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Citizens League

# Minnesota's Budget Problem:

## A Crisis of Quality, Cost and Fairness

A Citizens League Research Report

A CITIZENS LEAGUE REPORT

# MINNESOTA'S BUDGET PROBLEM: A CRISIS OF QUALITY, COST AND FAIRNESS

PREPARED BY
THE COMMITTEE ON STATE SPENDING

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# FOREWORD

**THE CITIZENS LEAGUE** is one of many civic organizations that have attempted to bring fresh thinking to Minnesota's persistent budget problems. The past year has brought a flurry of reform-minded proposals from the Minnesota Taxpayers Association, Minnesota Business Partnership, the Humphrey Institute and the Higher Education Coordinating Board, to give just a few examples. Those proposals have stimulated much-needed debate about how the state can move beyond the usual short-term rescue operations to achieving fundamental fiscal change.

Our study was an ambitious effort to attack the deepest root of Minnesota's budget woes. "Why is it that citizens keep spending more for public services, while seemingly getting less?" we asked. In the course of exploring that question, we heard from more than 100 Citizens League members and other citizens who came to a series of Speak Ups! on the subject.

Our answer to the question—that there is nothing in the current design of government policies that necessarily links spending with results—forms the basis of our report, and its recommendations for reform.

**THIS PROJECT** required us, and will require readers, to think differently about what government does. We believe, however, that once the fundamental flaws of current policies become apparent, so will the need for a new view of government—that government's role is to arrange environments where people are systematically oriented to achieve public purposes, and where spending is necessarily linked with results.

The change that will be required of government will not be easy. It cannot be accomplished by trimming a little from this budget, or shifting a few resources from this department to that or by training public managers to be more creative or thrifty. It can only be accomplished by changing the most basic structural features of our public sector.

We believe the design principles described in this report represent Minnesota's best hope for achieving the reform that is so urgently needed now. We urge legislators to respond boldly and courageously to these reform ideas. The specific recommendations offered here are samples of how to apply the design principles; we welcome vigorous debate about them. Citizens and legislators may respond with comments and additional proposals by contacting any committee member or the Citizens League staff, by writing to the editor of the *Minnesota Journal,* or by participating in Citizens League On-Line, a computer bulletin board operated by Twin Cities Metronet.

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# EXECUTIVE SUMMARY

MINNESOTA'S problem is not just balancing its budget. The so-called budget problem is really a symptom of a crisis of quality, cost and fairness in Minnesota's public sector. The state needs a new approach to public services, or citizens and lawmakers will find the quality of public services eroding and find themselves lurching from one budget crisis to the next. A new design, not tinkering with the existing system, will offer the best hope of meeting the challenges the state will face in the future given increasing constraints on resources.

## MINNESOTA'S BUDGET PROBLEM

**Despite the good news of economic recovery and more tax revenues, Minnesota's budget problems are not over because the state continues to spend more than it takes in.** The state has faced budget shortfalls periodically since the late 1970s. Spending growth in the coming biennium will outpace revenue growth 13.0 percent to 10.6 percent. The mismatch between revenues and expenditures is structural, so the gap will persist.

**The revenue-spending gap is a sign of a profound change in the economic environment.** For the past 20 years, state and local government revenues have consumed a relatively stable bite of total personal income, averaging 19.8 percent annually. Minnesotans seem to have arrived at a tacit agreement about how much they are willing to pay for public services. State and local governments increased spending without taking a substantially larger share of personal income because the economy grew rapidly, but in the next 20 years, the economy will grow more slowly. Continued large increases in spending will take a bigger bite.

**Citizens are not likely to be persuaded to spend more than the current 21 percent of personal income for state and local government services.** Slowing economic growth means fewer new jobs, slower increases in income, more pressure on household budgets. Many citizens have become skeptical about whether government actually delivers on its promises. Skeptical citizens with slimmer wallets are not likely to agree to major tax increases to solve the budget problem. Lawmakers should assume that 21 percent of personal income is the limit of what citizens are willing to pay.

**Lurking behind the budget problem are two even bigger problems: Quality and fairness.** Minnesotans have spent more and more on public services in the past, but those increases in spending have not delivered better results. For example, despite a 24 percent increase in real per-pupil spending for K-12 education during the past decade, Minnesota employers say that job applicants don't have the skills needed in today's workplace. The crisis results from the fundamental flaws that now characterize most public services.

## DESIGN FLAWS IN THE PUBLIC SECTOR

**The first flaw is that, in general, government and citizens do not require results from spending.** Rewards that public agencies receive are unrelated to the fulfillment of their missions. Repair and replacement—"remedial" services—are favored over prevention.

Government usually assumes that it will own and operate whatever services it decides should be provided. And the preferred method of delivery is the sole-source, non-competitive, indefinitely-renewable contract with this "owned" supplier. In other words, a monopoly.

**The second flaw is that government and citizens do not require equity as a result of redistribution.** On the contrary, many current policies either redistribute resources to satisfy institutional interests or to benefit individuals who are already advantaged.

**Because the budget problem results from these fundamental system flaws, good leadership and incremental change will not be enough to solve it.** If Minnesota is to maintain its high quality of life in the face of scarce resources, we must solve the state's underlying budget problem—not just disguise it—by correcting these fundamental flaws. This requires taking a new view of the role of government.

## A NEW ROLE FOR GOVERNMENT

**State lawmakers should embrace the view that the purpose of government is to design environments where individual citizens and institutions are systematically oriented to accomplish public purposes, and where they meet their own interests in the course of doing so.** The traditional view has been that government solves problems by regulating, taxing and spending money on programs. That view has been discredited. Government is not mainly about dishing out money, but about creating systems in which more money gets more results and subsidies go to people who need them.

**There are only a few design principles that orient people to accomplish public purposes while meeting their own interests and that systematically link spending with results.** These "design principles for better value" are described below, with some of the report's specific recommendations that result from applying the principles to Minnesota's main items of spending.

## NEW DESIGN AND BETTER VALUE IN EDUCATION, HEALTH CARE AND PROPERTY-TAX RELIEF

**Principle 1. Target public subsidies directly to people who are financially needy.** Provide subsidies only to individuals who have low incomes and wealth, and ensure that subsidies follow individuals who qualify for them. Redistribute resources explicitly rather than through indirect methods, and only to ensure equal access to basic services in which there is a compelling state interest.

> RECOMMENDATION: The state should, over the next several biennia, **reduce the share of higher education aid provided in the form of instructional appropriations to higher education institutions. The state should increase the share of aid provided directly to students who show financial need.** This policy reflects the belief that the public in general, not just the individual student, benefits from higher education, and therefore state tuition subsidies are appropriate. However, the policy focuses public aid on students who really need it and makes college more affordable to low-income persons.

**Principle 2. Use competition to align institutional self-interest with the public's interest in the quality and cost of services.** Break up the monopoly elements of public services by separating the different interests of institutions and the public, and by forcing service producers to win the public's business. This does not mean privatization; competing producers may be public organizations. Competition may be introduced in three ways:

**Create citizen markets.** Give citizens their allotment of public dollars (or their equivalent) and allow them to choose their public services from among competing public and private providers.

RECOMMENDATION: Strengthen Minnesota's existing citizen market for elementary and secondary education. **Remove the limit on charter schools, and allow charter schools to be chartered by either a local school board or the state board of education.**

**Split the roles of purchaser and producer of public service.** Now, school boards, city councils and other governing bodies plan, make policies and decide how public services will be provided. What is often overlooked is that these boards are also *purchasers of service*. They represent the public by purchasing services on citizens' behalf from producers (the firms and individuals who actually deliver the services).

For most services today, both functions, purchasing and producing, are accomplished by the same body and this results in an inherent conflict of interest. Rather than purchasing the services (snowplowing, teaching or firefighting, for example) that respond to their constituents' concerns, boards instead assign constituents to receive services from the only snowplowing, teaching or firefighting business in town—themselves. Government should ensure that the purchaser is a different entity from the producer. When purchasers have choices, producers risk failing if they don't serve their customers well.

RECOMMENDATION: **Create regional bodies to purchase flexible services on behalf of elderly citizens in their regions. Encourage, within regions, the formation of competing health-care plans** that serve seniors, on contract with the regional purchasers. Allow Medicaid recipients and private-pay consumers the opportunity to choose which health-care plan they prefer.

**Pay for performance.** When the Legislature makes grants to school districts, cities and institutions, it should make the grants contingent upon performance.

RECOMMENDATION: **Create an independent "value for money" auditing function** to assess the quality of services provided by local governments with the assistance of state aid. Make the results of such audits public so that voters can hold their local officials accountable for performance.

**Principle 3. Allow prices of public services to reflect true costs, including the social cost of individual decisions.** Prices give purchasers important information that helps them make decisions about how to spend their money. Current policies often disguise the true cost of public services, and distort citizens' choices about how to spend their money. Public policies should give citizens an economic stake in their personal decisions.

RECOMMENDATION: Increase the proportion of property-tax relief that is paid directly to individuals, and **reduce the amount of aid provided to cities in the form of general-purpose grants.** General-purpose grants insulate local taxpayers from the effects of their local spending choices.

**Principle 4. Meet more public responsibilities through non-governmental communities in which people already have relationships of mutual obligation.** Citizens are not merely consumers of government programs. Families, ethnic organizations and neighborhoods perform a variety of public purposes including child rearing, caring for the infirm and education. They are producers and problem-solvers. Government can make use of the motivations generated in these private communities by carrying out some of its responsibilities through them.

> **RECOMMENDATION:** Reduce the emphasis on professionalized services for elderly people, and **encourage alternatives that enable them to stay in their communities** with the help of families, neighborhoods and voluntary associations.

> **RECOMMENDATION:** When distributing need-based financial aid, **higher-education institutions should work closely with ethnic, neighborhood and community groups** that have existing relationships with low-income and minority people. These networks can provide the critical links needed to ensure that the most disadvantaged students are aware of, and are encouraged to make use of these aid programs.

> **RECOMMENDATION:** Create incentives that encourage families to save for their children's college education.

**Principle 5. Consider long-term economic growth to be one of the objectives of state spending.** To get the best long-term return from state expenditures, policy makers should take seriously their role as investors. Doing so means making sure that expenditures on infrastructure, research and education are met with measurable, demonstrated results, which in turn requires that results be evaluated rigorously and impartially. For other items of spending, "good investing" simply means getting the most value from every dollar of state expenditures.

> **RECOMMENDATION: Evaluate—systematically and impartially—the results achieved by appropriations to higher-education institutions for research** and community service. Make appropriations contingent upon demonstrated results.

## THE POLICY IMPERATIVE

We believe that the time has passed for short-term solutions. Minnesota needs structural reform, and there are only a few ways to achieve that. The five principles outlined above represent the essential requirements for structural reform.

# PART I

## A BUDGET PROBLEM OR A VALUE PROBLEM?

## Chapter One

# MINNESOTA'S BUDGET PROBLEM

MINNESOTA needs a new approach to public services. A new design, not tinkering with the existing system, will be the only real answer to the state's persistent budget problems.

The state has faced budget shortfalls periodically since the late 1970s. In November 1992, the prospect was a $769 million gap for the 1992-93 biennium. Revenue forecasters by March 1993 were predicting a much smaller shortfall because the rebounding economy was putting more tax dollars into state coffers. Even with the brief recovery, however, spending growth in the 1994-95 biennium will outpace revenue growth 13 percent to 10.6 percent compared to 1992-93. Thus, Minnesota has committed to spending more than it will take in. As we will see, the mismatch between revenues and expenditures is structural, so the problem will persist. The state's Department of Finance forecasts a shortfall of $393 million for the 1996-97 biennium if current spending and revenue patterns continue.

SINCE Minnesota's Constitution requires a balanced budget, the budget gaps will be closed, most likely by making short-term shifts and adjustments, as has been the case for the past two biennia. But temporary solutions—cutting services, raising taxes and exhorting government employees to sacrifice more and work harder—fail to address the long-term problem. Here is why:

- Cutting services may balance the budget but it won't solve the problem because demographic and economic pressures are driving up the demand for many services over the long term. For example, the number of elementary-age students and the number of elderly persons using medical care are both growing.

- Raising taxes is not a likely answer since we can expect slower growth in the state's revenue base. Since aggregate personal income will grow more slowly than it has in the past 20 years, further increases in state spending would require citizens to pay a bigger share of their incomes in taxes than they have been. At the same time, other parts of people's budgets—health care and housing, in particular—are rising steeply. Federal taxes, too, will increase as Congress and President Clinton attempt to curb the deficit. The squeeze on household budgets means that proposed state and local tax increases will face stiff competition.

  There are also signs that people are less willing to pay more taxes. The broken link between increased spending and better results has not been lost on citizens, many of whom believe that government does not deliver on its promises. The "haves" in society believe government is wasteful. The "have nots" believe government is failing them. Government has lost its monopoly on many traditional public services (security services, for example) as consumers seek, and find, better value elsewhere.

- Exhorting public managers and employees to work harder and sacrifice more won't solve the problem, because the employees are not the problem. The system is the problem. Repeated cycles of cutting, taxing and budgeting by crisis—the inevitable scenario when underlying problems are ignored—slowly erode service quality and deafen citizens and employees to further exhortation.

This report will examine the state's ongoing budget problem as an urgent call for new attention to the crisis of quality, cost and fairness in Minnesota's public sector. We will review the state's spending on four major commitments—K-12 education, post-secondary education, health, and local government aid and property-tax relief—and propose recommendations for lawmakers as they seek long-term solutions.

We argue that:

1. It has been possible for the state to increase spending in the past 20 years without taking a substantially larger share of personal income. This will not continue.

2. Persistent budget shortfalls are evidence that Minnesota's spending commitments are outpacing the state economy's capacity to finance government spending.

3. *Even if* very large increases in spending could achieve the results we want in the future, changing economic conditions will make increases of sufficient magnitude impossible. However, more spending has not guaranteed better results in the past, and it is unlikely that more spending—alone—will give us better results in the future. It is equally clear that simply spending more on public services has not assured equitable access to these services by all citizens.

4. Minnesota's fiscal problem is not just about balancing the budget. It is a crisis of quality, cost and fairness.

5. The fundamental flaws causing the crisis are that, in general, government and citizens do not require results from spending, or equity in redistribution.

6. If Minnesota is to maintain its high quality of life in the face of scarce resources, we must solve the state's underlying budget problem—not just disguise it—by correcting these fundamental flaws. We must build into government policies an inherent link between spending and outcomes, injecting the incentives that ordinarily drive organizations to improve results, value and productivity, and minimize cost—that is, to give the most value for the money. And we must design policies such that redistribution of resources is meaningfully connected to increased opportunity for the needy.

Let's look at these arguments more closely.

## MINNESOTA'S ECONOMIC GROWTH IS SLOWING

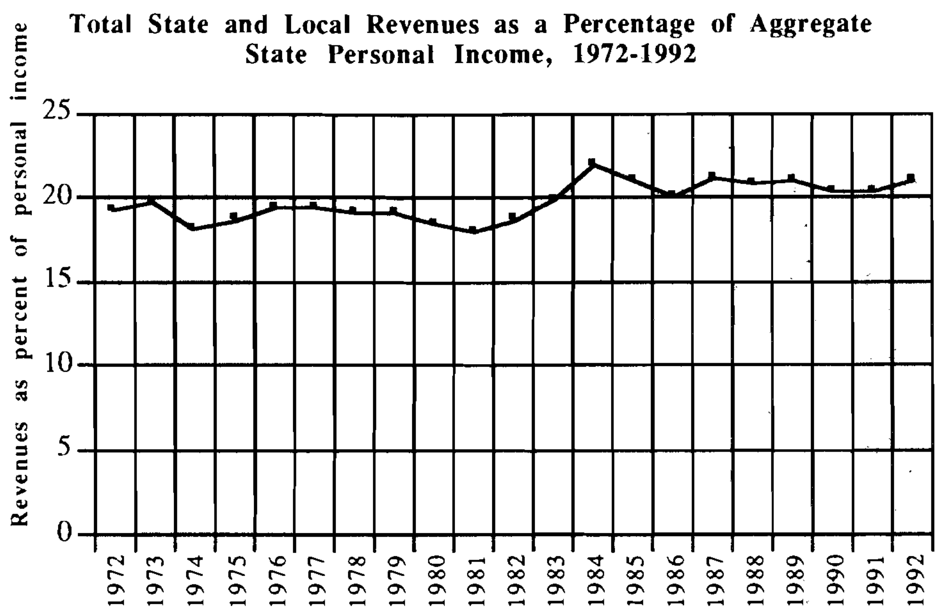
**It has been possible for the state to increase spending in the past 20 years without taking a substantially larger share of personal income. This will not continue.**

For the past 20 years, state and local government revenues have consumed a relatively stable bite of total personal income (see Figure 1).[1] It was as if Minnesotans—without ever voting on the question, or even discussing it—had arrived at an agreement about how much they were willing to pay for public services—19.8 percent.

Real state and local government revenues increased dramatically between 1971 and 1991. Since total personal income also grew rapidly through the 1970s and early 1980s, however, revenues stayed fairly close to 19.8 percent until about 1983. Simply put, Minnesotans were able to increase spending on public services without having to give up much else.

Figure 1

Total State and Local Revenues as a Percentage of Aggregate State Personal Income, 1972-1992




Source: Minnesota Chamber of Commerce, with data from the Minnesota Department of Finance and U.S. Department of Commerce

That situation will not continue.

The overall economy and personal income began to grow more slowly in the early 1980s, and growth has slowed even more dramatically since 1990. As a result, state and local revenues have crept up past that 19.8 percent average since 1983. Now, revenues take 21 percent of personal income.

The most recent recession is said to be lifting, so the short-term future appears brighter. However, over the long term the U.S. economy will grow progressively 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. It is projected to grow by an average 2.6 percent annually between 1996 and 2000, but slow to 2.1 percent between 2001 and 2007, 1.6 percent between 2007 and 2012 and just 1.4 percent between 2012 and 2017.[2]

How fast the economy grows over the long run is determined primarily by the size of the labor force and how productive it is. Productivity is influenced by the level of investment in technology, education and other tools that help people work smarter. Investment, in turn, is determined by the rate of saving. All three factors—the size of the labor force, productivity and investment—are working to put a drag on growth nationally:

- The baby boom is now passing the prime working and childbearing years, and the result is a slowdown in **population and labor force growth.** The U.S. population will continue to grow, but more slowly, at an average rate of 0.73 percent annually between 1991 and 2017, compared with one percent annually between 1965 and 1991.[3] The labor force, which had grown two percent per year between 1965 and 1991, will average one percent growth between 1991 and

2017.[4] A slow-growing labor force means aggregate income will also grow at a more sluggish pace.

- The great surge in **women's labor force participation** is over, contributing to the slowdown in the growth of the labor force. In 1948, 32 percent of women worked for pay.[5] Women began their mass entry into the workforce in 1960, and between 1964 and 1990 their presence accounted for 60 percent of the growth in the size of the labor force; by 1990, 57.4 percent of women worked for pay.[6] We can expect continued high participation of women in the work force, but the dramatic *increases* in participation that swelled the size of the labor force in the 1970s and 1980s are over.

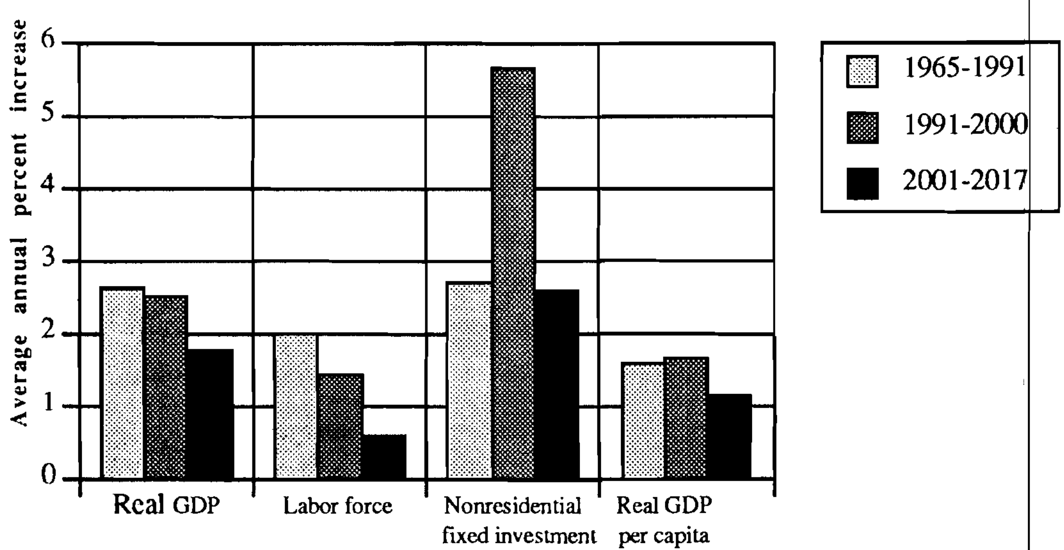
- **Total saving** by households, business and government, which was 16.5 percent of GNP between 1965 and 1977, fell to 15.4 percent of GNP between 1978 and 1991 and will drop to 13.6 percent between 1992 and 2000.[7] The slow pace of investment and saving will continue to adversely affect future gains in productivity.

- **Business fixed investment** in buildings, computers and other equipment slowed from 3.9 percent annual growth between 1965 and 1978 to 1.5 percent between 1978 and 1991, and the effects of this slowdown in investment are now apparent.[8] The economy's capital stock is worn and in need of replacement.[9] New investment is projected to increase by 3.6 percent annually between 1991 and 2017,[10] but the effects of the earlier slump are likely to continue to affect productivity growth in the short term.

- **Productivity,** measured as real gross domestic product per capita, grew at an average two percent annually between 1965 and 1978. Productivity gains

Figure 2

Historical Trends and Forecast Average Annual Percent Increase in Selected Economic Measures (U.S.), 1965-2017




Source: DRI McGraw-Hill, Trend Forecast

slowed to an average 1.1 percent annually between 1978 and 1991, and are expected to average only slightly better between 1991 and 2017.[11]

These underlying demographic and economic factors will shape our daily lives: fewer new jobs, slower increases in income, a quality of life different from the preceding generation. In 1991, Americans aged 35 to 44 were only half as wealthy, after inflation, as their parents had been at the same age, and the gap is expected to widen.[12] Between 1966 and 1991, the cumulative number of jobs grew 69.6 percent; between 1991 and 2017, that growth rate will slow to 28.9 percent—less than half its previous pace. Most new jobs will be in the service sector, as manufacturing's share of employment continues to shrink.[13] Real personal income will rise at an average 1.9 percent annually over the next 25 years, compared to 2.9 percent annually between 1966 and 1991.[14]

Minnesota will reflect these national trends:

- **The population** will grow more slowly—5.2 percent for the decade 1990 to 2000, compared to 7.3 percent during the 1980s.[15] Between 1992 and 2000, the fastest growing age group in Minnesota will be the 50 to 54 year olds; by 2017, that group will be retired.[16] A slow-growing labor force means the number of people earning incomes will be growing more slowly.

- **Women's labor force** participation rate is already much higher in Minnesota than in the U.S. generally, so large increases in the future are unlikely. More than 63 percent of Minnesota women with children under the age of six, and 82 percent of those with children between ages six and 17, now work for pay.[17]

- **Job growth** will slow from 17.8 percent (for the period 1982 to 1988)[18] to just seven percent between 1989 and 1996.[19] Throughout the state, more job openings will occur because people are leaving the labor force, for reasons such as retirement, than because new jobs have been created.[20]

- **Real personal income** will rise more slowly. From 1988 to 2000, Minnesota's total real personal income is expected to grow at an average rate of 1.9 percent, compared to 2.1 percent between 1979 and 1988.[21]

Thus, despite the good news of the economy's recovery from recession, recovery won't bring relief from state budget pressures over the long run. The economy is slowing for reasons that won't easily be reversed, and slow growth in the economy means slow growth in the revenue base for state expenditures.

## SPENDING COMMITMENTS ARE OUTPACING REVENUES

**Persistent budget shortfalls are evidence that Minnesota's spending commitments are outpacing the state economy's capacity to finance government spending.**

Lawmakers have taken "each budget as it comes," and have closed previous shortfalls by short-term measures, including draining the state's reserve fund and shifting certain spending commitments to later accounting periods. The most recent shortfall was reduced considerably by an economic rebound that temporarily boosted state revenues. However, few legislators and citizens have realized that the budget crises will persist because, over the long run, the demand for services and spending is growing faster than the economy's capacity to pay. Recall that already expenditure growth will outpace revenue growth 13 percent to 10.6 percent in 1994-95, compared to 1992-93.

Spending increases will no longer be relatively painless. In the future, for the most part, more spending will have to be financed by taking a bigger bite out of personal income. Minnesotans, if they want more government services, will have to spend more than the 21 percent of their budgets they are spending today, and thus must give up something else. Or state government must control spending increases in order to hold the tax bite steady. We believe that Minnesota citizens, given the pressures on their household budgets and their skepticism of government, will not be willing to increase that share significantly beyond 21 percent. As revenues become tighter and the need for trade-offs more apparent, each expenditure will be scrutinized for the value it represents to the state and its citizens.

## SPENDING DOESN'T GUARANTEE RESULTS

***Even if* very large increases in spending could achieve the results we want in the future, changing economic conditions will make increases of sufficient magnitude impossible. However, more spending has not guaranteed better results in the past, and it is unlikely that more spending—alone—will give us better results in the future.**

Minnesota's spending on education, human services and local aid increased, dramatically in some cases, between 1983 and 1992, even after accounting for inflation. Minnesota's state and local governments have consistently outspent those of other states overall, although the gap between Minnesota's expenditures and the national average narrowed slightly between 1987 and 1991.[22] We might expect that large spending increases would be accompanied by equally encouraging improvements in the problems we are trying so earnestly to solve. Unfortunately, as the following evidence suggests, that has not been the case.

**In elementary and secondary education,** real spending per pupil more than doubled in the U.S. between 1960 and 1983, but during the same period scores on the Iowa Tests of Basic Skills and the Scholastic Aptitude Test plunged.[23] In Minnesota, state and local spending per pupil increased 9.3 percent in real terms between 1982 and 1992.[24] During that period, many Minnesota students undoubtedly succeeded and many teachers excelled in increasingly challenging circumstances. Yet, a recent study by Harold Stevenson of educational achievement by students in Minneapolis, Japan and Taiwan found that Minnesota first graders, who had a slight edge in educational achievement, had lost their lead by fifth grade. By eleventh grade, almost all the Japanese and Taiwanese children in the study were achieving above the average of their Minnesota contemporaries.[25] Clearly, large increases in spending have not been enough to guarantee student competitiveness on global standards. Economist Eric Hanushek, in 1986, spotlighted this disturbing paradox in a review of more than 100 studies of education spending and education outcomes. His finding: school quality varies widely, but there appears to be no significant relationship between school expenditures and student performance.[26]

**Health-care** spending increases have been enormous, in part because of increases in the number of people who qualify for publicly-financed care. Minnesota's total real spending on General Assistance Medical Care increased 184 percent in real terms between 1983 and 1991, and spending on Medical Assistance enrollees increased 37.3 percent after accounting for inflation.[27] The state compares favorably to the national average on many measures of health, such as infant mortality. Yet it is also clear that huge amounts of public and private spending on medical care are not alone sufficient to buy good health. Health problems that are shaped by lifestyle and socioeconomic factors still account for a large share of Minnesota deaths. In 1991, for example, cardiovascular ailments were the cause of 41 percent of all deaths. A total of 688 deaths resulted from suicide, homicide and other violent causes.[28] And despite the state's overall good record with regard to child health, infant mortality for ethnic minorities in the Twin Cities is 17.1 per thousand live births.[29] This compares with 7.7 for all races in the Twin Cities, 9.1 for the U.S. overall, and 6.8 for Canada's overall population.[30]

**Higher education** has not shown the dramatic increases that other spending areas have. Total inflation-adjusted expenditures were only slightly higher in 1992 than in 1984 and spending per student held steady.[31] There is ample evidence that much greater productivity in learning is possible than is being achieved in our educational institutions. One study found that computer-based instruction can yield 30 percent more learning in 40 percent less time at 30 percent less cost.[32] The state provides institutional subsidies that write down tuition, but low-income and minority persons are still less likely to attend college or to graduate at the same rate as their more affluent contemporaries.

The often-stated purpose of **local aid and property-tax relief** is to ensure that all communities can provide a basic level of service (such as police and fire protection) without placing an undue or inequitable burden on taxpayers. However, numerous recent studies of the local government aid program have found that aid is poorly targeted. If the state wanted to distribute aid to the neediest communities, it would do almost as well by randomly mailing checks to cities.[33] The property-tax burden on individuals can hardly be considered equitable. The current classification system heavily favors homeowners at the expense of other property owners. Homeowners get about a $700 million tax subsidy as a result of classification alone.[34] The property-tax relief system does little to alleviate these inequities; "circuit-breaker" refunds paid on the basis of financial need account for only 10 percent of all relief and aid. And even though total property-tax relief expenditures (including Local Government Aid) increased at an average rate of four percent beyond the rate of inflation between 1983 and 1992, the public's complaints that property taxes are "too high" continue unabated.

We're spending more money, but we're not necessarily getting better—or even good enough—results.

## SPENDING MORE DOESN'T GUARANTEE EQUITY

**It is equally clear that spending more on public services has not ensured equitable access to these services by all citizens.** Government policies and spending patterns have resulted in deep inequities in education, health care and other services—inequities that are barely dented by the few public programs explicitly targeted to low-income people.

The Congressional Budget Office recently reported that when all 1991 federal tax expenditures (such as mortgage interest deductions) and direct outlays were added up, households with incomes under $10,000 collected an average of $5,690 in benefits. Households with incomes over $100,000 collected an average of $9,280.[35] The disparity is widening, the CBO said. Between 1980 and 1991, the average real federal benefit received by households with incomes under $10,000 (from targeted poverty programs) declined by seven percent, but among households with incomes over $200,000, average real benefits doubled.[36] At the federal level, public policies and spending represent a massive redistribution of resources in favor of the well-to-do.

Similar inequities are in evidence in Minnesota:

- In elementary and secondary education, the supplemental funding that is intended to be used to provide extra assistance for students from low-income families now can be used by districts for any program serving any student.

- Minnesota's system of financing higher education provides an across-the-board tuition subsidy to all college students, regardless of need. Since people with family incomes over $50,000 are three times likelier to attend a four-year college than people with incomes under $30,000, most of the public subsidy goes to those who are already relatively advantaged.

- The state boasts a world-class system of medical care, and the system is more accessible than most in the U.S., but still more than eight percent of citizens, and 12.9 percent of those whose incomes are below $30,000, have no health insurance.[37] Low-income and minority persons continue to experience poorer health on many measures than higher-income whites, at least partly because of their more limited access to health care.

- The state's property-tax relief system distributes 90 percent of relief dollars to governments, not to needy individuals, so these aid dollars benefit everyone—even the well-to-do.

Many citizens and policymakers are concerned about the growth in spending on programs typically called "welfare," such as Aid to Families with Dependent Children. These general aid programs for low-income citizens are *not* the source of the state's budget problem. Indeed, if the state has a redistribution problem, it is that policies and spending tend to be, at best, random with regard to equity and, at worst, tend to redistribute resources in favor of those who are well-off. There has been no systematic link between redistribution and equity, and thus it is unlikely that merely spending more—either on programs such as education or on "welfare" programs directly—will reduce inequity in the future.

Thus, Minnesota's fiscal problem is not just about balancing the budget. It is a crisis of quality, cost and fairness.

## THE FUNDAMENTAL FLAWS

**The fundamental flaws causing this crisis in quality, cost and fairness are that, in general, government and citizens do not require results from spending, or equity in redistribution.**

Most citizens would agree that there is an appropriate role for government in educating its citizens, ensuring basic health and mitigating some of the inequities that are inevitable in market economies. Minnesota has a long tradition of willingness to spend money on these public goals. Why, then, do we find that spending money is not enough to accomplish the purposes that most agree are worthwhile?

The answer is that there is little in the organization of government that requires that spending produce results. Nearly all public services today share the following fundamental design flaws:

- **Rewards are unrelated to mission.** For example, in health care, the financial well-being of providers does not depend on whether citizens are healthy. In education, almost nothing—financing, promotion or other rewards—depends on whether students learn.

- **Payments are made regardless of need.** On the contrary, policies seem to be either explicitly or surreptitiously designed to redistribute resources to satisfy institutional interests or to benefit individuals who are already relatively advantaged.

- **Repair and replacement are favored over prevention.** In general, government pays for and focuses on remedial "services"—prisons, hospitals and fire departments—rather than activities that reduce the need for services, such as block clubs, and health and safety education.

- **Government usually owns and operates—as a matter of course—whatever services it decides should be provided.** "Public" is assumed to mean "government-run."

- **The preferred method of delivery is the indefinitely-renewable contract with an in-house supplier.** In other words, a monopoly.

- **Change is suppressed.** In the current structure, the system can only do more if it has more resources; if there are fewer resources, the system must do less. There is little attention to improving productivity. Monopolies don't respond to pressures for productivity because their revenues are appropriated to them and the appropriations are unrelated to service quality or results. Monopolies empower providers, not consumers. They can take their customers for granted. If a competitive firm doesn't serve its customers well, it loses money and eventually fails. Monopoly bureaus cannot fail. Organizations that cannot fail are unlikely to find change necessary.

Examples of the missing link between spending and results are so commonplace as to go unnoticed. For example, elementary and secondary school districts now receive their per-pupil allotments regardless of whether their graduation rates or student achievement measures improve or decline. In education monopolies, as in other monopolies, the customer—not the producer—bears the risk of failure.

As long as these flawed principles remain the operative principles shaping public services, all efforts to manage better will fail, and all good leaders will turn out to be disappointments.

## NEEDED: A NEW DESIGN FOR GOVERNMENT

**If Minnesota is to maintain its high quality of life in the face of scarce resources, we must solve the problems of quality, cost and fairness—not just disguise them—by correcting these fundamental flaws.**

We must build into government policies an inherent link between spending and outcomes, injecting the incentives that ordinarily drive organizations to give the most value for the money. And we must design policies such that redistribution of resources is meaningfully connected to increased opportunity for the needy.

Minnesota needs a new design for government, so that when individuals act in the public interest, they also meet their own interests. The next section will describe a set of principles that should characterize this new design.

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[1]The Minnesota Chamber of Commerce computed this average using data from the Minnesota Department of Finance, including the Department's annual *Economic Report to the Governor* for 1992 and earlier years.

[2]DRI/McGraw-Hill, *U.S. Review Long-Range Focus*, Summer 1992, p. 4. The forecast figures cited here are from DRI's Trend Forecast, which assumes moderate growth and inflation and no major disruptions between now and 2017. DRI says this forecast, one of four scenarios, represents its best estimate of the economy's path between 1993 and 2017.

[3]*Ibid*, p. 40.

[4]*Loc. cit.*

[5]U.S. Bureau of Labor Statistics, *Handbook of Labor Statistics* (Bulletin 2340), August 1989. p. 27.

[6]DRI/McGraw-Hill, *op. cit.*, p. 39.

[7]*Ibid*, p. 45.

[8]*Ibid*, p. 1.

[9]*Ibid*, p. 44.

[10]*Ibid*, p. 1.

[11]*Ibid*, p. 40.

[12]Kevin Phillips, "Down and Out: Can the Middle Class Rise Again?" *New York Times Magazine*, January 10, 1993, p.18.

[13]DRI/McGraw-Hill, *op. cit.*, p. 40.

[14] *Ibid*, p. 47.

[15]U.S. Census figures for 1980 and 1990. Minnesota State Demographer forecast of 2000 population (dated 1983, the most recent forecast available).

[16]Minnesota State Demographer, testimony to committee.

[17]Minnesota State Demographer, testimony to committee.

[18]Minnesota State Demographer, *Population Notes*, July 1990, p. 2.

[19]Minnesota Department of Jobs and Training, *Minnesota Employment Outlook to 1996*, p. 17.

[20]Minnesota Department of Jobs and Training, *Minnesota Labor Market Review*, September 1992, p. 18.

[21]U.S. Department of Commerce, *Statistical Abstract of the United States*, 1991, p. 443.

[22]Carolyn MacDonald, "Review of Historical Trends in State and Local Finance, 1942-1987," Minnesota Department of Revenue, *Minnesota Tax Revenue and Policy Review*, March 1992, and Minnesota Taxpayers Association, *How Does Minnesota Compare?: Fiscal Year 1991 Comparisons*, March 1993.

[23]Eric A. Hanushek. "The Economics of Schooling: Production and Efficiency in Public Schools." *Journal of Economic Literature*, Vol. XXIV, September 1986, p. 1146.

[24]Minnesota Department of Finance data, adjusted for inflation using the U.S. Consumer Price Index (Urban).

[25]Harold W. Stevenson, "Learning from Asian Schools." *Scientific American*, December 1992.

[26]Hanushek, *op cit.*

[27]Minnesota Department of Human Services, "Minnesota Family Self-Sufficiency and Medical Entitlement and Related Programs, Revised Projections for the 1992-93 Biennium," June 30, 1992, and updated information, April 1993.

[28]Minnesota Department of Health, *1991 Minnesota Health Statistics*, December 1992.

[29]Metropolitan Council, *The Twin Cities Area in Perspective: A Report on 43 Regional Indicators*. November 1992.

[30]Annie E. Casey Foundation, *Kids Count Data Book: State Profiles of Child Well-Being*, 1993, p. 11.

[31]Minnesota Department of Finance, and Minnesota Higher Education Coordinating Board, Biennial Report. The method of counting enrollment changed in the early 1980s. Per-student spending figures are provided for 1984 and later years because enrollment figures for this period are consistent and can be compared reliably.

[32]Lewis J. Perelman, "The Technology Connection: A Business Action Plan for Increasing Learning Technology and Productivity." The Hudson Institute, January 29, 1991.

[33]Study sponsors have included the Minnesota Taxpayers Association, Minnesota Business Partnership and the Minnesota Department of Revenue. The Citizens League reported similar findings in 1987 and 1990. See also: Helen Ladd, Andrew Reschovsky and John Yinger, "Measuring the Fiscal Condition of Cities in Minnesota," submitted to the Minnesota Legislative Commission on Planning and Fiscal Policy, March 1991.

[34]Minnesota Taxpayers Association, *Reforming Minnesota's Local Property Tax and State Aid System: Ending the Fiscal Illusion*, December 1992, p.24.

[35]Neil Howe and Phillip Longman. "The Next New Deal." *The Atlantic Monthly*, April 1992.

[36]*Ibid*.

[37]Metropolitan Council, *op. cit.*, p. 12.

## Chapter Two

# DESIGN PRINCIPLES FOR BETTER VALUE

**HOW** can Minnesota increase the value of each dollar of government spending so it can achieve the results that will be necessary in the future, without substantially raising the proportion of personal income spent on government? This is the critical question state lawmakers should address.

Doing so requires that citizens and officials take a different view of the role of government. *The traditional view has been that government solves problems by regulating, taxing and spending money on programs.* It is this model that has brought us to the current situation, where it seems that the defining activity for government is the budgeting and appropriations cycle, and where money—who gets it, who gets to spend it and who is in danger of losing it—is the central focus.

We believe this traditional view has been discredited. Increases in revenue and spending have not necessarily been accompanied by improvements in results, and redistribution of money has not achieved equity. In any case, it is unlikely that sizable amounts of new money will be available to state and local government. Thus, the paradox we face is that while money commands the bulk of citizen and government attention today, more money will no longer mean much when it comes to getting the job done.

We are proposing a different view of government: *Government's purpose is to design environments where individual citizens and institutions are systematically oriented to accomplish public purposes, and where they meet their own interests in the course of doing so.* In this approach, government is not mainly about dishing out money, but about creating systems in which *money means something*—systems in which more money gets more results and subsidies go to people who need them.

**CHANGING** the design of government is different from exhorting managers and employees inside government institutions to devise a new mission statement, or to reshuffle priorities, or to be more participatory or customer-friendly. These steps can help. Good management is important. But there is a larger system of incentives and rewards that shape and limit what can be accomplished by even the most creative and dedicated public manager. The occasional heroic efforts that result from management innovation are inevitably overwhelmed when this external environment neither requires nor rewards appropriate results.

What are most often identified as problems in government are, in fact, symptoms. Most efforts to improve results attack these symptoms, rather than the underlying problems, and most efforts to attack symptoms fail.

The key may be in what a Minnesota business person, new to the public sector, liked to ask: "Is [improvement] something you do, or something that happens if you do the fundamentals right?" Most efforts to date have consisted largely of trying to "do improvement," of dealing with symptoms. These have not worked. Something is blocking the adoption of ideas that are widely known and widely agreed upon. We have to find what is blocking change and change that. What is blocking change, the underlying problem, is that the structure of government does not require results in return for appropriations, nor equity as a consequence of redistribution.

There are very few strategies that can solve these underlying flaws. The strategies are remarkably basic. They are outlined below.

## TO LINK REDISTRIBUTION WITH EQUITY...

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

Government should avoid writing down the price of public services for all citizens. Doing so creates enormous inequities. Government should especially avoid providing direct subsidies to individuals who are not economically needy. Giving public money to individuals who are not poor is, simply, spending money where it isn't needed and generally penalizes the truly needy, who are not treated equitably. Most especially, government should avoid policies that, regardless of their other intentions, surreptitiously redistribute resources to the disadvantage of those who are already disadvantaged.

Targeting means that government:

- ensures that subsidies follow individuals who qualify for them;
- provides subsidies only to individuals who have low incomes and wealth;
- gives recipients information to make the resources powerful;
- redistributes resources only to ensure equal access to basic services in which there is a compelling state interest and
- redistributes resources explicitly rather than through indirect methods.

One of the central functions of government is to mitigate some of the inequities that inevitably occur in a market economy, to ensure that all citizens have equal access to certain basic necessities of public life. Thus, to the extent that government redistributes resources in favor of the well-to-do, it fails to produce one of the most important results we should expect—fairness.

Government may occasionally wish to encourage certain services to be provided, and payments to individuals—including those who wouldn't be considered needy—may be an appropriate way of doing that. However, in these cases funding should be provided directly and explicitly in a contract for the service, and should be contingent upon performance. (For example, contract with physicians to provide care in rural communities if needed; don't subsidize all medical students with the hope that some will move to the country.)

Even if large amounts of new money were available in the future, current policies would not enable us to spend our way to equity. However, large increases in public resources are not likely. Minnesota can no longer afford to spend money where it isn't needed. Targeting public subsidies to those who are needy is the only path to fairness when resources are limited.

## TO CREATE AN INHERENT LINK BETWEEN SPENDING AND RESULTS...

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

The notion of harnessing competition in the name of public purposes is neither new nor radical. Indeed, it is a cornerstone of the American system of government. James Madison, principal architect of the U.S. Constitution, had it right. He said:

> [The] policy of supplying, by opposite and rival interests, the defect of better human motives, might be traced

> through the whole system of human affairs, private as well as public...[T]he constant aim is to divide and arrange the several offices in such a manner as that each may be a check on the other—that the private interest of every individual may be a sentinel over the public rights.[38]

The arrangement of "opposite and rival interests" permeates relationships between the three branches of government, and even within the legislatures and courts. For example, justice is dispensed not by one institution, but by the rival interests and duties of police, other enforcement agencies, prosecutors, defense attorneys, correctional institutions, judges and—most importantly—juries. Note that nearly all of these functions are provided within the public sector; accountability is assured not by the presence of private interests, but simply by the presence of rival interests. Taking the justice example, competition protects individual rights and advances society's interest in lawful order. The importance of the separation and competition among the various interests is reflected in the popular phrase expressing skepticism of those who would be "judge, jury and executioner, too."

Madison and the other framers of our system focused on creating checks *between* the different branches of government and within the judicial branch. Their aim was to prevent the concentration of power in the hands of individuals who might define the public interest as equivalent to their own personal ambition.

Competition does the same thing in private markets. When only one company made cars, you could "have any color you want, as long as it's black," as Henry Ford said. The company's interest—convenience or simply a preference for black—defined the public interest. Only when competition exists, only when customers have choices, are producers required to give customers what they want. Competition in commerce prevents a business from defining the public's interest as equivalent to its own interest.

Madison ingeniously injected competition into the design of government at a time when today's enormous bureaucracies could not have been foreseen. His analysis, however, is equally apt today with respect to the agencies that provide our public services. What is needed now is to allow the arrangement of opposite and rival interests—competition—to be the sentinel that protects the interests of citizens who use and pay for public services.

Public services should be arranged such that:

- those who buy service are motivated by self-interest to select the best service at the lowest cost;
- service providers must produce results that people value, or risk losing money;
- evaluation of service performance is conducted by someone other than the provider and
- when possible, individual citizens control their own expenditures and choose their own services.

"Dividing and arranging the offices" in this manner can take place entirely within the public sector. Injecting competition into public services is not the same as privatization. True, this arrangement does allow government to choose to provide public services through private firms. But this is not necessary. What is necessary is to break up the monopoly elements of public services by separating the different interests of institutions and public, and by forcing service producers to win the public's business. Those competing producers may well be, and often will be, public organizations.

Neither is it necessary for government to create a consumer marketplace for all public goods. This is arguably the most powerful arrangement for aligning public interests with institutional self-interest in many cases. However, it may not always be practical or even desirable to create such a marketplace. For some government functions the public as a whole, rather than individuals, is the consumer. For example, few individuals would choose to buy the services the Internal Revenue Service has to offer! In other cases, people may be uneasy about letting individuals have sole control of decisions about services, such as public education, that affect the community as a whole as well as individual students. In such cases, competition can still align institutional interests with the public interest, even when individual choice is restricted.

There are three ways that competition can be used as a tool to improve public services. Before we describe them, a few words about terminology.

For every public service, whether road repair, vocational education or health care, there is a body that makes policy decisions. That body may be the legislature, an elected school board, a city council or an executive agency that is accountable to the elected body. Taking a city council as an example: The council decides what services should be provided (with input from voters, of course), plans how the services will be delivered now and in the future, sets standards for assessing the quality of service, sets guidelines for who can or should be served and budgets for the costs.

Planning, making policy, deciding—those are the functions we typically think about when we think about policy boards. What is often overlooked is that these boards are also *purchasers of service*. They represent the public by purchasing public services on citizens' behalf from producers. *Producer* is an all-purpose term that includes any firm or individual that actually delivers the public service. Producers can be snow plowers, kindergarten teachers, biochemists, firefighters or public health nurses. Producers are the "doers."

The three examples below—performance-based appropriations, the purchaser-producer split and citizen markets—show how competition can link spending and results.

**Make appropriations contingent upon performance.**

In this arrangement, the elected body makes the purchasing (allocations) decisions. Individual consumers don't control the purchase of the service, only the selection of the elected officials who make the purchasing decision. However, in contrast to the current practice where there is no necessary link between spending and results, in this arrangement appropriations are contingent upon performance. If the producer doesn't achieve results as specified by the legislature or other elected body, the appropriation is lost.

Competition is provided by the presence of alternative producers who may compete for appropriations. If the elected body has several alternative producers from which to choose, it can transfer funding from a poor producer to a better producer. However, if it faces few choices, withdrawing funding may mean that the service is not provided at all. For services that are perceived to be essential, or that have powerful constituencies, this choice may become a practical impossibility. Choice exists only when there are few barriers hindering new producers.

This arrangement of services is especially appropriate for public functions that serve the public at large rather than citizens individually (the IRS is again a good example). It is also appropriate when the nature of the public service is such that the number of competing producers is likely to be small.

(In many cases, government policies can strengthen the link between spending and results by holding *individual citizen-consumers* responsible for performance. For example, need-based student financial aid is currently contingent upon satisfactory academic progress, but the state's general tuition subsidy benefits even those students who neglect their studies. For some services, it may be appropriate to view citizen-consumers as competitors for public funding and discontinue aid if performance is unsatisfactory.)

Establishing a systematic link between spending and results requires the presence of an independent source of information about the producer's results. Anecdotal evidence reported by the producers themselves is insufficient, since producers will tend to be motivated to over-report success and under-report failure.

For public services that serve individual citizens directly and where there are more potential producers, the link between spending and results can be strengthened further. In the following example, competition is injected into the producer side of the service.

**Split the roles of purchaser and producer.**

In this arrangement, government **splits the roles of service producer and service buyer.** For most services today, both functions—purchasing and producing—are accomplished by the same body and this results in an inherent conflict of interest. The governing body is supposed to represent the public interest by arranging for services that meet public needs. But there is no real sense in which these boards actually seek and select the best value for their expenditures. This is because these bodies also tend to be sole producers of the service they are purchasing, big government institutions that (like all big organizations) have their own interests, apart from those of the people they are supposed to serve. Rather than purchasing the services that respond to their constituents' concerns, they instead assign constituents to receive services from the only snowplowing, teaching or firefighting business in town—themselves.

In the purchaser-producer split, the governing body acts as policy maker and purchaser. This *purchaser's* job is to represent the public interest by choosing the best quality service at the lowest price, within the total budget the legislature (or voters) provides. The purchaser selects producers from among competing firms. The *producer's* job is to actually deliver the service. Producers may be public or private firms.

Minnesota's Department of Transportation is an example of this model. The Department makes plans and decisions about Minnesota's highway needs, but the roads are built by companies selected by competitive bid.

In a purchaser-producer split, policies should:

- allow purchasers to retain what they are able to save by choosing producers wisely (that is, motivate the purchasers' self-interest);
- minimize the barriers stopping the entry of new producers of service, so that purchasers have choices and
- provide for independent evaluation of purchaser performance.

Government may still restrict the choices available to citizens, such as by assigning children to certain schools. Competition here does not necessarily mean an individual marketplace; competition works on the producer side to spur better quality. When producers must compete for a purchaser's business, they face powerful incentives to improve value and control price.

For public services in which citizens benefit individually, it is possible to represent individual interests directly, as in the following example.

**Make citizens the purchasers.**

In this model, government **creates citizen markets for public services.** Individual citizens are given their allotment of public dollars (or their equivalent) and are allowed to choose their public services from among competing public or private providers. In this example, government links spending and results by:

- putting money under the control of the individual citizens who use the service;
- giving citizen-recipients choices by removing the barriers facing new producers;
- giving citizens trustworthy information about their options and
- allowing producers to fail and to go out of business.

Producers who wish to prosper must get to know their citizen-consumers and do a good job of meeting their needs. Quality standards need not be set in advance by the government. Instead, people are allowed to decide for themselves what quality means, and spend their money for whatever services gives them the most "bang for their buck."

Citizen markets are already in place for some public services. For example, low-income parents who are eligible for subsidized child care receive vouchers to pay for their care arrangements. Parents may choose whichever licensed provider they prefer. Government facilitates good choices by giving parents information about what is available and how to choose a provider, and by setting licensing standards that show which providers meet basic standards of quality.

These three arrangements—performance-based appropriations, the purchaser-producer split and citizen markets—may exist concurrently. Or they may be considered alternatives, from among which policymakers may select depending upon the characteristics of a particular public service. In the second section of this report, we will show specifically how these three different arrangements can be applied to reshape Minnesota's design for education, health care and aid to property-tax payers and local governments.

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

Prices give purchasers important information that helps them make decisions about how to spend their money. In the case of public services, the "price" may be an out-of-pocket fee such as a water bill or college tuition. Or the price may be the property taxes paid for local services such as police protection.

Current policies often disguise the true cost of public services, and distort citizens' choices about how to spend their money and otherwise invest their resources. Public policies sometimes artificially reduce the price to individuals who use the service. This encourages consumers to demand more of that service than they would otherwise. In other cases, people may behave in ways that are socially costly because they don't have to personally confront those costs. Sometimes, the effect of public policies is to make the prices of public services higher than they should be, so that people *don't* use services that would be in both their and the public interest.

When the prices people face conflict with government's exhortations about what they should do in the public interest, people usually respond to prices, not exhortations. To create a stronger link between public spending and desired results, public policies should give citizens an economic stake in their personal decisions, as follows:

- **Equalize people, not products.** In general, government should not "write down" the price of public services to make them seem less costly, whether by measures that reduce local property taxes, or by institutional subsidies that reduce fees for service. Doing this is inequitable. It also encourages overconsumption because consumers are unaware of the true cost of their decisions, and weakens the accountability between citizen-consumers and producers. To make essential services affordable to low-income persons, government should in most cases give these individuals money (subsidies) directly, rather than lower the prices of the services. Individuals then can make their own choices about how much public service they want given the competing demands on their budgets.

- **Make sure prices reflect social costs.** Government policies should strive to ensure that avoiding socially-costly behaviors and otherwise meeting public goals is in people's economic self-interest, not contrary to it. For example, riding a motorcycle with a helmet should be less expensive for the cyclist than riding without one. Recycling should be cheaper for the homeowner, renter or business owner than throwing trash out. Saving for the children's college education should be a better deal than leaving them to rely solely on financial aid. Getting help for a child's small problems, such as difficulty reading or adjusting to a new stepparent, should be easier and cheaper for the family than obtaining inpatient chemical dependency treatment later on.

## TO MAKE GOVERNMENT SPENDING MORE VALUABLE...

**Principle 4. Meet more public responsibilities through non-governmental communities in which people already have relationships of mutual obligation.**

While Principles 2 and 3 use material incentives to align individual economic self-interest with the public interest, the fourth principle acknowledges that economic self-interest is not people's only source of motivation. Here, government taps the inspiration frequently associated with membership in a community of shared values.

Citizens are not merely consumers of government programs. Nor is the family just a collection of people who sign up for convenient services from one another, said Thomas Fitzgerald in a recent *Ann Arbor News* commentary, noting that "each member is part of a patterned net of complementary responsibilities and mutual dependence."[39]

Families, ethnic organizations, churches—clans—fulfill a variety of public purposes including child rearing, caring for the infirm and education. They are producers and problem-solvers. Government can make use of the motivations generated in these private communities by carrying out some of its responsibilities through them. This does not mean that government dictates how families should live, or abrogates its responsibilities and transfers them all to individuals and the private sector. It does mean viewing these private communities as appropriate, effective and accountable mechanisms for meeting public responsibilities.

Government assistance, when provided through such communities, can accomplish public purposes that do not respond to regulation, tax incentives and spending alone. Amitai Etzioni says:

> The power of the community differs radically from that of the state. While the state coerces, preventing people from holding preferences they hold dear, the community persuades people to change their preferences to those that are socially responsible. Communities draw on the special bonding between children and parents, among friends and neighbors, in peer

groups, and between community members and their leaders. These powers rely on praise, looking askance, thankful glances, a congratulatory slap on the back, recognition in a town meeting, a story in the local paper. These make most people want to "behave" rather than forcing them to do so, and they make people feel good about being socially responsible, rather than antagonistic to state-imposed order.[40]

Recycling is a good example of how public purposes can be met in this way. Citizen participation in recycling has been phenomenal, even with the not-insubstantial personal investment involved. People must wash out their cans and bottles, separate items into several categories, store them for a longer period than their garbage, use specific containers and remember their pick-up date. Yet, thousands of Twin Cities residents are doing all of this, without the insistence of government regulations. There are no "recycling police." There is no "polluter's prison" for the noncompliant, or rehabilitation program for the recalcitrant. Citizens are participating voluntarily and with apparent good cheer, largely because communities—neighborhoods, grass-roots environmental groups, youth clubs—have convinced them that "good people" conserve resources. Government played an essential role by providing colorful bins, a few rules and convenient pick-up. All of these cost money. Government spending wasn't the driving force, however. Communities made recycling a success.

In short, government should seek out communities that nurture "other-mindedness" among citizens. Such other-mindedness does not eliminate the need for government financing. But fostering public-spirited behavior can, we think, reduce the need for costly government interventions in the long run and make government spending, when that is needed, more productive.

## TO STRENGTHEN MINNESOTA'S REVENUE BASE...

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

In the long run, our hope for improving the welfare of Minnesota citizens and solving many public problems hinges on building a more robust economy. We have said that the role of government should be about designing environments in which people are oriented to accomplish public purposes and in which money means something. Dishing out money is not government's primary purpose. But even in the best-designed public system, money will still be needed.

Minnesota has been able to increase its spending in the past without substantially increasing the total price of government—the portion of aggregate personal income devoted to state and local revenues. Slowing economic growth will slow the revenue base and crimp citizens' abilities to pay a greater share of their incomes for public services. That slowdown in economic growth is due in part to demographic factors beyond our immediate control. However, productivity improvements can boost economic growth even in the face of demographic constraints. Productivity improvement *is* within our control.

Thus, the resources Minnesota has available for future opportunities and problems depend on the decisions we make now that affect the state's productivity. And since productivity hinges on investment, the state's success in improving productivity depends on the wisdom of its investments.

It is popular to justify expenditures on a seemingly infinite number of public activities with the claim that such expenditures are investments in the future, that they will improve productivity or make the economy bigger or better. In practice, however, there are relatively few public activities that represent true investment. They are:

- improving infrastructure (roads, telecommunications, and so forth);
- engaging in research and development;
- encouraging private saving and capital formation and
- preparing young people for productive lives.

To get the best long-term return from state expenditures, policy makers should take seriously their role as investors. Doing so means making sure that expenditures on infrastructure, research and education are met with measurable, demonstrated results, which in turn requires that results be evaluated rigorously and impartially. For other items of spending, "good investing" simply means getting the most value from every dollar of state expenditures.

Principle 5 does not suggest that government spending *by itself* hinders economic growth. Citizens appropriately choose what level of resources they wish to devote to public services. Principle 5 does say that when an increasing share of personal income is devoted to public expenditures, with no necessary improvement in results, the capital needed for future growth is drained.

If the "design principles for better value" are applied to Minnesota's public services, state and local expenditure decisions can indeed contribute to a strong economy.

## THE POLICY IMPERATIVE

We believe that the time has passed for short-term solutions. Minnesota needs structural reform, and there are only a few ways to achieve that. The five principles outlined above represent the essential requirements for structural reform.

[38] James Madison, *The Federalist Papers by Alexander Hamilton, James Madison and John Jay* (Number 51), NY: Bantam, 1982, p. 263.

[39] "Communitarians Put Responsibility Above Selfish Wants." *The Ann Arbor News*, March 23, 1992.

[40] "A New Community of Thinkers, Both Liberal and Conservative," *The Wall Street Journal*, October 8, 1991.

# PART II

## REAL REFORM FOR EDUCATION, HEALTH AND PROPERTY-TAX RELIEF

## Introduction to Part II

# REAL REFORM FOR EDUCATION, HEALTH AND PROPERTY-TAX RELIEF

GOVERNMENT'S purpose is to design environments where individual citizens and institutions are systematically oriented to accomplish public purposes, and where they meet their own interests in the course of doing so.

What do these environments look like? And what should government do to get there?

In this section, we show how the "design principles for better value" can be applied to Minnesota's major spending items—elementary and secondary education, post-secondary education, health care and property-tax relief to individuals and cities. These four items account for the bulk of general fund expenditures, so improvements here will have the greatest impact on state spending.

It's important to emphasize what this section is *not*. It is not a budget prescription. We have detected an average of what Minnesotans appear to be willing to spend on public services, and have urged policymakers to assume that threshold is not likely to rise significantly. However, we have not issued a call for spending to be cut, capped at that level or even limited to a certain rate of growth. The chapters that follow do not claim to present a plan for cost savings. There are no budget figures, save for a few that put the scale of the current budget into context.

WHAT this section does do is provide practical, tangible examples of how government can go about designing environments in which people and institutions are oriented to serve the public interest...environments in which money means something...environments in which more spending gets more results and subsidies go to people who need them.

Each example includes:

- an overview of Minnesota's spending on that item;
- a description of the problems of cost, quality and fairness today;
- a discussion of how the fundamental design flaws have led to our problems;
- an explanation of how the "design principles" can correct those flaws and
- specific recommendations for policy changes.

Not every principle applies to every spending area; the examples highlight the principles that are most pertinent.

The impetus for this report was—and continues to be—Minnesota's budget problem, so the question "what will all this do for the budget?" is a fair one. The conclusion addresses this question, and offers our vision for how Minnesota can meet the challenges of quality, cost and fairness in the future.

First, an overview of state and local spending will provide the context.

# Overview of Minnesota's Spending

**The Minnesota Department of Finance has estimated that the state's general fund expenditures for the 1992-93 biennium will be $14.6 billion.**[41] The 1994-95 biennial budget totals $16.7 billion.[42]

**Minnesota's spending growth is outpacing revenue growth**. Expenditures will grow 13 percent in 1994-95 compared to 1992-93, while revenues will grow only 10.6 percent. The Department of Finance has estimated that unless action is take to correct this gap, lawmakers can expect a shortfall of $393 million for the 1996-97 biennium.[43]

**Four spending items account for most of the state's general fund spending.** Elementary and secondary education, post-secondary education, health care and property-tax relief to individuals and cities together account for 74.6 percent of the total budget. The remaining 25.4 percent covers all other spending on courts, corrections, family support, transportation and many other state programs. (See Figure 3).

**Two of the largest budget items are also the fastest-growing.** Department of Finance estimates show health care expenditures increasing 24.9 percent and elementary education aids growing 19.2 percent in 1994-95, compared to 1992-93.[44]

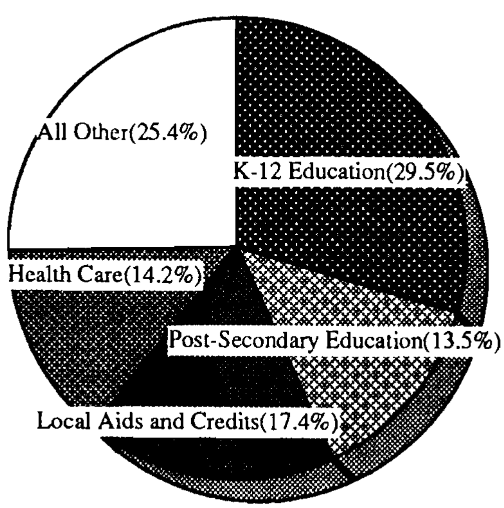
**Minnesota's state and local governments spend much more than those in other states, on average.** Total state and local spending in Minnesota was $4,250 per capita in 1991. That was 18.4 percent higher than the national average.[45]

State and local spending as a percent of personal income in the state was 18 percent higher than the national average.[46]

Minnesota's state and local spending on education, health care, and police and fire grew faster than the national average between 1990 and 1991.[47]

Figure 3

**1992-1993 General Fund Expenditures**
(Total expenditures: $14.6 billion)




Source: Minnesota Department of Finance, March Forecast

[41] Minnesota Department of Finance, *March Forecast*, March 1993, p. 29. At the time of this writing, the books were not yet closed on the 1992-93 fiscal year; we have used the March Forecast figures as estimates.

[42] Minnesota Department of Finance, information provided August 16, 1993.

[43] *Ibid.*

[44] *Ibid.* Comparisons of expenditures between biennia are based on this August 16, 1993 information. The estimated totals for various spending categories in 1992-1993 may differ from the March Forecast figures because some expenditures were shifted to different reporting categories.

[45] Minnesota Taxpayers Association, How Does Minnesota Compare? Fiscal Year 1991 Comparisons. March 1993, p. 19.

[46] *Ibid.*

[47] *Ibid*, p. 6.

Chapter Three

# NEW DESIGN AND BETTER VALUE IN ELEMENTARY AND SECONDARY EDUCATION

## RECOMMENDATIONS

To improve the value of its spending on K-12 education, Minnesota should:

1. Require that school districts separate the policy ("purchasing") functions from the management ("producer") functions.

2. Remove the limit on the number of charter schools.

3. Allow charter schools to be chartered by either a local board of education or the state board.

4. Allow teachers to form professional partnerships that can contract with school boards to provide instructional programs.

5. Create an independent body to assess district, school and student performance.

To make its education system more equitable, the state should:

6. Ensure that all state funding follows the individual student to the school and program he or she chooses.

7. Tie compensatory revenue to the school and program where the qualifying student is enrolled.

8. Eliminate weighting for teacher training and experience.

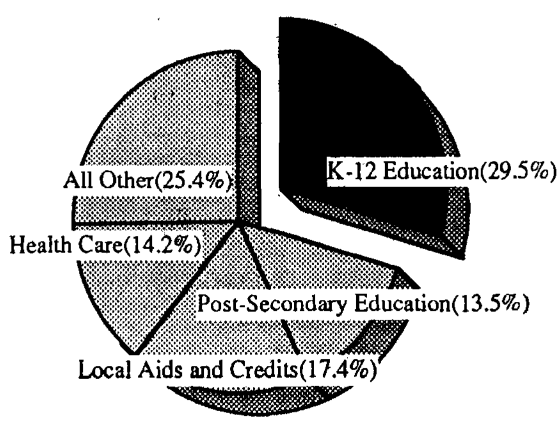
## BACKGROUND

Elementary and secondary education together represent Minnesota's largest single general fund expenditure. In the 1992-93 biennium, the state is expected to have spent about $4.3 billion to educate students in kindergarten through twelfth grade (K-12), or 29.5 percent of the general fund budget.[48] This is only 59 percent of the total amount spent on schooling. When local district spending (from property-tax revenues) is included, total expenditures in 1992-93 are expected to top $7 billion.

Minnesota's state government and local districts spend more than the national average on elementary and secondary education. This is true with regard to expenditures per capita, general expenditures per $1,000 of personal income, current operating expenditures per

Figure 4

**K-12 Education Expenditures, Share of Total Budget, 1992-1993**
(General Fund)




Source: Minnesota Department of Finance

student and per capita expenditures for capital outlay.[49]

Total state and local spending on K-12 education has increased dramatically in recent years. Following a decrease in education spending in 1983, general fund spending grew 28.8 percent between 1983 and 1992, after accounting for inflation.[50] Enrollments also increased, so real spending per pupil grew slightly less quickly—21.9 percent.[51]

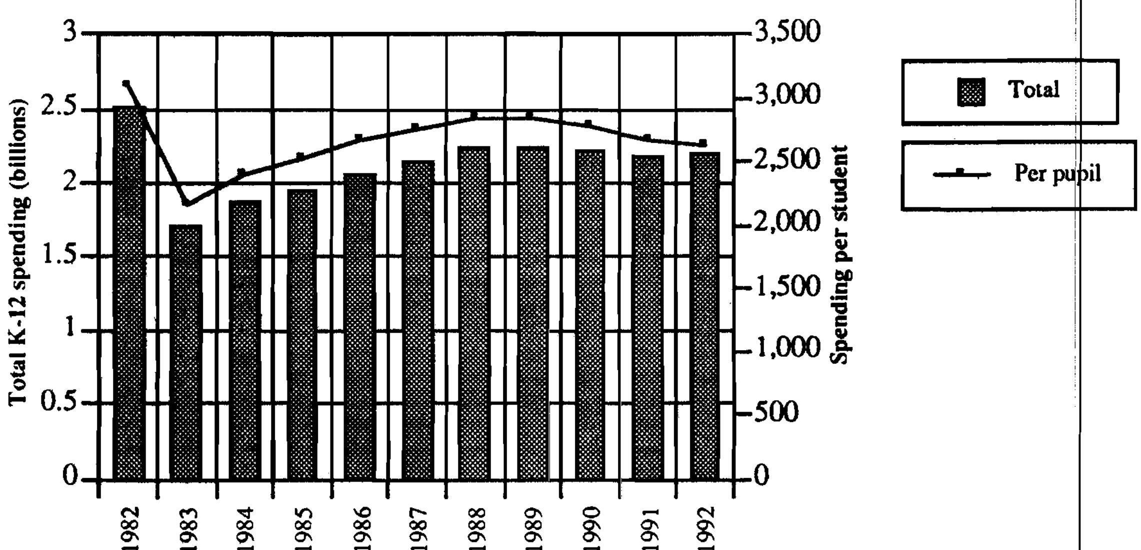
Minnesota's school-finance system is often thought of as a combination of state- and locally-raised revenue. However, in effect it is a state-financed system. In state fiscal year 1992, 59 percent of the total cost of K-12 education was paid from the state general fund from non-property revenue sources; the other 41 percent was paid from property taxes that the Legislature required local districts to raise.[52] The Legislature sets the "education revenue amount," then decides what part it will pay from general fund revenues and what part the districts will be required to pay from property taxes. The "local" tax is, in fact if not in name, a state property tax.

## THE PROBLEM

Many of the troubles in our public education system are caused by forces external to it, such as poverty and other stresses on families. As a society, we must do what we can to relieve the schools of these burdens.

Figure 5

**Elementary and Secondary Education Expenditures, 1982-1992**
General Fund only (1992 dollars)




Source: Minnesota Department of Finance, adjusted for inflation using the Consumer Price Index for All Urban Consumers, U.S. Includes education finance appropriations and the school district portion of tax aids and credits.

But schools can make a difference. We must insist that our schools meet these challenges. Schools must not use these problems as an excuse for failure.

We have three concerns about the current K-12 system. The system is inequitable. It is not achieving the quality of results that will be necessary to meet future state challenges. The cost of education is rising faster than the state's ability to pay. Let's examine each concern.

**It is an inequitable system.**

Public education—cherished for the contribution it has made in the past and defended in terms of the way it works in theory—is, in fact, a deeply inequitable system.

Like any democratic system, the public education system responds mainly to the majority interest. It is relatively inattentive to minorities of all kinds. People's success in influencing the system depends on how much money they have, how experienced and comfortable they are in organizational process and on the amount of time that can be spared from the necessities of daily life. When decisions are made politically, people with less experience, less money and less time are very much disadvantaged.

In any large urban region such as the Twin Cities, public education is stratified by income and race. Houses of like value tend to be built together, house value is closely related to income and income is related to race. District boundaries lock in these differences. True, busing of students has achieved some racial balance within districts, but between districts and within schools inequities persist. "Tracking," the grouping of students by what teachers call ability, is pervasive. As John Goodlad reported from his research, students described as "lower ability" are given the less-challenging courses, and they never catch up.[53]

Financing of education reinforces these inequities. For example, "compensatory revenue" is a mechanism put into law in 1971 that provides additional money for students whose families receive Aid to Families with Dependent Children (AFDC). It was intended that compensatory revenue flow to the schools in which these students are enrolled, to pay for the additional supportive services low-income students typically need. That compensatory revenue was, however, captured by districts, with no requirement that the aid follow the student who qualifies for the additional revenue. The state has no real idea whether the aid is helping the students it was intended to help.

Another financing mechanism that reinforces inequities involves the weighting, for budgeting purposes, of differences in teacher training and experience. The mechanism works like this: The state pays districts a certain per-pupil amount, which is used to pay for education resources including teacher salaries, the largest single item in most district budgets. Some teachers cost more than others, however, because they have more experience or education. The state has chosen to provide an extra amount to the districts that have the more experienced teachers, essentially insulating these districts from the cost of their staffing choices. These schools benefit from the additional funding made possible with the tax dollars of their peers.

In these and other ways, the existing public school system is rigged against those who need good education most as their way out of poverty.

**In the future, better results will be needed.**

Minnesota has been considered a model for public education nationally. There is some evidence that Minnesota parents are generally satisfied with their children's education.[54] What's the problem?

One concern is that we do not really have a very clear idea how well our schools and students are doing today. Few measures of education performance are designed to reveal results. Most measures focus on inputs. Administrators often compare (and the media astonishingly report!) statistics about spending as if these were measures of quality. We talk about student-staff ratios and about the number of computers per classroom, regardless of how the computers are used. Such input measures tell us little about what students know and are able to do.

In part, this situation exists because education performance is, by nature, difficult to assess. Goals, too, have not always been clear. However, the lack of satisfactory measures also persists because K-12 education is one of the few systems still allowed to be the sole evaluator of its own performance. Administrators fear that measures of performance will be used to compare districts and schools. Their solution has been to either not report performance at all, or to test for and report performance in ways that make comparisons impossible.

**We must do better.** As noted in the opening chapter of this report, however, there is evidence that large increases in spending have not been accompanied by significant or adequate improvements in student performance. As Harold Stevenson found, Minnesota students and their families may be pleased with their progress, but their contemporaries in Taiwan and Japan are far outperforming them. In a 1992 Minnesota Business Partnership/Employers' Association survey of 351 Minnesota firms, fewer than one-third of respondents said that today's employees are prepared to estimate results, prepare and interpret tables, use math techniques and decide how to use resources. Sixty-four percent said that while today's job applicants are as well-educated as applicants were 10 years ago, that standard is no longer good enough for today's world-class business standards.[55]

**We *can* do better.** The challenges facing Minnesota in an increasingly demanding environment will require a better-educated citizenry. Arguments about whether schools are worse (or better) now than in the past miss this challenge from the future. Comparisons of educational achievement with other states miss the challenge from other countries. Citizens, policymakers and employers know performance has to improve, and so do educators. As Willard Baker said, when he was executive director of the Minnesota School Boards Association: "We'll stipulate: We can do better."

So far, the debate about improvement has unsuccessfully relied upon exhorting educators and administrators to fix symptoms of the problem rather than the underlying system flaw. The underlying flaw here, as elsewhere, is that there is little in the broad motivational structure of education that necessarily links appropriations with performance. As long as that underlying flaw remains, we will experience the all-too-familiar frustration: Everyone agrees that change is necessary, and almost everyone agrees about what changes are necessary, but few of these changes get made and even fewer last.

**Cost pressures are increasing.**

In Minnesota, as nationally, per-pupil spending has been rising in real terms, for several decades. In 1992, 770,319 students were enrolled in Minnesota schools, and the average spending per pupil (general fund only) was $2,629; that was 24.4 percent higher in real terms than in 1983.[56]

The cost of elementary and secondary education is rising fast but is not out of control, as the cost of health care arguably is. The fact that all education revenue appears in public budgets (that is, people don't pay fees) means education is, however, a special problem for the public sector. The appropriation for the K-12 system is the largest item in the state general fund. Even small percentage increases on so large a base of expenditure require large increases in revenue. And as budget pressures mount in health care, local services and other spending areas, even small percentage increases in education will become more difficult to finance.

Several factors are pressing education spending to rise more sharply over the next few years.

- **Enrollment:** Enrollment has recently turned upward, with the "echo" of the baby-boom. This will continue for several years.[57]

- **Buildings:** Both in the Twin Cities area and in Greater Minnesota, districts are beginning a big program to repair, replace, improve and add new school buildings.

- **Increases in scale:** Consolidation of districts continues to be pushed as one supposed answer to the need for cost efficiencies. However, consolidation will drive up costs as salaries, benefits and programs are averaged upward to ensure consistency.

- **Compensation:** Districts have recently been overspending the funding provided by the Legislature in order to finance their contract settlements with teachers. School district leaders say they cannot restrain this overspending. The Minnesota Association of School Administrators said in 1992 that boards have decided they cannot win a teacher strike; therefore, boards generally decide not to take a strike, so they choose not to make demands or resist a settlement if that might cause a strike. Board members sometimes point out that administrators have little incentive to resist teacher salary demands either, since their salaries are usually some multiple of the amount agreed upon for teachers.

  The state and districts alike are finding their options for dealing with these compensation pressures unappealing. A district, for example, can finance large contract settlements by cutting staff and programs. Parents understandably resist this.

  The district can also raise extra funds locally if voters approve. This has become a common way of funding contract settlements in high-wealth districts. It is harder in low-wealth districts. Low-wealth districts have recently asked the courts to rule the referendum levies unconstitutional because of the inequities that result. These districts may not be seeking to shut off the referendum levies, but rather are hoping the Legislature will provide even more aid than it already does. Meanwhile, high-wealth districts lobby hard to keep the "local right to go beyond." The impact of these two pressures together is that the Legislature is asked to fund a level of spending set by somebody else. Legislators, however, are reluctant to finance spending set by somebody else.

## NEEDED: NEW DESIGNS FOR EDUCATION

Policy discussions about education are overwhelmingly about more money. The system is obsessed with the struggle for resources. In the past, districts have asked for and the public has supported large spending increases, even when the state's resources were tight.

Two things have become clear, however. Future economic conditions will mean that large increases in spending on elementary and secondary education will be unlikely, or at best will compete with other important spending items, such as health care. And recent experience has shown that merely spending more has not been accompanied by better student performance, nor by more equitable treatment of disadvantaged students. Thus, we will not be able to spend our way to better educational quality.

We will have to find a way to use resources more effectively. The sheer size of this budget item makes the need for reform more urgent.

## THE FUNDAMENTAL FLAW IN K-12 EDUCATION: WHY HASN'T SPENDING HELPED?

There have been countless good efforts to improve education. Most efforts have focused on activities that people agree are desirable but that the districts are not doing, such as creating new programs for staff development, helping teachers make small classroom improvements and providing computers. Innovative demonstrations, widely reported, give the impression of a changing system. But as Education Week reported in a recent series, few experiments last and fewer still spread widely through the system.[58]

Why is it so difficult to achieve the improvements that so many agree are necessary?

The structure of reward is unrelated to district improvement and student performance. The state guarantees districts their success whether they change and improve or not. Four interlocking features of the K-12 system provide the guarantee of success:

- **Mandatory attendance.** Children must go to school until they reach age 16.[59]
- **Districting.** Children go to school where they live.
- **The exclusive franchise.** Within a district, there is only one organization allowed to offer public education.
- **Pupil-driven financing.** Public funding is given to districts based on the number of students enrolled.

In effect, the state attempts to educate its young citizens by entering into sole-source, non-competitive, indefinitely-renewable contracts with roughly 430 districts, guaranteeing payment almost literally regardless of performance. Within very broad limits, nobody's success depends on whether the children learn. Districts—monopolies—are assured their existence, customers and revenues. Adults in the districts are also assured their jobs and their security. Albert Shanker, president of the American Federation of Teachers, put it bluntly: "This is a system that can take its customers for granted."

The state should repair the missing link between spending and student performance by making district and school success depend on the *students'* success.

Making this important change may be easier than we think.

## DESIGN PRINCIPLES FOR BETTER VALUE IN ELEMENTARY AND SECONDARY EDUCATION

The "design principles for better value" can be used to organize public education so that the interests of the public and students drive the institutions' interests. The solution is not simply to spend more money on education, but to change the structure of the education system so that rewards and incentives are properly aligned and students come first.

It is important to stress that this need not mean privatization. All of these changes can take place completely within the public sector. The essence of the change is not who provides the instruction. The essence is how the structure can be oriented so that student, family and public interests prevail.

Here is how to use the design principles to do that:

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

By design, public education involves no direct payment for service. Instead, public financing provides for the cost of education for all citizens. However, the public system also provides additional funding—subsidies—to some individuals and districts to allow for differences in need. Unfortunately, those subsidies do not always benefit those who need them most.

The state should change education financing mechanisms that tend to redistribute education resources randomly or in the wrong direction. Public subsidies should be targeted to individuals who are financially needy. We recommend that:

- **Compensatory revenue should follow the qualifying student to the student's school and educational program.** The state should not allow this subsidy to be treated by districts as undesignated funding available for general use.

- The state should **eliminate the weighting for teacher training and experience.** Instead, resources should be apportioned as dollars per student. This approach focuses on giving *students* equal resources, rather than on ensuring equity for district administrations. Advantaged districts, which now tend to employ the more experienced and expensive teachers, must face the consequences of their own management decisions, rather than being insulated from them.

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

Current state policy recognizes that K-12 education is a public service in which the public at large has a stake, but where individual students and families are also entitled to some direct choices. Many of the competitive features described in Principle 2 are already in place. Minnesota should strengthen and expand these features, with the following steps:

**Strengthen existing citizen markets for public education.**

Minnesota and other states have enacted policies that expand the choice that has always existed in education. Since the 1920s, students and parents have been allowed their choice of schools. For most of that time, however, choice required money: Families could pay tuition to private school, or they could move to another public school district. If you had money, you had choice. It was an inequitable plan, but it has been widely used.

Minnesota introduced a more equitable choice policy in 1985. "Open Enrollment," fully in law and operation by 1990, now allows students and families to choose which school district they prefer. The state permits per-pupil state aid to follow students when they move between districts, and between district schools and post-secondary institutions or charter schools.

A citizen market for education is already in place in Minnesota. It needs simply to be preserved and strengthened. To strengthen this citizen market, the state should:

- **Ensure that all state funding (per-pupil state aid and compensatory revenue) follows the students to the schools and programs they choose.**

  This policy would put money more directly under the control of the citizens who enroll their children in the schools. When parents and students have greater control of their resources, they become more valuable as customers and have a stronger claim on the institution's performance.

- **Remove existing barriers to new schools in order to expand choices for students where they live.**

  With the advent of the post-secondary option in 1985, the Legislature began to withdraw the "exclusive franchise" that had characterized public education. It let colleges and universities offer the top two years of high school. In 1991, the Legislature relaxed that "exclusive" even further with the charter school legislation that permitted groups of licensed teachers to form their own schools. With this new law, new schools may appear—not owned by the local board and, in some cases, not sponsored by the local board. The legislature should expand student choices by further removing barriers that hinder the formation of new public schools.

  **The limit on the number of charter schools should be lifted.** To encourage more new schools, the Legislature should **make it possible for people hoping to organize a school to approach either a local board or the state board directly to obtain a charter.**

In addition to strengthening the citizen market for education, much more can be done to create stronger links between spending and performance.

**Split the roles of purchaser and producer: Give choice to school boards.**

The school board today sits in a basic conflict of interest. It represents the citizens, taxpayers and parents of the community, whose interest is in getting the best possible education at the best price. That is what the board promises. But there is no real sense in which the board actually goes out to get the best methods and technologies of teaching and learning. It sits also as the board of directors of the only teaching-and-learning business in town and what it does—all it really can do, under present arrangements—is serve students through the learning-business it owns and runs itself.

Boards of education, like citizens, need the opportunity to choose in order for their money to be meaningfully spent.

Minnesota should create choice for boards by getting the board out of the ownership of the teaching-learning program, by separating the role of purchaser from that of producer. In such an arrangement, the board would focus on objectives, performance, money—in short, on policy. The people who now run its schools would be spun off into a separate organization. Between the purchaser and the producer there would be a contract for performance.

There could be several producer groups in any district, and some could be owned by the teachers.

In the process of creating a purchaser-producer split, it will be possible to give teachers the opportunity to take full responsibility for their work—essentially, to own the instructional program. This would be possible at the scale of an entire school, a department or program within the school. Teachers could form professional partnerships or cooperatives that they would own.

In this professional partnership, the teachers would select their colleagues, design their own program, arrange their training, determine their work-assignments, evaluate their members' performance and settle their compensation. The group would receive from the school board a certain level of funding per student enrolled. The teachers could keep for use in their program or as personal income what they did not need to spend.

This arrangement would set up strong incentives for the teacher partnership to reduce cost and improve student learning. As a consequence, there would also be an incentive to adopt learning approaches that involve students, parents and community people to a much greater extent than is the case now. Studies have shown that peer teaching is the most effective of the possible educational interventions. Its cost, while not zero, is far lower than the cost of other approaches such as making the school year longer or classes smaller.[60]

A teacher professional group would also have a powerful incentive to take up new technologies. Improvements that make an activity more productive are taken up very rapidly when work and ownership are combined. This is what is needed in education, and what is lacking at the moment.

For either approach to injecting competitive vigor into public education—citizen markets or the purchaser-producer split—another "check" on institutional interests is essential.

**Create an independent body to evaluate performance.**

Minnesota should establish a new body, perhaps outside state government, to appraise school and student performance. Such external assessment is commonplace in other fields. For example, the bar associations, not the law schools, administer the bar exam. The FDA, not the packing houses, grades the meat. The Highway Patrol, not the schools, gives the driver's test. Independent assessment would provide school boards, citizens and the state the information they need about district and school performance.

Minnesota also needs good statewide information about student performance. This information can be obtained through sampling. An independent body could periodically assess a random sample of students or classrooms, testing for what students at various levels know and are able to do. A sampling methodology would assuage administrators' fear of inter-district and inter-school comparisons, and sample results would have nothing to do with an individual student's grades or prospects for graduation.

**Principle 4. Meet more public responsibilities through non-governmental communities in which people already have relationships of mutual obligation.**

Principle 4 provides another reason that the state should remove existing limitations and encourage the formation of more charter schools. Principle 4 recognizes that families and communities are the primary sources of education for children.

Indeed, Coleman and Hoffer, in a study of public and private high schools, found that verbal and mathematical achievement were higher, and the likelihood of dropping out lower, in schools that were an outgrowth or agent of the community in which the student was a member. Their findings emphasized the "importance of the embeddedness of young persons in the enclaves of adults most proximate to them, first and most prominently the family, and second, a surrounding community of adults..."[61] Families and communities are more successful not because they spend more, or even necessarily use more advanced teaching methods, but because children feel valued. Government institutions that attempt to create this sense of community must work against the prevailing system of incentives.

**Minnesota should attempt to fill its public responsibility for education, in part, by enabling communities to start their own schools.** Such communities might include neighborhood groups, ethnic associations or groups of parents with other similar interests (the group who organized the new Metro School for the Deaf is a good example).

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

Minnesota's spending on elementary and secondary education is one of the state's most important investments in future economic growth. That is a statement many lawmakers, education leaders and citizens make readily. Unfortunately, all too often the reasoning has been "Invest in the future—spend more on education." That is no investment strategy.

Minnesota must take more seriously its responsibility as an investor. The state should insist on being given evidence about the performance of the education system. That evidence must come from independent, impartial sources. And the state should insist upon results.

Spending that is unconnected to results will contribute to continued economic malaise. If the design principles are used to create a link between spending and results, Minnesota's expenditures on education can instead build productivity and economic vitality.

## BENEFITS OF THIS PROPOSAL

This proposal has several potential benefits.

**It would provide real accountability.** In an explicit contract arrangement, the teaching-learning organization would insist on knowing what the board wanted. The board would insist on knowing what it received in return. Agreements would be renewed or not, depending on performance. This, and the opportunity for educators and others to propose new and better schools, would provide stronger incentives to improve value.

**It could reduce the concern some Minnesotans have about competition in public education.** Some people are not comfortable with the idea of families exercising educational choice alone. There is a desire—reasonable, we think—to have choice and competition controlled in the public interest. What we propose here would provide that control, by making parent choice available among a set of schools chosen by a responsible public body: The local board of education or the State Board of Education.

**It would improve equity.** Parents would be able to act directly and decisively, as well as politically, in the interests of their children. The money provided for at-risk children would go to the schools in which those children enroll. Of course, it would be foolish to expect legislation to solve all equity problems. Much will still need to be done to change the definitions of "ability" and to improve equity and racial balance within schools. But the inequities in the present system should be reduced.

**It would reward those who risk change.** For the teachers and administrators in the system who are trying to put students first, introducing these dynamics would bring the interests of the organization into alignment with their own desires for improvement. Today, teachers and administrators find change risky. With new incentives in place, the risk would appropriately be shifted to those who resist change.

**It would greatly speed the rate of improvement.** Change would not require restructuring, retraining and remotivating an existing organization. A board could move directly to bring in a new organization with a new program.

**It would clarify the roles of boards and educators, to the advantage of both.** In recent years, boards have become increasingly involved in administration. This has brought them into growing conflict with superintendents, with unfortunate results. Urban boards of education are now turning over superintendents about every three years. Significant restructuring is impossible under these conditions.

**The purchaser-producer split could make choice real in the smaller communities in Minnesota.** These communities are too small to offer parents and students two or more schools to choose from. But if the board could bring in different and better organizations to offer parts of the learning program within existing schools, choice would have meaning.

## CONCLUSION

The program outlined here will convert a sluggish K-12 system to a dynamic system.

Some people advocate a different approach. They call for a centralized state- or national-level process to set objectives, reform curriculum and assessment, revise teacher training and restructure governance, all at the same time. "Systemic," they call it. This is a regulated-public-utility model. It would leave education inert, like the present system is, and responsive to its own interests rather than the interests of students.

Some advocates for expanded school choice argue that students and families should be permitted to use their public education aid dollars to pay for schooling provided by private institutions, including churches. Certainly Principle 2 and Principle 4 appear to point in this direction. However, we acknowledge that this issue raises some troublesome questions about which reasonable people might disagree. The committee members, in fact, disagreed about the appropriateness of expanding school choice to religious schools. We therefore make no recommendations about the question, but leave that important issue for further debate. Here, it is sufficient to show how these reforms could be applied entirely within the *public* education arena. We believe that even if these reforms are applied only within the current public system, they can achieve substantial improvement in the value of Minnesota's education spending.

Reform, to be successful, must introduce dynamics that press institutions to improve value as defined by their customers. Nothing will change unless the district finds change necessary. Necessity can only be imposed by pressures from the outside, from parents, students, boards that are essentially buyers of education and from independent evaluators of performance.

We are not serious about getting better education for our state dollars if we do not introduce these structural reforms that drive change.

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[48] Minnesota Department of Finance, *March Forecast*, March 1993, p. 29. This figure does not include the school portion of tax aids and credits.

[49] Office of the Legislative Auditor, *School District Spending*, February 1990, p. 6.

[50] Minnesota Department of Finance. Adjusted for inflation using the Consumer Price Index for All Urban Consumers, U.S.

[51] *Ibid.*

[52] Minnesota Department of Finance.

[53] John Goodlad, *A Place Called School*, NY: McGraw-Hill, 1984.

[54] Harold Stevenson, *op. cit.*

[55] Minnesota Business Partnership Academic Agenda Subcommittee: "Employment Education Survey—Overview of Results." Summary, undated.

[56] Minnesota Department of Finance. The enrollment figure is Average Daily Membership. Spending per pupil is total spending divided by Weighted Average Daily Membership (WADM). WADM is a weighted count of pupils. In the weighting, one kindergartener equals 0.5 pupil units, one elementary student equals one pupil unit, and one secondary student (grades 7-12) equals 1.3 pupil units.

[57] Higher Education Coordinating Board, *Minnesota Higher Education: Changing for the 21st Century: Report to the Governor and 1993 Legislature.* January 1993, p. 36.

[58] "From Risk to Renewal." *Education Week*, February 10, 1993.

[59] A recent law raised the mandatory attendance age to 18. The law will take effect for students who are currently in grades five and below.

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[60] Henry M. Levin, et al, *Cost-Effectiveness of Four Educational Interventions.* Institute for Research on Education Finance and Governance, School of Education, Stanford University, May 1984.

[61] James Coleman and Thomas Hoffer, *Public and Private High Schools: The Impact of Communities.* NY: Basic Books, 1987.

## Chapter Four

# NEW DESIGN AND BETTER VALUE IN POST-SECONDARY EDUCATION

### RECOMMENDATIONS

To make Minnesota's higher-education system more equitable, the state should:

1. Reduce the share of support provided via appropriations, and increase the share provided directly to individuals on the basis of financial need.

2. When distributing aid, work closely with ethnic and other community groups that have relationships with low-income and minority people.

3. Create incentives that encourage people to save for college.

To improve the value of its higher education spending, Minnesota should:

4. Split the roles of purchaser and producer in higher education:

- view system boards as purchasers of service and as policymakers, not as operating entities that produce service;

- pass legislation that permits "chartered" higher-education programs;

- permit other private and public producers of non-instructional services to compete for the system's business.

5. Make appropriations for instruction, research and other service activities contingent upon performance.

6. View students as competitors for public funding, and discontinue public tuition write-downs if performance is unsatisfactory.

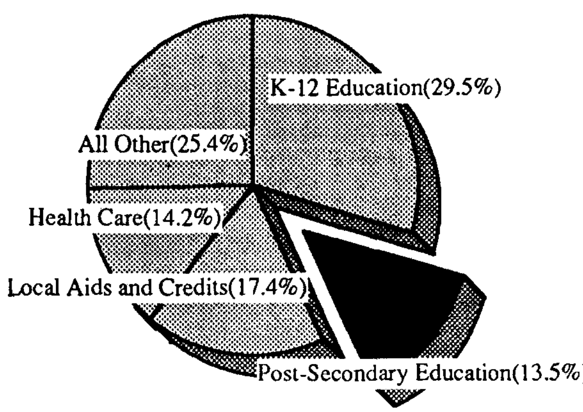
## BACKGROUND

The State of Minnesota operates 66 post-secondary education campuses in four systems: technical colleges, community colleges, the State University System and the University of Minnesota. In 1991, a total of 270,953 students were enrolled full- or part-time in post-secondary education, 77.6 percent of them in public institutions.[62] Minnesota shows high levels of participation in higher education. The state's public, full-time equivalent enrollment per 1,000 population was 22 percent higher than the national average in the 1991-92 school year.[63]

Minnesota is estimated to have spent $1.98 billion on post-secondary education in the 1992-93 biennium. Higher education is the fourth-largest single budget item in the state, accounting for 13.5 percent of the general fund budget.[64]

Figure 6

**Post-Secondary Education Spending, Share of Total Budget, 1992-1993**
(General Fund)




Source: Minnesota Department of Finance

The state spent $316 per capita on higher education in 1990. That compares with $304 in Wisconsin, $234 in South Dakota, 485 in North Dakota and $339 in Iowa. Minnesota's spending was 28.5 percent higher than the national average.[65]

The state's spending on post-secondary education generally increased during the 1980s (see Figure 7). Despite small declines in spending in 1983, 1985 and 1992, total inflation-adjusted expenditures increased 28.2 percent between 1983 and 1992 (13.4 percent between 1984 and 1992). However, enrollment also grew at about the same pace, so real spending per student was about the same in 1992 as it was in 1984.[66]

In 1991, the Legislature authorized a new "superboard" to oversee planning for a three-way merger of the technical college, community college and state university systems. The merger, intended to streamline post-secondary education in the state, must be completed by July 1, 1995.

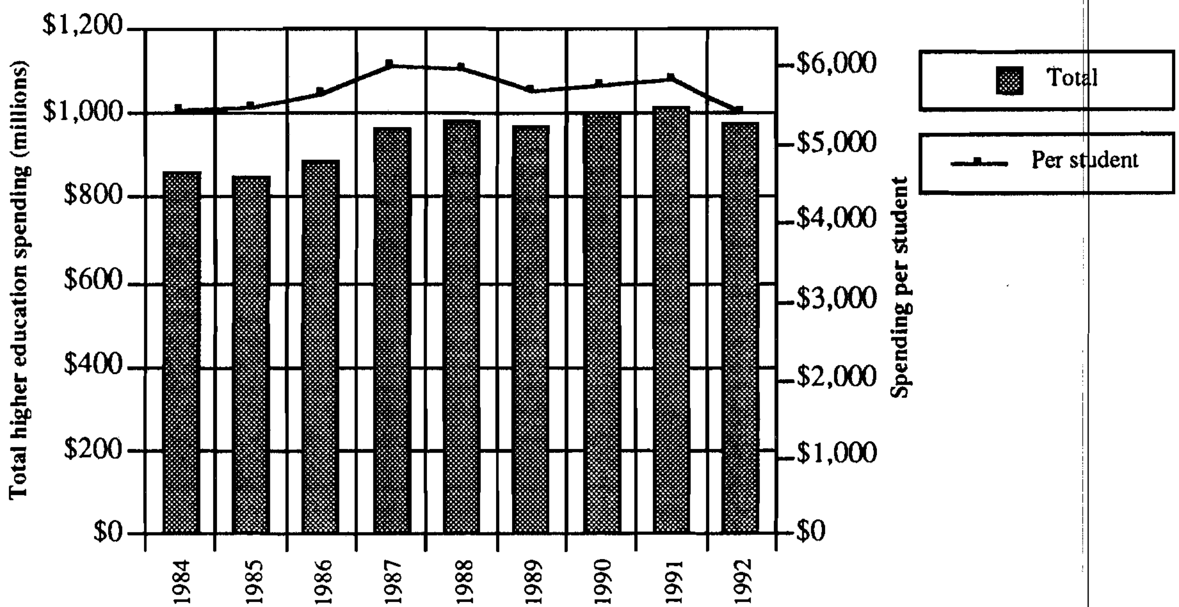
## THE PROBLEM

Higher education in Minnesota is a public service in which citizens have choices. The availability of choices is, we think, the reason why the problems of cost and quality are less acute in post-secondary education than they are in many other public services. Minnesota attracts people from all over the world to its colleges and universities, a sign of their relative quality.

However, we have four concerns: Post-secondary education in Minnesota is inequitable. Cost pressures, combined with a slowing economy, will make financing of higher education increasingly

Figure 7

**Post-Secondary Education Expenditures, 1984-1992**
General Fund only (1992 dollars)




Source: Minnesota Department of Finance and Minnesota Higher Education Coordinating Board. Adjusted for inflation using the Consumer Price Index for All Urban Consumers, U.S.

difficult. Parents are not assuming a sufficient degree of responsibility for financing their children's schooling. Finally, the monopolistic features of higher education will continue to stifle innovation and quality improvement at a time when more will be expected from our education institutions.

We'll examine each concern in turn.

**Post-secondary education is inequitable.**

Minnesota has failed to enable appropriate numbers of low-income and minority students to attend higher-education institutions and graduate successfully.

The current financing system is partly to blame. The system consists of state grants to institutions that enable the institutions to hold down tuition to about 40 percent of the true cost of instruction. These grants account for more than 90 percent of all state spending on post-secondary education. Another 8.7 percent of the state's higher education budget is provided in direct grants to students based on their financial need.[67] (The federal government also provides need-based financial aid but that aid has declined in recent years.)

Despite the state's institutional subsidies that "write down" the amount charged in tuition, many low-income students find the cost of attending college out of reach. Direct financial aid for needy students is often insufficient to fill the gap between the cost of attending college and their families' available resources. This burden persists even though poor families typically make great efforts to pay for their children's education. In Minnesota, low-income families contribute up to five times more in family resources than is expected under federal financial aid guidelines, and they ask for smaller reductions in what they pay than do their middle- and upper-income contemporaries.[68] As economic conditions have squeezed household budgets, low-income people have been less likely to even apply for financial aid. Since 1986, aid applications from families with incomes under $30,000 have dropped 25 percent.[69]

Higher-education finance in Minnesota constitutes a substantial redistribution of resources in favor of students who are from families that are relatively well-off. In Minnesota, a person with a family income above $50,000 is three times more likely to attend a four-year college than a person with family income under $30,000.[70] Since people who go to college tend to be wealthier than those who don't, and since need-based aid is only a small fraction of the total aid the state provides, most of the state's support is in the form of subsidized tuition to those who are already relatively advantaged.

These inequities also show up in how dollars are allocated among the state's higher education institutions. On average, students at the University of Minnesota are best off financially. (Indeed, the median family income of U of M students is greater than that of private college students in the state.) Next well-off are students in the State University System; then, those in community and technical colleges. But the state subsidizes the University most, then the State Universities, then the community colleges. Students who don't attend college, if they are lucky, get jobs and pay taxes—which subsidize the education of their more privileged peers.

Because people of color are more likely than whites to earn low incomes, this financing system has particular impact on minority participation. Financing arrangements and many other factors together have deterred minority students. Minority enrollments grew during the 1980s, but only kept up with the growth of the minority population in the state. Students of color participate in higher education at lower rates than whites (39 percent compared to 45 percent), and, with the exception of Asians, are more likely to drop out before they enter their second year.[71] The percentage of college graduates is still only 17.5 percent of the

African-American population, 17.2 percent of Hispanics and 7.7 percent of American Indians, compared to 21.9 percent for whites.[72]

The higher-education system perpetuates other inequities that prevail in the system of elementary and secondary education. Students from more advantaged backgrounds tend to do better in high school, so they are also more likely to meet the admissions standards of the more selective colleges. Low-income and minority students, even if they find a way to pay for higher education, are thus more likely than their privileged peers to find their choice of school restricted. Students with fewer choices are less powerful as consumers. Of course, admissions standards are appropriate for colleges and universities. These institutions should not be expected to lower their standards or to bear responsibility alone for inequities that exist elsewhere in society. Nevertheless, we should expect that post-secondary education be structured in such a way that disadvantaged students are not made more disadvantaged, but are equally powerful—as consumers—as their more advantaged fellow students.

**Cost pressures are increasing.**

Enrollments are projected to grow during the 1990s, a reflection of the "echo" of the baby boom. The number of students graduating from high schools fell throughout the 1980s, but between 1992 and 2000, the number is projected to increase by 29 percent.[73]

These enrollment increases will put pressure on the state's resources. Unfortunately, there is no large pool of funds that Minnesota spends on frivolous activities and that can, therefore, be painlessly transferred to higher education. Higher education now receives a healthy 13.5 percent of the state general fund budget. The other main objects of state expenditure—elementary and secondary education, health care and property-tax aid to individuals and cities—also are legitimate state responsibilities. Transferring funds from them to higher education is not a satisfactory or likely solution to the budget problems of higher education.

So, with enrollments continuing to rise and the economy languishing, and considering the demands that other items such as early education and health care are placing on the budget, it is unlikely that the state will put a larger fraction of its resources into higher education, much less that it will increase real per-student spending.

**Families are not preparing adequately for higher education.**

Minnesota families, in general, do not prepare sufficiently for their responsibility to pay for their children's college education.

More than half (56 percent) of Minnesota families in a recent study did not save or invest for their children's education. A low rate of saving might be expected from families whose incomes are also low. But even among families with incomes over $45,000, 47 percent did not save anything at all for their children's schooling.[74]

Saving for college is desirable for two reasons. First, a pool of savings means that families have more resources initially available for tuition and other educational expenses. Second, the study found that parents who saved for college contributed more to their children's education than non-savers, at all levels of income. It appears that a "savings mindset" is socially desirable.[75]

The reasons for this low rate of savings are not known. There are several possible explanations. The most plausible is that this is a reflection of Americans' disinclination to save generally, accompanied by a popular culture that encourages consumption rather than investment. In addition, public policies at best provide no incentives, and often provide disincentives to personal savings.

Some families might also believe (erroneously) that saving money for college is less advantageous than applying for financial aid.

The same study found that many low-income families do not apply for financial aid even though they qualify for assistance. Nearly 20 percent of families who earn less than $45,000 (and who therefore are most likely to qualify for aid) don't even apply, either because they don't know about the aid programs, are daunted by the 132-question form, or are too proud to ask for help.[76] Another possible explanation is that as federal aid has become tighter and more aid has been given in the form of loans, low-income families may be concluding that financial aid—meaning future debt—doesn't really help.

Since the primary beneficiary of post-secondary education is the student, the state should appropriately expect students and their families to make substantial preparation to finance their college expenses.

**Better quality will be needed in higher education.**

In the future, more will be expected of higher education. Nearly half of new American jobs in the 1990s will require high levels of learning, reasoning and mathematics. That fraction was one-fourth in the 1980s. Jobs disappearing the fastest are those not requiring high-level skills; the fastest-growing employment sectors are those requiring greater skills. Most people are entering the workforce unequipped for the latter. The Minnesota Business Partnership, in its 1992 survey of Minnesota employers, found that 50 percent of the jobs in responding firms required some post-secondary education or training. Eighty-five percent of the companies said that technical qualifications are more important than 10 years ago, but 65 percent of manufacturing firms and 53 percent of non-manufacturing firms find it far more difficult to recruit adequately prepared employees today.[77]

At the same time that colleges and universities are being pushed to do better, resources available to fund education are growing tighter. Unfortunately, higher-education institutions, like other public services, have been insulated from the forces that require them to change.

Abundant evidence demonstrates that much greater productivity in learning is possible than is currently being achieved in our educational institutions. For example, one study found that computer-based instruction can yield 30 percent more learning in 40 percent less time at 30 percent less cost than other traditional methods.[78] More than 100 educational methods have been found to be able to double productivity (that is, measured outcome per unit of cost).[79] But more than any other sector of society, education—including higher education—has successfully resisted productivity improvement.

## THE DESIGN FLAW IN POST-SECONDARY EDUCATION

At present, there is no necessary connection between Minnesota's spending on higher education and the results achieved by our higher-education institutions. The legislature does not require higher-education institutions to show evidence that increased spending has yielded improved results in the past or would do so in the future. The existing cost-based funding system provides each institution with a certain dollar amount per student enrolled, whether or not the students graduate successfully or in a timely manner. To justify their requests for instructional and other funds, higher-education institutions present only anecdotal evidence of their accomplishments. This "evidence"—lists of distinguished alumni, numbers of graduates, research projects—does not inform the state about whether spending *more* money on higher education would be worthwhile.

There is also little in the present arrangement of higher education that necessarily links the redistribution of state resources with increased opportunity for citizens who are disadvantaged. Quite to the contrary. Redistribution is now occurring in the wrong direction; the system works to the detriment of citizens who are already disadvantaged.

The higher-education system, as we have said, provides people with choices. This element of competition is the only element of current state policy systematically prodding higher education to be responsive and efficient. However, higher education is still a very imperfect system in which monopolistic institutions limit the vigorous effect of competition. For example:

- higher-education institutions operate as purchasers of service; they hire ("purchase") professors, teaching assistants and so forth to provide instruction to students. They also are the producers of those services. As we have said, when the two roles are shared by one institution, there is a basic conflict of interest that prevents the institution from being seriously at risk if results are not achieved.
- the price of higher education—tuition—has traditionally been manipulated to suppress competition. Tuition-setting has long been marked by collusion between private institutions. Large public subsidies create great tuition differentials between public and private institutions.
- different admissions standards, specialization among academic programs and financial considerations mean that students' choices are much more limited than they might appear. A prospective student of average academic standing has fewer options and less power as a consumer than a straight-A student, for example.
- state subsidies do not follow students to the campus or program they select. Higher-education systems are free to make internal allocation decisions based on institutional interests, rather than the interests of the individual students who bring the funding.
- the planned merger of three of Minnesota's public post-secondary systems may result in managerial efficiencies but will also eliminate some competitive pressure.
- in higher education, prestige and credibility are critical for institutions. This prestige factor means that new education providers face enormous difficulties entering the field. Innovation—in the form of new, competing instructional services—is stifled, too, by the political influence of the teachers and administrators who are the recipients of most higher-education spending.
- individual colleges and universities operate as monopolies to provide many non-instructional services. These activities—dormitories, copy centers, bookstores and custodial services, for example—are subject neither to the goad of competition nor to systematic evaluation of their quality.

Thus, while the level of quality in Minnesota's post-secondary education system is higher than the quality we find in elementary and secondary schools, many of the same factors shield our colleges and universities from the pressure to do better. Higher education, like K-12 education, is largely hide-bound—dedicated, still, to the same educational and operating methods that prevailed centuries ago.

Higher education in Minnesota has done well, but it must do better, and without significantly more money. The system is not likely to meet that challenge as it is currently structured. Until the system's design flaws are corrected, Minnesota will not be able to spend its way to better or more equitable higher education for citizens.

## NEW DESIGN FOR BETTER VALUE IN POST-SECONDARY EDUCATION

In order to achieve the quality that will be required in the future and to ensure that all citizens have a fair chance to obtain a college education, Minnesota needs a new design for post-secondary education.

Minnesota faces an important opportunity to shape its higher-education system now. A "superboard" is planning the merger of the community colleges, vocational colleges and State University System. Will the state be content to allow the new merged entity to continue in the traditional higher education model which, we argue, has not required results from its appropriations? Or, will state leaders consider this challenge an opportunity to rethink the old assumptions?

The "design principles" suggest how Minnesota can seize the opportunity to improve the value for its post-secondary education spending. In brief, the strategies are to make students more powerful by giving them greater control of their dollars, use competition to promote innovation and push institutions to demonstrate the results they achieve with their appropriations.

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

The state should, over the next several biennia, **increase the share of higher-education financing that is provided directly to students who are financially needy. It should reduce the share of higher-education financing that is provided in the form of instructional appropriations to higher-education institutions.**

This policy reflects the belief that the public in general, not just the individual student, benefits from higher education, and therefore that state tuition subsidies are appropriate. However, the policy focuses public aid on students who really need it and makes college more affordable to low-income persons.

The state's first priority should be to ensure that need-based aid programs are adequately funded. It is unlikely that sufficient new resources will be available in the future to allow full funding of need-based support without some reallocation, including reductions in instructional appropriations. The current "low tuition" financing system is the most expensive way for the state to pay for higher education. It is also inequitable for the state to provide the greatest share of public higher-education support to those who are already relatively advantaged.

The state can adopt a more targeted financing system while still providing some subsidy that encourages participation in higher education for all. However, the most important goal for public financing—and the highest priority for the state's resources—should be fair access for low- and moderate-income students.

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

The state should stimulate new forms of competition in post-secondary education, and strengthen existing competition, as the way to get better value for its education spending in the future. To do that:

**Strengthen the citizen market for post-secondary education.**

The Legislature should strengthen the citizen market for higher education by **increasing the share of higher-education**

**aid that is paid directly to students, and reducing the share provided to institutions.** This arrangement is more equitable, as has been noted. It also stimulates greater accountability. When students control a greater share of education dollars, institutions must earn their budgets by concentrating on students.

For the same reasons, the state should also **ensure that an individual student's state aid follows that student to the campus and program he or she selects.**

**Create a purchaser-producer split.**

The state should also **split the roles of purchaser and producer in higher education**. The two roles must be divided if higher education is to respond to the need for innovation and better quality.

Creating a purchaser-producer split in post-secondary education means:

- viewing the policy board (the University board of regents or the board of the new merged system) as the *purchaser* of education services on behalf of students and the State of Minnesota, not as the *producer* or deliverer of education. As a purchaser, the board would set educational and academic standards to be achieved and would choose who produces the service.
- enacting legislation, similar to the "charter schools" law in K-12 education—that encourages groups of instructors, researchers and other academics to form alternative post-secondary education programs. These programs—and groups of existing public faculty—would then compete for contracts to be awarded by the purchasing/policy boards.
- permitting new private and public competitors the opportunity to provide non-instructional services such as bookstores, dormitories and copy centers, under contract with the purchasing boards.
- removing barriers that prevent purchasing boards from contracting with alternative providers of instructional, research and support services.

**Make appropriations contingent upon performance.**

For the portion of instructional funding that the state provides directly to institutions, and for those functions of post-secondary education that serve the public at large rather than individual citizens (scholarly research is a good example), the state should **adopt a policy of performance-based appropriations.** Where institutional aid is given, the state should grant it only in response to evidence that worthwhile work is being accomplished. The evidence should be systematic, not anecdotal, and perhaps should be collected by an independent agency.

Post-secondary education is an example of where government policies can strengthen the link between spending and results by holding *individuals* responsible for performance. For example, need-based student financial aid is currently contingent upon satisfactory academic progress, but the state's general tuition subsidy benefits even those students who neglect their studies. We believe it is appropriate to **view student-consumers as competitors for public funding and discontinue aid (including tuition reduction from general appropriations) if performance is unsatisfactory.** In this context, "unsatisfactory" might be defined as failure to complete one's academic program despite accumulation of large numbers of course credits.

**Principle 3. Prices of public services should reflect true costs, including the social costs of individual decisions.**

This principle provides a third justification for changing the system of financing to favor aid to individual students. The change we propose has the effect of making the price students face—the tuition—more closely reflect the actual cost of education. When help is required to offset the burden on low-income students, it is provided to the students directly.

In higher education, as in other services, prices provide important information to consumers. Education represents an investment people make in their future productivity. When deciding whether or not to attend a post-secondary program or not, and then choosing a school, prospective students weigh their investment against the potential payoff. The cost of their investment includes the cost of the tuition and the work earnings they give up by becoming a student. The payoff includes the increase in earnings they can expect over their lifetimes by virtue of the additional education. Of course, the payoff also includes the enjoyment they get from the educational experience itself.

Tuition is a small part of the total cost of attending college (lost earnings are a much greater share) so simply reducing the price prospective students face doesn't greatly affect their decision about *whether* to go to college or not. But policies that affect the differences in tuition between educational institutions do affect students' *choices* of schools. When the state provides differing proportions of subsidies to different institutions, it makes some programs more attractive than they would otherwise be.

When tuition more closely reflects instructional costs, and subsidies flow to individuals, people can make better choices about their educational investments.

**Principle 4. Meet more public responsibilities through non-governmental communities in which people already have relationships of mutual obligation.**

Higher education in the U.S. already reveals the important role communities play in delivering public services. The system is more successful than other public services largely because students have some freedom to choose where they attend—where they feel comfortable, where they will learn best, where they are likely to succeed—in short, to find the community where they belong. When the fit is right, the student's and the public's spending on education is most productive.

However, we believe that the higher-education system should be prodded to make even fuller use of communities as important education resources.

**Permitting charter higher-education programs is one way to foster the creation of innovative education alternatives that tap community resources.** Such programs now face tough obstacles because of the systems' preference for instruction that employs traditional models, faculty and physical plant.

There are other challenges that require new and better ways of linking with communities. One such challenge is the need to improve opportunities for low-income students and students of color. We have a particular concern that as state subsidies are shifted to individuals rather than institutions, new strategies must be implemented to ensure that need-based financial aid actually reaches students who need it most.

**We recommend that higher-education institutions, when distributing need-based aid, work closely with non-governmental organizations that are led by and have existing relationships with low-income and minority persons.** Eligibility criteria, application requirements and accountability mechanisms would be consistent for all citizens. However, this strategy acknowledges that existing networks of neighborhoods, ethnic organizations and other private associations are a highly effective and accountable "delivery system" for aid to disadvantaged students.

Another challenge is to increase the participation of families in financing higher education for their children. We believe that delivering a major share of need-based financial aid is a step toward improving the utilization of aid programs. However, **the state must also create incentives that encourage people to save and otherwise prepare for college.**

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

Higher-education institutions frequently justify their appropriations with claims that colleges and universities contribute to economic growth. State officials should hold them to those claims and demand specifics, not just anecdotes.

**The state must evaluate its expenditures on higher education, directly and explicitly, for their immediate performance and for their impact on the economy.** As we have said, this means making appropriations for instruction, research and other community service activities contingent upon performance, with performance evaluated systematically and impartially.

Encouraging people to save for college also should be a key state strategy, both to finance education today and to strengthen the economy. A pool of capital, generated by personal saving, is necessary to fuel public and private investment, which in turn is the key to improved productivity and—ultimately—economic vitality.

## CONCLUSION

Minnesota's higher-education institutions are a competitive asset. The system already reflects some of the "design principles for better value." The changes we propose would strengthen the competitive features of the system, promote innovation, ensure greater equity and explicitly link the public's investment in these institutions with their contribution to the future productivity of Minnesota's economy.

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[62]Minnesota Higher Education Coordinating Board: *Minnesota Higher Education: Changing for the 21st Century*, Report to the Governor and 1993 Legislature, p. 28-29. The figures refer to "headcount," which tells how many people attend college either part- or full-time. Full-year equivalent enrollment (FYE) is usually used as a measure of instructional volume for budgeting and planning purposes.

[63]*Ibid*, p. 27.

[64]Minnesota Department of Finance, *March Forecast*, March 1993, p. 29.

[65]Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, Volume 2*, October 1991, p. 212.

[66]Minnesota Department of Finance and Minnesota Higher Education Coordinating Board. Changes were made in the early 1980s in how enrollments were counted and reported. We have made comparisons for 1984 and later years, when the data are consistent and comparable.

[67]Minnesota Higher Education Coordinating Board, *op. cit.*, p. 46.

[68]Minnesota Private College Research Foundation, *Ways and Means: How Minnesota Families Pay for College*, November 1992 (brochure).

[69]Minnesota Private College Research Foundation, *Ways and Means: How Minnesota Families Pay for College*, November 1992 (brochure).

[70]Minnesota Private College Research Foundation, *Ways and Means: How Minnesota Families Pay for College*, November 1992 (brochure).

[71]Minnesota Higher Education Coordinating Board, *op. cit.*, p 19.

[72]Office of the State Demographer.

[73]Minnesota Higher Education Coordinating Board, *op. cit.*, p. 36.

[74]Minnesota Private College Foundation, *op. cit.*

[75]*Ibid*, (full report), p. 54.

[76]*Ibid* (full report), p. 50-51.

[77]Minnesota Business Partnership Academic Agenda Subcommittee, "Employment Education Survey—Overview of Results," summary, undated.

[78]Lewis J. Perelman, "The Technology Connection: A Business Action Plan for Increasing Learning Technology and Productivity." The Hudson Institute, January 29, 1991.

[79]*Ibid.*

Chapter Five

# NEW DESIGN AND BETTER VALUE IN LONG-TERM HEALTH CARE FOR SENIORS

## RECOMMENDATIONS

1. Create regional purchasing bodies and give them the money, the authority to purchase services on behalf of elderly citizens in their regions and the responsibility for health outcomes.

2. Encourage, within these regions, the formation of health-care plans that serve elderly citizens.

3. Allow Medicaid recipients to select the elderly-care plan they prefer. Allow private-paying citizens to buy in also.

4. Reduce the emphasis on professionalized services and encourage alternatives that enable seniors to stay in their communities with the help of families, neighbors and voluntary organizations.

5. Create incentives for seniors or their children to purchase long-term care insurance to protect their assets from nursing home expenses.

6. Advocate for changes in federal regulations to permit the implementation of these recommendations.

## INTRODUCTION

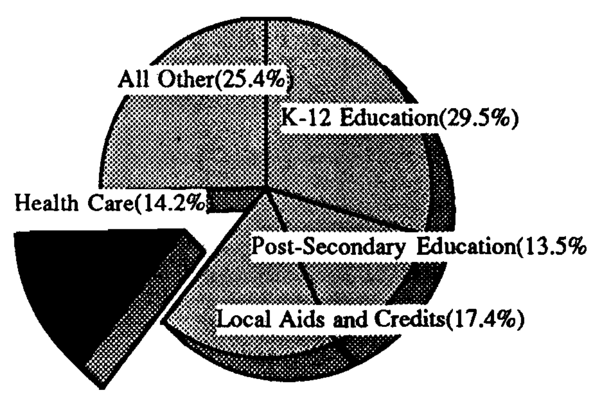
How can government promote and provide for good health for all citizens, while at the same time controlling the skyrocketing costs of medical care? This is one of the foremost questions facing policymakers today, both in Washington and here in Minnesota.

We have not attempted to tackle that monumental problem here. The "design principles for better value" do suggest a way to understand the health-care dilemma, however. We will show in this section how the design principles can be applied to one small piece of the problem, Minnesota's spending on health care for the elderly.

First, an overview of Minnesota's publicly-financed health-care programs.

Figure 8

**Health-Care Expenditures, Share of Total Budget, 1992-1993**
(General Fund)




Source: Minnesota Department of Finance

## BACKGROUND

The state finances health-care services to about 390,000 Minnesotans who qualify for assistance because they are poor or have disabilities.

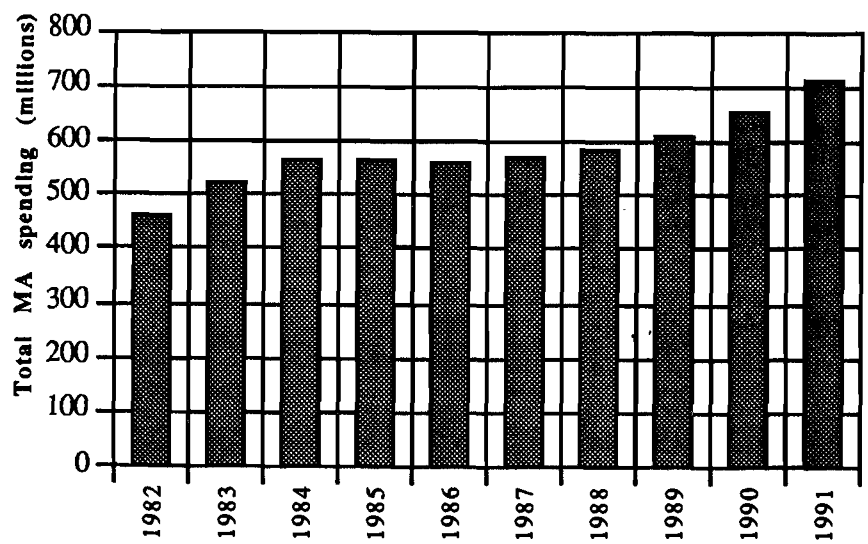
For the 1992-93 biennium, the state's spending on all publicly-financed health-care programs is expected to be \$2.07 billion. Health care, accounting for 14.2 percent of the general fund budget, is the third-largest single spending item.[80] (Total expenditures for Minnesota's Medical Assistance recipients are more than double the state figure after the federal contribution is counted.)

Health care is the fastest-growing part of the state's budget. State health-care expenditures are expected to increase 24.9 percent in the 1994-95 biennium compared to 1992-93.[81] This does not include the costs of subsidizing the enrollment of low-income households in the new MinnesotaCare program.

The largest of the programs is Medical Assistance (MA), Minnesota's version of the state-federal Medicaid program. Within it, care for people in nursing homes and other institutions accounts for about 60 percent of the budget. The other 40 percent covers all other medical services, including hospital and physician care, mental health, dental care and home health services.[82] MA pays for physician and hospital services for low-income persons, including families who receive Aid to Families with Dependent Children (AFDC). MA also pays for nursing-home care for qualifying senior citizens, and care for persons with developmental disabilities in state hospitals (Regional Treatment Centers) and in the community. Besides Medical Assistance, the state provides care through smaller health-care programs such as General Assistance Medical Care and the Consolidated Chemical Dependency Treatment Fund.

Figure 8

**Medical Assistance Expenditures, 1982-1991**
General Fund (1992 dollars)




Source: Minnesota Department of Human Services.
Adjusted for inflation using the Consumer Price Index for All Urban Consumers, U.S.
NOTE: Medical Assistance expenditures account for two-thirds of all publicly-financed health-care spending.

Medical Assistance accounts for about two-thirds of the state's overall health-care spending. Minnesota's expenditures per MA recipient in 1990 ranked second highest among the six Region V states (Illinois, Indiana, Michigan, Ohio and Wisconsin).[83]

## THE PROBLEM

### Costs of health care are rising rapidly

Spending on health care overall will rise 24.9 percent in 1994-95 compared to 1992-93.[84] Spending for Medical Assistance rose 37.3 percent between 1983 and 1991, even after accounting for inflation (see Figure 8). Spending is growing rapidly because of medical care inflation and:

- **Increasing caseloads.** The number of families and children enrolled in Medical Assistance has grown in the last four years and is projected to continue growing. The Department of Finance projects that one-third of this increase will result from the new MinnesotaCare program. People who apply to participate in that program will first go through an eligibility screening that is likely to find that some should enroll in MA instead. Prolonged economic recession and the growth of single-parent, low-income households will also continue to push the AFDC caseload up, and therefore the number of people eligible for MA as well. And as the baby boom ages, the number of nursing-home residents supported by Medicaid will grow steadily.

- **Increases in reimbursements paid to providers.** Rate increases to medical providers will account for 10 percent of the projected increase in MA costs in 1994-95. Health-care costs have been increasing dramatically, but for at least a decade the Legislature has held down the size of reimbursements to physicians and hospitals serving MA patients. Low reimbursement rates help to hold down budget increases, but they also may prompt physicians to refuse to serve MA recipients; there is concern now among policymakers that MA recipients are having more trouble getting medical care. In 1992, the Legislature increased payments to MA providers, partly to encourage more of them to serve low-income patients.

- **Increases in the average cost per recipient.** About one-third of the increase in General Assistance Medical Care spending will result from changes in the type of services people receive. For example, if GAMC recipients are sicker when they seek care and are hospitalized more often, the average spending per recipient increases.

The growth in health-care costs is, of course, not just a Minnesota problem. In fact, there is evidence that Minnesota is somewhat more successful than most other states in restraining the growth of health-care costs, in both the public and private sectors.

In particular, national surveys suggest that employers using HMOs and other managed health-care plans in Minnesota pay less for their coverage than in most other states. Similarly, Minnesota's state employee benefit plans are recognized nationally as an effective example of managed competition. Of course, these successes do not solve the problems of the small business or individual insurance purchaser paying double-digit premium increases, nor of state leaders who must deal with the growth of the MA budget.

### Costs of institutional care are also increasing.

The MA program pays for a wide range of health-care services. We have focused on the cost of nursing homes, one of the most expensive services.

Nursing-home care is the single largest MA expense, accounting for about one-third of Minnesota's Medicaid budget. Nursing-home spending has grown by an average of eight percent a year for the past eight years (in nominal terms), but the increases have accelerated in the past three years.[85] In 1992 alone, nominal MA spending for nursing homes increased by 14.5 percent over 1991 to $674.6 million.[86]

Minnesota's high spending and the pace of recent increases are explained by several factors. First, Minnesota has always relied heavily on institutional care, whether for seniors, people with developmental disabilities or troubled youth. Why? Minnesota expanded its commitment to caring for these individuals during the 1960s, a time when professional institutional care was widely considered the best practice. In addition, government has willingly funded health programs in institutional settings and has defined that care as an entitlement for citizens who are eligible. Medicaid has usually *not* paid for care in homes or communities. Those programs were typically funded with social service dollars that were subject to intense competition from other community needs.

Since 1983, a moratorium on nursing-home development has kept a lid on growth of nursing home capacity in Minnesota. Programs to screen people applying for nursing homes and, when appropriate, to direct them to alternative community services have helped contain the demand for nursing-home care. Still, the preference for institutions persists. In 1989, there were 7.8 nursing-home beds for every 1,000 people in Minnesota, compared to a national average of five, and three in Oregon (Oregon's efforts to create alternatives to nursing-home care are widely respected).

That preference for nursing homes will become more costly as the population ages. The number of seniors in the state is growing steadily. One projection suggests that if current demographic trends and rates of nursing-home care continue, the state will need another 8,500 nursing-home beds by the year 2010. Assuming five percent annual inflation, the state share of MA nursing-home spending could reach $713 million, a 217 percent increase.[87]

Communities in certain parts of the state may find that meeting the needs of a growing population of seniors is a matter of particular concern. For example, in several counties on the southern and western edge of the state, the overall population has declined, and seniors now make up 25 percent or more of the population.

**More nursing-home residents are relying on Medical Assistance.**

During the early 1980s, nursing-home residents were fairly evenly split between those paying with private funds and those supported by MA. No longer. The proportion of MA-paid nursing-home residents has increased steadily in the past five years and is above 60 percent now. There are about 45,000 licensed nursing-home beds in Minnesota, and average occupancy is 90 to 95 percent. In the past 18 months alone, the number of these residents supported by MA grew from 27,424 to 29,168. The Department of Human Services has projected that by 1994 more than two-thirds of all residents will receive Medical Assistance.

People entering nursing homes are usually required to "spend down" most of their personal assets—that is, to qualify as poor—before the MA program will pay for their care. There is anecdotal evidence suggesting that more seniors are now anticipating the need for long-term care and are using various legal devices to transfer assets to their children well before they expect to enter a nursing home. However, there is no conclusive evidence that shows that the greater share of MA recipients results from such transfers. Another explanation is the skyrocketing cost of care; yet another is that more people are delaying entry into nursing homes by using alternative services, so that by the time they do enter they have exhausted more of their resources. State agencies don't have sufficient information to draw firm conclusions about either explanation.

**Spending more on institutional care has not provided the health-care value people want.**

Minnesota has spent and continues to spend massive quantities of money on institutional care. The quality of care in these facilities is generally adequate, and in many cases is exceptionally good. However, there is also growing evidence that many elderly Minnesotans can get better value for these health expenditures than they are getting from institutional arrangements.

The scarcity of community alternatives tends to steer seniors toward institutional care, regardless of their needs and preferences, and regardless of the health outcomes the institutions achieve.

Consider this: Reimbursement for care in nursing homes is now based on a "case-mix" system, where the needs of each resident are evaluated and periodically reviewed. Residents are assigned to one of 11 care classes, based on their level of dependency. In 1990, 30 percent of nursing-home residents were in the two least dependent care classes, and thus were likely candidates for community-based alternatives.

**Health care in Minnesota and the nation is an inequitable system.**

In health care, perhaps more starkly than in any of the other four spending areas, it is clear that spending more money does not, alone, ensure fair access or better health for all. Public and private spending per capita on health care in the U.S. is the highest in the world. Yet many low-income—and, increasingly, middle-income—Americans still cannot afford basic health care.

## THE DESIGN FLAW IN HEALTH CARE

The U.S. health-care system, in general, is organized in such a way that massive amounts of spending are literally unconnected to improvements in the public health. While medical services are the best and most advanced in the world, Americans—Minnesotans included—are generally no healthier than citizens in Canada, who spend dramatically less on health care.

We have said throughout this report that, in general, government should put aid and subsidies into the hands of individuals and allow people to make their own choices. Health care, we think, is a service where consumer markets have limitations. In the current private and public health-care market:

- employers and governments choose and pay for most health benefits, so citizens have little responsibility for shopping carefully for the best value among packages and providers of health care.
- insurance companies and governments pay for professional inputs—doctor visits, lab tests and such—so health-care providers have an economic interest in selling more services, not in keeping people healthy.
- the third-party payment system masks the prices consumers face, so individuals have few clear economic incentives to stay healthy by making wiser lifestyle choices.
- individuals have very little information about the performance of their health-care providers, and thus are largely at the mercy of providers when it comes to choosing and paying for care.
- the financing system equates "health care" with professionalized medical services, and thus provides little incentive for citizens to use family, community and other informal services

that may provide better health value for less money.

In this present arrangement of health care, there is virtually nothing that depends on whether people are healthy.

## The Design Flaw in Institutional Care

The broken link between spending and results is particularly visible with respect to care for the elderly. Financing systems have vastly favored professional, institutionalized arrangements, essentially guaranteeing payment for these arrangements whether or not they actually serve the best interest of the clients or achieve improvements in clients' health and functioning.

## Needed: New Designs for Health Care for Seniors

Minnesota will not be able to afford spending increases of the magnitude of the past several years, but it will be required to respond to the increasing numbers of elderly citizens who will need state assistance. The state needs a new approach to health-care services for elderly citizens.

Here is how the "design principles for better value" can be used to improve client satisfaction, value and productivity and contain cost. The most critical design feature involves the arrangement of purchasers and producers of service, so we begin with the second principle:

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

In the case of health care, imperfections in the existing marketplace for health care have caused our current troubles.

However, we believe that competition is still a useful tool, but *how* competition is used, and the nature of the relationships between purchasers of service, medical providers and individual consumers must be changed. The key is to separate the purchasers of service from the producers of service, and thus to create a better kind of market:

**Split the purchasers and producers of health care: Build regional systems of flexible services for seniors.**

**Step One: The state should create regional purchasing bodies and give them the money, the authority to purchase services on behalf of elderly citizens and the responsibility for health outcomes.** The regions could be defined as counties, or some other existing or new government entity. All three pieces—money, authority and responsibility—must be present in order to prompt better value:

- give the regional purchaser a **budget** of public funds to serve seniors. The budget should be a pooled fund, created from portions of existing Medicare, Medicaid and social service budgets, that can be used to buy the continuum of services people need. The size of the allotment would be based on the current level of spending.
- give the regional purchasers **authority** to purchase services from competing full-service elderly-care plans (see Step Two, below).
- give the regional purchasers **responsibility** for results achieved by their health-care purchases. Allow them to keep what they are able to save by purchasing wisely, but put them financially at risk if they fail to produce results or overspend their budgets.

These regional purchasers can be thought of as "market makers." They set the standards and organize the playing field for competing medical plans.

**Step Two: The regional purchasers should encourage the formation of health-care plans that serve seniors.** These **elderly-care plans** would function like Health Maintenance Organizations (HMOs). Each plan would assemble a complete continuum of care and services, from home-delivered meals to acute medical care. The plans could operate these services themselves, or could contract with other existing providers in their regions. The plans would then compete for contracts that would be awarded by the regional purchasers. The regional purchasers would then give the selected plans budgets—a certain amount for each person enrolled—within which the plans would provide health care and other services to their customers (more about the customer's choice in Step Three).

To create a continuum of services, the plans must be able to "unbundle" the usual nursing-home package. To explain: Nursing homes and other institutions are classic examples of bundled services. A nursing home typically offers housing, meals, therapies, recreation, transportation and medical care in a total package that is paid for in a lump sum (either by the client or a private or public payer). To some extent, the bundling of services is tied to rules about what kinds of services are eligible for reimbursement through MA and other payers.

This bundling of services may be convenient for institutions and third-party payers, but it is frustrating for clients and expensive to society; people pay for services whether they need and use them or not. Worse, such arrangements may actually be detrimental to clients, since they promote dependence rather than independence. When services are unbundled, health-care plans can offer customers the flexibility to choose only those services they need and value.

In Step Two, the purchaser "capitates" the elderly-care plan. That is, the plan is given a set amount for each individual participant, within which the plan must serve its customers. Just as with the regional purchasers, plans that are able to save money are allowed to keep and reinvest what they save. But the plans are also at risk of failing if they overspend or lose their customers because of poor service. This financing arrangement would align the economic interests of the purchasing bodies and care providers with the interests of the public. The care-plans would have an incentive to stretch their budgets by keeping people as independent as possible, by steering participants to appropriate services, including services provided by families, volunteers and others in the community.

Once the state has created regional purchasing bodies, and the regional purchasers have fostered the development of competing elderly-care plans, we move to

**Step Three: Develop citizen markets by allowing citizens to choose the elderly-care plan they prefer.**

Within this new market, the link between spending and results is strengthened further by giving individual citizens choices. **To develop citizen markets:**

- **Give citizens health-care "budgets."** That is, give Medicaid recipients the power to pick which elderly-care plan they prefer. Allow private-pay and insured individuals to buy into the plans, too.

- **Give citizens information.** Give people information about the plans' track records and the quality of their services. Consumers need to know: What do I need? Which providers are good? Where do I get the best value? Developing and circulating trustworthy information is an essential role for government (although government need not do this itself).

- **Give citizens choices.** When regional markets for elderly services are in place, citizens will have the choice of several care plans, and once enrolled in a plan, will have more flexible choices of services.

With a budget, information and choices, people will seek the plan that gives them the best value for their "money." Citizens will be powerful consumers and health-care providers will be appropriately at risk.

When all three steps have been completed, the state will have created a new kind of market for health care, even though individuals won't control all of the purchasing decisions.

A marketplace where purchasing bodies are the paying customers is preferable to an individual consumer marketplace, for several reasons. Purchasing bodies can take advantage of economies of scale—significant, in health care—that are not available to individuals. Purchasing bodies are also more able to be informed about the hundreds of ailments, medical interventions and community resources, while individual citizens can't be experts about every medical service they will ever need. The regional-purchaser arrangement is a way to allow competition to work on citizens' behalf when citizens, individually, are unable to do so.

What about rural communities? Some have argued that competition isn't possible in communities where the numbers of both citizens and providers are small. It is true that when the population is small and scarce, and when there are few health-care providers, this purchaser-producer split is more of a challenge. It is not impossible, however. The same structures can be arranged by drawing the regional boundaries wider, for example. The key principle is to separate the purchaser of services from the producer of services, but the exact form that principle will take may vary from community to community.

**Principle 4. Meet more public responsibilities through non-governmental communities in which people already have relationships of mutual obligation.**

Minnesota's public spending on health care for the elderly should reflect what we know: That good health, for old as well as young, doesn't just come from lab tests and doctor visits. It comes from being connected to one's friends, family and community, from having purpose and dignity and from being happy. Families, neighbors and communities are not just consumers of services for the elderly members. They help one another in "relationships of mutual obligation." Public health-care programs have, for too long, preferred to fund professionals and have given these informal networks short shrift.

We are not calling for public policies that push all responsibility back to families. Families cannot do everything. But when policies allow for many different kinds of support, families and communities can help to ensure better care for their elders at less cost to the state.

The state should **reduce the emphasis on professionalized services and encourage alternatives that enable seniors to stay in their communities with the support of families, neighbors and voluntary organizations.** The state should focus especially on providing alternative services to reduce the number of seniors in the lowest nursing-home care classes.

State leaders should **advocate for changes in federal regulations to permit the implementation of these changes.**

Finally, we return to the first principle.

**Principle 1. Target government subsidies to people who are financially needy.**

The state should prevent middle- and upper-income seniors from transferring assets to their families in order to qualify for MA-funded nursing-home care. Instead, the state should create

**incentives for seniors or their children to purchase long-term care insurance to protect their assets from these expenses.**

## CONCLUSION

Minnesota can no longer afford to spend vast quantities of money on health-care services that are unconnected to desired results. State lawmakers have an obligation to the citizens of Minnesota, and to the country, to contribute to solving the problem of health-care cost. The solution cannot simply be cost containment. The solution must be cost containment and healthier citizens. The design principles can be used to improve Minnesota's publicly-financed health care, and they also suggest strategies for tackling the larger problem of privately-financed care.

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[80] Minnesota Department of Finance, *March Forecast,* March 1993, p. 29.

[81] *Ibid,* p. 35.

[82] Minnesota Department of Human Services: "Minnesota's Human Services Budget," undated (1992), p. 4.

[83] Minnesota Department of Human Services: "Minnesota's Human Services Budget," undated (1992), p. 7.

[84] Minnesota Department of Finance. Information provided on August 16, 1993.

[85] Hubert H. Humphrey Institute of Public Affairs, State and Local Policy Program, *No Easy Cure: Possible Options for Controlling Minnesota's Medical Assistance Spending,* December 1992, p. 11.

[86] *Ibid,* p. 7.

[87] Minnesota Departments of Human Services, Health and Finance and the Minnesota Board on Aging, *A Strategy for Long Term Care in the State of Minnesota, Developed in Response to the SAIL 1990 Report,* 1992-1993, p. 6.

Chapter Six

# NEW DESIGN AND BETTER VALUE: PROPERTY-TAX AID TO INDIVIDUALS AND CITIES

### RECOMMENDATIONS

1. Increase the proportion of property-tax relief that is paid to individuals through the circuit breaker on the basis on financial need.

2. Reduce the amount of aid provided to cities in the form of Local Government Aid and other general-purpose grants.

3. When aid is provided to governments, the aid should be only for services in which the state has an interest, and the size of the grants should be based on the amounts spent by providers who provide the best value for the money.

4. Remove barriers that prevent competing public and private firms from contracting to provide public services.

5. Create an independent "value for money" auditing function to evaluate local governments' performance in providing state-funded services.

## BACKGROUND

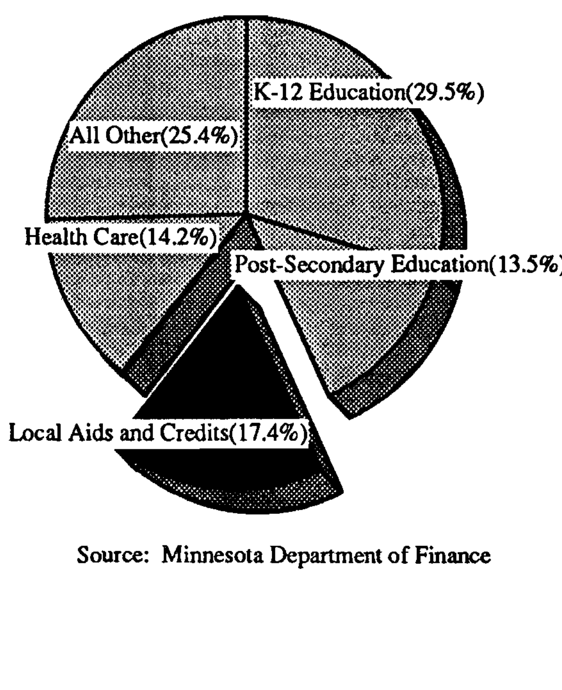
Minnesota is expected to have paid $2.54 billion in various forms of property-tax relief to individuals and local governments in the 1992-93 biennium. This budget item is the second-largest category of general fund spending, representing 17.4 percent of expenditures.[88] (This figure excludes per-pupil education finance appropriations.)

Property-tax relief and aid are provided through a number of programs, which have varied somewhat over time but include:

- **local government aid (LGA),** which provides block grants to cities for

Figure 9

**Local Aid and Property-Tax Aid and Credits**
**Share of Total Budget, 1992-1993**
(General Fund, includes Local Government Trust Fund)




Source: Minnesota Department of Finance

general property-tax relief and accounts for 24.7 percent of all state-paid aid. In 1992, LGA totalled $305 million.[89]

- **a variety of other credits and aid paid to local units of government,** such as homestead and agricultural credit aid (HACA). These refunds totalled $785 million in 1992.

- **tax refunds paid to homeowners and renters,** which are paid directly to individuals. There are two types of refunds. The circuit breaker is a refund to homeowners and renters whose property-tax bills are high relative to their incomes. In 1992, the state refunded about $126 million through this program.[90] The other program, the targeted property-tax refund, is provided to homeowners whose tax bills increased more than 10 percent (and a minimum of $60) over the previous year, regardless of the homeowner's income; $19.6 million was paid in targeting refunds in 1992.[91]

Expenditures on all of these tax relief and local aid programs combined have shown significant year-to-year swings since 1982 (see Figure 10). After accounting for inflation, these expenditures were 17.5 percent lower in 1992 than they were in 1982 (but 15 percent higher than in 1983). Real spending increased at an average of 2.5 percent annually.

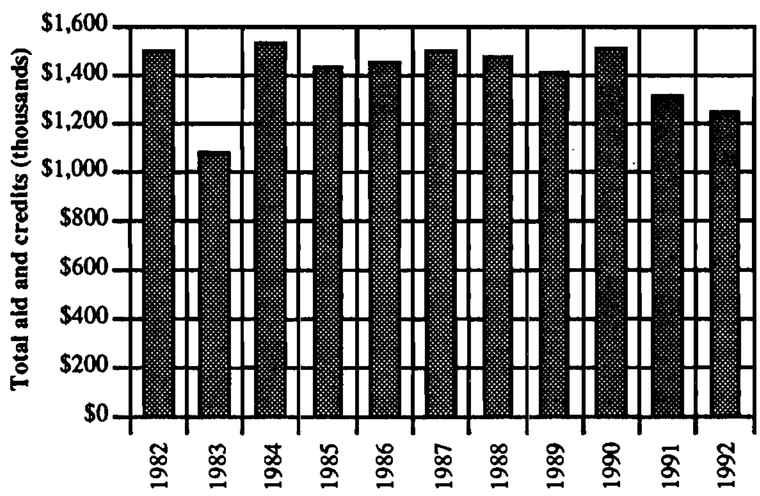
The Local Government Trust Fund (LGTF), created in 1991, receives two cents of the state's general sales and motor vehicle excise taxes. LGTF monies are used to fund non-school local government aid and property-tax relief.

**Why does the state provide property-tax relief to individuals and cities?**

Property tax is generally considered to be one element of a balanced revenue system that includes income and sales taxes. In

Figure 10

**Local Government Aid and Property-Tax Aid and Credits, 1982-1992**
General Fund and Local Government Trust Fund (1992 dollars)




Source: Minnesota Department of Finance. Adjusted for comparability. Adjusted for inflation using the Consumer Price Index for All Urban Consumers, U.S. Does not include education aid.

theory, property taxes permit a high degree of local accountability for local services and provide stability to the revenue base. Property-tax revenues don't go sharply up and down with the economy like income-tax revenues do.[92]

The Minnesota Department of Revenue has said that 25 to 30 percent of total state and local taxes should be obtained from property tax. If the share falls below 25 percent, local accountability is weakened and revenue stability is diminished; above that level, interstate competition becomes an issue.[93] In FY1991, Minnesota's local governments raised $3.14 billion in net property taxes (including school levies), or 31.1 percent of state and local taxes, slightly above that suggested range.[94]

Minnesota has chosen to fund local services primarily through the property tax. In FY 1991, almost 96 percent of local taxes were from the property tax, compared to 75 percent nationally in 1990. Local governments rely much less on local sales and income taxes,[95] although other revenues, such as fees, account for a significant portion of local receipts.

In theory, the amount of property tax a taxpayer pays is determined by the market value of the property, the tax base of the community, and the community's level of spending on services. Even in a simple, ideal system, these factors may combine in ways that produce inequities. For example, two homeowners with identically-valued homes may pay very different rates of tax for the same local services, if the communities they live in have different tax bases. And the interaction between tax bill and income can create further inequities. People with lower incomes tend to pay a higher share of their incomes on housing and, thus, a higher share on property taxes. Two homeowners who owed the same hypothetical $900 tax would be affected very differently if one had annual income of $6,000 and the other $600,000.

States can reduce inequities in tax burdens in at least two ways. They can make aid grants to local governments or otherwise attempt to even the playing field between communities with different needs and tax bases. They can also attempt to alleviate the burden on individuals whose tax burdens are high relative to their ability to pay.

## THE PROBLEM

Minnesota's property-tax system not only does not alleviate the inequities that may arise in any property-tax system. The state's complex classification system and other policies actually create vast additional inequities.

**The system is regressive.**

Property taxes in Minnesota are regressive. That is, people with lower incomes pay a higher share of their incomes in property tax than upper-income people do. The complex classification system now in place also creates inequities between owners of different kinds of property; homeowners are disproportionately favored, rental and commercial property owners are penalized.

A recent study by the Minnesota Department of Revenue concluded that the regressivity of the property-tax system arises because too much relief is provided to higher income households which benefit from the low classification rates extended to all homesteads.[96]

The Department found that while average home values do increase with income, the percentage of income used to pay for housing declines. There is also wide variation in the amount of housing consumed at any income level.[97] Home value, clearly, is not a good proxy for ability to pay. The report concluded that the classification system and generalized tax relief programs that use home value as a proxy for income are inefficient tools to target relief to households who have the least ability to pay.

There is ample evidence of inequity:

- Homestead and Agricultural Credit Aid (HACA), the largest of the aid programs, is generalized aid paid to local governments. The HACA formula provides proportionately more aid to areas with large amounts of farm and homestead property, which are favored in the class system, regardless of the income and need characteristics of the property owners.[98]

- So-called "targeted" tax relief, provided to individuals whose tax bill increased more than 10 percent (and a minimum of $60) is paid regardless of household income. In 1990, 125 refunds were paid to filers whose household incomes were over $1 million.[99]

- Property-tax refunds paid directly to homeowners and renters on the basis of financial need account for only 10.2 percent of all credits and aid. The distribution of average refunds among all households shows a progressive pattern (more refunds are paid to lower-income households) but the impact is minimal because of the overwhelming impact of the HACA subsidy. For taxes payable in 1990, the state reimbursed local governments $609 million to compensate them for lost tax capacity associated with the classification system, but only provided $39 million in PTR refunds to individuals.[100]

The shift in tax burden from homesteads to other types of property has contributed to rising rents and a dwindling supply of affordable housing.[101] This preference for homeowners has also meant that Minnesota businesses face one of the steepest property-tax bill in the nation.[102] A typical company in Minnesota pays $140,300 in property taxes annually, compared to $116,200 in Illinois, $53,200 in Wisconsin, $60,000 in Iowa and $41,900 in North Dakota.[103]

Inequities are also apparent in Minnesota's system for providing aid to local governments. The system is based primarily upon historical spending patterns. Cities that have spent more on local services in the past are allotted more state relief now, regardless of most need factors. A 1991 report commissioned by the Minnesota Legislative Commission on Planning and Fiscal Policy found that the distribution of Local Government Aid (LGA) funds was substantially unrelated to city need as determined by objective criteria.[104] Numerous studies by others, including the state's own revenue department, have reached similar conclusions.[105]

**Cost pressures continue to be acute.**

Minnesota can expect continued pressures on its property-tax relief budget.

According to Department of Revenue estimates, property taxes are increasing faster than any other state or local tax revenue source. The average annual increase in property taxes for 1993 through 1997 is estimated to be 5.8 percent, compared to 3.4 percent for income taxes and 5.2 percent for sales and motor vehicle excise taxes.[106]

Continuing demand for spending on local services will put pressure on the state for local tax relief. These pressures will be difficult for state lawmakers to resist, because their constituents have come to depend on property-tax relief. With a large portion of cities' budgets coming from the state, it is no wonder that cities have coalesced into a powerful interest group. Homeowners, too, have become dependent upon state aid to subsidize their property taxes. For a middle- or upper-income homeowner who would not qualify for need-based aid, the elimination of state subsidies would mean a dramatic increase in property taxes—not a popular prospect.

**There is no evidence that more spending produces better results.**

In the case of aid to local governments and property-tax relief, it is particularly difficult to assess the impact of increased state spending, because the goals of these programs have been unclear and not universally agreed upon. Regardless of which of the supposed goals one chooses, however, there is little evidence that more state spending has achieved better results.

Consider:

**Inequities in property-tax burdens have not been eliminated.** If the goal of these relief programs is to ensure that low-income taxpayers not bear a disproportionate property-tax burden, the spending has not achieved that result. Instead, it appears that the more important goals to legislators are to shift from property to income tax, which they think fairer, and to keep property taxes down for all their constituents.

**Property-tax pressures are still high in Minnesota.** In 1971, state lawmakers passed several property-tax relief measures that together became known as the "Minnesota Miracle." The package was intended to ameliorate Minnesota's soaring local property taxes, which in the early 1960s had put the state fourth in the nation, and 34 percent higher than the national average.[107] Since the "Minnesota Miracle," Minnesota's spending on all aid to individual taxpayers and local governments has generally increased faster than the rate of inflation, and the property-tax reduction strategy met with some initial success.

By 1979, tax collections were down to five percent above the national average (permitted largely by increases in the income tax) and the state ranked twenty-third.[108] Since 1980, however, the relative tax burden has climbed again. In 1991, Minnesota's local property tax was eight percent higher than the national average, and the state ranked seventeenth nationally.[109]

The Minnesota Department of Revenue has forecast some easing of growth in property-tax revenues (5.8 percent annually from 1993 to 1997, compared to 6.9 percent between 1990 and 1993).[110] However, competing demands for spending on education, health and other statewide concerns are likely to limit the growth in aid to local governments.

**There is no evidence that more state spending has yielded better local services.** Local governments are not required to show the results they achieve with their appropriations. We do not have very good information about what was achieved with the roughly $1 billion given in general purpose grants to cities. However, a recent study by the State Auditor found that cities vary in how effectively and efficiently they provide public services. The amount of money is only one factor in the results achieved; *how* the money is used is also important, the study found. For example, the lower-spending cities did tend to provide fewer services. However, they also tended to work with other units of government to provide services, were organizationally flat, showed great flexibility in using staff, and emphasized preventive strategies.[111]

## THE DESIGN FLAWS IN PROPERTY-TAX RELIEF TO INDIVIDUALS AND CITIES

There are at least three fundamental flaws in the current organization of property-tax aid to individuals and cities.

First, Minnesota's spending on local aid and property-tax relief is not meaningfully related to the financial need of either local governments or individuals. There is no clear policy delineation of what services people are entitled to; instead, property-tax relief is provided mostly in block grants to write down the tax bill for all the services a community chooses to provide. The current system implies a generalized entitlement to low property taxes for homeowners and farmers, even those who are well-to-do.

Second, Minnesota's spending on local aid and property-tax relief is unconnected to the resources the state has available. This happens because spending decisions and taxing decisions have been separated. Local officials can commit to high spending, knowing that somebody else (state income-tax payers) will foot the bill. The state's aid grants mask the true "price" of local service, and when prices are low, consumers usually demand more service. The cycle continues. Taxpayers want more service, local officials promise more service and the state picks up the tab. The current system suppresses the pressures that would ordinarily prompt taxpayers to weigh their priorities and seek the most value for their money.

Third, Minnesota's state spending on local government aid and property-tax relief is unrelated to the results achieved by these expenditures. The state provides money to local governments to deliver local services, but requires no evidence that the services are provided well, or even provided at all. There are no objective criteria determining cost of services, so funding is based on historic spending levels.

Given the prognosis of slow economic growth and increasing pressure on public budgets, the state should neither continue to subsidize individuals who are not financially needy, provide funding that is unconnected to results nor treat all local services as entitlements.

## NEW DESIGN FOR BETTER VALUE IN LOCAL SERVICES

The state should correct these design flaws. Here is how to use the "design principles" to get better value for our local services spending:

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

**The Legislature should gradually increase the proportion of property-tax relief that is paid directly to individuals on the basis of financial need** (determined by the relationship between income and tax bill).

**The state should reduce the amount of aid that is provided in the form of general-purpose grants to local governments.** When aid is provided to governments, that aid should be in the form of categorical grants for services in which the state has an interest. Local governments should be responsible for financing basic services, such as police protection, that most directly benefit local communties. Grants for special purposes should be made to cities that show need, as measured by objectively defined criteria.

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

**Create citizen markets.**

The best way to improve the value of the state's expenditures on local services is to pay state aid and subsidies directly to individuals who qualify based on the relationship between their income and property-tax burden. As noted above, this approach is more equitable. It also places control of local spending choices more directly into the hands of local taxpayers. Local citizens must decide what level and quality of service they want, and hold their local officials accountable for the officials' performance as purchasers of service.

However, we are also mindful of the argument that some public services have statewide repercussions. Decisions about these services should not be left entirely up to local taxpayers' choice. In the case of services in which the state has an interest, the state should adopt the following arrangements.

**Pay for performance.**

**The state should tie local government aid grants to achievement of appropriate results.** The first step for state policymakers is to clearly define the state interest to be met and the results that the state should expect to achieve. Then, formulas to distribute aid for these purposes should be redesigned to reward efficiency.

The Commission on Reform and Efficiency (CORE) is currently developing recommendations for a formula for the distribution of general-purpose aid to cities. The goal is to provide basic, minimal support for necessary, adequate and efficient services to cities whose needs are in excess of their revenue-raising capacity. CORE is establishing objective measures of "workload" for each major city service, and assembling information about the cost per workload for cities that provide adequate services at a reasonable cost. A city's spending need would reflect its workload and this "adequate" cost-per-workload. Each city's revenue-raising capacity will also be established. Under the proposed formula, city general-purpose aid amounts would be equal to the difference between city spending needs for all services and city revenue-raising capacity. City officials would have to raise additional money from city residents to support services that are more than "adequate" or that are inefficient.

We prefer that more state aid be provided in the form of categorical grants for specific services in which the state has an interest, rather than in general-purpose aid, the focus of the CORE project. However, we believe that the CORE approach to determining city aid *amounts* is an important advance in linking spending with results.

The CORE formula approach does three things: It builds incentives toward efficiency. It shifts more "say" to individual taxpayers at the local level. And it shifts greater accountability to local elected officials.

**Split the roles of purchaser and producer.**

**Local governments should split the roles of purchaser and producer in local services.** Municipalities must ensure that basic services are provided, but they need not actually run them. The functions of policymaking, including arranging for and purchasing public services, should be separated from the function of actually delivering public services.

Once these roles are split, the city governments' function would be to purchase the best and lowest-cost services from among competing vendors, given a total budget composed of locally-raised revenues and state categorical grants (the sizes of which are determined by a CORE-type formula).

To enable such competitive arrangements, **the legislature should remove barriers that currently hinder the entry of new public service firms.** For example, state and local laws should no longer prohibit local governments from contracting to groups other than public employees. Public employees' union contracts should be limited to negotiations over wages, hours and benefits. The state should also permit municipalities and neighborhoods to choose services provided by another municipality or government unit.

**The legislature should create an independent agency to measure how well services are delivered by municipalities.** Information on costs and quality for each jurisdiction should be made public, and should inform the aid-grant process.

**Principle 3. Prices of public services should reflect true costs, including the social costs of individual decisions.**

Principle 3 provides another argument for providing aid directly to individuals rather than to units of government. In this arrangement, property taxes more closely reflect the actual cost of taxpayers' preferences about public services. As we have said, when local taxes are kept artificially low, people demand more service. When taxes reflect costs (which in turn reflect the level of service and how efficiently it is provided), local officials are more accountable for their performance and property-tax payers are more accountable for their choices.

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

Current property-tax relief programs encourage local spending and property-tax increases because neither individuals nor local officials bear direct responsibility for their decisions. Increases in local spending have helped to push property taxes to 31 percent of all revenues, a level beyond what the state Department of Revenue considers appropriate.[112] This level of property taxes is a negative factor in competition. The current tax-relief programs also distribute massive public subsidies to people who do not necessarily need public assistance.

The inequities in the system should be eliminated simply because they are unfair. However, there is another compelling, and more utilitarian, reason to make the system more fair: Giving subsidies to people who don't need them wastes money, money that could be spent on productive activities or long-term investment. Further, requiring businesses to pay a disproportionate share of property taxes in order to provide subsidies for middle-class homeowners puts Minnesota businesses at a competitive disadvantage.

As currently structured, Minnesota's property-tax relief program represents a large drain on the state economy—an example of how government's attempts to protect institutional and parochial interests, rather than the public interest, can hinder the long-term growth of the economy.

## CONCLUSION

More state spending on property-tax relief has not achieved fairness for taxpayers or improvements in local services, because there is nothing in the current policies that requires spending to achieve these desired results. Simply spending more state money will be unlikely to solve the problem of escalating property-tax burdens and inequities in the future. The "design principles" point to how state lawmakers can correct the flaws in the system: Put the responsibility—and property-tax subsidies—directly into the hands of local taxpayers. Let local taxpayers decide how much service they want, and make local officials accountable to voters for their performance as purchasers of service. Most important, don't waste state money subsidizing people who are already advantaged.

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[88]Minnesota Department of Finance: *March Forecast,* March 1993, p. 29. In the biennial forecast, the spending figures include the school portion of tax aids and credits but exclude education appropriations made according to the school-aid formula. The figures reflect spending from general fund and Local Government Trust Fund revenues.

[89]*Ibid.*

[90]*Ibid.*

[91]Beginning in 1993, the maximum refund allowed will be $1,500.

[92]Arizona Joint Select Committee on State Revenues and Expenditures: *Final Report,* Vol. 2, November 1989, p. 638, 640.

[93]Minnesota Department of Revenue, *Model Revenue System for Minnesota,* July 1992, p. 32.

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[94]*Ibid*, p. 31.

[95]*Ibid.*

[96]Minnesota Department of Revenue, Tax Research Division, *Property Tax Regressivity in Minnesota,* January 1992, p. 13.

[97]*Ibid*, p. 7.

[98]*Ibid*, p. 11.

[99]Commission on Reform and Efficiency: *Imperatives for Change: An Assessment of Minnesota State Government*, December 1992.

[100]Minnesota Department of Revenue, Tax Research Division, *Property Tax Regressivity in Minnesota*, p. 11.

[101]Minnesota Taxpayers Association: *Reforming Minnesota's Local Property Tax and State Aid System: Ending the Fiscal Illusion,* December 1992.

[102]Roger Hale, presentation to Citizens League, December 15, 1992.

[103] Minnesota Taxpayers Association, *op. cit.*

[104]Helen Ladd, Andrew Reschovsky and John Yinger, "Measuring the Fiscal Condition of Cities in Minnesota," submitted to the Minnesota Legislative Commission on Planning and Fiscal Policy, March 1991.

[105]Study sponsors have included the Minnesota Taxpayers Association, Minnesota Business Partnership and the Minnesota Department of Revenue. The Citizens League reported similar findings in 1987 and 1990.

[106]The Minnesota Department of Revenue calculated averages for income- and sales-tax growth using data from the Department of Finance end of session estimates, June 16, 1993. Property-tax growth rates were extrapolated from the same Department of Finance estimate, which was for pay-1994 revenues.

[107]Dan Salomone, "Minnesota's State and Local Fiscal System: The Case for Property-Tax Reform," Fiscal Focus, Minnesota Taxpayers Association, No. 5, September/October 1992, p. 3.

[108]*Ibid.*

[109]Minnesota Taxpayers Association, *How Does Minnesota Compare? Fiscal Year 1991 Comparisons.* March 1993, p. 13.

[110]Minnesota Department of Revenue, Gordon Folkman?????

[111]Minnesota Office of the State Auditor, Research and Information Division, *Case Studies of City Spending: Explaining Differences in Per Capita City Expenditures.* April 30, 1993, p. i.

[112]An important related trend is the shifting, in recent years, of a greater share of the total cost of K-12 education to local school districts.

Chapter Seven

# CONCLUSION: BEYOND TAXING AND CUTTING

MINNESOTA'S task isn't just balancing the budget. A burst of short-term economic growth can do that. Juggling the ledgers can do that. Cutting spending can do that. Raising taxes can do that. And that is exactly what Minnesota *has* done.

Now we must do better, because in the future just cutting spending or just raising taxes won't be enough. An incremental approach, nipping and tucking, won't be enough. A slow-growing economy will mean slow-growing revenues, but the demands on state and local governments are growing faster than ever.

Now we must focus on getting better value from our public spending.

APPLYING the "design principles for better value" holds the most promise of attaining the results we need with the resources we have. Targeting aid only to people who need it, harnessing competition to prod innovation and improvement, giving individuals an economic stake in their service choices, working through families and communities and considering the role of spending in promoting economic growth—these are the handful of strategies that create necessary, intrinsic links between spending money and getting results.

But will these strategies save money? Perhaps, but not necessarily. What these strategies will do is *link spending and results*. When spending and results are linked, money means something. More spending means more results. You get what you pay for.

Earlier, this report noted that Minnesotans have, over time, appeared willing to spend about 19.8 percent of personal income on public services and are now spending 21 percent. We have detected this threshold, and argued that lawmakers should not expect taxpayers to substantially exceed 21 percent now, because citizens are facing their own economic squeeze and are distrustful of government. However, if citizens believed they "got what they paid for," that threshold might rise. Citizens might choose to spend 30 percent of their total personal income, or they might choose to spend only 10 percent. What is important is that the government services they would live with would be meaningfully connected to the spending choices they made.

Questions about how big the budget is, what proportion of personal income is spent on public services, and how fast spending should increase are pertinent only if we stay locked in structures that don't work and the old assumption that the purpose of government is taxing, spending and regulating.

It's time for a change. Real reform means going beyond cutting and taxing. Minnesota's lawmakers must set about the task of designing policies so that citizens' interest in better value comes first.

# APPENDIX

## THE WORK OF THE COMMITTEE

CHARGE TO THE COMMITTEE ON

# MINNESOTA'S FISCAL FUTURE: STATE BUDGET REFORM

FOR more than a decade, Minnesota has experienced repeated prospective budget shortfalls of increasing magnitude. They have forced the Legislature regularly to resort to a combination of these measures: (1) raise taxes and fees; (2) reduce direct state services and/or the financing of programs such as higher education and local government aid; (3) manipulate budgets to shift expenditures forward into the next biennium.

This pattern produces a downward drift in service quality, quantity and access and/or significant increases in state or local taxes. Neither course is desirable, and neither is likely to be publicly acceptable in the future. But absent fundamental change, such an unsatisfactory pattern appears likely to continue over at least the next decade, even with optimistic economic forecasts.

THE COMMITTEE'S principal goal should be to identify alternatives to the historic pattern —major strategies and/or restructuring that would avoid the usual choices of cut, shift or tax.

The committee should:

- Consider the pattern of state expenditures in the major general fund budget areas over approximately the last decade and project them several years into the future, assuming business as usual.

  (The major areas, accounting for more than 80 percent of the general fund, are elementary and secondary education and higher education, property-tax relief and local government aid, medical care and income maintenance. The committee should factor a few obvious demographic comparisons such as the size of school-age and aging population cohorts into this work. However, it should satisfy itself with generalized projections, concentrating its time and effort not on exacting forecasts, but rather on finding effective solutions.)

- Estimate the magnitude of program cuts or tax increases that would be required to support these expenditures in, say, a decade, or in the year 2000.

- Consider broad strategies within each of these areas that would allow state and local governments to do more with the same (or less) by making fundamental changes that produce a more productive public sector.

  (Key findings in this regard will be what the Legislature can do to give public sector organizations the opportunities and incentives to be cost-sensitive, value-adding, results-oriented and innovative.)

- Recommend a combination of restructuring/reform, taxing and spending increases (but not including analysis of which state taxes might be most desirable) and service/program reductions that is appropriate for the Legislature to reach over the next few biennia.

- Share the results of the committee's study with key decision makers. Explaining the committee's recommendations will also be a central part of the committee's work. The committee should convey to the board, apart from its substantive report, its recommendations for how best to inform and educate the public on its report and expand public discussion of the options available to the Legislature.

## COMMITTEE MEMBERSHIP

The committee was co-chaired by Ed Dirkswager and Jean King. George Latimer was co-chair from July 1992 through January 1993. A total of 20 committee members took an active part in the work of the committee. In addition to the co-chairs, they were:

Tobin Barrozo
John Brandl
Jerry Christenson
Albert de Leon
Paul Gilje
Peter Hutchinson
Ted Kolderie
Elizabeth Malkerson
Ron McKinley
Yusef Mgeni
Charles Neerland
Allen Olson
Al Quie
Hazel Reinhardt
Lyall Schwarzkopf
Tom Swain

## COMMITTEE MEETINGS AND RESOURCE SPEAKERS

The committee met for the first time on July 20, 1992 and concluded its deliberations on April 20, 1993. During its 35 full group meetings, the committee studied a variety of printed materials and heard from the following resource speakers:

Dick Braun, Center for Transportation Studies
Robert Cline, Minnesota Department of Revenue
Tom Dewar, Rainbow Research
Dennis Erickson, Minnesota Department of Human Services
Tom Gillaspy, State Demographer
John Gunyou, Commissioner of Finance
Peter Hutchinson, Public Strategies Group
Verne Johnson, Altcare
Ted Kolderie, Center for Policy Studies
Gene Mammenga, Commissioner of Education
David Powers, Minnesota Higher Education Coordinating Board
Dan Salomone, Minnesota Taxpayers Association
James Schug, Washington County Human Services
Tom Stinson, State Economist

## PUBLIC PARTICIPATION

The Citizens League used several new methods to share the work of the committee publicly throughout the process, and to invite public comment.

In addition to the 20 members who served on the committee, 115 were correspondent members. These correspondents received all meeting minutes, and were invited to attend meetings as observers. Forty people asked to be on a "fax list" to receive occasional updates about the committee's work. Faxed bulletins were sent in September and December, 1992 and February and March, 1993. The February and March editions also included a brief questionnaire and comment form to which readers were invited to respond.

The full texts of meeting minutes were available on Citizens League On-Line, a computer bulletin board operated by Twin Cities Metronet. This is a free service available to any computer user with telecommunications capabilities. The League staff has created a computer forum using On-Line. The forum will give interested computer users the opportunity to "talk" electronically to the League about this report in the coming weeks.

The findings and preliminary conclusions were released to the public at several points during the committee's work. Editorials were released to the major newspapers. Editorials based on committee findings were published in the *St. Paul Pioneer Press* in December 1992 and March 1993. Executive Director Lyle Wray appeared on two cable television programs and spoke about the committee's work at a program sponsored by the Hubert H. Humphrey Institute of Public Affairs.

During the months of November and February the Citizens League held a series of Speak Ups! on Minnesota's budget problem. These forums were open to League members and others who were interested in the issue but who did not participate in the full 10-month study. Early drafts of the committee's findings were distributed prior to the meetings and participants were invited to comment on and discuss them. The participants provided information and guidance to the committee, and the League acknowledges their valuable contribution. Below is a list of Speak Up! participants (this list does not imply the individuals' endorsement of the final document):

Bill Batcher
George Battis
Mary Battis
Bob Benke
Winston Borden
Pauline Bouchard
Bernie Bryant
Reed Carpenter
Darren Chase
Ron Clark
Pat Cragoe
William Craig
Carl "Buzz" Cummins
Lynn Dacey
Mary Dees
Susan Dees
Jagadish Desai
David Dillon
Vincent DiPasquantonio
Bright Dornblaser
Ann Duff
Nick Duff
John Duffy
Joanne Englund
Greg Finzell
Joe Glenski
Virginia Gray
Martha Grierson
Lois Gunderson
Roger Hale
Chip Hallbach
Jeff Hazen
Barb Heideman
Michael Hemesath
Rick Heydinger
Jack Hoeschler
Martha Hurr
Warren Ibele
John James
Beryl Johnson
Frank Johnson
Sharon Johnson
Phyllis Kahn
John Karr
John Knutson
Nick LaFontaine
Bill Lahr
David Laird, Jr.
Laura Langer
Harold Lasley
Patrick Leary
Lisa Lee
Barbara Lukermann
Maxine Mandt
Jennifer Martin
Duane Mattheis
Jon McGee
Robert Moe
Jim Newland
Nancy Nystuen
Ed Oliver
Tony Onnen
Victoria Oshiro
Ann Preus
Jim Prosser
John Richter
David Rodbourne
Irwin Rubenstein
Carol Rudie
Dean Rudie
Sue Sandidge
Jim Schneider
Alice Seagren
Dale Simonson
Elin Malmquist Skinner
Larry Struck
John Thomas
Bruce Thorpe
Kathleen Tomlin
Randy Treichel
Gordon Voss
Julie Wallace
Joan Wierzba
Lois Yellowthunder

Several Citizens League members hosted and moderated the Speak Ups!. We acknowledge them gratefully:

John Brandl
Jim Dorsey
Ann Duff
Paul Gilje
Milda Hedblom
Peter Hutchinson
Jean King
A. Scheffer Lang
Barbara Lukermann
Elizabeth Malkerson
Ron McKinley
Dick and Lila Moberg
Allen Olson
David Rodbourne
Lyall Schwarzkopf
The Urban Coalition
Ann Wynia

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## STAFF SUPPORT

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**Membership is tax-deductible and includes a one-year subscription to the *Minnesota Journal***

*Family membership entitles you to a second *Minnesota Journal.* Please indicate the name and address of the recipient.

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## *Join the Citizens League and help make things happen*

IMPACT

Being a member of the Citizens League means you care about what happens in Minnesota and believe that good public policy depends upon an informed citizenry. League members can participate in citizen research that helps to shape public policy. *If you join in 1993, the McKnight Foundation will match your dues.* Membership also offers these benefits:

MINNESOTA AGENDA

**Study Committees** -- League members frame solutions to critical public policy issues.

**Speak-Ups** provide opportunities for face-to-face involement. **Citizens League On-Line** uses technology to bring public affairs to you through a computer bulletin board.

MEETINGS

- **Mind-Opener breakfast meetings** — every Tuesday from Labor Day to June. Public officials, community and business leaders meet with League audiences to discuss and debate timely issues.

PUBLICATIONS

- ***Minnesota Journal*** — 12 issues a year of timely public affairs news, analysis and commentary.

- **Citizens League reports** — full reports and statements on topics studied — free copies are a benefit of membership.

- ***Minnesota Managed Care Review*** -- Important information and analysis for people working in Minnesota's dynamic health care marketplace. ***Minnesota Homestead Property Tax Review*** --The league's annual analysis of residential property taxes in the Twin Cities area and other Minnesota cities. ***Public Affairs Directory*** — a handy listing of agencies, organizations and officials involved in making and implementing public policy. ***The School Book*** — a comprehensive guide to elementary schools in the Twin Cities.

CITIZENS LEAGUE

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. For more information about Citizens League activities and membership opportunities, please call 612/338-0791.

CITIZENS CL LEAGUE

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Public Affairs Research
and Education in the
Minneapolis-St. Paul
Metropolitan Area.