What States Can, and Can't, Teach the Federal Government about Budgets

March 2012

Tracy M. Gordon

Fellow, the Brookings Institution

Brookings
202.797.6000
www.brookings.edu

Budgeting for National Priorities
at BROOKINGS

What States Can, and Can't, Teach The Federal Government about Budgets

Tracy M. Gordon

Fellow, the Brookings Institution

March 2012

The Issue in Brief

As governors unveil their Fiscal Year (FY) 2013 budgets, it is an opportune time to look back.[1] In the recent recession, states confronted their worst revenue declines on record together with rising demands for Medicaid and other public services. The result was massive budget shortfalls, or gaps between projected revenues and expenditures. Because they are generally expected to balance their budgets each cycle, states were compelled to raise revenues, cut spending, or draw on budget reserves and enhanced federal funds. Now, state revenues are rebounding but remain below 2008 peak levels.

At the same time, federal policymakers are facing their own fiscal challenges. Federal debt is expected to surpass the size of the national economy within a generation.[2] Although automatic spending cuts triggered by Congress' super committee will improve short term deficits, they do not address long term imbalances between revenue collections and spending commitments. Moreover, recent political stalemates over the federal budget, debt limit, and expiring tax and spending provisions suggest that addressing these challenges will be daunting.

A natural question is what, if anything, federal policymakers can learn from states' recent budget balancing experiences. Federal policymakers have long looked to states as a source of innovation in policy areas ranging from K–12 education to health care and welfare reform. They have also borrowed from state and local fiscal institutions, including the idea of an executive budget.[3] More recently, proponents of a federal balanced budget amendment to the U.S. Constitution have invoked the states as an example where such rules have worked.[4]

This policy brief examines potential budgeting lessons for the federal government from the states. After some background on state and local government finances, it reviews how states addressed major budget shortfalls. It next considers the effectiveness of state balanced budget requirements and other restrictive fiscal institutions. The brief concludes by exploring differences between state and federal policy environments and limits to generalizing from state experiences.

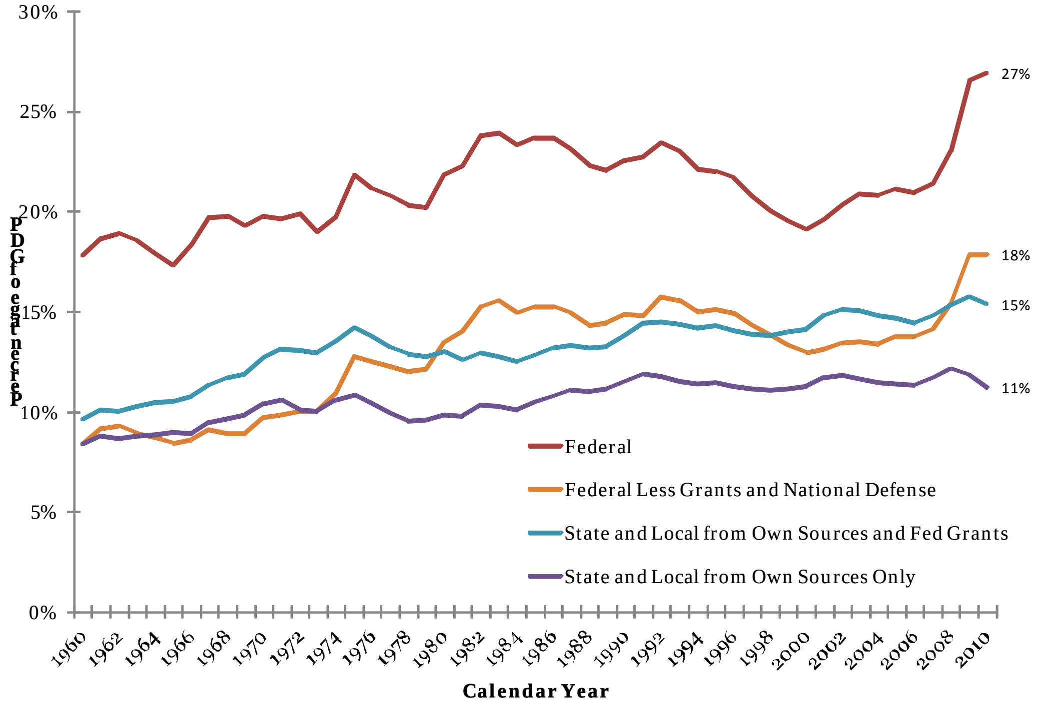
Background on State and Local Government Finances

The United States is a highly decentralized country with a rich federalist tradition. American states preceded the federal government and the Tenth Amendment to the U.S. Constitution reserves to them any powers not specifically granted to the federal government. In 1900, states and localities raised $1.75 for every $1.00 of federal revenue and they performed all government activities except national defense, foreign relations, court proceedings, and postal services.[5]

This picture changed dramatically with the onset of the Great Depression and World War II when the federal government created new social insurance programs and expanded its military. Nevertheless, even as it grew, the federal government continued to rely on states and localities to deliver public goods and services such as infrastructure and a social safety net. From 1933 to 1940, grants to state and local governments grew from a negligible portion to more than 9 percent of the federal budget.[6]

Today, state and local grants represent about 17 percent of federal outlays.[7] Total federal spending represents about 27 percent of Gross Domestic Product (GDP), whereas state and local spending from their own sources represents about 11 percent (Figure 1). These figures are skewed somewhat in the direction of increased federal spending by the recent recession. Federal spending since 1960 has averaged 21 percent of GDP.

Figure 1
Government Expenditures by Level



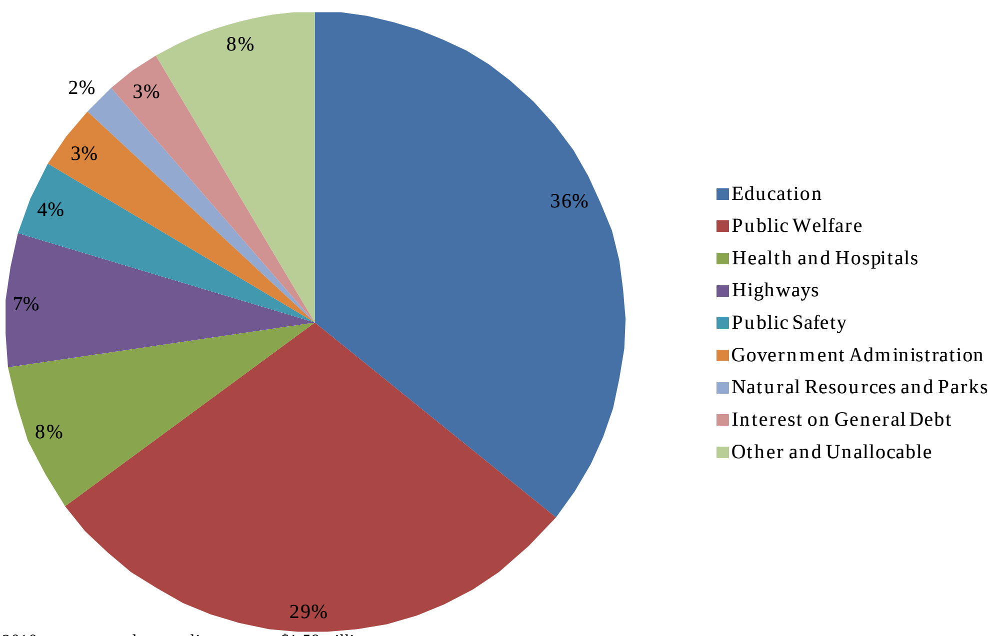
Source: U.S. Bureau of Economic Analysis, *National Income and Product Accounts*, December 2011, Tables 1.1.5, 3.16, 3.2, 3.3, and 5.10.

However, if we exclude national defense from federal totals and assign intergovernmental grants to the level where they are ultimately spent, federal spending drops to 18 percent of GDP and state and local spending rises to 15 percent in 2010. By this measure, state and local governments have outspent the federal government by an average of one half percentage point of GDP since 1960.

Perhaps more importantly, state and local governments provide goods and services that shape the U.S. economy and individual well being. States and localities fund more than 90 percent and deliver all of public elementary and secondary education. They enroll three quarters of higher education students and undertake three quarters of all infrastructure spending.[8] They also help maintain the social safety net through their own public assistance programs and their participation in joint federal-state programs such as Medicaid, Unemployment Insurance (UI), and Temporary Assistance to Needy Families (TANF).

Figure 2 reflects these spending priorities. In FY 2010, as over the past thirty years, education, public welfare (including Medicaid), health, and hospitals dominated state spending.[9] Demands for these programs tend to rise when the economy is faring poorly.

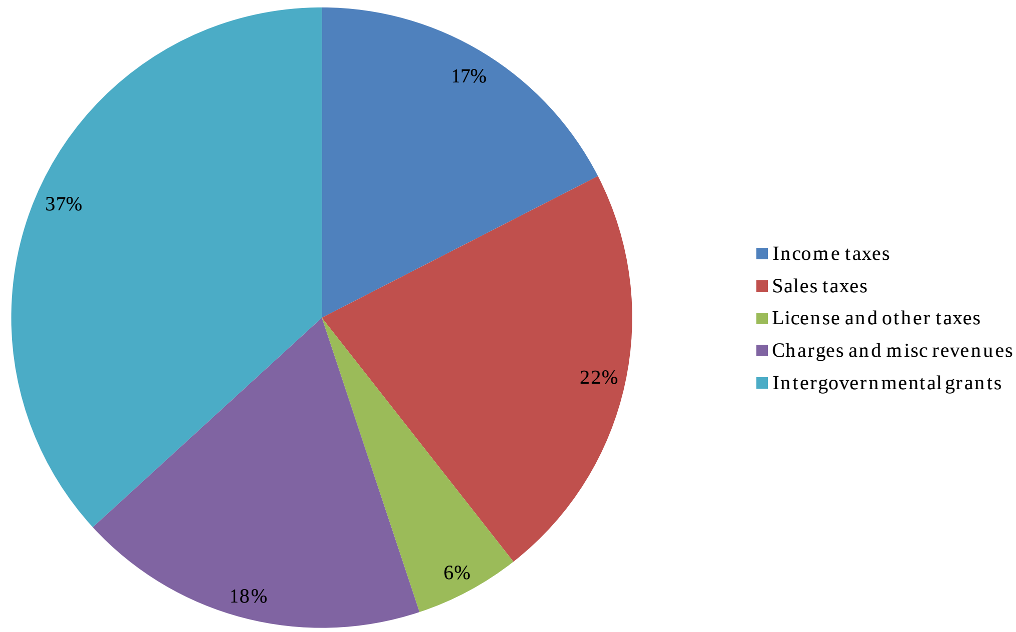
Figure 2
State General Expenditures for Fiscal Year 2010



Note: In FY 2010 state general expenditures were $1.59 trillion.
Source: U.S. Census Bureau, Census of Governments, *2010 Annual Survey of State and Local Government Finances* (Washington: Author, December 2011).

Meanwhile, states derive most (70 percent) of their revenues from their taxes, fees, and service charges (Figure 3). In particular, they rely on income taxes for 34 percent of tax revenue, compared to 25 percent in 1977.[10] These taxes have become more volatile over time as incomes increasingly comprise earnings from volatile sources like stock options and capital gains. As a result, state revenues fluctuate strongly with the economy—they are pro-cyclical.[11]

Figure 3
State General Revenues, Fiscal Year 2010



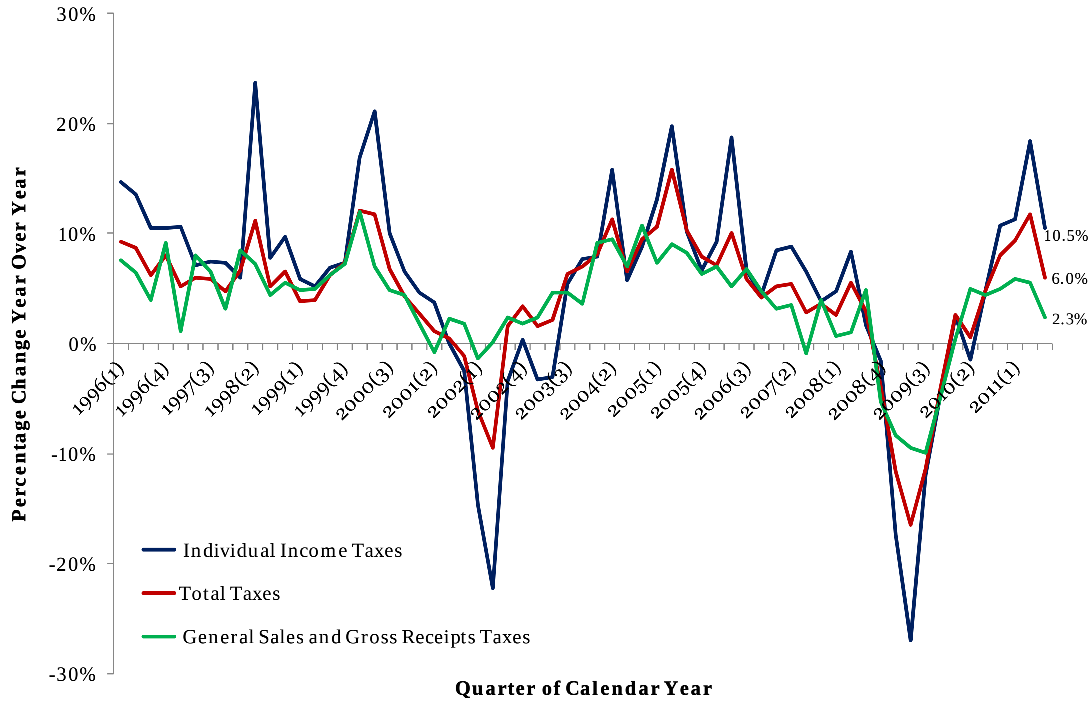
Note: In FY 2010 state general revenues were $1.56 trillion.
Source: U.S. Census Bureau, *2010 Annual Survey of State and Local Government Finances* (Washingon: Author, December 2011).

What Happened in the Great Recession?

Pro-cyclical revenues and counter-cyclical spending pressures can leave states vulnerable in an economic downturn, which is exactly what happened in the recent recession. Although state tax revenues initially rose after the recession's start in December 2007, they began falling in the fourth quarter of 2008. By the second quarter of 2009, individual income tax collections were 27 percent below their level one year earlier and total state taxes were 17 percent lower (Figure 4).

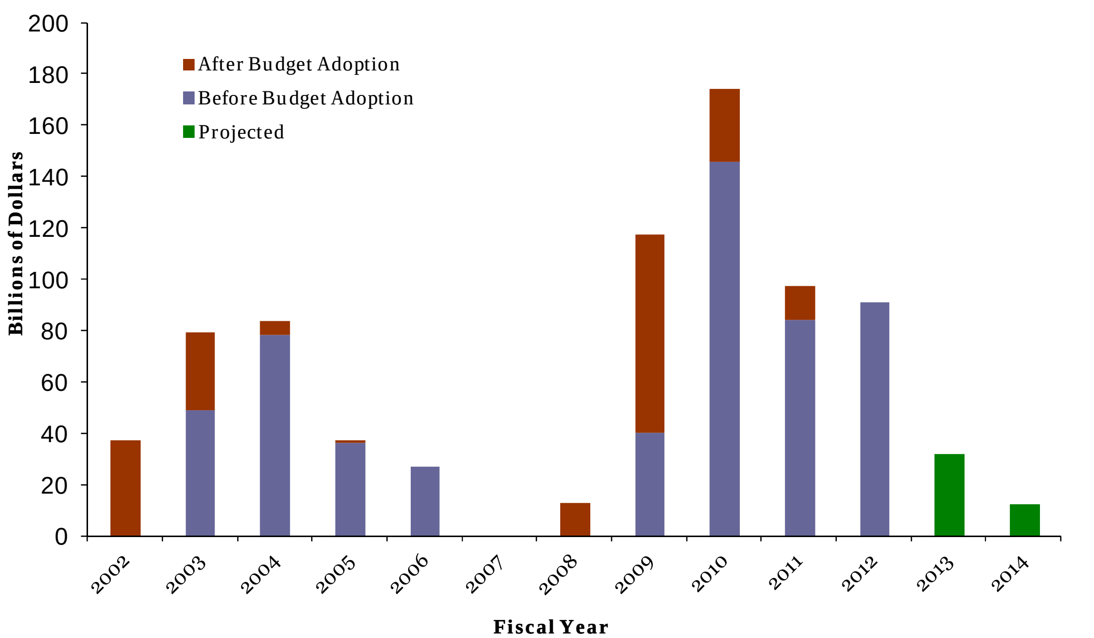
Massive budget shortfalls, or gaps between projected revenues and expenditures, opened in nearly every state. Total cumulative shortfalls from FYs 2009 to 2013 are estimated at more than $500 billion (Figure 5).[12] At their worst in FY 2010, overall gaps represented nearly thirty percent of state general funds.[13] In that year, a record number of states (forty-three) encountered gaps mid-year, forcing governors and lawmakers to reopen their budgets sometimes only weeks after having enacted them.[14]

Figure 4
Quarterly Changes in State Taxes, 1996-2011



Source: U.S. Census Bureau, *Quarterly Tax Survey* (Washington: Author, December 2011).

Figure 5
State Budget Gaps



Note: In FY 2007, the budget gap was 0.
Source: National Conference of State Legislatures, *State Budget Update: Fall 2011* (Washington: Author, December 2011).

Because states are generally expected to balance their budgets (see below), they may raise taxes or cut spending even though these actions risk prolonging the downturn. This problem has long been recognized by economists—in the 1940s Alvin Hansen and Harvey Perloff called it fiscal perversity[15]—and federal policymakers, who have responded by augmenting state aid in recessions.[16]

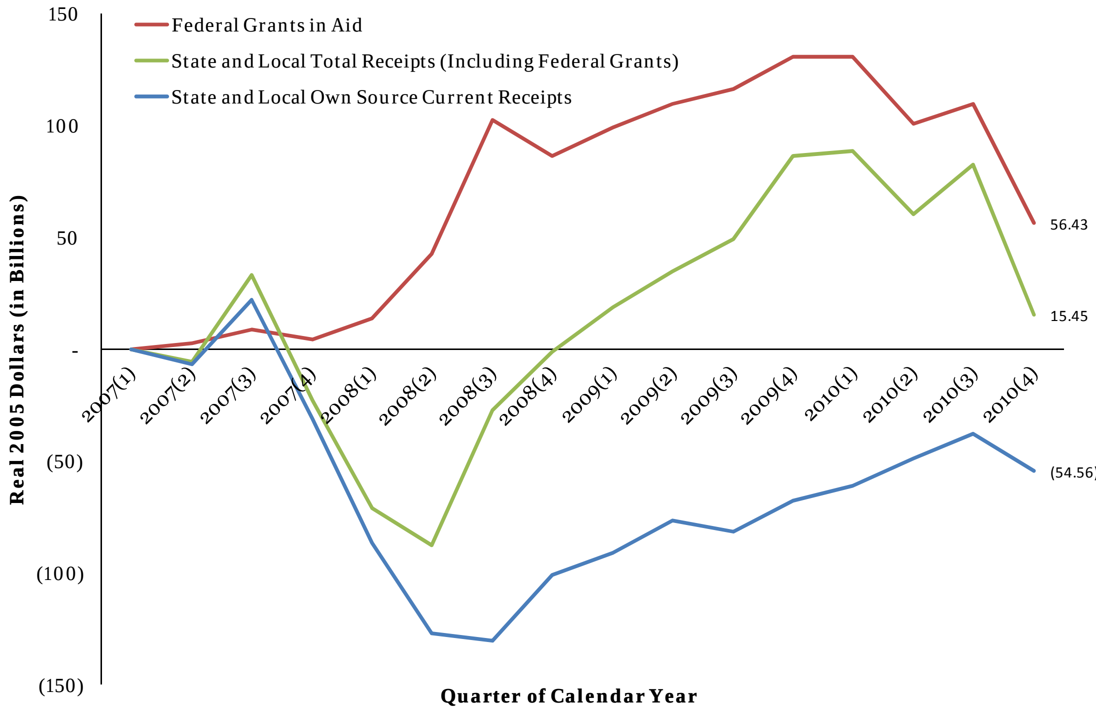
The same was true in the recent recession. Some federal aid came in the form of income tax burdens that automatically shrink and transfer payments (for example, UI and Food Stamps) that automatically rise in recessions. Beyond these automatic stabilizers, the administration and Congress acted repeatedly starting in 2008 to cut individual and business taxes and to extend temporary unemployment benefits.[17]

More directly, the American Recovery and Reinvestment Act of 2009 (ARRA) provided roughly $145 billion in state fiscal relief through a State Fiscal Stabilization Fund of $53.6 billion geared primarily toward education and $90 billion in enhanced federal Medicaid funds. Because these programs would have otherwise consumed state revenues, ARRA made these resources available for other purposes. Nevertheless, even at their peak, ARRA payments covered at most 40 percent of states' total budget gaps. Although extended briefly, these payments expired by 2012.[18]

Fortunately, state tax revenues began rebounding in 2010. In the third quarter of 2011 (the most recent quarter for which comprehensive data are available), taxes rose by 6 percent compared to one year earlier. Growth was particularly strong in individual income taxes (11 percent). Still, in 2011 taxes remained 6 percent below their 2008 peak level after adjusting for inflation.[19]

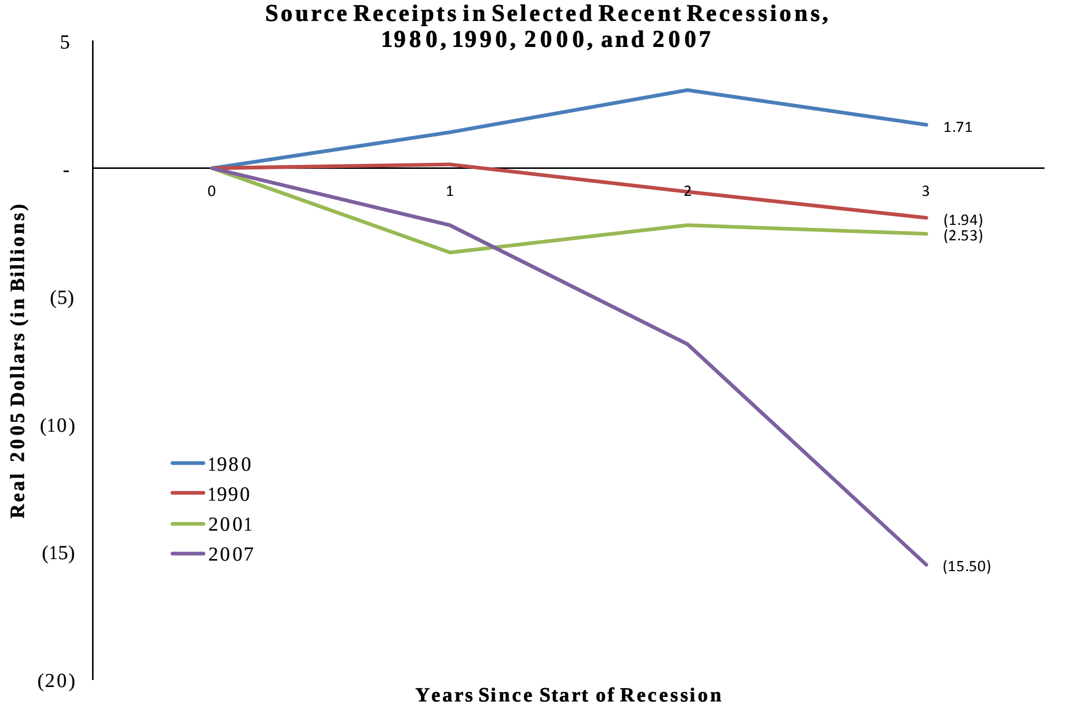
To put these trends in perspective, total own source state and local receipts (excluding federal funds) fell by $111 billion in inflation-adjusted terms from 2007 to 2009 (Figure 6a). Although federal grants offset some of these losses, they too declined after the scheduled end of stimulus payments. The revenue drop incurred by the state and local sector in the recession was deeper and more sustained than in other post—World War II economic downturns, including two consecutive recessions in the early 1980s (Figure 6b).

Figure 6a
Cumulative Quarterly Change in State and Local Finances, 2007-2010



Source: U.S. Bureau of Economic Analysis, *National Income and Product Accounts*, December 2011, Tables 1.1.5, 3.16, 3.2, 3.3, and 5.10.

Figure 6b
Comparison of Annual Changes in State and Local Government Own Source Receipts in Selected Recent Recessions, 1980, 1990, 2000, and 2007



Source: U.S. Bureau of Economic Analysis, *National Income and Product Accounts*, December 2011, Tables 1.1.5, 3.16, 3.2, 3.3, and 5.10.

How Did States Respond?

Although it is frequently asserted that all states except Vermont are constitutionally or statutorily barred from running a deficit, the reality is more nuanced. Many balanced budget requirements are prospective in nature, meaning that governors must submit (in forty-four states) or legislatures must enact (in forty-one states) a balanced budget. More restrictive rules (in at least thirty-eight states) prohibit states from carrying a deficit from year to year.[20]

However, even strict deficit rules may be evaded. Balanced budget rules typically apply to operating and not capital budgets or pension funds. Within current expenditures, they usually cover only general funds. States therefore can and do close projected budget gaps by shifting revenues between funds, deferring payments to employees, vendors, and local governments, rolling over short-term debts, securitizing future revenue streams, and selling off assets.[21]

Nevertheless, many of these strategies are viewed as dubious budget policy and all are only short-term or temporary in nature. There is a general expectation that states will balance their budgets, at least prospectively, and there is evidence that capital markets and voters penalize them for failing to do so.[22] As a result, states generally raise revenues (including relying on additional federal funds), cut spending, or draw down reserves to close a budget gap.

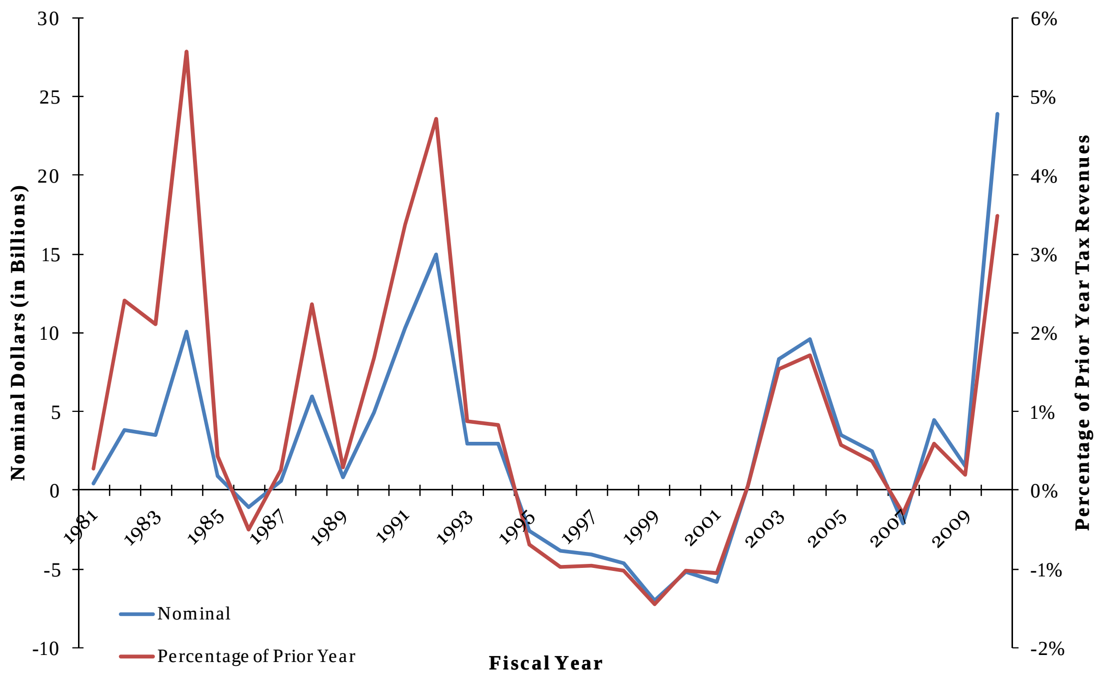
Before the recession that began in 2007, states had accumulated substantial reserve funds. Prior year surpluses and rainy day or Budget Stabilization Funds (BSFs) exceeded 10 percent of state general funds. Although substantial, these savings were insufficient to address shortfalls on the order of 30 percent. States also vary in their ability to access BSFs. Some funds have rules requiring a legislative super majority vote for withdrawals or stipulating that repayments begin as early as the same fiscal year.[23]

In any event, many states did draw on their budget reserves, bringing aggregate balances to below 5 percent of general funds, a common although rarely substantiated rule of thumb for these savings.[24] State balances are now rising but are expected to remain near 6 percent through FY 2012. Removing two large states with exceptional natural resource income—Alaska and Texas—brings reserves down to below 3 percent of general funds.[25]

Turning to revenues, media reports have highlighted that 2010 saw the largest nominal state tax and fee increases on record ($23.9 billion). However, as a percentage of prior year collections, tax increases were smaller than in previous recessions and many of them were temporary and expired by 2012 (Figure 7).[26] In addition to tax rate increases, states reduced deductions and credits, accelerated collections (for example, through tax amnesty programs), and bolstered compliance and enforcement efforts.[27]

Overall, 40 states raised taxes or fees between FYs 2009 and 2011. The largest increases (accounting for about half of the total) occurred in California and New York.[28] However, Wisconsin, Rhode Island, Illinois, and Delaware also raised revenues by more than 9 percent. Some states (Ohio, Indiana, North Dakota, Missouri, Alabama, West Virginia, Louisiana, and Michigan) cut taxes (Table 1).

Figure 7
Enacted State Tax Changes, 1981-2009



Source: National Association of State Budget Officers, *Fiscal Survey of the States* (Washington: Author, Fall 2011); U.S. Census Bureau, *Quarterly Tax Survey* (Washington: Author, December 2011).

Table 1
Revenue Changes in Fiscal Years 2009 to 2011
as Percentage of Tax Revenue During the Period

Magnitude of Tax Change	State
> 9%	CA, NY, WI, RI, IL, DE
7 to <9%	CO, AZ, OR, NH
5 to <7%	NV, CT, WA, KS
3 to <5%	TN, MA, NC, HI, NJ, ME
1 to <3%	FL, MN, GA, UT, VT, KY, MS
0 to <1%	NM, VA, IA, SD, AR, MD, TX, ID, MT, OK, SC, WY, PA, NE, AK
0 to <-1%	MO, AL, WV, LA, MI
>-1%	OH, IN, ND

Note: States organized so that largest percentage change is on the left; figures adjusted for inflation.
Source: Donald J. Boyd and Lucy Dadayan, “Will State Tax Reform (or Increases) Solve Structural Problems” (presented at the 41st Annual National Tax Association Spring Symposium, Washington, May 20, 2011).

Personal income taxes accounted for the bulk (40 percent) of revenue increases. Another 18 percent came from sales and use taxes, 7 percent from corporate income taxes, 4 percent from tobacco taxes, and 10 percent from other taxes (Table 2). The remaining 20 percent came from fees, including higher assessments on regulated industries and vehicle license fees.

Table 2
Types of Significant State Tax Changes, 2009 to 2012

	Type of Tax			
Magnitude of Tax Change	**Personal Income**	**Sales**	**Corporate Income**	**Cigarette**
Increases of more than 5%	CA, CT, IL, NJ, NY, OH, WI	AZ, CA, IN, KS, MA, NC	AL, CA, CT, DE, IA, IL, MN, OR	AR, CT, DE, FL, HI, KY, MS, NC, NH, NM, NY, PA, RI, UT, VT, WA, WI
Increases of 1 to 5 %	HI, MD, NC, OR, RI, VT	GA, KY, ME, NM, NY, VA, WA, WI	FL, KS, ME, NC, NJ, TN, VA	ME, TX
Decreases of more than 1%	AL, ME, ND, MN, OH	AR, CA, CT, LA, MD	AZ, CA, FL, GA, IN, MI, MN, MO, ND, OH, PA, RI, WA	

Note: Some states increased and decreased taxes over this period.

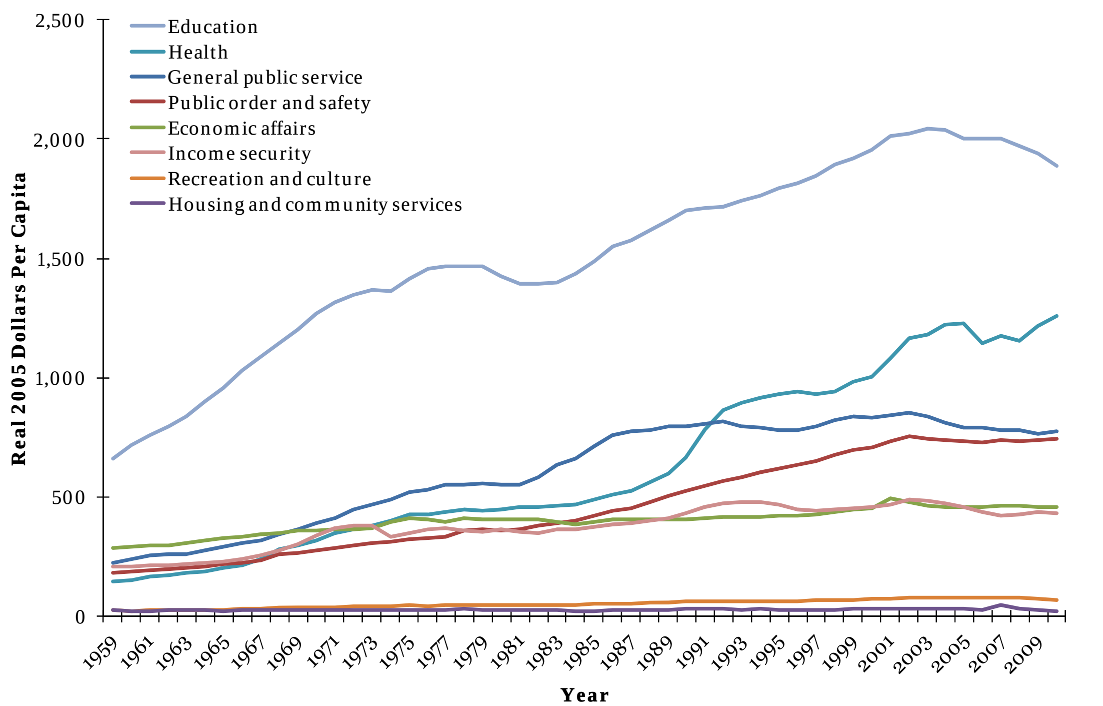
Source: Donald J. Boyd and Lucy Dadayan, "Will State Tax Reform (or Increases) Solve Structural Problems" (presented at the 41st Annual National Tax Association Spring Symposium, Washington, May 20, 2011).

Finally, nearly all states cut spending. Total general fund spending fell in real terms by 3.4 and 9 percent in FYs 2009 and 2010 respectively.[29] Cuts fell, perhaps unsurprisingly, in areas where states concentrate their activities. According to the Center on Budget and Policy Priorities, between FYs 2009 and 2011 thirty-four states reduced their expenditures on K–12 education, forty-three cut colleges and universities, thirty-one health care, and twenty-nine services to the elderly and disabled. Forty-four states reduced employee compensation through pay freezes, furloughs, or layoffs.[30]

Evaluating effects of these cuts on services is complicated because of limited data. The most comprehensive source, the Census of Governments, is published only after a twelve to eighteen month lag. A more timely resource on state and local government finances, the National Income and Product Accounts (NIPA), lacks detail on individual states and programs. Even more difficult is tracking program outcomes and linking them to levels of public spending.

Nevertheless, the most recent NIPA data show that total state and local current expenditures (including federal funds) declined in real per capita terms from 2007 to 2011. Based on data through 2010, declines occurred mainly in education (including the effects of higher tuition payments), whereas health spending increased in real terms (Figure 8).[31]

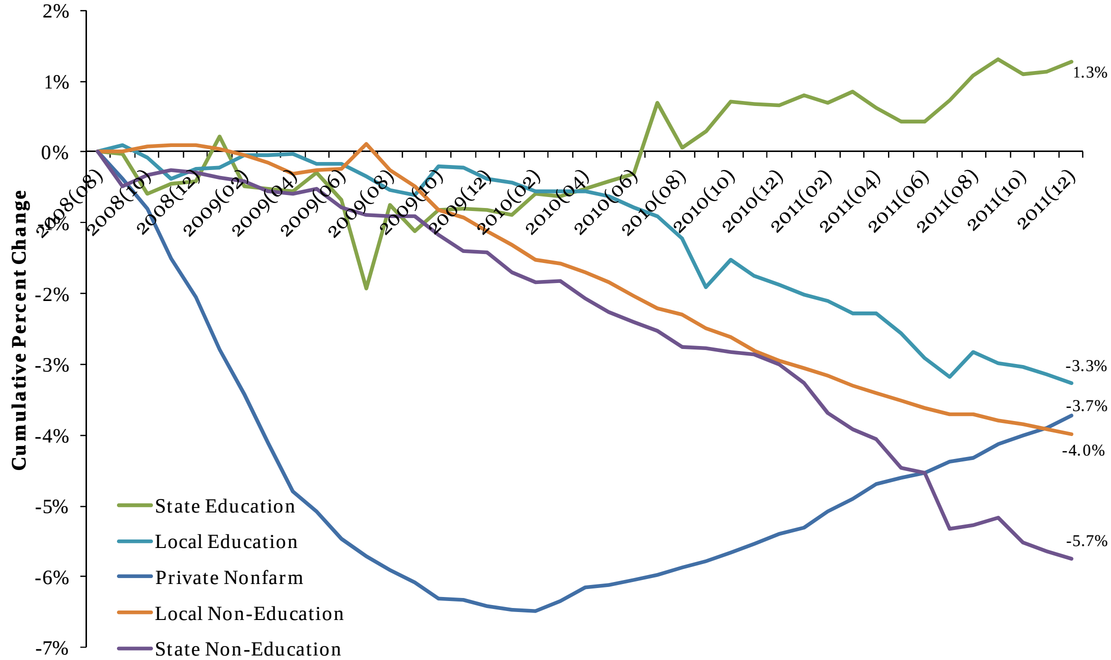
Figure 8
State and Local Per Capita Current Expenditures by Category, 1959-2010



Source: U.S. Bureau of Economic Analysis, *National Income and Product Accounts*, December 2011, Tables 1.1.5, 3.16, 3.2, 3.3, and 5.10.

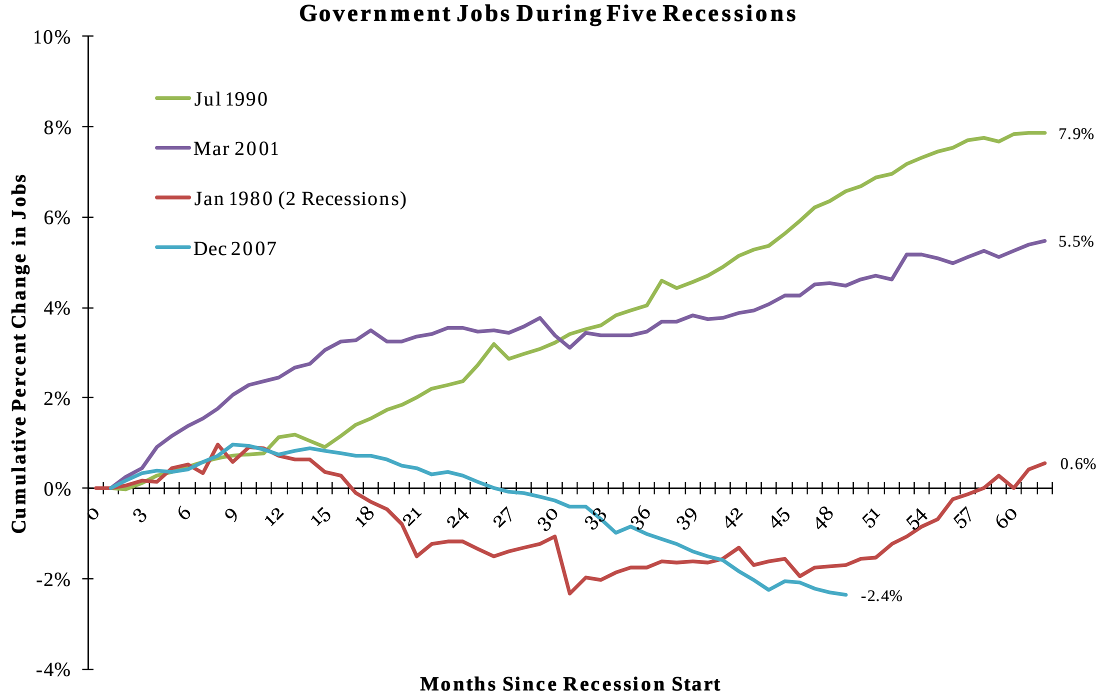
Effects of budget cuts are also evident in state and local employment. State and local governments continued to shed jobs even after the private sector began adding them in early 2010 (Figure 9a). Overall, state payrolls declined 2.5 percent (132,000 jobs) between August 2008 and December 2011 and local payrolls declined 3.6 percent (524,000 jobs). As with revenues, these job losses are more pronounced than in any previous recent recession (Figure 9b).

Figure 9a
Monthly Job Losses by Sector, 2008-2011



Source: U.S. Bureau of Labor Statistics, *Economics News Release*, January 2012, Table B-1.

Figure 9b
Changes in Number of State and Local Government Jobs During Five Recessions



Source: U.S. Bureau of Labor Statistics, *Economics News Release*, January 2012, Table B-1.

Focus on A Few States

So far, this brief has considered states as a single government unit even though they are fifty separate entities (plus the District of Columbia). States experienced and responded to the national recession differently based on their own economic, demographic, political, and institutional characteristics. This section briefly considers the experiences of a few states.

Among the states most severely affected by the recession were those that benefited most from the housing boom. For example, in November 2007, before the recession had officially started, Arizona faced one of the largest state budget gaps in the nation at 7 percent of its general fund. By June 2008, the gap had expanded to 14 percent and by FY 2011 it was more than 27 percent. [32] Nevada was in a similar position—its budget gap was 11 percent of the state general fund in FY 2008 and 45 percent by FY 2011.[33]

Starting in early 2009, Arizona Governor Jan Brewer called several special legislative sessions to address the state budget gap. As in many states, the governor and legislature clashed over proposed solutions, in particular a temporary sales tax hike which the Republican governor advocated but legislators opposed.

After several credit downgrades, a lawsuit, and a veto, lawmakers and the governor were able to reach agreement on a budget in March 2010, more than six months into the new fiscal year. The approved budget included a tax increase and several other temporary measures. Most famously, the state entered into a sale and leaseback arrangement of its Capitol and other public buildings for $735 million in immediate funds.[34] It also securitized future lottery revenues and shifted money from special funds to the general fund.

However, the bulk of solutions came from spending cuts. For example, from FY 2008 to 2010, the state cut K–12 education spending by 20 percent and higher education spending by 28 percent.[35] In late 2011, Arizona sought and won permission from the federal government to end a waiver that extended Medicaid to childless adults for anticipated savings of $250 million. As in a dozen other states including Michigan, Florida, and Indiana, Arizona also cut corporate income and other taxes as it was closing budget gaps.

Whereas states like Arizona and Nevada were buffeted by the housing crisis, others such as California, New York, and New Jersey faced significant revenue declines because of their dependence on the income tax and specifically high earners whose incomes fluctuate with the economy. Addressing budget gaps in these states was made even more difficult by years of structural gaps between inflows and outflows and political gridlock.

For example, in New York, lawmakers faced budget gaps of $5 billion (9 percent of its general fund) in FY 2009, $20 billion (37 percent) in FY 2010, and $9 billion (17 percent) in FY 2011.[36] They responded with a series of temporary fixes, including revenue accelerations and fund sweeps as described above. They also instituted a three year personal income tax rate hike on high earners and other temporary tax measures along with cuts to Medicaid and education.

Nevertheless, the state found itself facing a $10 billion FY 2012 budget gap as the national economic recovery stalled and savings from previously enacted budget solutions failed to materialize. After several delays in which the state comptroller warned of a potential cash crunch, newly-elected Governor Andrew Cuomo proposed a budget that pointedly did not extend the expiring personal income tax hike. The governor's budget also instituted a cap on local property taxes and a public employee wage freeze.

The vast majority of Governor Cuomo's budget solutions (85 percent) came through spending cuts. In particular, the budget reduced state Medicaid funding by $982 million and K–12 education by $1.5 billion. The governor made a point of eschewing temporary solutions while proposing cuts relative to prior year spending in what he billed as a return to "reality-based budgeting."[37] However, many cuts were left unspecified, to be formulated by redesign teams subject to program spending caps.

Although some legislators vowed to pursue an extension of the personal income tax surcharge, they ultimately agreed to the broad contours of the governor's proposal, producing New York's first on-time budget in five years. Had the legislature not agreed to his proposals, the governor had threatened to put forward an emergency spending measure, which would have effectively shut down the government and eliminated any negotiated concessions.[38]

California's budget crisis shared elements of Arizona's and New York's experiences. Like Arizona, California suffered from higher than average unemployment and housing foreclosures.[39] Like New York, the state had a history of structural deficits, or gaps between revenues and expenditures even in prosperous years.[40] Further delaying action were partisan politics compounded by institutional rules. Specifically, California was until recently one of only three states that required a two-thirds legislative majority to pass a new tax or new budget (a November 2010 voter initiative lowered the budget voting threshold to a simple majority).

As in other states, California balanced its books largely with temporary measures, including income and sales tax increases and higher vehicle license fees which have expired. It also made cuts to education and social services, some of which were restored with federal funds. Like several states, California also took steps to restructure the state-local fiscal relationship, shifting selected service responsibilities, along with enhanced revenues, to the local level and eliminating local redevelopment agencies.[41]

In the most recent budget cycle, Governor Jerry Brown was unable to secure legislative approval for a referendum extending the temporary tax increases. The FY 2012 budget therefore assumed $4 billion in unallocated revenues as well as trigger cuts to occur if these funds did not materialize. Because revenues were below projections, $980 million in cuts took effect in December 2011. The governor is now pursuing a November 2012 initiative to increase personal income and sales taxes. If that ballot measure fails, the governor has identified further cuts to schools and community colleges.

Finally, beyond states hit hard by the recent recession, some states were already on a difficult economic and fiscal trajectory. Michigan, for example, never quite recovered from the 2001 recession. Whereas the peak revenue year for most states before the recession took hold was FY 2008, for Michigan it was 2000.[42] Rhode Island similarly was losing manufacturing jobs for decades although its economy revived briefly with the pre-recession housing boom.[43]

In the recession's aftermath, both Michigan and Rhode Island sought to attract people and jobs by reforming taxes and addressing long-term pension and retiree health care liabilities. In Michigan, Governor Rick Snyder eliminated the state business tax and replaced it with a flat 6 percent tax on corporate income at a projected cost of $1 billion in FY 2012. He partially offset this tax cut with increases in personal income taxes and reductions in the state's Earned Income Tax Credit, to some controversy. The state also acted to increase its power over local governments in financial trouble.

In sum, states took a variety of approaches to address unprecedented budget shortfalls in the recent recession. As noted earlier, spending cuts constituted the bulk of solutions along with one time measures including federal funds, borrowing, fund shifts, and deferred payments. Although some states increased taxes, many cut them, in part reflecting a historic influx of new Republican governors and legislators in the November 2010 elections.[44] Now, as state finances improve, there is more talk of bipartisan comity and some spending increases in state capitols.[45]

Learning from State Fiscal Policies

Notwithstanding some of the temporary solutions and budget gimmicks cited above, states are often held up as an example of where balanced budget rules and other fiscal institutions (such as tax and expenditure limits, debt restrictions, and the line-item veto) have been effective. For example, architects of the EU considered the experiences of U.S. states in establishing their own member country deficit targets under the Stability and Growth Pact, as have federal policymakers in debating a balanced budget amendment to the U.S Constitution.[46]

In these considerations, it is important to remember that fiscal institutions vary widely in their design and structure. They can be statutory or constitutional, they can establish procedures or numerical targets, and they can work on the basis of norms or sanctions and penalties. Institutions may also interact with one another, such as rainy day funds that help states to smooth expenditures over time despite balanced budget rules.

More fundamentally, fiscal institutions can be adopted for a variety of reasons, including changing political tides as well as past fiscal performance. These factors can also influence budget outcomes. To take a historical example, states that defaulted on their debt after the financial panic of 1837 were much more likely to enact subsequent debt restrictions, but their debt also remained higher than other states for several years.[47]

Researchers have attempted to disentangle these influences. Several high-quality studies using appropriate econometric techniques have concluded that institutions matter. States with strict balanced budget rules tend to run larger surpluses and they are quicker to adjust to deficit shocks, usually by cutting spending.[48] States with binding tax and expenditure limits raise less revenue, and rainy day funds are associated with higher state balances.[49] However, effects can be modest and sensitive to background conditions, like unified or divided political control.

At the same time, fiscal institutions can produce unintended consequences. States with restrictions on general obligation debt tend to borrow more from other sources, including revenue-backed bonds and special-purpose or off-budget entities.[50] States with tax limitations spend more at the local level unless limits apply there as well.[51] Perhaps most worrying, states with restrictive fiscal institutions appear more exposed to the volatility of business cycles.

This last result is problematic because lawmakers under strict rules may be unable to respond to changing economic circumstances. Balanced budget rules, for example, may prevent cutting taxes or increasing spending in a recession. There are legitimate arguments about whether sub-national entities like states should be engaged in such countercyclical fiscal policy.[52] It is more difficult to see how these arguments apply at the federal level. There are also concerns about institutions interfering with the federal government's ability to fight wars, respond to natural disasters, and so forth.

Flexible fiscal rules provide a way around this problem. Cyclically-adjusted budget rules take into account where a country is in the business cycle, adjusting the limit for differences between actual and potential economic output. Structural balance rules allow for anti-recessionary policies and exceptions for emergencies. Over-the-cycle rules require that budgets be balanced on average in any business cycle but not in every year. The so-called golden rule excludes capital expenditures from a balanced budget limit. There is some evidence that these rules have been effective in other countries.[53]

Flexible rules also have their weaknesses. They require assumptions and modeling choices that can be controversial. Perhaps more troubling, flexible rules raise the specter of too much discretion. The EU among others has been criticized for allowing too much flexibility.[54]

Conclusions

Although it is a misconception that all states are bound by strict balanced budget rules, they are generally expected to make expenditures and revenues meet in each budget cycle. States therefore responded to budget gaps in the Great Recession by cutting spending and, to a lesser extent, raising taxes, as well as relying on budget reserves and enhanced federal funds. The apparent success of state balanced budget rules has often prompted questions about whether federal policymakers ought to enact similar budget process reforms.[55]

However, it is worth recalling that states differ importantly from the federal government. As emphasized throughout this brief, state and local governments specialize in service delivery, particularly goods and services in demand during economic downturns. The federal government, on the other hand, has an advantage in raising revenues because taxpayers may less easily flee liabilities by crossing jurisdictional boundaries.[56] This vertical fiscal imbalance is one justification for federal intergovernmental grants, along with equity or fairness.[57]

Federal grants also perform an important economic stabilization role. Some commentators have suggested that the federal government further enlist states in this responsibility through a permanent countercyclical assistance fund. However, soft budget constraints at the local level have generated serious macro instability in countries such as Argentina and Brazil and federations such as the EU. Historically, the U.S. federal government has almost always declined to come to the aid of distressed states and localities, most dramatically after the Panic of 1837 and state defaults that followed.[58] This refusal may be one reason for state and local governments' relative fiscal health.[59]

A less direct lesson from the recent recession may come from the majority of states that appointed government redesign or tax reform commissions.[60] In addition, several states took steps in 2010 and 2011 to address long term pension and retiree health care obligations.[61] Whether these efforts bear fruit in the near term, they are likely a positive step going forward. Showing a tighter connection between revenues and services may prove a valuable legacy from this recession for all levels of government.

Acknowledgements

This paper was developed as part of the work of the Budgeting for National Priorities project with support from the Annie E. Casey Foundation and the Charles Stewart Mott Foundation whose assistance is gratefully acknowledged.* The author would like to thank members of the Brookings-Heritage Fiscal Seminar for many discussions of these and related issues.

**Brookings recognizes the value it provides to any supporter is in its absolute commitment to quality, independence and impact. Activities supported by its donors reflect this commitment and the analysis and recommendations are not determined by any donation.*

References

[1] Fiscal years are generally referred to by their concluding year. Thus, Fiscal Year 2012-2013 is referred to as FY 2013. All but four states (New York, Texas, Alabama, and Michigan) start their fiscal years on July 1.
[2] U.S. Department of the Treasury, *2011 Financial Report of the United States Government* (Washington: Government Printing Office, December 2011).
[3] Previously, federal budgets were piecemeal appropriations summarized in a *Book of Estimates*: "rather a more or less well-digested mass of information submitted by agents of the Legislature to the Legislature." See U.S. President's Commission on Economy and Efficiency, *The Need for a National Budget, message from the President of the United States, transmitting report of the Commission on Economy and Efficiency on the subject of the need for a national budget* (Washington: Government Printing Office, 1912), p. 10.
[4] Senator John Cornyn, III, "Wisdom of a Balanced Budget Amendment," *Dallas Morning News*, December 1, 2010.
[5] John J. Wallis, "American Government Finance in the Long Run: 1790 to 1990," *Journal of Economic Perspectives* 14, no. 1 (2000), p. 65.
[6] Wallis (2000), p. 72.
[7] U.S. Office of Management and Budget, *Analytical Perspectives: Budget of the United States Government* (Washington: Government Printing Office, 2012), p. 304.
[8] National Center of Education Statistics, *Digest of Education Statistics: 2010* (Washington: Author, April 2011) and U.S. Congressional Budget Office, *Public Spending on Transportation and Water Infrastructure* (Washington: Author, November 2010).
[9] The Census Bureau distinguishes between four broad sectors of government activity: general government, utilities (water supply, electric power, gas supply, and transit), insurance trust systems (retirement, unemployment compensation, workers' compensation, and disability), and liquor stores.
[10] U.S. Census Bureau, *2010 Annual Survey of State and Local Government Finances* (Washington: Author, December 2011).
[11] Pew Center on the States and Nelson A. Rockefeller Institute of Government, *States' Revenue Estimating: Cracks in the Crystal Ball* (Washington: Pew Center on the States, November 23, 2011).
[12] National Conference of State Legislatures, *State Budget Update: Fall 2011* (Washington: Author, December 2011). These are estimates because each state projects its revenues and expenditures according to its own methods and assumptions. Projections can change as a result of new economic data or external events, including adverse court rulings or previously enacted budget solutions that fail to generate anticipated revenue or savings.
[13] State and local governments organize their activities according to funds. The largest fund, and the one over which local policymakers exercise the most discretion, is the general fund. In FY 2010, state general funds represented 38 percent of total spending. This figure reflects a higher than average reliance on federal funds in the wake of the recession. By comparison, state general funds were 46 percent of total

state spending in FY 2008. See National Association of State Budget Officers, *2010 State Expenditure Report* (Washington: Author, December 2011).
[14] National Association of State Budget Officers, *Fiscal Survey of the States* (Washington: Author, Fall 2011).
[15] Alvin H. Hansen and Harvey S. Perloff, *State and Local Finance in the National Economy* (New York: W. Norton & Co., 1944).
[16] Richard H. Mattoon, Vanessa Haleco-Meyer, and Taft Foster, "Improving the Impact of Federal Aid to the States," *Economic Perspectives* 34, no. 3 (Chicago: Federal Reserve Bank of Chicago, July 2010), pp. 66–82.
[17] For a description of other fiscal and monetary policy responses to the Great Recession, see Gary Burtless and Tracy M. Gordon, "The Federal Stimulus Programs and Their Effects," in *The Great Recession*, edited by David B. Grusky, Bruce Western, and Christopher Wimer (New York: Russell Sage Foundation, 2011).
[18] Public Law 111-226 provided an additional $16.1 billion to states through enhanced Medicaid funds, albeit at a lower rate than under ARRA (3.2 percent in the first quarter of FY 2011 and 1.2 percent in the second). The legislation also created a $10 billion Education Jobs Fund subject to maintenance of effort requirements. For estimates of the effects of state fiscal aid on job creation, see Daniel J. Wilson, "Fiscal Spending Multipliers: Evidence from the 2009 American Recovery and Reinvestment Act," Working Paper 2010-17 (San Francisco: Federal Reserve Bank of San Francisco, October 2010); James Feyrer and Bruce Sacerdote, "Did the Stimulus Stimulate? Real Time Estimates of the Effects of the American Readjustment and Recovery Act," Working Paper 16759 (Cambridge, Mass.: National Bureau of Economic Research, February 2010); and Gabriel Chodorow-Reich and others, "Does State Fiscal Relief During Recessions Increase Employment? Evidence from the American Recovery and Reinvestment Act," *American Economic Journal: Economic Policy* (Forthcoming).
[19] Inflation adjustments use the GDP Price Deflator, *National Income and Product Accounts*, Table 1.1.4, line 1.
[20] Interpretations of state balanced budget rules differ. For example, the National Conference of State Legislatures counts thirty-eight states with no carry-over rules, whereas the National Association of State Budget Officers puts the number at forty-three. See National Conference of State Legislatures, *Fiscal Brief: State Balanced Budget Provisions* (Washington: Author, October 2010) and National Association of State Budget Officers, *Budget Processes in the States* (Washington: Author, Summer 2008).
[21] Steven Malaga, "State Budget Bunk," *City Journal* 21, no. 1 (Winter 2011), pp. 1–7; Josh Goodman, "Budget Gimmicks Explained: Five Ways States Hide Deficits," *Stateline*, June 23, 2011 (www.stateline.org/live/details/story?contentId=583189).
[22] Robert Lowry and James Alt, "A Visible Hand? Bond Markets, Political Parties, Balanced Budget Laws, and State Government Debt," *Economics and Politics* 13, no. 1 (March 2001), pp. 49–72; James M. Poterba and Kim Rueben, "Fiscal News, State Budget Rules, and Tax-exempt Exempt Bond Yields," *Journal of Urban Economics* 50, no. 3 (November 2001), pp. 537–562.
[23] National Association of State Budget Officers (2008).
[24] Phillip G. Joyce, "What's So Magical about Five Percent? A Nationwide Look at Factors That Influence the Optimal Size of State Rainy Day Funds," *Public Budgeting & Finance* 21, no. 2 (2001), pp. 62–87.
[25] NASBO, 2011a; National Association of State Budget Officers, *Fiscal Survey of the States* (Washington: Author, Fall 2010).
[26] National Association of State Budget Officers (Fall 2011).
[27] National Conference of State Legislatures, *State Tax Actions 2010 (*Washington: Author, 2011); National Conference of State Legislatures, *State Budget Update: July 2010* (Denver, Colo.: Author, July 2010).
[28] Rithadhi Chakravati and Kim Rueben, "State Revenue Responses to Fiscal Shortfalls," *Tax Notes*, December 6, 2010.
[29] National Association of State Budget Officers (Fall 2011).
[30] Nicholas Johnson, Phil Oliff, and Erica Williams, *An Update on State Budget Cuts: At Least 46 States Have Imposed Cuts That Hurt Vulnerable Residents and the Economy* (Washington: Center for Budget and Policy Priorities, February 9, 2011).

[31] Inflation adjustment is based on state and local government consumption and gross investment implicit price deflator (NIPA Table 1.1.4, line 25), although similar results are obtained with the GDP implicit price deflator.
[32]National Conference of State Legislatures, *Budget Update: November 2007* (Washington: Author, 2007); National Conference of State Legislatures, *Budget Update: April 2008* (Washington: Author, 2008). Based on its survey of state budget officials, the Center on Budget and Policy Priorities estimate that Arizona's prospective budget FY 2011 gap was 39 percent of the general fund. See Elizabeth McNichol, Phil Oliff, and Nicholas Johnson, *States Continue to Feel Recession's Impact* (Washington: Center on Budget and Policy Priorities, July 2011).
[33] National Conference of State Legislatures, *State Tax Actions 2009* (Washington: Author, March 2010).
[34] Although much derided in the press, this transaction was part of a common technique known as a certificate of participation. In these arrangements, a state or local government essentially securitizes future lease payments using public assets as collateral. A trustee purchases the asset using proceeds from the debt issuance and leases it back to the government with the asset reverting to public ownership at the end of the lease period.
[35] The state also limited lifetime TANF eligibility, eliminated full-day kindergarten, and instituted six days of state employee furloughs. See Matthew Murray and others, *Structurally Unbalanced: Cyclical and Structural Deficits in Arizona* (Las Vegas, Nev.: Brookings Mountain West and Morrison Institute for Public Policy, January 2011).
[36] Donald Boyd, "New York State: Current Budget Conditions," (presented at the State Budgets: Possible Paths to Sustainability conference, Chicago, Ill., June 24, 2011).
[37] Nicholas Confessore, "Cuomo's Budget Cuts Spending on Schools and Medicaid," *The New York Times*, February 1, 2011.
[38] Nicholas Confessore and Thomas Kaplan, "N.Y. Budget Deal Cuts Aid to Schools and Health Care," *The New York Times*, March 27, 2011.
[39] Pew Center on the States, *Beyond California: States in Fiscal Peril* (Washington: Author, November 2009).
[40] Tracy M. Gordon and Margaret Weston, *California 2025: Planning for a Better Future* (San Francisco: Public Policy Institute of California, January 2011), pp. 2–5.
[41] Tracy M. Gordon, "A Funny Thing Happened on the Way to the Coliseum…" *TaxVox* blog, January 21, 2011 (http://taxvox.taxpolicycenter.org/2011/01/21).
[42] National Conference of State Legislatures (December 2011).
[43] Pew Center on the States (November 2009).
[44] Monica Davey and Michael Luuo, "Now in Power, G.O.P. Vows Cuts in State Budgets," *The New York Times*, November 7, 2010.
[45] John Gramlich, "After a Contentious Political Year, Republicans May Moderate Their Approach," *Stateline*, January 9, 2012 (http://www.stateline.org/live/details/story?contentId=623384).
[46] Jürgen von Hagen, "A Note on the Empirical Effectiveness of Formal Fiscal Restraints," *Journal of Public Economics* 44, no. 2 (March 1991), pp. 199–210.
[47] John J. Wallis and Barry R. Weingast, "Dysfunctional or Optimal Institutions? State Debt Limitations, the Structure of State and Local Governments, and the Finance of American Infrastructure," in *Fiscal Challenges: An Interdisciplinary Approach to Budget Policy*, edited by Elizabeth Garrett, Elizabeth Graddy, and Howell E. Jackson (Cambridge, United Kingdom: Cambridge University Press, 2008), pp. 331–363.
[48] James M. Poterba, "State Responses to Fiscal Crises: The Effects of Budgetary Institutions and Politics," *The Journal of Political Economy* 102, no. 4 (August 1994), pp. 799–821; Lowry and Alt (2001).
[49] Kim S. Rueben, "Tax Limitations and Government Growth: The Effect of State Tax and Expenditure Limits on State and Local Government," Public Policy Institute of California, 1996; Brian G. Knight, "Supermajority Voting Requirements for Tax Increases: Evidence from the States," *Journal of Public Economics* 76, no. 1 (April 2000), pp. 41–67; Brian G. Knight and Arik Levinson, "Rainy Days Funds and State Government Savings," *National Tax Journal* 52, no. 3 (September 1999), pp. 459–472.
[50] Wallis and Weingast (2008).
[51] Rueben (1996).

[52] Edward M. Gramlich, "Subnational Fiscal Policy," in *Perspectives on Local Public Finance and Public Policy*, vol. 3, edited by John M. Quigley (Greenwich, Conn: JAI Press, 1987), pp. 3–27.
[53] Manmohan Kumar and others, *Fiscal Rules—Anchoring Expectations for Sustainable Public Finances*, (Washington: International Monetary Fund, December 16, 2009); Peterson-Pew Commission on Budget Reform, *Tied to the Mast: Fiscal Rules and Their Uses* (Washington: Author, December 13, 2011).
[54] Barrett Anderson and Joe Minarik, "Design Choices for Fiscal Policy Rules" *OECD Journal on Budgeting* 5, no. 4 (2006), pp. 159–208.
[55] See James V. Saturno and Megan S. Lynch, *A Balanced Budget Constitutional Amendment: Background and Congressional Options* (Washington: Congressional Research Service, July 8, 2011) for a history of federal balanced budget amendment proposals.
[56] In fact, empirical evidence suggests that tax flight between states is modest. For example, see John Bakija and Joel Slemrod, "Do the Rich Flee from High State Taxes? Evidence from Federal Estate Tax Returns," Working Paper 10645 (Cambridge, Mass.: National Bureau of Economic Research, July 2004).
[57] U.S. Congress Joint Economic Committee, *Revenue Sharing and Its Alternatives: What Future for Fiscal Federalism?* 90th Cong., 1st sess., July 31-August 3, 1967, pp. 111–117.
[58] Erik Wibbles, "Bailouts, Budget Constraints, and Leviathans: Comparative Federalism and Lessons from the Early U.S," *Comparative Political Studies* 36, no. 5 (June 2003), pp. 475–508.
[59] Robert P. Inman, "Transfers and Bailouts: Enforcing Local Fiscal Discipline with Lessons from U.S. Federalism," in *Fiscal Decentralization and Challenge of Hard Budget Constraints*, edited by Jonathan A. Rodden, Gunnar S. Eskeland, and Jennie Litvack (Cambridge, Mass: MIT Press, 2003), pp. 35–83.
[60] National Governor's Association, *Redesigning State Government 2011* (Washington: Author, September 2011).
[61] Ronald K. Snell, *Pensions and Retirement Plan Enactments in 2010 State Legislatures* (Washington: National Conference of State Legislatures, 2010); Ronald K. Snell, *Pensions and Retirement Plan Enactments in 2011 State Legislatures* (Washington: National Conference of State Legislatures, 2011).