AMERICANS FOR PROSPERITY

States Can Unleash Freedom and Reclaim Sovereignty With Structural Balance

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EXECUTIVE SUMMARY

This paper describes model policy for a state structural balance tax and expenditure limitation (TEL), illustrates model policy, and compares it to annual balance and a population-and-inflation-based spending growth cap. Structural balance means that spending and revenue balance over the medium term, not every year. It concludes with design considerations and several legislative adaptations of the model policy in the appendices.

State officials' most basic governing duty is to enact a responsible budget each year (or biennium) while avoiding structural deficits and the buildup of debt. Yet current practices often interfere with holistic budgeting and distract policymakers from adding as much long-term value as they otherwise could. Today's poorly designed budget rules tend to promote excessive short-term tinkering that crowds out other priorities.

Annual balance is the most common budget goal in the states. This legacy rule is simple to explain, but it has many pitfalls. It encourages excessive spending during good years, and during recessions it forces policymakers to choose between immediate spending cuts and tax hikes, evading the balance rule, or being open to federal bailouts. Colorado's Taxpayer's Bill of Rights (TABOR) has a reputation as a "gold standard" budget rule, but it hasn't spread to other states despite many attempts.

Rules-based structural balance is a promising alternative. It provides policy stability even in a dynamic economy. The resulting increase in policy predictability promotes economic growth and reduces stress for policymakers and the public. Policymakers can focus more on higher-value policy than reacting to frequent economic and fiscal shifts. Other countries use it successfully, and members of Congress and state legislators are taking interest. Structural balance can strengthen state sovereignty as fiscal independence reduces the temptations of string-laden federal bailouts.

Policymakers should be realistic about what budget goals can accomplish. They can improve management and create incentives for better budgeting, but many other factors shape the real-world impact of budget rules. Well-designed constitutional provisions are more durable and binding than statutes, although structural balance can advance statutorily in the few states with suitable constitutional provisions.

ANNUAL BALANCE DRIVES UNCERTAINTY, WASTES RESOURCES, & UNDERMINES STATE SOVEREIGNTY

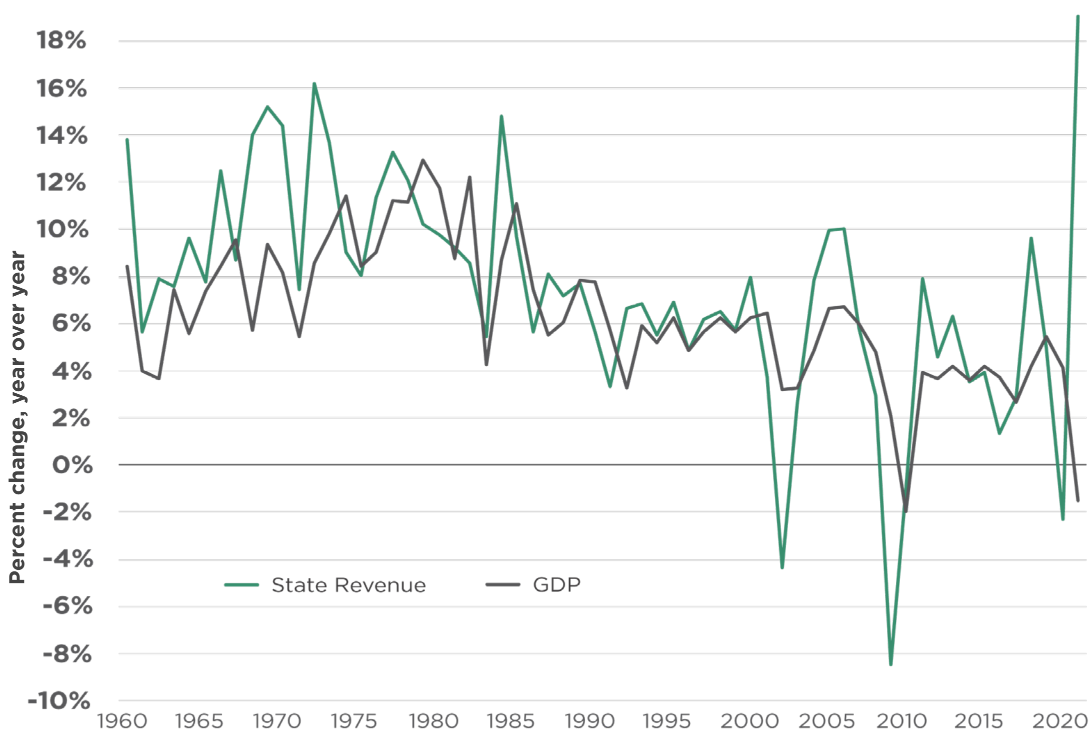
Every U.S. state except Vermont has something close to a balanced budget requirement, but they take many forms and vary in strength. Some are constitutional, some are statutory, and some are both. The balance goal may apply to the governor's proposed budget, to the legislature's approved budget, to the budget signed by the governor (after line-item vetoes), and/or to the executed budget at the end of the year.

Annual balance is the most common target. That is, projected spending for a fiscal year is supposed to be limited to projected revenue for that year. Some states let spending grow with the projected rate of state economic growth.

Dynamic state economies produce variations in revenue, especially in resource-intensive or otherwise less diversified economies. Figure 1 shows that state revenue is more volatile than U.S. gross domestic product (GDP). Business and personal income taxes are much more volatile than GDP, and commodity revenue even more so, while sales and (typically local) property taxes are relatively more stable.

Annual balance forces volatility in revenue collections into policy instability for both spending and revenue. This undermines the predictability that businesses and

Figure 1: State revenue is more variable than GDP



Source: U.S. Census Bureau, Bureau of Economic Analysis households need for productive planning. The risk premium caused by uncertainty reduces opportunity and prosperity, and it comes on top of the direct adjustment costs of frequent policy changes.

Cyclical policy adjustments are relatively poor uses of policymakers' time and energy compared to addressing outdated and conflicting statutes, cutting waste and other low-value spending, ensuring pension solvency, expanding educational freedom, and many other topics. Fluctuating budgets distract legislators from improving structural policy. The opportunity cost of annual balance is high.

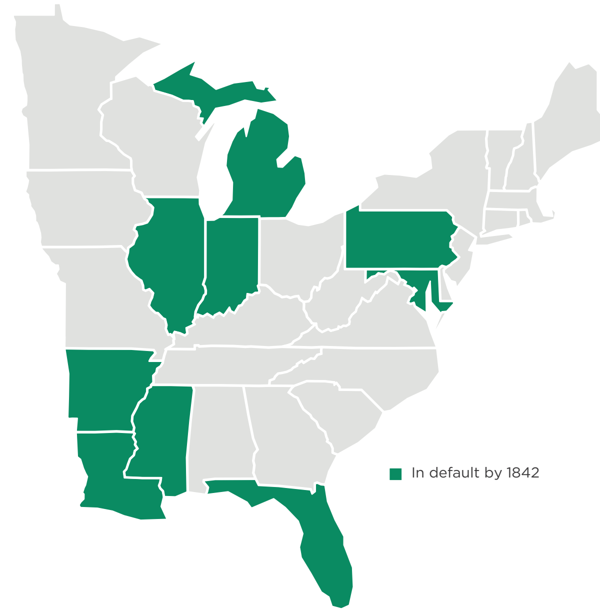
Annual balance also contributes to an erosion of state sovereignty due to federal bailouts. Bailout funds often include strings that encroach on state authorities. States' structural fiscal weakness gives powerful members of Congress more ability to intervene where they don't belong. And worse, state officials' independent judgements might be bent when they anticipate needing to ask Congress for help to fill recession-driven budget gaps.

State legislators today largely inherited their budget rules. States began to adopt annual balance requirements in the 1840s under pressure from creditors. During the 1820s and 1830s, northern states such as Pennsylvania, Ohio, Indiana, New York, and others invested heavily in canal construction, while southern states such as Arkansas, Mississippi, and Alabama borrowed to capitalize local banks.

In the wake of the Panic of 1837, a debt crisis came in 1841. Eight states and the territory of Florida had defaulted by 1842 (see Figure 2). The political and economic fallout led most states to enact hard budget constraints through balanced budget rules, debt limits, and related controls. Other states and new states adopted similar strategies.

Annual balance became the norm long before legislators understood the pattern of economic booms and busts that we now call the business cycle.

Figure 2: State defaults by 1842



Source: Wallis et al; created with historicalmapchart.net

As experience has shown, however, a strict annual balance rule would force state policymakers into one or more of three unpleasant options:

1. **Fiscal consolidation during recessions:** Revenue collections slow down or even decline during recessions due to stagnant or declining income and employment. In addition, annual balance can let policymakers spend too much during the boom years. Then, when a recession comes, bringing high spending back in line with depressed revenue requires significant and disruptive changes through spending cuts, tax increases, or both, adding to the uncertainty and stress of the recession itself.

2. **Deviation from the balance rule:** Rather than major policy changes during recessions, states might just not balance the budget. Some states generally require annual balance but allow tapping into reserve funds to cover shortfalls.

   That's not the only option. Former New York State Comptroller Edward Regan testified to the Senate Judiciary Committee that state annual balance rules *"have tended to push public officials* *into manipulative actions and outright deceptions. Shifting expenditures off budget; manipulating receipt and payment activities; accelerating tax revenues; postponing expenditures; delaying refunds to taxpayers and salaries to employees into the following fiscal year; delaying vendor payments; reducing contributions to pension funds by forcing changed actuarial assumptions; and, borrowing repeatedly against the same assets by refinancing them after the original debt has been mostly repaid."*

A recent study found that states with annual balance rules "frequently reported deficits in their adopted budgets and relied on sizeable and favorable expenditure variances to close budget gaps before the end of the budget period." Many in the public interpret news coverage of these juggling tricks as mismanagement, corruption, or worse. This is toxic to impressions of policymakers' commitment to the rule of law and sound governance. Even if they approximate reasonable fiscal practices overall, questionable kernels find fertile ground for accusations and nasty narratives that can persist long after budgets are back on track.

3. **Federal bailouts:** Receiving funds from the federal government might seem like the most attractive option of all, as it avoids both ill-timed fiscal consolidation and disreputable juggling tricks. Federal bailouts are uncertain, however, and they tend to come with conditions that stick around much longer than the money lasts. This can undermine the balance of power between state and federal governments. State annual balance requirements make it more difficult for states to resist seemingly free money and for their members of Congress to oppose it.

Annual balance produces messy budget management. The scramble for adjustments, transfers, bailouts, and other coping devices feels anarchic, and it makes planning more difficult for residents and businesses as well as for state and federal policymakers.

That said, annual balance has helped states control debt enough to avoid defaulting again (so far), and bond markets generally provide another layer of discipline. Yet annual balance does not support predictable, reasonable ways to build up and draw on reserves over the business cycle without undermining state powers. Annual balance has served a purpose, but it's time for an upgrade.

INFLATION-AND-POPULATION-BASED CAPS AREN'T ADVANCING

Some consider Colorado's Taxpayer's Bill of Rights (TABOR, Art. X, Sec. 20 of the Constitution) to be the gold standard of fiscal rules. The electorate adopted TABOR in 1992 through the state's initiative process on the fourth attempt by author and advocate Douglas Bruce.

The main features of TABOR's nine sections are limiting spending growth within the cap to changes in inflation and population, limiting revenue increases including through voter approval, and rebating most surpluses.

The revenue restrictions ensure that tax burdens are as much a part of the budget conversation as the claimed benefits from spending. TABOR generally requires voters to approve tax increases before they can go into effect. This encourages legislators to find savings during each year's budget instead of waiting to see if the people approve a revenue increase. Expectations for refunds are meant to check wasteful spending by keeping politicians from spending the extra revenue.

TABOR limits state spending growth within the cap to inflation and population growth, plus any revenue increases approved by the voters. This would, if consistently followed, reduce spending as a share of gross state product (GSP). Proponents say that improves prosperity by shifting resources back to the more productive private sector, while opponents say it undermines core public services.

State government spending doesn't have to be a constant share of GSP in the long run, of course, but a rule that *requires* change is different from a rule that *enables* change. Total spending emerges from a series of individually small decisions over time. Government spending—and the revenue to finance it—should provide for public goods within that government's core competencies and where benefits exceed costs at the margin. Legislators can weigh tradeoffs most effectively with a comprehensive budget that includes all spending and all revenue.

Most state government spending is for labor-intensive services. As the private sector becomes more productive and more prosperous, state government compensation must keep up to attract and retain a competent workforce. Beyond the near term, maintaining current government services implies that spending rises with general economic growth. To the extent that current activities don't provide greater value than costs, legislators should pare them back. At some point, however, further overall funding reductions would reduce net benefits from core services.

As a result, many Colorado politicians look for and sometimes find ways around TABOR. They test its limits, and sometimes they challenge it directly, including through the initiative.

Elsewhere, an inflation-and-population-based spending limit hasn't caught on. The state of Washington tried it from 2000 to 2007 and then switched to a rolling average of growth in state personal income. Numerous efforts to enact such rules in other states have failed. In 2022, for example, some Republicans and all Democrats blocked the Taxpayers Protection Act in the Republican-controlled Pennsylvania House.

As a policy matter, holding spending growth to inflation and population growth—to produce constant real, per capita state spending—may be a good *outcome* for one or several years. This may be especially so in high-spending states with many opportunities for savings. In some cases, spending growth could be less or even negative in nominal terms.

Yet *outcomes* and *goals* are distinct. Constitutional goals should be designed to last indefinitely and to accommodate changing circumstances. Imagine if the federal government returned broad authority to the states on health, education, and other topics. No state currently lacks bloat and waste, yet sooner or later, states that drive aggressively toward efficiencies would reach an equilibrium where further savings begin to undermine core responsibilities.

STRUCTURAL BALANCE OPTIMIZES ACROSS FISCAL POLICY GOALS

Structural balance is a promising alternative to annual balance. It can improve budget management and strengthen federalism with or without revenue restrictions. Like most constraints on those who pass the laws, constitutional provisions are most likely to keep legislators from undermining them. Still, legislators can amend statutes faster and more easily, so states with decent but vague constitutional provisions can benefit from legislation based on structural balance principles.

Structural balance simply means that spending and revenue *trends* stay together. A dynamic economy creates noise around those trends. Rules for structural balance can cancel most of the noise and let policymakers focus more on the trends. Figure 3 shows how this allows stable expenditure and revenue *policies* despite volatile revenue *collections* as fixed policies produce more revenue during booms than during busts.

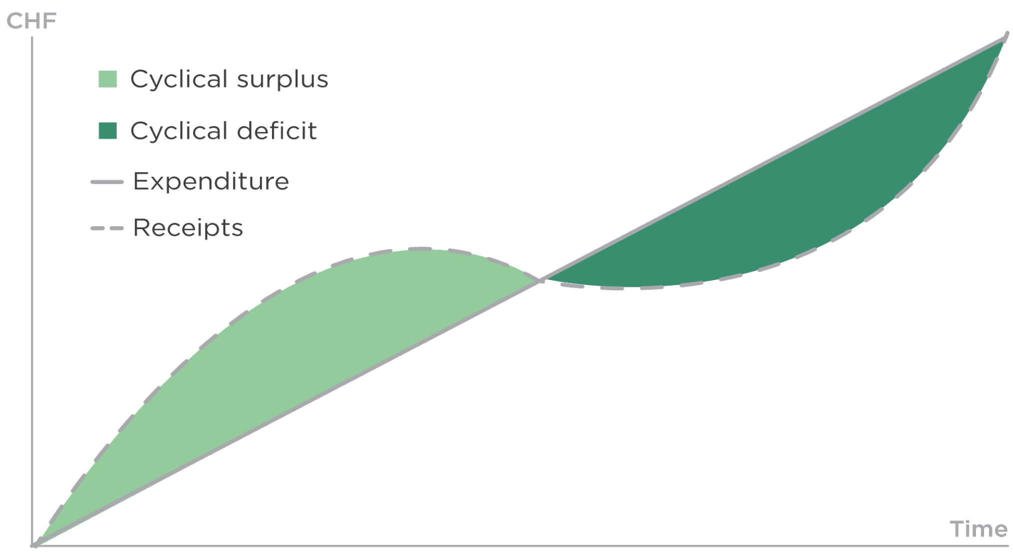
In practice, as discussed, states already try to do this to some degree. They save for a rainy day during the good years and draw from reserves during downturns and emergencies. But states generally do so within annual balance rules. Riding revenue waves over the business cycle while attempting annual balance is reactive and messy. Policies often end up half-baked, and the urgency of closing budget gaps displaces other, higher priorities.

Structural balance is more stable and predictable than annual balance

Structural balance substantially reduces spending limit variation compared to annual balance.

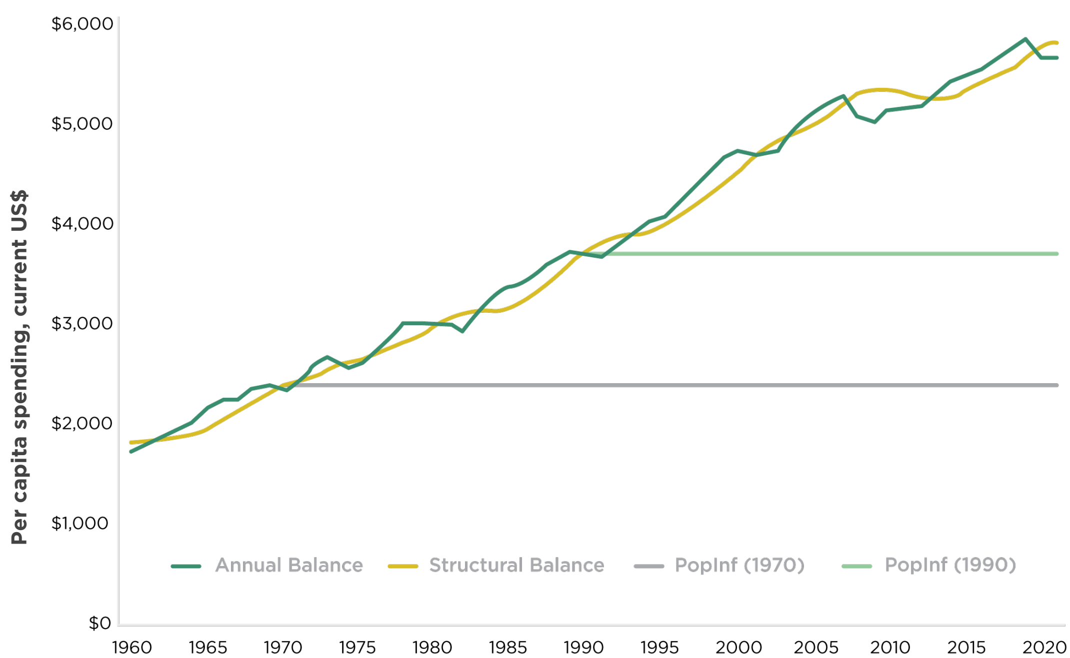
Figure 4 compares the structural balance model described later in this paper with an approximation of annual balance and inflation and population

Figure 3: Consistent path of expenditure and cyclically dependent receipts



Source: Swiss Confederation

Figure 4: Structural balance keeps spending trends smooth



Source: FRB of St. Louis, author's calculations growth limits, all at a constant percentage of real (inflation-adjusted) spending per capita. Structural balance and annual balance are set at 10 percent of GDP to ease illustration. It's also close to median combined state-and-local revenue in the U.S., excluding federal transfers.

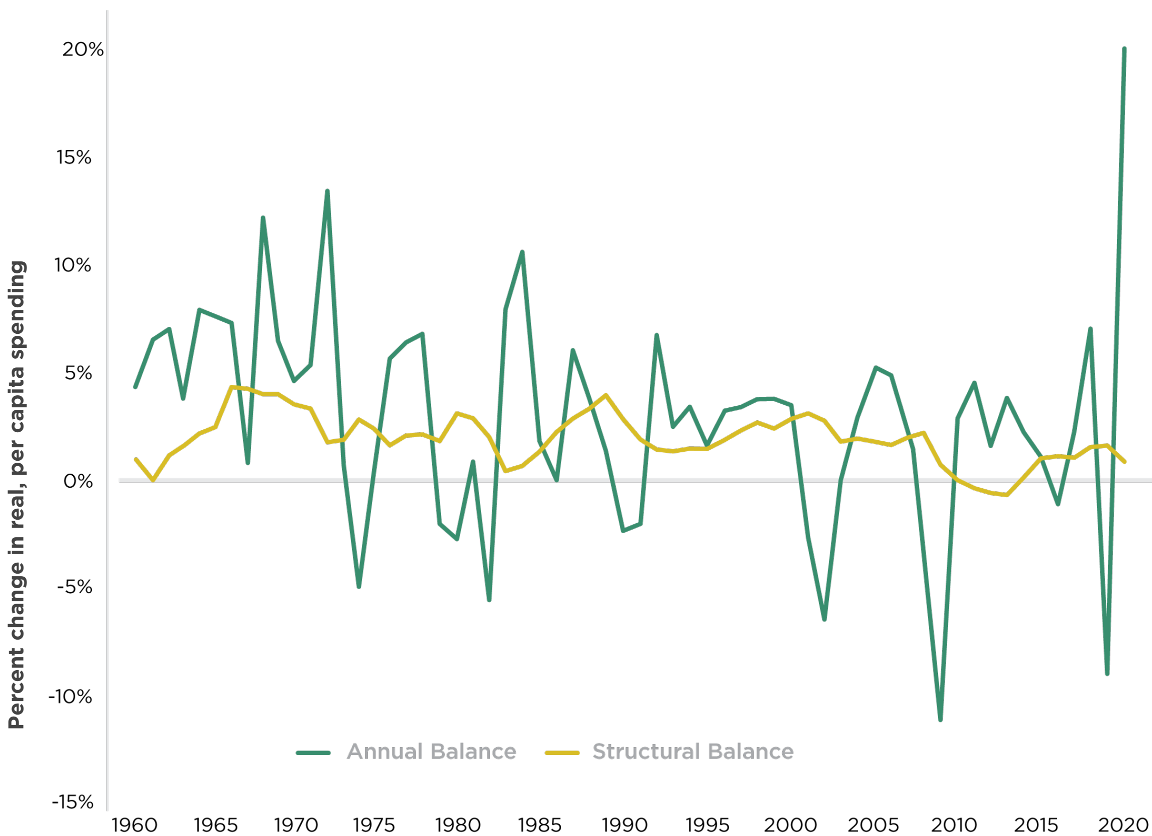
Annual balance (the green line) would vary even more depending on tax policy. Personal income and especially business income tax collections are much more volatile than GDP. Structural balance (yellow line) filters out most of the noise and lets spending trends unfold more smoothly. An inflation and population growth cap would be even smoother (if followed), but it would require substantial policy changes compared to current services.

Figure 5 compares the annual variation between modeled structural balance (yellow) and annual balance (green) based on actual state revenue. Again, swings under annual balance would be larger, perhaps much larger, if more reliant on more volatile sources of revenue. Strictly following annual balance would produce wild swings in inflation-adjusted, per-capita spending with little warning. Structural balance's movements around the trend are much smaller.

Model policy for structural balance

States can pursue structural balance in several different ways. They could rely on estimates for what revenue would be if the economy were on trend ("potential GDP"), although that leaves opportunities for projection games and mistakes. They can rely on personal disposable income growth, personal income growth, or economic growth generally. A rolling average of growth to dampen volatility could rely on three, five, or more years. This paper is based on a specific model policy.

Figure 5: Structural balance dampens budget volatility



Source: FRB of St. Louis, author's calculations

The full text of the model policy is in Appendix A. The spending rule has three parts: general spending growth, a deficit brake, and provisions for emergency spending and its offset. The model policy also includes revenue restrictions, a reserve fund, implementing authority, and an effective date.

General spending growth: Spending can grow from the prior year's authorized spending based on a five-year rolling average of GDP growth. The five-year rolling average reflects the average but variable length of expansions (trough to peak) of slightly more than five years between post-World War II recessions, which in turn last about 10 months (peak to trough). A five-year lookback will tend to incorporate most phases of the business cycle—which don't line up neatly with fiscal years—while being recent enough to stay relevant to legislators. In states where legislator turnover is high from term limits, competitive politics, or otherwise, structural balance can be especially valuable as a supplement to institutional memory.

A shorter or longer period would reflect different tradeoffs between policy stabilization and more recent economic trends. A longer period would reduce business cycle fluctuations even more, but it could let spending and revenue trends diverge longer than ideal. Conversely, a shorter period would tighten the feedback cycle, but it would increase economic volatility's impacts on budgeting, thereby leading to greater instability for spending and revenue policies.

GSP data for the last quarter of the five calendar years prior to the budget year comes out at the end of March, in time for most state budgets. Even with earlier budgeting in some states, economic growth in 19 of 20 quarters for those years is fully known by then. That minor uncertainty is nothing compared to economic projections that look to the future. State personal income data is available on a similar timeline.

This backward-looking rule lets spending continue trend growth during recessions. It incorporates recession-era GDP changes when setting spending caps for the boom years between recessions. It is mildly countercyclical, not simply neutral: it limits overspending during the good years while providing a little extra room in the budget during recessions.

Greater policy stability could help bring off-budget spending and revenue into the annual or biennial budget cycle. Pennsylvania's "shadow budget" describes the two-thirds of spending that is excluded from annual appropriations legislation. Frequent changes from unstable, reactive annual balance encourage policymakers to shield certain programs from scrutiny by removing them from the regular process. Reasonable budget targets like structural balance would help bring these programs back into the light and let policymakers manage the entire budget.

Deficit brake: Deficits would reduce the rolling average growth rate a little. In the model policy, each deficit year would reduce spending growth by 0.2 percentage points, and each surplus year would let it rebound at the same rate (0.2 percentage points) to the rolling average.

This would happen on a lag. Suppose that the five-year rolling average in GDP growth is always 5%. After a deficit in a fiscal year ending June 30, budget and appropriations legislation for the new fiscal year should already have been enacted, perhaps several months earlier. Rather than reopening the enacted budget, the deficit brake would reduce the next fiscal year starting a year later, so spending growth would be held to 4.8%. That gives agencies, the governor, and legislators a reasonable chance to consider how best to adjust the budget in the planning, proposal, and deliberation phases.

Likewise, a second year of deficits would allow spending growth in the following year of 4.6%. Assuming the next two years have surpluses, spending growth would go up to 4.8% the next year and then back to the 5% trend in the second year. This spending slowdown lets revenue catch up.

The model policy also permits an increase in revenue to adjust the spending limit. This has political and policy benefits. On the political side (discussed further below), this option helps build support among more marginal votes in a legislature whose buy-in is needed to adopt and sustain fiscal rules. On policy, converting tax preferences to spending programs can improve transparency and accountability, among other goals. For example, appropriating for education savings accounts through the annual budget might provide families more educational freedom and flexibility than an education tax credit program.

The deficit brake is the link between spending and revenue that keeps their trends from separating. Whether a separation is due to policy action or underlying economic factors, the deficit brake brings the trends back together within a few years.

Emergency spending offset: The model policy would allow two-thirds of legislators present and voting to declare an emergency and to spend for a crisis immediately without offsets. It would then require the offset of that emergency spending equally over the following six years. This is easier to sustain with the model policy in constitutional rather than statutory form.

Emergencies are sudden, unexpected threats to life, liberty, and property. They tend to require immediate responses to minimize harm, so they are not well-suited to a deliberative process in the context of the overall budget. Time is of the essence.

Yet the urgency of emergencies can let agenda setters' narrow priorities ride along without much challenge. After all, people are hurting. Emergency response legislation may become a vehicle for fiscal irresponsibility, and when less justified spending merely adds to state debt, most legislators don't feel like it competes with their other priorities.

This model policy therefore allows immediate emergency response while requiring equal offsets over the subsequent six years. A $600 million emergency this year would require the spending level in the next six years to be $100 million less than it otherwise would have been under the spending rule. Wasteful spending would have a harder time riding on an emergency response when it would put pressure on other legislators' priorities for the foreseeable future.

Revenue limits: Explicit revenue limits are compatible with structural balance. States with constitutional revenue limitations can still upgrade annual balance rules to structural balance.

States could adopt one or both optional revenue limitations in the model policy when adopting a structural balance tax and expenditure limitation (TEL). A legislative supermajority for revenue increases is one option. The other is voter approval of legislature-referred or citizen-initiated revenue increases, which could be by a simple majority or a higher threshold.

Such revenue restrictions are, however, optional because they can create challenges and might not even be necessary. Structural balance would substantially reduce the pressure to increase taxes to meet budget targets in the first place.

Moreover, states could avoid these complications by doing more to control spending. Nonetheless, they are worth exploring.

Either revenue limitation could narrow the potential coalition of support to enact and sustain a structural balance TEL. This could delay or derail its adoption entirely, leading a state to miss out on the benefits of structural balance.

A legislative supermajority to increase revenue could complicate budgeting. States might have to choose between, on the one hand, a comprehensive budget that includes all spending and revenue needing supermajority support to pass or, on the other, budgeting that separates spending and at least some revenue components.

Likewise, referring proposed revenue increases for voter approval separates a piece of the budget picture from the annual legislative process, at least in that year. The legislative calendar suggests that any revenue increase would be for the following fiscal year. Most state fiscal years begin on July 1 and state legislative sessions often conclude before the new fiscal year begins. Voter approval in November would be four months into the fiscal year and long after many legislative sessions have concluded, but it would come just in time for the next budget cycle.

In addition, the model policy's revenue limitations apply to "a net increase in revenue." This would allow revenue-neutral or -reducing tax changes to proceed without a supermajority requirement and/or voter referral.

Finally, states that can enact revenue limits probably also have preferences for leaner governments that provide fewer services and collect less revenue. That is, the ability to enact revenue limits and the reality of lower spending and tax burdens often stem from the same underlying political culture. The limits could be merely correlated with policy outcomes instead of causing them. Revenue restrictions might have more impact in competitive states, however.

Reserve funds: The model policy proposes a single reserve fund for downturns and emergencies. Most states already have some assortment of reserve funds, rainy day accounts, taxpayer relief funds, and so on. In practice, minor adjustments could coordinate one or more with a structural balance TEL without needing to create an entirely new fund.

The model policy suggests a cap on funds in the reserve account before policymakers use further surpluses to reduce revenue, debt, or other liabilities. That cap is tied to a percentage of the current spending limit. The bracketed placeholder of 15% is higher than many existing caps and even higher than many state rainy day funds (see Table 26B). Yet structural balance is designed to dip into the official reserve account during recessions and emergencies rather than various pots of money, so many states might prefer a higher cap or none at all (e.g., Alaska and Wyoming).

Implementation and effective date: The model policy explicitly empowers state legislatures to enact statutes to carry out this proposed constitutional amendment. This may not be necessary in states where the legislature's authority to enact implementing legislation for constitutional provisions is clear and known.

The effective date is "for the fiscal year that begins not less than 60 days following its adoption." States generally ratify constitutional amendments through voter approval. State fiscal years begin on July 1 (46 states), April 1 (New York), September 1 (Texas), and October 1 (Alabama, Michigan). As long as ratification occurs in a November general election, the 60-day delay for an effective date doesn't matter. The delay needs to be included only if a state would have a ratification vote at some other time, simply to ensure policymakers have time to adjust to the new targets.

Structural balance is catching on

Structural balance is a rule-of-law approach to managing the natural wax and wane of budgetary resources over the business cycle around a trend. It promotes policy stability within a dynamic economy. This reduces the opportunity costs of balance rules by letting policymakers focus more on adding value than on reactive tinkering. A more predictable and less chaotic approach to budgeting should also give the public more confidence in their representatives.

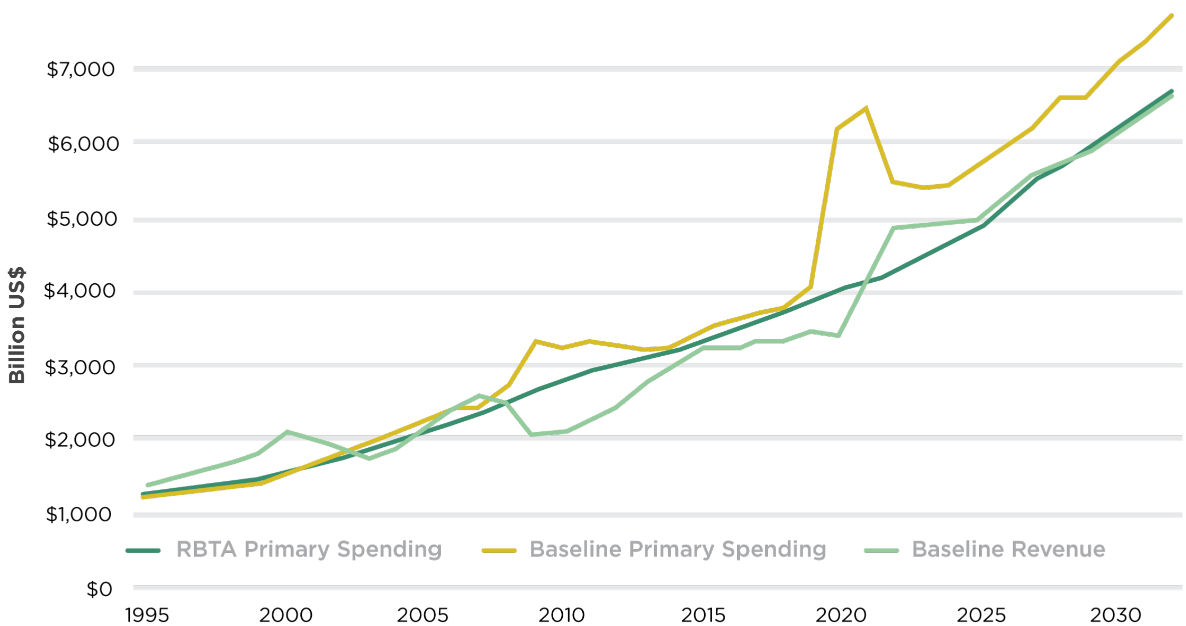
Other countries already do this. Switzerland's debt brake combines principles in the constitution with detailed implementing legislation. It relies on estimates of "potential GDP" to cap spending at the level that revenue would be if the economy were at full employment. It requires the national government to offset cyclical deficits as well as emergency spending through a pair of notional tracking accounts. In effect since 2003, the debt brake has helped Switzerland get control of its then-growing debt burden. The Swiss people's support is overwhelming: "85% of voters approved the constitutional provision on the debt brake in 2001, and approval is still very high according to surveys."

Structural balance is gaining ground in Washington, D.C. Representative Jodey Arrington and Senator Mike Braun introduced the Business Cycle Balanced Budget Amendment in March 2022. This innovative BBA without the problems of traditional BBAs was originally proposed in 2011 and had a broad, bipartisan set of cosponsors in the 112th Congress, with 45 Republicans, including Tea Party members, and 14 Democrats, including progressives. Separately, a bipartisan "principles-based" BBA provides broad scope for implementing legislation, including structural balance targets.

For federal statutory targets, Braun and Representative Tom Emmer introduced the Responsible Budget Targets Act (RBTA) in April 2022. This legislation would let primary spending (excluding interest) grow with a five-year rolling average of GDP, subject to a deficit brake, and requires subsequent offsets for emergency spending. Figure 6 compares the RBTA as if it were enacted in 2001 to actual and projected spending and revenue, taking the revenue path as given. RBTA's design resembles the state-based model proposed here.

In the Arkansas state legislature, Representative David Ray and Senator Ben Gilmore proposed a bill "to limit the increase in general revenue expenditures from year

Figure 6: RBTA would promote federal policy stability



Source: CBO, author's calculations

to year; and to create a nexus between the amount of general revenue expenditures and the growth of the state disposable personal income." Specifically, the bill would cap spending growth with the five-year rolling average of growth in total state disposable income, with exceptions for emergency spending.

The American Legislative Exchange Council considered and approved a [Statement of Principles on Balancing Budgets Over the Business Cycle] in December 2021. The design considerations in that statement of principles are consistent with the model policy discussed here.

Whether applied to budgets of federal or state governments, structural balance simply means that spending grows according to a rule so the budget balances over the medium term. It combines long-term fiscal responsibility with near-term flexibility and policy stability over the business cycle: Surpluses during the good years offset deficits during lean times. Structural balance generally eliminates major fiscal consolidations during recessions when they are most politically difficult.

Structural balance can attract and empower broad coalitions

To achieve the goal of structural balance, annual spending caps float with economic and revenue changes. It isn't a rule that attempts to force any specific vision for the size and scope of government, only that balance is achieved in a reasonable way. Structural balance can work in Atlanta or Albany, Topeka or Trenton, Lansing or Little Rock. In principle, every state could adopt structural balance, from R+25 Wyoming to D+16 Vermont.

A crucial advantage for structural balance is that it is calculated from known, recent data. Spending isn't tied directly to projected revenue in the same year. Instead, spending grows based on a rolling average of recent economic growth, adjusted for recent deficits. Structural balance has a firm, reality-based foundation that doesn't rely on the uncertain and easily gamed projections that most states currently use. Structural balance is far more immune to gaming.

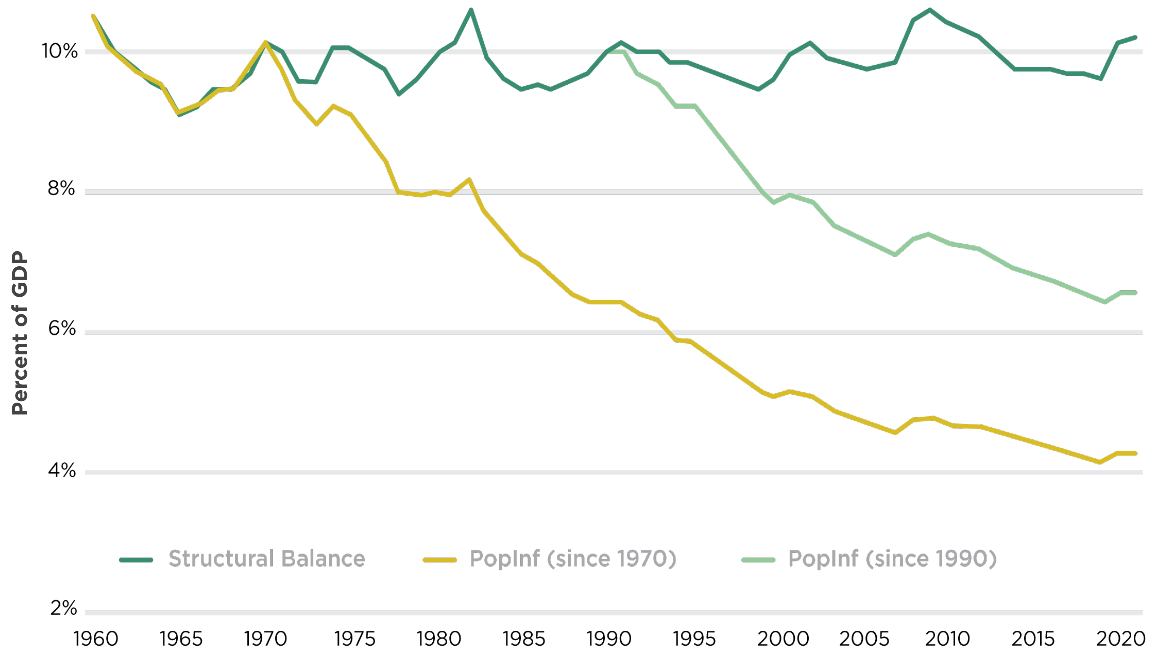
Greater policy stability would let legislators focus more on other priorities. Policymakers wouldn't have to sort through reactive fiscal adjustments driven by economic fluctuations, certainly not several times per year as happens in some states.

Moreover, when spending is based on prior economic growth and budget balance, policymakers have advance notice to develop policy options and familiarize colleagues with them. Slower growth might increase the urgency and acceptability of cost savings legislation in pensions, in health care, and ending narrow tax breaks, while providing more opportunity to build the necessary coalitions.

Conversely, robust growth expands the fiscal space for pro-growth tax reform, to cover any transition costs for new educational freedom initiatives, and much more. Structural balance encourages policymakers to grow the state economy through fiscal, regulatory, and other reforms because GDP growth expands policymakers' options. Policymakers are familiar with the economy's recent performance, so they would usually have a year or two to develop policy proposals tailored to current fiscal and economic conditions.

Structural balance can help states rebalance their relationships with the federal government. It helps states build reserves during booms that can be tapped during busts, which gives states more fiscal independence from the federal government. States that don't need bailouts can more easily refuse federal funds and the strings that come with them. Members of Congress would feel less pressure to support bailouts. This can give state officials more confidence to challenge federal overreach broadly.

Figure 7: Structural balance allows long-term stability



Source: CBO, Census, author's calculations

Structural balance gives policymakers long-term stability. Figure 7 compares spending as a percentage of GSP for the structural balance model policy described previously with a spending cap based on inflation and population.

Structural balance (dark green) would fluctuate around a constant percentage of GSP, here set at 10 percent of GSP. The seeming fluctuation is mostly driven by changes in the rate of economic growth, as the dark green line here is the percent-of-GDP version of the same green line in Figures 4 (per capita, inflation-adjusted *levels*) and 5 (per capita, inflation-adjusted *changes*). By contrast, an inflation/population rule would (if followed) reduce spending as percentage of GSP by nearly 60% if adopted in 1970 or nearly 40% if adopted in 1990.

State policymakers can and should seek opportunities to improve the value that state residents get from their governments. Technology, rising prosperity, educational freedom, health and pension reforms, and many other options can help states realize more efficient, effective services. Achieving those savings becomes easier under structural balance, which can adapt as needs and circumstances change. It may not be feasible, however, to drive continuous savings every year.

Again, structural balance is consistent with revenue limitations but does not require them. The model policy includes options for a supermajority to raise revenue or to require taxpayer approval of revenue increases. It may be, however, that a state where revenue limits could be adopted is likely to be a state with preferences for lower spending and lower taxation in the first place. Moreover, revenue limitations could complicate annual budgeting in states that include (or aspire to include) all spending and revenue in a single bill each year (or biennium) as we discuss elsewhere and above.

Legislative language for structural balance

The mechanisms for adopting structural balance vary from state to state. Almost all have annual balance requirements, but they differ in form and strength.

Appendix A sets out the model policy described above. Its provisions can adapt to the diverse norms, drafting conventions, and existing institutions of the states. These adaptations can take various forms, however, so this section explores several options.

Constitutional provisions are likely to be the most politically sustainable. They don't let the legislature simply change the rules by passing a new statute whenever it becomes convenient. In some states, however, the constitutional provision is written well enough, if a bit vague. Statute could fill in the details. That isn't as binding as a clear constitutional rule, but it's faster and easier to enact, and it should be politically sustainable as a reasonable extension of a constitutional provision.

Structural balance proposals must interact with existing statutory and constitutional language. Kansas, for example, has no existing constitutional fiscal rule. Starting from a blank sheet of paper makes it easier to draft, and Appendix B includes possible language for a constitutional amendment for Kansas. It resembles the model policy in Appendix A, adapted to the tone and form of the Kansas Constitution.

Pennsylvania's constitution requires annual balance. The proposed changes in Appendix C would replace annual balance with structural balance and build on an existing provision for reserve funds. This language maintains the distinction between "operating budget appropriations," and "capital budget appropriations," although it would be possible to apply structural balance to the expenditure of all non-federal funds.

South Carolina's constitutional provision is directionally good but vague. It lets spending grow with state economic growth and explicitly leaves the details to statute. Appendix D has recommendations for modifying the applicable statute to create structural balance via statute based on a constitutional foundation. Hawaii's constitutional provision is similar and could likewise support a statutory structural balance provision. Statutory supermajority requirements are unlikely to be sustainable when a new law can simply suspend, amend, or repeal them.

The appendices are first-draft suggestions to encourage further discussion, not presumed-to-be-final language. Inputs from the political dynamics, legal climate, and other aspects of specific states are important contributors to shaping the form of any successful proposal.

CONCLUSION

Annual balance forces policymakers into fiscal consolidation during recessions, shady maneuvers inconsistent with the spirit if not the letter of the law, accepting string-laden bailouts from Congress, or some combination. It fosters policy instability and displaces higher-value policies on the legislative agenda.

Spending caps based on inflation and population growth haven't been able to spread much beyond Colorado. Washington state abandoned it, and other states haven't been able to get it enacted. That approach to a spending growth limit would force continuous savings that could eventually squeeze core services of state governments.

Structural balance can provide both short-term policy stability and long-term fiscal responsibility. It can improve state budget management and help states reclaim their proper spheres of authority in our federal system. Structural balance can help state governments steer through a dynamic economy, providing residents the certainty they need to go about living their lives. Structural balance can improve policymakers' ability to advance higher value policy for their states while minimizing short-term tinkering, thereby delivering more results for the public they serve.

Several countries have embraced structural balance. Federal policymakers hope that structural balance can succeed in being enacted where annual balance proposals have fallen short. State legislators are increasingly interested in the benefits that come with structural balance. Annual balance has served a useful purpose, but upgrading state budgeting with structural balance can help states address today's challenges while embracing tomorrow's opportunities.

APPENDIX A: MODEL POLICY FOR A STRUCTURAL BALANCE TEL

Summary:
A well-crafted Tax and Expenditure Limitation (TEL) promotes policy stability for core state government functions even with a volatile economy while encouraging thoughtful stewardship of taxpayer resources. The Responsible Budgeting Act (below) is a constitutional proposal designed to accomplish these objectives. The Act includes a spending limit that reflects trend economic growth with a deficit brake, a provision for emergency spending, a reserve fund and disposition of excess revenue, and limits on raising revenue.

A Next-Generation Tax and Expenditure Limitation Act

Short Title: Responsible Budgeting Act.

Section 1. Structural Balance

(a) Sense of the Legislature: Stewarding taxpayers' funds requires a close connection between spending and revenue. Structural balance provides this link over the medium term instead of each year to provide policy stability, secure the rule of law, and preserve the state's fiscal independence. This structural balance spending limit generally lets spending grow along with a rolling average of the state's economic growth and includes a deficit brake that adjusts the spending limit to maintain the bond between spending and revenue.

(b) The limit on fiscal year spending equals enacted spending in the prior fiscal year increased by the structural balance factor.

(1) The structural balance factor is the difference between—

(A) The average rate of growth of gross state product during the five calendar years preceding the regular legislative session and

(B) The deficit brake.

(2) The deficit brake—

(A) Has an initial and a minimum value of 0,

(B) Increases by 0.2 percentage points, cumulatively, for the upcoming fiscal year after a fiscal year when spending was more than revenue, and

(C) Decreases by 0.2 percentage points, cumulatively, for the upcoming fiscal year after a fiscal year when spending was less than revenue.

(c) The legislature may adjust the limit on fiscal year spending—

  (1) To reflect enacted changes in revenue collections, or

  (2) To provide for emergencies under Section 2.

(d) The terms "revenue" and "spending" include all funds, accounts, and other moneys received (other than borrowed funds) and expended by the state, excluding the receipt and expenditure of funds transferred from the federal government.

Section 2. Emergency spending.

(a) The legislature may authorize spending in excess of the limit otherwise applicable in section 1 through legislation that includes an emergency declaration describing the situation and which obtains the support of two-thirds of the members present and voting of the Senate and the House of Representatives.

(b) Emergency spending shall be offset by equal reductions in the spending limit for each of the subsequent six fiscal years.

(c) Neither emergency spending nor its subsequent offset shall otherwise affect the basis for calculating subsequent spending limits under Section 1.

(d) An emergency is a sudden, urgent, unforeseen, and temporary situation that requires immediate expenditure to preserve the health, safety, and general welfare of the people.

Section 3. Reserve Fund

(a) In General.—Budget surpluses shall be deposited in a reserve fund. Interest and other earnings on the fund shall accrue to the fund.

(b) The reserve fund and current revenue shall support spending within the limit established in Section 1, including emergency adjustments.

(c) When the reserve fund equals [15] percent of the current spending limit, further surpluses shall reduce general debt or, as the legislature may direct, other liabilities of the state. Surplus revenue used to reduce state liabilities shall be excluded from the spending limit in section 1.

Section 4. Raising Revenue [optional]

(a) Legislation to enact a net increase in revenue shall require the approval of two-thirds of members from each of the House of Representatives and the Senate.

AND/OR

(b) Legislation to enact a net increase in revenue shall be referred to and shall require the approval of the state's electors in the next regularly scheduled general election. No such proposed revenue increase shall take effect, nor may the limit on fiscal year spending be increased pursuant to Section 1(b)(1), unless and until the Secretary of State certifies that such a referendum has been approved by a majority of electors.

Section 5. Implementation and Effective Date.

(a) The legislature shall have power to enact legislation to implement and enforce provisions of this Article.

(b) This Article shall take effect for the fiscal year that begins not less than 60 days following its adoption.

APPENDIX B: KANSAS – A NEW CONSTITUTIONAL PROVISION

Kansas' constitution has no constitutional spending limit, TEL, or balanced budget requirement. A new provision language can be inserted without amending existing provisions. The provision would apply to all state spending but not federal funds.

At the end of Article 11, insert the following new section, with the blank space to be filled in with the next available section number:

Section _. Requirement for Structural Budget Balance.

(a) In general. State spending may exceed the prior year's spending by trend growth in gross state product, adjusted to keep spending and revenue trends in balance. The spending limit may adjust for enacted revenue changes and for emergencies. State spending excludes federal funds.

(b) Emergency spending. Two-thirds of both houses of the Legislature may adjust the spending limit for emergencies. Such emergency spending shall be offset by reducing the limit by equal shares in the following six years, or over such other reasonable period as the Legislature may determine by statute. Neither emergency spending nor its offset shall otherwise affect the calculation of the spending limit.

(c) Reserve fund. Surplus revenue shall accrue to a reserve fund. It shall be available for emergencies and to supplement revenue up to the spending limit. When the reserve fund is full, as determined by statute, further surpluses shall reduce general debt, or as the Legislature may direct, other liabilities of the state, and such liability reductions shall not be considered state spending.

APPENDIX C: PENNSYLVANIA – AMENDING THE CONSTITUTION

Pennsylvania's constitution requires annual balance in sections 13 and 14 of Article VIII. Existing provisions could be modified along the lines indicated below with proposed deletions struck and in red font and with proposed insertions italicized and in blue font. Here the distinction is preserved between the commonwealth's operating budget and the capital budget.

That Article VIII be amended by revising sections 13 and 14 to read:

§13. Appropriations

(a) Operating budget appropriations made by the General Assembly shall not exceed the ~~actual and estimated revenues and surplus available in the same fiscal year~~ *prior fiscal year's operating budget appropriations, as increased by the structural balance growth rate.*

(1) The structural balance growth rate shall equal—

(A) The average growth rate of gross state product over the prior five years,

(B) Minus the structural balance factor.

(2) The structural balance factor shall—

(A) Increase, cumulatively, by 0.2 percentage points for the next fiscal year beginning after a year when total appropriations exceeded total revenue.

(B) Decrease, cumulatively but not below zero, by 0.2 percentage points for the next fiscal year beginning after a year when total revenue exceeded total appropriations.

(b) The General Assembly shall adopt a capital budget for the ensuring fiscal year.

§14. Surplus.

~~All surplus of operating funds at the end of the fiscal year shall be appropriated during the ensuing fiscal year by the General Assembly.~~ *The Commonwealth shall deposit all surplus of operating funds into a reserve account, from which the General Assembly may draw funds to finance spending up to the limit on appropriations set forth in §13.*

APPENDIX D: SOUTH CAROLINA – IMPLEMENTING A CONSTITUTIONAL PROVISION

Article X, Section 7(c) of South Carolina's constitution says:

> The General Assembly shall prescribe by law a spending limitation on appropriations for the operation of state government which shall provide that annual increases in such appropriations may not exceed the average growth rate of the economy of the State as measured by a process provided for by the law which prescribes the limitations on appropriations.

Like the U.S. Constitution, state constitutions can set forth general principles and leave the details to statute. Of course, that requires a well-crafted statute. South Carolina's related statute is closer to structural balance than other states, so a few changes can get it the rest of the way there.

SECTION 11-11-410. Appropriations subject to spending limitation; financial emergency; surplus funds.

(A) State appropriations in any fiscal year may not exceed appropriations authorized by the spending limitation prescribed in this section. State appropriations subject to the spending limitation are those appropriations authorized annually in the State General Appropriation Act and acts supplemental thereto which fund general, school, and highway purposes. A statement of total "General, School, and Highway Revenues" must be included in each annual General Appropriation Act. As used in this section the appropriations so limited as defined above must be those funded by "General, School, and Highway Revenues" that must be defined as such in the 1985-86 General Appropriation Act; it being the intent of this section that all additional nonfederal and nonuser fee revenue items must be included in that category as they may be created by act of the General Assembly.

(B) The limitation on state appropriations prescribed in subsection (A) is an amount equal to ~~either~~ those state appropriations *provided under* ~~authorized by~~ the spending limit for the previous fiscal year increased by the average percentage rate of growth in state personal income for the previous ~~three~~ *five* completed calendar years ~~or nine and one-half percent of the total personal income of the State for the calendar year ending before the fiscal year under consideration, whichever is greater.~~ As used in this section, "state personal income" means total personal income for a calendar year as determined by the Revenue and Fiscal Affairs Office or its successor based on the most recent data of the United States Department of Commerce or its successors. ~~During the initial year this spending limit is in effect, the actual state appropriations for general, school, and highway purposes for the fiscal year 1985-1986 must be used as the base figure for computation of the spending limitation if the average rate of growth method is used.~~ *The increase in the limitation shall be reduced by 0.2 percentage points, cumulatively, after each fiscal year deficit, and such reduction shall be reduced by 0.2 percentage points, cumulatively, after each fiscal year surplus, but in* *no case shall the increase in the limitation exceed the average percentage rate of growth in state personal income for the previous five completed calendar years. The General Assembly may adjust the spending limitation to reflect an enacted change in revenue collections.*

(C) The Comptroller General, or any other authorized agency, commission, or officer, may not approve or issue warrants which would allow disbursements above the amount appropriated for general fund purposes unless and until the General Assembly authorizes expenditures in excess of the limitation through procedures provided for in this article. This subsection may not apply to funds transferred from the reserve fund to the general fund.

(D) The Revenue and Fiscal Affairs Office shall annually compute and certify to the General Assembly a current figure to limit appropriations as provided in subsection (B) of this section prior to the Governor's submission of his recommended budget to the House Ways and Means Committee.

(E) Notwithstanding the provisions of subsection (A) of this section, the General Assembly may declare a financial emergency and *adjust* ~~suspend~~ the spending limitation for any one fiscal year for a specific amount by a special vote as provided in this subsection by enactment of legislation which relates only to that matter. The authorized state appropriations for the fiscal year following the *adjustment* ~~suspension~~ must be determined as if the *adjustment* ~~suspension~~ had not occurred and, for purposes of determining subsequent limits, must be presumed to have been the maximum limit which could have been authorized if such limitation had not been *adjusted* ~~suspended~~. *Emergency appropriations shall be offset by equal reductions in the spending limit over the subsequent six fiscal years, and like the prior sentence, such offset shall not otherwise affect the computation of the subsequent limits.*

The special vote referred to in this subsection means an affirmative vote in each branch of the General Assembly by two-thirds of the members present and voting but not less than three-fifths of the total membership in each branch.

(F) In any year when surplus funds are collected, such revenue surplus may be appropriated by the General Assembly to match funds for public education, public welfare, public health, road and highway construction, rehabilitation, replacement, or maintenance financed in part with federal participation funding or federal grants or tolls, or to accelerate the retirement of bonded indebtedness or transferred to the general fund reserve, or tax relief or for avoiding the issuance of bonds for projects that are authorized but not issued or any combination of these purposes without regard to the spending limitation. For the purposes of this section, surplus funds mean that portion of revenues, as defined in subsection (A) of this section, over and above revenues authorized for appropriation in subsection (B).

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