receive $5 for each year of service (maximum of $150 per month)
- Employers contribute 1.11% of salary for all employees, including DROP participants
- Cost in 2008-09 was $325 million
- Subsidy could be reduced or eliminated

For Additional Information

Kara Collins-Gomez
Staff Director: 487-4257

Linda Vaughn:
Senior Legislative Analyst: 487-9216

Ed Madden
Legislative Analyst: 487-9273

Reports Available online at:
www.oppaga.state.fl.us/reports/pdf/1015rpt.pdf
www.oppaga.state.fl.us/reports/pdf/1019rpt.pdf