



# Budget and Reengineering Government Transition Policy Group

PREPARED FOR GOVERNOR-ELECT JON S. CORZINE

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## Final Report

January 10, 2006

# **Report of the Budget and Reengineering Government Transition Policy Group**

## **Submitted January 2006**

### **INTRODUCTION**

The fiscal health of the State of New Jersey has plunged perilously close to ruin. Our message is very simple:

- the State cannot continue the past practices of spending more money than it receives in recurring revenues;
- the State cannot continue to defer current expenditures into future years so as to mask budget imbalances;
- the State cannot continue to use financial and budgetary gimmicks to give the appearance of “balancing” the budget; and
- the State cannot continue to adopt expenditure programs whose costs can be expected to escalate well beyond the revenues anticipated to pay for them.

In slightly more than a decade, under both Democratic and Republican administrations, the State has gone from an economic powerhouse to a financial basket case. The history is quite clear, but recounting this deterioration and the litany of all too-clever financial policies is not our focus. It is important, however, to understand the results of the past two decades of fiscal overspending. While the road to decline was often paved with good intentions, the results are alarming:

- the State has accumulated almost \$30 billion of debt; this is more than two times the debt that existed in 2000 and more than 3 ½ times the debt that existed in 1996;
- the State has unfunded liabilities in its retirement and health care programs, a different form of debt, that probably exceed another \$30 billion;
- the State is running out of money to pay for transportation needs totaling more than \$1 billion annually;
- the State budget, projected into the coming year (FY 2007), would require appropriations that are more than \$5 billion higher than its revenues;
- the growth of the spending base is significantly greater than the growth of the revenue base;
- the Executive Branch and Legislature have lost control of large chunks of the State budget because of court mandates, contractual obligations, and federal rules;
- New Jersey is not a low-tax state; its ability to raise taxes is limited by competitive economic factors;
- the State, already overburdened with debt, faces billions in unmet capital needs;
- the public trust in government, needed to explain and to gain support for difficult steps, needs to be restored;
- a thoughtful re-engineering of government policies and practices to reduce spending and restrain its future growth and to spur economic development and revenue growth cannot be accomplished in the few months available to prepare the first budget of a new administration; and
- the State tax structure has not evolved with the changes in the economy, technology, and federal laws; and has been weakened by unaffordable “tax expenditures” (i.e., exceptions, deductions, or credits that bear a cost to the Treasury.) granted over the years without regard for their cost.

Failure to implement fundamental change will have grave consequences, including a further downgrading of the State’s debt rating and, therefore, higher borrowing costs; skyrocketing property taxes due to a reduction in state aid and rebates; and reduced state services in order to pay for mandatory debt service, pensions, health care costs and more.

We believe that now is the time for the Executive Branch *and* the Legislature, in concert, to focus on a few critical financial truths to begin the process of returning the State to long-term fiscal health and financial discipline.

We approached our task with the underlying assumption that Governor Corzine's administration will not be "business as usual in New Jersey government." Rather, we assume and are energized by Governor Corzine's vision of working toward a New Jersey government that is highly ethical, professional and responsive to its citizens; and is a viable economic engine that attracts and retains a broad spectrum of businesses that contribute to the financial, cultural and educational vitality, diversity, and unique strengths of our state.

The following recommendations are not a blueprint for a budget. Instead they are a *blueprint for reform*; a statement of important and desirable principles and perspectives to move New Jersey toward that vision.

## **SUMMARY OF RECOMMENDATIONS**

### **ITEMS AFFECTING THE CURRENT YEAR and FY2007 BUDGETS:**

1. With respect to the current year's budget, **steps must be taken immediately to prepare to cut operating costs**. The Governor should be concerned about ending the year in balance and with a healthy surplus. Such steps include, but are not limited to:
  - Requiring all Departments to cut current-year operating budgets (methods could include freezing the current levels of workforce; across-the-board salary cuts for employees not in a collective bargaining unit; a mandated extra vacation week without pay; and preparation of lay-off plans with the Department of Personnel, as appropriate);
  - Examine other temporary, tough measures that would not be pursued in the long-run but appear necessary now (e.g., an out of state travel freeze that can only be overridden by the Treasurer);
  - Manage this endeavor in an accountable fashion, calling for Departmental bi-weekly progress reports to the Treasurer.
2. The 2007 Budget (and those beyond) should **be in true balance with recurring revenue sources equaling expenditures. One-time sources of revenue or gimmicks to defer expenditures must not be relied upon**. To the extent any "one-time" revenues occur, the resulting monies should only be used for capital investments or to pay down debt or unfunded obligations (see recommendation #7).

In order to achieve true balance, difficult decisions will need to be made to dramatically cut expenditures and significantly increase recurring revenues. Solutions must have the buy-in of members of both political parties and various constituencies from across New Jersey (the tough budget we need cannot and should not be enacted with the support of only one party.)

Clearly, sacrifices will have to be made. Pain will have to be shared. There must be the political will to make substantive, structural budget changes.

3. **Revenue increases should come from modernizing the State's tax structure** so it better conforms to economic and technological realities, enhances revenue growth over time, and leaves flexibility for later property tax reform. Examples of modernization steps include, but are not limited to:
- Closing illogical loopholes and exemptions in the sales and income taxes that serve no discernable purpose; the full range of exemptions must be considered;
  - Providing the same tax treatment for all retirement plans instead of the current exemption for 401k's;
  - Collecting sales and use tax on purchases from the internet, including music and software downloads; the State must continue to lobby the U.S. Congress for federal rules where necessary;
  - Reviewing programs that were once intended to be fully funded from fees, and ensure that the fees are sufficient to match the expenditures.
4. **If expanding the tax base and cutting expenditures can not produce a balanced budget for 2007**, then reluctantly, we recommend **a temporary tax rate surcharge to ensure sufficient recurring revenues to reach a balanced budget**. The surcharge would cease to exist when the State has had time to produce sufficient recurring savings from government reengineering and reorganization efforts, tax modernization as recommended by a Tax Study Commission (see Recommendation #12), or other structural changes.
- The surcharge should have a specific sunset.* We believe it is both substantively and politically more difficult to reorganize and reform government, restrain spending and close the structural deficit than it is to raise taxes. A sunset creates an impetus for action on these difficult items.
5. Budget actions, and particularly tax policy, should **support administration initiatives to promote economic growth and create and retain private sector jobs**.
6. **The severe and complex budget problem posed by the State's pension and post-retirement healthcare obligations requires swift action**. In conjunction with reducing the gap between the assets and liabilities of the plans, a multi-year strategy to curtail the growth rate of the benefits needs to be implemented. The programs need to be brought into line with the State's ability to pay and known abuses must be reversed. Action items to consider:
- Implement the actionable recommendations of the Pension Task Force;
  - Begin an immediate, stepped raising of the normal retirement age that ultimately goes beyond the recommendations of the Pension Task Force;
  - Make changes to the pension system in the context of the trends across the country, in both the public and private sector;
  - Review eligibility requirements for benefits;
  - Consider using industry standard cost reduction practices for health benefits – especially pharmacy, disease and demand management, and more;
  - Review all associated main vendor health benefit contracts for favorable pricing.
  - Issue a separate RFP for a direct contract with a PBM (pharmacy benefits manager), as recommended by the Pension and Benefits Review Task Force (see page 29 of their report)

7. **Proceeds of any asset sales must be invested in needed capital improvements and reduction of debt, including unfunded retirement obligations.** Revenue from asset sales should not be used as a substitution for recurring revenues. Asset sales and securitizations should be studied carefully, including:
- Conducting an inventory all of the State's capital assets and evaluate which excess assets can be sold;
  - Reviewing options with regard to converting Horizon to a private company.
8. **The Transportation Trust Fund should be funded without exacerbating the FY2006 or FY2007 State Budget problems.** In the short term, the TTF should be fixed by restructuring the existing debt and, if necessary, increasing dedicated funds - not by diverting money from the general operating budget. (The group notes that New Jersey has the second-lowest per gallon gas tax in the nation.)
- Going forward, however, the State must have the discipline to follow rules that clearly separate capital expenditures from operating expenditures.
9. **An appropriate capital plan** should be developed for School Construction Corporation and other capital spending programs, with effective managerial safeguards over the spending and prioritization of the investments.

**ITEMS THAT MUST BEGIN NOW, BUT PROVIDE LONGER-TERM COST REDUCTION BENEFITS:**

10. a.) **An Office of "Re-engineering Government" (ORG) should be created immediately to help focus and streamline government departments and processes.** The scope of the ORG should encompass all government operations and result in reductions in cost, improvements in quality of services, and a change in the culture of state government. We recommend that the ORG:
- Be tasked to conduct a multi-year "outcome based" review of all government operations to eliminate unnecessary activities, reduce/consolidate redundant organizations, and streamline/automate processes where appropriate. Apply technology, best practices, and benchmarks to identify further opportunities to lower costs and improve performance simultaneously;
  - Be created immediately and continue through the '07 and '08 budget years as needed;
  - Be led by a (new) cabinet-level Officer with considerable experience in conducting re-engineering efforts in large, complex organizations<sup>1</sup>;
  - Report every 4 to 6 weeks to a Steering Committee of cabinet level officers and the Governor;
  - Be staffed largely by personnel seconded by the various departments; such personnel should include influential career professionals who will likely lead in the implementation of the recommendations. Careful staffing with this model will ensure that reengineering is done by and not to the government;
  - This staff should be augmented by a few selected new recruits with experience in similar projects;
  - Issue a competitive RFP for selecting an experienced private consulting firm to help design and guide the process;

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<sup>1</sup> A minority of three members of the group (including former State Treasurers and a former Director of the Office of Management and Budget) concurred with the majority's view that a Re-Engineering Office should be created, but felt that for purposes of strengthening the effort it should be located within the Department of Treasury, reporting directly to the Treasurer, allowing its efforts to be linked with the budget and program review process.

- Include in its review, opportunities available from centralizing Procurement, Information Technology, HR, Fleet Management; Warehousing; Grants-in-Aid (and accountability for such grants); and develop plans for achieving the same;
- Include it its review, opportunities for both insourcing and outsourcing.
- Recognize that while the managerial portion of this process is key, much of the large-scale reengineering must happen through policy changes; this office should offer data and creative suggestions for such reengineering and the Governor should marry the concept of reengineering with his policy agenda.

b.) Simultaneously, the State should move ahead in two important areas: **Empowerment of a centralized Chief Information Officer** with the clout to require compatible systems across government, and **launching of a project to review Civil Service and other personnel rules to reflect a measurement of employee performance.**

The current technology structure throughout state government is decentralized. Each Department or agency is staffed with a Chief Information Officer (CIO) with a reporting structure and budget dollars managed independently by their respective Department, with minimum oversight from the State's core Information Technology (IT) department, the Office of Information Technology (OIT).

An enterprise approach to management of IT, with one Chief Information Officer with clout would provide more effective management, allow the State to implement compatible platforms across Departments, and is the model recommended by the National Association of State Chief Information Officers (NASCIO).

11. **The budget process needs to be reformed.** Multi-year budgets should be developed and presented which realistically assess the State's prospects for collecting revenues and expected costs of programs. Tax expenditure reporting also is an important improvement that the State needs to adopt. Defining "core government functions" to frame all of the budget discussions can dramatically improve the substance and discussion around the budget. We recommend reforms that include:
  - Join more than 30 other states that produce "tax expenditure" information, to assess the true cost of tax exemptions, credits and deductions;
  - A capital budgeting process, to include all debt-issuing agencies of the State;
  - Require that all legislation be analyzed for its "life cycle cost" instead of just the year-one costs;
  - Require the Governor to create a two-year budget, published with the constitutionally-required annual budget;
  - Stop the practice of bending revenue projections to fit an agenda of increased spending.
12. **A Tax Study Commission should be appointed to make recommendations in time for the FY2008 Budget.** This bipartisan Commission should closely examine the tax structure of the State, including "tax expenditures" (which are exceptions, deductions, or credits that bear a cost to the Treasury.)
13. **The State must develop an affordable and effective plan for controlling costs associated with funding education.** School aid is a nearly \$10 billion item, growing significantly every year. The budget problem cannot be solved until the State deals with controlling education costs. Key attributes of an affordable and effective plan could include:

- Consider revising the 10-year old Abbott funding requirements to reflect the changes in economic circumstances for the 31 Abbott school districts. Create an “exit strategy” for districts whose economic situation and education needs have changed so no undue burden falls upon the educational system or local taxpayers;
- Offer incentives to school districts to consolidate or create shared services to reduce administrative and other costs;
- Work with the New Jersey Congressional delegation to ensure New Jersey gets its fair share of federal education aid, as well as with the Department of Education to apply for national grants and funding for education initiatives.

14. We recommend **detailed cost benefit analyses of the key components of the Medicaid budget**. Medicaid is a \$6.5 billion program with the State supporting 50% of the costs. It has been one of the fastest growing areas of the budget, growing by 14% per year over the past 6 years. Future growth is unviable given the growth in health care costs and the increase in aging populations.

Time and expertise limit our ability to make recommendations that would result in thoughtful significant savings, but we know that savings must be achieved in this program area if the State is to maintain an overall balance between current revenues and current expenditures. Thus, we recommend:

- A detailed cost benefit analyses of the key components of the Medicaid budget including hospital costs, third party reimbursement policy, long term care costs and co-pay policies;
- Review non-mandatory health benefits;
- Review retail pharmacy dispensing fees for prescription drugs;
- A detailed review of initiatives undertaken by other states to determine the viability and applicability to New Jersey.

15. **Independent assessments of the validity and effectiveness of state expenditures** need to be incorporated into the process. Such a role can be effectively served by **an independently elected State Comptroller**. However, this important component should not be delayed until a Comptroller is elected.

## **THE WAY FORWARD**

During our short tenure as a Task Force, we have come to realize that there have been several panels, Commissions, study groups and outside reports that have devoted much broader and deeper study into New Jersey's fiscal problems.<sup>2</sup> It was interesting to us that these reports, in aggregate, provide much of the most important and necessary directional guidance that the Governor's staff and legislature require to restore New Jersey's fiscal stability, viability and credibility.

Regrettably, we have found no evidence of a serious and sustained effort to implement the processes and programs cited in these well-reasoned reports. The Governor does NOT need yet another report on these matters. Rather, the Governor should mine them for valuable recommendations, and provide what was missing from previous efforts: a "call to action" accompanied by political will, courage, and persistence.

With the Governor's determination to bring sound financial management practices and a "clean sheet of paper" analysis to spending, revenue and entitlement programs, we are convinced that New Jersey can be restored to stability and health. We recognize that the Executive Branch cannot accomplish this alone. Rather, this is a shared responsibility with the legislature, as well as with the people of the State.

It is imperative that Governor Corzine take the lead to muster the collective political will. It is the job of the Governor to use the bully pulpit to educate the public; to end the culture that allows 'sacred cows' to go untouched; and to create an atmosphere of universal agreement to work toward a necessary goal instead of horse-trading for pet projects.

We believe Jon Corzine is a uniquely qualified Governor serving at a unique time. He possesses a deep knowledge of financial markets and the business community, and has expressed independence and the political will to do what's necessary and right. Any pullback from this strong commitment will have longstanding and debilitating effects that will impact the stability and economy of New Jersey.

We are convinced that the citizens of NJ will understand the problems and support the actions necessary to accomplish a long-term fix. This will require that Governor Corzine clearly and consistently lay out the problems and his solutions for everyone to see, so that everyone can become part of the solution.

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<sup>2</sup> We call attention to just five such reports, although there are others:

- 1.) The BEST Commission and its report) created by Governor McGreevey's Executive Order on 1/17/02;
- 2.) The Codey Budget Advisory Panel report of 2/22/05;
- 3.) The Pension Task Force report, submitted November 2005, [http://www.state.nj.us/benefitsreview/final\\_report.pdf](http://www.state.nj.us/benefitsreview/final_report.pdf) ;
- 4.) The 12/20/05 statement to our Transition Committee by the Executive Director of the National Governors' Association;
- 5.) The Price of Government by Osborne (Basic Books, 2004)



Respectfully submitted,

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<sup>3</sup> Note that Richard Bagger recused himself from discussions and recommendations related to PBMs.

<sup>4</sup> Note that Michael Horn recused himself from discussions and recommendations related to Horizon Blue Cross.

[Note: Dominick Critelli International Vice President and President of Local 195, IFPTE, was an active member but remained outside the consensus of the group on several recommendations, and therefore elected not to sign the report]

## **APPENDICES – Part one**

**Our group broke into three subcommittees that studied issues in further detail. Many of the items examined by the groups made their way into our overall recommendations. We have attached the full reports of those committees here.**

- 1.) Report of the “Expenses Subcommittee”
- 2.) Report of the “Revenues Subcommittee”
- 3.) Report of the “Reengineering/Structure/Process Subcommittee”

## **APPENDICES – Part two**

**Other key topics were discussed in detail, and various members of the group have recommended them for further study.**

- 1.) Additional attention to raising the retirement age. In New Jersey state and local government, many defined retirement benefits are provided well before age 60. New Jersey taxpayers cannot afford to fund over 20 years of post-retirement benefits for state and local workers. A statement on this topic, authored by Josh Weston, is attached.
- 2.) Additional reforming of the New Jersey Legislative Budget Process. These items are further outlined in the attachment called “Reforming the New Jersey Legislative Budget Process,” authored by Rich Bagger.

## **BIBLIOGRAPHY**

(all items attached)

New Jersey Policy Perspective, “Let the Sunshine In: Making New Jersey’s Budget More Transparent,” 2005.

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Example from Connecticut’s “Current Services Budget,” shared by the Center on Budget and Policy Priorities

Center on Budget and Policy Priorities and New Jersey Policy Perspective, “Recommendation for Tax Expenditure Report,” memo to Budget and Reengineering Government policy group, December 30, 2005

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National Governors Association Center for Best Practices, “Cost-Cutting and Efficiency Reviews,” memo to Budget and Reengineering Government policy group, December 16, 2005

NGA Executive Director Ray Sheppach, “Statement for the New Jersey Budget and Government Reengineering Transition Committee,” December 20, 2005.