Structural Balance Can Produce Better Results

Overview

An annual balance rule creates policy instability and undermines state sovereignty. A structural balance rule would let surpluses in good years offset deficits in bad years. Structural balance can strengthen policy stability and predictability, improve budget management and legislators' focus on other challenges, and help resist federal mandates on states.

Annual balance: Simple concept, tough to live with

- Turns economic volatility into policy instability.
    - Promotes overspending during booms due to strong revenue.
    - In recessions, annual balance:
        - Adds policy uncertainty to economic challenges.
        - Encourages policymakers to play games with the budget.
        - Weakens state resistance to red-tape-heavy federal bailouts.
- Constant tinkering distracts from upgrades to business climate, health care, education, and pension/OPEB policies.

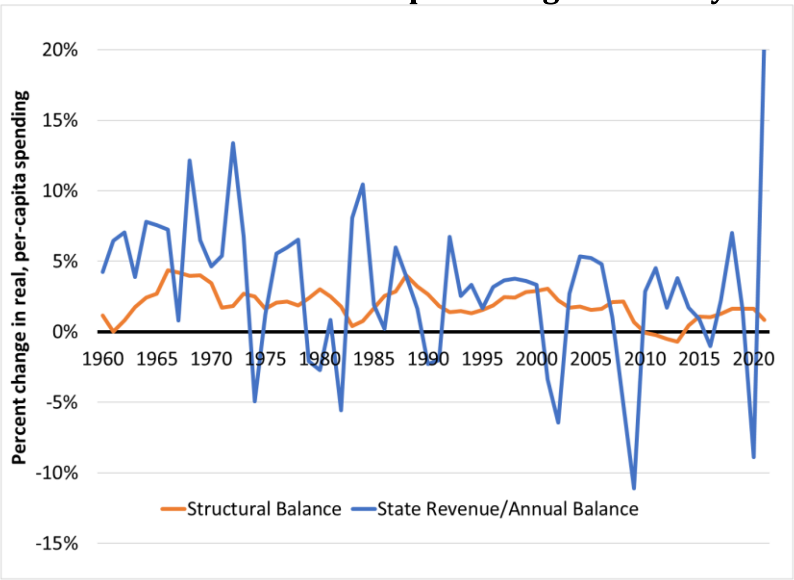
Structural balance can improve governance and federalism

- Surpluses in good years build up reserve funds, which can be tapped during recessions and for emergencies.
- Both spending and revenue policies can be more stable from year to year (see graphic).
- Households and businesses can better weather tough times if they face fewer policy changes.
- Fiscal independence reduces the appeal of string-laden federal funds and protects states from federal dysfunction.

A rule for structural balance

- Spending grows with a 5-year rolling average of prior gross state product (GSP) growth.
- Growth slows a little after a deficit, cumulatively, and increases after a surplus but not above the rolling average.
- The spending cap can adjust for inflation, changes in the revenue baseline, and emergencies.

Structural balance dampens budget volatility



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Structural Balance v. Inflation/Population Growth

Overview

Proposals to limit spending growth to inflation and population would reduce state spending as a share of gross state product (GSP). Such a rule tends to have limited support among legislators and may not be politically durable. Structural balance, on the other hand, allows long-term budget stability and appeals to a broader potential coalition of policy makers.

Colorado's political class hasn't lived up to the Taxpayer Bill of Rights (TABOR)

- The spending rule tries to limit spending growth to inflation and population, but it hasn't been followed.
- The spending rule covers less of the budget: down to 1/3 of spending due partly to the "enterprise" loophole.
- In addition, a 2005 referendum suspended and rebased the limit. It has only recently started to bind again.
- Colorado's general fund spending has been roughly stable as a share of GSP, but conflicts between the spending rule and politicians have made it messy.

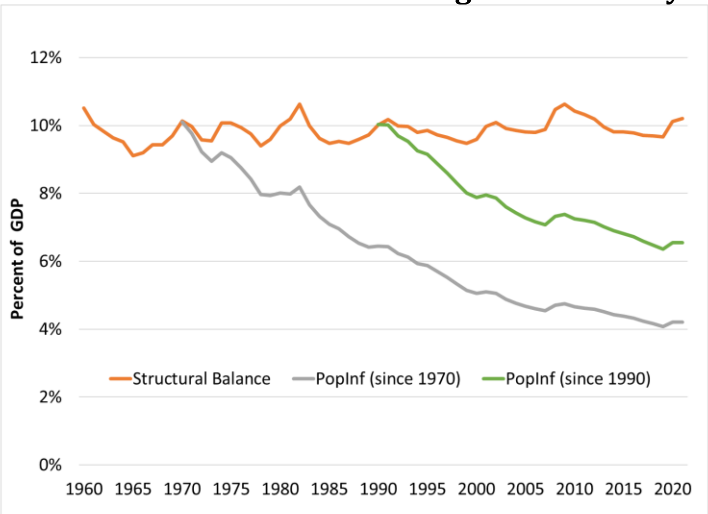
Inflation/population-based spending limits require ceaseless cost-cutting

- Nominal economic growth is the sum of inflation, labor force, and productivity growth.
- Limiting spending growth to inflation/population excludes productivity. Spending declines as a share of GSP.
- Efficiencies can reduce spending, but forcing them through a rule may produce fatigue or backlash.
- Competition for workers in a more productive economy drives increases in public employee compensation.
- Holding spending growth to population and inflation can be a good *outcome* for several years, but it is not an ideal budget *rule* for the long run.

Structural balance is easier to enact and more durable

- Structural balance produces smooth spending growth around a constant percentage of GSP, while inflation/population-based growth would, if followed, drive down spending (see graphic). It may also interact poorly with annual balance rules.
- Structural balance expands opportunities for upgrades and efficiencies that can reduce spending but without feeling forced.
- Structural balance exists in other countries, and a related federal BBA has attracted broad, bipartisan support.

Structural balance allows long-term stability



Note: Increases in share of GSP are from slower GSP growth – the denominator – during recessions.
The orange lines are the same spending cap in both graphics: here as a share of GSP, the other in dollars.