Alternative Financing for *e*-Licensing

Report to the Minnesota Legislature

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I. PREFACE

The purpose of this document is to outline funding options as well as funding opportunities for developing and maintaining an electronic licensing system ("*e*-Licensing"). It was created in response to Minnesota Laws 2007, Chapter 148, Article 2, Section 82, "Financing of Electronic Licensing Systems":

> The state chief information officer shall study the feasibility of alternative financing options for the purpose of developing and maintaining an electronic system for business and occupational licenses. The chief information officer must report the results of the study to the chairs of the senate State Government Budget Division and the house of representatives State Government Finance Division by January 15, 2008.

This document is also a continuation of discussion on alternative IT funding mechanisms presented in the Office of Enterprise Technology's recent study, entitled "IT funding strategies for the 21st Century: Building a comprehensive array of investment tools" (January 31, 2008).

II. INTRODUCTION

During these challenging financial times, *e*-Licensing continues to be a critical project for the state. It has been years in the making and is a vital step forward for better services and efficient government.

The creation of an *e*-Licensing system was recommended as part of the state's Drive to Excellence government reform initiative, which began in 2005. The State IT Master Plan, which was published in 2007, also envisions consolidated, enterprise-wide licensing services.

Currently, Minnesota's regulated licensing and permitting activities consist of at least 320 types of occupational/professional licenses and business/commercial licenses. The state's licensing operations for all license types are performed by over 800 full-time employees at more than 40 state agencies and boards, using in excess of 60 independent licensing systems. The annual expense is more than $60 million. It is accordingly no surprise that Minnesota has one of the highest rates of processing costs for the over 568,000 occupational/professional licenses and business/commercial licenses issued annually. For private businesses it is a cumbersome system that cannot be avoided. For example, to open a restaurant in Minnesota it requires 11 separate licenses using different processes and agencies.

Nearly 9 out of every 10 Minnesotans want online licensing. The *e*-Licensing initiative creates a "one-stop shop" where citizens and businesses can quickly, easily, and securely obtain a state-issued license or permit through the Internet. This includes occupational/professional licenses and business/commercial licenses. The new system will allow agencies to move from manual to automated licensing processes and to make access available 24 hours a day, 365 days a year.

The new system will significantly improve the state's individual and business license issuance process. As a result, the state's businesses, the public, and state government all benefit. Businesses and individuals will save significant resources because wait times and bureaucratic red tape will be reduced. Because the license and regulatory processes will be centralized, more secure, and more transparent, the public will know that a license holder has a legitimate identification and the license is current. In addition, because the system will be streamlined, the state's licensing business will be more efficient and effective.

Many states, as well as cities and counties, have successfully streamlined their licensing efforts with electronic/automated systems. In fact, at least 23 states are reaping the rewards today.

Minnesota's *e*-Licensing project was initiated based on Executive Order 05-05, dated April 4, 2005, entitled "A 'One-Stop Shop' for Licensing." The total cost to create the new system, which does not include on-going operating and maintenance costs after fiscal year 2012, is approximately $35 million spread out over five years or on average $7 million per year. Currently, the state's licensing systems generate about $165 million in revenue for the state each year. The 2007 legislature appropriated $7.5 million for the project from the general fund. The $7.5 million appropriation includes expenses to cover the operating and maintenance costs for fiscal years 2008-2009.

Going forth the need exists to identify funding mechanisms to support the construction and deployment of an electronic government ("*e*-Government") environment that enables the "one-stop shop" for licensing and the maintenance and upgrade of the IT platform in the future.

III. OVERVIEW: FUNDING OPTIONS & OPPORTUNITIES

The legislature appropriated the start-up funds to build the new licensing system infrastructure. To obtain the funding for the balance of the project, there are several funding strategies that could fund part or all of the *e*-Licensing project.

1. **General Funding.** In 2007, the legislature appropriated $7.5 million for the first phase of the project. The appropriation will allow for the completion of the *e*-Government infrastructure and beginning development of the critical Internet capabilities for *e*-Licensing and other *e*-Government systems under development.

2. **Vendor Financing.** Many states have used this funding strategy to fund part or all of their licensing projects. A vendor would pay for part or all of an IT project up front. The vendor recovers its costs from project savings and/or revenue, such as through a surcharge established on each license over a specific, short-term period of time (see licensing surcharge below).

3. **Revenue Bonding.** Several other states and Minnesota counties have pursued revenue bonds to fund their IT investments. Revenue bonds are a better match than general obligation bonds in terms of use and funding strategy. For licensing, a surcharge could be established on each license to repay the bonds over a specific, short-term period of time (see licensing surcharge below).

4. **Licensing Surcharge.** A licensing surcharge could be applied to some or all new and renewed licenses. For example, recreational licenses such as fishing licenses could be excluded from the surcharge. This new surcharge could repay the vendor or revenue bonds. In certain situations, a surcharge could be used to finance a project without pairing it with another funding mechanism; however, this requires that the surcharge is able to capture enough revenue to cover the project costs, especially in the early phases when there can be significant up-front costs. A surcharge is a user-funded approach. It has wide appeal nationally and has been used in several states and large cities to fund their licensing projects.

Funding methods may be subject to legislative authority and state agency requirements for finance and procurement.

IV. BACKGROUND & DISCUSSION

A. Vendor Participation

Vendor participation funding can create a mutually beneficial public-private partnership between the state and a private company. Generally, under this funding approach a state contracts with a vendor to pay for part or all of an IT project up front. The vendor recovers its costs from revenue and/or savings generated by the project.

More specifically, this partnership can take several forms. For example, in shared product development, the state and its partner jointly develop a product, such as application software. The state has rights to use the software and the private partner has the right to exploit its commercial potential. Another form is developer/benefits funding, where the state gets new equipment or systems and the vendor gets some of the savings or revenue that those new systems make possible. Yet another mechanism is for the vendor to advance the funding for the new system when other sources are inadequate or unavailable.

Who has used it? Many states including Arizona, Arkansas, California, Georgia, Texas and Virginia have successfully used this funding strategy to fund part or all of their licensing projects.

In Minnesota, during the fall of 2007, the state issued a RFP to fully fund the *e*-Licensing project through vendor financing. More than 15 respected vendors responded. Many had led successful licensing projects in other states. The agreement was subject to legislative approval. Rather than giving their approval, the legislature agreed to study the issue and provided the general fund appropriation to start the project. This use of a cash only approach was consistent with the Governor's recommendation, although the amount was half the recommendation.

Opportunities

- The vendor can bring additional planning resources to the project that may not be available to the state.
- The vendor investment will be increased because of the assumption of risk, thereby leveraging greater organizational resources that could result in increased project success.
- Vendor financing agreements require meticulous detailed development, which places a premium on accountability and design discipline that could increase project success.
- Vendor financing agreements have been successfully developed in a number of states and cities, creating a path for reduced risk and increased success.

Challenges

- This form of financing can be more expensive than state financing because of the need to cover the vendor's resource needs.
- Since operational savings and new fees are dedicated to repaying vendor financing of start-up costs, this may not be a suitable way to fund system life-cycle costs.
- Vendor financing agreements require meticulous, detailed development, particularly in those contracts involving cost or benefit sharing, and can therefore be difficult to develop.
- State staff is still needed to manage the projects and ensure successful outcomes.
- There will be less opportunity to develop in-house expertise, and a mechanism for knowledge transfer (training of state staff by vendor) is necessary for future system operations.

B. Bonding

Bonding for IT projects has been used by several states and local governments, including Hennepin County. Bonds are most often used for very large-scale or enterprise-level systems with a projected long-life expectancy. It generally covers development/purchase and implementation, including hardware.

There are two different types of bonding available to Minnesota state government: general obligation (GO) bonds, which are repaid from the state's general resources, and revenue bonds, which are repaid from a specific, dedicated revenue source. Due to state constitutional limitations on GO bonding, revenue bonding is currently the only viable bonding option for IT.

With revenue bonds, the bond holders, rather than Minnesota taxpayers, bear the risk of default. Because of this higher risk, revenue bonds may have higher interest rates and could be more costly for the state. Also, although the risk is legally shifted to bond holders, political leaders can still feel intense pressure to compensate bond holders if the state fails to pay its debts.

Who has used it? *S*tates that have used bonding to fund IT projects include: California, Connecticut, Delaware, Georgia, Nevada, New Mexico, North Dakota, Tennessee and Virginia.

Opportunities

- This method avoids the situation where operating funds are in competition with the generally large up-front costs of enterprise systems, and spreads those costs over the item's life cycle.
- Bonding leverages the state's low cost of capital for major systems investments.
- Decision-making processes for bonding emphasize pre-design and design before full implementation – a better match for the life cycle of IT systems projects.
- The state has high credit ratings, well-established laws and guidelines for bonding, and extensive experience in selling bonds.
- Revenue bonds are not subject to the state's 3% GO bond debt limit guideline.

Challenges

- Although public IT systems may last up to 12 to 15 years, IRS guidelines for the useful life of technology are typically three to five years. The market will demand higher interest or simply not buy bonds when the length far exceeds the useful life of the system.
- In order to secure lower interest rates on revenue bonds, the state must pledge revenues in excess of the actual annual debt service (usually at least 1.5 times the annual debt service).
- Debt service payments take precedence over all other spending, such as salaries and systems operating expenses, jeopardizing state programs that take on revenue bonds.
- Bond buyers expect there to be tangible assets ("security") that can be seized in the case of default. Modern systems investments include few tangible assets, with most of the cost going to software and vendor services. With less security to back the bonds, the market will demand higher interest rates.
- The additional interest cost must be carefully weighed against the foregone benefits and opportunity costs, particularly for major systems.
- Revenue bonds are currently subject to two state debt limit policies: total state agency debt (revenue bonds and lease purchase) must not exceed 3.5% of personal income in the state, and total state government debt (agency debt plus GO debt) must not exceed 5% of personal income in the state.

C. Surcharge or Fee

This strategy involves a direct charge to individuals or businesses for a state service in order to finance technology required to deliver the service. The underlying principle is to have only those who benefit from the technology pay for it. This approach is gaining support in many state and local jurisdictions.

User fees can be structured in a variety of ways:

- Legacy system user fees: charged for use of outdated technology to fund and encourage transition to new technology.
- Broad user fee: a single rate charged for all transactions with a new or existing system.
- Short-term surcharge: charged for a specific time to finance system start-up costs.
- Targeted user fee: charged to specific populations of users who can most easily bear the cost (often in conjunction with a subscription/premium service fee).
- Subscription/premium service fee: charged for the higher quality service or greater access provided by a new system.
- Indirect user fee: an allocated or transactional charge billed to agencies for use of an enterprise system, which agencies then pass on in varying ways to their customers.

Many of Minnesota's state agencies charge fees to cover the cost of government services, which may include technology used to deliver the service. Fewer agencies charge fees specifically to develop or replace technology systems associated with these services.

Whether user fees are appropriate for a particular project depends largely on how the fee is structured. User fees work well when the technology will benefit a particular population that is large enough to support the system and can afford to pay for it. User fees may also work well in conjunction with loan mechanisms, including vendor participation and revenue bonds. For example, the state can take out a loan to build a new system and then leverage the system to generate fees to repay the loan. Or, if annual fee revenue is insufficient to pay high up-front costs, the state may use a loan mechanism to spread out the cost. In certain situations, a surcharge could be used alone to finance a project if the annual fee revenue is sufficient to cover the project costs, especially the up-front costs in the early phases.

Who has used it? *S*tates that have used a surcharge or fee to fund IT projects include: Alabama, Arkansas, Arizona, California, Colorado, Florida, Illinois, Indiana, Kansas, Kentucky, Louisiana, Mississippi, Nebraska, New Hampshire, New Jersey, North Dakota, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah, Virginia, Washington, West Virginia and Wisconsin.

Opportunities

- The system costs are shifted so that the beneficiaries are assigned a greater share of the cost burden, as opposed to spreading the costs across all taxpayers.
- This method removes IT systems from direct competition with more public priorities like education and health care.
- User fees follow the current trend toward "unbundling" services; they keep costs from being subsumed within operating budgets.

Challenges

- Annual fee revenue may not be sufficient to pay high up-front costs of system development.
- Under current law, fees classified as departmental earnings must not significantly over- or under-recover the actual cost of providing a service over a two-year period, which may not match the system life cycle.
- Higher fees for licensing or regulation activities could potentially discourage compliance.

V. CONCLUSION

If good government is defined as convenient, effective services provided efficiently, then *e*-Licensing is an essential reform. This has been recognized by at least 23 other states that have instituted similar licensing systems and is strongly supported by Minnesota citizens. For years now, Minnesota has been working to implement an *e*-Licensing system. Recognizing the tremendous opportunity for better government and the prudence of year-after-year return on the bottom line, state leaders in both the executive and legislative branches worked together in 2007 to secure initial funding in the amount of $7.5 million from the general fund. However, the remaining $27.5 million needed to create the new licensing system has not been identified, nor has funding for the long-term on-going operating and maintenance costs of the new system.

With a myriad of proposals constantly competing for limited state resources, it is necessary and productive to consider alternative funding options, especially during these challenging financial times. Some of these options are also opportunities for new, innovative approaches for funding Minnesota's IT investments and, in particular, the *e*-Licensing project.

Vendor participation, revenue bonds and licensing surcharges or fees are among these funding options. Each presents opportunities and challenges. They should continue to be evaluated and considered for use for funding Minnesota's *e*-Licensing project.