

SECOND STATUS REPORT
GRANTS, SUBSIDIES, AND
PURCHASES OF SERVICE
Chapter 42, Hawaii Revised Statutes

A Report to the Legislature of the State of Hawaii

Submitted by the
Legislative Auditor of the State of Hawaii

Report No. 84-12
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FOREWORD

In the 1981 regular session, the Legislature enacted Act 207 which established qualifying standards for private organizations applying for public funds and prescribed procedures for the review of applications and the expenditure of funds.

The Act directs our office to monitor and evaluate the implementation of Act 207 and to submit status reports to the 1983 and the 1984 legislative sessions. A report was submitted to the Legislature in 1983. This is the second and final report.

We would like to thank the many public officials and members of private organizations for their cooperation during the course of our review.

Clinton T. Tanimura
Legislative Auditor
State of Hawaii

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Chapter 1

INTRODUCTION AND BACKGROUND

Act 207, Session Laws of Hawaii 1981, relating to grants, subsidies, and purchases of service, directs the Legislative Auditor to monitor and evaluate the implementation of the act and to submit status reports to the Legislature in 1983 and 1984. The first report was submitted in January 1983. This is the second report.

In our first report, we reviewed the initial progress in implementing Act 207, which was enacted to implement a 1978 constitutional amendment. The Constitution prohibits the grant of public money or property except in accordance with standards established by the Legislature. The implementing law, which has been codified as Chapter 42, Hawaii Revised Statutes, establishes qualifying standards for private organizations applying for public funds and sets forth procedures for the review of applications and expenditure of public funds.

In this chapter, we summarize the general requirements of the law, the principal findings of our previous report, and the objectives of this report.

The General Requirements¹

The law applies to the executive and judicial branches of government. It also requires each county to establish standards for the grant of public money or property.² The basic thrust of the law is to structure the review of requests for funds by private organizations as part of the basic budget review process of state government.

1. This summary of the general requirements of the law is drawn from: (1) Legislative Auditor, *Briefing on the Status Report on Grants, Subsidies and Purchases of Service*, House Finance Committee, February 22, 1983, pp. 2-5; and (2) Legislative Auditor, State of Hawaii, *Status Report, Grants, Subsidies and Purchases of Service, Chapter 42, Hawaii Revised Statutes*, Report No. 83-4, January 1983, pp. 2-4.

2. As noted in our first status report, each county has established standards by ordinance.

Three different kinds of funds for private organizations are identified and defined by law: grant, subsidy, and purchase of service. A "grant" is an appropriation of public funds to a recipient for a specified public purpose. A "subsidy" is an appropriation made to alter the price or the cost of a particular good or service of a recipient for the purpose of encouraging or discouraging the output of these items. A "purchase of service" is the exchange by an agency of goods and services to be delivered by a provider to the general public or specified members of the general public for cash payments substantially equal in value to such goods and services.

(There has been some confusion in the use of the foregoing terms, especially "purchases of service" and "grants." Some agencies define "purchases of service" as funds which they have included in their operating budgets for private organizations and consider "grants" or "grants-in-aid" to be those appropriations which the Legislature, on its own initiative, has included in the appropriation acts. Under such a mistaken differentiation, some agencies have not applied Chapter 42, HRS, requirements to purchases of service included in their operating budgets, and some believe that the law applies only to requests funded by the Legislature as "grants" or "grants-in-aid." We discuss this further in Chapter 2.)

Private organizations seeking public funds must meet certain qualifying standards. Their requests for funds are reviewed and analyzed by the appropriate agencies having jurisdiction over the program areas to which the requests relate. Those requests recommended for funding are incorporated into departmental budgets, and ultimately, those requests approved by the Governor are included in the executive budget. Those requests not recommended for funding are required to be summarized in a separate report to the Legislature.

The process does not preclude private organizations from going to the Legislature directly with their funding requests. But where private organization requests have not been reviewed by the appropriate government agency, the concerned legislative committee has a requirement to send the request to the agency for its review and recommendations.

Those organizations whose programs are ultimately funded must agree with certain conditions and enter into formal contracts with the State. Their programs are subject to the monitoring and evaluation requirements of state agencies.

Summary of Previous Findings

In our first status report, we identified and discussed a number of deficiencies in the initial implementation of the act. These deficiencies included: the lack of an adequate timetable for the submission and review of applications; overly complicated and burdensome forms and instructions for applications; improper exemptions of certain programs from the requirements of the law; inadequate criteria for reviews of requests; deficiencies in the wording of contracts; delays in issuing contracts; and lack of systematic monitoring and evaluation of private agencies conducting programs with public funds.

Objectives of the Report

This status report was prepared within our overall evaluation objectives:

1. To assess whether the various agencies are in compliance with Chapter 42, HRS, in the handling of grants, subsidies, and purchases of service;
2. To determine whether Chapter 42, HRS, is achieving the results intended; and
3. If appropriate, to make recommendations for changes in the law or agency procedures.

In addition to the foregoing, a specific objective of this particular report is to determine how effective the agencies have been in solving the problems and correcting the deficiencies identified in our previous report.

Organization of the Report

This report consists of three chapters. Chapter 1 is this introductory and background chapter. Chapter 2 assesses the budget development and appropriations process for the funding requests of private agencies. Chapter 3 assesses the procedures for the expenditure of public funds by private agencies.

Chapter 2

ASSESSMENT OF THE BUDGET DEVELOPMENT AND APPROPRIATIONS PROCESS

As part of the process in developing the supplemental executive budget for submission to the 1984 legislative session, applications by private agencies for public funds were solicited and reviewed by various government agencies. There was great concern by private agencies over funding for FY 1984-85, because many agencies were funded by the 1983 General Appropriations Act for FY 1983-84 only. Their concern was warranted. Because of the state administration's decision to generally hold the overall 1984-85 budget level to the level of appropriations already made, the requests of private agencies could be accommodated only by trading off funds for existing programs. This was not to be. Consequently, while the applications of private agencies were reviewed and evaluated, no new funding requests for private agencies were recommended by the departments or included in the supplemental budget approved by the Governor and submitted to the Legislature.

Even though the latest applications and review process did not result in funding recommendations, we review in this chapter the activities of the last cycle to determine whether there have been improvements in this process and whether there are any continuing problems. For the most part, this chapter covers the policies and procedures of the executive branch, although we conclude the chapter with a brief review of implementation in the Judiciary.

Summary of Findings

1. There have been improvements in the applications process. During the last cycle, more time was allowed for the preparation and review of applications, the once cumbersome and inappropriate application forms were simplified, and training sessions were held to help private agencies prepare their applications.

2. The Department of Budget and Finance (B&F) established new policies which could strengthen the review and evaluation of funding proposals by private agencies. These new policies require that state agencies: (a) develop specifications outlining the services they wish to purchase from private agencies and setting forth the criteria by which proposals are to be evaluated; and (b) rank all requests they receive in order of preference for funding and state their criteria for their recommendations.

3. There continues to be confusion over what constitutes a "purchase of service" and what constitutes a "grant." This could be clarified through legislative action.

4. Some agencies have separated themselves from the requirements of Chapter 42, HRS, or from B&F's implementation policies. B&F needs a more systematic method to identify all programs which are subject to the law and to resolve more promptly those situations which are questionable or debatable.

5. The lump sum approach which the Mental Health Division of the Department of Health was allowed to take in requesting purchase of service funds in the 1983 General Appropriations Act is disadvantageous and should not be continued or expanded to other programs and agencies.

Summary of the Applications and Review Process

The applications and review process officially began on June 23, 1983 with publication of public notices in the local newspapers that the State would accept funding requests for grants and subsidies and proposals for purchase of service contracts meeting certain specifications. The funds requested would be for the 1984-85 fiscal year.

B&F decided to accept funding requests even though the department was uncertain whether there would be funds available to accommodate the requests in the Governor's supplemental budget. It was made clear, in B&F's public notices and subsequent training sessions for private organizations, that there was a real possibility that funding for private organizations would not be accommodated in the executive budget.

Soon after issuance of the public notices, B&F conducted a series of training sessions for private organizations on Oahu and the neighbor islands. B&F, working closely with the private health and social service agencies, presented information on the applications and budgeting process and gave detailed instructions on how to complete the application and other forms required by the State.

By August 3, the deadline for submitting requests, private agencies had turned in requests totaling about \$15 million. These were routed to the appropriate departments for their review.

A week later, B&F issued its budget preparation policies and instructions to the departments for the development of their supplemental budget requests. B&F informed the departments that it would not accept any requests for additional state general funds. Only requests for the "most urgent situations" would be considered and only if the department identified trade-offs within existing departmental appropriations.

While this policy was in general response to the State's financial condition, private organizations, when they learned of the policy, understood that it would have one specific effect. Their funding requests would be denied. State agencies were not likely to recommend funding of private organizations' programs if this meant giving up funds for their own programs. None did. Thus, no funds for the programs of private agencies were included in the supplemental budget submitted to the Legislature.

Some Improvements in the Process and Changes in Policies

While from the standpoint of private organizations the applications and review process came to naught, there are a number of improvements worth noting. Generally, the applications and review process ran more smoothly in the latest cycle than in the first. This was due to greater familiarity of the departments and the private agencies with the general procedures, a lesser volume of requests in this supplemental budget year, but mainly, to efforts by B&F to correct many of the problems encountered in the first year of implementation.

B&F made several changes to improve the applications process. *First*, B&F allowed more time for the preparation and review of applications than the less than

adequate time it allowed last year. Applicants were given six weeks instead of four weeks to complete their forms, and state agencies were allowed seven weeks instead of three weeks to review applications and develop recommendations.

Second, B&F simplified the application forms and instructions for completing them by using less bureaucratic language and deleting information requirements that are not pertinent to private organizations. *Third*, B&F conducted training sessions for private organizations on the application and budgeting process in all counties and worked more closely and openly with the private organizations throughout the process.

B&F also made substantive policy changes relating to specifications for purchases of service and departmental priorities and criteria for funding private organizations.

Specifications or requests for proposals for purchases of service. A new policy, established by rule, requires state agencies planning to purchase services from private organizations to prepare specifications or "requests for proposals" (RFPs). These RFPs would be distributed to interested parties soon after publication of the State's solicitation notice.

According to the new rule, the RFPs must describe the kind, scope, and objectives of services that the State wants to purchase. They must also state specific performance requirements and the criteria by which the contracts will be monitored and evaluated. They must also inform applicants of specific qualification requirements for contracts and the criteria by which proposals will be evaluated.

The preparation of RFPs supports better state planning for services and focuses attention on the outcome of services and on the achievements of the contractors. The new policy also tries to be fairer to applicants by informing them of the criteria for evaluating proposals before, rather than after, funding decisions are made. The timely release of RFPs could stimulate better and more appropriate proposals from private organizations. And it could also stimulate competition for state funds, increase the quality of performance, or lower the cost of services.

Departmental priorities and criteria. Another important policy change is B&F's adoption, by rule, of the requirement that state agencies rank all requests received in order of preference for funding and state in writing the rationale for recommending or not recommending funding.

This requirement may spur the state agencies to develop previously lacking overall departmental plans, priorities and criteria relating to grants, subsidies, and purchases of service. It should also help the departments in making adjustments to funding decisions should departmental budgetary levels change during budget preparation or budget execution.

Confusion Over “Purchases of Service” and “Grants”

There continues to be confusion as to what constitutes “purchases of service” and what constitutes “grants.” It is more than a semantical difficulty. How the terms are used have important implications for both the budgeting and appropriations process and affect the implementation of Chapter 42, HRS.

As we pointed out in Chapter 1, there are separate statutory definitions for “purchases of service” and “grants.” Each category has certain unique characteristics, which we reviewed in an earlier report and are recapitulated in Table 2.1.

Table 2.1
A Comparison of Purchases of Service and Grants

	<i>Purchases of Service</i>	<i>Grants</i>
Purpose	Quid pro quo exchanges.	To stimulate, or support recipient activities.
Legal Instrument	Performance contract.	Grant agreements.
Method of Award	Competitive bid, negotiation. Request for proposals.	Technical eligibility, merit competition, panel awards.
Pricing Methods	Competitive bid. Per unit of service, formula.	None.
Beneficiary	Specified target group.	Recipient.
Agency Involvement and Accountability	Complete, includes monitoring and evaluation.	Very little.

Source: Based on Special Report No. 79-2 by the Legislative Auditor, State of Hawaii, *A Study of Guidelines for State Grants, Subsidies, and Purchase of Services*, January 1979, p. 9.

Possibly the most fundamental difference between the two is that a “purchase of service” is part of and serves the purpose of a government program, while a “grant”

is essentially a gift of funds to support the activities of the recipient. Funds to a private organization to conduct a drug abuse program consistent with the objectives of the State's mental health program would be a "purchase of service." On the other hand, funds to a private organization planning a centennial celebration for an ethnic group in Hawaii would comprise a "grant."

While the differences between the two terms turn on how the funds are to be used, usage of the terms by administrative agencies have caused confusion. Some agencies reserve the term "purchases of service" for those programs which they have funded through their operating budget over the years. The Legislature, on its own initiative, might also have appropriated funds for other "purchases of service" to be administered by the agencies, but these are treated by the agencies as "grants" and "grants-in-aid." The effect of this misapplication of terms is that the agencies would then provide for their own "purchases of service" through their operating budgets while leaving out the Legislature's so-called "grants-in-aid." Consequently, those private agencies which have been funded by legislative appropriations but not through an agency's operating budget are faced with the recurring problem of going to the Legislature to obtain funds.

Adding to the confusion and weakening its appropriations authority has been the Legislature's long-standing practice of lumping all appropriations to private organizations, whether they are intended for "purchases of service" or intended for "grants," in a separate section of the general or supplemental appropriations act entitled "Grants-in-Aid." Because these purchase of service appropriations are not funded as part of the operating budgets of the agencies, they are less likely to be implemented in times of financial stringency, and they are not likely to be incorporated as part of future operating budgets. In effect, these appropriations have a lesser status.

There are two things that the Legislature might consider to clarify the situation. One is to sharpen the definition of "grant." At the present time, "grant" is defined as an "appropriation of public funds to a recipient for a specific public purpose." The definition might be too general. If one did not know that the statute contained a specific definition for purchase of service, the definition of "grant" could be construed to apply to purchase of service.

The following definition would give "grant" a clearer meaning: "Grant" means an award of public funds to a recipient, generally on a one-time basis, based on merit or need, to stimulate and support activities of the recipient for a specified public purpose. Such a definition would differentiate the intermittent nature of grants from the more recurring nature of purchases of service.

The Legislature could also take a different approach in appropriating funds for legislatively initiated purchases of service. Rather than appropriating the funds in a separate "Grants-in-Aid" section of the appropriations act, it could include the funds in the operating cost category for the specific program to which the purchase of service relates. This is what the law apparently intends in providing that "funds for purchases of service may be appropriated to agencies without naming the specific providers." This would assign all purchase of service appropriations to each program's operating cost category—those budgeted for by the agencies as well as those initiated by the Legislature. If necessary, the Legislature could include appropriate provisos to ensure that the purchase of service appropriations which are attributable to legislative initiative are not accorded second-class status when allotments are made or adjusted in the budget execution process.

Programs Subject to the Law

In our first status report on the implementation of Chapter 42, HRS, we found that the requirements of the applications and review process were not being applied consistently by all agencies of the executive branch. We identified three agencies which had not complied with the law: (1) the State Foundation on Culture and the Arts which exempted from the applications process those purchases of service built into its operating budget; (2) the Division of Vocational Rehabilitation of the Department of Social Services and Housing which also excluded from the applications process those purchases of service funded by the operating budget; and (3) the Mental Health Division which received applications but did not evaluate or make recommendation on them. In addition, in a separate report, we found that the Department of Education had included funds for purchases of service in its budget without having followed the applications, review and recommendation procedures required by Chapter 42, HRS.¹

1. Legislative Auditor, State of Hawaii, *Budget Review and Analysis of the Lower Education Program (Department of Education)*, Report No. 83-10, February 1983, pp. 9-10.

It is uncertain whether all agencies will be in compliance in the next cycle. The State Foundation on Culture and the Arts and the Division of Vocational Rehabilitation received purchase of service appropriations as part of their respective operating budgets. Neither agency retrospectively complied with the applications and review requirements before entering into contracts for FY 1983-84. However, we were told by the Division of Vocational Rehabilitation personnel that they intend to comply with the applications and review requirements the next time around. The Mental Health Division did review and evaluate funding requests retrospectively before entering into FY 1983-84 contracts with their providers. It also received and reviewed additional requests for the supplemental budget and its 1984-85 appropriations.

On the other hand, the Department of Education did not agree with our finding that its purchases of service had to comply with the requirements of Chapter 42, HRS.² The State Superintendent wrote to the Attorney General that the purchases of service should not be subject to Chapter 42, HRS, but since this was a matter of law, she was requesting a legal opinion. This matter has been pending since June 7, 1983.³

Given this mixed state of affairs, we believe that B&F should take steps to ensure the compliance of all agencies and programs with purchases of service clearly falling under the law. As for those programs which appear to fall in a gray area, such as the Senior Community Service Employment Program of the Department of Labor and Industrial Relations and other programs involving arrangements with private, non-profit and for profit employers for subsidized employment of works, B&F should make the determination as to whether Chapter 42, HRS, is applicable, and, if necessary, seek timely legal advice.

2. Board of Education's Response to the Legislative Auditor's Report No. 83-10, *Budget Review and Analysis of the Lower Education Program (Department of Education)*, June 8, 1983, p. 4.

3. Memorandum to The Honorable Tany Hong, Attorney General, from Dr. Donniss H. Thompson, Superintendent of Education, Subject: Request for Legal Opinion on the Applicability of Chapter 42 Covering Funds for Private Organizations and Purchases of Service, June 7, 1983.

Mental Health Purchases of Service

As noted in the previous section, the Mental Health Division did not follow the timetable of the executive branch in reviewing and evaluating applications for purchases of service for inclusion in the 1983-85 budget. Instead, it requested lump sum amounts for purchases of service with the intention of reviewing and evaluating requests and making funding determinations at some later time.

The 1983 General Appropriations Act provided the Mental Health Division with purchase of service funds in three categories: (1) a lump sum for purchases of service in the mental health program's operating budget for each year of the biennium (FY 1983-84, \$2,303,850; FY 1984-85, \$2,707,875); (2) another lump sum (\$1,608,963) in the "Grants-in-Aid" section of the appropriations act for FY 1983-84 only; and (3) appropriations totaling \$846,459 for 16 specifically named private organizations for FY 1983-84 only. The approach in making the lump sum appropriations was unique. In effect, the Legislature permitted the division to select the providers and establish the costs of their services *after*, rather than *before*, the appropriations were made.

The Mental Health Division did proceed to go through the review process that other agencies went through a year earlier. It reviewed and made determinations on funding requests for FY 1983-84, and it solicited proposals for FY 1984-85 to be funded by its operating budget lump sum and additional appropriations it was anticipating.

In our latest review, as in our first, we did not find that the circumstances of the mental health program or the operations of the division are so unique as to warrant exceptional treatment in the budgeting and appropriations process. Except for the special situation of the 1983 legislative session, when the withholding of appropriations would have penalized the many private organizations involved in mental health programs which had faithfully followed the application requirements of the law, there is no reason to allow the Mental Health Division to defer doing what it could and should have done a year earlier.

The practice has several undesirable consequences. It deprives potential providers of mental health services of timely knowledge whether they have been recommended for funding. It leaves the Legislature with no basis to test the cost

estimates of the lump sum requests, thereby weakening the Legislature's budget review authority. And finally, without the requirement for review and evaluation of requests during the budget preparation phase, there is no incentive for the agency to engage in improved program planning and more precise budgeting. For the same reasons that we find that the practice should not be continued with mental health purchases of service, the practice should not be extended to other agencies and programs.

Summary of the Judiciary's Applications and Review Process

Compared with the executive branch, the Judiciary's purchases of service from private organizations is a small, well-defined program, much simpler to administer and control, and the Judiciary experienced no significant or unusual difficulties in implementing its applications and review procedures.

In accordance with the Judiciary's rules for Chapter 42, HRS, the Judiciary issued a public notice in the newspapers in May 1983 requesting applications from private organizations for the provisions of specific services in FY 1984-85 for juvenile and adult offenders involved with the courts. It also provided, upon request, details on the type, location, target population, and estimated use for each type of service that the Judiciary was interested in purchasing. These service requirements are similar in concept to the request for proposals of the executive branch.

Nineteen private organizations submitted applications, several of them for more than one type of service, making the total number of applications 27. Five were denied primarily because of comparatively high unit cost charges and because they did not address the needs of the courts. Those recommended for funding are the same agencies and programs that the Judiciary currently uses.

Concluding Observation

The overall objective of Chapter 42, HRS, is to establish a more rational system in providing public funds for private organizations. In the latest cycle, the results are inconclusive because the process did not lead to the culmination of recommendations to the Legislature. This was due to the lack of funds and budgeting guidelines rather than to the Chapter 42, HRS, process itself. Still, the

improvements that have been made since the law was first implemented indicate, for the most part, an earnest effort to make the law work. Another cycle is likely to bring further improvements.

Recommendations

We recommend that:

1. *The Legislature consider redefining the term, "grant," to differentiate it more sharply from "purchase of service."*

2. *The Legislature appropriate funds for purchases of service by including them in the operating cost category of the specific programs rather than appropriating them in a "Grants-in-Aid" portion of the appropriations act.*

3. *The Department of Budget and Finance (B&F) ensure the compliance of all programs and agencies which are clearly subject to the requirements of Chapter 42, HRS, and make or seek timely determinations for those programs which may or may not be subject to law.*

4. *B&F not allow the Mental Health Division to request lump sums for purchases of service without going through the evaluation and recommendation process in budget preparation. Related to this recommendation, the Legislature should not appropriate lump sums to the Mental Health Division or any other agency if the agency has failed to comply with Chapter 42, HRS, requirements. If such a situation should occur, the agency should be required to comply retroactively before appropriations are made.*

Chapter 3

ASSESSMENT OF EXPENDITURE CONTROLS OVER PRIVATE ORGANIZATIONS

This chapter reports on the State's control over expenditures by private organizations. It includes a review of the executive branch's budget restriction policies as they relate to appropriations for private organizations, and implementation of the contracting, monitoring and evaluation requirements of Chapter 42, HRS. Comments on the Judiciary conclude the chapter.

Summary of Findings

Our findings are as follows:

1. The Department of Budget and Finance's (B&F) conflicting policies relating to restrictions intended for private organizations caused some confusion and dispute. The policies require clarification. Despite the problems encountered, restrictions of funds for private organizations were more fairly applied in the current budget execution cycle than in the past.
2. Some agencies have made improvements in their contracting process, but standard contracts and the timely execution of contracts are not yet established routine practices.
3. There has been mixed progress in monitoring and evaluating the programs of private agencies. Further efforts need to be exerted to establish evaluation on a systematic basis so that evaluation results can be used routinely to improve programs and guide funding decisions.

Budget Restrictions

In the summer of 1983, the Director of Finance, anticipating a revenue shortfall for FY 1983-84, allocated less funds to state agencies than the amounts appropriated

to the agencies by the 1983 General Appropriations Act. The expenditure restrictions affected the funding levels of private agencies. There had been instances in the past when restrictions were applied against the entire appropriations for particular programs of private agencies.¹ In restricting funds for FY 1983-84, the administration's actions were more even-handed, but still controversial.

Restriction policies. The administration, within a month, issued two conflicting policies regarding restrictions on appropriations for grants, subsidies, and purchases of service. In June 1983, the Governor informed the state agencies of their expenditure ceilings for FY 1983-84 and directed them to plan their expenditures within the ceilings, cutting costs wherever they decided was appropriate.² This meant that the state agencies would decide if any funds for private organizations would be restricted.

The Department of Education (DOE) soon announced its intentions to restrict 25 percent of the appropriations for its "grants-in-aid" contracts with private organizations. The private organizations protested that this was excessive and that neither DOE nor the Board of Education had the authority to take this action.

After consulting with state attorneys, the Director of Finance soon changed the State's policy. The new policy said:

"... in order to conform to the requirements of Chapter 42, HRS, relating to fair and uniform allotments, all funds appropriated in Act 301/83 for grants, subsidies and purchases of service *shall* be reduced by 3.7%."³

This policy was also challenged. The Board of Education now questioned the Director of Finance's authority and considered cutting less than 3.7 percent. The Department of Health (DOH) argued that the second policy was inconsistent with B&F's own rules for Chapter 42, HRS, which allow the state agencies to determine

1. Newton N. S. Sue, *Hawaii Constitutional Convention Studies 1978, Article VI: Taxation and Finance*, Legislative Auditor, Honolulu, June 1978, pp. 9-10.

2. Memorandum to All Department Heads from George R. Ariyoshi, Governor, State of Hawaii, Subject: Budget Execution Policies and Instructions, Fiscal Year 1984, June 17, 1983, Attachment B, p. 2.

3. Memorandum to All Department Heads from Director of Finance, Subject: Addendum to Memo dated March 21, 1983—Model Contract Forms and Guidelines in the Administering of Grants, Subsidies and Purchases of Service Contracts with Private Organizations, July 20, 1983.

whether to cut back on funds for grants, subsidies, and purchases of service. DOH also argued that state law allows the state agencies to spend less than B&F approved allotments which means that the DOH could restrict more than 3.7 percent.

The issue of who had the authority to impose restrictions on appropriations for private organizations and the whole matter of restrictions for private organizations were referred to various deputy attorneys general by the different departments, B&F, DOE, and DOH.

The law and rules. The legal debate centered upon the interpretation of provisions of the law and rules relating to allotments. Section 42-7(a), HRS, states:

“Appropriations for grant, subsidy or purchase of service agreement shall be subject to the allotment system generally applicable to all appropriations made by the Legislature. The director shall adopt rules pursuant to Chapter 91 to ensure the fair and uniform allotment of appropriations for grant, subsidy or purchase of service agreement.”

The rules adopted by the Director of Finance say that all funds (subject to Chapter 42, HRS) are subject to the allotment system prescribed by Chapter 37, HRS. Then they specifically address the handling of restrictions:

“In the event of a revenue shortfall which requires a reduction in the allotment of funds appropriated, the director shall determine the level of reduction and inform all agencies of their new allotment ceilings. The director of the agency shall determine, within their ceilings, the programs to be reduced. All organizations to whom funds are allotted and to which a reduction will be applied shall be notified in writing prior to effecting any reductions. The agency may consult with the organization on any necessary reduction. The final determination of any reduction shall be made by the director of the agency.”⁴

State attorneys’ assessments of the restriction policies within the context of these and other legal standards, e.g., Chapter 37, HRS, varied, but none issued written opinions on the issue.

Resolving the issue. Our view is that the administration’s first policy—giving the state agencies the authority and responsibility for determining any restrictions within their overall departmental ceilings—is consistent with Chapter 42, HRS, the rules, and sound budget execution policies.

4. Section 6-3-10, Chapter 3, Title 6, Administrative Rules.

Nothing in the legislative history of Chapter 42, HRS, indicates that appropriations for grants, subsidies, and purchases of service were intended for special treatment. On the contrary, Chapter 42, HRS, specifically states that they "...shall be subject to the allotment system generally applicable to all appropriations made by the Legislature."

B&F's general policy of establishing overall departmental restrictions and allowing the departments to analyze their options and determine how much should be reduced from which programs, keeps responsibility for program decisions where they rightfully belong—with the responsible departments. Therefore, if there are future situations which require reductions in state expenditures, B&F should establish aggregate reduction levels and the departments should make the specific reduction decisions, including whether appropriations to each private agency should be reduced, by how much, or not at all.

B&F's second policy, established to prevent state agencies from imposing an undue burden of restrictions on the private organizations, was issued with good intentions and concern over "fair and uniform" allotments required by Chapter 42, HRS. However, we believe that it is inappropriate.

The statutory requirement for "fair and uniform" allotments was established to correct problems relating to the release of funds for private organizations. In the past, funds for some private organizations were sometimes not released until the end of the fiscal year. At other times, funds were released at the beginning. Some organizations received 100 percent of their appropriations. Others received 50 percent. Some received their funds in quarterly allotments and others, in one lump sum. These inequitable and unpredictable allotments made it difficult for private organizations to effectively plan or run their operations.⁵ These inconsistencies led to the requirement for "fair and uniform" allotments. The provision was not intended to require each private agency's appropriation to be restricted by the same uniform percentage in the event of revenue shortfalls.

Departmental restrictions. Because of the legal debate over the two policies, B&F did not insist on compliance with its 3.7 percent mandated reduction for all

5. Legislative Auditor, State of Hawaii, *A Study of Guidelines for State Grants, Subsidies, and Purchase of Services*, Special Report No. 79-2, January 1979, pp. 21-23.

grants, subsidies, and purchases of service, but ultimately most departments made uniform 3.7 percent reductions.

The DOH initially allowed its divisions to establish the level of restrictions for private agencies. The Mental Health Division imposed a standard 6.6 percent cut on all its contracts with private organizations, and the Developmental Disabled Branch of the Family Health Service Division reduced the amount of each of its contracts by 6 percent. However, in December, the DOH switched policies and reset all restrictions for private organizations at 3.7 percent.

The Department of Social Services and Housing (DSSH) and the DOE also originally planned to cut more but ended with 3.7 percent reductions for each of their “grants-in-aid” and purchase of service agreements.

The State Foundation on Culture and the Arts was unique. It cut 3.7 percent from each “grant-in-aid” appropriation. It cut nothing from the private organizations receiving funds from the foundation’s “project funds” in its regular operating budget. Because the foundation had not yet committed all of its “project funds” for the fiscal year, it used its reserve to achieve a savings of 3.7 percent of the total “project funds.”

For their part, the private agencies, recognizing the need for restrictions, generally accepted their share of the reductions without complaint. The reductions seemed fairer than in the past.

Contracts and Contracting

Standard contracts. B&F proposed, but did not succeed in adopting an amendment to its rules which would have required that all state agencies use its model contract forms as the basic contract and add whatever contract provisions may be unique to their respective programs. This requirement, which we recommended in our first status report, would ensure that the minimum legal requirements are met in each contract and facilitate the preparation and approval of contracts.

The amendment has not been incorporated in the rules to date because the state attorneys for the different state departments could not agree to the concept or the particular model contract forms. However, at least one agency, the Public Welfare

Division, voluntarily adopted the model contracts and supplemented them with its own requirements in preparing its 1983-84 contracts.

B&F should work through the Attorney General to resolve the differences over the model contract and proceed to adopt an amendment to the rules calling for standard contracts. We believe that the lack of a standardized approach to contracts is directly related to problems in the timeliness of preparing and executing contracts.

Timeliness. The state programs we monitored made greater efforts to execute contracts in a more timely way to ensure prompt payments to private organizations, but the results were mixed.

The State Foundation on Culture and the Arts made a push to execute its contracts within the 60-day limit set by law but it ran into various problems—organizations failing to submit information, the attorney general rejecting contracts, etc. On the deadline, only 12 of the 131 planned contracts had been executed and were ready for payments to be processed.

The Department of Health developed standard written procedures for their contracting process and one of its programs started its negotiations and preparations process earlier than usual. About two-thirds of its 141 contracts with private organizations were executed within 60 days, twice as much as last year—a substantial improvement.

The Public Welfare Division, using B&F's model contract as a base, completed all but one contract by September 1, and that last contract was held up because the private organization involved failed to comply with all of the division's requirements by that date.

Progress in Monitoring and Evaluation

Fiscal year 1983-84 is the third year that the legal requirement for the monitoring and evaluation of grants, subsidies, and purchases of service has been in effect. During the first two years, there was little progress in the state agencies' oversight of their private contractors. Last year, B&F developed guidelines for the monitoring and evaluation of private organizations' programs by state agencies that were generally reasonable, but B&F did not pursue their implementation. This year, B&F was preparing additional plans and policies for monitoring and

evaluation. These plans and policies were scheduled for completion and implementation later in this fiscal year.

During the first half of this fiscal year, several agencies we monitored put more effort into the assessment of programs of private organizations, partly in response to specific legislative provisos calling for monitoring and evaluation reports.⁶ In the following sections, we follow up on the progress made in implementing monitoring and evaluation systems by the State Foundation on Culture and the Arts, the Public Welfare Division, and the Mental Health Division.

State Foundation on Culture and the Arts. The State Foundation on Culture and the Arts has a monitoring and evaluation system consisting of on-site monitoring visits, reports by staff, and final project reports by contractors.

The on-site monitoring guidelines address attendance and audience response to projects, judgments of artistic quality, strengths and weaknesses of the event, and overall management and presentation of the event. While the foundation had not been monitoring projects regularly in recent years, the foundation has developed a list of selected projects it intends to monitor during the current fiscal year.

The final project reports call for information on actual expenditures and activities carried out by the private organizations. These must be submitted by the private organizations by the close of the fiscal year and are reviewed by the foundation's contracts officer prior to final payment of state funds.

Since many of the foundation's projects are events, rather than ongoing activities, its monitoring and evaluation system is appropriate for many contracts. The foundation just needs to use it more regularly.

Public Welfare Division. The division has moved quickly to improve and expand its monitoring and evaluation program. Its overall plans, schedule and guidelines were in place and discussed with the private organizations by mid-August of 1983. If things go as planned, the program should stimulate better performance and more effective use of public funds.

6. Sections 16, 25, and 74, Act 301, SLH 1983.

The division's monitoring and evaluation program has three components. The first, program monitoring, examines administration of the private agencies' programs primarily for conformance to contractual terms, and includes a review and assessment of personnel practices and staffing, recordkeeping for the clients and program, the level of services provided, the number of clients served, and compliance with federal and state laws regarding licensing, accreditation, non-discrimination, etc. Specific questions to be addressed by the monitors are in a written guideline.

The second component, financial monitoring, is new. The DSSH plans, for the first time, to send its auditors out to examine the financial records and systems of each private organization with a purchase of service or grant contract administered by the Public Welfare Division. The auditors will check on these major areas: (1) accounting records—for adequate identification of the source and use of funds for activities supported by the Public Welfare Division, for adequate documentation of expenditures, and for assurance that costs are reasonable, allowable and allocable; (2) the financial reports—to ensure that they are accurate, and complete disclosures of expenditures under the contract; (3) the control systems—to ensure that the contractor maintains effective control and accountability of cash, real and personal property, and other assets; and (4) the financial records generally—to ensure compliance with applicable federal and state rules, regulations, and requirements.

The third component, program evaluation, is also new. The division's monitoring focuses on operations and primarily conformance to contractual and legal standards. Its evaluation goes beyond this to assess program design and quality, impact on clients, and other program results.

Annual evaluations, at the end of each fiscal year, are planned for each program of private agencies. Because of limited staffing, the division plans to have each program evaluate itself and submit written reports to the division. After reviewing these reports and other sources of information, division staff will write up final evaluation reports. The division put together, and discussed with the contractors, comprehensive guidelines for the evaluation, explaining the purpose, scope and planned uses of the evaluations and listing specific questions to be addressed by the private organizations.

Mental Health Division. The Mental Health Division implemented a major effort to review all the programs of private organizations funded under purchases of

service and "grants-in-aid" agreements with the division. It managed to review a majority of its mental health and substance abuse programs during the first half of the current fiscal year. Although some of the division's programs have been monitored fairly regularly in recent years, this was the first monitoring of many substance abuse programs in years.

The effort was stimulated by a proviso in the 1983 General Appropriations Act requiring the division to submit a report to the Legislature describing its "monitoring and evaluation system, individual assessments on the efficiency and effectiveness of each provider's program, and each provider's compliance to Chapter 42, HRS, its contractual agreement, and the public purpose and legislative intent of the agreement."⁷ The division's report has been submitted directly to the Legislature. Our comments on the division's monitoring and evaluation guidelines and some results of its review follow.

Monitoring and evaluation standards. The division's standards for monitoring and evaluating programs of private organizations include many that are irrelevant. Other standards are missing but should be applied.

The division's monitoring and evaluation focused on agency compliance to the division's "Standards for Mental Health Service Programs." These standards were developed specifically for the division's community mental health centers. Many of the standards are not pertinent to the programs of private agencies, because the function and structure of the community mental health centers and the private organizations differ. The centers offer a variety of services for a broad range of clients and problems while the private organizations generally provide specific services to clients with specific kinds of problems and needs. Consequently, standards such as those relating to emergency and pharmaceutical services or qualification requirements for program chiefs or community boards, often do not apply to private organizations.

Staff monitors were directed to select those standards from the extensive list that they felt were appropriate for each program. The selection was left up to individual monitors and the result was a lack of clear and uniform criteria by which

7. Section 16, Act 301, SLH 1983.

programs were monitored and uncertainty among the private organizations about the standards they were expected to meet.

Standards missing from the review guidelines relate to the efficiency and effectiveness of the programs, their compliance to contractual agreements, and the requirements of Chapter 42, HRS, such as those relating to salaries, conflicts of interests, and nepotism. Some monitors addressed these matters, and others did not. What is needed is for the division to reassess its monitoring and evaluation guidelines and plans and tailor them specifically to the programs of private agencies.

Results of assessments. Although there were deficiencies in the division's monitoring and evaluation guidelines, the extensive review of private organization's programs produced considerable information on these programs, and some of the monitoring reports are quite candid.

According to the reports, some programs are well run. Others lack basic operational policies and procedures relating to such things as nondiscrimination, client confidentiality or routine program activities. Some lack adequate basic records of their activities and clientele to substantiate that they are providing services to the clients.

If the division intends to continue funding some of these programs, it should insist that the private organizations improve their management and operations as a condition for future funding.

The Judiciary's Control Over Expenditure

Like the executive branch, the Judiciary has been slow in implementing the requirements of Chapter 42, HRS, relating to the control over expenditures by private organizations. It has been late in executing contracts; contracts for FY 1983-84 were not scheduled for execution until December 1983. The Judiciary also lacks an effective fiscal monitoring and evaluation system for the programs of private organizations. It has implemented a quarterly activity reporting requirement to keep tabs on the number of clients served, waiting time for placement, and so forth, but it has yet to establish a system to assess how well the programs are performing and how effective they are.

Recommendations

We recommend that:

1. *If circumstances require the state government to reduce expenditures, the Department of Budget and Finance inform the departments of the aggregate reductions to be made, leaving it up to the departments to decide on the specific program adjustments to be made, including the programs of private organizations.*

2. *The Department of Budget and Finance renew its efforts to adopt a standard contract for private organizations.*

3. *The State Foundation on Culture and the Arts, the Department of Health, and the Judiciary improve its contracting procedures so that all contracts can be executed within the statutory guideline of 60 days.*

4. *The Mental Health Division revise its monitoring and evaluation guidelines to make them more appropriate for the programs of private agencies, and the Judiciary proceed to evaluate the programs of its providers.*