

**A STUDY
OF GUIDELINES FOR
STATE GRANTS, SUBSIDIES,
AND PURCHASE OF SERVICES**

A Report to the Legislature of the State of Hawaii

**Submitted by
Legislative Auditor of the State of Hawaii**

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FOREWORD

Traditionally, government has made payments to the private sector to secure goods and services for its own use. Increasingly, government is making public funds available to the private sector for a variety of other purposes. It has paid private organizations to carry out public services, such as welfare services, and it has used public funds as grants to stimulate and support a variety of private operations. The extensive use of public funds for private operations has raised questions as to the public purposes served and the effectiveness of monies so expended.

The Hawaii State Legislature has been cognizant of the problem resulting from the growing number of requests for public support of private organizations. Following the 1978 legislative session, it initiated two steps to deal with the problem. On June 29, 1978, it directed our office to study the issue and develop appropriate recommendations. On July 21, 1978, in a meeting with the Committee on Taxation and Finance of the 1978 Constitutional Convention, legislative leaders discussed the growing dimensions of the problem and presented their case for a constitutional amendment to provide the impetus for resolving the problem.

The 1978 Constitutional Convention acknowledged these concerns by adding a new requirement to what is commonly referred to as the "public purpose clause" of the State Constitution. The additional language in Article VII, Section 4, says, "No grant of public money or property shall be made except pursuant to standards provided by law."

This study was undertaken to assist the Legislature in establishing the required standards. The study focuses on all cash payments to private entities other than those payments made to procure goods and services for government's own consumption. These transfers of public funds to the private sector include purchases of services, grants, and subsidies. The recommendations in our study deal with all three types of payments.

We hope that the study will be useful to the Legislature in developing the required legislation and to the executive agencies in implementing whatever measure is enacted.

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Chapter 1

INTRODUCTION

The Hawaii State Legislature has been aware of the problem resulting from the growing number of requests for public funding of private organizations. Therefore, it undertook two initiatives to deal with the problem. *First*, on June 29, 1978, the presiding officers of the legislature directed our office to study the problem and formulate appropriate recommendations. *Second*, on July 21, 1978, legislative leaders met with the Committee on Taxation and Finance of the 1978 Constitutional Convention and proposed an amendment to the State Constitution which would provide the impetus and constitutional framework for resolving the problem.

The 1978 Constitutional Convention amended the article on taxation and finance in a number of significant ways. Among the changes which were ratified by the voters was an addition to the section on "Appropriation for Private Purposes Prohibited."¹ The additional language states, "No grant of public money or property shall be made except pursuant to standards provided by law." This study analyzes and recommends the kinds of standards that should be enacted to comply with the amended State Constitution.

Objectives of the Study

The objectives of the study are:

1. To identify and analyze those aspects of the present grant process which are in need of control through standards, and
2. To recommend appropriate standards.

Background

In the course of informational meetings and panel discussions, the Committee on Taxa-

tion and Finance of the 1978 Constitutional Convention heard testimony from legislative leaders of the house and senate on the need for standards and criteria against which the legislature may assess funding requests from private organizations. The legislative leaders pointed to the increasing number of private organizations appealing directly to the legislature for state assistance and the increasing dependence of these organizations on such aid. The dollar amount of state aid has increased substantially over the years. For fiscal year 1978-79, over \$3 million has been appropriated. Without appropriate criteria and established procedures for reviewing aid requests and for granting funds, there is no assurance that the funds actually disbursed to these private organizations meet the test of public purpose. The legislative leaders, therefore, suggested that the Constitution provide clarifying language which would help ensure that public monies are indeed expended only for public purposes. The result has been the adoption of the additional constitutional language quoted above.

Scope of Study

Although the addition to the Constitution refers generally to "grants of public money or property," this study focuses on cash payments to the private sector. It does not cover appropriations to governmental entities. All appropriations to public agencies are assumed to be for public purposes. The study also does not cover the disposition of property other than cash. The disposition of other tangible property is already governed by HRS Chapter 106, "Inventory, Accounting, and Disposal of Government

¹Formerly Article VI, Section 2, now renumbered as Article VII, Section 4.

Assets," and by HRS Chapter 171, "Public Lands, Management and Disposition of." Further, this study is concerned only with the actual bestowal of public funds, and not with other types of government transfers, such as tax subsidies and credit subsidies. Cash subsidies, however, are included.

The study is further limited to cash payments made to private organizations for purposes other than the delivery of goods and the rendering of services directly to the State. However, it does include cash payments made to private organizations for the purpose of providing services to third parties.

The term "transfer" is used to refer to all cash payments made to private organizations and with which this study is concerned.

Scope of Standards

The end result of the study is the development of standards to ensure that transfers of public funds are for public, and not private, purposes. The task of fashioning these standards might be viewed narrowly or broadly. When viewed narrowly, it entails the development of standards by which one may be able to determine whether a particular purpose is public or private. A broader approach delves into the development of standards (1) for determining whether a purpose, in itself public, ought to be funded at all by the State and (2) for ensuring that the funds that are appropriated are actually used for the purpose intended and that they are so used effectively and efficiently.

Although virtually all state constitutions require that public funds be spent only for public purposes, a public purpose is not easy to define. The fact that an appropriation is made to a private party is not in and of itself an appropriation for a private purpose. So long as the primary purpose is to serve a public need and the benefits to the public are direct and not remote, such an appropriation, though made to a private party, is nonetheless for a public

purpose. Generally, what is a public purpose is a matter resting in the judgment of the legislature. Legislative discretion in this respect is wide, and courts are reluctant to overturn a legislative determination unless it is clearly arbitrary.²

The above being the case, the intent of the amended Constitution is best furthered by taking a broad rather than a narrow approach to the development of standards to ensure that public funds are used for public purposes. This study takes this broad approach.

This broad approach, however, requires that we examine the basic structure of transfers and the entire system by which transfers are made to private organizations. This study therefore examines the character of transfers and the operations of the three principal parts of the transfer process: (1) the executive budget process, (2) the legislative appropriations process, and (3) the executive budget execution procedure; and makes recommendations as appropriate.

The impact of federal aid. Federal funds comprise a substantial portion of the State's budget. In FY 1978-79, about 15 percent of the State's operating budget and 18 percent of the State's capital investment budget consisted of federal funds.³ A good portion of the federal funds flow through the State to private organizations in support of their programs. The availability of such federal funds is a mixed blessing. As stated by the legislative leaders from various states before the U.S. Senate Subcommittee on Intergovernmental

²For a discussion on public purpose, see generally 63 Am. Jur. 2d, *Public Funds*, Sec. 59, pp. 447-448.

³Briefing by Eileen Anderson, director of finance, department of budget and finance, before members of the House committee on finance, December 14, 1978.

Relations,⁴ federal grant programs reflect overriding national goals and priorities and not those of individual states. This being so, the use of federal funds often causes the states to support programs which are not necessarily in accord with the states' sense of priorities and with the states' notion of a public purpose that merits government support.

The disruption of the states' priorities and approaches frequently extends beyond the period of federal funding. This happening is aptly described by the New York assembly ways and means committee thusly:

"Certain federal programs start with 100 percent funding but eventually lead to a full state commitment. However, by the time state dollars become necessary, many of these programs have developed a constituency, i.e., employees, local organizations, recipients of services, which can make it extremely difficult for the Legislature to terminate the program."⁵

A good example in Hawaii of the thrust of the New York assembly ways and means committee's statement is the private model cities organizations which were established under the federal Demonstration Cities and Metropolitan Development Act of 1966. Since the termination of federal grants, many of these organizations have become dependent upon the State for support.

Despite the above consequences, the agencies in Hawaii (as in other states) have, up to now, usually welcomed uncritically the prospect of any kind of federal aid. Generally, no analysis is made of present and continuing state commitments resulting from acceptance of federal grants, or of the other social and economic costs of receiving federal aid.

After an extensive study of the inter-governmental grants system, the Advisory

Commission on Intergovernmental Relations recommended greater state legislative control over incoming federal funds. Specifically, the commission recommended that state legislatures include anticipated federal grants in appropriation bills; prohibit receipt of federal grants above the amount appropriated without the approval of the legislature; and establish program allocations where the state has discretion in formula-based or block grants in order to specify priorities, the basis for fund allocations, recipient eligibility, and conditions of performance.

We are in accord with the recommendations of the Advisory Commission. Thus, the standards developed in this study are applicable to federal as well as state funds where the federal funds flow through and are administered by the State.

Form of our Recommendations

The recommendations we make in this study are of two kinds: (1) those which ought to be statutorily enacted; and (2) those which should be administratively adopted in practice or by written rules, procedures, or guidelines. These recommendations are made as we examine the various phases of the transfer process. Chapters 2 to 4 contain the body of the report and supply the basis for the recommendations. For the convenience of the reader, all recommendations are summarized in chapter 5 of this study. The reader who wishes to view the recommendations in their entirety may choose to read chapter 5 before reading chapters 2 to 4.

⁴See U.S. Subcommittee on Intergovernmental Relations of the Committee on Governmental Affairs, *Hearings on the Role of State Legislatures in Appropriating Federal Funds to States*, June 16, 1977.

⁵New York State assembly ways and means report, *Appropriating Federal Funds—A Proposal for New York State*, December 6, 1976, p. 10.

Organization of the Report

This report consists of five chapters.

Chapter 1 consists of this introduction. Chapter 2 deals with establishing a perspective

for transfers. Chapter 3 discusses and makes recommendations on the budget preparation and enactment process. Chapter 4 is concerned with agency operations and makes recommendations for administering state transfers. Chapter 5 summarizes our recommendations.

Chapter 2

TRANSFER DEFINITIONS: A FRAMEWORK FOR THE DEVELOPMENT OF STANDARDS

Transfers of public funds to the private sector are made in a variety of ways. Some are made outright; others with conditions attached.

The development of standards for transfers is greatly facilitated if the characteristics of the various forms of transfers are clarified. Transfers in Hawaii are being made by the use of language that has been less than precise. "Grants," "grants-in-aid," and "subsidy" in particular have been used loosely to describe all sorts of transfers, although the intended nature of the transfers may have differed one from the other. As a result, the expectations of particular transfers have generally been unclear and consistent administration of such transfers nearly impossible.

In this chapter, we examine the character of the various forms of transfers of public funds to the private sector and propose a scheme of classification of transfers for the purpose of establishing standards in conformance with the requirements of the amended Constitution. At the outset we examine the experiences of other states and those of the federal government to determine whether any of such experiences might be of assistance in this endeavor.

Other State Approaches

Generally. In general, it does not appear that other states have done very much in terms of establishing a rational and consistent policy concerning transfers of public funds to the

private sector. As a consequence, there is little in the experiences of other states which can assist in viewing transfers in a systematic manner.

Generally, provisions concerning transfers are found in the state constitutions rather than in statutes. Then, because they are in the constitutions, the provisions tend to be general and inexact. Moreover, a number of these constitutional provisions attempt to avoid entirely the problem of funding private entities by simply prohibiting the giving of state aid to private persons and agencies. The constitutions of Arizona, North Dakota, and Wyoming, for example, prohibit the giving of state aid to persons, associations, or private enterprises. The New Mexico constitution prohibits appropriations to any corporation, association, or institution not under the absolute control of the state. The California constitution provides similarly as New Mexico's, except that it makes an exception for institutions which support orphans, abandoned children, the needy blind, and the physically handicapped.

Other state constitutions do not avoid the issue and have provisions to ensure that public funds appropriated to private entities are used for public purposes. However, most of these do no more than make it a little harder for the legislature to appropriate funds to private groups. The assumption here is that, if it is made a little more difficult than ordinary to make appropriations to private groups, the legislature would give greater attention to these appropriations and that thereby there is some

assurance that such appropriations would be made only for public purposes. Examples of these constitutional provisions are the following.

Alabama, New Mexico, and Colorado have constitutional provisions that the general appropriations bill encompass only appropriations for the ordinary expenses of the executive, legislative, and judicial branches of government. All other appropriations are required to be in separate bills. Other state constitutions require that, with the exception of the general appropriations bill, no bill is to contain more than one appropriation and the purpose for the appropriation must be clearly expressed therein.

Alabama's constitution contains the added provision that no appropriation may be made to any charitable or educational organization not under the absolute control of the state except by a two-thirds vote of the members of both houses of the legislature. The requirement for a two-thirds vote on bills appropriating funds for private use is also found in the Iowa, Michigan, New York, and Rhode Island constitutions.

Some state constitutions go a little further and seek to ensure some state control after funding. The California constitution is an example. While it excepts institutions supporting orphans, abandoned children, the needy blind, and the physically handicapped from the general prohibition of state aid to private entities, the California constitution requires that uniform rules be established for the granting of aid to the excepted organizations and gives the state the right at anytime to inquire into the management of organizations receiving aid. This provision appears aimed in part to ensuring that public funds are used efficiently and effectively.

It appears that of all the states, the State of Vermont has made the greatest effort to adopt policies on support to private organizations. Its experience is of some guidance to Hawaii and is described below.

The Vermont experience. Sometime in the mid-1960's, the Vermont general assembly directed its legislative council to study the legal basis for state appropriations to private and quasi-private organizations and to recommend a consistent and equitable policy for such financial support. The Vermont legislative council enlisted the aid of The Council of State Governments in conducting a survey of the practices in the 50 states. Questionnaires were sent to all the states, and responses were received from 46.

The survey showed that support of nongovernmental organizations was widespread. Thirty-nine states reported supporting private organizations in 1967. The recipient organizations included veterans groups, agriculture and agricultural promotion associations, historical societies, museums, mental health and mental retardation groups, and civil air patrols.

The survey found states reporting standards in three areas: standards for hiring personnel; standards for operations, such as meeting health, safety, and sanitation requirements; and standards for determining the amount of financial assistance. Only 15 states reported having some kind of standard for determining the amount to be made available to private organizations. These varied from percentages of operating or capital costs, amounts per unit of service, to flat sums or sums requested by the recipient.¹

Based on its study, the Vermont legislative council made a number of recommendations to the general assembly. The recommendations, in general, focused on how the state should proceed in deciding whether to fund a purpose at all and on how the state might exercise control over the organizations which are funded by the state. Among the recommendations were the following.

¹The Council of State Governments, *State Support of Private and Quasi-Public Organizations*, August 1968.

1. That the state should use the services of private organizations where these services are otherwise not available. Before doing so, the state should satisfy itself as to the ability of the organization to provide quality service.

2. That the state pay for services on a reasonable charge basis. In determining the reasonableness of the charges, the state agency should inquire as to the manner and efficiency of the organization's operations.

3. That all requests for funds by a private organization be made to the appropriate state agency which would include these in its regular budget request.

In this study we make a number of recommendations that are similar to those proposed by the Vermont legislative council in 1967. However, the Vermont study did not identify the varying forms of transfers and did not address the question of how the recommendations might be implemented to accomplish the purposes of the various kinds of transfers.

The Federal Approach

The need to ensure that public funds are used for public purposes and that they are used effectively and efficiently exists not only at the state level, but at the federal level as well. The federal approach has been one of distinguishing the various kinds of transfers made to the private sector and of developing instruments by which to ensure that public funds flowing to private groups are actually used for the intended public purpose.

The federal development began as far back as 1949 when the first Hoover Commission report was issued. Studies conducted since then have reiterated the need for extensive reforms in the federal aid programs. A 1972 assessment of federal grant operations by the U.S. Commission on Government Procurement found that, "[f]ederal grant-type programs are a vast and

complex collection of assistance programs functioning with little central guidance in a variety of ways that are often inconsistent even for similar programs or projects. This situation generates confusion, frustration, uncertainty, ineffectiveness and waste."² This chaos was traced to three basic causes:

1. The confusion of "grants" or assistance transactions with "procurements";

2. Failure to recognize that there is more than one kind of grant; and

3. Lack of governmentwide guidance for grants.

In addition to recommendations to deal with the third cause, the commission recommended heavily on the first two causes. It recommended new legislation to distinguish assistance relationships from procurement transactions and the use of different, standardized, legal instruments for the different kinds of transfers. Since statutory inconsistencies cause some of the confusion, the commission recommended enabling legislation giving agencies the authority to use whichever instrument they judge appropriate for the transaction.

In response, a series of bills were introduced in Congress, and in 1977 the Federal Grant and Cooperative Agreement Act (P.L. 95-224) was enacted.³ This act adopts in substance the recommendations of the Commission on Government Procurement.

The act distinguishes three kinds of transfer transactions and establishes separate legal instruments for each: procurement contracts; grant agreements; and cooperative agreements.

²U.S. Commission on Government Procurement, *Report* Vol. 3, Part F, *Federal Grant Type Assistance Programs*, 1972, page 153.

³A similar bill was passed by Congress in 1976 but was vetoed by President Ford.

Under the act, a procurement contract is to be used when the principal purpose is the acquisition of property or services for the direct benefit or use of the federal government. A grant agreement is to be used whenever the principal purpose is the transfer of money or anything of value to local jurisdictions or other recipients to accomplish a federally authorized public purpose of support or stimulation. In a grant agreement, there is no substantial involvement between government and recipient. A cooperative agreement is to be used whenever the purpose of the relationship is the transfer of money or anything of value to local jurisdictions or other recipients to accomplish a federally authorized public purpose of support or stimulation. A cooperative agreement differs from a grant agreement in that the former anticipates substantial involvement between the federal government and the recipient.

The act gives federal agencies the authority to use whichever legal instrument is appropriate to the transaction. It also mandates a study of alternative means of implementing federal assistance programs and the feasibility of developing a comprehensive guidance system for such programs.

Proposed Typology

We believe that the federal approach has much to contribute to Hawaii's efforts to establish standards. In table 2.1 we classify transfers in a way which we think assists in viewing and discussing these transfers. In fashioning table 2.1, we followed generally the federal procedure. Although the terminology differs, we believe that the classification of transfers set out in table 2.1 is compatible with the requirements of the Federal Grant and Cooperative Agreement Act.

The classification proposed by table 2.1 clarifies terminology and the relationship that is created between the government and the private sector by the various kinds of transfers. Two major categories of transfers are recognized by

table 2.1: "Purchases" and "Assistance." "Purchases" in turn is subdivided into procurement and purchase of services. "Assistance" is also subdivided. Its subclasses are grants and subsidies. Each major category and the subclasses are described below.

Purchase. The two types of purchase transactions, procurement and purchase of services, serve the same purpose. In both instances, government pays for goods and services supplied and furnished by private parties. They are *quid pro quo* transactions in which the value of goods and services is equivalent to cash payments by the State.

1. **Procurement.** This study is not concerned with procurement per se. This is because the practices and procedures for procurement are well established and generally clearly understood. It is, however, included in the typology and briefly touched on here as a point of departure for the discussion of the other forms of transfers.

Public procurement is governed by HRS Chapter 103, "Expenditure of Public Money and Public Contracts," and by rules adopted by the state comptroller regulating the expenditure of public money. To ensure that government is getting fair value or the best price, present procedures require public advertising for sealed tenders for all expenditures over \$8000.

Expending agencies are the direct recipients of the goods and services. The goods and services flow directly to them. The agencies are responsible for proper authorization of expenditures and proper receipt of goods. The department of accounting and general services approves and makes the payments on all state vouchers submitted with sufficient supporting documentation.

2. **Purchase of services (POS).** POS has increased substantially in recent years. It was fueled by the federal government when it encouraged private organizations to serve as implementing agencies for the 1964 Economic Opportunity Act.

Table 2.1
Typology of Transfers to the Private Sector

	<i>Purchase</i>		<i>Assistance</i>	
	<i>Procurement</i>	<i>Purchase of services (POS)</i>	<i>Grants</i>	<i>Subsidies</i>
Purpose	Quid pro quo exchanges	Quid pro quo exchanges	To stimulate, or support recipient activities	To encourage certain economic behaviors
Legal instrument	P.O., voucher, contract	Performance contract	Grant agreements	Subsidy agreements Subsidy contracts
Method of award	Competitive bid, negotiation	Competitive bid, negotiation. Request for proposals	Technical eligibility, merit competition, panel awards	Technical eligibility
Pricing methods	Competitive bid	Competitive bid. Per unit of service, formula	None	Demonstrated market deficiency or need
Beneficiary	Government	Specified target group	Recipient	Special groups
Agency involvement and accountability	Complete	Complete, includes monitoring, evaluation	Very little. Emphasis on planning and evaluation	Some monitoring. Emphasis on evaluation of output
Eligibility	Unrestricted	Unrestricted	Defined in statute	Unrestricted. Defined in statute.

Under POS, the State contracts with private organizations for the delivery of services to specified target groups or the general public. POS differs from procurement in that the services are delivered directly to third parties and not to the expending government agencies. In other jurisdictions, the most typical example of the kind of services purchased by a POS is solid waste collection. Other commonly found examples are street sweeping, abandoned vehicle removal, lot clearing, and sanitation functions. In Hawaii, the State has contracted with private organizations for many social service functions such as day care services, services to alcoholics and drug abusers, and training and employment services.

The relationship created by a POS is one of purchase, and not assistance. Most POSs are funded, either partially or wholly, by the federal government. The federal funds are often referred to as "grant funds." However, the grants become POS transactions when they are used to purchase services, notwithstanding the original

federal nomenclature. The aid relationship is between the federal government and the State, and not between the State and private suppliers of services. The State is responsible for ensuring that it is getting full value in exchange for the monies expended.

POS has gained in popularity for various reasons. The assumption is that it allows government to enjoy the benefits of private market competition while retaining control over services. It also allows government to maintain a flexible response to demands for services. A recent study by The Urban Institute discussed the arguments for and against POS.⁴

The advantages are:

- Competition for service contracts may lead either to lower cost or better performance.

⁴Fisk, Donald et al., *Private Provision of Public Services, An Overview*, Washington, D.C., The Urban Institute, May 1978.

Specialized skills that are too expensive for government to maintain on a full-time basis can be acquired as needed.

Growth of government employees and bureaucracy can be avoided.

Large initial costs can be avoided if private suppliers have already made the investment.

It permits flexibility in adjusting program size. Operations can be expanded or reduced without negotiations with public employees.

Private operations can provide a yardstick for measuring the efficiency and effectiveness of comparable government services.

Agencies can be more objective in evaluating services as program operations are separate from planning and evaluation.

It produces better management and better management information. Agency program managers can focus on monitoring and evaluating instead of day-to-day operations. Contractors can be required to furnish explicit statements of work performed and to generate other kinds of management information.

The disadvantages are:

It may cost more as it would include government administrative costs as well as private overhead costs.

It may result in poorer services. The objectives of private organizations may differ from those of government. The organization may emphasize services other than those for which it has a government contract.

Chances of corruption of public officials are increased.

The contractor may not fulfill his contract, resulting in disruptions in service.

There may be problems in enforcing public policies, such as equal employment opportunity.

It is difficult to draw up adequate contracts that ensure that government receives the kinds of services which it wants and pays for. If the contract is very specific, changes in services cannot be accommodated. If the contract is general, there is less control over the service offered.

It displaces public employees and may be opposed by unions.

It requires close monitoring.

At the present time, POS payments are limited to providers of services. In the future, the State could consider making POS payments to consumers of services. This would encourage consumer choice in purchasing services. Competition and the probability of better services at lower cost would be increased. The voucher systems in education and cultural affairs are examples. New York experimented with cultural vouchers which were redeemed by museums, theaters, and other cultural organizations. By all accounts, the program has been a splendid success. The money is allocated effectively from the consumer's point of view and accomplished with little overhead.⁵

Assistance. The category "Assistance" differs from "Purchase" in that in assistance there is no equal exchange. The purpose of assistance is to stimulate and support the activities of the recipient.

1. **Grant.** The direct beneficiary of a grant is the recipient. The purpose of a grant is to stimulate and support. A grant is used to help

⁵Bridge, Gary, "Citizens Choice in Public Services: Voucher Systems" in *Alternatives for Delivering Public Services, Toward Improved Performance*, Ed. by E.S. Savas, Westview Pr., 1977.

the recipient carry out functions which are in accord with public policies. Generally, the grantee is allowed to define the actual program to be carried out. For example, the State awards grants in culture and the arts. However, specific activities which support the broad objectives of stimulating culture and the arts are defined by grant recipients.

Since the recipient defines the program to be carried out, government has less involvement in a grant relationship than in a procurement transaction. In procurement, the rights and duties of government and vendor are spelled out in detail and government may control or direct the supplier. In a grant relationship, government plays the part of a patron, with responsibilities for performance resting largely with the recipient. Government's responsibility in a grant is largely at the beginning and at the end—that is, in planning before the grant is made and in evaluation after the grant has been expended.

Pricing has little bearing on selection of grantees. A grant is generally awarded on the basis of need or capability. The reasons for selection are usually a function of the objectives of the authorized grant program. There may be competition but this would not take the form of lowest bids. As an illustration, awards in culture and the arts should be based on the merits of proposals submitted by the applicants and their respective potential for accomplishing the purposes of the State's culture and arts program.

Grant recipients serve governmental objectives but their activities are not public service functions. Grants, by definition, are one-time awards of specified duration. If a grant program is renewed repeatedly, serious questions are raised as to whether or not such a program should become a state responsibility, subject to performance by the State itself or by purchase of service contracts.

2. *Subsidy.* A subsidy is given to achieve specific economic goals. It differs from a grant, as we define it, in that it seeks to induce the recipient to behave, in the economic sense, in a certain way. The intent is to alter the use of resources in the private sector.

A subsidy is generally aimed at altering the price or costs of a particular good or service of the subsidy recipient so as to encourage or discourage the output or supply of these items. An illustration of a subsidy would be cash payments to sugar cane producers to protect the sugar industry and to ensure ample supplies of sugar to consumers at reasonable prices.

A subsidy may take one of several forms. It could be a tax subsidy where the recipient is relieved of paying certain taxes or the tax rate is lowered for the recipient. It could also be in the form of a credit, purchase, or regulatory subsidy. In this study, we are concerned only with cash subsidies.

Recommended Action

The suggested transfer classification above brings some order to the array of transfers which government makes to the private sector. The distinction in character and government-recipient relationship between and among the various forms of transfers provides a clear basis on which to establish guidelines by which the flow of public funds into private hands may be better controlled. Some of these specific guidelines are discussed and recommended in the remaining chapters of this study.

We recommend that the suggested classification be statutorily adopted, together with the specific guidelines suggested later in this study.

Chapter 3

BUDGET PREPARATION AND ENACTMENT

The state budget preparation and enactment process involves both the executive branch and the legislative branch. The Constitution requires the governor to submit to the legislature a budget setting forth a plan of proposed expenditures for the executive branch, and estimates of the aggregate expenditures for the judicial and legislative branches. The legislature is then responsible for enacting the budget for the state government. This chapter discusses these respective responsibilities as they relate to the transfer of public funds to the private sector and suggests ways to strengthen the State's control over public funds flowing to private entities at the initial stages of the flow.

Executive Budget Preparation

HRS Chapter 37, Part IV, spells out the process and form to be followed by the governor in preparing the executive budget. It is based on the concepts of planning, programming, and budgeting, and brings a programmatic focus to budget making. This program focus is intended to enable the governor and the legislature to make meaningful fiscal decisions in light of the state objectives to be attained, the costs and effectiveness of alternative programs in attaining the objectives, and other information derived from systematic analysis and appraisal of programs.

Current status. HRS Chapter 37, Part IV, is well suited in assessing the efficacy of transfers of public funds to private organizations. Adherence to the requirements of this statute will assist in ensuring that public funds are

indeed used for public purposes and that the funding of particular private organizations is an efficient and effective means of accomplishing state objectives. The applicability of HRS Chapter 37, Part IV, to transfers to private organizations was commented on by the joint senate-house interim committee on planning, programming, and budgeting, in its report reviewing the implementation of the PPB budget system, thusly:

“Your committee has reviewed the question as to whether agencies outside of State government but dependent on State appropriations, such as the Hawaii Visitors Bureau, private hospitals, and the counties, need to conform to Act 185 requirements. It has been determined that while all of the requirements of Act 185 may not be applicable in all such cases, the State agencies which are responsible for administering the appropriations should review all appropriations requests to ensure that *all relevant information* required by Act 185 is, in fact, included in submissions to the legislature.”¹

[Italics added.]

Despite the applicability and soundness of the use of HRS Chapter 37, Part IV, in transfers to private organizations, such transfers are for the most part excluded from the

¹Joint Senate-House Interim Committee on Planning, Programming, Budgeting, Special Committee Report No. 10, March 3, 1972.

budget prepared by the executive. This exclusion appears to be by choice rather than by accident. The director of the department of budget and finance testified recently before the house finance committee that “[a]s a matter of past policy and practice, the Administration has not recommended private subsidy items in the executive budget.” Then, the instructions which the department of budget and finance issues to state agencies in preparing the agencies’ budget requests touch only incidentally on the subject of private sector programs. The June 1978 “Instructions for Preparing Program and Financial Plans and Program Budget Requests,” for instance, made only this brief comment:

“This section should identify important program relationships involved. Federal, city and county and *private sector programs* which have significant relationships to the current approved program should be identified since obviously the State’s activities should be integrated and coordinated with those of all other agencies.” [Italics added.]

This inadequate treatment of transfers to private organizations in the executive budget means that substantial amounts of public funds are escaping scrutiny in terms of the objectives and purposes to be accomplished by the expenditure of such sums and the efficacy of expending such sums. Questions such as whether the results to be achieved by the transfers ought to be pursued by the State and, if so, whether transfers to private organizations are the most cost-effective means of accomplishing the results, are not posed and answered.

The result is that private agencies make requests or proposals directly to the legislature during the session, and the legislature is compelled, during a short period, to make a decision, without the benefit of systematic analysis or, at the least, information on how and to what extent transfers to these organizations impact state objectives and programs.

This failure to treat transfers adequately in the executive budget applies to grants, subsidies, and purchases of services. Note the following grant and purchase of service examples.

1. *Grants: The case of the Bishop Museum.* In recent years, the Bishop Museum has been funded by the legislature to the tune of about \$100,000. The expenditure is administered by the Hawaii foundation for history and the humanities, which is within the department of budget and finance. Although the appropriation is a recurring one, it is not included in the executive budget. The Bishop Museum submits its requests independently to the legislature on its own format. The information the legislature gets, therefore, is often devoid of the kind of programmatic information on purposes and governmental objectives which it needs for intelligent decision making. Funds for Bishop Museum were released on the basis of the following expenditure plan:

1. Salaries of library staff primarily with public service ..	\$ 21,100
2. Purchase of books and periodicals	18,000
3. Partial salary for education department	11,000
4. Exhibits: salaries of preparator and coordinator ..	19,200
5. Exhibits: development of Children’s Museum	18,700
6. Completion of Hawaii Hall of Natural History and refurbishing others	12,000
	<u>\$100,000</u>

The plan provided minimal information. It said little about the programs of the Bishop Museum. It said nothing about the public purpose to be served by the \$100,000 appropriation.

2. *Purchase of services: The case of the providers of the state department of social services and housing.* The state department of social services and housing (DSSH) purchases a variety of services from private organizations. The amount of public funds involved in the purchase of these services is substantial. Seventy-five percent of the costs of the services are funded by the federal government. Federal funds are conditioned on the payment of the remaining 25 percent of the costs from locally generated funds.

In 1972 when the program of purchasing social services first began, the private organizations from whom services were purchased were expected to marshal for themselves the 25 percent in matching funds. In the first year or two of the program, the private organizations did indeed provide the 25 percent matching funds. In the subsequent years, however, the private organizations experienced difficulty in generating the 25 percent, and they turned to the legislature for assistance. Beginning in 1974, the state legislature has appropriated state funds up to the 25 percent required by some private organizations for continued federal funding.

Neither at the time when the program of purchasing social services first began nor at present when state funds are appropriated to match the federal contribution has the cost of purchasing social services been adequately dealt with in the executive budget. Except for brief references in the narratives to the purchase of services, the executive budget makes no effort to examine the purpose of these purchases and to analyze whether it is better for government to purchase the services or to provide the services itself.

In the absence of proper treatment of service purchases in the executive budget, the following is occurring, promising to make the situation in the future worse than it is today.

Between 1975 and 1977, the legislature named in the appropriations act the specific private organizations that were to receive state funds to cover 25 percent of the costs of pro-

viding services. Each year the legislature added to this list of organizations. There is, however, a federal ceiling of \$10.2 million for DSSH's purchase of service programs. As the legislature adds to the list of organizations designated to receive state funds, it in effect increased the number of organizations that were to share in the \$10.2 million. As the number of such organizations increased, the chances also increased that not all of the organizations would receive the 75 percent in federal funds which they had anticipated for their operations. All of this occurred without the benefit of analysis as to whether the services of all providers were of equal value, whether they were in accord with the state objectives and state priorities and whether the purchase of services from all of them were indeed cost-effective.

Recommended action. If the State is to derive maximum benefit from transfers of public funds to private organizations, such transfers need to be integrated into the executive budget. The proper use of transfers can further public purposes. However, the efficacy of transfers can best be viewed in light of the total state plans for achieving governmental objectives. The role and extent of transfer should be clearly defined in the State's financial plans.

The need for this integration in the executive budget has been recognized over the years by the legislature. In the various general appropriations acts since 1971, the legislature has inserted a proviso requiring all nonpublic organizations to submit all future subsidy requests on forms prescribed by the director of finance.² This requirement has been honored more in breach than in compliance.

With respect to purchase of service transfers, DSSH itself has recognized the need for integration in the executive budget. In the 1977 Multi-year Program and Financial Plan, it made this comment:

²See, for instance, Section 27, Act 68, 1971; Section 104, Act 218, 1973; Section 198, Act 195, 1975; and Section 107, Act 10, 1977.

"The availability of Federal Title XX funds for social services and subscribed to in full force in 1973 created an imbalance within our social service program in that the greater portion of our federally allotted monies were allocated for purchase of services rather than direct DSSH services where it has not only the mandate but greater still to implement specific services. There is need to more clearly identify those services best implemented through DSSH, strengthen and expand; and those services best provided by other programs and purchase those." [Sic]³

To accomplish the integration described above, the following actions need to be taken.

1. *Generally. a.* Every private organization that desires to receive public funds should be required to submit its request to the state agency whose programs and functions are related to the purpose for which public funds are sought by the private organization. The request should be submitted on forms prescribed by the department of budget and finance. The form should conform to the requirements of HRS Chapter 37, Part IV, and should, among other things, require the private organization to state the objective to be sought by the transfer of public funds, the program operations and program performance measures.

b. Each state agency with which a request for public fund transfer has been filed should review such request in terms of state objectives and assess the relative importance of the ends sought to be achieved by the transfer. It should further subject such proposed transfers to cost-effectiveness analysis. The results of the agency's analysis should be included in the program and financial plan and budget submission to the legislature.

c. Appropriate guidelines and instructions should be established by the department of budget and finance for each form of transfer. Among the guidelines should be the eligibility

requirements for each kind of transfer and the information that the applicant for a transfer must submit. The guidelines should further provide for full program, planning, and budgeting analysis by the government agencies concerned.

2. *Grants.* With respect to grants, since by definition they should be one-time awards, all applications for renewal of grants should be subjected by the executive agencies concerned, including the department of budget and finance, to careful scrutiny in terms of objectives, costs, and benefits. The State should consider whether it should assume responsibility for those private programs receiving recurring state grants, by operating the program itself or through a purchase of services mechanism.

3. *Subsidies.* Subsidies tend to continue even when the original justification for them has disappeared. Thus, any application for subsidy should be scrutinized closely in terms of the length of the subsidy. As recommended later in this study, any legislation authorizing a subsidy should contain a termination date. As a general rule, no subsidy should extend beyond two to four years without a rigorous analysis of its continued value to the State.

4. *Purchase of services.* The department of budget and finance should establish general policies concerning the use of purchase of services mechanism by state agencies to achieve state objectives. The policy should specify, among other things, when services should be purchased instead of being provided in-house by agencies. It should require a cost-benefit comparison of private and public provision of services. The policy should also require that the target group or recipients of the service, and the kind of service to be delivered, be defined in operational terms. Only with a clear comprehension of what is being purchased is it possible to establish a price. Agencies should be required to take steps to set a pricing policy based on some uniform units of service. Agencies should

³Hawaii department of budget and finance, *Multi-year Program and Financial Plan*, 1977, Vol. IV, p. 2185.

also be required to prepare specifications detailing all the requirements and to solicit bids or proposals prior to budget formulation and submission. To the extent possible, competition should be encouraged to achieve the cost-benefits of POS. POS should be avoided where there is but a single supplier.

The Budget Enactment Process

All appropriations must be authorized by the legislature. The legislature authorizes operating expenditures through a general appropriations act which is enacted in every odd-numbered year and amended as needed in even-numbered years by a supplemental appropriations act.

Transfer payments to private recipients and providers are authorized by the legislature in several ways. They may be included in the executive's budget request and authorized through the general and supplemental appropriations acts; they may be the subject of separate appropriations acts; or they may be legislatively initiated and added to the general appropriations act. The last method has grown in popularity in recent years.

The growth in legislatively initiated transfers. The changing structure of the general and supplemental appropriations acts provides evidence of the growing popularity of the practice of legislatively initiated transfers. In 1971, the general appropriations act consisted of five parts. These reflected the executive's budget requests. Since then, additional parts have been added to the general appropriations acts. The most significant of these is a new Part V, titled "supplementary appropriations," which is referred to colloquially as the "program pork barrel." In the new Part V, specific organizations are named to receive state funds.

In 1973, Part V was rather short. Only five organizations were specifically named to receive public funds. The 1974 supplemental appropriations act increased Part V items substantially. It provided funds for a number

of specified private organizations, including day care centers, rap centers, and drug abuse centers. This set the pattern for subsequent appropriations acts, and, each time, the number of private organizations designated for funding has increased. The number has grown from five organizations in 1973 to over 60 in FY 1977-1978.⁴

Inadequacies in legislative initiation of transfers. Legislatively initiated transfer appropriations result because private organizations make direct appeals to the legislature for funding. The reluctance of the executive agencies to handle these requests contributes to the growth in the number of requests made directly to the legislature and in the number of legislatively initiated transfers.

There are, however, deficiencies in this practice of the legislature initiating transfer appropriations. In the main, the legislature expends too little effort to analyze the merits of the requests made by private organizations. This is apparent in the language used to appropriate funds for the organizations. The transfer appropriations are generally couched in language such as these: "to provide for the continuation of . . ."; "to defray expenses involved in the sponsorship of . . ."; "grant-in-aid to . . ."; "to provide funds for . . ."

This sort of language provides little insight as to the public purpose to be served by the appropriations. It provides no clue as to the relationship intended between government and the recipient. As such, the language gives little guidance to the executive agencies in administering the transfers. The situation is compounded and made even more difficult when different terms are used to authorize transfers to different organizations, even though the apparent purpose appears to be the same for both transfers; and when a transfer to a particular organization is worded in one way in

⁴There were no Part V supplementary appropriations in 1978. Instead, appropriations to private organizations were designated in "Special Program Appropriations, Fiscal Year 1978-79," an attachment to Conference Committee Report 46-78, to the Supplemental Appropriations Act.

one year and in quite another way in a subsequent year, even though the purpose of the transfer does not appear to differ from one year to the next.

The consequence of these inadequacies is that it makes it possible for private organizations to be funded to carry out projects which either duplicate those carried out by governmental agencies or which do not appear to fulfill a real pressing need. For instance, the transfer of public funds to the Kalihi-Palama immigrant services center (KPISC) might be questioned along these lines.

The transfer to KPISC is made through the state commission on manpower and full employment. Until two years ago, KPISC was administered by the progressive neighborhood program. A few years prior to that, the KPISC was a model cities program. The progressive neighborhoods program assumed administration of KPISC when federal funding for model cities was terminated.

The manpower commission contracts with the Palama Interchurch Council, which, in turn, administers KPISC. The KPISC provides information and referral services to recent immigrants and arrivals from American Samoa through bilingual employees. However, similar services are provided by the social workers of the department of social services and housing and by the community services centers of the progressive neighborhood program, without the element of translation that the bilingual workers of KPISC provide.

Real questions are raised as to whether or not KPISC, DSSH, and the progressive neighborhood program are providing duplicate services which are better provided by a single agency. Yet, in 1976, KPISC bypassed the commission and secured an additional Part V appropriation of \$117,854 by appealing directly to the legislature. These additional funds were intended to cover the impending loss of federal Community Development Block Grant (CDBG) funds. KPISC had expanded through other areas of Oahu under the CDBG funds and sought to

have the State pick up the tab. The manpower commission did not testify at the legislature, but, when asked for its recommendation on the administrative release of the appropriated additional funds, recommended against it. The funds in the end were withheld. However, the fact remains that the legislature appropriated these funds without adequate analysis. The KPISC might be a worthwhile program, but funding without proper analysis in terms of state objectives and programs gives no assurance of efficient use of public funds.

Recommended action. Two factors appear to cause this apparent lack of care on the part of the legislature. First, the general and supplemental appropriations bills provide a mechanism which does not require the legislature to give sufficient thought to the requests made by private organizations. These appropriations bills are, by and large, simply a delineation of the amounts appropriated. No programmatic purpose is required to be stated in the general and supplemental appropriations bills. This is because the general and supplemental appropriations bills are intended primarily to fund governmental agencies, and the amount to be appropriated to each such agency is derived from the program and financial plan, the development of which presumably resulted from an analysis of objectives and alternative programs. The use of the general and supplemental appropriations bills, therefore, does not compel the legislature to analyze with any degree of care the merits of the requests of private organizations.

This is not to say that the legislature makes no analysis whatsoever. In some cases it does, but not to the degree it might otherwise be compelled to make. The general and supplemental appropriations bill format simply does not encourage in-depth analysis to take place when requests for funding are made directly to the legislature.

The second factor which contributes to inadequate analysis of requests made by private organizations is that the legislature simply does

not have the time or the staff to make an adequate analysis during the period of a legislative session. Requests by private organizations are generally submitted when the legislature convenes in session.

To ensure that transfer appropriations to private organizations are wisely made, it would appear that the legislature should require, as suggested earlier in this chapter, that all requests from private organizations be channeled through the executive branch and that the agencies concerned subject such requests to thorough analysis. The results of that analysis should be reflected in the executive budget.

As further insurance that transfers to private organizations are given the scrutiny they require, it should become a legislative practice that all requests by private organizations which are received during a legislative

session or otherwise sent directly to the legislature are forwarded automatically to the department of budget and finance and the appropriate executive agencies for their analysis and recommendations.

Finally, it appears that proper analysis of requests by private organizations can be assured if grant and subsidy appropriations to such private organizations are made by separate bills for each organization. This means that grant and subsidy appropriations would no longer be a part of the general and supplemental appropriations acts. The separate bills appropriating funds to nongovernmental entities should include a clear statement of the findings of need and the public purpose intended to be served and the terms and conditions which the recipient is expected to meet. Purchase of service appropriations would continue to be included in the general and supplemental appropriations acts.

Chapter 4

BUDGET EXECUTION: THE EXECUTIVE ROLE

After the legislature has appropriated funds, the execution of the appropriation measures is the responsibility of the executive branch. In this chapter, we examine that budget execution process as it relates to transfers to private organizations.

There are three principal parts to the budget execution process for transfers: (1) the allocation and allotment process; (2) the process of establishing the legal relationship with the recipient; and (3) the reporting, monitoring, and evaluation process.

Budget Allocation and Allotment

The governor's signing of the appropriations act signals the formal beginning of the budget execution process. Here, the department of budget and finance (B&F) has primary responsibility. By law, it is required to assist agencies in achieving the most effective expenditure of public funds and to determine that such expenditures are in accordance with budget laws and controls.

Before the fiscal year begins, B&F allocates a ceiling for each agency. Within the allocation, each agency prepares an operations plan for the year, with estimated quarterly requirements and submits the plan to B&F. The director of finance has the authority to approve, increase, or decrease the estimates. Monies are actually released for agency spending on the quarterly basis in accordance with the approved estimates. This allotment system is intended to promote

more careful supervision and more economic and efficient management of state funds.

Transfers to private organizations are subject to the State's allocation and allotment system. However, under present practices, the allocation and allotment system is applied inconsistently and inequitably to the various transfers. This is because there are no guidelines on the matter and the agencies are allowed considerable discretion in dealing with transfers. Note the following.

The allocation process. Each agency's allocation is inclusive of transfers to private organizations. No separate allocation is made for transfers. Within each agency's initial allocation (which in recent years under the governor's austerity program has been less than the total appropriated to the agency by the legislature), the agency is given freedom to decide how the allocated amount is to be spread out among the programs within the agency. The general procedure within each agency is for each program manager to be assigned an allocation ceiling. Except for fixed costs, which may account for a good portion of their budget, the program managers are in turn given discretion to decide how these funds are to be spent. The program managers are given no instructions as to how to deal with transfers, particularly when the allocations are less than the appropriations.

The tendency of most program managers and agencies is to implement the programs which were built into their executive budget requests. Transfers, particularly those

legislatively initiated, are implemented only as funds permit. Program managers are aware, of course, that it is impolitic to ignore these transfer items completely and they, thus, usually manage to provide at least some funds to the private organizations. However, the program managers are not uniform in their treatment of the transfer funds, either among themselves or among the transfer items that each program manager is responsible for. Sometimes, particular organizations are able to secure consideration by applying pressure on the program manager.

The level of state support forthcoming and the timing of its release has not been consistent. This has undoubtedly created hardships for private organizations in planning their program operations.

For example, most culture and arts organizations did not receive any of their state-appropriated funds for fiscal year 1977-78 until the fiscal year had ended. The amounts released were approximately 50 percent of the amounts that had been appropriated, although one organization received 70 percent of the appropriated amount.

An entirely different pattern was followed in fiscal year 1978-79. Private culture and arts organizations were notified, by the second quarter, that they would receive 100 percent of the appropriated amounts. Thus, within a span of four months, these organizations received funding for both fiscal year 1977-78 and fiscal year 1978-79. In addition, many organizations also received funds which had been budgeted for them in the state foundation on culture and the arts' budget.

The foregoing permits undue discretion on the part of program managers and creates unnecessary hardships for private organizations. Present procedures do not ensure equitable treatment of transfers authorized by the legislature, and private organizations cannot plan ahead since they have no certainty when or if funds will be released to them or how much will be released.

The allotment process. The manner in which funds are actually allotted and paid over to private organizations is also inequitable and without uniformity. There appears to be no guidelines as to whether funds should be disbursed monthly, quarterly, or annually to private organizations. All three schedules are used by the agencies, usually on the basis of the recipients' preferences. Large, lump sum payments are of particular concern. The appropriation to the Bishop Museum is a case in point. The \$100,000 appropriation for fiscal year 1976-77 was paid in one lump sum to the museum in March 1977 by the Hawaii foundation for history and the humanities (HFHH), the administering agency.

This lump sum payment apparently violated HRS Chapter 37, Part II, and the provisions of the appropriations act, both of which subject transfers to the allotment process, and the basic control and accountability objectives of the allotment requirements. Equally important, the lump sum payment might well have placed the museum in a more beneficial or detrimental position when compared to those of private organizations which received their transfers in accordance with the allotment process. Note that more than half of the \$100,000 was intended to cover the salaries of specific positions at the museum, and note also that the entire \$100,000 was paid over in the latter part of the third quarter of the fiscal year. This could mean that the salaries to be paid from the \$100,000 had either been advanced by the museum from other sources or the services intended to be secured had been foregone. In either case, it could mean that the museum was not treated properly in the payment of the transfer.

Recommended action. It seems quite clear that, if private organizations are to be treated fairly and if they are to plan their programs, a much more systematic procedure needs to be followed in the allocation and allotment process. HRS Chapter 37, Part II, the allotment procedures, should be applied to every transfer. In addition, the administration needs to develop

a policy on state support of private entities and prepare guidelines for agencies on how transfers should be allocated and allotted.

Establishment of Legal Relationship

The present executive policy, as contained in the governor's budget execution instructions, is for each concerned agency to secure a "public purpose clearance" from the department of the attorney general (AG) before any transfers are actually paid out. This clearance is followed by a contract, or other document, before the funds are paid out.

The system does not work well in all cases, and there is need for improvement if the State is to be assured that transfers are meeting public purposes and that they are doing so efficiently and effectively.

Public purpose clearance. Although the governor's budget execution policies and instructions provide that a public purpose clearance be secured from AG before any transfer is actually made, this requirement is not always followed. Even in the same agency the requirement is sometimes followed and at other times not. For instance, in the department of health (DOH), public purpose clearances are secured as a matter of course in cases of subsidies to private hospitals. However, in the case of payments to private organizations for alcohol and drug abuse programs, public purpose clearances are sought only if there is some doubt.

This pattern of behavior is encouraged in part by AG's attitude concerning the need to determine whether an authorized transfer serves a public purpose. The view of AG is that, if the legislature appropriated the sum, it is for a public purpose.

AG cannot be blamed entirely for this attitude. It merely reflects the general approach of the courts to accept a broad definition of public purpose. See our discussion on the matter

in chapter 1. However, it would seem that all transfers should nonetheless secure such public purpose clearance from the attorney general, perfunctory though it may usually be. It is entirely possible that a particular transaction may be found by the attorney general to be clearly repugnant to the constitutional requirement that public funds be used for public purposes only.

Contract necessity. Different kinds of transfers establish different relationships between the State and the recipients. Some are simply out-and-out grants requiring very little formal articulation of how the State and the recipient relate to one another. Others create some significant rights and obligations between the parties, requiring some formal and detailed writing spelling out those rights and obligations. Currently, there is no consistent practice in the matter. In a large measure this is because transfers are appropriated by the use of language that shed little light on the precise purpose of the appropriation.

In the first instance there is some confusion as to whether or not any formal contractual arrangement is necessary. AG has been treating transfers labeled "grant" or "grant-in-aid" as outright *gifts*. Unless the appropriations act specifically states the purpose of the appropriation, AG has been advising the agencies that there should be no controls exercised over how the funds are spent by the private organization. However, program managers have not all been satisfied with this simplistic approach and on occasions have disregarded the AG's approach and have negotiated some contractual arrangements with the recipient organizations, imposing on the organizations such state controls as the managers deemed fit, and have executed such agreements without the AG's concurrence. Note the case of the Kalihi-Palama Immigrant Service Council (KPISC).

When the state commission on manpower and full employment first took over from the progressive neighborhood program the

responsibility to administer the transfer to KPISC, it entered into a contract with the KPISC's parent organization (the Palama Interchurch Council) using the same form as previously used when the transfer had been administered by the progressive neighborhood program.

In the second year, however, the manpower commission was advised by the attorney general that the transfer appropriation was a gift, and hence it was improper to use a contract. The manpower commission was advised that it should simply transmit a check to the Palama Interchurch Council after securing a public purpose clearance. The manpower commission, however, was unsure of the ramifications of so loose a practice. It therefore drafted a contract in the same form as before and had it executed without the attorney general's concurrence.

Whether or not any contractual arrangement is necessary is further confused by such advice given by AG to SFCA to differentiate between a "grant agreement" and a "grant award," a "grant award" being a transfer of less than \$4000 and not requiring a contract, and a "grant agreement" being a transfer larger than \$4000 and requiring a contract. There appears to be no rational explanation for this differentiation, and it apparently does not apply to all agencies. For example, HFHH and SFCA (both within B&F) make grant awards and grant agreements to various organizations. SFCA has transmitted funds via letter agreements to the Honolulu Theater for Youth for specific productions and tours, such as the presentation of "Folktales of the Philippines" on the neighbor islands. The letter agreement for this particular program included specific terms and conditions. HFHH, on the other hand, has made transfers without such terms and conditions. For example, even though the Bishop Museum receives more than the Honolulu Theater for Youth, the transfer is made without specifying any conditions.

Contract form. Where it is deemed that a contract should be negotiated and written to

govern the relationship between the State and the transfer recipient, it is not clear as to the form that the contract should take. There are virtually no guidelines to assist program managers on this matter.

The formal contract appears to be most widely used. It is used for most of the larger transactions, particularly for purchase of service transfers. Within these, there is a wide range in the specificity of the contract terms. These range from the voluminous contract between the department of planning and economic development and the Hawaii Visitors Bureau to the shorter contracts between the department of education and Maui Hui Malama, Inc., an alternative education school.

Generally, a program manager tends to use the same formal contract form for making similar kinds of transfers. This is done in the alcohol and drug abuse branch of the department of health and the purchase of services office of the department of social services and housing. Appendices usually spell out the specific variants for each contract relationship.

When a program manager has to administer several different types of transfers, however, he has to devise an appropriate form for each. And, depending on the assistance provided by the AG or the internal organization within his department, the program manager may be compelled to devise the contract himself. This would then have to be reviewed in the many layers of the department and reviewed by AG. If there are any changes along the way, and, invariably there are, the process begins anew. The process can take many months.

Other transfers of public funds are made more informally via letters. These letters are of varying degrees of specificity. The letters and attachments, if any, spell out the conditions to be met by the recipients.

Still another type of document used by agencies is the memorandum of agreement. This

instrument occupies a middle ground between formal contracts and letters in specificity. The department of education utilizes memos of agreement. It has a standard form for such memos.

Terms and conditions of transfer. Variations in specific requirements are to be expected in the several forms of transfers. There are, however, some terms which ought to be applicable generally to all transfers and other requirements which should apply to all transfers within each given class. The requirements in some cases ought to apply whether or not a transfer is supported by a formal contract between the State and the recipient. Currently, there does not appear to be any consistent requirement for all transfers or for transfers within a given class. We note below the presence of this situation in three areas where we think some consistent requirements are in order.

1. *Financial disclosure and reporting requirements.* Different degrees of financial disclosure are required by the various state agencies. They range from the detailed requirements for transfers administered by the alcohol and drug abuse branch of the department of health to the total absence of requirements for the Bishop Museum. For the transfers administered by the alcohol and drug abuse branch, the information required include all sources of funds, both cash and in-kind contributions, including other government sources and amounts received, income-producing activities, client or third party fees, and public contributions. For the Bishop Museum, the State has not required the museum to open its books. The State does not know all the sources of the museum's revenues.

The rationale for providing Bishop Museum with \$100,000 is based on Bishop Museum's funding requirements. The museum has represented a deficit of over \$100,000 in its operating budget. The deficit is based on expenditures, including expenditures for salaries and materials, the same objects for which the museum is given the \$100,000 state support.

Yet the museum has not agreed to any conditions in exchange for the transfer, and it has discouraged any attempt to inquire into the efficiency of its management practices.

Financial reporting requirements also vary. Some private entities are required to report periodically while others are not. Some are required to submit certified financial statements and others face no such requirement. It would seem that POS contracts should require regular and detailed financial reports, while grants need not impose very rigorous financial reporting requirements. However, there must be some reporting to ensure that state funds are put to proper uses.

2. *Nondiscriminatory employment and service requirements.* Title VI of the Civil Rights Act of 1964 provides that "no person shall, on the grounds of race, color, or national origin, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving federal financial assistance." The employment practices of recipients of federal assistance are included in this prohibition against discrimination if a primary objective of the federal assistance is to provide employment or if discrimination in employment causes discrimination to the beneficiaries. In addition, recipients of federal financial assistance may be subject to other provisions of the Civil Rights acts and to other federal laws on discrimination.

State-administered transfers which receive federal funds have been required to comply with the nondiscrimination provision of Title VI. The department of health requires compliance with some nondiscriminatory provision by all providers in grant applications; the department of social services and housing provides for nondiscriminatory practices in its contracts for purchase of services agreements. SFCA also makes similar provisions. However, HFHH does not provide for nondiscrimination in employment or in service in the transfer to the Bishop Museum. The agreement between

the progressive neighborhood program and Palama Settlement for the welfare recipients advisory council does not contain any explicit proviso for nondiscrimination, nor does the agreement between the manpower commission and the Palama Interchurch Council for KPISC.

We believe that all recipients of transfers, as a condition for state funding, should be required to comply with all applicable federal and state statutes on nondiscrimination.

3. *Certification and licensing requirements.* Certification of personnel and licensing standards exist for a variety of facilities and organizations. For example, there are personnel certification and facility licensing standards for hospitals and schools. These standards are intended to ensure quality in the services provided. Where such standards exist, it would appear that the recipients of transfers ought to be required to meet the standards as a condition of the transfers.

In recent years, state agencies have begun to require compliance with applicable standards. The department of health, for instance, has recently included in its contracts for alcohol and drug abuse services the requirement that providers comply with certain certification and licensing standards. Similarly, DSSH purchase of services contracts also require compliance with applicable licensing standards. Requiring recipients to meet applicable certification and licensing standards ensures that the recipients possess the capability to carry out the intended purpose of the transfers.

Recommended action. There should be a systematic approach in establishing and defining legal relationships between the State and the recipients of transfers. The inconsistencies that currently exist do not enhance the use of public funds for public purposes. The systematic approach should include the following.

1. Before transfers are made, they should be cleared by the attorney general to ensure that they are for public purposes.

2. B&F in cooperation with AG should establish rules by which agencies may be able to determine whether a particular transfer should be made under a formal agreement with the recipient. Such rules need to be developed on the basis of the purpose of the transfer.

3. Model forms of contract should be developed by B&F in cooperation with AG. Such model forms are needed to guide state agencies in administering transfers to private organizations. The development of a variety of forms is possible, ranging from a rather general one to a considerably detailed contract, depending on the kind of transfer involved. In some kinds of transfer, greater state control may be desirable.

4. By rule and by contract provisions, B&F should specify the conditions upon which all transfers and all transfers of each particular class of transfers are to be made. Such conditions should encompass at a minimum matters related to financial disclosure and reporting, nondiscriminatory employment and service requirements, and adherence to known personnel certification and licensing standards.

Monitoring and Evaluation

As in the case of programs operated directly by the State, that public funds transferred to private organizations actually fulfill the purposes intended can be determined only by a program of monitoring and evaluation. In the case of programs operated directly by the State, monitoring and evaluation form a part of the cycle of planning-programming-budgeting embodied in HRS Chapter 37, Part 10. Transfers to private organizations, however, to a large degree are not now subjected to monitoring and evaluation.

A part of the reason why no monitoring and evaluation of transfers occur is that these requests have not been subjected to the planning-programming-budgeting rigors as have, presumably, the state programs. But, even in

those instances where some analytic requirements are imposed for transfer requests, monitoring and evaluation have been inadequate. The transfer made in support of the state programs on alcohol and drug abuse is an example.

The alcohol and drug abuse branch of the department of health imposes some rather detailed requirements at the initial point of the transfer process. An applicant organization must make a comprehensive submission, declaring its assessment of need, target population, goals and objectives, methods to accomplish the objectives, methods of evaluation, and organizational structure and job descriptions, among others. In this situation, it is natural to expect that the department of health would follow through by monitoring implementation. The funds are disbursed on a quarterly basis and the fourth quarter payment can be withheld pending fiscal audit or final evaluation report. However, evaluation is not pursued vigorously.

The personnel of the branch very seldom make site visits and do no formal evaluation.

On rare occasions, some agencies have external evaluations of transfers. They contract with an outside government or nongovernment agency to assess the transfer programs. For the most part, however, monitoring is minimal.

Recommended action. To ensure that public funds are being used efficiently and effectively for public purposes, monitoring and evaluation of transfers should occur as a matter of course. Such monitoring and evaluation activity, whether performed in-house or contracted out, should be built into the activity of every agency which administers transfers. Monitoring and evaluation can be assured to some degree, if transfers are incorporated at the initial stage (that is, when requests for transfers are made) into the planning-programming-budgeting cycle of HRS Chapter 37, Part IV.

Chapter 5

SUMMARY OF RECOMMENDATIONS

The purpose of this study was to develop standards to ensure that public funds are used for public purposes and that they are used effectively and efficiently in accomplishing such public purposes. Of particular concern have been payments to private persons and entities where neither goods nor services are provided or furnished directly to the State in return for such payments. In chapters 2 to 4 we made a number of recommendations. The recommendations taken as a whole constitute the standards.

In this chapter we summarize our recommendations. Our recommendations are of two kinds: statutory and administrative. Statutory recommendations require that the legislature enact appropriate legislation. Administrative recommendations require the executive branch, namely, B&F, to develop rules, policies, and guidelines. In this summary we designate which recommendations require legislative action and which require administrative action. In many cases both types of actions are needed.

In General: Need for a General Statute

There is today no statute to govern the payment of money to the private sector, except where such payment is made to procure goods or services to be consumed directly by the State. If the State is to ensure that public funds appropriated and made available to private entities serve public purposes effectively, some legislative policy on the matter needs to be enunciated.

Our initial recommendation, therefore, is that the legislature enact a general statute on payments to the private sector other than payments to procure goods or services to be consumed directly by the State. The specific provisions to be contained in the statute are outlined below.

Classification

To ensure that public funds made available to private entities serve public purposes and that they do so effectively and efficiently means that the State must exercise some control.

One of the problems today is that the State has been unclear as to the kind and degree of control which should be exercised over the various kinds of transfers. As a consequence, there is virtually no control.

To assist in bringing order to the payments made to the private sector, we recommend that the legislature adopt a classification system which distinguishes the various kinds of payments made to private organizations. These should be differentiated according to the purpose for the payment. We think that payments should be divided into two broad categories: Purchases and Assistance. Purchases are cash payments made in exchange for goods or services of equal value. Assistance includes payments made not in exchange for goods and services, but to support the program or programs of the recipients.

Within the category "Purchases," cash payments made in exchange for goods or services provided directly to the State should be distinguished from payments made in exchange for goods or services furnished directly to the general public or a portion of the general public. The former are "procurements" and the latter "purchase of services."

Within the category "Assistance," one-time "grants" made to stimulate or promote the recipients' activities should be distinguished from "subsidies" paid to recipients. The latter serve to alter the price or cost of particular goods or services produced or furnished by the recipients so as to encourage or discourage the output or supply of those items.

This classification will provide clarity as to the kinds and degrees of control the State should exert over the cash payments and recipients.

Budgeting Transfers

A private entity should not be funded, whether by way of purchases or assistance, unless the activity it intends to carry out furthers state objectives and strengthens state programs. That the intended activity appears to serve some public purpose, should not be sufficient justification for the use of public funds. Like all other programs, such activity should compete for the State's resources on the basis of the results to be achieved and the costs and benefits of the activity.

Funding for private organizations has not been, for the most part, subjected to such scrutiny because it is not now a part of the executive budget process, nor has the legislature subjected such funding requests to rigorous analysis.

To ensure that the State derives maximum public purpose benefits from monies appropriated and paid over to private organizations, we recommend as follows.

1. The general statute on payments of money to private entities should require that all requests by private entities be submitted to those state agencies which have jurisdiction over the programs and functions proposed by the private entities. B&F should be required to devise the forms for submission of such requests.

2. All state agencies receiving requests for funding from private organizations should be required to review such requests in the same manner as they do state programs under HRS Chapter 37, Part IV.

3. B&F should be assigned statutory responsibility for establishing appropriate guidelines and instructions concerning requests for public funding by private organizations. The guidelines should include requirements for eligibility for the various kinds of transfers and the submission of such information as will assist the state agencies in their analysis as required by the planning, programming, and budgeting process outlined in HRS Chapter 37, Part IV.

4. B&F should also have the statutory responsibility for establishing general policies concerning when and under what conditions the various forms of transfers may be utilized in funding private organizations. Policies specifically on the use of purchase of service are desirable to ensure that purchase of service is indeed the most cost-effective means of delivering goods or services to the public. Further, the policies should require that agencies prepare specifications, if services are to be purchased, and solicit bids or proposals before budget formulation and submission.

5. The legislature should refer all requests for funding by private organizations to B&F and the appropriate executive agency or agencies for their analyses and recommendations.

6. To further ensure that funding requests by private organizations have been properly reviewed, the legislature should appropriate grant and subsidy funds by separate bills,

one for each organization and funding request. The general appropriations and supplemental appropriations bills should be reserved only for appropriations to governmental agencies, including funding to enable the agencies to enter into purchase of service transactions. Each separate bill for funding a private organization should clearly state the need for, the public purpose served by, and the terms and conditions of the funding. In this connection, we recommend that any subsidy made to any organization be limited to a duration not exceeding two years. Renewals should not be made without a rigorous analysis of its continued usefulness to the State.

Budget Execution

Continuing supervision of funds appropriated by the legislature is needed to assure the use of public funds for public purposes. Currently there is no consistent practice in administering these funds once they have been appropriated.

We recommend as follows:

1. The State's allocation and allotment procedures be applied consistently to all funds appropriated for use by private organizations. In addition, B&F should establish policies to ensure that all private organizations are treated fairly in the amounts they receive. When allocations are less than appropriations, agency heads and

program managers should have guidelines to assist them in determining which private organizations should receive funding and the appropriate level of funding.

2. A systematic approach should be taken in defining the relationship between the State and the transfer recipients. To this end:

- a. All transfers should be required by statute to be submitted to the attorney general for public purpose clearance.

- b. B&F, after consultation with the attorney general, should establish rules governing the kinds of formal agreements which should be used in executing the various kinds of transfers and develop model forms for each of the various classes of transfers.

- c. B&F should formulate rules in conformance with statute specifying the conditions under which the various classes of transfers are to be made. Among the conditions should be those requiring (1) financial disclosure, (2) compliance with all applicable federal and state statutes on nondiscriminatory employment and servicing practices, and (3) adherence to established certification and licensing standards.

3. All transfers should be subject to monitoring and evaluation. Administering agencies should be required by statute to monitor and evaluate transfers to determine their efficiency and effectiveness.

