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Public Policy Commentary

Comprehensive fiscal reform must address "expenditure straightjacket," increase budgetary flexibility, and unlock spending restrictions

State's "structural deficit" not just about revenue, but how government spends the taxpayer dollars it already receives

By Michael DiResto
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As BRAC previously expressed in its 2015 Legislative Review – analyzing the "disappointing" session that imposed significant tax increases on businesses throughout the state and severe cuts to the economic development programs that have helped power the state's job-producing momentum -- attention should rightly have turned even more urgently to the fall elections, in which all of the announced major candidates for governor have stated an intention to call a special legislative session at the start of 2016 to consider fundamental and comprehensive state fiscal reform to address the structural deficit in Louisiana state government finances.

Yet with more than a month gone by since the session ended, few details have emerged from either legislative or gubernatorial candidates about what topics would be addressed in the special session or what specific solutions would be pursued. As the constitution makes clear, should the new governor call the legislature into special session, its power to legislate is limited to the objects specifically enumerated in the proclamation. It's not too soon, or unreasonable, for voters to call upon candidates to clearly state what, exactly, will be included in the "call."

During the recent legislative session, most attention focused on the revenue side of the equation – dealing with various tax expenditures in the form of credits, exemptions, exclusions, and rebates. This topic has also been informed by various studies, most recently in a report led by Louisiana State University's Dr. Jim Richardson, which, it is hoped, should help inform a sober reevaluation of the changes made during the session. And to date, discussion of a special session similarly has centered on these revenue questions. Regarding these questions, BRAC will, of course, seek enactment of major tax reform that results in a tax code that's simpler, fairer, and promotes the state's long-term economic competitiveness. With regard to reforming tax expenditures, BRAC will also promote a careful, targeted, and selective approach, one that takes into account each provision's relative importance, priority, and performance, rather than the recently-enacted blunt instruments: across-the-board measures that jeopardize the growth and diversification of our economy, harm Louisiana's business climate, and threaten opportunities for every Louisiana citizen seeking a new or better job.

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However, in order for fiscal reform efforts to be truly comprehensive, similar focus needs to be devoted to the expenditure side of the equation as well – dealing with the myriad of non-discretionary restrictions, mandates, and spending dedications – the "expenditure straightjacket" that reduces budgetary flexibility and hinders true prioritization in funding decisions.

In short, a special legislative session on comprehensive fiscal reform that focuses solely on revenue, but does nothing to address government spending, would make about as much sense as the sound of one hand clapping. It would also represent a tremendous missed opportunity for the betterment of the state.

The Fiscal State We're In: By the Numbers

Budget Growth through the Years by Means of Finance

A common refrain one hears about the state budget, particularly in the context of calls to raise taxes or other forms of revenue, is that "Louisiana does not have a revenue problem, but a spending problem" – and it's true that state government's total budget has grown significantly over the last decade. But in order to get a fuller picture of that growth, and to begin to understand why state government seems perennially to face challenges in prioritizing funding, it's important to look closer at a breakdown of spending by various means of finance.

Louisiana State Budget as Appropriated (Approx., Excluding Double Counts)

	FY 04/05	FY 14/15	10-Year Growth ($)	10-Year Growth (%)
STATE GENERAL FUND, DIRECT	$6.8B	$8.7B	$1.9B	27.9%
FEES & SELF-GENERATED REVENUE	$1.3B	$2.5B	$1.2B	92.3%
STATUTORY DEDICATIONS	$3.1B	$4.3B	$1.2B	38.7%
TOTAL STATE FUNDS	**$11.2B**	**$15.5B**	**$4.3B**	**38.4%**
FEDERAL FUNDS	$6.3B	$10.0B	$3.7B	58.7%
GRAND TOTAL	**$17.5B**	**$25.5B**	**$8.0B**	**45.7%**

Sources: FY 2004-2005 and FY 2014-2015 Louisiana State Budget, BRAC Analysis

The chart above represents, respectively, the appropriated amounts, by means of finance, for the fiscal year that closed at the end of June 2005, or right before Hurricane Katrina, and the fiscal year that closed at the end of June of this year, as well as the dollar amount and percentage of growth over that time period.

Federal Funds

Compared to a 10-year national inflation rate of almost 23 percent, or an average rate of nearly 2.3 percent inflation per year, on the surface the Grand Total figures in the chart above would seem to indicate extraordinary growth in total state government expenditures, indeed at almost twice the rate of inflation. On closer inspection, however, one notices that, out of the total $8 billion increase in appropriated funds, about $3.7 billion, or 46 percent of that increase, is comprised of Federal Funds, which typically are tied to specific uses such as public education grants, health care (Medicaid), and social services (TANF), or targeted grants related to hurricane recovery within the offices of homeland security (HMGP) and community development (CDBG). In other words, while these programs may provide valuable services outside of, in coordination with, or in addition to those funded by state revenue sources, almost half of the growth in the state's appropriated budget has been within a restricted means of finance that cannot be directed toward general state government operations.

Fees and Self-Generated Revenue

If not by dollar amount, then certainly by percentage increase, the spending category with the largest growth over the last decade, by far, is Fees and Self-Generated Revenue, with a 92.3 percent increase. However, as the Louisiana Budget Project has pointed out: "Self-generated revenue is most often generated by fees state agencies charge to defray all or a portion of the cost of services provided by that agency. Citizens who use the service pay the largest portion of the cost of providing the service. Revenue from these fees cannot be transferred to another agency to be used for another purpose." That is to say, self-generated revenue has restrictions in its use similar to federal dollars, yet even though the annual amount appropriated from this form of revenue has nearly doubled in the last decade, it is an unlikely source for expanding budgetary flexibility – or, depending on one's point of view, has already been utilized as a tool for budgetary flexibility – insofar as increases in fees and self-generated revenue in recent years have been used to replace the state's investments in various services previously made through the General Fund. It would probably surprise few people to learn that in the FY 15 budget, for example, one of the largest appropriated amounts of this kind supporting a state service falls under Higher Education, with $1.37 billion raised through tuition and various fees.

Statutory Dedications

A remarkably consistent – or persistent, as the case may be – aspect of the state budget is the proportion of it taken up by Statutory Dedications from the start to the end of the decade under review. The $3.1 billion appropriated from this category in FY 05 out of total state funds of $11.2 billion represents almost the exact proportion (27.7 percent) as it represents in the FY 15 amounts of $4.3 billion in appropriated Statutory Dedications out of total state funds of $15.5 billion. A helpful, fuller explanation of the role of Statutory Dedications can be viewed in the non-partisan Public Affairs Research Council's "Guide to the State Budget Crisis" (pages 11 and 12) published in April of this year. For our purposes, in relation to an exploration of the inflexibility of Louisiana state government's expenditure structure, we will cover just the highlights, starting with PAR's definition: "In general terms a dedication is a requirement that certain revenues are set aside in special funds which can only be used for specified purposes." As PAR also notes, despite the adjective "statutory," this means of finance also includes funds protected by the state constitution – which provides an even stronger wall against their use for general government operations. On the other hand, one reason to look toward statutory dedications as a possible path toward increased flexibility is a "broad category" of dedications that PAR describes as "diversions of general fund dollars … state taxes set aside for specific purposes and that otherwise would flow into the general fund." Taken as a whole, however, while statutory dedications may hold promise for unlocking the budget, "the situation," PAR cautions, "is more complicated."

Out of the total amount of $25.5 billion appropriated in FY 15, only 11 percent was truly discretionary in its use, a decline from 13 percent in FY 05.

The first complication is the sheer number of dedications – close to 400 in total, out of which about 300 are annually *appropriated*. Although fewer than 40 of these dedications were constitutionally established, they represent a dollar value of around $2 billion out of the $4.3 billion total. In addition, while the amount represented in the "general fund" diversion category for FY 15 also totaled about $2 billion, its flexibility is complicated by the fact that there is overlap, in that funds under this category have also been established constitutionally.

Separately, there is the complication of another dedication category that PAR describes as "fees collected from particular groups to be spent on related programs." In short, many industries are assessed specific fees with the assurance, or even requirement, that those revenues will be used only for specific services or purposes, including their own regulation. A persuasive case has been made in recent years that repurposing some forms of specific fees toward general government operations is tantamount to turning them into a tax.

General Fund

Finally, when looking at figures for direct General Fund appropriations in the chart above on page 2, we see that, as a means of finance which presumably serves as the most flexible form of revenue to be used for general government services and operations, it shows, comparably speaking, the smallest amount of growth over the decade, at just under 28 percent. While this amount of growth still exceeds inflation over that time period, unfortunately its usefulness is anything but as "general" as its name suggests.

According to the FY 15 State Budget, about $5.9 billion, or 68 percent, of the state General Fund is considered non-discretionary in nature, with only $2.8 billion, or 32 percent, of the $8.7 billion of the total considered discretionary. As the budget points out, in addition to all the funding restrictions in the various means of finance outlined above, the bulk of the General Fund itself is effectively off limits for various non-discretionary purposes like: constitutional mandates, court orders, debt service, federal mandates, statutory and other unavoidable obligations.

The largest of these, at $3.3 billion, or more than half of the $5.9 billion in non-discretionary appropriations, is the cost constitutionally mandated to be paid out of the General Fund itself toward state support for local K-12 public schools, known in the budget as the Minimum Foundation Program (MFP).

As the word suggests, appropriations that are "non-discretionary" are difficult if not impossible to avoid, and insofar as Higher Education and Health Care historically have comprised more than 70 percent of the discretionary portion of the General Fund, those two areas of the budget have by necessity been most vulnerable to cuts during deficits and shortfalls.

Conclusion: Decade of Spending Growth but Declining Discretion

On the one hand, Louisiana state government over the last decade has seen the total amount of state funds appropriated for a fiscal year grow by more than 38 percent, and increasing by more than 45 percent when all means of finance are taken into account. On the other hand, over the same time period, annual discretionary General Fund spending has grown from $2.3 billion to $2.8 billion, a comparably smaller increase of 24 percent.

While overall state spending has increased substantially over the last decade, the growth in the discretionary portion of that spending has barely kept pace with inflation, while its proportion to the whole of state spending has actually declined. We're spending more but prioritizing less.

What's more, out of $15.5 billion of total "state funds" appropriated in FY 15, only the $2.8 billion in discretionary General Fund, or 18 percent, has true flexibility in how it's spent. This reflects a slight decline from the 20 percent discretionary share of total state funds, using comparable figures from FY 05. With federal funding factored in, out of the FY 15 grand total of $25.5 billion appropriated, only 11 percent was truly discretionary in its use, a decline from 13 percent in FY 05.

In other words, while overall state spending has increased substantially over the last decade, even far outpacing the rate of inflation, the growth in the discretionary portion of that spending has barely kept pace with inflation, while its proportion to the whole of state spending has actually declined. To be more succinct: we're spending more but prioritizing less.

The Tools at Hand and the Path Going Forward

One disclaimer to all of the analysis above would be to point out that, at least with regards to dedications established by statute (but not by constitution), the Legislature already has some additional discretion during the legislative session to reduce appropriated amounts for specific funds and direct them toward general government operations, on the theory that any new statute can supersede ones previously passed as "the latest expression of the Legislature." In practice, this approach has been avoided, and in any event represents a less than ideal method for increasing budget flexibility insofar as it takes a special action to address a special fund. As PAR has noted, the more "typical practice is to take, or 'sweep,' some portion of a fund above the amount the fund is expected to spend for its primary purpose."

State law does set forth procedures for addressing projected shortfalls and midyear deficits (Const. 7:10, and R.S. 39:75) which, after a certain amount of General Fund reductions and other conditions are met, does allow for up to 5 percent reductions to dedicated funds. However, even though state government has experienced a number of recent midyear deficits, this tool has been used sparingly. In the case of perennial shortfalls projected for upcoming fiscal years, such tools actually could not even be used, for these "continuation shortfalls" have consisted mainly in estimates of increased expenses, and the need to replace one-time revenues, rather than in actual revenue declines.

That's not to say that attempts have not been made in recent years to bring greater clarity to these spending issues. Act 492 of the 2009 legislative session established a statutory dedication review process, which, though never fully acted upon, resulted in the creation of an online portal of Special Funds that lists non-fiduciary and non-constitutional dedications, which could serve as a resource to begin serious re-examination of these issues again. In addition, Act 419 from the 2013 legislative session required that the Revenue Estimating Conference include all dedicated funds in its annual forecasts, a step in the right direction at least from the standpoint of demonstrating that these funds contain recurring sources of revenue.

Recommendations

> *"It can be conceptually helpful to imagine a world where no dedications exist. Budgeting would consist of prioritizing the state's needs, then taking all of the funding available and applying it to the top level priorities. Nothing would be safe from cuts and nothing would be 'off the table.' This approach would allow policymakers to focus on those areas that are truly important without being constrained by spending requirements and revenue restrictions that might prevent an optimal budget…. However, as dedications are examined more closely, the idea of simply eliminating them is not necessarily a budget elixir." – PAR's "Guide to the State Budget Crisis"*

Before outlining specific recommendations, it might be helpful to outline a few general points, both echoing and adding to PAR's analysis. First, it's important to note that un-dedicating or eliminating a special fund does not necessarily mean the service it supports would receive a spending reduction – in an ideal world, it would simply mean that no area of the budget would receive preferential protection and would instead be subject to the same amount of scrutiny by appropriators and compete openly for resources on a fair and open playing field.

Second, BRAC acknowledges that we do not, in fact, live in an ideal world, but in one that often forces us to choose the option that's the least bad among all the others. However, when the amount of state funds appropriated by Louisiana's government has grown by more than 38 percent over the past decade, for the sake of the state's continued economic growth, it would be far preferable for a Governor and Legislature to look toward even temporary remedies to maximize the funds already available to them before seeking to increase taxes.

Third, as PAR cautions, examining these spending issues more closely is not easy, nor will it provide a silver bullet. But the work is essential, and it is urgent. If, as the gubernatorial candidates all indicate, a special legislative fiscal session will take place as soon as January, one would prefer if such complicated work would have already begun.

The following list of specific recommendations, then, is directed toward gubernatorial and (where appropriate) legislative candidates, and starts with the most immediate. These recommendations span from large to small, some procedural and some prescriptive, though not necessarily cumulative, but with the hope that, by choosing among them, state budget officials may develop a comprehensive approach to improving expenditure flexibility.

1. Pledge that any special legislative session on comprehensive fiscal reform will address the spending side of the fiscal balance sheet, and include specific solutions for loosening state government's "expenditure straight-jacket."
2. Upon election, immediately establish within the transition a special task force – made up of private citizens, policy organizations like PAR, with support from executive and legislative branch budget officials – whose mission will be to examine these issues and develop recommendations in time for the special session.
3. As PAR recommends, sunset all non-constitutional statutory dedications by specific date and abide by these sunset dates.
4. Open up select constitutional dedications based on well-defined criteria that distinguish long-term state needs like transportation infrastructure and coastal protection.
5. Implement multi-year "phase back" of dedications that divert from the General Fund.
6. Increase from 5 percent to 10 percent the amount of dedicated funds that may be reduced during shortfalls and deficits.
7. As PAR also recommends, require certain fee-based dedications to contribute a small percentage of revenue to the General Fund to help pay for the service provided.
8. Consolidate similar dedicated funds, or convert select dedications to self-generated revenue sources, to achieve incrementally increased budget flexibility.
9. Conduct a review of non-discretionary General Fund restrictions to identify long-term cost drivers and develop solutions in areas such as pension reform, criminal justice reform, civil service employment protections and pay increases, risk management, and workers compensation.
10. Create an "Expenditure Estimating Conference," similar in make-up to the REC but with recommendations offered by the state Budget Director and the Legislative Fiscal Officer, that would:
11. Provide a more clearly defined analysis of projected expenditures used to calculate the "continuation budget" and make more meaningful shortfall projections that may trigger the use of deficit avoidance tools.
12. Conduct an annual review of spending dedications, including examination of funds with recurring over-collections, to identify additional opportunities to reduce dedicated funding.

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