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Building a Legacy of Better Value: Choose Reform, Not Declining Quality

Report of the Committee on State Spending II

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Introduction

In 1992, Minnesota faced bad news. Forecasters predicted a state budget shortfall upwards of $1 billion for the 1992-93 biennium. Lawmakers braced for another round of discussions about the usual painful remedies: Cutting budgets, slashing services, raising taxes, or juggling accounting periods to make the problem "disappear."

The Citizens League issued a report that session cautioning the Legislature not to succumb to the usual temptations. The problem, we said, was not one of balancing the budget. The problem was deeper—a crisis of quality, cost and fairness in Minnesota's public services, a crisis that would get worse because of demographic and long-term economic forces beyond our control. We urged a dramatic new view of the role of government and proposed five "design principles" to get the best value for Minnesota's public spending.

Then, happily, the revenue picture improved. The budget shortfall turned into a modest surplus. We were, frankly, a little disappointed.

The dark cloud of immediate crisis, we had hoped, would reveal a silver lining of courageous reform efforts. Without the crisis, the urgency of reform would evaporate.

We needn't have worried. According to briefing documents prepared by State analysts:

- The U.S. economy will grow more slowly than it has in the past two decades. The nation's gross domestic product grew at an average 2.6 percent per year between 1965 and 1991 (DRI/McGraw-Hill, *U.S. Review Long-Range Focus*, Summer 1992, p. 4.) During the most recent economic recover a series of one-time events, including a rash of mortgage refinancings that fueled consumer spending, boosted economic growth to 4 percent in 1994. But the growth rate will slow to an average of 2.1 percent between 1995 and 1999, and the growth rate in 1999 is predicted to be only 1.7 percent.

- Slow growth in the economy means slow growth in the revenue base for state expenditures. Assuming no changes are made in tax rates, the average annual increase in General Fund revenues (over the previous year) is forecast to be 2.8 percent, compared with 5.4 percent in 1994 and 5.7 percent in 1995.

- While revenue growth is slowing dramatically, the demand for public services is increasing even more dramatically. That demand is driven largely by demographic forces, including the growth in K-12 and college enrollment and the huge increase in the population of elderly people. Public demand for more and stricter crime laws will also continue to put pressure on criminal justice budgets.

- Even without the prospect of reduced federal aid, Minnesota's fiscal gap—the difference between anticipated expenditures and projected revenues—is expected to reach $800 million by the 2004-2005 biennium. The *cumulative* gap will reach $2.5 billion by 2001.

- Federal aid to Minnesota will be reduced by $88 million in 1996. In each year through 2002, federal aid will be reduced from the 1995 base line, with the steepest reduction—$438 million—occurring in 2000.

- The state doesn't have an easy target for budget reductions. Nearly 85 percent of the general fund budget is devoted to education, health and human services, and local government aid—programs that most citizens view as high priorities for state government. (All figures above, unless otherwise noted, are taken from budget briefing documents prepared by Minnesota Planning.)

The crisis looms again. We are on a path to higher taxes, creeping decline in the quality of services, or widening inequities in who gets services—or, probably, all three.

This year's budget crisis should give lawmakers a new opportunity to reverse this trend and get at the root of the problem—a system that doesn't systematically link spending with results. Just as in 1992, incremental budget tightening won't solve the budget problem. Incremental responses are sure to lead to an inexorable decline in the quality of our elementary and secondary schools, our colleges, our local services, our health care. And, at the same time, other economic and technological changes will be remaking all of our major institutions, whether we like it or not.

The current environment is more conducive to reform than at any time in the last decade. In addition to the economic, demographic and political conditions described above, action by the 1994 and 1995 Legislatures to limit total state and local revenue growth should make the strategies that we propose more attractive than ever. Legislation passed in 1994 requires the Governor to recommend and the Legislature to adopt a comprehensive revenue resolution (frequently referred to as the "price of government") by March 15th every odd-numbered year. The 1995 resolution calls for reducing the price of government from 18.4

percent to 17.7 percent of personal income by fiscal year (FY) 1999. Since this constraint will not affect the demand for services, policy makers should be more value conscious than ever. If policymakers don't focus on value, they will have to debate and then vote to raise the price of government.

DESIGN FOR BETTER VALUE

The Citizens League said in 1993 that government should no longer be mainly about taxing, regulating and spending money on programs. Instead, we argued, the role of government should be to design environments in which people are prodded systematically to meet public purposes in the course of meeting their own interests.

In its 1993 budget report, the League outlined five principles for designing such environments:

1. **Target public subsidies directly to people who are financially needy**—rather than spreading subsidy around randomly, or providing aid to institutions or units of government.

2. **Use competition to align institutional self-interest with the public interest.** Give consumers choices so that suppliers must respond to *their* preferences. To provide more choices, government can give customers tax dollars to buy their own public services from an array of public and private suppliers. Government can also give itself more choices, by splitting its role as policymaker from its role as operator, then choosing from alternative service providers.

3. **Allow prices of public services to reflect true costs, including the social cost of individual decisions.** Current policies often disguise the true cost of public services, and distort citizens' choices about how to spend their money.

4. **Meet more public responsibilities through communities in which people already have relationships of mutual obligation.** Work with families, ethnic groups and neighborhoods to achieve public public goals, rather than relying only on professionalized "services."

5. **Consider long-term economic growth to be one of the objectives of state spending.** Make sure that expenditures on infrastructure, research and education are met with results that are rigorously and impartially evaluated.

ABOUT THIS REPORT

We began this summer's project aiming to show how these five design principles could be applied to reduce spending, or slow the growth in spending, on four of the state's major program responsibilities. Few of the changes we recommend will produce immediate savings. We believe reforming these systems according to the five principles *can* save money over the long run, however. Quantifying potential savings from such reform efforts is difficult—much more difficult that calculating the savings from incremental nipping and tucking—and we provide only rough estimates here.

Global budgeting—the practice of capping spending on specific items or the overall budget—is a strategy frequently embraced in times of scarce resources. There are at least three ways to use global budgeting. First, policymakers can set a global budget cap as a way to limit the size of government as a matter of policy—as Minnesota has done by limiting the growth in the "price of government" to 18 percent in the current fiscal year. Second, policymakers can decide on the state's priorities, then cap spending on each major program at a certain percentage of the budget to prevent the crowding out of some spending responsibilities by others. Third, global budgets can be used as a strategy to stimulate innovation and efficiency within major spending areas. In this approach, departments (for example) might be permitted to keep whatever "savings" they are able to achieve through increased efficiency.

This report makes no recommendation about how much should be cut from Minnesota's spending overall, or from any budget area. Nor have we said how much of the state's total budget should be apportioned to any spending responsibility. We leave it to the Governor, the Legislature and citizens to debate those issues as matter of policy. Our focus is on obtaining the best value for spending—whatever the amount the state's resources permit and the state's citizens choose.

We have recommended:

- **A new approach to K-12 education** that funds learners, not institutions, so that students are seen as the customers for education. The new system would free the teachers, parents and staff to decide how education gets done at their school site and would provide plenty of alternatives for parents to choose from.

- **A 30/30 vision** for post-secondary education in which sixty percent of appropriated funds would go to students, who would be free to spend those funds at the Minnesota campuses the students choose.

- **An "ABC plan"** to simplify and standardize many features of the property tax and aid system, increase accountability, use state funds more efficiently, and raise the state's share of K-12 funding and other state mandates.

- **A managed-care approach to long-term care for the elderly,** which emphasizes flexible, community-based alternatives to institutional care.

Major reform will be needed if we are to maintain the quality of our public services in the face of a $2.5 billion budget gap. We must:

- **remake our institutions now** to meet the public purposes policymakers and citizens define—putting aside orthodoxy in favor of a spirit of experimentation;

- **define a new compact** between citizens and government—a compact that redefines the responsibilities of individuals, families, communities and government;

- **strike a balance**—between ongoing expenses for services today, and investment to build the productive capacity of the state tomorrow.

The choice Minnesota faces now is clear. There is no option *not* to change. We can accept inexorable declines in the quality of education, public services and health care. Or we can choose major reform and leave a legacy of better value to Minnesota's future generations.

K-12 Education

Fund learners and free schools to perform

INTRODUCTION

K-12 education is one of the main drivers of Minnesota's spending growth. Elementary and secondary education accounted for 29 percent of state and local spending in 1994 and between 1981 and 1993 increased 15 percent in real dollars. K-12 education is projected to consume half of all the new revenues available this biennium compared with the 1992-93 biennium (Minnesota Department of Finance Adopted Budget).

From the state's perspective—and the perspective of public education itself—continuation of these past trends is both unsustainable and unacceptable.

Were current K-12 education spending allowed to grow at its current rate, overall expenditures would increase by an additional 76 percent between 1994 and 2005. However, state and local revenues that support education spending will grow at only a little more than half that rate in the same 11-year period—an estimated 43 percent.

The rapid projected increases in spending result from a number of factors. Among them:

- Enrollment will grow 25 percent from the "baby-bust" low of 695,00 in 1985 to a peak of 867,000 in 2001.

- Real spending per student on special education is growing much faster than enrollment. Special education enrollment grew 11 percent between 1982 and 1993, but real spending increased 81 percent.

- Employee benefit costs (not including salaries), which accounted for 14 percent of the 1993 budget ($683 million), are skyrocketing. Of the $808 increase in real per-pupil spending between 1981 and 1993, the largest share—54 percent—went to employee benefits. Like all employers, school districts have been hard-hit by past increases in the cost of health care and health insurance.

These pressures on state and local funding are coming at a time when funding for federal education programs is in serious jeopardy. Federal funding for Minnesota schools will total $297 million in FY1995, about 6 percent of total revenues, and is concentrated in programs for disadvantaged and special education students. Deficits in these federally-funded programs are already often covered by local tax dollars. (All figures above, unless otherwise noted, are taken from budget briefing documents prepared by Minnesota Planning.)

PROBLEMS WITH THE CURRENT SYSTEM

Minnesota's public education system is suffering from a missing link: The link between education spending and learning for students.

After inflation is taken into account, spending has tripled in the past thirty years. Yet student performance has not improved commensurably, and in many respects has declined. Employers complain that graduates are unprepared for the demands of the workplace. Despite increasing resources, the system isn't delivering the value we need:

- Most Twin Cities high school graduates lack the basic skills needed to do entry-level work and compete in the job market, according to a Northwestern National Life Insurance Company survey of 200 Twin Cities human resource and customer service managers. The survey found that 56 percent of the human resource managers and 77 percent of customer service managers believe most high school graduates lack the skills or abilities needed to adequately perform in entry-level positions.

- Minnesota students have tended to fare favorably in comparisons with students in other states. However, when student performance is measured by world-class standards, the results are disappointing. Only 37 percent of Minnesota eighth graders, and 27 percent of fourth graders, meet the National Education Goals Panel's performance standard in mathematics. Only 28 percent of Minnesota fourth graders meet the Goals Panel's performance standards in reading (National Education Goals Report: Building a Nation of Learners, 1993).

- During the decade between the 1982-83 and 1992-93 school years, the annual dropout *rate* for all Minnesota public secondary students nearly doubled, from 2.1 percent to 3.9 percent. The *number* of dropouts in grades 7 through 12 rose from 7,653 to 13,640, an increase of 78 percent (Minnesota Department of Education, reported in *Research Update*, Minnesota Private College Research Foundation, July 1995).

- Gaps in graduation rates and achievement levels between white students and students of color are alarming. The Minnesota Department of Education has projected that if current annual dropout rates for grades nine through 12 remain constant, the four-year cumulative high school dropout rate for the ninth grade class of 1994 will be 19 percent. However, the rate ranges from 15.1 percent for white students to 53.9 percent for Hispanics, 57.1 percent for Native Americans and 61.9 percent for African Americans. (Minnesota Department of Education, *Information on Minnesota High School Graduates and Dropouts*, 1993-94.) This measure is a worst-case scenario, since some dropouts will re-enroll or earn a G.E.D. Nevertheless, the measure is cause for concern about the schools' performance with students of color.

Of course, education providers aren't the only ones responsible for students' learning; parents, the community and students themselves are also responsible. It's important to point out that current flaws in Minnesota's educational system should not be blamed on individual teachers, administrators, parents or students. The problem is not one of ill will or laziness or ineptitude.

The real problem is the system itself. And the critical flaw in the current system is that education providers do not face consequences if they fail. Rather, power is currently in the hands of education providers, not consumers (students and parents) and the interests of students are seldom considered paramount. The symptoms are familiar. Centrally-controlled, bureaucratic decision-making structures prevail. Higher-order public authority—from school boards and the Legislature—confronts individual schools with a regulated, politically-dominated environment that resists change. Teachers burn out.

Given the fundamental misalignment of incentives and performance, "good management" may trim a few dollars here or there. Heroic teachers and administrators may produce a few noteworthy quality improvements. But neither will be enough to halt the unsustainable upward march of education cost or the avoidable decline in student performance.

So, making education's contribution to solving the long-term budget problem means more than reducing the rate of increase in spending. It will require much more fundamental reforms in Minnesota's K-12 education system that link spending with results. That goal is attainable. We can live within our means. The stakes are too high to assume we will do anything less.

The Citizens League's 1993 budget report outlined the elements of a K-12 reform strategy in terms of the five "design principles for better value":

Principle 1. Target government subsidies directly to people who are financially needy. Public financing provides for the cost of education for all citizens. Additional funding—subsidies—are provided in compensatory aid to districts to cover the higher costs of educating low-income children. Unfortunately, those subsidies do not always benefit those who need them most, since aid flows to districts, who can allocate the resources however they wish. A reformed system should ensure that the subsidy follows the student it is intended to assist.

Principle 2. Use competition and other market forces to align institutional self-interest with the public interest. This requires empowering consumers through various school choice programs, and introducing new forms of accountability, rewards and consequences for schools that both succeed and fail. A critical step is linking funding more closely to students, so that the *student* is viewed as the customer for education.

Principle 3. Allow prices of public services to reflect true costs, including the social costs of individual decisions. In universal free public education, people don't pay directly for services. But Principle 3 suggests that consumers should nevertheless know the "price" of the education they pay for indirectly through property and income taxes.

Principle 4. Meet more public responsibilities through non-governmental communities in which people already have relationships of mutual obligation. Communities—neighborhoods, ethnic associations, churches—can often provide high-quality education at lower cost because one of the critical factors influencing school performance is whether students feel valued and connected to the adults closest to them. Communities and families are often naturally inclined to enforce quality standards and require accountability. The state should expand the number of education options that tap into this power.

Principle 5. Consider long-term economic growth to be one of the objectives of state spending. In the knowledge era, education builds the key productive capacity of the economy. Minnesota's lawmakers should insist that expenditures on education produce results that build the state's productivity and economic vitality.

RECOMMENDATIONS: BUDGET SAVINGS IN THE SHORT RUN

It has taken decades to establish an educational system in Minnesota that so seriously lacks incentives, rewards and consequences to change. And, much of what we must do to alter that system—including making it more cost-efficient—will take time.

There are some steps, however, that can yield immediate savings and that don't require wholesale system redesign. They include:

1. **The state should encourage school districts to "pool" their employees with other school districts (and possibly with other units of government) for purposes of purchasing employee benefits, especially health care.**

   Education is a staff-intensive activity; compensation costs represent the largest share of school budgets. One portion of that compensation expense, employee benefits, is accounting for the largest share of the growth in per-pupil costs, largely because of increases in cost of health insurance.

   Controlling these health insurance costs can make a significant impact on overall K-12 spending and need not mean fewer benefits to individuals. Private sector employers are increasingly forming purchasing cooperatives because the larger the employee "group," the more leverage the employer has in negotiating premiums and service levels.

   In Minnesota, many units of government have also pooled employees for purchasing health benefits:

   - The Minnesota State Employee Insurance Program (SEIP) covers State of Minnesota and University of Minnesota and technical college employees. The plan covers 154,000-164,000 employees, retirees and dependents.

     A comparison of 1993 premiums in the SEIP program to premiums for other public sector employee groups shows the SEIP rates ranging from 13 percent to 23 percent less (John Klein, Health Strategies Group, Inc. The comparison does not reflect differences in benefit levels or risk rating.)

   - The Department of Employee Relations runs the Public Employee Insurance Program (PEIP), which is open to local governments.

About 80 groups, covering 6,000 enrollees, participate in this program.

- In rural areas, the Educational Cooperative Service Units (ECSUs) purchase health insurance for combined school districts.

[Just as this report was being completed, six metropolitan school districts—Minneapolis, Hopkins, St. Louis Park, Wayzata, Robbinsdale and West St. Paul—announced their intention to purchase benefits as a coalition. The coalition, called the Alliance of Metro Area Schools, represents between 15,000 and 20,000 lives.]

There are several benefits to pooling for employers and employees. The most attractive benefit is the lower and more stable premiums that usually result. And lower rates are possible without compromising the extent of coverage, since the "clout" afforded by larger numbers helps the purchaser negotiate a better package of benefits. The California pooled insurance program (CALPERS), for example, was able to lower premiums while allowing portability and eliminating limitations on coverage for pre-existing conditions. A large employer pool can also make it profitable for the insurer to offer value-added services such as workplace health education and wellness programs.

It is important to stress that cost savings do not result *automatically* simply by increasing the size of the group. To achieve significant cost savings, the employer must also adopt a sophisticated purchasing strategy that focuses on managed competition.

There are several obstacles to insurance pooling.

- Given group risk rating practices, groups can be expected to seek better deals by pooling with groups with better risk ratings, while groups with the best ratings will resist pooling. It may be difficult to create a pool if the risk characteristics of the various populations are unknown.

- Pooling reduces some—but not all—local control over the design of the plan and benefits provided.

- There are political obstacles to relinquishing local autonomy. The efficiencies that result from pooling may mean that some local benefits roles will no longer be needed.

- School districts may lack the expertise needed to design and negotiate a large-scale pooled arrangement.

It is difficult to estimate the potential savings that could be gained by pooling, since premium costs are affected by many factors, including the groups' risk ratings, the package of benefits offered and the purchaser's buying strategy and expertise.

A complete review of existing pooling programs, analysis of strategies for pooling, estimate of cost savings and specific recommendations are beyond the scope of this project. Our conclusions are based on a very preliminary review. However, in conversations with a number of health policy experts, we heard agreement on several points:

- Pooling represents a source of significant cost savings for the state.

- The teachers unions have viewed the idea of pooling favorably. Their members view pooling as a "win-win" proposition, with the state saving money and employees getting better benefits.

- The key to implementing widespread pooling is to ensure that the pooled program is viewed favorably by local government units.

- Pooling is more likely to yield significant savings and better service when everyone is in the pool—that is, when participation is mandatory.

- Because of the obstacles noted above, widespread pooling will be unlikely unless required by law.

There are several options for encouraging potential savings from insurance pooling, including:

a. fund a demographic study of a defined pool to determine a risk rating, then seek bids from managed care providers to determine the "most competitive" price for a benefit package comparable with the typical current school district package.

b. mandate that all health benefits will be purchased through a statewide pool. In conjunction with such a mandate, the Legislature might pay for a study to determine how local school districts could also be provided with some flexibility to tailor benefits for their employees.

c. put some limitations on public spending for benefits packages above the "most competitive" level—for example, by requiring individual employees to cover the cost of a richer package.

d. create an option for the two teachers' unions to pool their members for purchasing health benefits. In this approach, the unions would determine the basic design of the program democratically and then require all members to be in the pool.

e. require districts to report to their taxpayers what the districts are paying for health insurance, compared with the "most competitive price."

2. **The Legislature should take steps to define the entitlement to special education services.** Exceptional instruction—most of it special education—accounted for 15 percent of total public school spending in 1993. Exceptional instruction is the fastest-growing program in the education budget; between 1981 and 1993 exceptional instruction grew $468 per student (a 103 percent increase), compared with $347 per student for regular instruction (a 17 percent increase), $103 per student for community education (a 93 percent increase) and a loss of $224 per student for vocational education (a 62 percent drop).

   School districts face tremendous pressure to classify students as eligible for special education funding. Once a child is determined eligible, families are entitled as a matter of federal and state law to special education services as set forth in an individual education plan. There is no limitation on services and no limitation on costs.

   The federal government has provided very little funding to support the entitlement. The state has provided a partial reimbursement for special education costs, combined with an authorization for a special education levy.

   The situation is comparable to the situation in medicine before Diagnosis Related Groups (DRGs) or HMOs: An uncapped entitlement to service with a cost-based reimbursement system. The result is also similar. Special education costs are rising faster than all other costs and school districts are reducing services to non-special education students in order to handle the financial responsibility.

   The 1995 Legislature attempted to address the situation. Beginning in the next school year, the State will appropriate a global budget for special education to each district. School districts may spend more than that amount only by using their general formula aid or local levies. The Legislature's expectation is that the spending cap will give districts an incentive to be more efficient in delivering special education services. However, because the federal mandate for special education is broad, and because federal courts have interpreted the mandate broadly, the "cap" may simply prompt districts to further tap their general formula aid.

The Legislature should consider the following options for controlling the growth in special education costs:

- Require outside assessment and classification of students.
- Have parents or nonschool sources pay for noneducational support services.
- Define legislatively "appropriate education" for students with various disabilities. (see: Minnesota Planning, *Within Our Means*, p. 25)

The Legislature might also consider a capitated system similar to the DRG approach in medical care. In such a system, the Legislature would define "appropriate education" for students with different disabilities. The state would then determine a capitated amount of aid to which students who are eligible are entitled. Then, families would be given this aid directly, to use either in their own school district or wherever they like.

A NEW VISION FOR BETTER VALUE FOR SPENDING IN THE LONG RUN

The steps above could yield significant savings in the short term. To improve quality while controlling costs over the long run, however, we need major reform to correct the fundamental flaws in the system—particularly the lack of real accountability for results.

Our vision for this kind of fundamentally reformed system would attach funding to students, so that students not only are, but are seen as, the customers for education. The new system would recognize that it is the school—not the district—that the parent is "buying" and thus would free the teachers, parents and staff to decide how education gets done at their school site. The reformed system would provide plenty of alternatives for parents to choose from, including alternatives that capitalize on the special capacity of communities to help children learn. In the new system, parents would have good information to help them choose their school and make sure the school is delivering on its promises. Finally, the system would ensure that the public's interest in education is met by requiring performance contracts and providing mechanisms to enforce them.

This vision is based on several assumptions. First, consumers demand better value when they have purchasing power, good information and a choice among options. Second, the common interest and commitment of the families who have chosen a particular school foster the sense of community in the school—and community helps kids learn. Third, education isn't a perfect market, so some public oversight is needed to protect parents and students as consumers and ensure that the public's interest in education is met.

The public school oversight must not remain focused on inputs, however, like how many hours in the school day, days in the school year, or even students in the classroom. It must hold schools accountable for *results*—for meeting pre-determined goals for what students actually learn.

We cannot put a price tag on the potential savings this system would yield if implemented. But we argue that this new system of education can be expected to link spending with results in a way the current system can't. With the link re-established, the state will get better value at whatever level of spending the Legislature—and taxpayers—will allow.

RECOMMENDATIONS: IMPLEMENTING THE LONG-TERM VISION

The following recommendations help define these major elements of system reform and the steps that would be required to implement them. (Any expenditures recommended would be accomplished by making minor reallocations from the state's general (formula) support.)

1. **Attach funding to students.**

   a. **Have per-pupil aid and levy to go the school—not the district—in which the student enrolls.** When dollars follow students, it becomes clear that the *student* is the customer for education.

      The committee supports S.F. 1306 (introduced and considered in the 1995 Legislature). Sec. 1 of that legislation requires each district to credit 95 percent of the operating revenue and 25 percent of the capital revenue to accounts established for each of its schools. This scheme would replace the present system, in which state and local funding flows through a central administration which takes its share of the district's money off the top, with the remainder going to schools based on a number of factors including their costs. Those costs—largely dependent on the relative experience and educational levels of each school's faculty—may or may not reflect the funding each student brings to the district from local, state or federal sources.

b. **Require compensatory aid to follow students to the schools in which the qualifying students enroll,** again as required by S.F. 1306, Sec. 1. Current law now encourages districts to consider the number of qualifying students at each site when allocating compensatory aid. The Legislature should go further to link the aid to the students.

2. **Ensure that the public interest in education is met by requiring every publicly funded school to have a contract with a district, the state or another public agency to deliver certain specified education outcomes, and by establishing a mechanism to enforce these contracts.**

a. In general, every school receiving public funding should have to meet whatever results-oriented standards the state establishes (the graduation rule, for example) and **have a performance-based contract with the state, a district or another public agency to assure the school meets its goals.** The model is charter schools—and, in Boston, pilot schools. The requirement would include all traditional public schools, any non-public schools receiving funding as a contract school (as in Minneapolis and St. Paul) and other providers selected by families participating in a voucher program, if implemented.

These contracts are needed to assure accountability for the use of public funds and to substitute for the political and input-oriented regulatory oversight now provided by the state and districts. The contract, and a school's record of compliance with its contracts, can help parents make better choices. And since even well-informed consumers don't have complete freedom to switch their child's school, the contract provides an additional source of accountability for quality.

3. **Free teachers, parents and staff to make decisions about *how* education services are delivered at their public school site.**

   a. The committee supports S.F. 1306, Sec. 1, which requires that the **use of revenues be controlled by the school site.**

   b. The committee supports S.F. 1306, Sec 3 which sets in motion a process by which the **site will be able to make major decisions about budget, personnel and education methods.** The bill allows maximum flexibility to tailor the decision-making process to each site. The initiative is with the principal or lead teacher to propose a decision-making arrangement to the board or district.

   c. The committee also supports S.F. 1306, Sec. 3 which **permits school sites to purchase instructional and non-instructional support services from either the district service center or from other sources in the community.**

   d. The Legislature should amend MSA 124.15, Subd. 2(1) to **permit schools to employ non-certificated individuals in a classroom,** under the supervision of a certified teacher. Current law bars the use of competent, subject-matter or teaching-practice specialists in Minnesota classrooms.

4. **Expand the number and diversity of public school choices through several strategies.**

   Expand the alternatives available to parents within their current public school districts.

   a. **Allow parents to select the public school—not just the district—that their child attends.** (S.F. 1306, Sec. 4.)

   b. **Move toward site-based management, as described above, as a strategy for broadening the diversity of educational choices within school districts.**

   c. **Encourage existing public schools to become deregulated and autonomous, either by becoming charter schools or by agreeing to waive current employee contracts and district mandates.**

   Under Minnesota charter school law, any public school can voluntarily become a charter school. Yet none have, perhaps reflecting unnecessarily restrictive statutory requirements, opposition from teachers' unions or central administrators and school boards, or both. We believe those barriers should be eliminated and believe any public school in Minnesota should have the opportunity to seize both the opportunities and obligations of being a charter school.

Another route to a similar end was permitted by the most recent contract negotiated between the Boston School District and Boston Teachers Union, which authorized the creation of a limited number of what are called "pilot schools." The intent of the agreement was to allow less-regulated schools to be created out of existing public schools, creating a more level playing field with charter schools that were then beginning to emerge in Massachusetts. Such "pilot schools" operate outside the district's master contract and are site managed and funded and allowed to seek waivers from burdensome rules and mandates. To implement a pilot school experiment in Minnesota, school districts should be specifically authorized to enter into such agreements, with necessary attention to allowable waivers from state collective bargaining and other employee relations and employee benefits laws.

Encourage an expansion in the supply of public charter schools.

d. **Lift the current statutory limit of 40 charter schools.** Although this cap has been raised several times since the charter law was first adopted, it contributes to a general climate that limits rather than encourages school choices.

e. **Amend Minn. Stat. 120.064 Subd. 4(a) to permit charter schools to be proposed and operated by teachers who are not licensed.** (This step will require a change at Subd. 11, which defines teachers by reference to Minn.Stat. 125.03, Subd. 1, and further limits teachers to persons who are licensed.) The fundamental premise of charter schools is that the school is accountable to the chartering authority for educational results, not inputs. The restriction on teaching personnel is a barrier to the supply of new education options. A more appropriate way for the State to ensure quality is to monitor how well students are learning.

f. **Authorize the state board of education and/or a specially created state charter school agency, as well as any public post-secondary education institution operating in the state, to charter schools** without any prior role for the school board in the area in which the proposed charter school is located.

Current law limits the charter role of the state board of education to handling appeals of proposals that have been denied by a local board. And the 1995 Legislature, while creating a new role for public colleges and universities as charter authorities, limited that authority to three such institutions.

g. **Empower and fund the state Department of Education or a new state chartering agency to provide more proactive support of charter proposals** through a program of technical assistance, planning and start-up loans, revolving loans, research and development of model, results-oriented contracts, and general public awareness initiatives.

Expand or maintain other education options.

h. **Preserve and enhance the Post-Secondary Enrollment Options program.**

i. **Remove current obstacles that now prevent parents and students from making full use of the Open Enrollment program.**

j. **Experiment with a variety of approaches to provide families with additional education choices and stimulate new models for cost-effectively meeting the public interest in education.**

The concept of education vouchers—particularly vouchers that permit students to choose private schools—has recently emerged to the forefront of the educational debate.

The Citizens League has long argued that a service need not be wholly owned or operated by the government to be a public service. What makes a service "public" is that government ensures the service is provided, determines the results it must achieve, sets the basic framework of rules within which it is delivered, arranges for financing and pays for all or part of the cost.

We believe that the object of public education is the citizen or the person, not the district or school. Thus, for example, we have called for attaching the funding entitlement to *students*, not to school districts, with a requirement that per-pupil aid and levy follow the student to the school site he or she attends.

We have further argued that competition and other market forces should be used to align institutional self-interest with the public interest (Principle 2). In other words, education *institutions* should face real financial consequences if they fail to deliver value to *students*, their customers. The League has also urged that government meet more public responsibilities through non-governmental communities in which people already have relationships of mutual obligation (Principle 4). Such communities can often achieve public purposes—including education—at much lower cost than formal, professional bureaucracies can.

Finally, we have recommended that the *public* interest in education be ensured through performance-based contracts that every school must have with an appropriate public policy entity.

For these reasons, we believe Minnesota should consider ways to allow currently non-governmental schools to become part of the system for meeting the public interest in education. Vouchers should be considered as one potential element in an overall reform strategy. We also stress that vouchers should not be the sole focus of education reform, or even the centerpiece of a reform effort. (We should note, however, that while this recommendation represents the view of the majority of our committee members, Todd Otis and Pam Neary dissented.)

State policymakers should begin the process of experimenting with vouchers by clarifying the objectives of any program that would be implemented.

The public purposes of a voucher program should be to (a) enable Minnesota to reduce the growth of public education spending over time while maintaining or improving education outcomes, and (b) to improve the fairness of the state's K-12 education system, while maintaining or reducing its cost to taxpayers.

The Governor, Legislature and education leaders should not view vouchers as a yes-no proposition. An education voucher program can be structured in a wide variety of ways to respond to equity, efficiency and community concerns. Appropriate concerns to address when designing a voucher program include:

- What will be needed to ensure that the public interest is being served by non-governmental schools, without introducing the mandates and bureaucratic controls that have often stifled public schools?

- How should the program be designed to preserve the incentive on private schools to seek private financial support and maintain low cost structures?

- How should the voucher system be designed to meet the goal of controlling the overall growth in education spending?

- How should a voucher system be linked with other comprehensive reforms in existing public schools? (In other words, how do we free up public schools to provide some of the same attractive features that private schools can now offer—and not just threaten public schools with competition while leaving their hands tied?)

The Governor and Legislature should implement a program to test vouchers in a limited number of school districts and for a limited number of students. This would allow the opportunity to evaluate the impact of such a program on both public and non-public schools, determine demand, evaluate impacts on student performance, and determine what size voucher is appropriate. It would also cost the state a fixed and limited amount of money to implement.

In general, we think that a voucher program should:

- **Require participating non-public schools to meet certain basic requirements of public education** (perhaps similar to the requirements now made of charter schools). The requirements must be minimal in order to avoid the constitutional prohibition against encroachment—for example, accepting all applicants the school has room for; not discriminating on the basis of race, sex, disability, etc.; not charging tuition to the voucher-funded students beyond the level of public funding; ensuring financial reporting and accountability; meeting the state graduation rule; and having a performance-based contract with an authorized public agency, covering the publicly-funded students it serves.

- **Provide funding to individual families, who themselves choose which schools their children attend, and not provide aid to schools directly.** The purpose of a voucher program is to broaden choices for families and stimulate system improvements, not to support certain schools. (This mechanism also addresses the legitimate concern about the constitutionality of voucher programs that include religious schools. Such vouchers are more likely to pass Constitutional muster if religious schools benefit only through the independent choices of parents.)

- **Include private schools at the same time that other reforms are implemented to have funding follow the student to the *public* school site he or she selects,** and which provide the *public* school site with meaningful authority (see Recommendations 1 and 2).

- **Have the voucher amount be large enough to put providers at real financial risk**—the key to stimulating system-wide improvements.

- **Ensure that the program meaningfully expand choice for those who can least afford it now.**

- **Encourage new models for linking the opportunities available to students among existing "public" and "private" schools.** For instance, a student at a public school might enroll in a certain class at a private school that is not offered in his or her own school site. Or a private school could become the traditional alternative in a menu of school options. Or private high schools could be added to the options available to all high school students, public and private, in the Post Secondary Enrollment Options program. All these new configurations would require legislation, we presume.

1. **The Legislature should require school districts to ask their voters, in a general-election referendum, whether to permit their students to use per-pupil aid and levy to purchase education options from currently non-governmental providers.**

5. **Empower parents to be good consumers of education. Provide reliable information about the performance of schools and programs.**

   a. **Look for ways to make the "price of education" more visible to consumers.** For example: Require districts to report to parents and taxpayers the amount of resources allocated to each school site. Require each school site to inform parents annually about the per-pupil amount of aid allocated to the school on the student's behalf. Inform people via the Truth in Taxation forms about the amount they are "spending" in taxes and the total amount, with state aid, of per-pupil spending in their districts.

   b. **Create an independent state-level function to conduct annual assessments of Minnesota students' academic performance.** The Legislature should ensure that the education system is not the sole evaluator of its own performance. The independent assessment would enable Legislators and the public to answer the question: How well are our students learning? The assessment need not be conducted on the total population of students each year—a costly proposition. Careful sampling by student characteristics and geographic location, reported at different levels of aggregation, can provide useful information at less cost.

   c. **Conduct "best practices" reviews of educational programs.** Minnesota's "best practices" law (Minn. Laws (1994) Ch. 632, Art. 3, Sec. 15) empowers the legislative auditor to examine the procedures and practices used to deliver local government services, identify practices to save money or improve service effectiveness, and make recommendations to local governments. The law can and should be interpreted to include educational programs and services—special education, mathematics instruction or transportation, for example.

   d. **Create a process for measuring, rewarding and publicizing *improvement* of schools.** Such a program would measure a school against itself and reward relative progress toward meeting education outcomes (see: Educational Policy Transition Committee Report, State of Maryland, 1995). The process recognizes that schools face widely varying conditions, including family, socioeconomic and other conditions, that affect student achievement, and that the state has a stake in learning from and rewarding significant progress, whatever the starting point. The rewards to the "most improved schools" could include awards, public recognition, dissemination of information about *how* the results were achieved in a "best practices" system, or small financial awards.

e. **Empower the state department of education to establish a proactive program to provide widely accessible information** on school choices, beginning with schools operating in the Twin Cities metro area. Encourage private organizations such as neighborhood associations to also provide information about schools to their constituents.

OTHER ISSUES

The reforms we outline here, if implemented, change the geography of education. In the current system, school districts can ask their constituencies for "extra" money beyond the state aid and state-mandated local levy. And school facilities have been authorized and paid for by local districts. When dollars follow students to school sites, when the school *site* is the locus of spending decisions, and when families can choose from a broader range of options, several questions arise: Who builds the school facility? Who is asked to pay for it? Who decides where it will be located? The issues are complex and would require careful consideration.

State policymakers should provide opportunities for citizens to shape key elements in the reform plan. We are especially concerned that advice be sought from communities of color and low-income citizens, whose interests are too often overlooked by major educational systems. The Governor should convene advisory groups of leaders from the communities of color to advise on: the objectives and design of voucher experiments; the process for defining "improvement" in schools; and the process of informing the public about school choices.

Higher Education

30/30 Vision: Make students the customers

INTRODUCTION

Minnesota's current practice of appropriating 90 percent of its general fund monies for higher education to the two large systems fails to reward innovation and efficiencies in delivery of higher education. The following recommendations propose a radical change in Minnesota's approach to funding higher education. In this scheme, 60 percent of appropriated funds would go to students, who would be free to spend those funds at the Minnesota campuses the students believe provide the highest quality education. Increased emphasis would be placed on performance-based funding for the University of Minnesota and the Minnesota State Colleges and Universities System (MnSCU). Support for the state's long-term economic growth would be enhanced through increased higher education opportunities for more Minnesotans and through direct appropriations to support research in sectors vital to the state's economy.

CURRENT AND FUTURE TRENDS

- State general fund support for higher education between 1987 and the 1996-97 biennium has declined as a percentage of general fund expenditures from 15.8 percent to 11.8 percent.

- Between 1985 and 1995, tuition and fee increases exceeded increases in Minnesota per capita income adjusted for inflation. Constant-dollar per capita income grew by 13 percent, while constant dollar tuition and fee increases ranged from 17 percent in the community colleges to 55 percent in private colleges.

- Approximately 90 percent of state general fund appropriations for higher education are made to the University of Minnesota and MnSCU systems. Approximately 10 percent is appropriated for student financial aid.

- In 1994, the Minneapolis/St. Paul metropolitan area accounted for 46 percent of high school graduates. By the year 2011, the Twin Cities share will increase to 56 percent. The total number of statewide high school graduates will increase from approximately 52,000 in 1994 to 68,000 in 2008.

- Nonwhite 15-24 year olds accounted for 7.5 percent of Minnesota's population in 1990, but the share is project to increase to 19 percent by 2020, with the most rapid increases expected in the metropolitan area.

- According to the 1994 State Survey, 70 percent of Minnesota adults plan to pursue some type of learning opportunity in the next three years, compared with 43 percent of Minnesotans who said they used learning opportunities in the preceding year.

- There is a substantial geographic mismatch between post-secondary education opportunities and concentrations of population. Fifty-three of the state's 66 public post-secondary campuses are located outside the metropolitan area. (All data above: Minnesota Higher Education Coordination Board.)

THE PROBLEM: WHY INCREMENTAL CHANGE WON'T BE ENOUGH

These trends—declining per-student appropriations, rising tuition, and growth in the population of college-age persons—have disturbing implications for the state. Population growth implies increased spending just to keep per-student investment static. Budget pressures in the institutions imply continued, or worsening, pressure to raise tuitions.

At the same time, the population of people of color as a percentage of the college-age population is rising rapidly. High school dropout rates for students of color are appalling. People of color, who are disproportionately poor and low-income, face significant financial barriers to attendance—another pressure for increased spending, not reduced. Once enrolled, students of color are more likely to drop out for a wide variety of reasons, including financial reasons; only 31 percent of American Indian students, and 39 percent of African American students, were still enrolled full-time four years after entering four-year institutions (compared with 55 percent of Asian students and 54 percent of white students).

These population trends and the systems' poor performance with students of color and low-income students pose a human capital disaster for the state, aside from raising other important issues of equity and justice.

The political economy of the higher education system points to ever rising costs of operation—cost creep, maybe even galloping cost creep. But the political economy of state and national governments points to static or falling public spending for higher education.

Thus any list of "salami-tactic" cuts—close campuses, freeze salaries, or drop departments—would be non-strategic and pointless. Instead, recommendations must seek structural change in the political economy of the higher education system. Reforms are needed to recast incentives, priorities and accountabilities to spur self-generated cost control and quality improvement.

FIVE PRINCIPLES FOR BETTER VALUE: SUMMARY RECOMMENDATIONS

Principle 1. Target public subsidies directly to people who are financially needy. Under this proposal, need-based financial aid for low and middle income students would be nearly tripled, thus providing access to higher education opportunities for more Minnesotans.

Principle 2. Use competition as a tool to align institutional self-interest with the public interest. The scheme proposed here would place 60 percent of the state education funds in the hands of students and would force Minnesota higher education institutions to compete by providing high quality education services that meet the needs of consumers. In addition, efficiency and innovation would be fostered through competition to meet performance objectives within the two systems.

Principle 3. Allow prices of public services to reflect true costs, including the social costs of individual decisions. Tuitions would be allowed to rise to reflect instructional costs. These increases would be offset by the availability of increased state grants and lifetime learning grants appropriated to all Minnesota students.

Principle 4. Meet more public responsibilities through non-governmental communities in which people already have relationships with mutual obligation. The proposed system would include an extensive information, education and outreach effort, in partnership with communities that have the trust of low-income students and students of color.

Principle 5. Consider long-term economic growth to be one of the objectives of state spending. The renewed commitment to producing well-educated post secondary graduates to lifetime learning, and to funding necessary research will maintain and vitalize Minnesota's economy.

DISCUSSION

The 1996-97 biennial appropriations for higher education continued to be provider-driven, not consumer-driven. Approximately 90 percent of the $1.1 billion appropriated will go to the two large public systems to operate the state's 66 traditional campuses. Only 10 percent of the general fund appropriations will go to students for direct financial assistance. The legislature rejected a proposal to create an independent commission to evaluate the feasibility of closing inefficient, low quality or under-enrolled campuses in order to shift scarce resources to high quality institutions better able to meet future demand for higher education services, including the provision of more technology based post-secondary learning opportunities.

State appropriations, on a per-student basis in constant dollars, will actually decline in the coming biennium. The increasing demands for state spending on K-12 education, social services, and criminal justice have reduced the state spending commitment for higher education at a time when demand for post-secondary education opportunities is increasing. The result of this trend is that state government has adopted a *de facto* high tuition policy, most recently evidenced by the announcement of a 7.5 percent per year tuition increase at the University of Minnesota.

The Legislature has rejected the opportunity to support significant new technological initiatives in higher education in order to support traditional institutions and faculty. While appropriations were provided to continue to expand the Learning Network of Minnesota, the legislature rejected proposals to create an open learning institution and a consortium to develop alternate delivery methodologies.

To maintain higher education opportunities, particularly for low- and middle-income students, increased resources must be made available *to students* through financial aid programs to meet the state's higher tuitions. Proposed changes in federal support for financial aid programs will increase the financial burdens on low and middle income students and will exacerbate the growing problem of inadequate access to post-secondary educational opportunities.

IMPLICATIONS OF FEDERAL CUTS

Higher education has already experienced reduced per-student appropriations for the 1996-97 biennium. Further growth in the budgets of other state programs—the likely response to expected federal reductions in those programs—would further erode state support for higher education, would adversely impact education quality, and could jeopardize the success of the merger that resulted in the formation of MnSCU.

The most immediate concern is the potential effect of proposed federal reductions in student financial aid programs. While it appears that there will be no reductions in Pell Grants, proposals to eliminate in-school interest subsidies for Stafford Loans would cost Minnesota students approximately $32 million per year (Minnesota Higher Education Coordinating Board). Such increased costs would act as a significant additional barrier to the pursuit of post-secondary education by low- and middle-income students.

The Minnesota Legislature should not automatically assume responsibility for the cost of budget reductions at the federal level. However, the Legislature should consider access to higher education to be one of its major policy imperatives. And ensuring access will be harder to do if federal support for financial aid is reduced.

THE 30-30-30-5-5 APPROACH: FUNDING LEARNING FOR STUDENTS

The central recommendation of this report is that, consistent with the "Five Principles for Better Value," the state appropriations process should shift from supporting existing public higher education *systems* to funding learning opportunities for *students.*

Action steps:

1. **Beginning with the 1998-99 biennial budget, the current general fund appropriations ratio of 90 percent to systems and 10 percent to financial aid should be replaced with a new system that provides a majority of the appropriated funds directly to students, who would be free to spend those funds at the Minnesota higher education campuses of their choice.**

   As an example of this new funding approach, a new 30-30-30-5-5 formula could be used to allocate general fund appropriations in the following way:

   30 percent appropriations to systems. The state has a substantial public interest in maintaining a basic post-secondary educational infrastructure. Thirty percent of the state's total appropriation to higher education would be appropriated to the U of M and MnSCU for this purpose. A portion of this appropriation should be in the form of incentive funding tied to specific performance objectives.

30 percent "lifetime learning grants" to all Minnesota students. The state has a compelling interest in educating all of its residents. Thirty percent of state appropriations would be used to fund grants to be given to all Minnesota high school graduates and all adult learners. These learning grants would partially replace the taxpayer subsidies which are currently appropriated to the two systems. Each high school graduate could, for example, be given a grant worth $10,000, of which no more than $2,000 could be expended in any given year. The amount of the grant would follow the student to a particular post-secondary institution, either public, private or alternative. Thus, the dollars would follow the students to campuses that offer quality programs. A formula or methodology will need to be devised to make grants available to graduate students and adult learners.

30 percent need-based financial aid. These funds would provide substantially increased assistance to low income students expanded eligibility for lower-middle- and middle-income students, in two ways: (1) by increasing the share of the state's total appropriation that is provided in need-based aid; and (2) by adopting the changes in eligibility requirements recommended by the Doermann report on higher education financing. Those changes included raising the Living and Miscellaneous Expense Allowance from the current $4,115 to $5,500 and defining the student share at 40 percent (rather than the current 50 percent). Continued eligibility for financial aid would be contingent on the student's satisfactory performance.

5 percent research. The research provided primarily by the University of Minnesota has been vital to supporting Minnesota's economy. This research component should by separately identified and fully funded to assure that the research conducted by Minnesota's higher education institutions continues to remain a valuable economic development tool for the state.

5 percent new higher education initiatives and technologies. These monies would be available to fund new initiatives and new technologies in delivering higher education services. As examples, an open learning university could be created; development of new alternative learning technologies could be funded; collaborative programs among various institutions could be supported; new entrants into the higher education market could be funded; or information centers, either publicly or privately operated, could be established to provide students with information about higher education alternatives.

Under the current funding system, declining resources are allocated by the Board of Regents and the MnSCU Board among all of the existing campuses, thus assuring a slow but inexorable decline in the quality of education at all institutions. The 30-30-30-5-5 approach, by assuring that a majority of the funding ends up at campuses that are successful at attracting students, could result in the closing of inefficient, lower quality or under-enrolled institutions. The appropriations to create an open learning university could include the development of 50 to 75 technology learning centers around the state, offering post-secondary education programs through distance learning and technology-based education. This system would be modeled after the Maine system, and, while campuses would close, would actually increase public access to higher education opportunities.

2. **The Legislature should require the Higher Education Service Office to develop and plan for communicating the new financing system to the public.** This step is critical to ensure that citizens understand that Lifetime Learning Grants and substantially increased financial aid will be available to offset the tuition increases that will be the most immediately visible result of the change.

   The State should implement the communication/information plan in partnership with communities, perhaps contracting out certain responsibilities to community organizations that serve low-income people and people of color.

OTHER LONG-TERM RECOMMENDATIONS

1. **The state should establish incentives for students and their families to save more for higher education.** For example, a Learning Savings Account could be established for each student, the earnings from which would be free from state tax. These savings accounts could match the Lifetime Learning Grants appropriated by the state. The existence of such a savings account for a student would not count against the student's eligibility for financial aid. Since the objective of the learning savings accounts would be to provide educational opportunities for Minnesota students, the proceeds could be used at any higher education institution, inside or outside of the state of Minnesota. As an alternative, parents could be allowed to purchase Series EE United States Savings Bonds with their income tax refunds exclusively to help finance higher education for their children.

2. **A substantial portion of the funds appropriated to institutions should be distributed on the basis of performance on state policy goals.** By putting 60 percent of total funding into the hands of students, our proposal builds in a process for prodding institutions to provide the outcomes that *individual students* seek. Another form of accountability is needed to track performance on those outcomes that pertain to the interests of the *state as a whole.*

   Ultimately, Legislators and other policymakers must be able to answer the question: Is higher education delivering the outcomes the state seeks to "purchase" through its legislative appropriation? To answer the question, policymakers must define what outcomes they expect the higher education system to produce. Then, the state will need a robust set of outcome measures that gauge the effectiveness of institutions in delivering the outcomes. It is important that the focus be on outcomes (for example, skill levels of students completing programs) and not on inputs (qualifications of entering students) or process measures (student-faculty ratios).

   The sensitive task of composing and defining an initial set of outcome measures should be addressed soon. Such measures should be shaped by professional educators, but also by a broad spectrum of higher education users and anticipated users. Especially solicited for their views should be citizens from sectors with relatively few post-high school students in the past, but with increasing numbers expected in the future. Among such sectors are communities of color, new immigrants, young adults from low-income families, older adults with needs and wants in "lifetime learning" and citizens without English as their native language or America as their mother culture.

   Action step:

   a. The Governor and Legislature should convene and staff a panel of such groups in the fall of 1995, to draft and propose higher education outcome measures to the Legislature.

3. **All of the principals in the higher education enterprise should be accountable for performing their respective responsibilities.** The governing boards should be empowered to govern the systems; administrators should have the authority to effectively operate campuses; and faculty members should be free to provide quality learning opportunities for students.

Action steps:

a. The Legislature should establish clear statements of policy and performance indicators in making appropriations to the systems, but should refrain from attempting to micro-manage system operations.

b. The MnSCU Board of Trustees, not the Department of Employee Relations, should be required to negotiate and approve all contracts with faculty.

c. All faculty contracts should be related to the performance indicators and policy purposes identified by the Legislature making the appropriations.

d. A system of merit increases should be reinstated to recognize individual and team excellence in delivering higher education services.

CONCLUSION

These recommendations, while controversial, would ultimately lead to improved learning opportunities for students and improved efficiencies and cost-effectiveness for Minnesota's higher education systems, which ultimately would enable the state to provide its residents with more and better higher education services at lower cost.

Aid to Local Governments

The "ABCs" of accountable and efficient local services

INTRODUCTION

Minnesota's current property tax system scores poorly on accountability, equity and efficiency grounds. Its many complex aid formulas are poorly designed, wasteful and confusing. Its classification system creates excessive disparities that lack a clear rationale and, worse, undermine local accountability.

Too few taxpayers, administrators, and even policy makers understand how the system works, what factors affect the tax and how, and who's responsible for changes in tax liabilities. This lack of understanding breeds taxpayer suspicion and cynicism, and allows the system to be manipulated by the few who understand it. Taxpayers are unable to provide the important oversight function that we depend on for intelligent, accountable local decisions.

All of this has produced an upward spiral of local spending, state aids, state taxes and local property tax levies that cannot be sustained.

PROBLEMS WITH THE CURRENT SYSTEM

The specific problems with the state and local governments are well-known. They have been documented by studies dating back to the 1960s. Here they are presented in the context of the Citizens League's "five principles for better value" in public services.

Principle 1. Target public subsidies directly to people who are financially needy.

Needy people do not do well under our current system. State funds are not targeted to them and, through classification, many other property owners pay a property tax surcharge ostensibly to help needy taxpayers, but much of the benefit accrues to middle- and upper-income owners of lower-value homes.

Of $1 billion in annual undesignated state aid for property tax relief, only $150 million is means-tested through the circuit-breaker (Property Tax Refund) program, which provides property-tax refunds directly to individuals based on the relationship between the individuals' incomes and property-tax liabilities.

To the extent that the remaining general aid reduces levies, relief is provided to all property owners, many of whom are not needy.

Classification has been used as a means to protect low-income homeowners from the full impact of local spending decisions. This policy uses home value as a proxy for income and provides the greatest relief to first-tier homes (homes with most of their value in the one percent, $72,000 tier). However:

- This approach to property tax relief ignores the fact that many middle and even higher income taxpayers live in lower-valued homes.

- The policy applies the same $72,000 standard to all parts of the state, even though median home values vary dramatically statewide.

- Besides distorting relationships between classes of property (Minnesota has the most classes and highest class disparities of any state), the use of classifications constitutes the least efficient way to help low-income people. As a policy instrument, it is simply too blunt. Alternatively, the circuit-breaker offers a way to target dollars to needy taxpayers while facilitating more meaningful "tax-prices" for others. It is the correct way to deal with the equity problems of the property tax and to strike a balance between equity and efficiency.

- Classification also distorts the spatial distribution of state aids because it creates an arbitrary definition of local property wealth that is used to direct more aid to places with relatively more first-tier homes, regardless of their real ability to pay taxes (perhaps better measured by resident income).

Principle 2: Use competition as a tool to align institutional self-interest with the public interest.

In general, our current approach to the state and local relationship has been to empower local governments with exclusive state franchises and direct state appropriations. Combined with our current approach to aid design and classification, these franchises encourage local jurisdictions and their residents to demand more state aid and frequent system changes to accommodate growing local spending demands. State protection has become a substitute for local accountability. We need to introduce a form of competition in the provision of public services to break this dependency and increase accountability. This can be accomplished by changing our approach to state aid, providing relatively more to taxpayers through means-tested programs and relatively less directly to jurisdictions. This arrangement results in more direct competition for taxpayer dollars and creates a healthy stress between public and private uses of disposable income.

Principle 3: Allow prices of public services to reflect true costs, including the social costs of individual decisions.

Minnesota's spending on local aid and property-tax relief masks the true "price" of local service. When prices seem low, consumers usually demand more service. The current system suppresses the pressures that would ordinarily prompt taxpayers to weigh service-spending tradeoffs and demand efficiency. When aid is provided to individuals rather than institutions, the prices people face reflect the true cost of the local services they buy. Individuals have a greater stake in local budgeting decisions.

Principle 5: Consider long-term economic growth to be one of the objectives of state spending.

As currently structured, Minnesota's property-tax relief and local aid program gives subsidies to people who don't need them and fails to reward efficiency in the provision of local services. In short, the system wastes money. It consumes resources that could—and should—be spent on productive activities or long-term investment.

THE "ABC" REFORM PLAN

The "ABC" reform plan attempts to simplify and standardize many features of the property tax and aid system, increase accountability, use state funds more efficiently and raise the state's share of K-12 funding and other state mandates.

At the center of this proposal is a standard categorization of state and local funding responsibilities that is applied to cities, counties and school districts alike. This plan provides a consistent rationale for state aids and clarifies the responsibility for local tax levies.

A central feature of this plan is that certain services are defined as state-level responsibilities and are funded by state-level sources. The state source may be a statewide property tax. However, the statewide revenues could come instead (or in addition) from state income or sales taxes. The choice of revenue source will obviously affect different groups of taxpayers differently. However, whether the statewide source is income, sales or property taxes is less important to the ABC plan than simply clarifying the state and local responsibilities for different services.

ELEMENTS OF THE PLAN

All funding falls into three groups (ABC). Spending for schools, cities and towns, counties, and even special taxing districts is grouped as follows:

LEVEL A
Basic Service Funding
100% state funded with statewide property taxes and other state revenue sources.

Definition: This is the package of services that the state determines to be of compelling state interest and for which the state assumes funding responsibility, at basic service levels considered to be minimally adequate. The specific level of state funding and the state/local share of spending will be different for cities, counties and schools. Local services deemed to be of no compelling state value are not part of the basic service package.

Level of state funding: State funding is determined using best-practices cost estimates for a package of basic services. Examples are:

- **Schools:** Level A funding might be $3,250 per pupil or other relevant number representing the cost of providing some basic package of educational services. For Level A calculations, each student is given an equal weight. Cost differences associated with student characteristics are recognized in Level B funding described below.

- **Cities and Counties:** For counties, Level A funding might be based on a flat dollar amount per capita, since basic county services are oriented to individuals.

  For cities, Level A funding might be a flat dollar amount based on the number of households—probably a non-linear function of households. The specific nature of the services constituting Level A will provide more guidance on the household vs. population question. Special adjustments for cost factors outside of the control of local officials are recognized in Level B funding. The effects of "changes" in the number of households for cities experiencing rapid growth or decline, crime rates, and the age of the household stock are examples of such factors.

Source of funding. Level A funding is provided from a statewide property tax levied on all taxable property, and other state revenue sources. Statewide property taxes should ideally be levied on market value. However, initially Level A and B services would be funded with property taxes using the existing classification system, with future A and B revenues and all current and future Level C revenues levied on market value. Retention of the current classification system for the initial statewide levy reflects the judgment that, in the short run, it would be difficult to radically alter the classification without creating politically unacceptable shifts in state taxes and aids.

However, the state must begin the process of eliminating classification now, and the phase-out of classification must be an ironclad commitment of state government. Accordingly, **we recommend that the Legislature pass a Constitutional amendment requiring that all increases in state and local property-tax levy, beyond the initial design amount in the ABC plan, be distributed on the basis of market values, not tax capacity.**

LEVEL B
Categorical Funding
100% state-funded adjustments to basic service payments provided by statewide property taxes and other state revenue sources.

Definition: This spending relates to certain cost factors outside of local control that raise the cost of providing a basic package of services. For schools, the cost factors may derive from the attributes of students or from certain community problems. Certain cities may face costs associated with higher crime rates, or a host of other factors.

To the extent that these factors are not recognized in Level A cost calculations, they are funded with Level B categorical aid. Use of these aid programs allows the Level A aid formulas to be simple and understandable.

Source of Funding: Level B funding is provided from state general funds. Possible sources include spending reallocations, existing state general tax fund revenues, and a statewide property tax.

LEVEL C
Local Preferences Funding
100% locally funded from property taxes and other existing local revenue sources.

Definition: Local service add-ons are services or service levels deemed desirable by the community, but of no compelling state interest. With basic service Levels A and B fully funded with state aid, there is no case for state assistance in funding these add-ons. (For example: If the state provides 100 percent funding for a best-practices level of fire protection, and categorical adjustments for special needs, a local community would have to raise its own revenues to support a "luxury" level of fire protection service beyond the state-funded level.)

Source of Funding: Level C funds are raised from local property taxes, *without classification.* Spreading the full amount of all such levies on market value will greatly enhance local accountability.

Though a case might be made for other forms of local taxing authority such as local income or sales tax, no such authority is recommended.

SCHOOL FUNDING

School funding deserves special attention. Among the set of state mandates for local government, the state constitutional mandate to provide a general and uniform system of public education is the most urgent.

The appropriate level of state financial involvement is the subject of much debate. Some argue that a higher state share is necessary to fulfill the constitutional mandate. Others call for a higher state share simply as a means of reducing the property tax burden.

In general, a higher state share is associated with a greater potential for equalization, but also a greater concern about the local accountability and control.

Within the proposed ABC framework of funding, appropriate classification of Level A and B responsibilities would lead to the appropriate share of school funding. Recent work by the Commission on Education Reform and Accountability (CERA) suggests that an increase in the state share is warranted, not just for property tax relief, but as a matter of state responsibility.

Lacking a definitive determination on an appropriate share, we expect that the state share of K-12 school expenses will increase to at least 75 percent (though there is some sentiment in the subcommittee that the share should go as high as 100 percent). Initially, the increase in state share must be matched by a dollar-for-dollar reduction in the Level C, local levy component. To the extent that there continues to be a Level C funding component, however, it does not follow that the state should prospectively increase its funding as local school levies rise merely to preserve the percentage.

How should the increase in state share be paid for? Each percentage point costs about $50 million. An increase to 75 percent would require an increase of $700 million in state education aid (to Level A and/or Level B).

The increase in the state's share should be provided from the following sources:

a. Reductions in city or county Local Government Aid (LGA) and Homestead and Agricultural Credit Aid (HACA).

b. Extension of the sales tax base to additional final consumption.

c. Adjustments to the statewide property tax.

We further insist that the increased state funding for K-12 spending be contingent on the enactment of substantive school finance and operational reforms as recommended in the K-12 section of this report. Unless these reforms are adopted, we do not recommend raising the state share of K-12 funding above the current 61 percent.

We should also point out that the education reforms we recommend—such as site-based management and broadened school choice—have important implications for how funding flows. State policymakers should be prepared to ask whether state support of Level A education services should continue to be directed to school districts, or whether some other unit, such as a county or city, would be more appropriate.

IMPACT OF THE ABC PLAN ON CITIES AND COUNTIES

City Funding: Corresponding to the rise in the state share of school funding, there will be a reduction in the state share of city spending. We anticipate that cities' LGA and HACA will be reduced substantially as a result of the ABC calculations. In the first year of the ABC reform, cities might want to raise their property tax levy by the amount of lost LGA and HACA aid to cover current Level C services or service levels. This will raise the city share of the total property tax levy, bringing the property tax levy more in line with the costs of servicing property, a change most taxpayers would understand and support.

County Funding: Conceptually, the ABC plan treats county funding the same as city and school funding. However, special consideration needs to be given to the specific relationship counties bear to state government. To a large extent, counties are administrative agents of the state with many service mandates, many of them less than fully funded.

In theory, state mandates by definition constitute Level A state funding obligations, with Level B funding being used for categorical adjustments not recognized in Level A amounts.

For counties, Level C funding is associated with optional, non-mandated services not considered part of a basic package of services that most counties provide, plus locally enhanced levels of service associated with state mandates.

Because of the large amount of unfunded mandate spending, the initial state funding of Levels A and B may not completely reflect the full cost of the state obligation. However, ideally, over time, these should be fully funded by the state.

OTHER ISSUES

The ABC plan undoubtedly will raise a number of issues we have not considered, much less resolved. We are confident that many of these will be only transition issues. As with many comprehensive reform plans, many unanticipated issues and defects surface as more information about the plan's impacts and implications are determined. These issues can be resolved as they arise.

In the context of the ABC plan, attention must be given to the treatment of tax increment financing (TIF), city redevelopment spending, fiscal disparities, truth-in-taxation, and the use of property tax refunds as a substitute for local government aid.

- In the case of **tax increment financing,** it may be necessary to disallow district recertification for purposes unrelated to their original intent; prohibit the TIF dedication of the tax base associated with the statewide levy; provide special transitional categorical aid for existing TIF debt service; and, prospectively, to restrict TIF to the city tax base, leaving school, county, and state tax bases unaffected by the creation of new districts.

- The issue of **city redevelopment** will need special consideration in the ABC plan, and is ultimately part of a much larger consideration of the state's obligation to provide for the unique financial needs of its urban areas. To what extent should the costs of urban redevelopment be factored into the property-tax system, and to what extent should these responsibilities be funded through direct appropriations? Within the local aid system, one must decide if such expenditures are part of the basic package of city services funded in Levels A and B; is city redevelopment a Level B categorical need? These are essentially political and budget decisions. What services ultimately are considered as Level A or B state obligation is not as important as the discipline imposed on prospective funding once these decisions are made.

- The current metro area **fiscal disparities** program is not inconsistent with the ABC plan. The ABC proposal simply provides a better statewide rationale for state aid.

- Under the ABC proposal, **truth-in-taxation** meetings can focus on the local property tax levy. The statewide property tax levy will be more clearly defined and understood. Taxpayers will know that local officials are fully responsible for the local levy only.

- Finally, though no dramatic increase in the **property tax refund** is initially proposed, such an increase would not be inconsistent with the ABC plan if Levels A and B are fully funded and additional property tax relief funding is available. **All future state attempts to provide property tax relief not associated with appropriate Level A and B funding should take the form of circuit-breaker or other means-tested payments to taxpayers.** "Buydown" aid should be prohibited. When Level A and Level B services are fully funded with state revenues, there is no longer any justification for further jurisdictional relief.

SOURCES OF STATE SAVINGS

The ABC plan does not automatically yield immediate savings; it simply rationalizes the system of local aid. Any immediate savings would be gained as a result of the choice of services included in Level A and what is defined as the cost of these basic services. **Over the long-run, however, the ABC proposal can be expected to control the growth in spending and improve value for spending.** The state currently spends about $5 billion in state aid each year, much of it with inadequate attention to efficiency and equity. With better local accountability and more need-based aid programs, annual state savings of several hundred million per year would not be unlikely.

SUMMARY OF RECOMMENDATIONS

1. Adopt a three-level plan (ABC) for state funding of cities, counties, school and other taxing districts.

    - Level A "Basic Services" comprises a no-frills package of basic services, priced at the best-practices cost of providing the services, without adjustments for specific categorical needs. These basic services are 100 percent state funded from a statewide property tax on all property and other state revenue sources.

    - Level B "Categorical Funding" provides state aid for local costs arising from factors outside the control of local officials that are not specifically recognized in Level A funding calculations. Level B is also 100 percent state funded from the same sources as Level A.

    - Level C "Local Preferences Funding" stems from local decisions to enhance services beyond the basic level or to provide services that are not part of the basic package of services associated with Levels A and B. Level C services are 100 percent locally funded with property taxes and other currently authorized local revenue options.

2. Move away from the current classification system and toward levies on market values.

   - The statewide property tax associated with Level A and B initially uses the existing classification system to spread levies. The local property tax of Level C is initially and prospectively spread on market value, not tax capacity.

   - A Constitutional amendment should be passed requiring that all increases in levy beyond the initial amount associated with the implementation of the ABC proposal are spread on market values, not tax capacity.

3. No new local revenue options are recommended.

4. The ABC system should include school district funding.

   - Pending a specific calculation of Level A and B state responsibilities, the state share of K-12 funding is expected to increase to at least 75 percent. The increased state share should be financed by reallocating city LGA and HACA to schools, broadening the sales tax base to final consumption items, and/or adjusting the statewide property tax (with no particular priority among the three options specified).

   - All state spending increases associated with K-12 funding should be contingent on the enactment of significant finance and operational reforms within the school system.

   - Increases in the state share of K-12 funding must initially be matched by an equal reduction in the school levy. Prospectively, state funding should be increased or decreased as the costs of providing for Level A and B increase or decrease. State funds for education should not be increased simply to preserve a given state share of school spending.

4. The ABC system will have several effects on cities and counties:

   - The state share of city funding is expected to fall as the share of school funding increases.

   - Cities may wish to levy back all aid reductions in the first year of reform.

- County program mandates promulgated by the state should eventually be fully funded to the extent they appropriately fall within Levels A or B.

- Related issues such as TIF, city redevelopment, metro fiscal disparities, truth-in-taxation, and the future use of means-tested aid such as the circuit-breaker need careful reexamination in the context of the ABC proposal.

CONCLUSION

Long-term savings from an ABC plan could be substantial if the current upward spiral of levies and state aid is broken by targeting aid more carefully to individuals and communities who need it, giving taxpayers clearer signals about the cost of government services, and clarifying who is accountable for spending.

Capitate, deregulate, and encourage community options

INTRODUCTION

Health care is an enormous and fast-growing spending commitment for Minnesota. Solving the state's long-term budget problem is first and foremost a matter of solving the problem of health-care spending. Fixing the health-care spending problem is largely a matter of reforming the system of long-term care.

- During the past 10 years, non-inflation adjusted spending on health care (Medical Assistance and General Assistance Medical Care) has tripled.

- Health care is projected to grow faster than any other major spending category between 1994 and 2005; non-inflation adjusted spending is expected to grow from $1.3 billion in 1994 to $5.8 billion in 2005. Health care shows the single largest projected increase in spending among all major budget items, accounting for 35 percent of the total increase in spending between 1994 and 2005. And health care will consume an increasing share of Minnesota's spending—from 7.4 percent in 1994 to 19 percent in 2005, an increase of 11.6 percentage points.

- Why is health care spending growing so fast? A Department of Human Services analysis of the expected growth in spending between 1995 and 1999 found that 42 percent of the real growth in spending will be accounted for by rate increases and 40 percent by enrollment, with another 17 percent occurring for other reasons besides inflation. (All data above: Minnesota Planning.)

- Enrollment growth, in turn, has been and will continue to be driven by demographics, particularly the growth in the number of elderly, who consume a disproportionate share of Medicaid spending. In 1993, nearly half of the $947 million in Medical Assistance spending went to people age 65 and older (Within Our Means, p. 11). The 65-plus age group will increase by 348,000 between 1993 and 2020 (Within Our Means).

- Minnesota spends more than the national average on both nursing home and community-based care, but relies much more than other states on institutional care. (National Mentoring Project, Dr. Robert Kane, principal researcher, 1995).

- Minnesota continues to have one of the highest rates of nursing home use in the nation. In 1994, 7.6 percent of Minnesota's persons over 65 were living in institutions (*ibid.*). This rate compares with five percent nationally and three percent in Oregon, which has a well-developed system of community-based alternatives (Minnesota Department of Human Services, 1992). Minnesota's reliance on institutional care, combined with the growth in the number of elderly people, will help to drive increases in Medical Assistance costs. Nursing facilities are expected to account for 26 percent of the total growth in Medical Assistance costs between FY1990 and FY1997 (Minnesota Planning).

- Medical Assistance covers the cost of care for 63.5 percent of Minnesota's nursing home residents (Kane). In FY 1995, total payments for services to elderly in nursing homes and community-based care will exceed $913 million, about 90 percent of which goes to nursing homes (Long Term Care Commission, 1994).

Lawmakers are confronting tremendous pressure to bring Minnesota's state and local spending into balance with revenues. Health care spending is one of the culprits behind that budget pressure. Unfortunately, the Medical Assistance program also relies substantially on federal aid. The federal government covers 54 percent of the costs of Minnesota's Medical Assistance program (Minnesota Planning, *Line Item*, March 1995, p. 3).

Under the Congressional budget resolution, the growth rate in the Medicaid program will be limited to four percent per year through federal FY2002; as a result, the State of Minnesota will have $2.73 billion less Medicaid funding during this seven-year period (DHS, Health Care Administration Fact Sheet, July 31, 1995). Debate is now raging in Washington over the form of federal aid—categorical grants or block grants—and the possibility of capping the formula for the currently open-ended federal reimbursement for Medicaid. Minnesota Planning has cautioned that, depending on how much growth is allowed in a federal cap, "within a few years Minnesota could lose millions annually in federal funding for Medical Assistance" (Minnesota Planning, *Line Item*, March 1995, p. 6).

Our health care budget problems are bad enough on their own, and retrenchment in Washington may mean that a bad budget situation could get much, much worse.

THE FLAWS IN THE CURRENT SYSTEM

In this report, we focus on long-term care for the elderly, while recognizing that the budget pressures involved in long-term care for people with disabilities are at least as acute.

The problem of spending on long-term care will not be fixed by simply reducing payments to providers, adjusting eligibility slightly or trimming a few costs here and there. Spending on long-term care is out of control because there are fundamental flaws in the design of the system:

- Any fee-for-service system, including the current long-term care system, encourages providers to add services. That tendency spawns regulation and bureaucracy with all their attendant costs. When providers are not at financial risk, there is little incentive to do prevention and great incentive to overemphasize professionalized services.

  By contrast, capitation—providing a fixed amount of funding per-capita—encourages conservation, including the use of community and family supports that are typically less expensive, and prevention to avoid the need for complicated solutions later. The important role of the informal care system cannot be overlooked. Estimates suggest that the majority of all long-term care is provided by friends or relatives in homes and other informal settings (conversation with Dr. Robert Kane, professor, Institute for Health Services Research, University of Minnesota).

- When people aren't spending their own money, but instead are spending what feels like "somebody else's" money, they aren't as cost-conscious. Third-party payment systems shield people from the true cost of the health-care choices they make. When money is instead placed in the hands of consumers, consumers tend to demand that excess costs be eliminated.

- The system of publicly financing the majority of costs of long-term care for the elderly may be a disincentive to individuals to save, insure and otherwise assume responsibility for the costs of their own care.

Spending is also increasing rapidly because we are confronting demographic changes that are outside of our control:

- In 1990, the population age 65 and over was 548,933—12.5 percent of the state's population. The population is projected to grow to 675,370 in 2010, an increase of 23 percent. The number of elderly over age 85 is growing even faster and is expected to grow by 64 percent by 2020 (Long Term Care Commission). People over age 85 are heavy users of long-term care services.

Reform means fixing the system's fundamental flaws. Reform doesn't mean rationing. There is enough money in the system now to provide appropriate and, in many cases, superior services to the people who now qualify for them. No one need be deprived of care. It's a matter of designing the system to allow existing resources to be used best.

MINNESOTA NEEDS A REFORMED SYSTEM

Minnesota needs a dramatically reformed system for serving the long-term care needs of elderly and disabled citizens. The system must be one that orients health-care providers, individuals and communities toward prevention and conservation, rather than consumption of services.

The Citizens League outlined the features of a reformed system in 1993. In this new system:

- The state creates regional purchasing authorities that are responsible for managing the comprehensive long-term care system for their elderly citizens.
- The various sources of money for elderly care are consolidated and allocated to the regional authorities based on the population of elderly citizens in their regions.
- These regional purchasing bodies encourage the formation of competing health-care plans to serve seniors with a full and flexible range of long-term services, from home and community supports to acute medical care.
- Regulations are loosened to allow providers more flexibility in designing community-based services.
- Individuals choose the long-term care plan they prefer.

A capitated managed-care approach to long-term care for the elderly should lead to lower-cost services and better outcomes. Managed care models for routine and acute care have yielded significant savings over comparable fee-for-service systems. Where managed care is used most extensively, health care costs tend to be lower and the rates of increase slower. Of course, there is little information available to prove that a capitated, managed-care approach would offer similar savings in long-term care, since few such models exist. But the results in acute care suggest that economies are encouraged when incentives are aligned properly to encourage cost-effective use of resources.

The League has also recommended that other reforms be implemented to encourage individuals to take more personal responsibility for planning and providing for the costs of their long-term care.

Other groups have made similar recommendations to increase the system's flexibility and encourage community alternatives. The state's own Long-Term Care Commission recommended steps to consolidate funding and allow providers greater flexibility to use non-institutional care. The commission's recommendations led to the Long-Term Care Options project now underway. The project has secured demonstration waivers allowing the state to combine Medicaid and Medicare funding, thereby eliminating some of the conflicting incentives that encourage over-use of acute care facilities.

The Minnesota Legislature, in passing the Housing Services Act of 1995, also recognized that greater flexibility was needed in the system of long-term care. The Act covers senior housing arrangements, not including nursing homes. The central feature of the law is that it centers on the relationship between the elderly customer and the housing and services provider: The customer and the provider mutually agree on an individually-tailored package of services, rather than the government determining a standard package. Once the contract is struck, the provider is accountable to the customer to deliver those services and make sure they are of high quality. Government's regulatory role is lessened.

The option to allow a contract between consumer and provider to serve as the principal regulatory vehicle, replacing the current system of detailed government interventions and inspections, is a model that needs refinement. Many of the nursing home regulations that providers and state regulators identify as burdensome originated in the federal OBRA Act, so changes in state law will probably require changes at the federal level.

STEPS TO REFORM

The Governor and Legislature should move ahead now to build on recent successes and put together the coherent system of managed long-term care described above. The following steps should be taken to build this system:

1. **Clarify the goals of the long-term care system.**

   The Governor and Legislature should specify what results the State expects the long-term care system to produce. This step is appropriate, since government is the largest single payer in the system. The starting point of any reform is answering the question: What are we trying to accomplish?

We believe that the goals and incentives should be guided by a vision of a diverse, community-based long-term care system.

For the elderly population, specific results might involve reducing the rate of nursing home utilization, especially among the least disabled persons, reducing "non-productive overhead"—inefficiency—in nursing homes, controlling spending growth to a certain rate and adding new forms of community-based care.

Action steps:

a. **Each year, the Legislature should adopt measurable goals for the long-term care system.** At minimum, the goals should deal with resource consumption, general outcomes for the populations at risk, efficiencies in the delivery system, and range of alternative care options.

2. **Set global spending targets.**

The Governor and Legislature should set six-year spending targets for long-term care services for elderly and disabled persons. The global spending targets should be six-year targets to force long-range planning that reaches beyond the regular budget cycle. The imposition of spending targets must be a serious effort. Both the Legislative leadership and the Governor must be fully committed to managing within these limits.

Implicit in the global budget approach is the further notion that changes in eligibility and benefit sets may need to occur if we are to manage within these limits. The first step, of course, should be to achieve all the efficiencies that are possible by reforming the system in the way we suggest. However, the savings that can be obtained from a managed care approach, while significant, will likely not be sufficient to permanently "solve the long-term care budget problem" into the future, since the future demand for long-term care services is driven in large part by the tremendous growth in the population of elderly people. If further budget reductions occur, some changes in eligibility requirements or levels of service will be required.

Action steps:

a. **The Department of Finance should start the process of developing these targets** by developing projections of spending by population. The Governor must ultimately take the leadership to propose the budget targets to the 1996 Legislature.

b. **The Department of Human Services should consider whether to include Medicare in the spending targets.** Currently, the incentives in the Medicare and Medicaid programs tend to favor acute care over long-term care. A consolidated system of comprehensive elderly care will tend to save Medicare (acute care) dollars by increasing Medicaid (long-term care) spending. Since Medicare is a federal program and Medicaid a shared state-federal responsibility, the state faces a disincentive to save overall resources. These incentive problems must be addressed at the federal level.

The Department should build on the work done by the Long-Term Options project to determine how incentives in the Medicare program affect the use and cost of various long-term care services. In the short term at least, the state's goal should be to save Medicaid as well as Medicare dollars.

3. **Decide who will be responsible for purchasing long-term care services.**

Once the results are specified and the global budget targets are set, the Legislature should fix responsibility for managing the long-term care system on regional purchasing authorities.

Who should the regional purchasing authority be? There are several options. For example, a county could be a purchasing authority—particularly in the Twin Cities metropolitan area, where county populations are large enough to permit competition between providers of long-term care services. Or a group of counties could form a new joint regional health purchasing authority. Or another existing authority could be designated the purchaser. Or the state could itself allow regional entities to "buy in" to a state-purchased plan. The purchaser could even be a private association, such as the American Association of Retired Persons. There need not be a one-size-fits all approach; instead, the Legislature should choose the option that appears best suited to the particular region.

Once established, the purchasing authority would be given a fixed budget and would be responsible for overseeing the long-term care service delivery system for elderly people within the region, with accountability for producing the results the Legislature specified. The budget may be based on historical long-term care spending in the region, or it may be formula award based on population statistics and data on at-risk senior populations.

Action steps:

a. **The Department of Human Services should prepare a proposal for the 1996 Legislature that establishes specific regional purchasing authorities** (so that every region in the state is encompassed by a regional purchaser). The proposal should specify the role and responsibilities of the regional purchaser.

4. **Give purchasers an annual budget for long-term care.**

   The Legislature should determine an annual budget for long-term services for the elderly population in each region. The budget should consolidate funding from all the various sources of long-term care dollars. Pooling and consolidation of funds is essential: The Legislature must remove irrational categories (and seek such waivers from the federal government) so that each region has one pool of resources for serving the long-term care needs of its citizens. The number of programs should also be significantly reduced.

   Action step:

   a. **The Department of Human Services should prepare a proposal for the 1996 Legislature to consolidate long-term care funding.** The funds that should be consolidated include Medicaid funds now committed to nursing home and long-term care services, alternative care and elderly waiver grants, and some of the Area Agency on Aging Funds. Program services now funded largely by counties should be considered as well.

   b. **Monitor the Long-Term Care Options project closely to determine whether Medicare should be included in the elderly-care fund.** After the demonstration phase, determine whether to seek expanded and extended waivers from the federal government to permit consolidation.

5. **Put providers at risk.**

   The regional purchasing authorities should solicit bids from competing providers of integrated long-term care services. The authorities should then award contracts to the best bidders, giving the provider plan a capitated budget within which the specific services must be delivered.

   For example, Wilder and HealthEast Corporation might choose to collaborate in a proposal to serve the senior population in St. Paul and the northeast metro region. If the bid is successful, the partnership would be awarded a pre-determined budget based on the population to be served, and would have to meet their customers' needs within that budget. Wilder and HealthEast would be generally free to decide how to do that.

   Capitation puts providers at financial risk and thus encourages providers to keep their customers as healthy and independent as possible, with services that are as efficient as possible. Capitation also encourages innovations, as providers attempt to develop lower-cost service models, build on existing informal care networks and design service combinations that are less expensive.

When providers are at financial risk, they will be motivated by self-interest to develop informal care services common in communities, churches and families—because community-based services are nearly always less expensive and more responsive to individual needs than professionalized services are. The providers will have every incentive to experiment with creative new approaches for tapping these networks. Community-based alternatives, rather than being the exception—and available only by jumping steep regulatory hurdles, as is now the case—will become the "first resort" for long-term care.

One of the most difficult technical challenges involved in a managed-care approach is determining the capitation amount. The long-term care needs of individuals vary enormously; the 90-year old woman with advanced Alzheimer's requires much more expensive care than the 70-year old woman with a broken hip.

Conceptually, the simplest method is to determine the total cost of spending for the population, based on historical experience, and divide by the number of elderly citizens. When the population is large enough, the variation in individuals' service requirements—and thus the cost per person—should "average out" over the whole population. However, for smaller populations, or in cases where people can self-select into the plan they prefer, the average cost may not be appropriate or it may present providers with undesirable incentives (see further discussion of the adverse selection problem, below).

6. Determine mechanisms for accountability.

The managed-care model aligns incentives so that providers make their money by conserving spending. Coupled with the freedom to experiment, providers will tend to develop ways to prevent health problems and seek lower-cost community alternatives to costly institutionalization. However, accountability mechanisms are needed to make sure that plans don't make their money by underserving their customers. The goal of the managed-care system should be to encourage more cost-effective community solutions, not just to restrict utilization of acute care.

Accountability can be ensured by:

a. Allowing individuals to select the plan they prefer and to change to a different plan during open enrollment periods. (However, it's important to note that this consumers of long-term care, because of their health condition, tend not to change their providers even when dissatisfied.

b. Setting performance outcomes and state policy goals related to expanding community-based alternatives (in Step 1) which regional purchasing authorities must meet. The regional authorities would then hold provider plans accountable for *results.*

The state must also ensure that provider plans aren't given incentives to make money by seeking the healthiest populations. If individuals are allowed to choose which plan they prefer, actuarial study will be needed to determine the risk characteristics of plan participants. Capitation amounts would have to be adjusted to reflect differences in risk.

6. **Decide how to provide choice to consumers in the context of a managed care model.** Choice can be provided either by:

   a. Allowing individuals to choose the managed-care plan they prefer, and to switch plans during open enrollment periods, or

   b. Providing individuals with a basic package, and allowing them to choose a more expensive provider or service by paying out-of-pocket for the additional cost beyond the basic plan.

7. **De-regulate to encourage innovation.**

If the providers assume financial risk, they must also be given much more freedom to decide *how* to meet the needs of their customers and the deliver the results expected by the state.

With the possible exception of the downsizing of state institutions, the long-term care delivery system has not changed much over the last 12 years. The Alternative Care Grant Program and the Elderly Waiver were first tested 15 years ago. The federal waiver for people with developmental disabilities is more than 10 years old. Even these programs limit innovation; their service delivery strategies are prescribed in detail by federal and state statutes and rules. The Governor and Legislature should recognize the need to support new experiments in the delivery of care. (Of course, federal OBRA regulations limit significantly what states can do.)

The Governor and Legislature should work to loosen the restrictions that now stifle innovation in service delivery. The passage of the Housing Services Act was a good step in this direction; several key state and federal regulatory changes will be needed to implement the Act—changes to allow providers to tailor services to a customer's needs, use of a broader range of professionals to provide care, and offer customers some choice of service site. Similar flexibility will be needed in other long-term care services for seniors.

Action steps:

a. **The Governor should continue and expand recent efforts to investigate and propose substantive reforms in regulations covering nursing homes.** The reforms should not focus only on easing the burden of fiscal reporting, but must also examine alternatives to the current system of facility inspections.

8. **Take steps to provide greater incentives for individuals to assume responsibility for their own care.**

Action steps:

a. **Tighten asset transfer rules** and enforce them more vigilantly.

b. **Design incentives to purchase long-term care insurance**—for example, by allowing individuals who have long-term care insurance more latitude to preserve assets.

c. **Simplify the process of developing "living wills"** and otherwise encourage individuals to plan ahead for their future medical and long-term care decisions.

INFORMATION NEEDS

Policymakers will need better information if they are to succeed in reforming the system as we have described.

9. **State policymakers need a budget picture that shows all spending for long-term care services, arranged by population.** It is not possible now to appreciate all the state, federal and local resources committed to elderly and disabled persons, because the data we have are organized by program, not by population. Policymakers should be able to get answers to questions such as "how much has it cost historically to provide long-term care to people age 85 and older?"

Action step:

a. **The Commissioner of Finance should develop an ongoing process that identifies and tracks the historical state spending for each special population.** The Department of Finance should convene an *ad hoc* group to identify these populations and then proceed with the analysis. The Department's Biennial Budget Information System and the new statewide accounting system should be capable of producing the financial information. The financial information should be placed in context. Thus, the spending should be expressed in terms of a population base—for example, per 10,000 elderly persons.

10. **Policymakers and providers need better information about the cost-effectiveness of different treatment and care approaches.**

11. **Policymakers and the public need a clear understanding of what it costs to administer public health care programs.** Under the budgeting approach now being considered by Congress, administrative and program expenditures will no longer be separate funding streams. Instead, both program and administrative funds will be rolled into a single capped entitlement. Programs and services will be competing with department bureaucracies and statewide overhead for dollars. This means that state policymakers must pay increasing attention to administrative overhead and the cost of running the health care programs.

    Further, there is a widespread belief that the government health care bureaucracy is not efficient and has not faced the same cutbacks as other departments of state government. However, the debates are rarely supported by data.

    Action step:

    a. **The Department of Finance should carefully investigate and publish annually the cost of administering governmental health care programs.** The cost should be reported in a way that allows comparisons with other states and with similar private sector programs—for example, cost per recipient month or per enrolled client.

Appendix A

Summary of Recommendations

Appendix A

Summary of recommendations

K-12 Education

1. Take advantage of the potential savings from insurance pooling (p. 11).

2. Take steps to define the entitlement to special educational services (p. 14).

3. Attach funding to students, not districts (p. 16).

    a. Have the per-pupil aid to go the school—not the district—in which the student enrolls (p. 16.)

    b. Require compensatory aid to follow students to the schools in which the qualifying students enroll (p. 17).

4. Ensure that the public interest in education is met by requiring every publicly funded school to have a contract with a district, the state, or another public agency to deliver certain specified education outcomes, and by establishing a mechanism to enforce these contracts (p. 22).

5. Free teachers, parents and staff to make decisions about *how* education services are delivered at their public school sites (p. 18).

    a. Require that the use of revenues be controlled by the school site (p. 18).

    b. Set in motion a process by which the site will be able to make major decisions about budget, personnel and education methods (p. 18).

    c. Permit school sites to purchase instructional and non-instructional support services from either the district service center or from other sources in the community (p. 18).

    d. Permit schools to employ non-certificated individuals in a classroom, under the supervision of a certified teacher (p. 18).

K-12 Education (cont'd)

6. Expand the number and diversity of public school choices.

   a. Allow parents to select the public school—not just the district—that their child attends (p. 18).

   b. Move toward site-based management, as described above, as a strategy for broadening the diversity of educational choices within school districts (p. 18).

   c. Encourage existing public schools to become deregulated and autonomous, either by becoming charter schools or by agreeing to waive current employee contracts and district mandates (p. 18).

   d. Lift the current statutory limit of 40 charter schools (p. 19).

   e. Permit charter schools to be proposed and operated by teachers who are not licensed (p. 19).

   f. Authorize the state board of education and/or a specially created state charter school agency, as well as any public post-secondary education institution operating in the state, to charter schools without any prior role for the school board in the area in which the proposed charter school is located (p. 19).

   g. Empower and fund the state department of education or a new state chartering agency to provide more proactive support of charter proposals (p. 20).

   h. Preserve and enhance the Post-Secondary Enrollment Options program (p. 20).

   i. Remove current obstacles that now prevent parents and students from making full use of the Open Enrollment program (p. 20).

   j. Experiment with a variety of voucher approaches to provide families with additional education choices and stimulate new models for cost-effectively meeting the public interest in education (p. 20).

K-12 Education (cont'd)

7. Empower parents to be good consumers of education. Provide reliable information about the performance of schools and programs.

    a. Look for ways to make the "price of education" more visible to consumers (p. 24).

    b. Create an independent state-level function to conduct annual assessments of Minnesota students' academic performance (p. 24).

    c. Conduct "best practices" reviews of educational programs (p. 24).

    d. Create a process for measuring, rewarding and publicizing *improvement* of schools (p. 25).

    e. Empower the state department of education to establish a proactive program to provide widely accessible information on school choices (p. 25).

Post-secondary education

8. Replace the current general fund appropriations ratio with new system that provides more funds directly to students (p. 31-32):

    - 30 percent of appropriations for post-secondary systems
    - 30 percent for "lifetime learning grants" to all Minnesota students
    - 30 percent for need-based financial aid
    - 5 percent for research
    - 5 percent for new higher education initiatives and technologies.

9. Require the Higher Education Service Office to develop and plan for communicating the new financing system to the public (p. 33).

10. Establish incentives for students and their families to save more for higher education (p. 33).

11. Distribute a substantial portion of appropriated funds on the basis of performance according to state policy goals (p. 34).

Post-secondary education (cont'd)

12. Hold all principals in the higher education enterprise accountable for performing their respective responsibilities (p. 34).

    a. The Legislature should establish policy and performance indicators but should refrain from micro-managing system operations (p. 35).

    b. The MnSCU Board of Trustees, not the Department of Employee Relations, should be required to negotiate and approve all contracts with faculty (p. 35).

    c. All faculty contracts should be related to the performance indicators and policy purposes identified by the Legislature making the appropriations (p. 35).

    d. A system of merit increases should be reinstated to recognize individual and team excellence in delivering higher education services (p. 35).

Aid to local governments

13. Adopt a three-level plan (ABC) for state funding of cities, counties, school, and other taxing districts (p. 40).

    - Level A—Basic Service Funding: This base-level package of services is 100 percent state funded through property taxes, and is not adjusted for categorical needs at the county or local level (p. 40).

    - Level B—Categorical Funding: Also 100 percent state funded by property taxes, this level pays for local costs arising from factors outside the control of local officials, and not covered by Level A (p. 41).

    - Level C—Local Preferences Funding: 100 percent locally funded, this level allows local officials to enhance services beyond the basic level at their own cost (p. 41).

14. Pass a Constitutional amendment requiring all increases in state and local property tax levy (beyond the ABC's initial, designed amount), be distributed on the basis of market values, not tax capacity (p. 41).

Aid to local governments (cont'd)

15. Add no new revenue options for local governments (p. 42).

16. Increased state share of K-12 spending over its current level should be financed by reallocating city LGA and HACA to schools, broadening the sales tax base to final consumption items, and/or adjusting the statewide property tax (p. 42-43).

17. All future state attempts to provide property tax relief not associated with appropriate Level A and B funding should take the form of circuit-breaker or other means-tested payments to taxpayers. This method of providing tax relief should fully replace what used to be called simply "buydown" aid (p. 45).

Long-term care for the elderly

18. Clarify the goals of the long-term care system, and specify what results the system should produce, adopting measurable goals each year (p. 53).

19. Set global, six-year spending targets for long-term care services for the elderly and disabled; the Department of Finance should start the process by developing spending projections by population, and the Department of Human Services should consider whether to include Medicare in spending targets (p. 54).

20. The Department of Human Services should propose a plan to fix responsibility for managing the long-term care system on regional purchasing authorities (p. 55).

21. Give purchasers an annual budget for long-term care, and look to consolidate funding for all types of long-term care programs (p. 56).

22. Put providers at risk by requiring them to provide services within a capitated budget (p. 56).

23. Determine mechanisms for accountability (p. 57).

Long-term care for the elderly (cont'd)

24. Decide how to provide choice to consumers in the context of a managed care model (p. 58).

25. Deregulate to give providers more freedom in meeting the needs of their customers while satisfying state expectations (p. 58).

26. Provide incentives for individuals to assume greater responsibility for their own care (p. 59).

27. Take steps to improve information on long-term care needs, spending and service results (p. 59-60).

Appendix B

Work of the Committee

Appendix B

Work of the Committee

Charge to the Committee

Background: In 1993, the Citizens League conducted a study on Minnesota's state spending. The study committee, co-chaired by Jean King and Ed Dirkswager, produced a report, *Minnesota's Budget Problem: A Crisis of Quality, Cost and Fairness.* The report critiqued the fundamental flaws in the design of Minnesota's public sector and offered five design principles that, if followed, would re-establish the link between spending and results and improve the value of our state and local public spending.

John Brandl, a member of that study committee and League president during the time it was underway, was recently appointed with Vin Weber to develop recommendations to the Governor and Legislature on how to resolve the state's long-term budget problems. Brandl and Weber have been asked to submit their recommendations by the first of September for consideration by a special session of the Legislature in November.

The appointment of Brandl and Weber to this task represents a golden opportunity for the Citizens League to make a thoughtful contribution to the solution of our budget woes. The League board has convened a special committee to capitalize on this opportunity.

Charge to the committee: The board of directors has requested the committee to:

- review the specific implementation recommendations in the 1993 state spending report, and the progress made to date;

- review reform proposals that are already underway, initiated by the League or others, which reflect the ideas in the report;

- identify achievable reforms that together represent a solution to Minnesota's budget problem in light of long-term revenue pressures and anticipated reductions in federal spending;

- produce instructions for drafting statutes and take other steps to enable specific proposals to be introduced to the special session and the 1996 regular session of the Legislature.

(This charge was approved on June 12, 1995.)

Committee membership

The committee was co-chaired by Becky Malkerson and Chuck Neerland. Buzz Cummins, David Doth, Lynn Reed, Dan Salomone and Jon Schroeder provided leadership to four subcommittees and contributed portions of the final report. A total of 29 committee members took an active part in the work of the committee. In addition to the co-chairs, they were:

Allan Baumgarten
Duane Benson
William Blazar
John Cairns
Michael Christenson
Carl (Buzz) Cummins
Glenn Dorfman
David Doth
Kent Eklund
Rick Heydinger
Peter Hutchinson
Verne Johnson
Douglas Kelley
Jean King
Ted Kolderie
David Laird
Mike Latimore
Yusef Mgeni
Ted Mondale
Anthony Morley
Pamela Neary
Allen Olson
Todd Otis
Hazel Reinhardt
Dan Salomone
Jon Schroeder
Lyall Schwarzkopf
Stephen B. Young

Ted Mondale, Pamela Neary and Todd Otis dissented from the committee's recommendation to experiment with voucher options for elementary and secondary education. Peter Hutchinson also expressed reservations about this section of the report; his concerns are presented in the letter at the end of this appendix.

Committee meetings and staffing

The committee met for the first time on June 12, 1995 and concluded its deliberations on August 9, 1995.

This report was prepared by Janet Dudrow. Lyle Wray and Jonathan Brenner (intern) also provided staff assistance. Char Jones and Trudy Koroschetz provided administrative support.

Acknowledgments

The Citizens League thanks First Bank System for providing meeting space for this project and Lorraine Grohoski (Corporate Relations) for her generous staff assistance. The League also acknowledges gratefully the contribution of budget and demographic information from Minnesota Planning.

Peter Hutchinson
1621 Mount Curve
Minneapolis, Minnesota 55403

August 29, 1995

Lyle D. Wray
Citizens League
708 South Third Street, #500
Minneapolis, Minnesota 55415

Dear Lyle:

This letter is to express my reservations about the section of the budget report dealing with education vouchers.

During the course of the project, I urged that the rhetoric about vouchers not be included in the report. I suggested that we stress expanding options for parents to choose nongovernmentally sponsored school programs that are "public" in character.

My concern is that people confuse the issue of public and private schooling with the issue of governmentally and nongovernmentally sponsored schools. In particular, people assume that the only public schools are those that are governmentally sponsored. That, of course, is not the case. For example, the Minneapolis Public Schools contracts with "Alternative Schools" for the provision of services to our students. In the course of accepting those contracts, these schools, which are privately sponsored, take on a public character and agree to a set of public standards. The same could be true for schools chosen by individual families if participating nongovernmental schools agree to take on an appropriate set of public characteristics.

Because I think the report does not adequately address this issue and unnecessarily enters into the rhetorical debate about vouchers, I feel the need to separate myself from that portion of the report.

With respect to the rest, I think it is a helpful and challenging document that will prove a useful contribution in the debate about how to produce quality public services at prices that citizens can afford.

Sincerely,

Peter C. Hutchinson

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The Citizens League promotes the public interest in Minnesota by involving citizens in identifying and framing critical public policy choices, forging recommendations and advocating their adoption.

The Citizens League has been an active and effective public affairs research and education organization in the Twin Cities metropolitan area for more than 40 years.

Volunteer research committees of League members study policy issues in depth and develop informational reports that propose specific workable solutions to public issues. Recommendations in these reports often become law. Over the years, League reports have been a reliable source of information for governmental officials, community leaders, and citizens concerned with public policy issues of our area.

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