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Budget Processes and the Great Recession

Seventh Annual Brookings Municipal Finance Conference
By Kim Rueben, Megan Randall, and Aravind Boddupalli

State Budgeting and Fiscal Institutions

- States passed 2019 budgets largely on time after experiencing unexpected surge in tax revenues
- Notably different than last year when ten states passed 2018 budgets late and others required emergency sessions
  - Partly due to unexpected revenue shortfalls despite almost a decade of economic recovery
  - CT budget passed in October including new fiscal institutions
- Do these rules matter in actual decision-making?
- We examined what actions states take when faced with unexpected deficits (and surpluses)

Research Design

- We examined how rules or institutions interacted with presence of deficits/surpluses to lead states to spending cuts, tax increases or other actions
  - Used NASBO data, Poterba (1994)
  - Measured differences as unexpected changes or difference between projected revenues/expenditures compared to actual revenues/expenditures
  - However, actual revenues are affected by changes made during the budget year so need to take out any changes

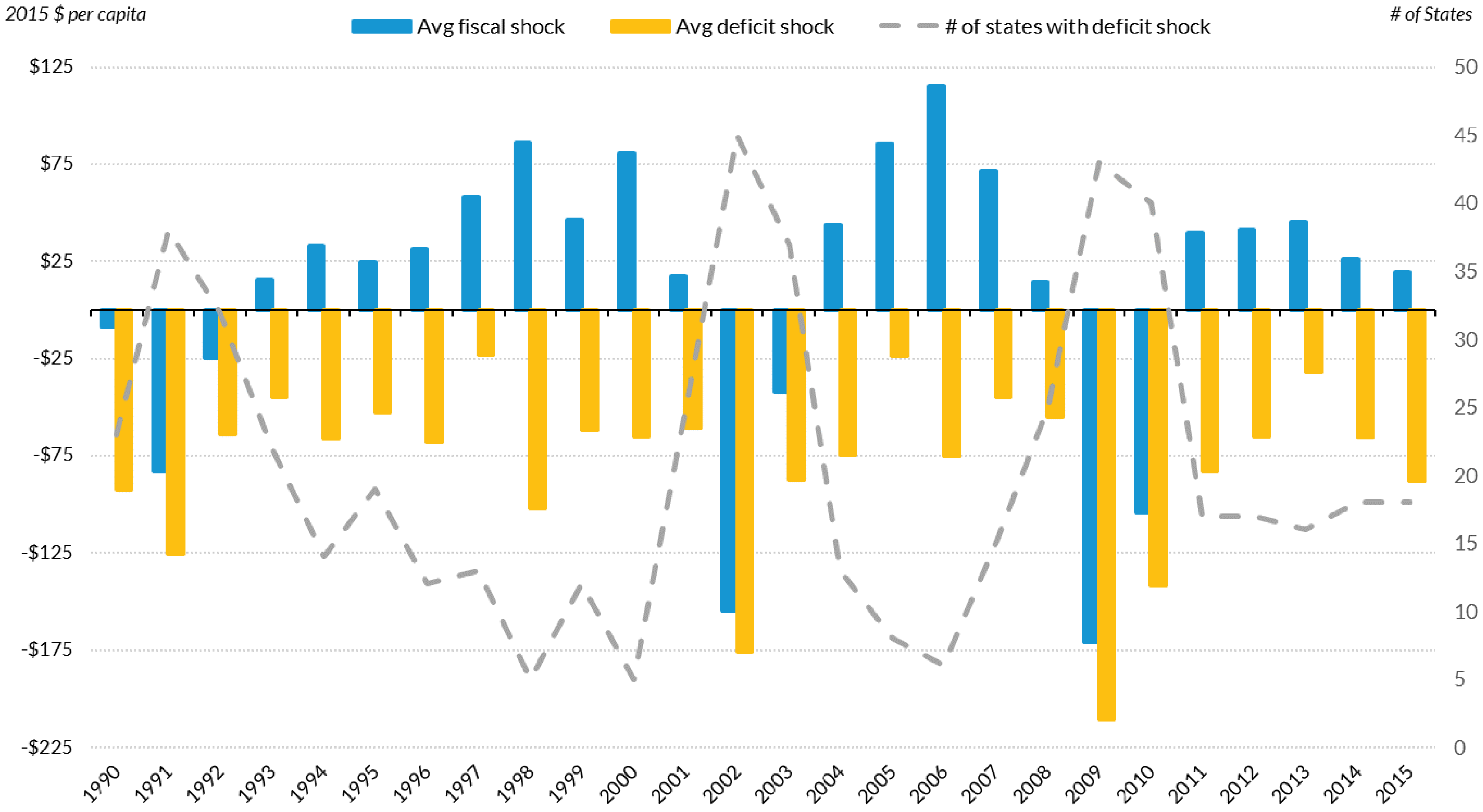
Revshock = Actual Revenue – Projected Revenue – Tax change

Expshock = Actual Expenditure – Projected Expenditure – Budget Cuts

Fiscshock = Revshock – Expshock

State Fiscal and Deficit Shock (1990 – 2015)

Average fiscal and deficit shock, and number of states with deficit shock (2015 $ per capita)



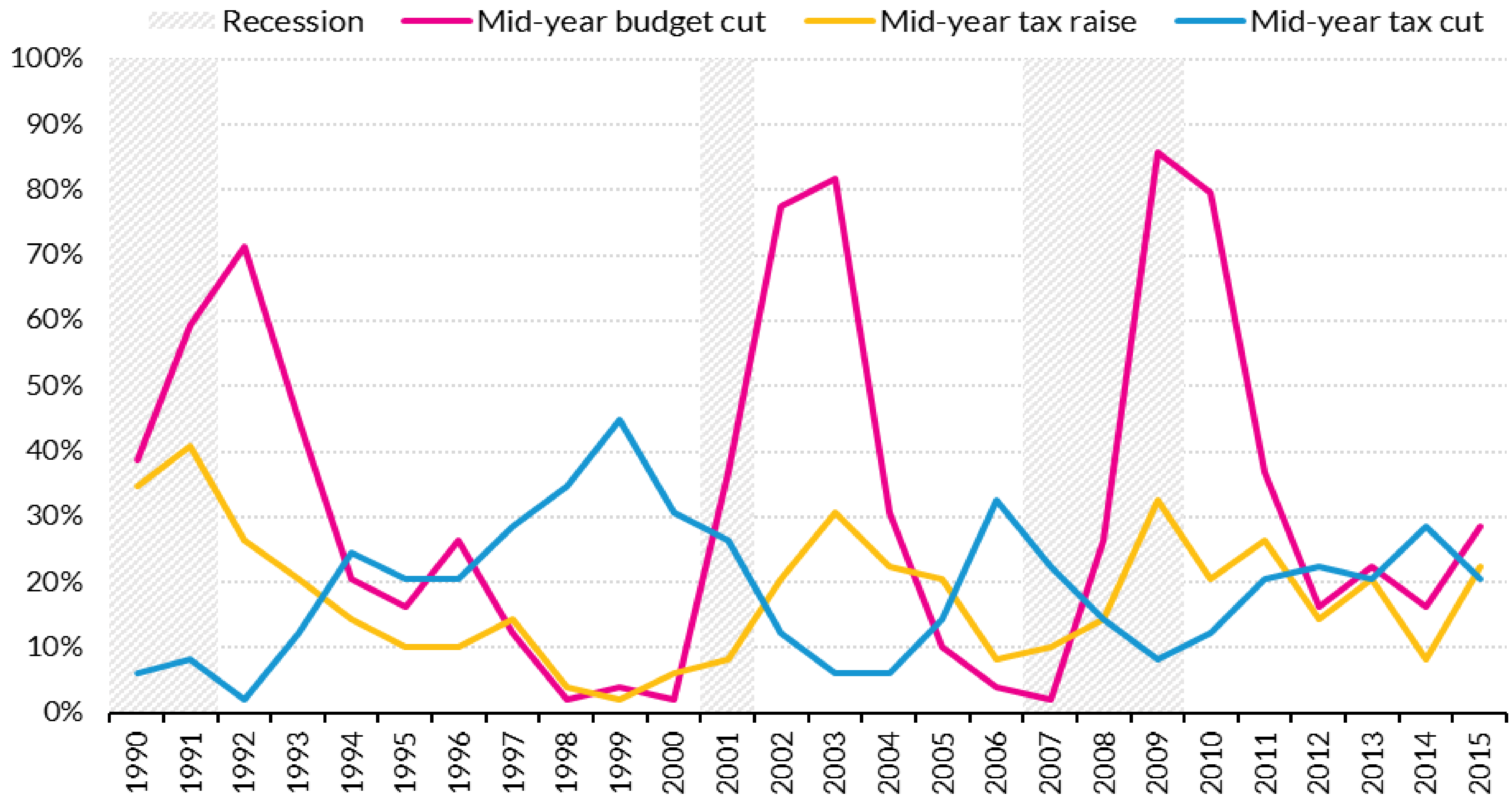
Research Design

- We estimated equations that examined how the presence or absence of unexpected revenues or deficits affected the level of changes made in state budgets.

  - BUDCUT = $a_0 + a_1$* surplus + a_2 * deficit + a_3 *wbbr + a_4 *wbbr*surplus + a_5 *wbbr*deficit
  - TAXCH = $a_0 + a_1$* surplus + a_2 * deficit + a_3 *wbbr + a_4 *wbbr*surplus + a_5 *wbbr*deficit
  - TAXNEXT = $a_0 + a_1$* surplus + a_2 * deficit + a_3 *wbbr + a_4 *wbbr*surplus + a_5 *wbbr*deficit

States with Mid-year Budget Cuts and Tax Changes (1990 – 2015)

Percentage of states that cut budgets or raised or cut taxes mid-year

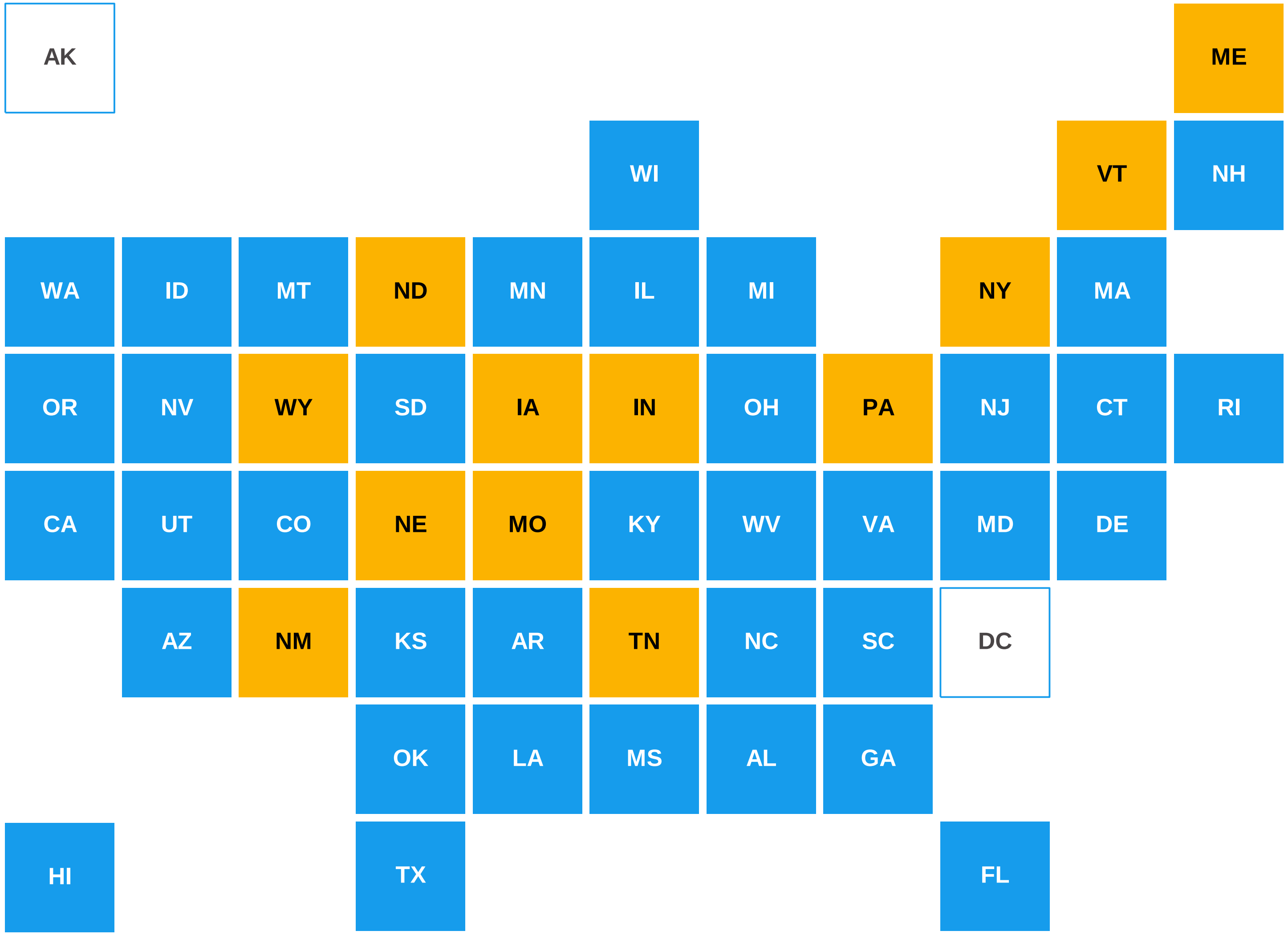


Fiscal Institutions and Party Control

- Randall and Rueben (2017) summarized existing literature on what seems to affect budget process and state actions.
- Weak balanced budget rules – state had limited actual requirement to pass and have governor sign a balanced budget (16 weak to start, 12 in 2015).
- Binding expenditure limit – State had limits on how much overall budget could grow typically based on population or inflation (7 in 1990, 11 in 2015).
- Binding revenue limit – State had limits on how much revenue can grow over prior year's revenue or requires supermajority to pass or raise tax rates (9 in 1990, 17 in 2015)
- Defined as binding if required voter approval or supermajority to override.
- Party control – same party controls executive and both houses.

Balanced Budget Requirements

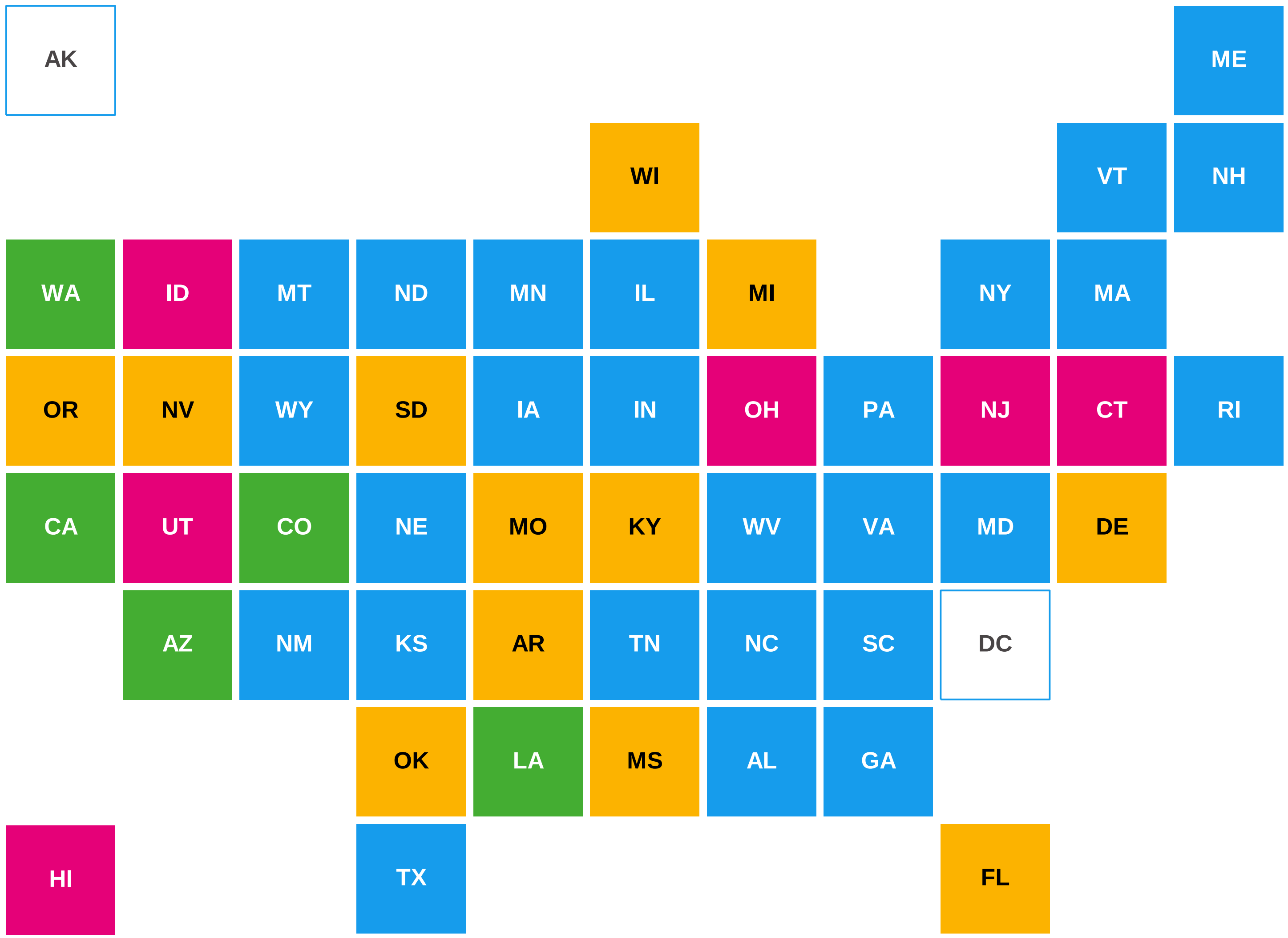
- 12 states had a **weak BBR** in 2015*



**Wyoming and North Dakota had no BBR.*

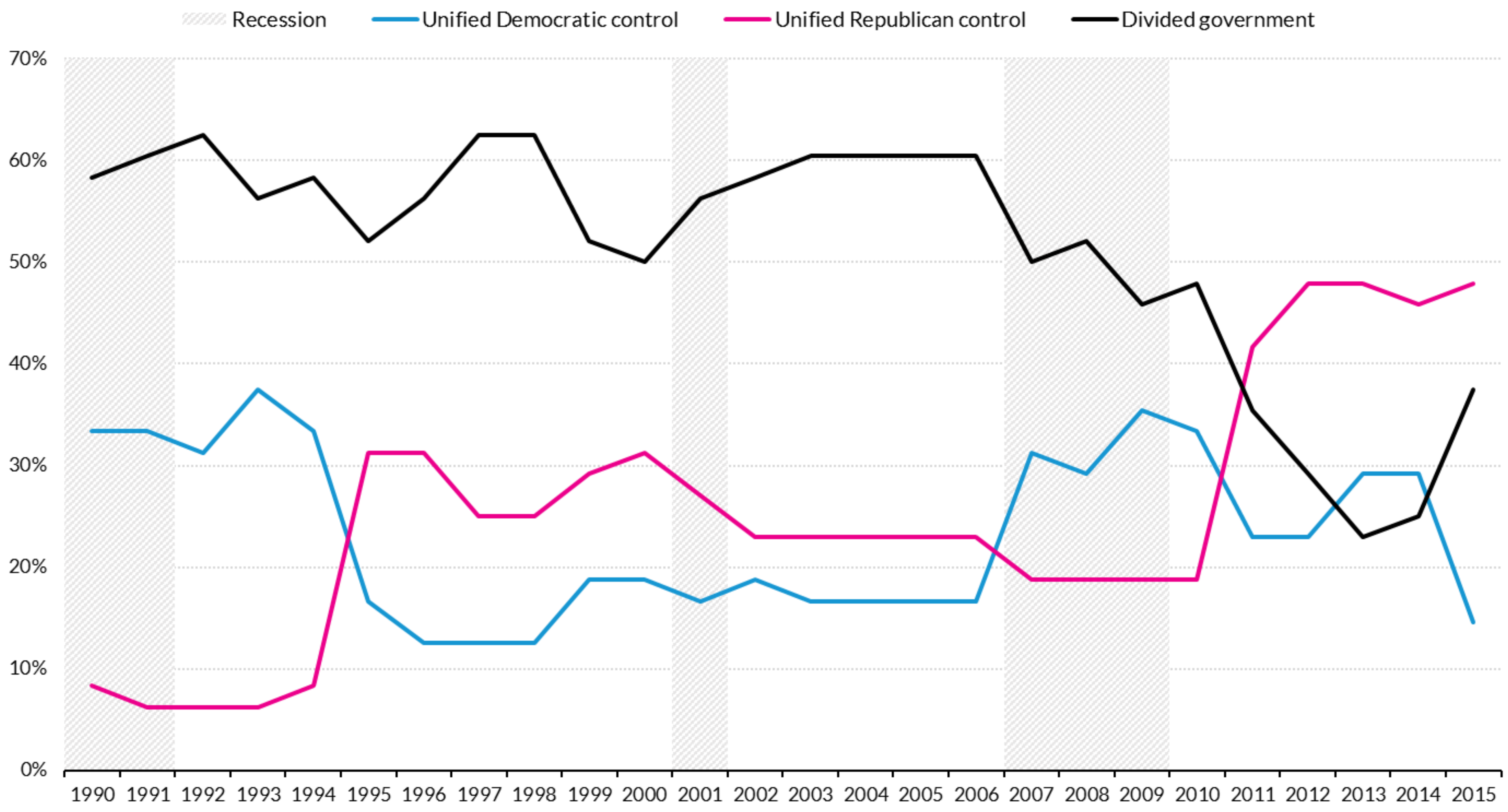
Tax and Expenditure Limits

- 12 states had just a **strict revenue limit** in 2015
- 6 states had just **strict expenditure limit**
- 5 had **both**



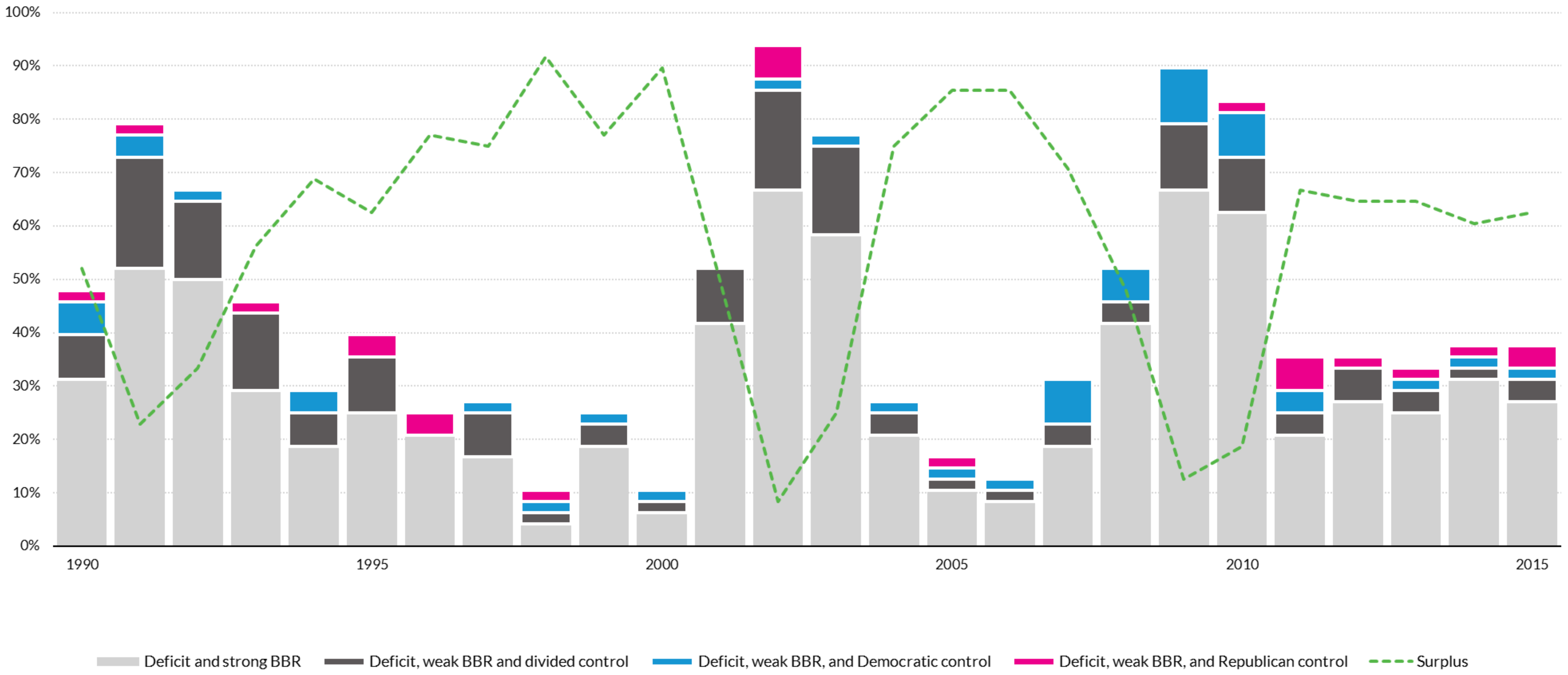
Unified Republican Control Increased Over Time (1990 – 2015)

Percentage of states with legislature and governorship controlled by same party



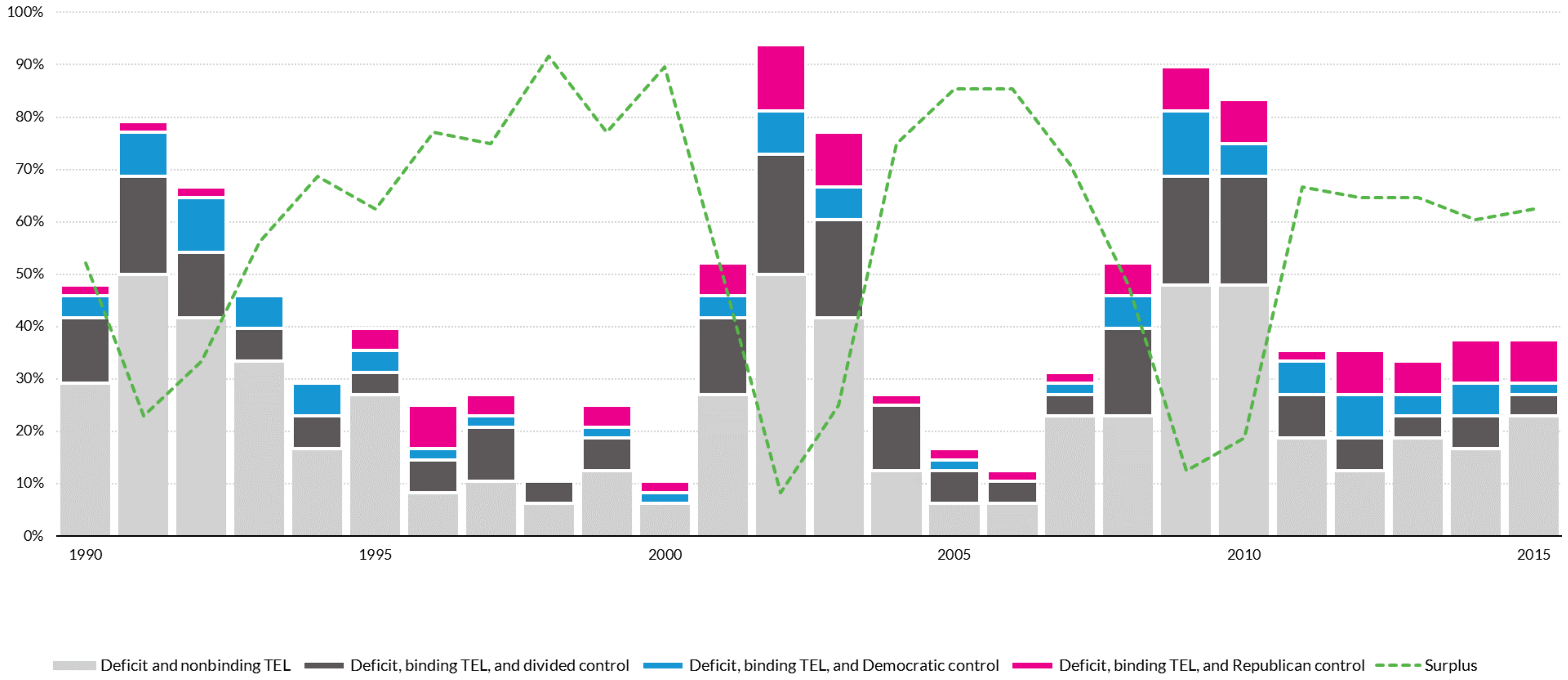
States with Deficit, Unified Party Control, and BBR are Limited

Percentage of states that met three-way interaction criteria each year (1990 – 2015)



States with Deficit, Unified Party Control, and TEL are Limited

Percentage of states that met three-way interaction criteria each year (1990 – 2015)

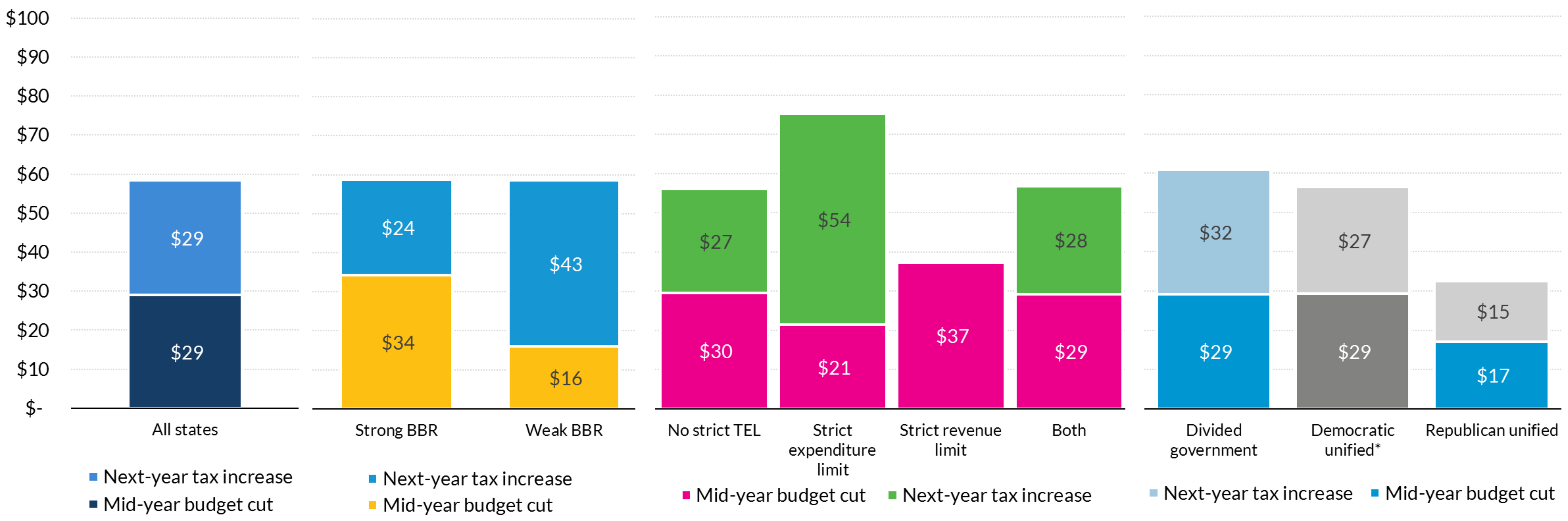


Results

- Despite some larger unexpected deficits, results tempered in the later period. On average, 60% of an unexpected deficit was closed with budget cuts or tax increases in the following year before 2008. This dropped to 40% post Great Recession.
- Hard to examine three way interactions
- From 1990-2007
  - States with strong and weak BBRs both responded to lessen 60% of unexpected deficits, though weak BBR states did this through tax increases the following year
  - States with strict only strict revenue limits only relied on budget cuts, while those with spending limits relied more on tax increases.
  - Unified Republican states closed about half as much of deficits than states with divided government or were controlled by Democrats.
- From 2008-2015
  - States with strong budget rules closed about half of unexpected deficits while weak BBR states took little action.
  - States with strict revenue limits closed more of unexpected gaps and unlike the earlier period this included some tax increases, with states with both limits taking the largest actions.
  - Republican controlled governments closed much less of unexpected deficits and it was solely with budget cuts.
  - Republican controlled governments also more likely to cut taxes when experiencing unexpected surpluses.

Budget Cuts and Next Year Tax Increases in Response to Fiscal Shock (1990 – 2007)

Per $100 of unexpected deficit per capita



*Grey sections not statistically significant.

Budget Cuts and Next Year Tax Increases in Response to Fiscal Shock (2008-2015)

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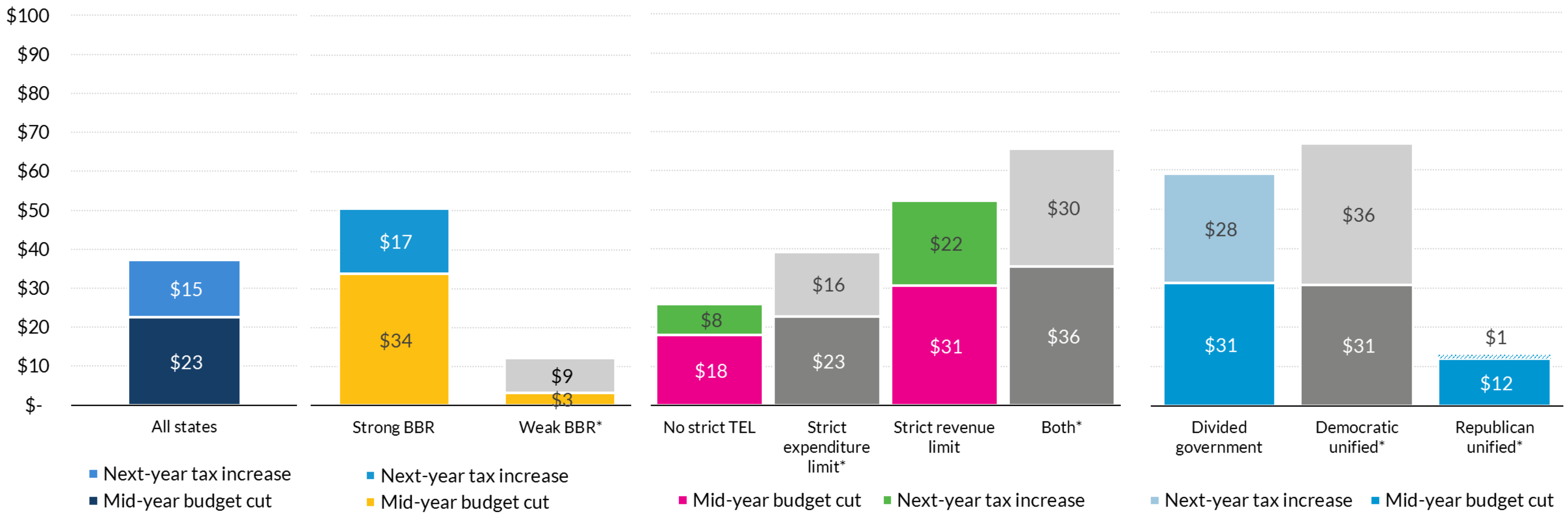

**Grey sections not statistically significant; for unified Republican control, there is $1 tax cut. "Both" is additive of sections that are not statistically significant. No analysis was done on joint statistical significance.*

Conclusions and Next Steps

- We find some evidence that fiscal and political institutions affect both the extent and how states respond to unexpected deficits.
- This relationship seems to have changed in the recent past
  - Question if less response was due to spending moving out of general fund (federal stimulus)
  - Changing reliance on future actions
  - deficits and surpluses
  - Surprising economic changes in how forecast
- Examine what seems to cause unexpected conditions
  - Changing Federal policies
  - Changing actions by states or population

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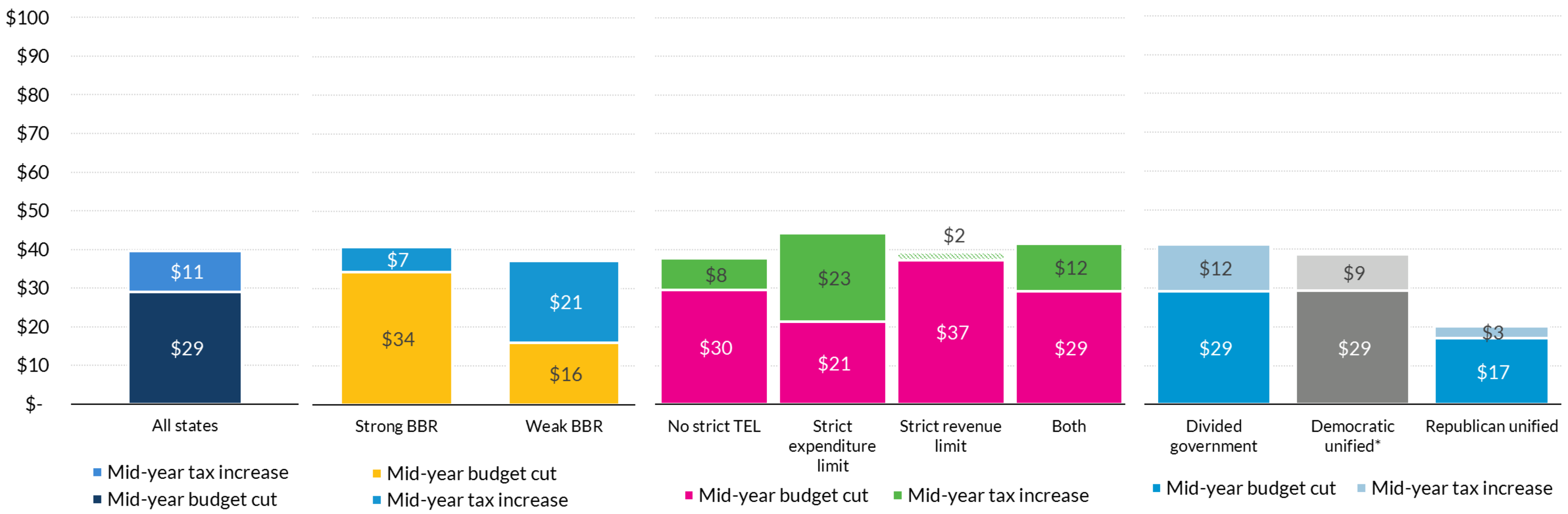
Budget Cuts and Mid-year Tax Increases in Response to Fiscal Shock (1990 – 2007)

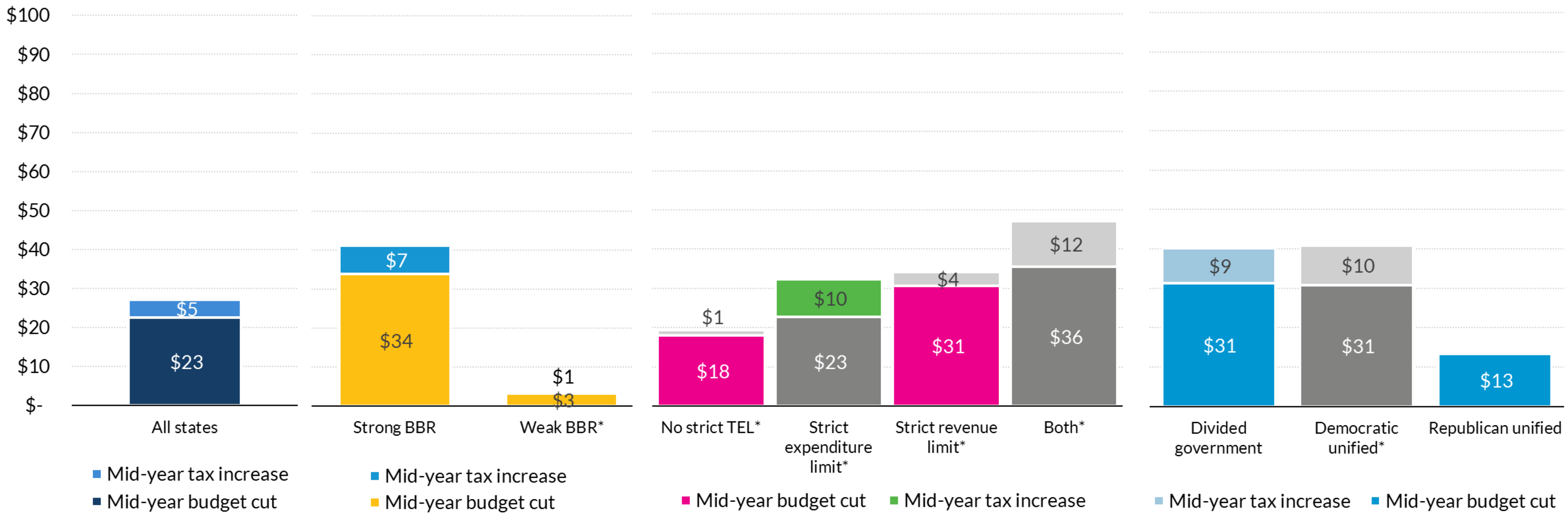
Per $100 of unexpected deficit per capita



**Grey sections not statistically significant; for strict revenue limit, there is a $2 tax cut.*

Budget Cuts and Mid-year Tax Increases in Response to Fiscal Shock (2008-2015)

Per $100 of unexpected deficit per capita



**Grey sections not statistically significant; for strict expenditure limit, the base tax raise (i.e. no TEL) is not statistically significant, but the difference is. "Both" is additive of sections that are not statistically significant. No analysis was done on joint statistical significance.*