

Transforming Government into a 21st Century Institution

Redesigning Ohio

December 2010

About Our Report

Redesigning Ohio: Transforming Government into a 21st Century Institution is the result of a year-long project undertaken by Ohio's Metropolitan Chambers of Commerce and the Ohio Chamber of Commerce. Recognizing that there is no easy or quick solution to the fiscal and structural problems facing Ohio, we came together to study ways in which our state can make transformative changes that will address our immediate challenges and—more importantly—change the way in which we govern ourselves.

Over the past several decades, Ohio's state government has addressed good times and bad by making incremental changes in the way we create budgets and fund programs and services. By and large, we have perpetuated the status quo and failed to take a step back to examine the broader fiscal and operational landscape. The time for such an examination has come. This report reflects contributions from each of our Chambers, our members, and the advice and counsel of experts in the fields of study included in our work. Our work is intended to challenge the process that has led to the inefficient, unsustainable situation we face today. Our recommendations are based on common sense, not ideology. They are practical approaches to problems that demand new solutions.

We wish to express our deep appreciation to David Osborne and Greg Browning, both of whom played major roles as consultants throughout this process.



David Osborne, senior partner of Public Strategies Group, is co-author of *The Price of Government* and *Reinventing Government*, both of which provided inspiration for this work. David has served as an advisor to Vice President Al Gore as well as numerous governors, mayors and city managers nationwide. He has published five books on government reform, while also writing for *The Atlantic*, *The New York Times Magazine*, *Harper's*, *The New Republic*, *The Washington Post* and many other publications.

Greg Browning, Ph.D., president of Capital Partners in Columbus, Ohio, is one of Ohio's foremost advisors on state budgets and governmental processes. As Director of the Ohio Office of Budget and Management from 1991 to 1998, Greg served as the State's CFO. He has also served as president of the State Medical Board of Ohio and chairman of the Ohio University Board of Trustees.



We are indebted to David, Greg, and the many other experts, advisors, elected officials, and civic leaders who guided this important work.

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Redesigning Ohio: Executive Summary

Transforming Government into a 21st Century Institution

Ohio is facing an unprecedented fiscal crisis. Although we're not alone, we would be remiss in not taking this opportunity to transform our state government to one that is sustainable and provides greater value to our citizens. Getting more for less is both the best response to our current crisis and a necessary step toward building a strong state economy that can compete in the 21st century. The time for action is now. Our state government must become more flexible, adaptable and innovative – searching constantly for new ways to improve services and heighten productivity.

Recognizing this need and our responsibility as leading economic development organizations, Ohio's eight Metropolitan Chambers of Commerce and the Ohio Chamber of Commerce joined together to produce this report. It offers a road map for long-term, transformational change as well as meaningful recommendations for tackling our current fiscal crisis. This report includes an analysis of our existing economic situation, a review of best practices from other states and recommendations that range from the way our state budget is developed to specific productivity improvements.

Our recommendations are offered as a look forward, not a condemnation of the past. After all, it has taken many years – decades, in fact—to arrive at this point. No particular Administration or any one General Assembly can or should be singled out. Incremental changes in the way we govern ourselves have brought us to this point. But it is time to rethink these practices and make bold changes. It will take hard work, difficult decisions and broad consensus to implement the changes required to reinvigorate Ohio's economy.

This report is not intended to be a proposed solution to the estimated \$6-8 billion budget deficit we are facing, although full implementation of these recommendations will result in significant long term savings as well as in the FY 2012-2013 biennium. But, perhaps more importantly, our recommendations target specific ideas in key areas of state government; with a focus on those that are particularly well suited to private sector solutions. That is, by viewing these functions through the lens of the private sector, we believe we can make a meaningful difference. Similarly, this report proposes a market-based approach for reforming the way state government and Ohio's

local political subdivisions work together. Clearly, it is not just our state, but the more than 3700 local governments as well, that are on an unsustainable path that must be reversed.

Important areas of state spending, such as Medicaid and education, are not addressed here. It is our view that these issues require additional, significant study and we pledge to collaborate with other groups that have or will undertake additional analysis of these programs.

Underlying all of our recommendations is the management philosophy known as Budgeting for Outcomes, which has been developed and championed by David Osborne of Public Strategies Group. Mr. Osborne is a nationally recognized author and expert in government redesign and streamlining. Working closely with him and with Greg Browning of Capital Partners, who has a vast understanding of Ohio state government and budgets, we have researched selected practices and targeted areas of government for reform. These include:

- Budgeting for Outcomes
- Charter Agencies
- Entrepreneurial Management
- Government Regulations
- Tax Expenditures
- Civil Service System
- Public Employee Pensions
- Health Care Costs
- Criminal Justice System
- Local Governments

Budgeting for Outcomes is not about incremental change. It turns traditional budgeting on its head and focuses on what matters most: purchasing outcomes that citizen's value. Transforming government to get more for less must include redesigning the state budget process itself. We recommend adopting this new budgeting paradigm in three stages:

- FY 2012-2013: In developing the state operating budget, the Office of Budget and Management (OBM) works with the Governor and agency leaders to designate leading agency outcome goals and rank major state programs from most to least cost-effective.
- FY 2012-2013: OBM leads an inclusive effort to develop program performance measures for each major state program.
- FY 2014-2015: Fully implement Budgeting for Outcomes, including broader stakeholder outreach efforts designed to inform the budget development and prioritization process.

We also recommend that the state set aside \$20-\$40 million in a State Innovation Fund for investment in system reform, redesign and capacity building.

Charter Agencies are government departments or agencies that accept less funding in exchange for more flexibility and freedom to manage. They deliver measurable improvements in results and contribute savings and/or new revenues to the state. In this section our recommendations include:

- Enact legislation or issue an executive order to allow the next governor and his cabinet members to negotiate charter agency agreements.
- Negotiate biennial written agreements that specify needed management flexibilities, expected reforms and performance targets that will lower costs and improve outcomes.

Entrepreneurial Management is a strategy for getting more bang for the buck from internal support services. It forces agencies to earn revenue by selling their services to other agencies, often in competition with private sector providers. Our recommendations include:

- Reorganize internal support services such as information technology, vehicle/fleet management, and facility management as competitive enterprises that have flexibility to operate like businesses competing for work with both public and private sector providers.
- With utility services (internal services that should be monopolies, like telecommunications), place money in the hands of the customer agencies and give them seats on a customer council that has the power to set rates and approve investment plans, to improve the value equation.
- Create a public agency customer council to improve the price/value ratio primarily through collaborative efforts to improve purchasing outcomes.

Government Regulations are often overly burdensome and expensive to enforce. Market-based principles provide an effective strategy for moving from expensive command and control regulation to an approach that boosts voluntary compliance. This approach maximizes the regulatory benefits and tax revenues while reducing compliance burdens. Strategies to reform the regulatory climate by winning voluntary compliance include:

- Build support for rules and standards by involving compliers in their creation.
- Make regulations performance-based.
- Educate compliers about what is expected of them.
- Make Compliance easy.
- Make the quality of agency service to compliers consequential.
- Report compliance information.
- Treat different compliers differently.
- Create a continuum of public consequences and rewards.
- Create market incentives to encourage compliance.

Tax Expenditures are revenue the state foregoes when it issues tax credits, exemptions and deductions. In Ohio, tax expenditures add up to \$7.7 (FY 2008) billion in foregone revenue annually. Tax expenditures are often valuable tools that help create jobs and increase other revenue for the state. But some have been on the books for years without a review to ensure that they are meeting their intended policy outcomes. Recommendations to change this status quo model include:

- Utilize the tax policy principles outlined in this report (neutrality, economic competitiveness, stability, and simplicity) to conduct a thorough review and cost-benefit analysis of the 122 existing tax expenditures in the FY 2012-2013 budget development and review process.
- Use both a static and dynamic analysis of the costs and benefits of tax expenditures.
- Improve the quality and scope of Ohio's current biennial Tax Expenditure Report.

Civil Service systems, once an important protection for public employees, often stand in the way of achieving results-based public organizations today. In order to reap the benefits of a more efficient, productive workforce, Ohio must liberate its bureaucracies. Specific recommendations to reform the civil service system include:

- Give managers more freedom to manage their employees.
- Shift to broad job classifications and use market based employee compensation studies, updated regularly, to create broad and competitive pay bands.
- Limit compensation increases beyond these pay bands to merit-based bonuses based on objective performance measures; eliminate automatic pay raises via steps and longevity pay.
- Invest in building employees' skills and capacities.

Pension Benefits are crucial to making the right investments in the state's most important resource—its employees. Consistent with our proposed civil service reforms, market-based reforms should be used to ensure that Ohio has a competitive, highly effective employee benefit system—one that will attract and retain good employees while being fair and affordable for Ohio taxpayers. Recommendations include:

- Require a shared, 50-50 employee/employer contribution for state pensions and retiree health insurance.

- Fund any remaining shortfall in pension and retiree health insurance benefits from increased employee contributions, not from taxpayer funds.
- Require uniformity in the percentage of health insurance costs paid by old and new retirees.
- Allow political subdivisions to pay employees' contributions to their retirement programs only when there are compelling reasons to do so.
- Limit "double dipping" to extraordinary, high-need situations.
- Reduce the number of state pension systems to capture administrative savings.

Health Care spending is at the core of the state's budget problem and must be resolved. Unless Ohio finds a sustainable solution to the rising cost of health care, it is unlikely that we can recover from the fiscal crisis we face today. State government can help reduce health care cost increases and improve outcomes by using a strategy that includes smarter use of public sector health insurance buying power while fostering a genuinely competitive health insurance marketplace. Recommendations include:

- Drive health care costs down and improve patient outcomes by using the state's leverage as a large purchaser to move toward new reimbursement methods, including "global payment" models. Reward providers for keeping patients healthier; pay for results and not simply service volume.
- Support, through incentives and other means, the creation of Accountable Care Organizations (ACOs) and other innovative programs to deliver care.
- Improve transparency and access to price and quality data from health care providers and health plans by utilizing web sites and other communication vehicles that enable purchasers to be informed about the most cost-effective options.

Ohio's Criminal Justice System is underperforming. It costs too much and the outcomes are inadequate. From a bottom line perspective, it is time to ask a fundamental question: would public safety, prisoner rehabilitation, recidivism and correctional costs be improved if Ohio directed more nonviolent offenders away from adult prisons toward non-residential community-based monitoring and treatment? We believe the answer is, yes. Specific recommendations include:

- Continue the commitment to remove violent offenders from society for extended periods of time.
- Direct most low-risk, truly nonviolent (and nonsexual) felony 4 and 5 offenders who are amenable to treatment to supervised release in non-residential community-based correctional options, including day reporting, electronic monitoring, work programs and education and treatment programs.

- Enact legislation to revise criminal sentencing provisions, including limited expansions of earned credit for prisoners, to better protect the public, improve offender outcomes and reduce taxpayer costs.
- Make smarter investments in the management of probation and parole, including greater use of evidence-based risk assessment instruments, GPS monitoring, and random drug testing.
- Analyze the cost-effectiveness of selling or leasing public prisons and other necessary assets.
- Provide better education, training, and treatment services for prisoners who have a high incidence of functional illiteracy, workforce skill deficits, and mental health/substance abuse problems.
- These reforms can allow for the closing of three state prisons over two years, reducing the high cost of incarceration (\$24,000 per prisoner per year) by 4,500.

Ohio's Local Government System is out-dated and unsustainable. After years of frustration regarding a 19th century local government model that has produced 3,700 political subdivisions in Ohio, all in the name of "local control", it is time to bring this system into the 21st century. Recommendations that will produce fewer governments, lower costs, and more value include:

- Push local government to implement Budgeting for Outcomes.
- Create and implement county-led Local Government Service Coordination and Collaboration Plans.
- Advance planning work through Local Government Transformation grants funded from a State Innovation Fund.
- Strategically redirect the state's Local Government Fund toward buying better results by earmarking 15% of the fund in FY 2012 and 20% of the fund in FY2013 for local government reform demonstration projects.
- Establish a new State & Local Government Transformation Authority to provide policy and technical support to local governments.
- Reduce or cap costly real property tax roll-backs.

We offer these observations and recommendations with great respect for those who govern us and with the belief that by working together, we can forge a sustainable, more productive future. The crisis we face is real, but it offers the opportunity to take bold, measurable actions that will result in a brighter future.

Greater Akron Chamber
Canton Regional Chamber of Commerce
Cincinnati USA Regional Chamber
Dayton Area Chamber of Commerce
Greater Cleveland Partnership
Columbus Chamber
Toledo Regional Chamber of Commerce
Ohio Chamber of Commerce
Youngstown/Warren Regional Chamber

1 Getting More for Less

We Need To Think Differently About How We Spend Money

Given the unprecedented fiscal crisis Ohio faces, the question of the day is simple: How can we get more for less from Ohio government? Citizens oppose most tax increases, but they also oppose most service cuts.

The basic political responses to this crisis are predictable. From the right, “cut spending,” so we’ll have less government. From the left, “we need more money” to preserve current services and add new ones, because people are hurting and we ought to help them.

Neither response does much to get at the root problem. At the root is our underlying system of governance, the one that’s proving the truth of this old chestnut: “Every system is perfectly designed to produce the results it currently produces.”

Think of “underlying system” here like a computer’s operating system. Our government’s operating system is obsolete. It’s the equivalent of DOS. It can no longer do what needs to be done.

Not recognizing that fact, we engage in all kinds of hopeful misdirection: We change our leaders, cut or add to budgets, appoint blue-ribbon commissions, install new technology, yell and stamp our feet. Only somewhat more enlightened, we look for solutions in better policy—better education policy, better health policy, etc.

People, policies and technologies are all important, but they are merely the software programs that execute education, health, public safety and all the other results we want from government. They are all constrained by the operating system. They cannot be any better than the operating system. In 2010, our software is running on antiquated operating systems. We need a major upgrade.

Our current bureaucracy was designed and adopted a hundred years ago to cure the ills of the 19th century’s operating system: the spoils system. Bureaucracy was largely successful in that task, at least in most parts of the country. The word “bureaucracy” actually enjoyed a positive connotation then, because it was the solution.

It was also the reigning business model. The Fords and General Motors of the world created large, centralized bureaucracies with elaborate rules and regulations and hierarchical chains of command and governments copied them. But in today’s world of economic crisis, fierce global competition, and sophisticated information technologies, such institutions are dinosaurs. To be effective in the 21st century, institutions must be flexible,

adaptable and innovative—as GM and Ford have learned the hard way. They must search constantly for new ways to improve services and heighten productivity.

We must now lead the charge for a new and better operating system for government. Courageous experimenters scattered across the country have been piecing it together. The “From-To” chart on page 8 contrasts bureaucracy with this emerging operating system.

So how do we produce a redesigned 21st century institution? We can begin by adopting the reforms outlined in this report, which are built on a new, post-bureaucratic set of principles:¹

Government’s central role is to steer, not to row. Steering is the most important thing government leaders do: setting direction, developing policies to move in that direction, measuring progress, and making adjustments. Government needs to do that well. But government doesn’t have to do all the rowing. To get things done, it can leverage many different resources, public and private. It can choose the most cost-effective method possible, whether that means contracting with nonprofit or for-profit organizations, using public employees, partnering with community organizations, using vouchers, creating tax incentives, or many other methods.

Government must focus all its efforts on producing results. We must shift accountability from inputs (“Did you follow the rules and spend according to the appropriated line items?”) to outcomes. We must measure the performance of public agencies, reward those that improve their results, and use the budget process to shift our taxpayers’ dollars to those programs and strategies that deliver the best bang for the buck.

Government must make public service organizations accountable to their customers. They must treat those they serve—the parents whose children they teach, the people who line up to renew drivers’ licenses, the students at their universities—as successful businesses treat their customers. They must

listen to what customers want, set customer service standards, and whenever possible give customers the power to take their public dollars to a competing provider.

Government must use the power of competition to drive innovation and improvement. Competition is a fundamental force that gives organizations no choice but to improve. By requiring those who deliver public services—whether they are public employees, nonprofits, or for-profit firms—to compete for their business based on their performance and price, we can dramatically improve the results we produce.

Governments must free public managers from much of the red tape that binds them. In the past, we have tied managers and employees up in rules and regulations and then ordered them to improve. It has never worked. 21st century governments must deregulate internally, eliminating many of their internal rules and radically simplifying their administrative systems, such as budget, personnel, and procurement. They must require each agency to get clear on its mission, then free managers to find the best way to accomplish that mission, within legal bounds.

Governments must decentralize, pushing decision making closer to the customer. In today’s fast-moving world, large, hierarchical bureaucracies move too slowly and inspire too little commitment from their employees. We must take out layers and push authority down through the ranks, encouraging those who deal directly with customers to make more of their own decisions. We must shift key decision-making authority away from functional silos such as procurement and HR offices, to operational managers.

Governments must use the marketplace to leverage better results for the dollar. To create more public value without more dollars, 21st century leaders often take advantage of market mechanisms to solve problems, rather than relying on the traditional administrative mechanisms, like service delivery or command-and-control regulation. They create financial incentives to get the needed results.

We understand that changing the operating system is a daunting task. Many people and institutions are invested in the old one—or in opposing it. They know how to work it; it’s good for them and in some cases it sustains them. We should not assume, however, that all in government cling to the status quo. Many are just as frustrated with bureaucracy as the rest of us.

So far, champions for these kinds of reforms have felt more like Don Quixote than Bill Gates. But we no longer have a choice. We cannot print money. We cannot cut \$6-8 billion of state spending and still have the same schools, the same local governments, the same highways, the same health care, the same prisons. Likewise, we cannot raise taxes by \$6-8 billion and still have the same economy, the same jobs.

The pages that follow describe how we can begin to upgrade Ohio’s antiquated operating system: its cost-plus budget system; its 100-year old civil service system; its lock-‘em-up criminal justice system; its fee-for-service health insurance system; its command-and-control regulatory system; its bureaucratic approach to managing agencies; and its horse-and-buggy system of local governments. For the first time ever, nine Ohio Chambers of Commerce have joined together to help find ways to give our state government a 21st century operating system.

There is no finger-pointing at any one Administration or General Assembly. It took us many years—many decades, in fact—to get to this point. The unwieldy behemoth known as state government is the product of an incremental approach. Process improvement initiatives have already been implemented, with varying degrees of success; now we have reached a point at which major structural change is necessary. And that change must also address the way in which state government and Ohio’s 3,700 political subdivisions work together. State funding provided for local governments can no longer be simply a transfer of funds; solving this crisis depends in large part on reform at the local level.

FROM: 20TH CENTURY BUREAUCRACY	TO: 21ST CENTURY GOVERNMENT
Statute & rule directed	Mission & results directed
Hierarchically driven	Team & network driven
Control centralized	Decentralization
Primarily accountable for conformance to rules	Primarily accountable for results for people
Manage costs	Manage value
Quality defined as adherence to standards	Quality is defined as meeting or exceeding customer expectations
Exclusive service mandate	Choice and competition
Focus on what’s best for government	Focus on what’s best for customers, citizens, and taxpayers

Chart courtesy of David Osborne, Public Strategies Group.

BALANCING SHORT-TERM AND LONG-TERM SOLUTIONS

Our report is not a silver bullet. We all know there is no such thing. We don't profess here how to magically and instantly solve a looming \$6-\$8 billion budget shortfall. And we don't touch upon several areas of state spending – such as Medicaid and education – that in themselves demand separate, dedicated analysis.

But what we do offer is a series of compelling, reality-based reforms applied to ten important areas of state government where productivity improvement will generate significant benefits. Recommended reforms in each area—from budget process improvements to state/local government relations to public sector health insurance purchasing—have direct implications for the state budget.

Most of the benefits will accrue over a longer term than two years. But we estimate that our reforms will save nearly \$1.4 billion in FY 2012-2013. However, it is important to state clearly that this report is about system productivity improvements that will take years to implement fully. This means that short-term budget balancing questions are not the central subject of the report and recommendations.

The system redesigns discussed herein are not about preservation of the status quo. This is usually the central focus of budget deliberations: How to close a deficit while hurting as few people as possible. The chambers believe that such short-term thinking will lead to higher costs and worse outcomes in the long run – the opposite of the productivity enhancing approach we are recommending.

System redesign is also the best way to advance an important component of a strong economy: a business tax structure built on the principles of neutrality, economic competitiveness, stability, equity and simplicity. The tax reforms enacted in 2005 reflect these principles. Fair and reasonable tax policies are an essential element of a successful business environment and thriving businesses mean more good jobs for Ohioans.

In June 2009, we published a report that outlined the impact of Ohio's 2005 tax reform legislation. *Ohio's State Tax Climate for Business and Jobs is Warming* captured the essence of these tax reform measures and provided real-life examples of businesses that had experienced significant growth as a result of tax reform. The aim of tax reform was to make Ohio more competitive and attractive for business growth. That required shedding a tax structure from a bygone era and replacing it with one that reflects a new tax strategy, one that has shifted toward taxing consumption. Tax reform has been a solid success. Despite the fact that some argue otherwise, it is important to realize that tax reform is accomplishing its intended goals. It has made Ohio a more attractive place to establish and grow businesses. Our revenue problems are the result of a troubled economy. Had tax reform measures not been in place, there is good reason to believe that our economy would be suffering even more than it is.

These perspectives lead the chambers to the following conclusions relative to the state's FY 2012-2013 budget deficit:

- Our productivity-enhancing system changes should be analyzed and adopted.
- FY 2012-2013 savings of nearly \$1.4 billion should be used to address the deficit.
- Transformation requires investment. We are proposing the creation of a \$20-\$40 million Innovation Fund. Without this level of commitment, it is doubtful that the recommendations in this report can be implemented effectively.
- The remaining deficit should be addressed using the Budgeting for Outcomes budget process outlined in this report. The highest budget priorities should be funded to the extent possible while the lowest priorities should be phased-out, if not eliminated immediately.

In the end, the biggest benefit these recommendations will have is not the substantive short-term savings, but the more significant, longer-term system changes that will pay major dividends for many years. These benefits will result in measurably improved outcomes at lower costs – exactly what the public wants.

Ohio Government Situation Analysis

The Numbers Aren't Pretty



Ohio is in the painful throes of fiscal crisis and economic transition. This chapter describes a state burdened with legacy organizational structures that need to be redesigned in order to lower costs and improve results. Process change initiatives have been implemented with varying degrees of success; now we have reached a point at which major structural change is needed.

An economic snapshot of Ohio

- 7th most populous state (11.5 million)
 - Gross State Product (GSP): \$471 billion (2008)
 - Diverse economy with approximately 12.5 percent of the workforce employed in manufacturing; ranked 3rd nationally in manufacturing GSP
 - 14 percent working in agribusiness
 - 47th in economic growth and 2nd in job losses
 - 6th nationally in Fortune 500 company headquarters (23)
 - Personal income below the national average
 - The price of state and local government is above the national average and trending upward.
-

The facts speak for themselves

Ohio, like other states in the Midwest, has been buffeted for decades by the winds of global economic change. Its longstanding manufacturing and agribusiness strengths have suffered as knowledge and technological know-how have been transferred to other nations that are willing and able to produce goods at substantially lower cost. The result has been the loss of hundreds of thousands of manufacturing jobs. And despite losing one out of four of these jobs between 2000 and 2007, more job losses occurred with the onset of the recession. In fact, according to a July 2010 report compiled by Business First of Buffalo, New York, between May 2000 and May 2010 six of Ohio's seven largest metropolitan areas combined lost more than 233,000 manufacturing jobs.²

The Ohio manufacturers that remain are tough competitors, but much of their success has come through careful reductions of labor, the implementation of technology, and a significant increase in the skills of the remaining workforce.

Though these lost manufacturing jobs may never be replaced, what have replaced them over the past few decades are often lower paying service sector jobs. These trends have taken Ohio from a high wage, relatively wealthy state to one in which wages are below the national average as is the educational attainment of the workforce (39th).³

But all is not bleak. Ohio has many islands of excellence and growth ranging from world-class health care institutions in Cleveland to the booming logistics industry in Columbus to the solar energy manufacturing industry in Toledo. Unfortunately, these economic jewels cannot offset Ohio's structural economic challenges, many of which emanate from the challenges of globalization.

An \$8 billion storm bearing down on the Statehouse

As with the vast majority of states, Ohio is facing a substantial operating fund deficit for the FY 2012-2013 biennium. Preliminary estimates suggest that this problem will be in the \$6-8 billion range.⁴ The biggest part of the projected shortfall relates to the fact that the current biennial budget includes more than \$8 billion in *one-time* resources—including federal dollars from the American Recovery and Reinvestment Act (ARRA). It is also worth noting that this looming deficit does not include the state unemployment compensation fund depletion and the consequent need to borrow heavily from the federal government—a situation that will ultimately require higher employer assessments among other financial fixes.

But the state's most serious fiscal problems relate to underlying economic realities. The connection between these economic trends and the fiscal condition of state government is direct and

substantial. A weaker economy and relatively low personal income growth translate into reduced state and local tax receipts. These same economic forces—along with persistent poverty and an aging population—result in greater demand for social contract-related spending. This is particularly true in the state’s Medicaid (health care) program, which currently serves more than 2 million low income people at an annual (state and federal) cost of \$14.3 billion.⁵ This ever-growing entitlement program has for many years crowded out spending for other vital state services, including K-12 and higher education. This safety net expenditure and others are counter-cyclical; they grow faster during economic downturns. In fact, Medicaid spending is expected to grow by 9 percent in FY 2011 alone.

These cost pressures have grown over the past few decades to the point that Ohio has gone from a being low tax state to one that is well above average in terms of per capita state and local taxation. Examined from the perspective of the total cost of state and local government as a percent of aggregate state income, Ohio’s state/local tax burden amounts to 16.89 cents per dollar, which is above the 2007 national average of 15.67 cents.⁶

Yet, the biggest driver of the state’s growing tax burden is not state taxes. It is taxes imposed by local governments. There are more than 3,700 political subdivisions in Ohio and almost all of them have taxing authority. In fact, Ohio is one of only a few states that permit local governments to impose income taxes.

Unfortunately, there remains an imbalance between revenue growth and spending growth. State spending has typically

- Capping or marginally reducing investments in these same areas in difficult economic times to fund health and human service entitlement increases that result from a weakening economy, rising unemployment and under-employment.
- Reforming state and local taxes to spur economic growth.
- Raising tax and non-tax revenues.
- Making incremental adjustments in the state budget process to increase operational efficiencies and effectiveness.
- Delaying subsidy payments and refinancing state debt.
- Drawing down financial reserves: rotary funds; Budget Stabilization Fund; GRF fund balance; and other.

What the state has not done is step back and redesign major systems with a goal of improving their effectiveness.

Instead, there have been big increases in social contract spending—health care, K-12 and higher education—and big expansions in prison spending. Meanwhile, increased pressures to respond to other legitimate needs have resulted in a growing array of state agencies and programs created over the past 30 to 40 years. New agencies are like puppies – they grow up. Agencies that started out as commissions have morphed into full-blown cabinet agencies. The Commission on Aging became the Ohio Department on Aging. The Youth Services Commission became the Ohio Department of Youth Services. Veterans’ organizations called for a state veterans department, and it became a reality recently.

“ What the state has generally not done is step back and redesign major systems and their governance and finance structures with a goal of improving program and policy effectiveness. ”

grown in the four to five percent range annually. Much of this relates to the market basket of goods and services the state buys, dominated by education and health care. Because of inflation in both areas, state spending routinely outpaces wage growth and growth in the consumer price index.

This public finance dilemma is not unique to Ohio, but pressures found across the nation are intensified in Ohio because of its longstanding economic challenges.

We’ve always done it this way

The state’s leaders have responded to these fiscal problems over the years by:

- Spending more in relatively good economic times to increase investments in education, higher education and workforce training with the assumption that greater public sector investments in human capital will produce a more economically competitive state economy.

Maintaining the status quo is very expensive

The price for this “status quo approach” has been high in terms of missed opportunities to improve system productivity. This has become increasingly clear as Ohio struggles with the aftermath of the 2007-2009 recession, vestiges of which continue to retard economic growth. During these turbulent times, the state’s organizational structure has remained largely intact. Indeed, it appears that the primary (bipartisan) strategy state elected officials have used to respond to the recession has been to maintain the existing array of essential state services in at least a minimally adequate form without raising general taxes. But improving the productivity of what has been saved has not been a major priority.

The state government organizational scene

The state of Ohio is a major, multi-faceted organization. Its current FY 2011 budget is more than \$55 billion (all funds) and it employs more than 59,000 people, excluding college and

university employees. Most of the state's General Revenue Fund (GRF) budget consists of transfer payments to its political subdivisions: schools, colleges and universities, local governments and a largely state-financed but county administered human service system. The state also provides a large number of direct services ranging from institutional services (corrections, mental health and developmental disabilities) to park services.

The institutional agencies are particularly dominant in the employee headcount: the Department of Rehabilitation and Correction employs more than 13,300 and the Department of Youth Services employs nearly 1,900. In fiscal year (FY) 2010, state payroll and related costs are estimated to be \$4.36 billion, about \$1.85 billion of it in the General Revenue Fund. This \$1.85 billion represents a reduction of \$126 million over comparable FY 2009 costs – in part from job reductions and a mandatory ten-day furlough for all state employees.

There have been steps in the right direction

Over the years, Ohio has engaged in various improvement initiatives. From TQM (total quality management) to the current focus on Kaizen (Japanese for improvement or change for the better), there have been various attempts to improve management and employee performance. Most of these initiatives—and they are usually business process improvement initiatives as opposed to systemic reforms—have been modeled on private sector methods. TQM, Kaizen and Lean are closely related, all implementing tools to reduce waste, improve results, and empower employees to engage in continuous improvement.

A recently created division in the Ohio Office of Budget and Management is a promising example of organizational change possibilities. Ohio Shared Services is creating state government efficiencies by consolidating support service functions such as expense reporting and reimbursement. Tasks that were previously siloed in individual agencies can now be shared. And though participation is currently voluntary, with agencies picking and choosing which functions they actually use, all state agencies are required to use the center for travel reporting. The staff of Ohio Shared Services is also held accountable based on performance measures.

Despite these well-intended initiatives, reform efforts have been constrained by funding limitations and by bureaucratic inertia. Union contracts have also made the introduction of new management and operating reforms more difficult. Thus far, shifting from a rule-driven, bureaucratic culture to one that frees employees to focus on results may have gained more intellectual favor than active adherents. Yet this means there is plenty of fertile ground in which to plant seeds of organizational change.

In summary, Ohio is struggling with significant fiscal and economic challenges and the need to substantially lower government costs and improve outcomes for the benefit of all its citizens. Hence, it is vital to determine new ways to increase system productivity.

Budgeting for Outcomes

A new budgeting process that has been used with success elsewhere



Following the most fiscally challenging year since the Great Depression, state leaders are planning the next state budget. As they struggle to meet impossible demands, they should consider how system redesign applies to the budget process itself. One such approach, which has been employed by several states and another 20 cities, counties, and school districts, is known as Budgeting for Outcomes (BFO). Rather than making incremental changes to the status quo, Budgeting for Outcomes focuses on what matters most: purchasing outcomes that citizens value most. Programs that don't contribute much to those outcomes are no longer included in the budget.

Leading recommendations under Budgeting for Outcomes include:

- Adopting Budgeting for Outcomes in three phases:
 1. Office of Budget and Management (OBM) works with the Governor and agency leaders to designate leading agency outcome goals and rank major state programs, from most to least cost-effective, in the development of the FY 2012-2013 state operating budget.
 2. In FY 2012, OBM leads inclusive effort to develop program performance measures for each major state program.
 3. Fully implement Budgeting for Outcomes in FY 2014-2015, which will include broader stakeholder outreach efforts designed to inform the budget development and budget prioritization process.
 - Set aside \$20-40 million in existing resources for a new State Innovation Fund for investment in system reform, redesign and system capacity building.
-

More than 20 jurisdictions have used this budgeting process since the Public Strategies Group developed it with Washington State in 2002-03. Other public entities that have used it include Iowa, Michigan, Dallas, Baltimore, Los Angeles and half-dozen counties. The April 2010 edition of *Government Finance Review* highlighted the use of BFO by Savannah, Georgia.⁷

Ohio's primary approach to state budgeting can be described as a combination of program and modified zero-based budgeting, according to a 2008 report by the National Association of State Budget Officers (NASBO).⁸ Program budgets organize appropriations by program, rather than by more traditional line items, such as salaries, benefits, and other expenses.

Zero-based budgeting subjects all programs, activities and expenditures to justification. However, Ohio uses a modified version, which does not assume a zero starting point for programs. In fact, as has been the case for many Administrations, the FY 2012-2013 budget guidance specifies that agencies should

assume funding at 90 percent of FY 2011 in FY 2012 and FY 2013 for General Revenue Fund (GRF) budget requests; spending any more will require special justification. For non-GRF funds, there is a spending cap of 100 percent of adjusted FY 2011 appropriations. This practice has, in essence, become the status quo for budgeting.⁹

With the current approach, program managers have historically assumed that they will receive at least 90 percent of what they spent in the past biennium—regardless of the results their program delivers. (Ohio is one of only 10 states with no performance measures in its budget, according to NASBO.) As the budget office examines their requests, most of the focus will be on what to cut. And as the legislature debates the governor's resulting budget, the focus will again be on the cuts—plus any tax or fee increases proposed. Throughout the entire process, 90 percent of most programs will slide through largely unexamined. Changes will be incremental; no one will really be examining programs from “zero.”

RECOMMENDATIONS FOR PRODUCTIVITY IMPROVEMENT

In government, as in most realms of life, we find it safer and easier to do what we've always done, simply because we've always done it. Only on rare occasions—usually at times of crisis—do we step back to gain a broader perspective, erase all our preconceived ideas and routine behaviors, and take a fresh look at how to make the most of our limited time and resources.

Budgeting for Outcomes allows public leaders to do some of this big-picture, creative thinking each time they prepare a budget. In fact, the process demands it.

In traditional budgeting, leaders start with last year's costs, then add or subtract. In Budgeting for Outcomes, they start with the results citizens value. This approach clears away all the games departments play—padding costs and hiding excess—to protect themselves against the inevitable cuts. It focuses squarely on the real issue: producing results citizens value at a price they are willing to pay.

In a traditional budget process like Ohio's, the governor decides on a total budget number only after all departments have submitted their requests and the budget office has spent thousands of hours scrubbing them, searching for cuts.

Budgeting for Outcomes starts at the other end: the executive—or legislature, or both—decide how much they want to spend, as a first step. Policy makers take the latest revenue projections and decide whether to raise taxes or fees, cut them, or leave them where they are.

Policy makers then engage stakeholders, including citizens, to define the 5-10 results most important to them: a better economy, better schools, better health, better safety, better mobility, a cleaner environment, and so on. Most jurisdictions use surveys and focus groups to get an accurate reading of what results citizens want. Then—informed with data collected through community feedback—leaders make decisions about how much each of these outcomes is worth and divide total spending among them. (These allocations can—and often are—changed later in the process. Leaders are making value judgments, without accurate information about how much the state spent on each outcome in previous years. Sometimes, after the work of ranking programs has been done, more money may be needed in one policy arena and less in another.)

In addition, \$20 to \$40 million should be set aside biennially in a State Innovation Fund, for investment in reform, redesign, and system capacity (information technology, training, and the like).

For each finite pot of money, a team of strategic thinkers who understand the policy arena but don't have an axe to grind or a budget to protect, act as buyers for the citizens. Their task is to produce the outcome, not to fund programs. "Better mobility" as an outcome does not necessarily mean more money for the Highway Patrol or the Department of Transportation, for instance; it may mean congestion pricing on toll roads and more fiber optic cable.

These "results teams" should include strategic thinkers from the agencies, budget staffs, and the governor's policy staff—people who know the policy arena well but can wear citizens' hats rather than defend an agency's turf. It is also useful to include a few people from outside state government—experts from academia, think tanks, or the consulting world. These outsiders can help the insiders think outside the box of current state practices.

Results teams start by choosing three indicators used to measure progress toward desired outcomes. These give the state a report card: 15-30 indicators, measured every year, which spell the difference between success and failure, from a citizen's perspective.

Then the results teams ask the most important question: What factors most influence this outcome? What really makes a difference? They do research to answer this question, then portray the results in a "cause-and-effect map"—a diagram showing the factors that affect the desired outcome. This step forces them to articulate their "theory of what matters most"—how different activities contribute to produce the outcome.

Given that analysis, they propose what strategies the state should pursue. Next, they draft "requests for results" (RFRs), which take the place of the old budget instructions. These documents define the desired outcome, present indicators used to measure it, then define the strategies to be pursued and roughly how much money will be available to fund each one. In addition to these strategies, more generic criteria can be defined, such as: "We would like to see collaborative initiatives between different programs and offices." This encourages program managers to get out of their silos and look for partners who could help make their programs more effective. Some governments also encourage agencies to partner with nonprofit organizations and businesses that can help them deliver better results for less.

The requests for results go out to all managers in state government. (For even more powerful competition, Ohio could let local governments, unions, and nonprofits submit offers.) The RFRs ask each of these potential suppliers to identify how they would help deliver the expected results and at what price. Their "offers" must describe an existing or proposed program, its price, the results it would produce, and the performance data that supports this contention. All tax expenditures—i.e., tax breaks for particular groups or activities—should also be treated as offers, just like other spending programs.

A ranking of what is most important to fund

The results teams then rank these offers, from most cost-effective to least, and draw a line where the money runs out. Programs ranked below the line are not recommended for funding. Next, they send the rankings back out and ask for better offers. At this point, when managers see their programs ranked below the line, many wake up and start scouring the globe for new ways to produce better results for less money.

When the improved offers come in, the results teams again rank them, from most cost-effective to least, and draw a line where the money runs out. At this point, their chairs meet together to talk about what they need to purchase from one another. In Washington State, for instance, two teams decided to move some of their money into public safety, to reduce the number of prisoners who would have to be released early. The higher education team decided to use some of its funds to pay for better K-12 education, to better prepare its incoming students. And two teams jointly bought increased efforts to protect water quality, to improve both health and natural resources. This cross-team buying is often necessary for two reasons: first, the initial allocations are based on informed guesswork; and second, the work of state government is so interconnected that spending in one area contributes to outcomes in others.

Without the initial allocations of money, however, the process would not work nearly as well. The allocation provides finite pots of money for which agencies and programs have to compete. And it is that competition for scarce resources that drives creativity.

The results teams' final rankings are *recommendations*, not decisions: they send them to elected leaders, who use them to put together the budget. (In states, the executive normally does this and presents the budget to the legislature.) Adjustments to

Governor-elect Kasich has until March 15, 2011 to prepare his budget. Hence Ohio will need a phased transition to outcome budgeting. In the first phase, the next governor could designate outcome goals and use results teams to rank programs, from most cost-effective to least. But there will not be time to develop RFRs and solicit offers. Over the following year the administration should concentrate on developing good performance measures for each program, to prepare for the next round of budget development. Then a full-blown version of budgeting for outcomes can be used to create the next biennial budget.

THE BENEFITS OF BUDGETING FOR OUTCOMES

At the core of budgeting for outcomes are seven fundamental steps:

- 1) Set the price of government;
- 2) Set the priorities (outcome goals) of government;
- 3) Set the price (budget allocation) for each priority;
- 4) Develop a set of purchasing strategies for each priority outcome goal;
- 5) Solicit offers from providers to deliver the desired results;
- 6) Buy the best and leave the rest; and
- 7) Negotiate performance agreements with the chosen providers.

Because of its successful track record, the Government Finance Officers Association (GFOA) recommends that governments consider Budgeting for Outcomes as a practical way to integrate

“ More than 20 jurisdictions have used this budgeting process since the Public Strategies Group developed it with Washington State in 2002-03. ”

reality are always necessary: Some low-ranked programs are mandated by the courts, for instance, or by the federal government. But most of the rankings hold, and the budget thus proposes to fund what produces real value and eliminate what doesn't.

Every citizen can understand the resulting budget, because it reflects common sense and taxpayers' priorities. It can be summarized in one or two pages per outcome: a list of programs to be funded, a line, and below that, a list of programs the state can no longer afford, because they don't produce enough value.

Most leaders have found political benefits in using Budgeting for Outcomes, particularly when they publicize the process. It helps them do exactly what citizens think they should be doing in tough times: make the difficult choices between those things it would be nice to have and those that are absolutely necessary.

After the budget passes, the executive branch can use offers to negotiate performance agreements with the sellers. Since offers spell out promised results, department heads can use them to negotiate performance agreements with program managers.

performance into the budget process. In 2007, GFOA adopted a National Advisory Council on State and Local Budgeting (NAC-SLB) recommendation of four specific principles of effective budgeting, which are closely aligned with outcome budgeting:

- 1) Set broad goals to guide decisions,
- 2) Develop strategies and financial policies,
- 3) Design a budget supportive of strategies and goals, and
- 4) Focus on the necessity of continually evaluating a government's success at achieving the goals that it has set for itself.¹⁰

The most obvious benefit of Budgeting for Outcomes is a balanced budget, without gimmicks. When Washington State pioneered budgeting for outcomes in 2002-03, for instance, it closed a 14 percent shortfall by cutting roughly \$2.7 billion in state spending. (Washington continues to use—and refine—BFO today.) But the process has numerous other advantages:

- It pushes leaders to rethink—and be explicit about—their priorities.
- It focuses energy on what to keep, not what to cut. The cuts are simply those programs that fall below the line.

- It purchases results. Last year's costs are no longer the starting point, and every manager now has a powerful incentive to drive his or her costs down, not to pad them. During the second round of Budgeting for Outcomes in Washington, for example, managers at the Health Department looked at research that said alcohol and drug addiction treatment programs lowered emergency room costs, because they reduced ER visits due to overdoses, drunken driving accidents, and the like. They proposed to shift \$85 million in Medicaid money from emergency room spending to drug and alcohol treatment, and the legislature agreed to \$45 million.
- It forces low-value spending out of the budget, every year. In preparing its FY 2006-07 budget, for instance, Fort Collins, Colorado, faced a \$5-6 million structural deficit. During its first BFO process, the city manager asked staff to identify activities they considered obsolete, because they didn't directly address the city's chosen outcome goals. These were put on a "Stop Doing" list, which precipitated 42 layoffs and the elimination of another 60-odd jobs that were vacant.
- It helps leaders fund new investments that promise important results, rather than forcing them to compete for the scraps after existing programs are funded. In Ft. Collins, for example, the city manager convinced the city council to increase pay for staff by about \$4 million, even while closing a \$5-6 million budget gap, because a three-year pay freeze had threatened his ability to attract and retain high performing employees.
- It creates accountability for performance. If program managers cannot use data to demonstrate that their programs deliver significant bang for the buck, they risk going out of business.
- It stimulates continuous improvement, because managers have such powerful incentives to look for promising innovations and best practices. In Iowa, for example, the Corrections Department brought in a set of offers that reflected exactly what they had done the year before. The results team chairperson met with the director and asked, "If you were creating a correctional system for Iowa from scratch, is this what you'd propose?" Surprised, he said no. After the two had an animated discussion of what an ideal system for Iowa might look like, they decided to scrap the offers and start with a clean sheet. The director and his staff chose to make lowering recidivism rates—the numbers of inmates who commit new crimes after leaving prison—their most important goal. To do so, they proposed an individualized development plan for each inmate, a dramatic boost in the percentage of inmates placed in private sector jobs or community service, moving more inmates to lower-cost community corrections and supervised parole, boosting substance abuse treatment, and saving money in behind-the-scenes business functions. Their offers promised to deliver a four percent reduction in recidivism and a 10 percent increase in the use of inmate labor on community service projects. Within two years, the percentage of inmates failing their probation periods fell by 17 percent.

It strengthens the general interest at the expense of special interests, by making the trade-offs involved in any budget transparent. BFO does not eliminate pressure to spend more or cut taxes from interest groups, but it does force them to justify their proposals in terms of the results they will produce. When legislators hold budget hearings, they ask interest groups that lobby for their favorite spending programs questions such as: "What program should we move below the line to accommodate your program, and why would your program produce better results?" That is exactly the debate we want at budget time. Legislators can still change the rankings, but when they do so in a BFO budget their actions are far more transparent.

- Finally, BFO helps leaders talk with the public about the budget in common sense terms. Traditional budgets are impenetrable for most readers, but the average citizen can understand a BFO budget. In 10-20 pages, they can see the fundamental decisions their leaders are making with their tax dollars. This has enormous benefits. As former chief of staff to Washington Governor Gary Locke said about the first BFO budget, "Never has such bad news been received so well."¹¹ The Tacoma News Tribune offered a typical comment: "Few Washingtonians will find much to like about the brutal state spending plan Gov. Gary Locke recommended Tuesday. But as ugly as the result was, there's a lot to like about the way Locke and his staff arrived at it, using a new process that forced hard choices about the core priorities of state government."¹²

POTENTIAL FISCAL IMPACT

Budgeting for Outcomes is designed to set a spending target and budget accordingly. It is not focused on protecting or extending the status quo simply because it exists. As such, a BFO budget will appropriate what is available and no more. If the gap between the spending target and the status quo is \$6 billion in Ohio, BFO—if used properly—will deliver \$6 billion in savings. These savings will not come without pain, but as experience in other jurisdictions has proven, they will come.

By identifying essential results desired by the public and aligning available resources to deliver them in the most cost-effective fashion possible, BFO replaces a process in which all the energy is focused on "making cuts" with one focused on "spending well" Ohio's limited resources.

Charter Agencies

Offering the potential for more accountability and lower costs



Charter Agencies pioneer a new, bureaucracy-busting “deal.” They volunteer to deliver measurable improvements in results and to contribute savings and/or new revenues to the state. In exchange, the state exempts them from many bureaucratic rules and requirements. Value for Ohioans becomes more important than rules.

Specific recommendations include:

- Enact legislation or issue an executive order to allow the governor and his cabinet members to negotiate charter agency agreements.
 - Negotiate biennial agreements specifying needed management flexibilities, expected reforms and performance targets that will lower costs and improve outcomes.
-

Concisely defined, a charter agency is a state government agency or department that agrees to accept less funding for its operation in exchange for more flexibility and freedom to manage.

When agencies truly focus on results, they often run up against rigid rules that focus more on **how** government does things than on the **results** government produces.

Margaret Thatcher and Bill Clinton used forms of charter agencies.

Margaret Thatcher, then prime minister of the United Kingdom, had spent her first eight years in office privatizing and downsizing. But after eight years, she still hadn't figured out how to make her remaining bureaucracies more efficient or effective. Frustrated, she asked her “Efficiency Unit” to study the problem and recommend the next steps.

Over the preceding 150 years, British leaders had commissioned many studies to recommend ways to shape up the civil service. But this study team did something none of the others had ever done: it asked the civil servants themselves. The answer came back loud and clear: If you want better management, untie the managers' hands and let them manage. Hold them accountable for results—not for following silly rules and spending every penny of every budgeted line item.

The reform they proposed—which Thatcher embraced—became known as the “Next Steps” initiative. It:

- Separated departments' service delivery and regulatory/compliance functions into discreet chunks, each one called an “executive agency.”
- Gave those agencies much more control over their budgets, personnel systems, and other management practices.
- Paid agency chief executives whatever it took to get the talent needed, including performance bonuses of up to 20 percent of their salaries—but denied them the normal lifetime tenure of a British civil servant.
- Required agency CEOs to negotiate a three-year “framework document” with their department, specifying the results they would achieve and the flexibilities they would be granted.
- Set annual performance targets for each agency.
- Put agencies on trial for their lives every three years.
- Required CEOs to reapply for their jobs every three years.

The British went on to create some 130 executive agencies, which by 1997 employed 76 percent of their civil service. They also extended the basic time frame for performance contracts from three to five years. Every five years, each agency is reexamined, to see if it should be abolished, privatized, or restructured. Over the first 10 years, at least a dozen agencies were privatized.

Over that same decade, the executive agencies steadily improved their performance, while saving considerable money and shrinking their workforces by 15 percent. By 1995, agencies were hitting an average of 83 percent of their performance targets—many of which had been raised over time. A series of studies, by both Labor and Conservative governments, concluded that the initiative was a resounding success, and executive agencies have simply become the normal way of doing business in the British government.

In the U.S., the Clinton Administration borrowed the British model to create three “performance-based organizations” (PBOs): Patent and Trademark, Air Traffic Control, and Federal Student Aid (FSA). While a PBO, FSA turned into a more efficient electronic service, reduced turn-around times on student aid applications by 50 percent, improved customer satisfaction dramatically and registered the largest one-year gain in employee satisfaction ever measured by the Gallup Organization in a federal agency.

The state of Iowa did an even better job with the idea. Governor Tom Vilsack and the legislature chose six agencies, gave them greater operating flexibility, and asked them to produce better outcomes at less cost than under the standard bureaucratic

- Freedom from FTE ceilings or other employment controls.
- Authority to purchase travel tickets directly instead of using the state’s travel contractor.
- A special process for waiving other administrative rules.
- Access to a \$3 million Transformation Grant Fund to foster innovation.
- And more . . .

Over their first three years, Iowa’s charter agencies saved the taxpayers more than \$90 million. Meanwhile, they produced significantly better results. The Revenue Department boosted its rate of return on audit staff from \$8.53 for every dollar invested in auditing to \$9.28, while improving the percentage of individual income tax refunds issued within 45 days from 75 to 94. The Iowa Veterans Home increased the percentage of admissions completed within 30 days from 69 to 90. The Human Services Department increased the percentage of children with health insurance by a third. And the Corrections Department drove the three-year recidivism rate from 46.7 to 35.4 percent.

These results were impressive enough to win Iowa the prestigious Innovations in American Government Award.

“Over their first three years, Iowa’s charter agencies saved taxpayers more than \$90 million.”

system. Vilsack also coined the term “charter agencies”—since the deal he offered them was not unlike that offered to charter schools.

Agency directors were given a long list of management flexibilities, and they had an opportunity to negotiate for others. The list included:

- Authority to “stand in the shoes” of the directors of personnel, general services, and IT. Whatever those directors could do, a Charter Agency director could do – without going through personnel, general services, or IT (Information Technology or computer services.). Rather than having to relinquish this management function to a centralized office, charter agency managers had authority to make decisions – for which they were held accountable.
- Authority to waive administrative rules in personnel, general services, and IT matters.
- Savings earned by the agency remained within their agency as opposed to going to the general fund.

RECOMMENDATIONS FOR PRODUCTIVITY IMPROVEMENT

Ohio should follow in Iowa’s footsteps by passing a law or creating an executive order that would allow the next governor and his cabinet members to negotiate charter agency agreements with their agencies. Ohio has 24 cabinet departments and more than 150 agencies and boards. Given this sprawling landscape, the most effective model in Ohio might well be the British model, in which departments negotiate charter agency agreements with their own agencies. However, the Governor’s Office and/or Office of Budget and Management should be involved in these negotiations, to ensure that they are taken seriously and focus on important results, significant savings, and meaningful flexibility.

As the U.K. and Iowa did, Ohio would be wise to begin with the agencies it trusts are ready to handle more operational freedom. As charter agencies are created, biennial written agreements should specify the results expected, the flexibilities granted, how performance is to be measured and reported, and the consequences of good and bad performance—including bonuses for effective managers and employees.

At various times in the past, elected officials and interested parties have discussed merging state agencies as a way to improve productivity. On the surface, this would seem to offer savings. But without changing the way in which agencies operate, little can be gained in terms of efficiency. Creative and flexible management is the key; merely changing the size of an agency does not address the problem.

POTENTIAL FISCAL IMPACT

Iowa's six Charter Agencies were collectively required to achieve \$15 million per year in savings and/or increased revenue. The first year they achieved \$22 million; the second year \$20 million; the third year \$52 million. Ohio is much larger than Iowa, with a current General Revenue Fund more than five times what Iowa's was when it began this effort. Ohio also has more agencies than Iowa. We suggest that more than six agencies be chosen to start with, in the first biennium, and more in each successive biennium. The eventual target should be at least 75 percent of all agencies.

Given this scope—and based on Iowa's performance—with a staged implementation, Ohio should be able to produce at least two and a half times Iowa's savings and increased revenue, or \$100 million in the first biennium.

If Iowa is a good example, savings and new revenue in these agencies would expand in the second biennium, perhaps doubling to \$200 million. If Ohio could double its number of charter agencies in the second biennium, it could save the taxpayers \$400 million (\$200 million from pre-existing charter agencies; \$200 million from new charter agencies). Savings would continue to mount in future biennia.

5

Entrepreneurial Management

Ohio should expose its internal support services to external competition

Entrepreneurial Management is a strategy for getting more bang for your buck from internal support services. It withdraws appropriations from some internal service organizations, forcing them to earn their revenue by selling their services to other agencies, often in competition with private providers. Suddenly, survival depends on how well they please their customers and at what price. Significant savings result.

Specific recommendations include:

- Reorganize internal support services such as information technology, vehicle fleet/maintenance, and facility management, as competitive enterprises that have the need and flexibility to operate like businesses competing for work with both public and private providers.
- With “utility” services (internal services that should remain monopolies, such as telecommunications), place money in the hands of the customer agencies and give them seats on a customer council that has the power to set rates and approve investment plans, to improve the value equation.
- Create a public agency customer council to improve the price/value ratio primarily through collaborative efforts to improve purchasing outcomes.

Governments spend a considerable amount on support services, such as recruiting, hiring, training, information technology, data entry and processing, vehicle maintenance, facility management and maintenance, custodial services, travel services, security, accounting, and telecommunications.

Many governments have turned some of their internal service operations into competitive enterprises, which must sell services to their customers to get revenue. Iowa, Minnesota, Milwaukee, Phoenix, the Edmonton school district in Canada, the U.S. federal government, Australia and the United Kingdom have all used this approach in significant ways.

In Iowa, for example, the legislature created a new Department of Administrative Services (DAS) in 2003. That department established marketplace enterprises to handle training, conference planning, motor pool vehicles, repairs, printing, graphic design, and a variety of IT services, including mainframe, networking, and e-government solutions. Those enterprises are now utilizing accrual accounting, business plans, competitive pricing, and customer satisfaction measures to run their businesses. The Department of Administrative Services budget was cut by

\$35 million at the beginning of this process; the reforms allowed it to work effectively despite the deep cuts. In addition, other departments saved more than \$1 million a year because of lower rates from the new enterprises.

Entrepreneurial management is different from charge-back schemes that just send agencies a bill.

The reform process begins with a careful inventory of all internal support services. They are classified into three categories:

- “Marketplace” services, where there is no need to maintain a public monopoly.
- “Utility” services, which can be charged to customers but which should remain monopolies.
- “Leadership” or “steering” functions, which serve collective interests rather than specific customers and therefore should continue to be funded from the General Revenue Fund, as in the past.

The “Yellow Pages” test is a good one for determining if a service or function lends itself to entrepreneurial management. It can answer the question: does a marketplace exist? If there are three or more providers listed in the Yellow Pages, the answer is probably “yes”. These marketplace services are reorganized as public enterprises and given as much flexibility to operate like businesses as possible. Their appropriations are spread among their customer agencies (minus a 10 percent annual efficiency savings for each of the first three years), and those customers are allowed to purchase the service anywhere. Hence these new marketplace enterprises must compete to earn their keep, based on their quality and cost. It’s sink or swim; hence these enterprises work very hard to get their costs down and their quality up. Very few sink, because they have the advantage of knowing their customers so well. But for this approach to work, those that do sink must be allowed to go out of business, rather than being subsidized by the General Revenue Fund.

Some internal services need to remain monopolies, for consistency, efficiency, or privacy reasons. For example, if every agency uses the same telephone provider, the state will be able to negotiate a better volume discount. And if everyone uses the same e-mail provider, communications will be facilitated.

These services are called “utilities” and treated much as we treat private utilities. They are restructured as public enterprises and given the flexibility to operate like businesses. Their appropriations (minus the dividend) are spread among their customers, but those customers cannot purchase from anyone else. Still, they can choose how much they want to purchase—and when they have to pay for the service, rather than receiving it for free, their consumption tends to drop.

Utilities’ customer agencies also get seats on a customer council, which sets policy, decides what kind of services are provided, and sets rates/prices. Utility services and costs tend to improve if their customer council sets clear expectations of a price/value ratio and holds the utility accountable. But utilities generally produce smaller efficiency dividends than marketplace enterprises, because they don’t face competition.

With Marketplace Services...

- The new public enterprise gets to set the price for its services.
- Customers (state agencies) can purchase as much or as little as they want.
- Customers can go anywhere to purchase the services. They don’t have to purchase from the public enterprise.
- No budget is allocated (e.g., from the General Revenue Fund) to the enterprise for the services. The enterprise is dependent on sales for its budget. The enterprise operates like a business, living on its income.

- The enterprise needs seed capital as it goes through the transition, to cover expenses while its revenues are coming in. It gets that seed capital from its legislative authorizing body. This is one-time money that comes from a separate fund (e.g., reserves and/or the proposed Innovation Fund), NOT a budget. The amount depends on how frequently the transactions generating income are repeated (e.g. printing is more frequent than training). A general rule is a minimum of two months worth of operating capital.
- Legislatures typically call marketplace services “enterprise funds” and utilities “internal service funds.”
- Where does the enterprise go for ongoing capital? It should be able to borrow money from a Finance/Budget office—say, from a reserve or revolving fund. Such loans should be repaid over time. Budgeting for ongoing capital is antithetical to Entrepreneurial Management.

With Utility Services...

- Money is placed in the hands of the customers, so they pay for the services, but they are forced to buy from the single source. The public enterprise keeps its monopoly.
- In the budget process, money is taken away from the utility and is, instead, distributed on some basis (e.g., per capita) to the customers (with a percentage kept back as an efficiency dividend—i.e., as savings for the General Revenue Fund).
- Seed capital (15-20 percent of expected revenues) is provided to the utility for transition purposes.
- To set rates, the customer council negotiates with the utility. It might start the conversation by saying: “Last year, we spent \$X to get this utility service. The rate/price and service were \$XX..” The utility might say to the council, “If you were satisfied with what you got, then let’s charge the same. If you weren’t satisfied, let’s set a new target – either a higher or lower rate—and define the standard of service expected.”
- Customer councils should not be collections of technical people. The nature of the work is not technical. Rather, they should be high-level general managers interested in improving the price/value ratio, who will ask questions such as, “We want this service level. How much will it cost?” Or: “We want to pay this price. What service level will it buy?” Chief operating officers of customer organizations make the best council members.

It is important for all enterprises to report to their governing bodies, to keep them informed about how they are doing financially. They use financial statements to report on cash flow, profit-and-loss statements to report on net revenue and return on investment, and balance sheets to report on the status of their capital and retained earnings. To produce accurate and meaningful balance sheets, they must use accrual accounting—as a business would—counting income when the invoice goes out and counting liabilities, such as loans, when they are incurred.

Those who run these enterprises need new management, financial, and marketing skills, and it is in their interests to invest in training their employees. To the extent that current managers can benefit from additional training and skills development, such an investment should be made. However, for managers who do not demonstrate the desire or aptitude to perform in this new environment, their positions should be carefully reviewed.

Most enterprises flourish in this environment. They use their management flexibilities to slim down, change their business processes, purchase technology, and take other steps to improve

POTENTIAL FISCAL IMPACT

When it creates an enterprise, the state takes an efficiency dividend off the top, on the assumption that the enterprise will find ways to become more efficient. Here is an example: experience suggests that a state spends \$25 million for vehicle maintenance. It turns its maintenance shop into a marketplace enterprise and capitalizes it with \$4 million in seed money, to be repaid over time. The General Fund then distributes \$22.5 million, or 90 percent of past appropriations, to the enterprise's customers, using a formula based on their past consumption of these services. The state would take an efficiency dividend of 10 percent (\$2.5 million) per year for each of the first three years.

“These new marketplace enterprises must compete to earn their keep, based on their quality and cost.”

their productivity. Because their customers know them far better than they know their private sector competitors, most enterprises don't find it hard to compete. But because unhappy customers can now go elsewhere, the enterprises strive mightily to lower their prices and satisfy their customers. Most managers and employees thrive in their new situation, and some enterprises begin to seek other customers, outside state government. After a few years, some even ask to be privatized, so they can compete for private business and make more money.

The customer agencies are asked to give up some money, but in return they have a choice about where they can go for services. If Jiffy Lube offers better service at a lower price, they can take their vehicles there. Hence customer agencies generally love this deal.

Entrepreneurial management has numerous advantages over simply contracting out internal support services:

- It is more competitive: the competition doesn't just happen every three or four years when contracts are bid out; it is constant.
- It is more customer-oriented: marketplace enterprises must respond to their customers' needs or they lose money.
- It makes buyers (other agencies) sensitive to costs and drives both consumption levels and prices down; hence it saves more money.
- It makes enterprises truly accountable for performance, which forces continuous improvement.
- It is administratively simpler than contracting out, because there is no bidding process.
- It is politically simpler than contracting out, because there is no vote to eliminate or downsize organizations. Any downsizing tends to happen gradually, not all at once.

Ohio's Department of Administrative Services spends roughly \$180 million per year on its internal support services. Let us assume that half of this amount can be converted to marketplace enterprises and 25 percent to utilities. It would take about a year to make the conversion, so savings would only begin to accrue in the second year. If marketplace enterprises generate a 10 percent efficiency dividend in each of their first three years and utilities generate five percent, savings would total \$11 million in the first biennium (only one year's savings) and another \$22 in the second biennium. These savings are in addition to the estimated personnel savings that would be realized across state government. Full phase-in of Entrepreneurial Management by FY 2013 results in savings targets of \$20 million in FY 2012 and \$55 million in FY 2013 for a total biennial impact of \$75 million.

Government Regulations



Improved business regulation will streamline government and save money

Command-and-control regulation is a well-established tradition, but it is extremely expensive—both in dollars the state spends and in good will the state squanders among those regulated. To its credit, the Strickland administration worked to make state regulations less burdensome through its executive order on “Common Sense Business Regulation.” The Ohio General Assembly has also considered legislation that would help make the regulatory process more user-friendly. By adopting several other strategies to boost voluntary compliance, the state could maximize regulatory benefits and tax revenues, while reducing the compliance burdens even further.

Specific recommendations include:

- Build support for rules and standards by involving compliers in their creation.
 - Make regulations performance-based.
 - Educate compliers about what is expected of them.
 - Make compliance easy.
 - Make the quality of agency service to compliers consequential.
 - Report compliance information.
 - Treat different compliers differently.
 - Create a continuum of public consequences and rewards.
 - Create market incentives to encourage compliance.
-

Much of what government does involves trying to get citizens and organizations to pay their taxes, obey the speed limit, protect the environment, or maintain safe workplaces. To achieve compliance, most public organizations rely on enforcement—that is, detecting and punishing violations. Enforcement has a long history, and it is often effective. But it is very expensive.

Bureaucratic public compliance organizations often assume the worst—and produce the worst—from those they are trying to regulate. Consider special education, where teachers often spend up to 50 percent of their time filling out forms to demonstrate compliance with federal and state regulations. Or child welfare, where caseworkers sometimes spend three quarters of their time on paperwork. Or the seemingly endless and duplicative local and state permitting processes that waste both time and money.

All these processes and rules were inspired by specific problems and instituted to keep them from reoccurring. But enormous amounts of money are wasted on this kind of mistrust.

By adopting performance or competitive contracting, governments have brought market forces to bear on activities formerly carried out by the public sector as monopolies. This increased market pressure has often produced better results for customers and taxpayers. But governments are frequently less willing to open regulatory and compliance activities to competition. The public is seldom comfortable with the idea of private companies collecting taxes, operating environmental protection agencies, or running police departments. But this lack of competition needn't lead to indifferent performance. Public-sector compliance organizations have ample opportunity to increase their value by utilizing proven approaches that “win” voluntary compliance.

Post-bureaucratic compliance agencies keep enforcement as a last resort, but they turn first to other approaches. By building support for the rules, working in partnership with compliers, making the process of compliance easier, and creating incentives to reward compliance, leaders can often win voluntary compliance at a fraction of what they now spend, while achieving equal or higher compliance rates. This can boost employee

morale as well as performance, while giving schools, child welfare workers and environmental agencies an infusion of what they need most: time.

RECOMMENDATIONS FOR IMPROVING PRODUCTIVITY

There are nine potential strategies Ohio's regulatory agencies can use to boost voluntary compliance. The current administration has begun using several of these approaches and others will add power to a comprehensive regulatory reform agenda.

1. Build support for rules and standards by involving compliers in their creation.

To convince people and businesses to comply, allow them to participate in setting the rules and designing the compliance process. When Madison, Wisconsin reformed its purchasing system, for example, it asked its purchasing agents to involve police officers, firefighters, and other city employees in the process of drawing up product specifications and testing equipment the city might buy.¹³

Fifteen years ago, Occupational Safety and Health Administration (OSHA) officials in Maine were fed up with the failure of their traditional inspect-and-fine approach. They kept winning awards for issuing the most citations and fines, but Maine's safety and health records were at the bottom. So they invited the 200 employers with the highest volume of injury claims to create employee teams focused on improving safety. The teams would draw up plans, survey hazards in their own plants, and correct most of them within 12 months. As long as the company was making a good faith effort, OSHA would forego its traditional inspections and fines. Each quarter the employers had to file a report outlining their progress, and OSHA would occasionally visit to verify those reports. Employers who were not carrying out their plans would be subject to comprehensive inspections.

Maine gave the 200 employers a choice: they could adopt this self-inspection model, or OSHA would step up its inspections. All but a handful chose the first alternative. And in their first two years, they identified and fixed 14 times more hazards than OSHA had on its own.¹⁴ Their payable worker's compensation claims dropped by 47 percent—far outpacing declines in other companies. The businesses saved money, and the taxpayers got exponentially greater value for their dollars.

2. Make regulations performance-based.

Many regulations prescribe exactly how compliers have to comply with the law, particularly in the environmental arena. They tell business what technology they must use, how it must be installed, and how often it must be inspected. Often compliers know there is a better way, but the law won't let them use it. Reformers have begun to substitute regulations that define the outcome required, but leave it up to compliers to figure out how to produce it. If a new technology will meet the goal at a lower price, they are free to use it. This not only makes it easier for them to comply, it stimulates innovation to find better and cheaper methods.

In Massachusetts, few small businesses were captured by the state's permitting system in the mid-1990s, and it would have been very expensive to force them all to apply for permits. Instead, the state adopted a new "Environmental Results Program." It mandated that a senior company official in all dry cleaners, photo processors, and printing shops annually certify that the facility was and would continue to be in compliance with all state air, water, and hazardous waste performance standards. The Massachusetts Department of Environmental Protection (DEP) helped with this self-certification by providing assistance, including sector-specific workbooks and workshops that were developed with the help of business people. DEP evaluated compliance with random sampling and statistical analysis. Staff could then concentrate on sector-wide problems and target inspections and assistance to facilities that fell short.¹⁵

Already in Ohio, the governor's executive order on Common Sense Business Regulation requires 13 agencies (Administrative Services, Agriculture, Commerce, Development, Environmental Protection, Health, Industrial Commission, Insurance, Job and Family Services, Natural Resources, Taxation, Transportation, and Workers' Compensation) to review their existing regulations and amend or rescind those that are unnecessary or have unintended negative consequences. In amending rules or drafting new ones, the order asks them to "focus on achieving outcomes rather than the process used to achieve compliance." As of August 2010, the agencies had reviewed 4,650 rules, rescinding 307 and amending 2,270.

This is a good start, but more can be done to simplify regulations and make them performance-based.

3. Educate compliers about what is expected of them.

Many people and businesses fail to comply with rules because they simply don't understand them. Anyone who has filed the IRS's long form without the help of a tax accountant knows this problem firsthand. In Minnesota, the Revenue Department did a study during the 1990s which showed that half of noncompliance was the result of taxpayer errors, not willful evasion.¹⁶ Department leaders decided to invest in more taxpayer assistance rather than in auditing, and they reengineered operation of the sales tax to make it easier for businesses. The results included higher compliance rates and a \$20 million increase in revenues. As Greg Tschida, the department's CIO for Strategic Services, explained, "We're looking for future compliance. I can audit you and get \$10,000 this year. But if I teach you to comply the right way, for the next 40 years I get the money up front without any effort on my part."

Ohio EPA's Office of Compliance Assistance and Pollution Prevention provides valuable assistance to small businesses struggling to comply with the agency's regulations. There is currently legislation pending that would expand the number of small businesses this program can help. This and other new initiatives that focus on compliance assistance should be a priority for regulators.

4. Make compliance easy.

Many compliance processes are so complex that the best way to boost voluntary compliance is to streamline them. If Ohio can make it easier to pay taxes, ensure a safe workplace, and get a permit to construct a building, more of us will comply with the law. Many local governments around the nation have created one-stop permitting processes, consolidated related processes into single applications, and waived rules for businesses that have good compliance records.

Another method is to offer services that facilitate compliance. For example, OSHA developed a series of Web-based “expert systems” – computer programs that answer questions and guide people through compliance processes. Each is focused on a separate problem or substance, such as asbestos, lead, or cadmium.

A recent Ohio initiative designates Regulatory Ombudsmen to act as problem-solving liaisons between compliers and the agencies. Other positive approaches for providing compliance

While Ohio regulatory agency personnel are urged to speed up their permitting processes and achieve specific time limits, redress policies would produce far more impact, as Massachusetts’ experience demonstrates. They would also discourage “gaming” of the system, where bureaucratic actions can stop compliance clocks from ticking; thereby, lengthening and complicating the compliance process.

6. Report compliance information.

People respond to feedback. If taxpayers are told that they have filed incorrectly, or businesses discover that they have violated environmental rules, most (but not all) will correct their errors. Think of how you respond when you drive by one of those flashing signs the police set up to clock your speed. According to a U.S. Department of Justice report, these “speed display boards have been shown to reduce speed and crashes.”¹⁸

Compliance reports can be helpful to those who are regulated as well as to citizens who organize to ensure specific policy results.

“There is no sense in treating people who have made an honest mistake the same as habitual scofflaws. The police don’t do it, the courts don’t do it, but many compliance agencies do.”

assistance include Ohio EPA’s “permitting assistance web site,” to help businesses with the environmental permitting process, and the Ohio Business Gateway, a one-stop portal for filing taxes and other information required by state government. All of these initiatives are a good start, but much more can be done to streamline compliance processes and advertise positive steps already underway.

5. Make the quality of agency service to compliers consequential.

If compliance agencies face consequences when they provide lousy service to compliers—and rewards when they provide excellent service—they will improve. In the 1990s, for example, the Massachusetts Department of Environmental Protection set time limits for processing each permit and issued a money-back guarantee: If the department missed the deadline, it had to return the permit fee. “It was the single best thing we did,” remembers former Commissioner Dan Greenbaum. “It created a dynamic like a business trying to collect a fee for a service. It provided impetus for management reforms, like a real tracking system so you would know what was happening with each permit. ... Staff told us they’d need lots more people to meet the time lines. But we met the deadlines the first year; it turned out there was a lot of slack in the system.”¹⁷

7. Treat different compliers differently.

There is no sense in treating people who have made an honest mistake the same as habitual scofflaws. The police don’t do it, the courts don’t do it, but many compliance agencies do.

The Kansas Department of Revenue instituted a database that stores each taxpayer’s payment history. If a business misses a due date, the agency can tailor its automated schedule of responses accordingly. Those with a good record of payment receive a notice. If they fail to respond, the options escalate to more notices, telephone calls, and ultimately collection efforts. For those with a more questionable payment history, the schedule is greatly accelerated.¹⁹

Many school districts demand accreditation visits on a rigid, five-year cycle. Iowa changed the rules so that, if a district has had a sterling record and no issues arise suggesting the need for on-site inspection, accreditation visits can be on an as-needed basis.²⁰

In Ohio, the current administration’s executive order takes small steps in this direction when it instructs, “Furthermore, where authorized and appropriate, agencies should make exceptions to rules and provide exemptions for small businesses.” It also says, “Agencies should, when appropriate, waive penalties for first-time or isolated paperwork or procedural regulatory noncompliance.” This approach received an important boost from the Ohio General Assembly, when it enacted a bill in May

2008 that prevents businesses from being fined for first time paperwork violations. But Ohio regulators should quickly transition from a “one-size fits all” approach to one that recognizes unique situations and works with compliers to creatively address their specific needs.

8. Create a continuum of public consequences and rewards.

States normally use sticks to ensure compliance: they create stiff penalties for failure, including fines and jail time. The winning compliance approach doesn’t abandon the sticks, but it adds carrots. A number of states have performance-based environmental permitting programs, for instance, that treat companies differently if they demonstrate a real commitment to environmental protection.

North Carolina’s Environmental Stewardship Initiative (ESI) provides a good example. It creates incentives for companies that use innovative approaches to exceed normal state requirements. The first tier, “environmental partners,” must set environmental performance goals and commit to implementing at least one measurable green project per year that is appropriate to the scale and environmental impact of their company. In return they get coaches who provide technical assistance and serve as a single point of contact with the state, plus specialized training and networking opportunities.

The second tier, “rising environmental stewards,” must go beyond minimum compliance standards, set measurable environmental performance goals, and adopt an ISO-certified environmental management system or ESI stewardship plan. They get all the help environmental partners get, plus the right to use a program logo demonstrating that they have qualified for the designation.

The third tier, “environmental stewards,” must meet the criteria for the first two tiers, plus set aggressive environmental performance goals, mentor companies in the first two levels, communicate with their local community about their program activities and performance goals, and demonstrate how environmental issues are integrated into their core business functions. In addition to what the first two tiers receive, they also get formal public recognition from the governor and environmental secretary, shorter time frames to have their permits processed, and help pursuing U.S. EPA approval for specific regulatory innovations.

In its first five years, 107 companies joined the ESI program. In 2005 and 2006, ESI facilities reported \$ 23.1 million in cost savings from lower water and energy usage, reduced chemical and material consumption, fewer landfill fees, and increased recycling revenue.²¹

9. Create market incentives to encourage compliance.

The most powerful way to win voluntary compliance is to reward it financially. Taxes or fees can also be used as market incentives to discourage certain forms of behavior. Consider emissions trading, in which companies that reduce pollution below the amount required by law receive credits they can sell to other firms. This is designed to reward companies for reducing pollution, but to let them figure out the most cost-effective way to do it. If they can cut one source of pollution economically, they can use the credits they generate to offset areas where reduction is more expensive. The federal government has used this mechanism for 25 years, to clean up the air, get lead out of gasoline, and reduce acid rain. It has saved businesses tens of billions of dollars, while delivering on environmental goals.

These nine strategies can work in virtually any compliance activity, whether it deals with the public (policing, tax collection), businesses (OSHA, environmental protection, food and drug enforcement), or internal government operations (procurement, personnel rules). Used as a checklist, they can help leaders come up with alternatives to enforcement strategies they can no longer afford. While Ohio has begun to use some of these strategies, there is room for improvement—particularly in taking greater advantage of strategies 1 and 5 through 9.

POTENTIAL FISCAL IMPACT

The winning compliance toolkit can cut costs—for government, business, and citizens—at the same time that it improves outcomes. It is difficult to quantify the potential savings and/or revenue increases for state government. But consider the experience of Minnesota’s Revenue Department with winning compliance strategies in the 1990s, which boosted revenue from the sales tax alone by \$20 million. Ohio has more than twice the population of Minnesota, and \$20 million in 1994 dollars would be almost \$29 million today. Hence a thorough winning compliance approach at the Department of Taxation might yield well over \$100 million a year in new revenues. In addition, savings are possible in other departments and agencies. Including a start-up period, we estimate a 2012-2013 biennial impact statewide of \$107 million (\$20 million in 2012 and \$87 million in 2013).

Tax Expenditures



Ohio Needs To Review the Effectiveness of State Tax Credits, Exemptions, and Deductions

Ohio has 122 distinct state tax expenditures – tax credits, exemptions and deductions – that amount to \$7.7 billion (FY 2008) in foregone state revenue annually, with no formal review process to ensure that they are meeting their intended policy outcomes and worth their price. This must change. Ohio should implement a comprehensive Tax Expenditure Review to regularly examine tax expenditures. The information from this review should be shared with the public and policymakers in the form of a detailed report analyzing all tax expenditures. The report should be comprehensive enough to be a valuable tool in the development of the state’s biennial operating budget and for making future tax expenditure policy decisions, including the enactment of any new expenditure.

This tax expenditure review process is entirely consistent with the report’s focus on improving public value by redesigning major public sector systems. It also aligns with Ohio’s 2005 tax reforms, which reduced Ohio’s tax burden through policies that resulted in lowering the rates and broadening the base of state taxes. Base broadening efforts result in a reduction in the number of state tax expenditures

Specific recommendations include:

- Utilize the tax policy principles outlined in this report (neutrality, economic competitiveness, stability, equity, and simplicity) to conduct a thorough review and cost-benefit analysis of the 122 existing tax expenditures in the FY 2012-2013 budget development and review process.
 - Use both a static and dynamic analysis of the costs and benefits of tax expenditures.
 - Improve the quality and scope of Ohio’s biennial Tax Expenditure Report.
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The Ohio Revised Code defines a tax expenditure as “any tax provision in the Revised Code that exempts, either in whole or in part, certain persons, income, goods, services, or property from the effect of taxes established in the Revised Code, including, but not limited to, tax deductions, exemptions, deferrals, exclusions, allowances, credits, reimbursements, and preferential tax rates.”²²

Tax expenditures, like direct spending, help achieve specific policy goals and cost the state money. However, in Ohio, like

many other states, tax expenditures receive far less scrutiny than direct expenditures. Many of these expenditures continue year after year, with little or no new evaluation of whether they are achieving their purpose or meeting original cost estimates. For example, Arizona enacted a tax credit on vehicles that operate on alternative fuels. It was estimated to cost between \$3 million and \$10 million per year, but in its first year alone, it cost the state \$680 million. This is certainly a vivid example of why tax expenditures must be carefully evaluated just like direct expenditures.²³

Regularly reviewing tax expenditures is entirely consistent with improving government productivity and with the philosophy that drove Ohio's 2005 tax reforms. These tax reforms were based on the assumption that tax policy should be driven by the principles of neutrality, economic competitiveness, stability, equity and simplicity. These successful reforms have resulted in a tax code with a broader base and lower rates.

Despite these consensus principles, Ohio has enacted an array of tax expenditures over many years without clearly determining if they align with these goals. Most of them fall under one of the following rationales:

- They are constitutionally required.
- They exclude a “necessity”, such as food, from taxation.
- They enhance Ohio's incentives to invest in manufacturing equipment, to locate businesses in targeted economic development areas, etc.
- They limit double taxation.

Leading examples of Ohio tax expenditures are the 53 sales-and-use tax exemptions that total an estimated \$4.5 billion a year in lost revenue. They can be classified as follows:

- Exemptions whose intent is to prevent “pyramiding” of the sales tax. These are exemptions that primarily relate to goods that are used in the creation of other goods. An example is machinery or other equipment used in agriculture, mining or manufacturing.
- Exemptions intended to make the tax more equitable or to favor certain entities or types of economic activity. An example would be the exemption of newspapers, due to the essential role they play in a free society.

Some tax expenditures, when used correctly, can be a tremendous economic tool that we often endorse. Such tools can mean the difference between success and failure for a start-up company – or a company that wants to expand and create more jobs. They often result in more revenue for the state through increased investment and employment. A good example of this is the recently approved Ohio Motion Picture Tax Credit. It provides a tax incentive for motion pictures made in Ohio. Since its inception, it has significantly increased the number of films made in Ohio and the number of jobs affiliated with these projects. Other examples include Ohio's job creation and job retention tax credits. To qualify for these credits, a business must meet higher investment thresholds tied to significant new or saved jobs.

Still, Ohio has no formal policies in place to regularly determine what value its tax expenditures are producing for citizens. A tax expenditure report is prepared as a companion piece to the Executive Budget. However, based on an evaluation of the Ohio report conducted by the Center for Budget and Policy Priorities, there are many opportunities for improving Ohio's approach to analyzing tax expenditures.

In its 2009 report, Promoting State Budget Accountability Through Tax Expenditure Reporting, the Center for Budget and Policy Priorities reviewed the tax expenditure reports from 41 states—including Ohio—and the District of Columbia. By its standards, Ohio's report falls short on several counts:

- It fails to include the cost of exempting services from the sales tax.
- It does not include the number or description of the recipients impacted by specific tax expenditures.
- It does not report the cost of tax expenditures to local governments; instead, it combines the local impact with the costs to the state general fund.
- It fails to classify tax expenditures using the same categories as direct spending.
- It does not explain the purpose of each tax expenditure.
- It fails to evaluate the extent to which that purpose has been accomplished.
- It does not analyze the distribution of benefits by income level and size of business.

Ohio's laissez faire approach to tax expenditures is the opposite of the biennial budget review process required for all state appropriations. *These shortcomings should be corrected under a new tax expenditure review.*

Finally, analysis of tax expenditures should be both static and dynamic. Static analysis considers a tax expenditure as a cost to the state without considering other benefits, including revenue that is generated as a result of an expanded economic activity. Dynamic analysis looks to the future and is critical to understanding how the economy is likely to respond to the change. For example, historic tax credits are an important economic tool to preserve historic structures. They also drive economic development and enhance the economic well-being of a community. Yet, without a dynamic analysis, this impact might not be fully recognized and supported, because a static analysis simply estimates revenue losses without assuming that the tax expenditures add value.

RECOMMENDATIONS FOR PRODUCTIVITY IMPROVEMENT

One important way to advance productivity would be to improve the quality and scope of *Ohio's Tax Expenditures Report*.

If properly designed and implemented, a tax expenditure report makes tax expenditures more transparent, encourages accountability by enabling policymakers and voters to evaluate individual tax expenditures and decide whether to continue them, and saves money by allowing policymakers to monitor the costs of tax expenditures and rein in their costs as appropriate. For example, the state of Oregon's first tax expenditure report showed the state exemption of lottery winnings from the income tax was costing about \$44 million per biennium. Armed with this information, policy makers scaled back the exemption, saving the state more than \$40 million per biennium.²⁴

In our recommendation on Budgeting for Outcomes, we suggest that tax expenditures be ranked along with other spending programs in deciding what programs to eliminate and what to keep. To ensure that tax expenditures get the level of analysis they deserve, Ohio should revise its laws requiring a

4. Evaluate each tax expenditure using performance measures prior to decisions to retain the expenditure; and
5. Require an objective state entity to audit each of the tax expenditures based on the performance measures developed by the legislature and reported during the budget process.

“If properly designed and implemented, a tax expenditure report makes tax expenditures more transparent, encourages accountability by enabling policy makers and voters to evaluate individual tax expenditures and decide whether to continue them, and saves money by allowing policymakers to monitor the costs of tax expenditures and rein in their costs as appropriate.”

tax expenditure report to expand the scope and depth of analysis required. The report should meet the accessibility, scope, detail and analysis criteria outlined by the Center on Budget and Policy Priorities and correct the shortcomings the Center has identified.

Ohio's Tax Expenditures Report should include a full assessment of both the cost and economic benefit of each tax expenditure, but decisions regarding the elimination and reduction of tax expenditures should remain with policymakers. If justified by the tax expenditure review and analysis, policymakers should consider the elimination of tax expenditures that are no longer achieving their intended policy goals. Likewise, tax expenditures that exceed the cost necessary to achieve their underlying policy goal should be reduced. This comprehensive analysis of tax expenditures should also be employed when decisions to add new expenditures are considered.

The Center for Budget and Policy Priorities identifies Oregon, Minnesota and Connecticut as three states with comprehensive and informative reports. These and other states that score high in the Center's evaluation could be models for the changes Ohio needs to make. In reviewing the reports issued by these states, we recommend that the following be considered by Ohio:

1. Prior to a tax expenditure becoming effective, the authorizing body should clearly:
 - a. Determine the policy outcome (desired result) for which the tax expenditure is being enacted;
 - b. Assign appropriate performance measures for the outcome;
 - c. In the biennium after initial enactment, the authorizing body should consider whether the results are being met prior to reauthorization.
2. Tax expenditures should be reviewed with the same scrutiny that is applied to appropriation items;
3. Include the relevant statutory tax provision(s) for each tax expenditure;

Ohio's tax expenditures should be thoroughly reviewed and analyzed in the development of the FY 2012-2013 biennial state operating budget. The review should include an analysis of whether or not the expenditures are meeting their intended fiscal and policy outcomes. The General Assembly should then consider amendments to and/or repeal of the statutes that created specific tax expenditures that are not meeting intended outcomes.

POTENTIAL FISCAL IMPACT

The potential fiscal impact of an ongoing review of tax expenditures is difficult to determine. However, if a review led to any reductions, each 2% reduction of the current \$7.7 billion annual total would produce \$154 million savings per year.



Civil Service System

Ohio needs to liberate its bureaucracies and empower its managers

Productivity Improvement. It's the path forward for state and local government during a period of intense change, but it's a path that will result in a dead end without an authentic partnership with governments' most important resource: their employees. In order to leap forward from rule- to results-based public organizations, Ohio needs to liberate its bureaucracies.

By giving managers the freedom to manage their staffs and invest in building the skills and capacities of public employees, Ohio can create a more efficient, productive workforce. These strategies are closely linked to the way in which public employees are compensated. For example, pay should be linked to performance, not primarily based on longevity. Creating the right tools for managers will require reform.

Specific recommendations include:

- Give managers more freedom to manage their employees.
 - Shift to broad job classifications and use market-based employee compensation studies, updated regularly, to create broad and competitive pay bands.
 - Limit compensation increases beyond these pay bands to performance-based bonuses; eliminate automatic pay raises via steps and longevity pay.
 - Invest in building employees' skills and capacities.
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Background

Management guru Peter Drucker underscored the realities of change when he said: "... unless it is seen as the task of the organization to lead change, the organization—whether business, university, hospital and so on—will not survive. In a period of rapid structural change, the only ones who survive are the Change Leaders. It is therefore a central 21st -century challenge for management that its organization become a change leader."²⁵ Drucker understood before almost anyone else that intense change combined with the rise of the knowledge worker meant that productivity improvement could only happen when employees were treated not as underlings but as partners, associates, even volunteers who could walk away at will.

Yet how does this happen within the context of today's civil service, which is rigid and rule-driven? Answering this question requires a brief look at the historic foundations of civil service.

Civil service first came to the United States in the late nineteenth century. It created a new set of personnel rules intended to control political manipulation of public employees and limit patronage appointments of unqualified personnel. Since then, states and their local political subdivisions have created mirror images of the federal civil service. Civil service in Ohio greatly reflects the federal system.

When most civil service systems were developed, public employees were not unionized. The courts had not yet outlawed most patronage hiring and firing, nor did they protect most employees from wrongful discharge. Civil service rules were the only protection public employees had from the whims of elected officials—who were in the habit of firing thousands of employees when a new party took power and rewarding political supporters with their jobs.²⁶

Today Ohio has multiple layers of protection, including unions, the courts, and civil service, and the result is often gridlock.

Managers have trouble hiring the talent they need, because the centralized hiring process is so bureaucratic and slow. Thousands of job classifications divide employees into absurdly narrow categories and pay grades, frustrating managers' attempts to move them or reward them with higher pay.²⁷

Within each classification, pay is largely determined by longevity, not performance, and when good employees reach the top of their pay grade, further raises are impossible without a promotion.²⁸

In addition to restrictive civil service rules, collective bargaining has a direct impact on the ability of managers to manage effectively. State government, according to Ohio's State Employment Relations Board, has twelve collective bargaining contracts covering 42,295 employees, approximately 72 percent of the state workforce. Boards of Education have 1,237 contracts covering 196,743 employees and universities and local governments (cities, counties, and townships) have 2,023 contracts covering 122,360 employees.

Despite its rule-driven civil service and highly unionized workplaces, Ohio more than ever needs to create innovative solutions to increasingly complex public policy issues. It needs a culture of innovation, not the rigid, sclerotic organizational structure and culture of the past.

Recommendations for Civil Service Productivity Improvement

A more productive workforce environment anchored in accountability and employee empowerment will require transformational civil service changes. The following recommendations, which were originally developed by David Osborne and Peter Hutchinson in their book, *The Price of Government*, provide an initial roadmap for bringing greater productivity to Ohio's civil service system.

Give managers freedom to manage their people. Decentralize authority for hiring, firing, and promotion. Take it away from the Department of Administrative Services (DAS) and give it to the agencies and departments themselves, along with accountability for performance. Make DAS a consulting or support resource.

Shift to broad job classifications to give agencies flexibility in organizing work. Reduce the number of job classifications dramatically—down to a few dozen if possible. Group jobs based on type of work, level of responsibility, occupational group, and competencies required. This will give managers more flexibility to move people to new positions within the same broad classification, as needs change.

Couple this with a “broadband” pay system, with only three to five broad pay ranges within each job classification. Broadband systems, which have proven themselves in many places, allow managers to set salaries at levels required to recruit and keep the talent they need. The bands should be defined as much as possible based on compensation studies to determine what pay levels are required in Ohio to attract the talent needed.

Streamline hiring, promotion, and discipline processes, and base them on objective performance expectations. Use performance criteria rather than seniority in personnel reductions. Put an end to replacing displaced workers through disruptive “bumping” procedures. Keep high performers and let low performers go. And streamline firing processes, by allowing only one appeal, for instance.

Link compensation to performance. Automatic pay increases based on longevity should be eliminated. Salaries should be determined by what it takes in a particular labor market to attract and keep talented employees, and bonuses should be used to reward performance. (Salary increases to reward performance are too expensive, because they cost more in every future year. Hence one-time bonuses have proven much more sustainable over time.) Wage rates inconsistent with this approach should be adjusted as necessary and practical within existing resources. If pay scales need to be reduced in some cases, a reasonable approach would be to do this through multi-year pay freezes.

Ohio should also allow for variable compensation rates (permanent or temporary) based on particularly challenging assignments, such as teaching in difficult schools or leading teams on complex projects; let managers link salary increases to the acquisition of new skills; and reinforce the role of teams in delivering results by employing team-based rewards, such as team-based bonuses, gainsharing and other performance awards.

The entire performance evaluation process should be redesigned to focus on achievement of objective performance goals laid out in teams' balanced scorecards, not on subjective ratings of performance by supervisors.

Invest in building the skills and capacities of employees.

Major corporations spend much more than governments do on training and professional development. But in today's fast changing, fiscally squeezed world, the need for highly effective public employees is growing exponentially, along with the scope and complexity of public policy and program challenges. In fact, managing knowledge workers effectively and helping them transform antiquated systems is arguably the leading challenge of public sector managers. With these realities in mind, Ohio needs to invest widely in training and professional development for its employees.

These civil service reforms will all move Ohio toward a more effective work environment. Yet reform cannot end here. It must also include—via negotiations—collective bargaining contracts that change the way public employees are evaluated and compensated. Progress on this front may also ultimately require modification of Ohio's collective bargaining statutes.

POTENTIAL FISCAL IMPACT

These reforms will lower costs and improve agency outcomes. Agencies spend the majority of their funds on personnel (\$4.4 billion, from all funds), so each 1 percent reduction will equal \$44 million.

Public Employee Pensions

Investing in Government's Most Important Resource

Ohio's public entities need to attract, retain and invest in their most important resource: the people who work in state and local government and in the state's public colleges and universities. And, to the extent possible, they need to do this in a way that is a win-win for these employees and the taxpayers.

Consistent with our proposed civil service reforms, market-based reforms should be used to ensure that Ohio has a competitive, highly effective pension and benefits system. Reforms should result in attracting and retaining employees while being fair and affordable for Ohio taxpayers.

Specific recommendations include:

- Require a shared, 50-50 employee/employer contribution for state pensions and retiree health insurance.
 - Fund any remaining shortfall in pension and retiree health insurance benefits from increased employee contributions, not from taxpayer funds.
 - Require uniformity in the percentage of health insurance costs paid by old and new retirees.
 - Limit "double dipping" to extraordinary, high-need situations.
 - Reduce the number of state pension systems to capture administrative savings.
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Historically, public service has consisted of a variety of wage and benefit trade-offs relative to the private sector. In the private sector, wages were generally higher, but there was less job security. The public sector was nearly the reverse: job security was high, as were health and pension benefits, but wages were lower and there was less opportunity to reach a high paying position. In recent years, evidence has materialized that public employees have enhanced their position through salary increases, some of them from automatic pay raises tied to job tenure (step and longevity pay), not job performance. Public employees have also been advantaged by retention of a defined benefits pension system that exceeds what most private sector employees receive through defined contribution pension programs. Additionally, there is rising concern in Ohio regarding "double dipping," which allows public employees to retire and begin receiving pension payments, then be rehired into their job at the same or similar pay.

In Ohio, the median private sector income is \$38,126, while the median public sector income is \$47,507. This is quite misleading, however. Nearly half of state and local government employees have a four-year college degree and one-fourth have advanced degrees, while 30 percent of private sector employees have college degrees and only 10 percent have advanced degrees.

Discussing public and private sector compensation at the aggregate level is ultimately of limited significance. It would be far more revealing and instructive to conduct fair and accurate compensation studies that provide an apples-to-apples comparison by occupational categories.

An overview of public and private compensation is relevant and instructive as outlined on the next page:

Wage and Retirement Income Benefits Comparative Profile

Employee Wages	Private	Public
Median Ohio salary*	\$38,126	\$47,507*

Employee Benefits (Pensions and Health Care)	Private	Public (OPERS)
Retirement contribution**	Social Security = 12.4% of gross pay 6.2% Employee contribution 6.2% Employer contribution 401(k) 6% (Representative Example) 3% Employer 3% Employee Total: 18.4% (includes only retirement income)	Social Security = N/A Public Retirement = 24% 10% Employee contribution 14% Employer contribution Total: 24% (also includes health insurance in retirement)
Pension plan enrollment rate	70%	90%**
2009 Estimated Monthly Retirement Check for 65 year old retiree earning \$50,000/year at retirement.	Social Security = \$1,530	OPERS = \$2,283
Avg. 401(k) balance by participant age and tenure, 2008***	\$135,018 Age group 60's with 20-30 yrs.exp. at one company	NA

Note: Public employees are generally not eligible for Social Security. If they are eligible and have less than 30 years of Social Security earned credit, there is a reduction in their benefit.

* The Buckeye Institute for Public Policy Solutions, *The Grand Bargain is Dead*, July 2010, p. 13.

**Profit Sharing/401(k) Council of America, *50th Annual Survey of Profit Sharing and 401k Plans*.

***Investment Company Institute, *Research Perspective, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2008"*, October 2009, Vol. 15, No. 2., p. 16.

Employee Pension Profiles

Ohio's public pension systems must be carefully analyzed when comparing the public sector to the private sector. According to a recent report from the Pew Center on the States entitled *The Trillion Dollar Gap: Underfunded State Retirement Systems and the Road to Reform*, Ohio is noted as a "national leader" in managing its long-term liabilities for pensions, retiree health care and other benefits. Yet, despite this good news, between 1999 and 2007, Ohio's pension liabilities grew by 55 percent, outpacing assets that grew by only 43 percent. Meanwhile, the same report notes that while retiree health care and other non-pension benefits are 23 percent of Ohio's total retirement bill, they constitute 58 percent of its retirement funding shortfall.

Private sector employees: In 2008, twenty percent of all private sector employees participated in **defined-benefit** plans and 43 percent participated in **defined contribution** plans, indicating a clear trend toward defined contribution plans.

Of these pension-eligible employees, 80 percent have Social Security and defined contribution pensions. IRAs and 401(k) accounts (and related income) are tax deferred and **completely portable**, which is increasingly important in a highly mobile society.²⁹ However, employer contributions are often quite limited; one common approach is to provide \$1 for every dollar of employee contributions up to 3 percent of the employee's annual income. And on average, 30 percent of eligible employees do not participate in 401(k) plans.³⁰

Public sector employees: In contrast, while the great majority of public employees do not contribute to Social Security, they have **defined benefit** pensions that provide them with as much as two-thirds of their average high three years pay after 30 years of service. Cost of living adjustments—currently 3 percent per year—are also provided. In 2009, the average new retiree in the Ohio Public Employee Retirement System (OPERS) retired at age 60.2 with 25.6 years of service and an

annual income of \$50,867 (average high three years). As the chart on page 33 shows, public pensions are substantially higher on average than private sector defined contribution plans.

Public Sector Retirees Health Insurance Subsidies

Public employees receive deeply subsidized health insurance after they retire. Of the 24 percent of their wages paid into OPERS by the state and its employees, 5.5 percent is required to pay retiree health insurance costs. These “legacy costs” are unsustainable and have been eliminated by the vast majority of private sector employers. It is estimated that only 29 percent of private sector employers provide subsidized health insurance to retired employees, and the downward trend is continuing as businesses look for ways to survive in a challenging economy.

RECOMMENDATIONS FOR PRODUCTIVITY IMPROVEMENT

Public Pension Options

State pension systems should be brought into line with private sector realities and into balance for the long term. Ohio’s public pension systems are being responsive to the latter point by advancing generally reasonable cost saving reforms. But more should be done as outlined below.

From the employee’s perspective, defined benefit plans are superior to defined contribution plans because they generally pay more and last a lifetime, though they are not portable. Public pension systems earn returns roughly one percent higher per year than the average 401(k)—an amount that is quite significant over a 30–40 year career. In view of these realities, retaining a defined benefit system would provide a major incentive for attracting and retaining public employees. But within this structure, state and local governments should change the contribution formula to more closely align with the private sector.

A sensible approach would be to mirror the private sector by requiring the public employee and employer to each pay the same amount into the pension system (50-50). Private sector policies vary, but a representative approach requires the employer and employee to each pay 6.2 percent for Social Security, with an additional 401(k) defined contribution pension that includes a dollar-for-dollar employer/employee match of up to 3 percent of salary. The Ohio public sector should mirror this approach by requiring the public employee and employer to each pay 9.25 percent of salary to fund retiree pension payments. Currently, in OPERS the amount is 10 percent from the employee and 14 percent from the employer, though only 18.5 percent of this 24 percent is used to fund pension payments. (The rest pays for retiree health insurance.) The 18.5 percent paid into OPERS falls into the range of typical private sector benefits that include Social Security and a defined pension contribution.

Retiree Health Insurance Benefits

Because private employers generally do not provide health insurance to their retirees, it seems unreasonable and inconsistent with market realities for public pension systems to provide their members with health insurance as deeply subsidized as it is today. This is particularly true given the fact that this expensive and not contractually required benefit is threatening the solvency of public pension systems. A better approach would be to require a shared, 50-50 pension and health insurance payment structure. Using OPERS as an example, this would require employees and employers to pay 9.25 percent for pensions and 2.75 percent for health insurance. Since existing pension benefit levels can be retained with a 9.25 percent contribution rate (employees and employers), total pension contributions can be held at 24 percent. However, we recommend that both employers and employees pay 12 percent. This would retain the existing benefit structure at a higher price for employees and a lower price for public employers. Compensation studies would need to determine if any of the savings from this change should be allocated to help pay for market-based wages.

This rebalancing, along with other reforms discussed below, will not be enough to stabilize all of Ohio’s public pension systems. The remaining funding gaps are due to rising retiree health insurance costs. Given the disparity between public and private benefits, it seems reasonable that these gaps be filled through additional employee contributions for health insurance, rather than additional taxpayer subsidies.

To control rising health care costs, Ohio should create greater aggregation of public health care purchasing with other public sector entities, including all public pension systems. As explained in our section on Health Insurance Reform (see page 36), the goal would be to transition to value-based purchasing rather than paying for procedures.

Retire/rehire practices (“double dipping”)

The practice known as “double dipping,” which allows employees to retire, collect benefits and be immediately rehired to the same position, must be reformed. One example of this practice is the “DROP” program provided to Ohio’s safety forces. This voluntary program allows police and fire management employees who are at least 48 years old and have 25 years’ experience to technically “retire”, but stay in their same jobs up to an additional eight years. During this period, they receive pension benefits and cost-of-living adjustments. At the same time, they receive additional lump-sum pension benefits that accrue in a separate fund and are released when the employee officially retires. It is also important to note that many of these employees have had their share of public pension contributions paid by their employer. There are other examples of “double dipping” that should be reviewed and limited to extraordinary, high-need situations as determined by statutorily defined criteria. This practice is virtually unique to the public sector and is inconsistent with market realities.

Employer payment of retirement contributions

In an effort to bring the public sector into alignment with the private sector, programs at all levels of the public employee pension system should be evaluated in order to identify inconsistencies. For example, certain political subdivisions pay employees' contributions to their retirement program. Unless there are good reasons for retaining these costly variations, they should be eliminated.

Reduction in the number of state pension systems

Ohio could realize administrative and other cost savings, such as greater purchasing collaboration, by reducing the number of state pension systems from five to a lower number. One approach would be to have one system; another would be to create three systems: one for general public employees; one for all school and university employees; and one for all public safety (police, fire and high patrol) employees.

POTENTIAL FISCAL IMPACT

Taken together, these recommendations would lower state and local government's costs.

FY 2012-2013 Fiscal Impact: Savings would be as follows:

- State Government Savings: \$88 million/year due to the shift from a 14/10 to a 12/12 percent contribution model for state government (which spent \$4.4 billion on wages in FY 2008).
- Employer pension contribution savings would also accrue to Ohio's 3,700 political subdivisions, including local governmental units, schools and colleges and universities.
- Total Biennial State Savings Estimate: \$176 million.

Health Care Costs

Reducing Costs and Improving Outcomes

10

Recently enacted federal health care reforms created both challenges and opportunities for states. Regardless of how these changes are viewed, it is incumbent upon Ohio to consider how to meet the law's goal of increased access to coverage, as well as the best strategies to lower costs and improve outcomes. Within this new regime, it is clear that a market-driven approach can achieve the best results.

State government can help reduce health care costs and improve system outcomes by using a strategy that includes smarter use of public sector health insurance buying power while fostering a genuinely competitive health insurance marketplace. Most importantly, state buying power should be used to steer the market away from volume-based fee-for-service reimbursement and toward value-based purchasing models that help lower health care costs and improve results. Demonstrated improvements in costs and outcomes in government-purchased health care – more than a third of the market, beginning in 2014 – will help change the rest of the market as well.

Unless Ohio finds a sustainable solution to the rising cost of providing health care, it is unlikely that we can recover from the fiscal crisis we face today. Health care spending is at the core of the state's budget problem and must be resolved. For that reason, this is a top priority.

Specific recommendations include:

- Drive health care costs down and improve patient outcomes by using the state's leverage as a large purchaser to move toward new reimbursement methods, including “global payment” models. Reward providers for keeping patients healthier; pay for results and not simply service volume.
 - Support, through incentives and other means, the creation of Accountable Care Organizations and other innovative programs to deliver care.
 - Improve transparency and access to price and quality data from health care providers and health plans by utilizing web sites and other communication vehicles that enable purchasers to be informed about the most cost-effective options.
-

Total state health care spending across all sectors of Ohio totaled \$89 billion in 2008. Estimates suggest that this number will reach \$200 billion by 2018.³¹ On the public side, this growth includes both employee and retiree health insurance costs and the price of Medicaid for over 2 million low income Ohioans. The Medicaid program is already the fastest growing element of the state budget, and it will grow faster when more than 500,000 additional Ohioans are placed on the rolls in 2014 due to federal health insurance reform.

Yet Ohio ranks 42nd nationally in “healthy lives,” according to the *2009 Commonwealth Fund State Scorecard on Health System Performance*.³²

In health care, low quality and high costs go hand in hand, in part because it costs less to keep people healthy than it does to treat illness. Health spending in the United States now stands at an annual average of \$7,500 per person.³³ And health insurance costs have escalated accordingly. The average family policy now costs nearly \$14,000 annually—an increase of 114 percent since 2000—according to a 2010 survey conducted by the Kaiser Family Foundation.

America pays more and gets less than other developed nations for three principal reasons:

1. Our health care system responds to illness rather than prevention.

We spend most of our energy and money treating the symptoms of illness, rather than their causes. Yet our lifestyles are creating an epidemic of expensive, largely avoidable chronic conditions, such as obesity, diabetes and heart disease.

2. In most cases, we pay for procedures, not for health.

Under a fee-for-service payment system doctors and hospitals are reimbursed for each medical procedure. Consequently, providers make more money by performing more services. For example, if a provider makes a mistake and the patient has to be treated again, or a lab test must be repeated because the results are unavailable, the provider generates more income and the incentive to be more efficient is removed. If a medical group figures out economical ways to keep its patients healthy, it will likely earn less money. Hence, America leads the world in medical procedures, but lags in the overall health of its citizens.

Doctors John Wennberg and Elliott Fisher at Dartmouth College have studied Medicare data for decades. Their research shows that in regions with more physicians per capita, rates of hospitalization and procedures are far higher—often twice the level of regions with fewer doctors. Yet this higher spending does not yield better outcomes or more satisfied patients—it yields just the opposite.³⁵ Wennberg believes that up to a third of the \$2.4 trillion America spends on health care each year is wasted on unnecessary treatments, expensive drugs, and end-of-life care.

3. Our system is fragmented, but today's problems demand coordinated care.

Our fragmented system of medical practices, hospitals, and insurance companies produces enormous waste. Complex administrative processes, such as billing, consume too many health care dollars.³⁶ Different doctors and hospitals treat the same conditions in very different ways, at very different prices. And because multiple specialists dealing with the same patient rarely coordinate their care, patients fall through the cracks and quality suffers.

Yet teamwork is more important today than ever before. Our medical institutions evolved to provide episodic care for acute illnesses, but the real burden has shifted to chronic problems that need continuing, coordinated care. In fact, health care experts Alain Enthoven and Laura Tollen report, “about 45 percent of non-institutionalized Americans have chronic illnesses, and they account for 75 percent of personal health care spending.”³⁷ More than 40 percent of them have more than one chronic condition.³⁸ Yet our health-care institutions are not designed to provide coordinated care for chronic conditions.

RECOMMENDATIONS FOR PRODUCTIVITY IMPROVEMENT

Shift the Market to New Financing Models

The new federal health insurance reform law will extend health insurance to some 32 million Americans, some through Medicaid, some because of the individual mandate to purchase it, with partial subsidies in many cases. It changes the rules of the marketplace, so insurance companies cannot deny coverage to people with pre-existing illnesses, cancel their policies when they get sick, and so on. It also requires the creation of health insurance “exchanges” through which people will purchase health insurance. The federal law promises \$1 billion-\$2 billion a year for state and local prevention and wellness programs, to attack underlying causes of illness. Medicare will launch demonstration projects to develop alternatives to fee-for-service reimbursement, and the law offers financial support for states to experiment with new payment solutions and more coordinated care, among other things.

To take advantage of these new opportunities to increase access, control costs and improve results, the states must now summon their own political will. Ohio should do everything it can to expand its efforts to shift the market from fee-for-service reimbursement to a payment system that rewards providers for keeping patients healthier, paying for results, not procedures. This means transitioning to new payment methodologies, such as “global payments,” which offer set annual payments to provide all care for an individual (with prices reflective of appropriate patient risk assessments).

Many Ohio health insurers are already moving in this direction. These companies, which as of 2006 financed \$31 billion out of \$62.2 billion in non-institutional spending, are moving away from traditional fee-for-service reimbursement models. Instead, they are gradually adopting managed care systems that pay physicians and other health care providers for better results—for adding value at the medical condition level—as the best way to lower costs.

In a famous Rand Corporation study, group medical practices that charged a set, prepaid fee cost 25-30 percent less than those operating on a fee-for-service basis.³⁹ The fundamental reason was that the prepaid physicians had clear financial incentives to become more cost-effective, as Enthoven and Tollen explain:

Prepayment rewards doctors for keeping patients healthy, for solving their problems in economical ways, and for avoiding errors. It encourages superior ambulatory care for patients with chronic conditions, thereby reducing their need for hospitalization. In contrast, the fee-for-service payment system gives doctors powerful financial incentives to do more (and more costly) procedures, which may not be in patients' best interests, financially or clinically.⁴⁰

Entire managed care delivery systems that receive set annual fees to care for patients, such as health maintenance organizations (HMOs), have similar incentives and even more tools to improve quality.

Experience shows that purchasers with at least 20 percent of the market can use their purchasing power to reshape the entire medical marketplace. Governments in Ohio (state and local) already purchase health insurance for more than one quarter of all Ohioans,⁴¹ - mostly public employees and retirees and Medicaid recipients. Federal reform will raise that figure, by adding those required to purchase insurance, many of whom will do so through a new “exchange.” This leverage should be used to push the market away from fee-for-service reimbursement.

Unlike many other states, Ohio has a robust health insurance market. Aggregating the state’s buying power and employing coordinated strategies aimed at improving results while main-

percent of the private (non-Medicare and Medicaid) market. State employees there have a choice of four high quality HMOs in tier one. By 2009, HMO premiums charged state employees in Dane County had fallen 16 percent below the average in the other 71 counties. Between 2004 and 2009, these premiums grew by 35 percent for single people and 37 percent for families in Dane County; in Wisconsin’s 71 other counties, they grew by 42 and 45 percent.⁴²

Wisconsin’s experience indicates that both patients and doctors can be satisfied in such a system, as long as they have choices. It also demonstrates that a government can restrain costs by including just 20 percent of the non-Medicare, non-Medicaid market in this kind of arrangement. This is true because most health plans compete for that 20 percent, and when they strive to become more efficient to capture that market, the changes they make affect the rest of their business.

“ Total state health care spending across all sectors of Ohio totaled \$89 billion in 2008. Estimates suggest that this number will become \$200 billion by 2018. ”

taining our competitive market will help bend the cost curve. This approach should guard against unnecessary, anticompetitive practices that exclude high quality, cost effective health care providers. It should also strive to ensure a genuinely competitive marketplace featuring the ability of local and regional insurance companies and insurance administrators to compete.

The Wisconsin Example

Wisconsin’s medical marketplace for state employees is an example of how one state is attempting to bend the health care cost curve. Wisconsin defines a basic benefit package, asks health plans to submit bids specifying the monthly dollar amount they would charge individuals and families for this package, then ranks those bids into three tiers. Plans in tier one, which are low in price and high in quality, cost the least for state employees. If they prefer a more expensive plan—because their family physician is not part of a tier-one plan, for instance—they are free to choose it and pay part of the difference. The vast majority of members choose tier-one plans, and this fact creates an incentive for health plans to lower their prices.

Wisconsin put this three-tier approach into effect in 2003. In Dane County, which includes the state capital and the largest state university, the state employee plan covers more than 20

Better Results for Less Money

The process described in the Wisconsin example would push hospitals, doctors, and insurance companies to create the kind of health care organizations that deliver better results for less money: integrated, managed delivery systems that coordinate care for their patients. Federal reform requires Medicare to incentivize the creation of such organizations—called accountable care organizations (ACOs) in the federal health care bill—by allowing them to share the savings they generate. Ohio should piggyback on this initiative by actively catalyzing the formation of ACOs.

According to Wennberg and Fisher, who helped create the ACO concept, regions dominated by integrated, managed systems have costs up to one-third lower than other areas.⁴³ Some of these systems employ physicians as staff members, while others pay independent practitioners. Some are fully integrated, even owning their hospitals. Others are virtual networks that knit together many private practitioners and hospitals to act as one coherent system.

As an example, rather than charging fees for procedures, ACOs agree to care for all of a person’s health care needs for a set price per month. Delivery systems paid this way have a built-in incentive to bring down their costs. Hence they embrace

prevention, evidence-based care, electronic health records, a more cost-effective mix of doctors, nurse practitioners, midwives, medical assistants, etc., and other best practices.

These factors help such systems deliver higher quality as well. Their integrated nature also helps: Patients fall through the cracks less often.

Ohio could create incentives for health insurance plans to shift from fee-for-service reimbursement of doctors and hospitals to lump sums for cycles of care for specific medical conditions, such as nine months of obstetrical care and delivery, a knee replacement, or a year of treatment for diabetes.

If medical groups had to compete based on price *and* the results they produced over a full cycle of care (which could be multiple years), they would face very different incentives. They would be rewarded not just for performing procedures, but for driving down their costs by eliminating errors, managing chronic patients more effectively, providing care in doctor's offices rather than hospitals, helping their patients make healthy lifestyle choices, and the like.

This approach will be more effective if it is coupled with reporting policies that provide transparency for provider prices and patient outcomes. Illustrative models of transparency in reporting already exist in Ohio. To further enable conversion to payment for cycles of care, Ohio should create a web site on which physicians and hospitals have to list their prices and outcomes for each cycle of care, enabling health plans (and individuals) to purchase the most cost-effective options.

Purchasing in this way would drive hospitals and doctors in the direction of creating accountable care organizations. However, they should be required to meet the same legal and financial requirements of other health plans.

In the end, moving to a pay-for-performance model will require careful, well grounded efforts to create standardized, objective measures of provider quality that are consistent with evidence-based protocols. It will also require accurate health care cost and patient outcome reporting (price and quality transparency).

To protect against "adverse selection," in which some health plans attract older or sicker people who drive up their costs, each individual covered through a state exchange should be "risk-adjusted" – meaning that the price the individual or state pays to health plans would reflect the person's degree of risk upon entry. In addition, the state would be wise to make certain that there is a mechanism to ensure that risk is distributed fairly within the exchange. Without mechanisms like risk adjustment and reinsurance, health plans would submit higher bids, to limit their risks.

Given the challenges of moving to this new model, it should be accomplished in stages, using demonstration projects that allow policy makers to learn from successes and shortcomings and make adjustments as necessary. It may also be best to start with larger health practices and organizations and possibly with a focus on higher cost disease management initiatives, to give individual and small group physician practices more time to transition to a new payment model.

Progress toward cost and quality improvements will require fair and reasonable health care financing. This is especially true as Ohio and the nation work to reduce health spending increases and implement national health insurance reform. With this in mind, Ohio's FY 2010-2011 budget included a new hospital assessment that was designed to reduce the state Medicaid match burden by requiring hospitals to pay a portion of this cost themselves through the hospital assessment. This approach resulted in the vast majority of Ohio hospitals failing to receive their full assessment dollar back in Medicaid revenues and is thus a de facto tax on health care.

This policy has been amended recently with an infusion of additional federal Medicaid funds. The hospital assessment should be discontinued unless every Ohio hospital receives a full dollar back on every dollar of assessment.

POTENTIAL FISCAL IMPACT

The strategy we propose would not only limit state and local government health care costs, it would bend the cost curve for all Ohioans. Every 1 percent reduction in the growth of Ohio's health care spending represents a savings of at least \$89 million, both public and private.

FY 2012-2013 Estimated Savings: Limit annual state employee health insurance spending (\$600 million) to 1 percent growth per year instead of the estimated (FY 2012-2013) 6.3 percent per year at an estimated biennial savings of \$66 million. This savings would come from greater health insurance purchasing aggregation and shifting to performance-based purchasing and, if necessary, by requiring employees to provide additional funds and/or reducing benefits. Note: This same approach would yield additional savings for state colleges and universities and for local governments.

11

Criminal Justice System

Ohio must spend less on prisons and focus on more effective outcomes

Ohio's criminal justice system is underperforming. It costs too much and the outcomes are inadequate. Adult prisons now consume 88 percent of correctional spending, while front-end investments in parole, probation, treatment and alternatives such as victim-offender mediation lag far behind. From a bottom-line perspective, it is time to ask a fundamental question: Would public safety, prisoner rehabilitation, recidivism and correctional costs be improved if Ohio directed more nonviolent offenders away from adult prisons toward non-residential community-based monitoring and treatment?

The answer is yes. Ohio needs to spend less running high cost prisons and more on evidence-based education and treatment programs for low-risk, non-violent offenders.

Specific recommendations include:

- Continue the commitment to remove violent offenders from society for extended periods of time.
- Direct most low-risk, truly nonviolent (and nonsexual) felony 4 and 5 offenders who are amenable to treatment to supervised release in non-residential community-based correctional options, including day reporting, electronic monitoring, work programs and education and treatment programs.
- Support legislation to revise criminal sentencing provisions, including limited expansions of earned credit for prisoners, to better protect the public, improve offender outcomes and reduce taxpayer costs.
- Smarter investments in and management of probation and parole, including greater use of evidence-based offender risk assessment instruments, GPS monitoring and random drug testing.
- Analyze the cost-effectiveness of selling or leasing public prisons and other necessary assets.
- Provide better education, training, and treatment services for prisoners who have a high incidence of functional illiteracy, workforce skill deficits, and mental health and substance abuse problems, which will result in less recidivism.

Reforms will allow for the closing of three state prisons over two years thereby reducing high cost (over \$24,000/year per prisoner) incarcerations by approximately 4,500.

There are approximately 2.3 million adult prisoners incarcerated in the nation's criminal justice system, about half of them for nonviolent crimes, including most of the 500,000 locked up for drug-related offenses. This represents a 500 percent increase over the past 30 years. All told, America imprisons seven times as many people as it did in 1972 – much more than any other nation in the world.

According to a March 2009 report by the Pew Center on the States, national spending on corrections has reached \$68 billion, an increase of 336 percent since 1986. Much of this spending increase paid for the construction and operation of additional prisons. In the 1960s and 1970s an average of four prisons per year were under construction nationally, but by the 1990s the number had jumped to 24.⁴⁴

“Ohio has approximately 51,000 adult inmates, who each cost an average of more than \$24,000 per year.”

Increasing reliance on determinant sentencing policies, including mandatory minimums, is part of the reason incarceration rates have escalated. For instance, between 1980 and 1987 the number of people incarcerated for drug crimes increased eleven-fold nationally. These trends suggest that these mandatory minimums need to be subject to objective cost/benefit analysis to see if they are working—and at what price—relative to alternative approaches.

To what degree these policies have worked is a subject of intense debate. It appears that both policy and demographics share credit for crime rate reductions. What is not debatable is that crime rates plunged between 1994 and 2004. And in 2009 this pattern resulted in the first reduction (0.4 percent) in nearly 40 years in the size of the adult prison population nationally.

Ohio's story mirrors national trends. According to the Pew Center on the States, one in 25 adult Ohioans is under correctional control, which ranges from probation to incarceration, at a state cost of \$1.8 billion annually. This compares to a national average of one in 31. In 1982, the Ohio figure was one in 116.⁴⁵

Ohio has approximately 51,000 adult inmates, each of whom costs an average of more than \$24,000 per year. State spending on the Department of Rehabilitation and Correction has risen from \$432.8 million in FY 1990 to \$1.58 billion in FY 2010, an increase of 246 percent. Ohio's 31 prisons are currently (2009) at 132 percent of capacity.⁴⁶ Without policy changes, the prison population will reach nearly 56,000 inmates by 2018, according to the Ohio Department of Rehabilitation and Correction (DRC).⁴⁷

One important reason for this increase is the growing prevalence of short-term offenders. In Ohio, felony offenders may be sentenced to prison for as little as six months. In 2009, nearly half of the 25,000 new offenders committed to DRC were admitted for sentences of a year or less, and the majority of them were nonviolent offenders. Five thousand of them served less than six months. Nearly 85 percent of those serving less than a year were admitted for fourth or fifth degree felony offenses.⁴⁸ Of this group of incarcerated individuals, half had no prior history of incarceration.

These trends mean that significant numbers of truly nonviolent offenders are being placed in high cost prisons for relatively short periods of time. In 2009, according to the Ohio DRC, there were nearly 7,300 truly nonviolent offenders in our prison population, most of whom were felony 4 or 5 offenders serving one year or less.

The explosion of Ohio's prison population over the last 30 years helps explain why corrections employees (both DRC and the

Department of Youth Services- DYS) represent 25 percent of the state government's workforce. Moreover, during 2010, these two departments accounted for 54 percent of the state's General Revenue Fund (GRF) expenditures for payroll and benefits. These facts reflect the reality that DRC is much more than a jailer; it is the state's biggest institutional provider of services for mental health, developmental disabilities, aging and substance abuse.

Yet an analysis of 1997 Ohio prison data shows that escalating institutional costs resulted in a decrease since 1991 in pre-release treatment, educational programs and vocational training.

Ohio's prison system is clearly expensive. Is it effective? Are we getting our money's worth? The answer is no. A Bureau of Justice analysis⁴⁹ of state prisoners showed that over two-thirds were rearrested within three years of leaving prison, with most re-arrests taking place within one year of release. Almost 47 percent of released prisoners were reconvicted of a new crime within three years and 51.8 percent were re-incarcerated.

Meanwhile, a new report from the Council of State Government's Justice Center, titled *Justice Reinvestment in Ohio*,⁵⁰ finds that Ohio has:

- An ineffective use of prison for nonviolent offenders with more than 7,300 lower level property and drug offenders sentenced to prison annually. These prisoners stay an average of 9 months in prison and then 72 percent are released with no supervision.
- No clear criteria for effectively using prison alternatives. Ohio invests more than \$130 million annually in diversion programs, but has no clear criteria to inform the selection of program participants by offense and risk level.
- A patchwork of probation supervision for an estimated 260,000 probationers. There are 187 municipal, county and state probation agencies, whose training and supervision standards vary widely. And no data is collected statewide.

RECOMMENDATIONS FOR IMPROVING PRODUCTIVITY

A focus on improved productivity argues for common sense changes in correctional policies. There is growing consensus within the correctional policy community that the new way forward should be to reduce prison spending and use these resources more effectively by investing in education, workforce training and mental health and substance abuse treatment. The latter is particularly important, because an estimated 80 percent or more of incarcerated offenders have a history of alcohol and/or substance abuse problems.

Understanding these issues, in 1996 Ohio created a sentencing reform commission headed by the late Ohio Supreme Court Chief Justice Thomas Moyer. The Commission called for a number of reforms, including more community-based options for felony convictions, so that not all felons would automatically go to high cost prisons.

But local decision-making still drives the state system. For instance, there are an estimated 7,000 to 8,000 prisoners in Ohio adult prisons who would not be incarcerated if they had been sent to prison from a different county, with a different set of penalties. (These are mostly nonviolent offenders.) Counties appear to be making convictions that would normally result in offenders being sent to county facilities, but because those facilities are full, they are increasingly being sent to state prisons.

The 128th Ohio General Assembly is considering how to address Ohio's expanding prison population. Legislation is pending to revise criminal sentencing provisions and expand earned credit for prisoners (S.B. 22) and to expand state privatization initiatives (S.B. 269), opening the door for the sale and transfer of state correctional institutions to the private sector. Currently, Ohio has two privately owned and operated prison facilities that cost 5 to 10 percent less to operate than similar public sector facilities.

S.B. 22 includes two important changes that would reduce costs and encourage public safety: a) it would allow mostly low level and non-violent prisoners to earn up to five days per month off their sentence, instead of only one day as under current law, for completing education and substance abuse programs; and b) it would allow current petitioning for judicial release after a prisoner serves 85 percent of his sentence to be expanded to prisoners with sentences that are longer than 10 years.

In addition to S.B. 22, Ohio should put the following principles into law and action:

- Continued commitment to removing violent offenders from society for extended periods of time.
- Assessment criteria that would direct most low-risk, nonviolent (and nonsexual) felony 4 and 5 offenders who are amendable to treatment to supervised release in non-residential community-based correctional options, including halfway houses, day reporting, electronic monitoring, work programs and education and treatment programs.
- Smarter investments in and management of probation and parole, including greater use of GPS monitoring and random drug testing.
- Cost and results-based analysis regarding the sale or lease of public prisons and other necessary assets.
- Better education, training, and treatment services for prisoners, who have a high incidence of functional illiteracy, workforce skill deficits, and mental health and substance abuse problems.

These policy shifts could result in the closure of two to three

1,500-inmate prisons over a two-year period. This would save an estimated \$109 million per year if approximately 6,000—or about 82 percent of the truly nonviolent offenders—were released from prison and two to three prisons closed. However, 30 percent (\$36 million) of this savings should be used to provide necessary support for improvements to pre-release policies, including education, mental health counseling and job preparation, combined with greater support for probation and parole services in community correction alternatives.

Additionally, Ohio should create a new, gubernatorially appointed Corrections Inspector General to monitor compliance and evaluate results of this reformed system.

Ohio would not be alone in pursuing this approach to reform. For example, Mississippi, which has a long history of being tough on convicted criminals, is moving to reform its prison policies. It has amended its truth-in-sentencing bill, making nonviolent offenders eligible for parole after serving 25 percent of their sentences. Mississippi also implemented an evidence-based “risk instrument” that the parole board could use to make better judgments about parole decisions. This approach has resulted in more decisions to grant parole, with the rate moving from 30 percent to 50 percent. Mississippi also allows for up to 30 days of earned credit in a thirty-day period of incarceration for lower risk inmates.⁵¹

The reforms we have recommended should be implemented as soon as possible in FY 2012. They will put public safety first, improving results for both offenders and society. The alternative is pouring ever more money into a dysfunctional prison system that does not reduce crime or rehabilitate prisoners.

POTENTIAL FISCAL IMPACT

Criminal justice reform means less money spent on correctional costs with better results for the public. Thirty percent of the projected \$109 million in annual savings (\$36 million) should be reallocated for investments in training, treatment and monitoring. The potential fiscal impact thus would be a net savings of approximately \$73 million per year when the proposal is fully phased in. This assumes that 4,500 truly nonviolent offenders will be sent to some form of supervised release and two to three 1,500 bed adult prisons will be closed over two years. A staged implementation strategy would result in savings of \$25 million in 2012 and \$73 million in 2013.

Local Governments

The state should push local governments to enact cost-cutting efficiencies

It's time to form a more efficient relationship between Ohio's state and local governments. Over the years, our 19th century local government organizational model has produced more than 3,700 Ohio political subdivisions in the name of public service and "local control". But, Ohioans are waking up to the fact that despite the good work of most local governments, too many of these entities have become cumbersome, ineffective and expensive creatures of the past.

Ohio's local governments must become smarter, cheaper, and more effective. To get there, we need a productivity enhancing strategy that results in more public value, lower costs and fewer political subdivisions. This strategy should include a local government transformation planning process, new requirements to advance greater collaboration, and—where possible—consolidation of political subdivisions. Ohio should strike a new and better deal between state and local government: less funding for local government in the midst of a fiscal crisis and better results for the dollars invested.

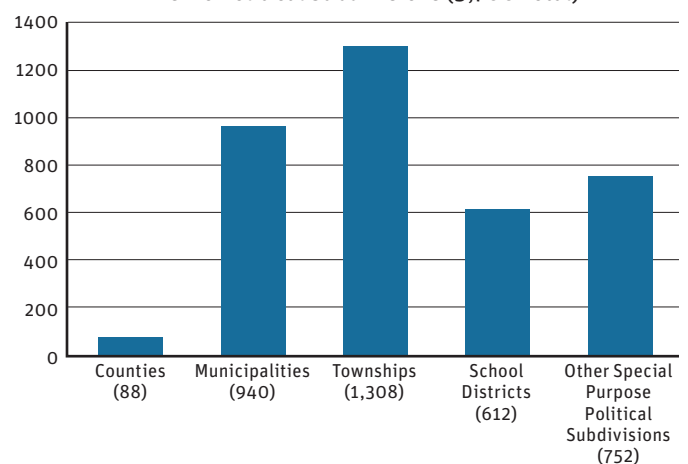
Recommendations:

- Push local governments to implement Budgeting For Outcomes (see page 13).
- Create and implement county-led Local Government Service Coordination and Collaboration Plans.
- Advance planning work through Local Government Transformation grants funded from a State Innovation Fund.
- Strategically redirect the state's Local Government Fund toward buying better results by earmarking 15% of the fund in FY 2012 and 20% of the fund in FY 2013 for local government reform demonstration projects.
- Establish a new State and Local Government Transformation Authority to provide policy and technical support to local governments.
- Reduce or cap costly real property tax roll-backs.

Background

Ohio's 3,700 counties, cities, townships, villages, school districts and special districts vary in size and sophistication. Some of our 1,308 townships are relatively large, while a third have populations of fewer than 1,500. Similarly, of the state's more than 600 school districts, 35 percent have fewer than 1,300 students. Despite these differences, each entity has its own employees, buildings, budgets and revenue sources. The weight of all of this government can be seen in our uncompetitive state/local tax structure. While the state ranks low (38th highest) nationally on its per capita state tax burden; when local taxes are added, we move up to the 16th highest per capita tax burden in the nation.⁵² This drives up the overall price of government in Ohio to well above the national average and it's growing.

Ohio Political Subdivisions (3,700 Total)



Shared Services. Ohio's local government infrastructure encourages independence ("local control"), and costly redundancies in an era that increasingly needs the value-added efficiencies and effectiveness that can emerge from intergovernmental collaboration, focused on common goals. That means lower quality, higher cost public services. Despite increasing evidence that a cooperative approach using "shared services" is a win-win for local political subdivisions, far too little of it is taking place in Ohio. When cooperation does occur it produces positive results, but it tends to be the exception rather than the rule.

Leading examples of successful collaborations include:

- The Fund for Our Economic Future in NE Ohio, a 16-county region, has awarded more than \$600,000 in grants to shared-service projects that involve more than one governmental entity. Among the recent winners was Stark County which will save \$2 million a year by consolidating 10 dispatch centers and one call center into a joint emergency dispatching operation.⁵³
- The Ohio Mid-Eastern Regional Education Service Agency in Steubenville regionally manages, among other cooperative activities, health benefits, shared purchasing and natural gas programs. More than 12,000 employees from 86 school districts and governments from 38 counties are members of the health benefits consortium. In FY 2007, cooperative purchases totaled more than \$1.3 million, generating a 40% savings.⁵⁴
- Ohio's 56 Educational Service Centers (ESCs) provide more than \$1.2 billion in programs and services in partnership with and on behalf of school districts. Clearly, the cost of these programs and services would be higher if purchased or provided separately by each school district.⁵⁵

State/Local Revenue Sharing. Ohio's historic approach to governing has resulted in an almost laissez faire state/local relationship. The state, bowing to the power and wishes of local governments, has provided ongoing state revenue sharing—a percentage of state income and sales tax revenues—without requiring (or buying) specific results. This revenue transfer, \$1.031 billion in FY 2010, takes place primarily through the Local Government Fund and the Public Library Fund. Revenue sharing on the capital appropriations side comes in the form of a long-standing state ballot issue that is renewed every 10 years. It provides over \$100 million per year in financial support for local infrastructure projects.

The state also pays for 10 percent of the local real property tax obligation of every residential property owner plus an additional 2.5 percent for owner occupied residences. These state subsidies were, in part, a trade-off for the creation of the state income tax (1971). They were also responsive to escalating property tax increases during a high property valuation growth period. Additionally, there is a homestead property tax exemption that excludes taxation of the first \$25,000 in residential property for the totally and permanently disabled and senior citizens who have annual incomes below \$26,200. In 2007, the income cap was removed. The total FY 2010 cost to the state of all these non-means tested subsidies was more than \$1.54 billion.

Just as the federal government passes unfunded mandates on to the states, the state/local relationship includes a history of the state passing its fiscal pain to local governments by cutting local government funds and state subsidies (education, health and human services etc.) without cutting state mandates. State mandates often control both the goals local governments must strive to achieve and the methods by which they must meet them, including collective bargaining constraints.

All of this duplication, inefficiency, and excess cost adds up to an argument for a 21st century redesign of Ohio's state/local government relationship. Too often, the strengths of systems become their weaknesses when they are taken too far. Such is the case with Ohio's local government model. It's a model that allows the important goals of local democratic representation and control to effectively block cost-cutting, productivity enhancing, collaborative efforts.

Recommendations for Productivity Improvement: A New State/Local Government Partnership.

Ohio must move to a 21st century, results- and citizen-centered state/local partnership. The short list of key first steps includes aggressively moving to more shared services and greater collaboration. Additionally, reforms on the finance front will help improve the existing state/local government arrangement and respond to our current budget crisis.

Encourage Shared Services and Greater Collaboration Require County Led Local Government Service Coordination and Collaboration Plans. Research reveals important benefits from shared services, including cost savings.⁵⁶

As a matter of state policy, Ohio counties should be required to lead a collaborative shared services effort with all governmental units or quasi-governmental units within the county, including municipalities, townships, school districts and public libraries. This planning process should result in the creation of a Local Government Service Coordination and Collaboration Plan for each county designed to lower costs and improve quality in key service areas and purchasing.

Key local service areas that could be leveraged more effectively through shared service and other agreements include: police and fire services, emergency medical services, communication/dispatching/911 services, transportation infrastructure related services, human services, judicial and criminal justice services, information technology, and bulk purchasing of office, road materials and other supplies.

This initial planning process should last no longer than one year and result in a written plan. Planning work should be advanced through Local Government Transformation grants funded through the proposed State Innovation Fund. Future local government fund eligibility should be contingent upon completion and implementation of the plans.

The 21st century redesign we are advocating also includes reforms on the finance front. To understand the proposed implementation pathway, it is useful to differentiate between state aid given to local governments and state aid that benefits individuals.

State Aid to Local Governments

A Model For Performance-Based Local Aid. In most states, including Ohio, local aid is blind to performance. It showers as much money on wasteful, ineffective governments as it does on their innovative, cost-effective neighbors. In their effort to balance budgets, state leaders should not miss the opportunity to get more value for the dollars they send to local governments. To do so, Ohio needs to transition to a new model, under which state government buys better, more clearly defined results and related operational efficiencies from local governments. This new model should also require these public entities, at least on a limited basis beginning with demonstration projects, to compete for state resources based on the results they achieve and should include relief from unfunded mandates that stand in the way of achieving the desired results.

This strategy will facilitate more productive partnerships at the local level and between local governments and the state. It may also result in fewer political subdivisions producing better

Ohio should establish a new State and Local Government Transformation Authority. In order to ensure that this Authority does not become just a new, growing government bureaucracy, we recommend it be subject to a 5-year sunset provision. The Authority would, in essence, be a best practices information center for local governments. It would also recommend legislative reforms, as necessary, to help facilitate local government productivity improvements, including policies that facilitate local government mergers and consolidations.

The state's "no strings attached" approach to funding local government must be changed to one that more effectively buys specific results. In 2012, we recommend that at least 15 percent of the state's existing local government fund be used to finance a Local Government Transformation Fund administered by the Transformation Authority. The resources should be used to finance and thereby incent demonstration projects to help advance county-led coordination, collaboration and consolidation plans. In FY 2013, this is increased to 20 percent of the state's existing local government fund should be redistributed on a competitive basis to fund demonstration projects leading to identification and replication of good government best practices within local political subdivisions.

“ In the end, the state needs to work with local governments to promote and, when necessary, require system redesigns that will lower the cost and increase the quality of local government services.”

results at lower costs. State leaders should use this process to create incentives to eliminate non-performing or low-performing local governmental units, as well as mergers and consolidations where they will produce greater efficiencies.

Moving From Sharing Revenue To Buying Results. Revenue sharing, as it exists in Ohio today, through the Local Government Fund and the Public Library Fund comes with no strings attached. Although this money helps local governments provide services, they receive it absent any performance-based agreements that include measurable outcomes. Given the state's fiscal dilemma and the fact that there is no requirement that local governments do what other public agencies must do and provide a rationale as to why requested funds are needed, it is time to end this traditional revenue sharing approach.

In the end, the state needs to work with local governments to incent and, when necessary, to require system redesigns that will lower the cost and increase the quality of local government services. This should emerge from a voluntary process that allows local citizens to keep their various local political subdivisions, but not at any cost. In other words, if local decision-making results in the ineffective delivery of quality public services defined by state funding criteria, the state should reduce or eliminate funding. This approach allows for local control while providing incentives for performance-based collaboration and consolidation. Over time, it will likely result in a significant reduction of local political subdivisions. As respected management expert Peter Drucker has long noted, it makes no sense to invest in making organizations more efficient if they should no longer exist.

State Aid to Individuals

Reforming Real Property Tax Entitlements. On the individual aid front, the leading policy question relates to the previously referenced state real property tax rollback program. Ohio does not have a personal income or property valuation based means test for this costly entitlement. Nor does it have a cap. Every time a local real property tax levy passes, the state cost goes up accordingly because the state pays 12 ½ cents of every local real estate property tax dollar collected on primary residences. In effect, the state has increased its total state tax burden enough that it can recycle 12 ½ cents on the tax dollar to help local residential property taxpayers pay their taxes.

This is not the best use of these scarce resources, particularly during a period of fiscal and economic duress. It does not make sense to use limited state resources to subsidize high wealth individuals. This is especially true when it causes the state to either reduce spending on essential public services or set state taxes at a higher level than would otherwise be needed. Ohio's property tax burden is just average for a state (24th) so we believe it makes sense to limit this entitlement.

One approach would be to cap the existing entitlement at current levels, thus disengaging the policy from new tax levies. According to the Ohio Legislative Service Commission, if this policy had been in place in FY 2008, it would have saved the state \$87.9 million. Another option would be a property value-based means test. For example, if the cap was at \$300,000 all property valued in excess of this amount would be treated for property tax relief purposes as though it totaled \$300,000.

This means-testing strategy should also be applied to the homestead real property tax exemption subsidy. One approach would be to phase-out the exemption for all eligible taxpayers. This would amount to a savings of nearly \$329.4 million annually. Another, better approach would be to return to an inflation-adjusted version of the policy that was in place through 2006. This would limit eligibility to those with approximately \$30,000 or less in annual income.

These reforms will take political courage and thoughtful action. There is growing awareness of the need to move in this direction, but too little action. Stronger, more accountable local governments will be more able to manage their way through difficult fiscal and economic environments.

Meanwhile, the state will get better results and greater efficiency in return for the money it sends to local governments. So, instead of simply cutting aid to local government as a partial response to balancing the FY 2012-2013 state budget, state policy makers should not "waste" the fiscal crisis, but, instead, use it to buy progress in local government.

POTENTIAL FISCAL IMPACT

Every 1 percent reduction in state revenue sharing and real property tax rollbacks (\$2.57 billion) would result in state savings of \$25.7 million per year. Additionally, increased use of shared service agreements can generate significant potential savings in local government costs, which could be recouped through lower local aid and generate considerable cost savings for the state.

The estimated impact of the recommendations assumes a 5 percent savings by capping or means testing the existing real property tax rollbacks, resulting in savings (based on 2009) of \$61 million in 2012 and \$65 million in 2013 and placing a \$30,000 cap on the Homestead Exemption (\$169 million a year). The 2012-2013 biennial impact would be \$464 million.

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