NCSL

State Fiscal Health Workgroup

A Guide to Better State Budgeting Practices

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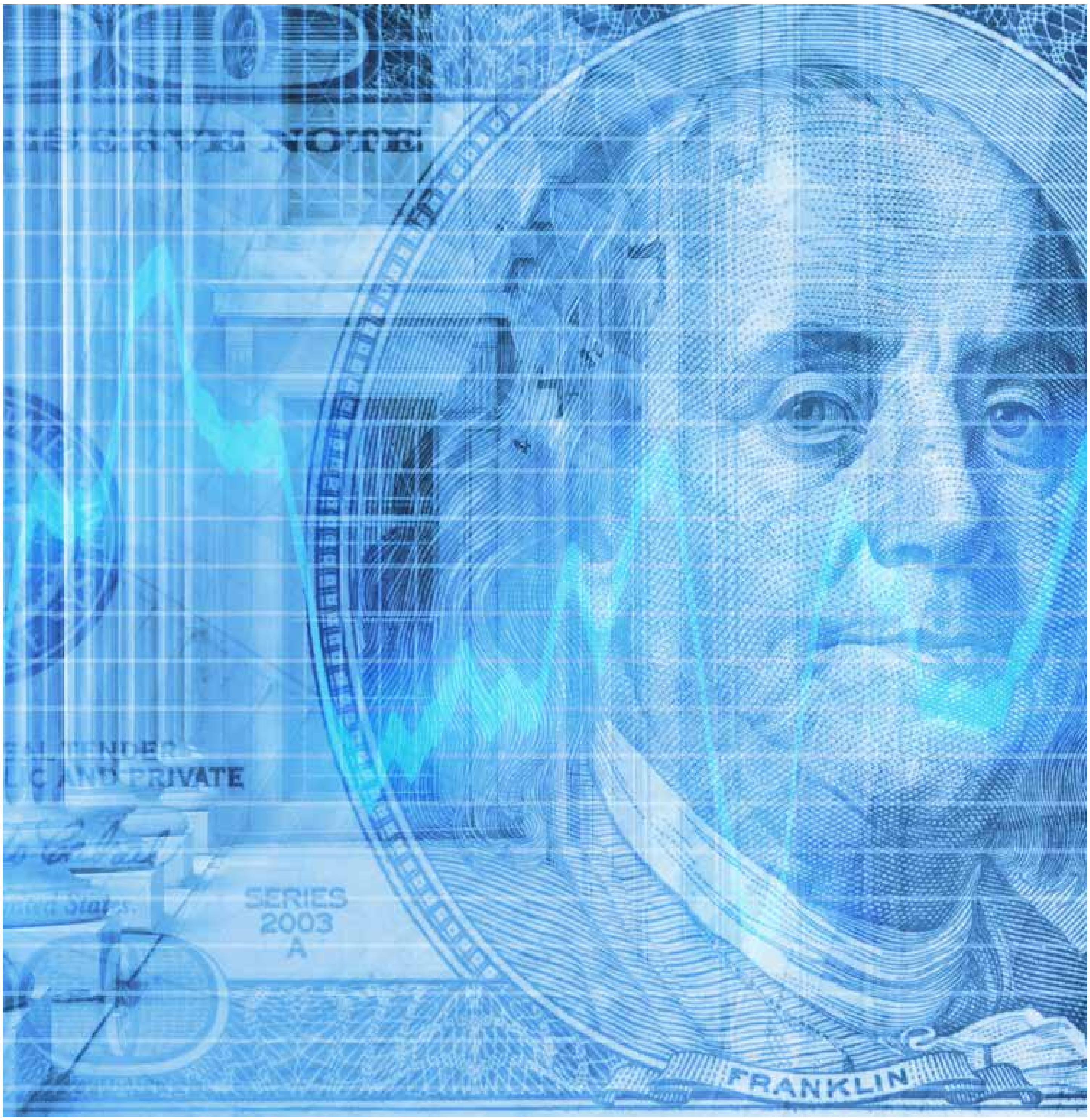

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The NCSL State Fiscal Health Work Group was staffed and this report was prepared by Arturo Pérez, program director, Luke Martel, senior policy specialist, and Erica Michel, research analyst II, for the Fiscal Affairs Program in NCSL's Denver, Colorado office. Other NCSL staff contributors were Tamara Rivale and Aron Snyder, who wrote subsections and provided significant research assistance; Glenda Riebeling, who provided administrative support; and Corina Eckl, Mandy Rafool and Mark Wolf, who edited the report. Besides drawing upon the expertise of those who participated directly, the NCSL staff who compiled this report made use of many published documents from state legislatures and academics, some of which are noted in the endnotes.

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The NCSL Fiscal Affairs Program assembled the State Fiscal Health Work Group in 2012. The bipartisan, 17-member group includes some members of NCSL's Budgets and Revenue Committee and other legislators and legislative staff who are recognized experts on state budget and tax issues. The group met twice in 2012 to discuss and identify overarching principles for effective state budgeting practices and to produce this report.

This report is based upon a May 1995 publication titled "Fundamentals of Sound State Budgeting Practices." The original report was also the work of many contributors: legislators, legislative staff and representatives of members of the Foundation for State Legislatures. Ronald Snell and Corina Eckl were the principal NCSL contributors to the original 1995 report.

It is the intent of NCSL and this work group that the practices and examples presented here will help guide and inform many aspects of state budgeting and tax policy now and well into the future.

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Introduction: State Budgeting Process

About This Report

This report deals with the nuts and bolts of state budgeting practices—ways to make the process of enacting and managing a budget work more smoothly. It is designed primarily for new legislators, legislators who have not been members of budget committees, and people outside legislatures who are interested in state budgeting processes. The report does not try to explain state budgeting processes from A to Z. It is more concerned with some issues that are common to all the states and it reports on procedures that states have developed to strengthen the process.

Where it seems appropriate, this report recommends specific practices. The practices recommended here cannot be expected in and of themselves to end budget shortfalls, ensure balanced budgets, or settle differences over policy. They can be helpful in eliminating procedural issues and allowing policymakers to focus on issues that need attention; e.g., where and how the state should be spending the taxpayers' money. Although the central purpose of every state's budget process is how to allocate funds, there is no single, preferred method. As a result, the main principle of sound state budgeting is to maintain flexibility.

Because budgets have so many functions, the process of writing one is often conflict-ridden, unsatisfactory to observers and participants, and flawed in its outcomes. Budgets seem to increase rather than resolve partisan competition; they sometimes are late; they may leave problems unresolved; they spend too much or too little; they may fail to include adequate program review, planning for the future, accounting for past expenses or controls on planned spending.[1]

These complaints have shown up ever since formal, comprehensive budgeting became a feature of state and local government in the early years of the 20th century. The Taft Commission, which examined federal budget processes in 1912, criticized federal budgeting procedures for the same flaws. Some of the problems—partisanship, indecisiveness, lack of closure—are inherent in the democratic process. Others spring from conflicting expectations of the process. The central function of a budget—the decision of how much to spend for what—will always create disputes, and no budget will ever satisfy everyone.

This document highlights some central issues in the state budgeting process, summarizes current thinking on them, and identifies some mechanisms and techniques that can help solve problems in the process.

What is a Budget?

A budget is the most important document the legislative branch considers. Budgeting varies greatly by state and every state has a unique process for allocating funds. The process is influenced by many variables, including the traditions and structure of the legislature. In some states, the budget is presented as one omnibus bill. In others, the budget is created and voted on in a series of individual bills. Whether a legislature meets year-round, or for only a few months each year, can also affect the budgeting process. These and other factors will be discussed later in this report, but they are important to keep in mind when considering changes to the budgeting process.

Budgets express state governments' power to act. They summarize legislators' evaluations of past programs and public agencies and their forecasts of current and future needs and resources. Budgets set goals, decide among alternative objectives, and create means for controlling and accounting for the expenditures of public money. They can create pressures for tax increases or tax cuts. They can push reform or they can discourage it. The budget is the blueprint for the state government's priorities in the coming year or biennium. To the extent legislators can improve the budgeting process, they also can improve efficiencies in their state governments.

Purpose of the Budget

The state budget implicitly establishes lawmakers' policy priorities for an upcoming year or biennium, but in many cases the goals of the state budget are not explicitly included in the budget document. Some states are beginning to change that by adding a "purpose of the budget" to their state budget laws.

In Vermont, the effort to include a vision for the state budget began as a citizen grassroots campaign. **"The People's Budget Campaign,"** organized by an advocacy group for Vermont workers, aims to place people's needs, rather than available revenues, at the center of the budget process. In response to their movement, the Vermont legislature voted in 2012 to amend the state budget bill to include a mission for the state budget. Vermont's mission includes addressing "the needs of the people of Vermont in a way that advances human dignity and equity."

Illinois lawmakers also revised their state budget law to include language on the budget's purpose and priorities beginning in FY 2012. The law requires the governor to prioritize outcomes for state agencies for the coming fiscal year before submitting his or her budget to the General Assembly. The language also requires the governor to establish a commission, which will hold at least two public meetings, to gain public input on budget priorities.

It is no easy feat to compare and prioritize all of a state's funding options—to balance the needs of all departments, programs and public interests. While all states share this challenge, and before discussing different approaches to state budgeting, it is helpful to review some of the institutional differences among states that create varying budget structures.

The Budgeting Process

State budgets consist of one or more pools of money (funds) that together make up the state's operating budget. The majority of state revenues are deposited in a state's largest fund, called the general fund, which finances most major programs and day-to-day operations. Medicaid and K-12 education together account for 50 percent or more of state spending from the general fund. States also enact a capital budget separately from the state's operating budget, which outlines long-term spending on large capital projects. When lawmakers and others refer to the state budget, they generally are referring to the operating budget.

Authority over the budget process in each state is split between the legislative and executive branches. The specific responsibilities and powers delegated to each branch differ from state to state, but generally, the executive branch is responsible for:

- Preparing agency budget requests;
- Submitting a budget recommendation to the legislature;

- Approving or vetoing budget bills; and
- Implementing the enacted budget.

The legislative branch is responsible for:

- Deliberating budget requests;
- Prioritizing spending and balancing the budget;
- Enacting budget bills;
- Authorizing spending and reviewing results; and
- Overriding gubernatorial vetoes.

States either enact budgets annually or biennially. In most biennial budgeting states, two annual budgets are enacted together, but a handful of biennial states enact one budget that covers two fiscal years.[2] The fiscal year for most states begins on July 1 and ends on June 30, but four states (Alabama, Michigan, New York and Texas) have fiscal years that begin and end at different times.[3] The benefits and challenges to both annual and biennial budgeting have been debated in policy circles for years.[4] In the end, the length of the budget cycle is less central to a successful budgeting approach than the commitment of state officials to good budget implementation.

To draft a balanced budget, policymakers must have an estimate of the amount of money they have to spend in a fiscal cycle. The entities responsible for preparing revenue forecasts vary across the states. Seventeen states rely on an executive office to issue a revenue forecast and 22 states produce a consensus revenue forecast, which is a joint effort between multiple branches or entities. Eleven states rely on a different process, such as a special commission or board, to produce their forecasts. The revenue forecast is usually produced at least once immediately before or during the budget process to ensure the most accurate forecast before the legislature allocates funds, but many states produce updated revenue forecasts throughout the year. In 26 states, the revenue forecast is binding, which means policymakers cannot spend more in their budget than the forecast anticipates in revenues.[5]

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While state governments must produce a budget annually or biennially, state legislatures are partisan bodies and lawmakers may disagree over funding issues. There have been times when such disagreements resulted in a state failing to enact a budget by the beginning of a new fiscal year. States have many different methods for dealing with late budgets. Nine states have continuing resolutions that continue to fund government at the current level until a new budget is passed. In 12 states, payments continue for certain government services, usually those deemed most critical for public health and safety. The government shuts down in 23 states, and 12 states have no provision for late budgets, or the need has not arisen to develop a plan for a late budget.[6] Generally, states enact timely budgets, but there are exceptions. For example, nine states began FY 2010 without a finalized budget as lawmakers grappled with particularly challenging fiscal circumstances.

Approaches to state budgeting vary from state to state and the process is always evolving. The next chapter focuses on state budgeting techniques and how states allocate funds to agencies and programs.

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Traditional & Alternative Budgeting

State budgeting traditionally has focused on incremental funding increases and line-item appropriations with the goal of controlling costs. This approach often fails to take program effectiveness into account. Because of this deficiency and others, legislators are continually looking for methods to improve the budgeting process.

Critics charge that current budgeting practices discourage program scrutiny in favor of automatically continuing existing programs, some of which may be inefficient and wasteful. Legislators always are looking for ways to use state dollars as wisely as possible, particularly during recessions. To this end, legislators look for budgeting alternatives that more effectively review past performance and plan for the future.

This chapter focuses on the following forms of budgeting, and the challenges of incorporating changes into existing budgeting systems:

- Traditional methods of state budgeting;
- Performance-based budgeting;
- Zero-base budgeting; and
- Mixed-budgeting.

Periodic reconsideration of the budget process is beneficial because, at a minimum, it improves lawmakers' understanding of a very complex process. But it also can do more than that if reconsideration leads to process improvements and efficiencies.

This chapter contends that changing the budgeting process may not achieve the desired results when too much is expected of the changes. This is not an argument against change, but a caution that budgeting has many inputs and faces many challenges, and that no change can create a perfect budgeting process.

Traditional State Budgeting

Traditionally, state budgets have focused on controlling expenditures. Control is expressed in written budgets through "line items"—statements allocating specific dollars for a specific expense: computers for tax collectors, books for the state library, or salaries for prison guards. Where written budgets focus on line items, legislators tend to do so as well.

Line-item budgeting tends to be incremental—previous appropriations are increased or decreased by small increments over time. This approach is likely to take previous policies and programs for granted, without rigorous review of priorities, program effectiveness or service outcomes.

These practices are sometimes said to foster a business-as-usual approach to government. This approach often comes under scrutiny during difficult economic times when the public may challenge whether state government operates efficiently and effectively.

Line items focus on what money buys (an input) rather than on the service provided (an outcome). Inputs could be asphalt for state highways or new computers for property tax assessors. Outcomes could be improved road safety measured by fewer car accidents, or quicker processing of tax bills. Nothing in a line-item budget prevents outcomes from being considered, but the format does not encourage it.

Many budget experts contend that the traditional focus on line-item budgeting and incremental change neglects outcomes so much that the budgeting process itself is an impediment to effectively delivering programs. Critics argue that line-item budgeting does not do enough to take program results into account. These challenges to traditional budgeting often prompt lawmakers to consider different techniques to improve budget outcomes. Two alternative budgeting methods legislators often consider for reforms are performance-based budgeting and zero-base budgeting. Sometimes they are combined with traditional budgeting.

Performance-Based Budgeting

This type of budget procedure emphasizes performance and results. It goes by many names: outcome-based budgeting, performance budgeting, and sometimes, program budgeting. These terms can be confusing because, as currently used, they overlap but do not mean exactly the same things. In general, though, the goal of these formats is to reshape the process to reward efficient and effective programs, encourage the revamping of programs that do not meet specific goals or, in some cases, eliminate programs that are no longer useful. In this report, this type of budgeting is called performance-based budgeting.

Unlike traditional state budgeting, which focuses on incremental changes in detailed expenditure categories, performance budgeting focuses on the results of spending. The basic principle of performance-based budgeting is accountability, not only compliance with the law and what was allocated in previous years. Performance-based budgeting encourages lawmakers to reconsider priorities and allows flexibility to make decisions that are not easily permissible under traditional budgeting systems.

A performance budget has the following characteristics:

- It presents the major purpose for which funds are allocated and sets measurable objectives. A performance budget also offers agencies the flexibility to reallocate money when conditions merit a change, and it may reward achievements or impose sanctions for poor performance.[7]
- It tends to focus on changes in funding rather than on the base (the amount appropriated for the previous budget cycle).
- It assists in identifying programs and agencies that are seeking similar outcomes, thereby drawing legislators' attention to such inter-relationships.

Many states incorporate performance information into some areas of budgeting. Tennessee, for example, instituted a funding mechanism for higher education based on outcomes. Rather than rewarding colleges and universities for the number of students they enroll, the formula rewards schools based on the number of students who graduate.

Tennessee's Outcomes-Based Model for Funding Higher Education

In most states, higher education funding is largely based on an institution's student enrollment. Some states, however, have been seeking ways to reward institutional performance rather than providing funding based mostly on student numbers. The Tennessee Legislature passed the "Complete College Tennessee Act" in 2010 after much deliberation and input from communities, universities and the public. The Act established a new funding formula for institutions based on outcomes—the number of students completing a degree—rather than student enrollment.

The Act did not just change the way Tennessee funded colleges and universities, but also the way the state organized its higher education system. Each university, college and community college defined its institutional mission, deciding if it would focus on research, student access and affordability, or certain fields of study, among other things. This reorganization is designed to ensure the state is spending public funds on higher education wisely, with less duplication statewide. Tennessee's new funding formula employs a weighting mechanism based on an institution's mission and desirable outcomes to ensure it is receiving the necessary funds to achieve its education goals. A number of other states are including performance measures in their higher education formula, but Tennessee is the only state to completely do away with enrollment-based funding.[10]

Performance-based budgeting is a way to measure the effectiveness of programs and services, providing legislatures with better tools to prioritize spending, which is especially useful during economic downturns. Other benefits of performance-based budgeting for policymakers include:

- Better understanding of state programs;
- Explanations of previous funding decisions;
- Program effectiveness (outcomes);
- Program efficiency (costs and benefits);
- The justification for new funding decisions;
- The identification of potential savings;
- Quantitative evidence of program success and shortcomings; and
- Communicating what is received in return for the investment of tax dollars.[8]

Despite widespread theoretical consensus on the benefits of performance-based budgeting, it remains difficult for states to implement in practice. One of the challenges can be getting all parties to agree on fair measurements and program goals. As researchers from the University of Georgia noted in a 2010 report:

> *"Developing measures that realistically evaluate the performance of an agency undertaking may be difficult. Not only must departments develop a means to measure outcomes and support those intricate measurement systems with the administrative and technological resources to adequately use them, but also they must align these measures with the demands of government entities external to the agency."*[9]

Oregon has been working to collect agency and program data for nearly 20 years to incorporate data-driven performance objectives into program budgets. Despite progress, the state still faces obstacles to using more performance-based metrics, including designing realistic measures and obtaining reliable data. Effective performance-based budgeting is challenging. During implementation, selecting effective measurements requires a significant investment of time, a continuing commitment to which is needed to review and analyze program achievement.

Another practical challenge to implementing performance-based budgeting is the degree to which agencies and programs are realistically able to control spending. Some programs, such as those in criminal justice and health and human services, have statutory obligations for spending based on caseloads and other factors. Those obligations can make it difficult to achieve more efficiencies in some programs, or to reduce a program's spending if performance measurements are not met.

Performance-based budgeting can allow policymakers to tie funding to achieving benchmarks and goals. If goals are not met, the legislature may choose to reduce a program's funding. Some lawmakers caution, however, that reducing a program's funding when it does not achieve performance objectives may be an oversimplified response. There may be cases when programs are unable to meet performance measures because their budget is stretched too thin and a funding increase may be necessary. Performance-based budgeting can create a quantitative framework for evaluating agency performance and adjusting funding based on results, but outcomes cannot be analyzed in a vacuum. There must be case-by-case reviews of performance to solve the root causes when agencies underperform.

Other questions policymakers should keep in mind when integrating performance-based budgeting into their budget process include:

- What will a state legislature do if a program does not reach its target goals?
- How can rewards for performance be established without creating incentives to reshape programs to reap rewards rather than improve programs?
- How willing are legislators to trade certain control over budget details for promises of improved service delivery that require greater executive discretionary power?

Zero-Base Budgeting

Zero-base budgeting (ZBB) has evolved over time and remains a popular idea as states look to control government spending. ZBB appeals to many people who are concerned with public budgeting because, in its original form, it requires reviewing budget requests from point zero, without giving priority to continuing existing programs. Although the original goals of ZBB have proved elusive, in a modified form it has become a widely used budgeting tool.

Zero-base budgeting was first popularized in the public sector by former President Jimmy Carter during his time as governor of Georgia. It was designed to control expenditures by identifying the purposes and measuring the effectiveness and efficiency of all activities. In its original form, the zero-base budgeting process focused on creating "decision packages" for agencies that identified a minimum level of funding necessary, a maintenance funding level, an intermediate level, and an increased level that would allow the agency to provide additional services.[11]

While a useful tool to evaluate agency funding and performance, this method proved unfeasible for wide implementation. State programs are not, in practice, amenable to such a top-to-bottom annual or biennial re-examination. Statutes, obligations to local governments, federal government requirements, and other past decisions have often times created state funding commitments that are difficult to change significantly in the short term. Examples abound. Education funding levels, for instance, are determined in many states partly by state and federal judicial decisions and state constitutional provisions, as well as by statutes. Federal mandates require that state Medicaid funding meet a specific minimum level if the program is to exist at all. Federal law affects environmental program spending, and both state and federal courts help determine state spending on prisons. Much state spending, therefore, cannot usefully be subjected to the kind of fundamental re-examination that ZBB envisions.

Although ZBB is extremely difficult to implement in its pure form, states have incorporated it into their budgeting in more practical ways. In a popular variation of ZBB, often called alternative budgeting or targeted budgeting, agencies make budget requests at various percentages of their previous funding. For example, at 90 percent, 100 percent and 110 percent—and analyze what effects those levels would have on their programs.[12] This is a useful technique and may also be referred to as a sensitivity analysis. It provides valuable information both when state resources are expanding and when spending reductions might be necessary, as well as assists policymakers in breaking with the tradition of incrementalism. It also can ease tensions between legislators and program managers when only a portion of the program's budget is being considered for change.[13] Even more important in the budget climate of recent years, the process makes it possible to avoid across-the-board cuts by emphasizing the effects of different cuts on services.

Because annual or biennial justification of every activity and program can be problematic, some states implemented periodic agency reviews. Two of the first states to adopt this practice were Florida and Oklahoma in the early 2000s. Eventually, the process was dropped in both states as it became too unwieldy.

In a popular variation of zero-base budgeting, often called alternative budgeting or targeted budgeting, agencies make budget requests at various percentages of their previous funding. For example, at 90 percent, 100 percent and 110 percent—and analyze what effects those levels would have on their programs.

Looking to trim budgets in the face of the Great Recession, both Idaho and New Hampshire implemented agency reviews in an effort to cut or contain costs. Agency and program reviews in both states are largely executive driven and are designed to inform the governors' budget recommendations to the legislatures. In Idaho, the process has largely been used to ensure agencies are focusing on their central missions and prioritizing central functions in their strategic plans.[14] In New Hampshire, reviews have been used to streamline agency responsibilities and to help trim agency budgets by 5 percent to 10 percent.

Variations of zero-base budgeting in the states can be helpful when evaluating agencies and programs, and ZBB can help states prioritize spending. It forces more review of incremental spending increases and may create more accountability for taxpayer dollars.

Mixed-Budgeting

This chapter has focused on outlining the differences between traditional, performance-based and zero-base budgeting. In reality, states often combine elements of these different budgeting processes. The enacted budgets for most states is still largely a line-item document (or series of documents), although some states supplement traditional budgeting with performance-based budgeting, zero-base budgeting or both. Georgia is an example of a state mixing various budgeting methods.

Georgia has used performance measures since 1993, but in 2005 these became a more integral feature of the budget process. Agencies are responsible for creating and tracking performance measures, which are then reviewed by the legislative budget offices and the Governor's Office of Planning and Budget. There are no automatic budget increases or reductions as a result of performance measure review, but the information is taken into consideration when planning the budget, and can be useful if reductions are necessary.[15]

Term limits and budgeting

The budget process in every state is influenced by many different actors, events and cultural factors. Fifteen states, however, have another challenge in their budgeting process—term limits. Term limits for state legislators became popular in the 1990s with California, Colorado and Oklahoma implementing the first limits through the voter initiative process. A number of other states followed suit.

Supporters of term limits argue that turnover of legislators fosters innovation and allows lawmakers to make tough choices with less concern for upcoming elections. New legislators also will have less loyalty to past budgeting practices, and might be more willing to question whether traditional budgeting practices are leading to desired outcomes.

Critics counter that term limits break down institutional knowledge, which can be especially important in the complicated budget process. New lawmakers may be unfamiliar with the reasoning behind previous budgeting decisions, and why some historic spending is especially difficult or impossible to change. As a result, legislative fiscal staff often spend a significant amount of time educating new legislators on the budget process. This also can affect the ability of lawmakers to focus on innovative strategies if they are focusing on budgeting basics.

Term limits are designed differently in each state. Some states, such as Arizona, Colorado and Florida, have consecutive limits, which places a limit on the number of terms a legislator can serve at a time, but allows them to return to the legislature after a certain period of time out of office. Other states, such as California, Michigan and Missouri, impose lifetime limits on legislative service. States' experience with term limits varies widely, but they certainly can affect the budgeting process.

For more information on term limits in the states, please see NCSL's 2007 report **Institutional Change in American Politics: The Case of Term Limits**.

In 2012, the Georgia legislature voted to add zero-base budgeting to the state's process. Each year, the House Budget and Research Office and Senate Budget and Evaluation Office, in consultation with the Governor's Office of Planning and Budget, identify programs and agencies that will submit their budgets in ZBB form that year. Since ZBB can require a significant amount of staff time, the offices take agencies' staff availability into account when choosing agencies and programs for review. Agencies are required to submit statements on program purposes and effectiveness, as well as to prioritize programs and explore alternative funding levels. Agency staff works closely with the Governor's Office of Planning and Budget to identify program priorities, goals and measurements. Each agency is reviewed at least once every 10 years, but no more than once every eight years. This time frame is intended to limit the burden on agencies and budget staff, but still provides information that can help lawmakers determine whether agency funding levels are aligned with desired outcomes. Together with performance measures, zero-base budgeting in Georgia is designed to create more accountable and efficient agencies that provide taxpayers with services to match tax dollars.[16]

Why Traditional Budgeting Survives

Why is it so hard to change traditional budgeting methods? Why does budget reform seem to excite more interest than activity? Some of the reasons are:

- Traditional budgeting provides predictability and stability for agency and program planning.
- Budgeting is complicated. Budgets must respond to many different competing needs and goals, which can be difficult to measure.
- Traditional budgeting allows legislators flexibility on where to focus their review efforts each year.

Proposals for reform focus on particular unsatisfactory results from the existing process and recommend ways to improve those results. They may, however, fail to consider how many conflicting expectations the budget process has to meet.

Creating a budget requires policymakers to balance a number of competing spending pressures, and the process is often a reaction to other structural and environmental inputs. Establishing metrics and agency goals is a useful process, but budgets must also react to outside forces such as economic downturns. Traditional budgeting allows lawmakers to take performance measurements into account when drafting a new budget, but allows them some flexibility in how these measures are applied. Performance budgeting techniques are not mutually exclusive to traditional budgeting.

Perhaps one of the most significant reasons traditional budgeting survives is time constraints. Alternative forms of budgeting require rigorous analysis and evaluation, which is very time-intensive—especially when most state legislatures meet part time. Likewise, legislators lack the time to make use of all the information that is available to them. The traditional budget process provides lawmakers with flexibility in how they spend their limited time. If necessary, traditional budgeting allows legislators to prioritize which areas of the budget to focus their limited time and attention on. This flexibility is one of the greatest strengths of traditional budgeting methods.

Hal Hovey, the former editor of State Policy Reports, who closely followed state budget reforms once wrote: "Many of the values of reforms can be lost by expecting too much from them. They won't ever solve the real problem, which is that we voters want to spend more than we want to pay in taxes, and insist on elected officials who agree with us. We are all in for trouble if state officials do what the Congress has made a practice of doing—substituting a new round of budget reforms for dealing with the budget."[17]

Hovey's observation is a reminder that a budget cannot meet all of its objectives while also satisfying the public. The competing desire of citizens to have more government services while keeping tax rates low will always serve as a challenge to those seeking to establish a balanced budget. Reforming the process can help make the system more efficient, but it can never solve this underlying problem.

Despite the obstacles, it is important for lawmakers to continue working to improve methods of state budgeting because these advancements can lead to more effective government spending, which benefits citizens. Traditional budgeting will likely continue to serve as a practical budgeting methodology, but alternative budgeting methods will continue to provide useful information to policymakers, and provide a valuable review of state spending.

3

Constraints on State Government

Traditional budgeting survives, in part, because of the flexible and predictable process it provides to legislators to prepare the budget in a practical and timely manner. Nonetheless, many state legislatures face constitutional and statutory restrictions. In addition to long-standing balanced budget requirements, tax and expenditure limits have become widespread. Some legislatures must meet **supermajority requirements** to enact budget or tax legislation, and voters sometimes impose budget obligations, revenue limits and procedural requirements on legislatures. Policy decisions also are often subject to voter and judicial review. Federal mandates can restrict a legislature's budget choices, too.

Legislators may welcome or rue such policies. Some legislators argue that restrictions on their authority force a desirable reconsideration of the purposes and extent of government and may encourage creativity. Others suggest that such limitations needlessly restrict the role a legislative body should play in a representative government. Regardless of legislators' reactions to these restraints, the limits complicate legislators' jobs. This chapter describes the most common kinds of limits that affect state budgeting, and discusses some ways to preserve the flexibility that remains.

Balanced Budget Requirements

The requirement for a balanced state budget is the most important and widespread limit. It is commonly reported that all states except Vermont have a formal requirement to balance their operating budget.[18] In actuality, the limits vary from state to state and observers may disagree on exactly what the formal requirement is for a specific state. Many agree that some expenditures, such as capital expenditures financed by bond issues, should be outside the balanced budget requirement. The expectation, however, that annual or biennial budgets will be balanced is so fundamental to state government that the concept of it being a limit on state government hardly arises.[19] Like other restrictions, balanced budget requirements have mixed consequences. They force states to live within their means and prevent the accumulation of deficits, but when resources are tight, they can impose reductions in services that decision makers may find unacceptable. This may lead to so-called budget "gimmicks" or inflated revenue estimates to cloak deficit spending, often at a cost to the reputation of the governors and legislatures responsible. Balanced budget requirements leave state budgets at the mercy of the business cycle, and make it difficult for states to adopt significant counter-cyclical fiscal policies.

Tax and Expenditure Limitations

In addition to balanced budget provisions, many states have adopted legal caps on the growth of state expenditures or revenues, or both, to control budget growth.[20] Some of these have unquestionably restrained the growth of state budgets. A notable example is Colorado's Taxpayer Bill of Rights (TABOR) provisions—a package of limits on state budget growth, the amount of revenue growth governments may retain from existing taxes and the need for voters' approval of tax increases. These constitutional provisions were adopted in 1992 and have been only somewhat loosened since then. While Colorado has one of the strictest tax and expenditure limitations, 30 states have some type of limit.[21]

Supporters of tax and expenditure limits argue for their expansion into more states as a means of downsizing state government by containing spending and taxes. Proponents often cite Colorado's TABOR as a model, and recommend indexing government spending to the inflation rate plus population growth and mandating immediate rebates of government surpluses, as TABOR does. They support constitutional status for such limits, along with requiring voter approval for tax increases.

Opponents express concern about governments' ability to fund public services adequately under such provisions. The Bell Policy Center of Colorado points out that tax and expenditure limits in the state have indeed limited government, but have also impaired the state's ability to set budgetary and program priorities and respond to crises.[22] However, as the Colorado-based Independence Institute asserts, "the fundamental principle of the Taxpayer's Bill of Rights is that taxpayers have a choice. If they want to raise taxes, rapidly increase spending, or increase debt, they can do so. Nothing about TABOR prevents a government from taxing, spending, or borrowing more money—as long as taxpayers give their consent."[23] More information about TABOR in Colorado is included below.

Colorado's Taxpayer Bill of Rights (TABOR)

In 1992, voters in Colorado approved a constitutional amendment known as the Taxpayer Bill of Rights (TABOR). TABOR established a spending limit for state government, and mandated that any revenue collected over the spending limit be refunded to the taxpayers unless voters approved a revenue change. To determine the spending limit each year, TABOR calculated the previous year's spending and indexed government spending for inflation and population growth.

During the economic downturn of the early 2000s, some practical challenges to TABOR emerged:

- Under the spending cap formula, if revenue for a fiscal year was less than the spending limit, then the next year's baseline spending would be calculated at the lower revenue level (adjusted for inflation and population growth). This became known as the "ratchet-down" effect.
- The "ratchet-down" effect permanently reduced the limit to recession-level revenue collections, threatening to strain government resources with fewer revenues available for a growing population.

To address the issue, Colorado voters approved Referendum C, which instituted a "timeout period" for TABOR, allowing the state to keep revenue collected above the TABOR limit for five years (FY 2006 through FY 2010). Referendum C also changed the spending cap formula to allow the state to retain all revenue over the limit up to a "cap" equal to the highest total state revenue for a fiscal year during the "timeout period," indexed for the rate of inflation plus population growth. Fiscal year spending limits after the timeout period use the previous fiscal year's spending cap as a baseline, rather than the collected revenues, which avoids the ratchet- down effect.

More than two decades after its adoption, TABOR is still widely considered to be the most stringent expenditure limitation in the United States, and has served as a model for many other states looking to limit state spending.

Voter Initiatives and Popular Referendum

In many states, voter initiatives and the popular referendum are important limits on legislative budget authority. The initiative allows voters to recommend, and in some states create, legislation or a constitutional amendment without legislative action. The popular referendum allows voters to submit a legislative enactment to a popular vote.[24] Twenty-four states have a voter initiative process and 24 states also allow popular referendums. These two tools allow many state voters to repeal or enact taxes, mandate or repeal spending programs, or impose procedural controls on legislatures' tax and budget authority. California's Proposition 13 and Colorado's TABOR provisions demonstrate the reach of the initiative process, and voter rejection of legislatures' tax changes has been a repeated feature of government in Maine and Washington. Initiatives can fundamentally alter government; referendums can reject legislative decisions. They are limits within which legislatures must adjust their work.

Maintaining Budget-Setting Flexibility

This section discusses some ideas for sustaining flexibility in state government. They become even more important when tax and expenditure limitations eliminate some other possibilities.

CONSIDER IMPOSING PROGRAM COSTS UPON PROGRAM BENEFICIARIES

Over time, state governments have increased their reliance on fees and charges, although to a lesser extent than local governments. The difference is, in part, because charges are less workable for state services than for municipal and county services. However, education, recreation, transportation, environmental preservation, and licensing and regulatory activities may be appropriate areas to transfer costs to users.

The consequences of fee increases have to be considered case-by-case. It is an economic truism that imposing costs on users discourages the use of a service. A fee for park admission will turn some possible users away and highway tolls may cause crowding on free roads. Discouraging use of a service may or may not be desirable. Those who advocate charging drivers for using highways during peak commuting hours contend that the reduced congestion would provide drivers with savings. A different consideration is that agencies or programs that charge fees for their services often come to feel that the money raised is their own and that they should be allowed to decide how it is spent. It may take a special effort to conduct legislative oversight of the use of revenue from fees and charges.

WEIGH THE CONSEQUENCES OF DEDICATING REVENUES

Dedicating revenues for specific expenditures requires careful consideration. The argument for doing so is to provide continuous, guaranteed support for a specific program, or to win voter support for a tax increase. The argument against it is the reduction in decision makers' power to set budget priorities. A designated revenue amount may provide too little or too much revenue. If it is too little, it may defeat the purpose of committing the funds; if it is too much, it can be difficult to shift resources to other priorities. Such a limit on budget flexibility may or may not be desirable, but it does restrict policymakers' budget decisions.

Similarly, mandatory expenditure requirements (a requirement that a given percentage of total revenue growth or collections go to a specified program) hampers good budget management and adaptability. A trend in state finance overall has been the reappearance of explicitly or implicitly dedicating sales or income tax increases for elementary and secondary education. Such decisions are a tradeoff between flexibility in budget management and maneuvering to enact a tax increase.

REVIEW FUND MANAGEMENT PRACTICES;
CONSOLIDATE FUNDS IN THE STATE GENERAL FUND

Having a large number of separate funds is a relic of 19th-century state budgeting, when the practice was to assign a revenue source and a fund to each of many different activities instead of adopting a comprehensive budget. A large number of funds unnecessarily complicates revenue forecasting, budgeting and accounting, and is likely to confuse the public. Having a large number of funds also restricts the ability of legislatures to move funding between programs as the need arises. To the extent that states can avoid special funds designated for a specific purpose or program, and concentrate state resources in the general fund, there will be increased flexibility for policymakers.

APPROPRIATE LESS THAN THE STATE REVENUE FORECAST

Some states protect themselves against erroneous revenue estimates and downturns in collections with provisions that prohibit appropriating all of the expected general revenue for the coming budget period. Any revenue saved from one year can be appropriated in the next. Provisions in Delaware, Mississippi and Rhode Island only allow the appropriation of 98 percent of the general fund revenue estimate. Iowa allows 99 percent to be appropriated. Oklahoma, traditionally plagued by unpredictable revenue fluctuations because of energy prices, allows the appropriation of 95 percent of the forecast. State practices differ in the use of the revenues above the limit. Such revenue can be appropriated in a subsequent legislative session or may be deposited into the state budget stabilization fund.

CREATE AND FUND A BUDGET STABILIZATION (RAINY DAY) FUND

Almost all states attempt to smooth the business cycle by setting money aside in good times to use when shortfalls occur. "Budget stabilization funds" and "rainy day funds" are two names for this practice. States vary greatly in the ways such funds were created, how they are funded, and how the money can be used.[25] Some states maintain balances in their general fund when possible for use in the subsequent fiscal period. Many have more than one reserve fund with different purposes and provisions for use. Techniques are less important than a commitment to smoothing the impact of the business cycle by setting aside revenues.

Rainy Day Funds

Over time, the number of budget stabilization funds across the nation has expanded along with the allowable usage of existing funds. Forty-seven states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands have budget stabilization funds. Since 2000, at least 11 states have raised the percentage caps on their funds, allowing for their funds to play a larger role in the event of economic instability. Previously, many states allowed withdrawals only when pressure was placed on budgets due to poor revenue performance. States also have expanded the purposes of their funds to include pressures from unanticipated state expenditures resulting from catastrophic events (e.g., the 9/11 terrorist attacks and Hurricane Katrina). The public generally appears to support budget stabilization funds. During the last decade, voters have overwhelmingly approved the creation of budget stabilization funds when the issue was brought before them.[26]

For more information on state rainy day funds, see NCSL's online report **"State Budget Stabilization Funds."**

4

Managing the State's Finances

Balancing the budget is at the heart of state fiscal management. As previously discussed, the specific nature of the requirement varies from state to state. It is possible in some states to roll a deficit forward from one year to the next, to use short-term borrowing, or to use accounting practices to resolve a budget shortfall. But this seldom occurs. Even when fiscal conditions are as harsh as they were during the Great Recession, states almost invariably balanced their budgets. This is partly because of constitutional and statutory balanced-budget requirements, but mostly it is because the state political expectation is that the budget will be balanced for each budget period.

Balanced budget requirements refer to the state operating budget and not to the capital budget. Generally, operations include all ongoing activities. For example, salaries, payments to vendors for medical care, rent of buildings, purchases of supplies and equipment, and grants to local governments. Capital budgets include new construction, the acquisition of land, other major equipment purchases and repairs or modifications of structures. The specific guidelines vary from state to state. In FY 2010, the 50 states' capital expenditures came to $117 billion, while states spent $1.4 trillion on current operations and aid to local governments.[27]

State governments typically borrow money to finance capital expenditures, although when fiscal conditions are strong, the practice of financing capital projects from annual revenues becomes more common. States can issue long-term debt to fund capital expenditures; however, the amount of debt that states can issue is limited in most states by state law or the state constitution.[28]

Long-term borrowing to finance operations refers to instances when the amount borrowed is not paid back in the same fiscal year. States also issue short-term debt, such as revenue anticipation notes, to fund operating deficits.[29] States use this type of short-term borrowing, which is paid back within the same fiscal year, to finance operations due to temporary imbalances between revenue receipts and expenditures. Long-term borrowing to finance operations is rare, yet in recent years this practice has occurred.

When managing their states' finances, lawmakers must also take federal funds into account. Every state receives and administers funds from the federal government. Federal funds make up a significant share of total state spending. In FY 2008, 26.3 percent of state spending was from federal funds. Federal funding to state governments increased after the adoption of the American Recovery and Reinvestment Act of 2009 (ARRA). In FY 2010, federal funds represented about 34.1 percent of total state spending.[31]

The rules and processes governing how states spend federal funds are complicated. In some instances, federal law dictates how the funds must be spent. In other cases, the state is given spending discretion, and the state legislature or executive branch determines how the money is allocated.

Regardless of a state's strategy in handling federal funds, balancing a budget is not a simple matter. It involves good revenue and expenditure forecasts and mechanisms to finance or reduce state spending when revenues fail to meet expectations. This chapter discusses the following ways of meeting those needs:

- Agree on the basic budget numbers;
- Account for and review tax expenditures;
- Develop clear guidelines for capital budgeting;
- Provide a mechanism to reduce expenditures when revenues fall short; and
- Beware of quick fixes that create long-term problems.

Borrowing to Finance Operations

California provides a rare example of long-term borrowing to finance operating expenses. In 2003, California officials faced accumulated deficits totaling $12.3 billion.[30] In response, voters approved the California Economic Recovery Bond Act (CERBA) through Proposition 57. CERBA authorized the state to issue up to $15 billion in Economic Recovery Bonds (ERBs) to eliminate a general fund reserve deficit and cover general fund obligations. The state issued $10.9 billion in ERBs in FY 2004 and $3.2 billion in FY 2008. Repayment of the ERBs is secured by a pledge of revenues from a one-quarter cent increase in the state's sales and use tax.

Agree On the Basic Budget Numbers

Some numbers that are basic to budget negotiations can be agreed upon through established processes, removing potentially divisive issues from debate. The following suggestions are based on what state governments have found to work effectively.

ESTABLISH A CONSTITUTIONAL OR STATUTORY PROCESS TO PRODUCE A REVENUE FORECAST THAT IS BINDING UPON THE LEGISLATURE AND GOVERNOR

Over half of the states have mechanisms to produce a binding revenue forecast. As a rule, binding forecasts are produced by executive branch agencies or by a consensus process; the latter typically includes legislators or legislative staff. No state legislature by itself produces a revenue estimate that is binding on the executive. In some states, however, legislative agencies prepare revenue estimates that are used by both the executive and legislative branches. The advantage of a binding forecast is that it removes this difficult, technical process from political debate or, at least, terminates the debate at some point so that all parties can proceed. For the mechanism to work, the process of arriving at a binding forecast must be trusted by the governor, legislators and the general public. The procedure has to be clear, open and consistent from year to year.

Almost half of the states have processes to produce a consensus forecast, requiring the agreement of at least the executive and legislative branches. Several states include a state university faculty economist or private sector economists in the process. In addition to their expertise, their involvement makes the revenue forecast less of a routine activity for elected or appointed officials. Combined with an open and publicized process, this adds to its credibility, which in itself can strengthen the binding character of the forecast.[32]

Forecasts are developed from past trends and are susceptible to error in times of rapid change. States could benefit from supplementing their forecasting system with occasional revisions. The team that establishes the forecast should have the power to review it formally and to revise it occasionally. Doing so more than quarterly is unnecessary because frequent revisions give too much emphasis to trends that might be short-lived.

ESTABLISH A PROCESS TO FORECAST THE FIGURES THAT DRIVE THE BUDGET

Examples of statistics that drive the budget are school enrollments, prison populations and social services agency caseloads. Other important data of budgetary significance are long-term public obligations represented by public employee pension and health insurance plans, capital needs and bonded debt.

The goal is to remove from debate what can reasonably be settled by technical analysis. Whether the prison population is too high is a matter for policy discussions, but the size of the prison population should not be debatable. In certain instances, base funding levels for certain programs—most commonly K-12 education— have been set by court order. This usually happens when a court rules that lawmakers have failed to meet the state's constitutional duty to provide a certain service at its legally required level. In these cases a base funding level for those spending areas is largely established before the formal budgeting process begins. Such numbers should be readily available to legislators, legislative staff and the public. The executive branch is the appropriate source of such numbers, but the process of generating them should be open to legislative participation and critique, because legislative deliberations rely on such numbers.

ESTABLISH A PROCESS TO DEFINE THE BUDGET BASE AND AGREE ON THE AMOUNT

The most common method of state budgeting begins with the current level of spending on operations (the budget base), assumes the level of services it provides is the appropriate level, and then adds to or subtracts from the base in relatively small amounts (increments). Even as some states move toward more emphasis on performance-based budgeting—focusing on the outcome of services rather than on the amount of resources given to an agency—the base is an essential starting point.

Calculating the base can be complicated because it does not include all state spending. The base often excludes capital expenditures and other one-time expenses. It may need adjustments to reflect the full annual cost of a program that was initiated midyear. Because the base is typically the beginning point for the next budget, it is important to reach agreement to keep the process moving.

A particular area of difficulty has to do with developing a continuation-level budget. This term refers to a budget in which the base for the coming budget period is not just the amount spent in the current budget period, but where the base is increased to cover the effects of inflation, cost increases other than inflation, allowances for caseload growth, increased insurance costs, statutory cost-of-living adjustments and any other additional amounts required to continue current levels of services. A continuation-level budget makes the assumption that such costs will be covered. These budgets have the advantage of showing how much additional money is needed just to continue existing programs. There can be an apparent budget shortfall even in the face of growing revenues, however, if the total amount required to cover "continuation" costs is greater than the revenue growth.

This process can be confusing to legislators and the public. Continuation-level budget costs can absorb year-to-year revenue growth unless it is substantially above inflation, possibly turning apparent revenue growth into apparent shortfalls. Continuation-level budgets can easily become political footballs, turning a theoretically useful tool into an impediment in the budget process.

For these reasons it is essential that budget documents specify the nature of the base they are built upon and the nature of any assumptions. Amounts added to previous levels of funding to cover costs or caseload increases should be identified as such, and the rationale for the estimates should be specified. Laying out the facts may not bring agreement with them, but can, at a minimum, clarif what the numbers are intended to mean.

Account For and Review Tax Expenditures

A tax expenditure is a tax credit or exemption designed to encourage some particular activity. For example, tax breaks to encourage economic development or charitable contributions. Such tax expenditures represent foregone revenues and are the fiscal equivalent of state expenditures for the same purpose. Tax expenditures should be subjected to the examination that formal budget items regularly encounter.

ACCOUNT FOR ALL TAX EXPENDITURES IN A COMPREHENSIVE TAX EXPENDITURE BUDGET

While tax expenditures have a cost, they rarely are listed in the budget document. To account for these expenditures, at least 43 states now produce separate tax expenditure budgets, also called tax expenditure reports.[33] A tax expenditure budget shows the costs, expressed in lost tax revenue, of a tax credit or exemption that is intended to benefit some group of taxpayers or encourage a public policy goal. It shows revenue losses just as a regular budget shows expenditures. For example, states may exempt a portion of retirement income from personal income taxes or provide deductions for business subsidies for child care. In addition to identifying the revenue loss from such tax preferences, useful tax expenditure budgets also provide data that can be used to evaluate the effectiveness and efficiency of these policies.

Tax expenditure budgets vary in their format and content. To make sound decisions, policymakers need comprehensive information, yet some states' reports neglect vital information. Weaknesses common in tax expenditure budgets include omitting certain types of tax expenditures, omitting some tax expenditure cost estimates and publishing reports sporadically.[34]

ESTABLISH A PROCESS TO REVIEW TAX EXPENDITURES ON A REGULAR CYCLE

Individual tax expenditures should be reviewed on a regular basis. Subjecting state tax expenditures to thorough evaluations helps lawmakers make informed policy choices and enhances accountability. Appropriated expenditures are normally subjected to regular review as a part of the annual or biennial budget process, but in many cases tax expenditures are not reviewed on a regular cycle, if at all. Additionally, the lack of regular review can allow the cost of some tax expenditures to grow unrestrained beyond what policymakers might find acceptable.

Tax expenditure evaluations allow policymakers to examine the costs and benefits of these polices and to determine whether to continue them. Lawmakers have a responsibility to ensure that individual tax expenditures produce their intended effect and do so at a reasonable cost. The Pew Charitable Trusts studied states' evaluations of tax incentives for economic development and their report found that most states do not know whether these tools deliver strong returns.[35] The report found that no state regularly and rigorously tests whether their tax incentives for economic development are working nor ensures that lawmakers consider this information when deciding whether to use them, how much to spend and who

Oversight Through Sunset Provisions On Tax Expenditures

Oregon and Nevada implemented sunset provisions to force tax expenditures to expire periodically. Before a tax expenditure is set to expire, the reviewing body may retain it, modify it or allow it to terminate. This sunset review requires legislatures to review individual tax expenditures on a regular basis. Sunset provisions mandate oversight of tax expenditures that might otherwise remain in the tax code with little subsequent evaluation.

In 2009, Oregon passed House Bill 2067B, which established expiration dates of six years for a variety of tax credits. The expirations are staggered for the different categories of tax expenditures in the coming years. In 2011, environment, business and agricultural tax credits were set to expire. In 2013, education, housing and community service tax credits sunset, and in 2015, medical care, childcare and family tax credits will sunset. New tax credits that are passed expire six years after the enactment by default, unless specified otherwise.

In 2011, the first phase of the tax credit review process occurred. Oregon's Joint Committee on Tax Credits reviewed 20 income tax credits scheduled for sunset that year. The committee allowed nine credits to sunset, extended nine after modification, accelerated expiration of one, and broke the business energy tax credit into three new tax credits for conservation, renewable energy generation and alternative transport. According to the Oregon Legislative Fiscal Office, the sunset provisions saved the state $30.7 million in the 2011-13 biennium and will save $117.1 million in the 2013-15 biennium. The savings were calculated by comparing the impact of the credits as modified in 2011 to the cost of continuing the tax credits in its existing form.[37]

In Nevada, a constitutional amendment requires that all new tax exemptions on property and retail sales include a sunset date.[38] The legislatively referred constitutional amendment was originally was passed by a majority of the Legislature in both the 2005 and 2007 sessions and was ratified by voters in the 2008 general election. The amendment became effective on November 25, 2008. In addition to requiring a sunset date, the amendment requires the Legislature to make public the purpose and benefit of the tax exemption and requires that similar classes of taxpayers meet similar requirements for claiming exemptions.

As stated in the ballot question submitted to the voters, the goal of the amendment is to ensure that exemptions do not outlive their usefulness or reduce revenue unnecessarily. Periodic review allows the Legislature to decide if an exemption serves the social or economic purpose stated and whether the benefits exceed the costs of maintaining the exemptions. The amendment, however, does not set a specific date or a period of time by which exemptions must expire, nor does it establish standards for the Legislature to follow when considering effective periods.[39]

should get them.[36] Although tax incentives for economic development are a subset of overall tax expenditures, the lessons from this study may have broader applicability to all tax expenditures. Not only should tax expenditures be accounted for and regularly reviewed, but a process should be in place to ensure that lawmakers have integrated the evaluation results into the budget and policy process.

Develop Clear Guidelines for Capital Budgeting

States spend a significant amount of money on capital projects—over $117 billion in FY 2012.[40] To make informed decisions, legislators need an up-to-date inventory of capital stock and its condition, a long-range plan outlining future needs, and information on how capital budget requests fit into overall budget plans. Capital requests should appear in a single budget, separate from operations requests, to facilitate comparison of projects with each other and with long-term plans and statements of needs. Capital budget requests should include forecasts of the costs of operating and maintaining facilities, as well as acquisition or construction costs. An orderly process of developing and financing capital facilities can assist legislators in making optimal use of resources and in using capital to foster economic and social development.[41]

Provide a Mechanism to Reduce Expenditures When Revenues Fall Short

Reducing spending after a budget has been passed is painful and politically difficult. A formal process for making reductions can mitigate the difficulty by clarifying the roles of the governor and the legislature. Additionally, for the majority of states where legislatures are not in session year-round, an established process can permit a timely response to a sudden problem.

The powers that legislatures and governors have to cut budgets differ greatly from state to state and from time to time, so having these roles well-defined makes the budget-cutting process smoother than when these roles are ambiguous.[42]

Nine states give their governors full authority to cut the budget when there is a revenue shortfall. Very few states prohibit the governor from making any spending cuts. California, which has a full-time legislature, is the exception. Vermont delegates budget-cutting authority to an eight-member Joint Fiscal Committee when the legislature is not in session. Generally, state constitutions give governors limited authority to make cuts and require legislative participation when the extent of gubernatorial authority is inadequate. Maryland, for example, allows the governor to cut any line item appropriation by as much as 25 percent. Louisiana and Montana limit such cuts to 10 percent and Connecticut limits such cuts to 5 percent.

The state legislatures' role, if one exists, in cutting an enacted budget is an issue settled on the basis of state constitutions, traditions and preferences. In all cases, a specific mechanism to cut an enacted budget should be in place before the need for it arises.

Beware of Quick Fixes that Create Long-Term Problems

Sound policy for one situation may prove to be unsound policy when circumstances change. Various legislatures have ignored the advice below because they saw no alternative. But these are sound rules that make sense to observe whenever possible:

BE VERY CAUTIOUS WHEN SPENDING RESERVE FUNDS

Lawmakers should be wary of using rainy day funds for ongoing purposes. Pressure to spend these reserves can be great, especially during an economic downturn. While tapping into rainy day funds may be appropriate, lawmakers should exercise caution when using these reserves to increase spending or backfill spending for ongoing programs. Using rainy day funds may dampen the effects of economic trouble in the short term, but if revenues do not rebound, then these practices can force more long-term budget and service cuts.

DON'T MAKE SHORT-TERM BUDGET DECISIONS WITHOUT CONSIDERING THE LONG-TERM BUDGET EFFECTS

In a political system that often rewards short-term decision making, it can be difficult for lawmakers to focus on long-term planning and budgeting. Long-term budget outlooks can help states maintain good fiscal standing, and can help limit the effects of economic cycles on state finances. Such planning documents help states avoid common financial pitfalls, including neglecting the maintenance costs of assets, shifting money from one fund to another to close gaps, borrowing to finance day-to-day operations and relying on one-time revenues for ongoing expenses. Long-term budgeting can help policymakers avoid one-time fixes, even under the pressure of an economic downturn.

PROTECT THE TAX BASE THROUGH GOOD AND BAD TIMES

When revenue collections routinely exceed expectations, protect the tax base by rebating taxes rather than cutting taxes. Years of exceptionally high collections do not last, and cutting taxes at a time of economic expansion can lead to calls for tax increases when economic growth slows. When recessions reduce collections more than expected, consider temporary tax increases. This can help avoid the cycle of higher revenues and expanded spending when prosperity returns.

Early Retirement Incentives

In 2011, Kansas instituted a voluntary early retirement program, offering approximately 4,000 state employees an incentive to retire early.[43] The program ran from August 2, 2011, through October 31, 2011, and offered participating employees two choices. Employees could choose between a lump-sum cash payment of $6,500 or post-retirement group health insurance coverage. Under the second option, an eligible employee could continue group health insurance coverage and the state would pay the employer's share of the plan for 60 months for individuals or 42 months for employees on the member-plus-dependents plan, or until the employee reached age 65.

By the close of the program, at least 951 state employees had elected to participate in the early retirement plan. Kansas Employee's Retirement Plan System (KEPRS) executives estimated that paying early retirement benefits would not cause a significant earlier-than-expected demand on the state's pension fund.[44] However, the program's impact on the KPERS long-term liability is unknown. According to the Kansas Legislator Briefing Book 2012, at least three more years of data are needed to compare with the past three-year study to determine the actuarial impact.[45]

The Governor's Budget Report Fiscal Year 2013 noted that the Voluntary Retirement Incentive Program would result in savings of $24 million if all vacated positions remained unfilled.[46]

DON'T INTENTIONALLY OVERESTIMATE REVENUE OR UNDERESTIMATE EXPENSES, PARTICULARLY WHEN IT COMES TO THE STATE RETIREMENT SYSTEM

In general, overestimating revenue or underestimating expenses can lead to budget shortfalls, which can force budget cuts. Accurate revenue forecasts benefit policymakers when developing state budgets. Seek sound actuarial advice when considering changes to the assumptions or the contribution rates connected to a state retirement system.

DON'T EXPECT TOO MUCH FROM EARLY RETIREMENT INCENTIVES

Early retirement incentive programs can be expensive in the long run if they are not carefully designed and subjected to an actuary's calculations of costs. Where savings exist, they are most likely to result from a reduction in the number of state employees. Such reductions can be difficult to preserve. If not carefully managed, early retirement incentive programs can substantially increase a pension fund's long-term liability.

5

Making and Communicating Decisions

Total state budgets range from about $4.5 billion in South Dakota to more than $282 billion in California.[47] South Dakota's Legislature has 12 weeks to consider its budget, while the California Legislature has about 20. In both cases—and in most other states—consideration of the budget occurs in the midst of all the other legislative activities of a regular session. The complexities of the budgeting process, combined with the compressed nature of legislative sessions, can be challenging for not only legislators and the governor, but also the taxpayers, who are the ultimate beneficiaries of the budget.

Every state's budget process has unique features. Legislatures vary greatly in their independence from the executive branch, in the proportion of legislators who participate directly in the process, in the amount of time it takes to write a budget, in the attention they give to budget administration and program evaluation, and in partisanship. A fair and open process does not depend upon any specific set of procedures and there's no way to ensure a timely, smooth completion.

The points that follow are not intended as one-size-fits-all recommendations. States are too distinctive for any formula to apply. This chapter instead discusses a variety of solutions legislatures have found for the problems they have in common.

The Budget Cycle—Annual and Biennial Budgets

One of the most common recommendations for budget reform is to change the budget cycle to a biennial budget in an annual-budget state, and vice versa. The trend among state governments for the past 70 years has been to abandon biennial budgeting for annual budgeting. In 1940, 44 states enacted biennial budgets; only 19 do so now.[48]

However, not all changes have been in one direction. A few states have moved from annual to biennial budgeting over the past 20 years or have changed back and forth, because of partisan politics, uncertainty as to which worked better, or both. Connecticut returned to biennial budgeting in 1991, reversing the decision lawmakers made to adopt annual budgeting when the state began annual legislative sessions in 1971. Arizona made a gradual transition from annual to biennial budgeting in the 1990s, and completed the process with the enactment of a biennial budget in 1999. Then, in 2002, it shifted to a bifurcated system under which larger agencies receive annual budgets while smaller agencies continue biennial budgeting. This system allows for some flexibility, with smaller agencies also receiving an annual budget when the Legislature and governor deem it appropriate. For example, in the years following the Great Recession, all agencies had received annual budgets in response to the uncertainty of state revenues. Kansas uses a similar method.

The arguments for and against annual budgeting are well known and rarely change. They are discussed at length in a separate NCSL report, "State Experiences with Annual and Biennial Budgeting." The essence of that report can be summarized with two quotations it contains. The first is from a report on budgeting cycles that the Council of State Governments (CSG) released in 1972:

> *"In reality, a state can develop a good system of executive and legislative fiscal and program planning and controls under either an annual or a biennial budget. The system would work differently with the alternative time spans, but could be effective under either approach."* [49]

The Public Affairs Council of Louisiana looked at the same issue 10 years later and reported:

> *"The arguments used to justify and refute both annual and biennial budgets remain essentially unchanged [since the CSG report 10 years before] and unproven. The success of a budget cycle seems to depend on the commitment of state officials to good implementation rather than on the method itself."* [50]

Biennial budgeting is sometimes said to be more conducive to long-term planning, program review and evaluation than annual budgeting because more time is available.

LONG-TERM PLANNING

Evidence from states that have switched from annual to biennial budgeting over the past 40 years fails to show that biennial budgeting has enhanced long-term planning. The CSG study in 1972 produced such conflicting evidence that it could neither confirm nor reject the idea. A Texas A&M University study in 1984 also was inconclusive on the point, as was the study conducted by the U.S. General Accounting Office in 1987.[51] Analysts in Connecticut, however, emphasized that the governor and legislature greatly improved their long-term budget forecasting and analysis after the state adopted a biennial budget in 1991.

PROGRAM REVIEW AND EVALUATION

A strong argument for biennial budgeting is that it can provide time for administrators and legislators to focus on the results of their decisions and not just the process of budgeting. This was one of the principal arguments that led Connecticut to return to biennial budgeting in 1991. Proponents contended that, "The present system (of annual budgeting) does not allow enough time to review expenditures in depth. Those preparing the budget finish one year and then immediately plunge into the next year's budget."[52] The biennial cycle was intended to focus on making major programmatic and budget decisions in the first year, and to devote the second year to in-depth evaluation of agency programs.

A Connecticut legislative committee that reviewed the biennial budget process in 2003 reported it had not met expectations. "Beginning with the first biennium," the committee observed, "the governor and legislature have proposed new and expanded programs along with significant policy changes in each year of the cycle. As a result, second-year adjustments and revisions are often extensive. There is also no evidence that legislators or state agencies give greater attention to program outcomes and performance measures in the second year of the cycle." It recommended, nonetheless, that biennial budgeting be retained to bring a perspective of more than one year to the process and to allow for greater performance evaluation.[53]

There is little evidence that either annual or biennial state budgets hold clear advantages over the other. The evidence is inconclusive on the question of whether biennial budgeting is more conducive to long-term planning than annual budgeting, although some evidence indicates that biennial budgeting is more favorable to program review and evaluation.

Beginning the Process Early

BEGIN LEGISLATIVE HEARINGS BEFORE THE GOVERNOR HAS SUBMITTED A BUDGET

In most states, legislators wait for the governor's budget recommendations before starting budget deliberations, although in some states agency budget planners submit their budget proposals to legislators (or legislative staff) at the same time that the proposals go to the governor. This allows legislators and their staffs to begin work on the budget as early as September or October of the year before they have to vote on a budget. An early start allows for greater understanding and consideration of agency proposals and requests. It also allows for more program review and evaluation than may be possible during a legislative session.

Except for states with year-round sessions, such a schedule requires a substantial commitment of time when the legislature is unlikely to be in session, which part-time legislators may find difficult. It also requires legislative access to agency budget requests and personnel, which some governors may resist. Solving these challenges enriches the process by increasing legislative knowledge of agencies and budgets, expanding opportunity for executive officers to make their case to the legislature, and enhancing public knowledge of state finances through hearings and media coverage.

ENCOURAGE THE GOVERNOR TO SUBMIT THE BUDGET EARLY

A governor's budget is the most important comprehensive planning document most legislators ever see. Even in the handful of states like Texas and Colorado where the enacted budget is in all senses a legislative product, the governor's budget sets the agenda for a legislative session as no other document can. When governors issue their budgets late, usually in violation of established rules, they truncate the time available for consideration. Governors should recognize the importance of a timely budget submission and observe statutory and constitutional requirements.

> **The governor's budget sets the agenda for a legislative session as no other document can. When governors issue their budgets late, usually in violation of established rules, they truncate the time available for consideration.**

Who to Involve in the Budget Process

How much rank-and-file legislators are involved in the legislative budget process varies greatly among the states. In some states, budget committees are small and powerful, and in others, budget and appropriations committees seek input and guidance from a number of subcommittees and legislators.

In Colorado, for example, most budgeting decisions are made by the powerful Joint Budget Committee, which includes only six of the 100 legislators. While these six legislators largely shape Colorado's budget, there have been recent efforts to involve more committees in the budget process. In 2010, the legislature passed the State Measurements for Accountable, Responsive, and Transparent (SMART) Government Act. The act establishes a new process of performance budgeting for departments, and requires the departments to present and review their plans with a "committee of reference" assigned by the Senate President and Speaker of the House. Committees of reference are charged with making recommendations to departments, and may hold meetings to obtain public testimony on department performance and goals. The SMART Act is an attempt to make the budget process more effective and transparent and also to involve more legislators in budget choices.[54]

Wisconsin's Joint Finance Committee—the unique example in the United States of a joint budget and tax committee—is limited to 16 members out of the 132 Wisconsin legislators. The committee dates back to 1911 and is still the main force behind the Legislature's budget proposal moer than 100 years later (though the number of committee members has changed from 14 to 16). In addition to its role in shaping the budget, the committee has many other functions, such as supplementing appropriations after the budget is passed, adjusting agency staff numbers, and reviewing all revenue and spending bills in the Legislature.[55]

Supermajority Requirements to Pass the Budget

Does requiring budget approval from more than a majority of legislators improve the process? There is little empirical evidence identifying the effects of supermajority vote requirements on the budget process. Nevertheless, such requirements exist in a number of states:

- Connecticut and Hawaii require a supermajority (three-fifths and two-thirds, respectively) to pass the budget if the general fund expenditure limit is exceeded (see Chapter 3 for information on expenditure limitations).
- Arkansas requires approval of three-quarters of legislators on appropriations bills, except for spending on education, highways and paying down the state debt.
- Rhode Island requires a two-thirds majority vote for appropriations for local or private purposes.

Other states require a supermajority vote under specified circumstances. In Illinois, it takes a three-fifths vote in each house to pass budget bills after May 30 each year (an effort to encourage legislators to pass the budget on time).

Until 2010, California had perhaps the most well-known supermajority requirement to pass the budget. In November 2010, however, voters approved Proposition 25, an initiative measure, to eliminate the state's long-standing two-thirds vote requirement. Some groups had been trying do away with the requirement for years. The California Citizens' Budget Commission—a private, nonprofit, bipartisan study group—issued a report in 1995 that advocated eliminating the supermajority requirement.[56] The 1995 report argued the requirement had many negative effects including:

- The requirement did not restrain state spending growth. Small groups of legislators often used the power of minority veto to increase spending in certain areas as often as to reduce spending.
- It encouraged undue compromise both in times of scarcity and of plenty. As the budget deadline approached, trading for votes became more costly.
- It was difficult to establish responsibility and accountability for fiscal decisions.
- There is no observable tendency for states with supermajority requirements to spend less than states with majority requirements.

At the other end of the spectrum are Iowa, North Carolina, and Utah, where the legislatures appoint between two-thirds and all of the members to budget subcommittees. Legislators who are not on the budget committees are on revenue committees so that every legislator has a direct, formal role in budget legislation. This does not mean that every legislator has an equal role in deciding fiscal issues. Such broad participation has required strong leadership roles in each of the three states, and majority rule still prevails.

Most states have found a balance between involving nearly all legislators in budget decisions and one powerful committee.

- In Florida, each subcommittee is allotted a certain funding amount to create a targeted budget. These budgets are presented to the full committee and incorporated into the full proposed budget.
- Subcommittees in Georgia make budget recommendations to the full committee, and legislative leaders are responsible for fitting the final pieces together.
- In Vermont, decisions largely are made by the appropriations and fiscal committees, but the committees make an effort to hold joint hearings, give other committees an advisory role and make information available to all legislators.

There are costs and benefits to a less inclusive budget process. Small committees often are able to reach consensus more easily, and in difficult economic times, small committees may make it easier for legislators to make budget cuts. On the other hand, excluding many rank-and-file legislators may lead to resentment, and could make it difficult to gain support in the full legislature. In most cases, the process seems to function best when everyone can suggest a recipe, but only a few legislators are in the kitchen.

The Need for Effective Leadership

Legislative leaders and the chairs of the budget committees have the essential roles of maintaining a legislative budget schedule and reconciling all budget proposals to produce a balanced budget. This is critical to timely budgeting, and is not just a matter of leaders demonstrating their power. The challenge for fiscal leaders is to make clear to other legislators and the public the necessity of the timely passage of the budget.

Budgets have to be balanced and ought to be completed on schedule. In addition, someone has to pull it all together. Legislatures like those in Iowa, North Carolina, and Utah, where most or all legislators are on budget-writing subcommittees, still require the legislative leadership to make major decisions. In each case, the leadership of the two chambers agrees on budget targets for the budget subcommittees before the process begins. At the end of the process, the leaders reconcile the subcommittee recommendations to produce a balanced budget.

The need for effective leadership in the budgeting process is especially pronounced during difficult economic times. When states must reduce their budgets during a recession, leaders play an important role in prioritizing spending and justifying cutbacks to other legislators and the public.

Communication with the Public

Due to the 24-hour news cycle and widespread Internet access, there is arguably more transparency in government than ever before. The public has many access points to legislative actions and documents, and there are a number of tools legislators are using to connect with the public. Recent innovations that have drastically changed the way legislatures communicate with the public include email and social media. Email allows lawmakers to send information updates to constituents at a low cost, and also gives the public an easy method to voice concern or support for government actions. Social media options such as Facebook and Twitter provide another avenue for lawmakers to share information and gain valuable public input on initiatives. All of these tools allow for expanded and expedited communication with a public that relies heavily on technology for information.

The following are other ways legislators are connecting with the public:

- Many states stream committee meetings live from their websites and archive them.
- Most states make budget documents easily available on state websites.
- Some states, such as Alaska and Vermont, allow the public to testify before joint committees via a statewide interactive television network.
- Arizona, among other states, schedules joint committee hearings on the budget so the public can speak before both the House and Senate committees on Appropriations, which normally meet separately.
- Many states are providing laptops and electronic tablets to legislators. This allows bills and amendments to be streamed instantly to legislators and to the public.

In addition to providing the public electronic access to the budget process and budget documents, many states also engage the public in town hall meetings to discuss the budget. The Joint Committee on Finance in Wisconsin travels the state to connect with the public and gather citizen input on budget priorities. The Oregon legislature also has a history of traveling across the state to gain public insight on the budget, and more recently, of using technology to allow more participation from citizens who cannot travel to the capitol. These efforts not only allow the public the opportunity to comment on spending, but also gives lawmakers the chance to improve the public's understanding of the state budget.

The public has instant access to more information than ever before. But is all of this transparency leading to better governance? While public access to floor debates and committee hearings has created more accountability in the legislature, some legislators question whether it is also forcing lawmakers to make more "behind-the-scenes" deals in order to reach compromises—especially across the political aisle.

As technology continues to improve, it is likely that state governments will become increasingly more transparent. Legislators will continue to find new and innovative ways to communicate with the public, which has the potential to improve the budget process and better align the public's priorities with state spending.

Conclusion

Writing a budget for a state government involves arguably the most complicated and controversial issue in public life: determining how the public's money is spent. Given the number and variety of interests and issues that need to be reconciled for a budget to be completed, it is an accomplishment in and of itself that the process moves along as relatively smoothly as it does year after year. But for many observers, it is the competitiveness, compromises, and incomplete nature of the process that are most striking, not the real accomplishment that every annual and biennial budget represents.

This report has presented some suggestions for easing the budget process at specific points. It has reported on the solutions some legislatures have identified to address problems that most legislatures face. There is no assurance that what works in one state will work in another. State government exists in this country to let individualism flourish, and in budgeting—as in many other areas of state government—there are as many solutions to problems as 50 different groups of creative individuals can invent. The point of this report is not that there is one tidy solution to every problem legislators face in the budgeting process. The point is that there is a great deal of inventiveness to be seen in how states have grappled with the process, and that there is always an alternative to an unsatisfactory process. The NCSL fiscal partners who put this report together hope that it is an encouragement to legislators, staff, and everyone concerned with the state budget process to keep looking for better ways to write budgets, to keep experimenting, and to keep learning from their neighbors.

Glossary of Terms

Appropriation	An authorization by law for the expenditure of funds or to acquire obligations.
Balanced budget	A budget where expenditures do not exceed the amount of cash and revenue available within each fiscal year.
Base budget	The resources needed for the operation of state government that provide for expenses of an ongoing and non-extraordinary nature in the current year or biennium.
Capital budget	The budget for the acquisition or construction of major capital items—including land, buildings, structures and equipment.
Dedicated funds	Revenues assessed and collected for a specific state program.
Expenditures	Payments against appropriations that reduce the cash balance after legal requirements have been met. A fiscal year's expenditures are payments actually made in that fiscal year, regardless of the state fiscal year in which the appropriations were reserved or encumbered for such payments.
General fund	Accounts for all governmental financial resources except those required to be reported in another fund.
Line-item	Specific purpose of an appropriation.
Operating expenses	All operating expenditures that do not meet the personal services and capital outlay classification criteria. These expenditures include, but are not limited to, professional services, supplies, rent, travel, and repair and maintenance.
One-time appropriation	Appropriations for a one-time purpose that are excluded from the base budget in the next budget.
Revenues	Receipts from taxes, fees, assessments, grants and other payments used to fund programs.
Tax expenditure	Any tax provision that exempts in whole or in part certain persons, income, goods, services or property from taxation.

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