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Briefing Report to the Chairman, Task Force on the Budget Process, Committee on the Budget, U.S. House of Representatives

December 1985

BUDGET ISSUES

State Balanced Budget Practices

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

ACCOUNTING AND FINANCIAL
MANAGEMENT DIVISION

December 10, 1985

B-221235

The Honorable Butler Derrick
Chairman, House Task Force on
the Budget Process
House Budget Committee
House of Representatives

Dear Mr. Chairman:

In response to your May 8, 1985, letter, the General Accounting Office analyzed state government balanced budget requirements and practices in order to document their practices and assess the relevance of the states' experiences to the federal government. On November 19, 1985, we presented a briefing to you and members of the Task Force on the results of our study. At that time, we were asked to provide the Task Force a written version of the briefing. The enclosed document is submitted in response to that request.

Based on our analysis, we believe the Congress should be aware of the following significant issues in considering proposals to require a balanced federal budget.

- The federal government assumes several major responsibilities not assumed by state governments, including providing for the national defense and promoting national economic growth, full employment, and price stability. In some circumstances, the execution of these responsibilities may require intentional budget deficits.

- If state balanced budget processes were transferred intact to the federal government, they would cause significant changes in the balance of power between the executive and legislative branches of the federal government. For example, state governors often have the unilateral power to, in effect, impound funds--a power that the President does not have under current legislation.

Our responses to the questions raised by the Task Force during our briefing will be provided under separate cover.

I would be pleased to discuss this information with you further at your convenience. If members of your staff have any questions about the results of our work, please call me on 275-9487. Due to the interest in balanced budget issues, we plan to release this report to other interested parties at this time.

Sincerely yours,

John R. Cherbini

John R. Cherbini
Associate Director

GAO REVIEW

STATE BALANCED BUDGET PRACTICES

PREPARED FOR THE HOUSE TASK FORCE ON THE BUDGET PROCESS

DECEMBER 1985

JOB DIMENSIONS

The Chairman of the House Task Force on the Budget Process asked GAO to evaluate the balanced budget requirements of the 50 states. Further, he requested that we obtain information on:

--how state governments define their balanced budget requirements,

--how the states comply with those requirements, and

--how to relate the states' experiences back to the federal government.

We gathered information on all 50 states' balanced budget requirements and on their compliance with them during the 1980's. In addition, we obtained more detailed information on 6 states.

We used two primary methods to gather data: (1) a questionnaire was mailed to all 50 state budget offices, and (2) visits were made to 6 states, including California, Florida, Maryland, Michigan, Minnesota, and New York. In selecting states to visit, we considered a number of factors, including size of the state budget, type of balanced budget requirement, length of fiscal period, volatility of state economy, and geographic location. The information we gathered about individual states is not intended to be representative of all 50 states, but rather illustrates the problems faced in dealing with balanced budget requirements.

We did not verify the information provided by state officials but accepted what they said about their balanced budget requirements and experiences.

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OVERVIEW OF PRESENTATION

This briefing consists of three main sections:

--a comparison of the federal and state government environments;

--a 50 state overview of balanced budget requirements and techniques used during budget development, enactment, and execution; and

--detailed information on balanced budget implementation by selected states.

OVERALL OBSERVATIONS

Significant interest has surfaced for a balanced federal budget, similar to those which many states employ. Proposals for such a federal requirement are designed to reduce the federal deficit. Achieving that goal will mean difficult choices between higher taxes and reduced spending.

These choices must be made in the context of the current federal budget process, which is much more complex than the states' budget processes. The complexity of the federal budget process, combined with the difficulty of achieving a consensus on revenue provisions or funding decisions, will increase if balanced budget requirements are added.

Balanced budget requirements are very much a part of state budget practices. Nearly all states' budget processes are subject in part to some form of balanced budget provision. In most cases, the governor must submit a balanced budget. In fewer cases, the funds covered by the requirement must end the year in balance. Requirements usually apply to the state's general fund, but coverage of other funds such as capital, trust, and special funds is not so universal.

States use many techniques to live with balanced budget requirements in all phases of their budget processes. The primary methods of keeping state budgets in balance were program cuts and tax changes.

Despite balanced budget requirements and techniques to comply with those requirements, states sometimes incur deficits. These deficits are usually the result of unanticipated conditions.

FEDERAL AND STATE ENVIRONMENTS

This section addresses federal and state environments. We identify factors which currently influence the implementation of balanced budget requirements at the state level and which could also influence balanced budget requirements if they were imposed on the federal budget process.

OBSERVATIONS ON FEDERAL AND STATE ENVIRONMENTS

The environments of the federal budget and the states' budgets are different. Consequently, state experiences with balanced budget provisions may not be directly relevant to the federal government. For example, the federal government has responsibilities not shared by the states, such as national defense, promoting national economic growth, and encouraging full employment and price stability.

Fulfilling these and other responsibilities in some circumstances may require intentional federal budget deficits. This may yield an attitude toward deficits which is different than the state perspective on budgets. This perspective on budgets is a crucial ingredient in implementing balanced budget provisions. Some characterize this perspective as a "mind set"--a belief that budgets ought to be in balance. However, state governments, also incur deficits. The state deficits usually result from unanticipated conditions, rather than being planned.

Budget structures are also different. The federal government employs a unified budget which includes all government activities, except those exempted by law. Most state budgets have separate operations and capital components. In many cases, a state's balanced budget requirement applies only to the operating component.

Differences also exist in the balance of power, particularly during budget execution. Under potential deficit conditions, state governors often have the power to reduce the amount of funds available to executive branch activities without approval by the legislature. In the federal government, the President and the Congress each have roles in decisions to impound funds.

FEDERAL ENVIRONMENT

The environment in which a federal balanced budget would operate is an important factor to consider in relating the states' experiences to the federal government. This is particularly true because of differences between state and federal environments.

The federal government follows a unified budget concept which includes all government activities, except those exempted by law. The budget process is complex, with many critical decision points such as budget resolutions and budget reconciliations. Achieving a consensus on major decisions is difficult, as evidenced by debt ceiling, reconciliation, and continuing resolution debates. Adding a balanced budget requirement, which would eventually limit planned expenditures to the amount of anticipated revenues, would increase the complexity of the process.

The federal government assumes several major responsibilities not assumed by state governments. This includes providing for the national defense and promoting national economic growth, full employment, and price stability. In some circumstances, these unique federal responsibilities can be effectively discharged only if the federal government is allowed to run intentional budget deficits.

Also, the federal budget process has controls to maintain the balance of power between the executive and legislative branches. For example, the Impoundment Control Act supports the balance of power by requiring the President to notify the Congress of plans not to spend money appropriated. The Congress then has the power to overrule proposed impoundments.

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STATE ENVIRONMENT

The state environment has characteristics which are conducive for implementing balanced budget requirements. State governments often have separate operating and capital budgets. This enables states to limit the coverage of balanced budget requirements to operations. State governments also have a "mind set" which favors balanced budgets. They begin the budget process with a balanced operating budget and try to keep the budget in balance throughout the year.

States, however, are not immune to deficits. Their deficits occur more as a result of unanticipated conditions than as part of a conscious plan to spend more in a particular year than is collected.

The balance of power during the budget execution phase generally favors the executive branch. When states face potential deficits during the year, the governor often has considerable discretion in taking actions to keep the budget in balance.

State governments are also instituting financial management improvements which will enable them to produce better financial reports. States have an incentive to do this because they believe that bond ratings will rise and interest costs will decline.

50 STATE OVERVIEW

This section provides a broad overview of the 50 states' balanced budget requirements and techniques used to develop and maintain balanced budgets. Information is presented on the portion of state budgets covered by balanced budget provisions, the reporting basis used to determine compliance with the requirements, and the phases of the budget processes influenced by the requirements.

OBSERVATIONS ON THE 50 STATES

Although 49 states have balanced budget requirements, the requirements vary considerably. They cover different parts of the budget cycle, i.e. budget development, enactment, or execution. The requirements also differ in the identification of what funds are subject to the requirement. Some cover only the general fund, others cover all funds. Finally, some requirements result more from interpretation than from explicit constitutional or statutory provisions.

States often have legally prescribed reporting to determine compliance with balanced budget requirements. Each state establishes legal reporting to meet its own needs for information. Different results could be reported if compliance were based upon accrual accounting for which generally accepted accounting principles provide guidance for treatment of financial transactions.

Balanced budget requirements can influence the entire budget process. During budget development and enactment, the governor and legislature base their plans on an anticipated revenue level. The influence is most noticeable during budget execution when the balance of power favors the executive branch. The governor in many cases must act to achieve a balanced budget using numerous techniques. For example, the governor often has authority to (1) reduce executive agency funds, through an impoundment type of action, (2) shift expenditures into the next fiscal year, or (3) limit hiring. States often increase revenues through tax changes which necessitate legislative approval.

States are increasingly relying on nonguaranteed debt to finance activities such as capital projects. This debt generally is not subject to restrictions and is growing faster

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STATE PROVISIONS FOR A BALANCED BUDGET

All states except Vermont have balanced budget requirements. But, variations exist in the types and explicitness of the requirements and the phases of the budget process to which they apply. Forty-four states have constitutionally based requirements and five have statutorily based requirements.

Some requirements result more from state interpretations of their constitution or statutes rather than an explicit statement that the state must have a balanced budget. For example, Alaska's constitution requires a majority of the people to approve contracts for new debt for capital improvements. The statutes require the legislature to provide for revenue measures to balance the fiscal year's budget. The state government interprets these provisions as requiring the governor to submit a balanced budget, the legislature to enact a balanced budget, and all state funds to end the year in balance.

Not all states are required to have a balanced budget throughout the budget process. In 47 states the governor must submit a balanced budget for the fund(s) covered by the requirement. In 35 states the legislature must pass a balanced budget and in 34 states the fund(s) covered must end the year in balance.

BALANCED BUDGET IMPLEMENTATION FACTORS

In looking at state balanced budget provisions, we noted the following factors affect implementation of the requirements:

- Coverage - what part of the budget is subject to the balanced budget requirement, i.e. general fund, trust funds, special funds, federal funds;

- Reporting - what reporting basis is used for determining whether the budget is in balance, i.e. legally prescribed or generally accepted accounting principles; and

- Timing - what phases of the budget process are affected by the balanced budget provisions, whether: (1) the governor must submit a balanced budget, (2) the legislature must enact a balanced budget, and/or (3) the executive branch must execute a balanced budget.

FUNDS COVERED BY BALANCED BUDGET REQUIREMENTS

Our questionnaire to state budget offices asked which of the various state funds are subject to balanced budget provisions and the percentage of total expenditures that are covered. Responses from 44 states provided the following information.

- All states that have balanced budget requirements said the general or operating fund is covered.

- The information on the opposite page shows other funds the states use and the number that are covered by balanced budget requirements.

- In looking at total state expenditures, the percentage of funds covered by balanced budget requirements ranged from 46 percent to 100 percent.

The states also identified major activities that are not covered by some state balanced budget requirements. Examples include:

- highway construction/maintenance,

- pension benefits, and

- capital activities.

BUDGETARY VERSUS ACCOUNTING REPORTING

The differences between states' budgetary and accounting methods can produce markedly different results in reporting on their financial operations. States may report surpluses on a budgetary basis while at the same time reporting deficits on an accounting basis. While balanced budget requirements typically apply to the budgetary basis of reporting as specified in state law, there is variation among budgetary reporting given the degree of discretion states have in designing the budget structure and establishing reporting requirements to meet their own needs. Thus, the budgetary presentation for each state tends to be unique, thereby inhibiting comparability.

On the other hand, the rules for reporting on an accounting basis are more consistently applied. State governments are moving toward adhering to generally accepted accounting principles (GAAP) for reporting purposes in their external financial statements. State officials believe it is in the best interest of the state to do so, or at least to specify how the budgetary and accounting reports differ, because of the influence of the bond rating community. Higher ratings on state debt result in lower interest costs.

BALANCED BUDGET INFLUENCES ON THE BUDGET PROCESS PHASES

State balanced budget provisions can influence all phases of the budget process, including submission by the governor, enactment by the legislature, and execution by the executive branch. In looking at state experiences with balanced budget provisions, we considered whether they occurred during development and enactment before the fiscal year begins or in budget execution during the fiscal year. The timeline on the opposite page shows when the budget process activities take place.

EFFECTIVENESS OF DEVELOPMENT AND ENACTMENT ACTIONS

In the questionnaire sent to state budget offices, we asked the states to identify techniques used during the 1980's in developing and enacting their budgets and to indicate the effectiveness of those techniques in helping achieve a balanced budget.

The lists on the opposite page are based upon responses from 44 states. The lists show (1) the techniques used by most states during the 1980's and (2) the perceived effectiveness of those techniques.

Here are some reasons cited for these techniques being effective.

- Line item reduction - allows the governor to reduce a program without abolishing it. This makes it more politically acceptable than a veto. Line item reductions also allow the governor to eliminate legislature-initiated program increases.

- Legislative super majority vote for higher taxes - increases the difficulty of raising taxes because a great deal of support is needed to increase taxes and thus puts a cap on program increases due to funding limits.

- Revenue limitations - puts limits on program funding by prohibiting tax increases.

- Expenditure limits - puts a ceiling on the total funds that may be appropriated.

- Line item veto - enables the governor to eliminate a program or activity added by the legislature.

EFFECTIVENESS OF EXECUTION ACTIONS

In the questionnaire sent to state budget offices, we also asked the states to identify techniques they used in the 1980's during budget execution and to indicate the effectiveness of those techniques in helping achieve a balanced budget.

The lists on the opposite page are based on responses from 44 states. The lists show (1) the techniques used by most states during the 1980's and (2) the perceived effectiveness of those techniques.

Here are some of the reasons for these techniques being considered effective.

- Accelerated revenue collections - Actually a form of tax changes which require earlier submission of tax payments.

- Tax increases - Some states have tax increase provisions in the event of revenue shortfalls.

- Spending cuts - Some states have contingency plans in the event actions are needed. For example, as part of Arkansas' appropriation process, programs are placed in one of three categories which indicate relative priority. When spending cuts are needed, the percentage cut applied to a program reflects the priority category.

- Stabilization (rainy day) fund - Money set aside for use when needed without disrupting program funding.

- Interfund transfers - Ability to borrow money easily from other funds, and sometimes with no interest charge.

EXAMPLES OF GOVERNORS' POWER DURING BUDGET EXECUTION

Governors are responsible for keeping the budget in balance once the fiscal year begins. In doing so, some governors have the unilateral power to reduce the amount of funds available to executive branch activities without approval from the legislature. In carrying out this power, they:

- Determine the need for and size of budget cuts - A governor must monitor the revenues received versus what was anticipated and institute actions to correct a potential deficit when revenue collections are below estimates.

- Make across-the-board cuts - Programs share proportionally in reductions and thus maintain relative priorities established by the legislature in making funding decisions. Sometimes selective program cuts are used.

- Call special legislative session - Sometimes used, especially for large cuts.

- Permit agency discretion - The governor sets targets for each agency, giving the agency head the discretion to determine how the total savings are achieved.

LONG-TERM STATE DEBT

Apart from developing balanced operating budgets, states issue long-term debt to finance activities, principally capital projects. The Bureau of the Census categorizes state long-term debt as either 'full-faith and credit' or 'nonguaranteed' debt. Full-faith and credit debt is debt "for which the credit of the state, implying the power of taxation, is unconditionally pledged." State constitutional debt restrictions commonly apply to this type of debt. Alternatively, nonguaranteed debt "does not constitute an obligation against any other resources of the state if the pledged sources are insufficient." This debt is outside state constitutional debt restrictions.

The existence of and growth in nonguaranteed debt as presented on the opposite page shows that states have developed ways to live outside restrictions on their budgets. Data from the Bureau of the Census indicate that long-term nonguaranteed debt not only exceeds the amount of full-faith and credit debt, but nonguaranteed debt is also growing at a faster rate.

STATE VIEWS ON BALANCED STATE BUDGETS

We asked state budget officials to comment on the value of balanced state budgets. In answering our questionnaire many officials commented on the advantages and/or disadvantages, as well as implementation considerations. The following comments are not necessarily representative of all states, but provide insights to balanced budget requirements by those who have experience in dealing with the requirements.

ADVANTAGES

- Instills discipline throughout the budget process.
- Forces the governor and the legislature to prioritize programs and activities and allocate funds to the perceived greatest need.
- Encourages agency heads to employ effective planning and programming systems to ensure they effectively use their funds.
- Restricts growth in the size and number of programs.
- Fosters conservative fiscal spending and taxing policies.
- Increases public awareness of government decisions.
- Positively influences bond rating organizations' opinions of state debt.

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STATE COMPLIANCE WITH BALANCED BUDGET REQUIREMENTS

This section is based on our work in six states: California, Florida, Maryland, Michigan, Minnesota, and New York. Our focus was mainly on actions taken once a budget was enacted to bring it in balance after the fiscal year started and when economic conditions did not occur as projected.

Five of the states visited had to institute numerous actions to bring the budgets back into balance or minimize the actual deficits. Maryland, on the other hand, had underestimated its revenue and consequently did not have to cut programs or raise taxes. Therefore, the following material focuses on the five states that had to institute budget balancing actions.

OBSERVATIONS ON STATES VISITED

Our work in the states we visited demonstrated differences among the budget components, relevance of balanced budget requirements to state funds as well as coverage of the budget process, and approaches to deal with potential deficits.

The states have similar budget structures but the relative proportion of the budget represented by each fund varies. For example, the size of the general fund ranges from less than 50 percent to nearly 70 percent of the total budget. Also, one of the states--Florida--does not have a special fund, which accounts for nearly 10 percent of the budget in the other four states.

The balanced budget requirements also varied. In three states the requirements applied to the entire budget, but in the other two, only the general fund is covered. Furthermore, two states had stringent close-ended requirements that mandate balanced budgets at the end of the annual or biennial fiscal period, whereas the other three states had open-ended requirements allowing them to carry over a deficit into the next fiscal year if necessary.

States faced potentially large deficits during the 1980's, and they took actions to preclude or minimize the deficits. In attacking potential deficits, states employed both revenue and expenditure measures. No single approach was followed by the states, but they generally used both program cuts and tax increases. The governors generally had power to institute needed program cuts without action by the legislature.

Revenue forecasting and monitoring plays a key role in the states' efforts to develop balanced budgets and keep the budgets balanced during the year. The projected amount of revenue for a

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STATE BUDGET STRUCTURES

The way a balanced budget requirement is interpreted depends in part on the fund structure of the budget. The charts on the opposite page show a comparison of budget structures for five states. It demonstrates the diversity of budget structures and also highlights the difficulty in making state-to-state comparisons. For example:

- The size of the general fund ranges from 47 percent of Florida's budget to 66 percent of Michigan's budget.

- Special funds represent at least 10 percent of the budget for four of the states, but Florida does not report any special funds.

Coverage of balanced budget provisions also varies. Three of the states--Florida, Michigan and Minnesota--have balanced budget provisions that cover their entire budget. In California and New York, only the general fund is covered.

States also incur long-term debt to finance their activities. Total long-term debt is shown on the opposite page as a percentage of total state expenditures. For example, New York's long-term debt equals 75 percent of its expenditures. Over half of that debt was issued by off-budget authorities.

EXTENT OF POTENTIAL DEFICITS

In visiting the states, we obtained information on the size of potential deficits they each faced. After the states enacted their budgets, they predicted deficits ranging from 0.2 percent to about 26 percent of their general fund expenditures. Maryland underestimated its revenue in preparing budgets for each of the years reviewed. Furthermore, in four of the years, the year end balance was higher than the budget amount.

These predictions were based upon worst case scenarios--the cumulative effect of what would have occurred if the states had done nothing to avoid or minimize deficits.

As we will discuss later, the states took a number of actions and avoided or minimized the deficits which were unanticipated at the time the budgets were passed.

STATE CASE STUDIES

The next series of pages provide background data on the states in terms of balanced budget requirements and actions the states took to comply with those requirements.

We also present data on the amount originally budgeted for the general fund, an interim estimate of the general fund ending balance, and, finally, the actual general fund ending balance. The three amounts reported for each year show the wide swings that the states faced during the 5 year period.

operations during the year. Despite these and other attempts to balance the budget, California did carry over a $521 million deficit into fiscal year 1984.

Potential Deficit in 1984

The potential deficit for fiscal year 1984 was approximately $1.8 billion. Part of this was the inherited $500 million carry-over deficit from the external borrowing to cover the fiscal year 1983 operating deficit. As a result, during budget development and enactment a number of new and increased revenue initiatives were passed, including a restored gross receipts tax, increases in nuisance taxes on alcohol and cigarettes, revised fees on motor vehicles, imposition of a new realty gains tax, and accelerated property assessments. New spending actions included a savings of approximately $140 million through a 5 percent reduction in the work force. In addition, payments were deferred for school aid, highway, and Medicaid programs. The fiscal year ended with a $551 million planned surplus, after operating expenditures, which was for the payment of $500 million for the short-term notes to finance the previous year's deficit and $51 million to repay the Tax Stabilization Fund for prior years' borrowings.

STATE OF MICHIGAN BALANCED BUDGET EXPERIENCES IN THE 1980'S

Open-Ended Requirement

In Michigan, the governor must submit a balanced budget and the legislature must pass one for all funds. Any surplus or deficit must be included as a line-item in the next fiscal year's budget. The state constitution specifically requires the governor to reduce expenditures authorized by appropriations whenever actual revenues fall below estimates agreed to by the legislature. Before instituting reductions, the governor must obtain approval from appropriating committees of both the House and Senate. The governor must follow certain guidelines for making cuts in the executive branch and is prohibited from decreasing expenditures of the legislative and judicial branches or funds constitutionally dedicated for specific purposes.

Rainy Day Fund Based on Economic Triggers

Michigan instituted a rainy day fund, the Counter-Cyclical Budget and Economic Stabilization Fund, in fiscal year 1978 and based the receipt and release of funds on economic triggers. The fund receives general fund revenues when real annual growth of adjusted personal income exceeds 2 percent and releases funds when the change in personal income is negative. Another provision is that if there is an 8 percent or higher unemployment rate a percentage of the fund may be withdrawn and appropriated for capital outlay, public works, public service jobs, tax credits, or other uses that the legislature may designate. In 1979 the state first withdrew moneys from the fund and by the close of 1981 had nearly depleted it. However,

STATE OF MINNESOTA BALANCED BUDGET EXPERIENCES IN THE 1980's

Close-Ended Requirement

The governor of Minnesota must submit a balanced biennial budget for all state funds. The legislature must pass a balanced biennial budget and the biennium must end in balance. However, the mid-year of the biennium is not required to be in balance and often experiences deficits which must be overcome during the second year. Enforcement of the balanced budget requirement is through a series of "trigger" actions the governor is statutorily required to make. Use of the Budget and Cash Flow Reserve Account (rainy day fund) is the first required action. If this is not sufficient, the governor must suspend the indexing of income taxes and, finally, impound funds. If the above measures are not sufficient, the governor and legislature can and have raised taxes to make up for the potential deficit even though this is not one of the trigger actions specified in the statute.

Rainy Day Funds Help to Avoid Deficits and Cash Flow Problems

The Budget and Cash Flow Reserve Account was established in fiscal year 1984 with an original appropriation of $250 million. Additional transfers are made by appropriation only. Withdrawals are made for cash flow and budget problems. Moneys totalling $100 million were released from the fund for revenue shortfalls experienced during the three month period ending June 30, 1985. The balance as of July 1, 1985, was $350 million, or 7 percent of fiscal year 1985 expenditures.

STATE OF FLORIDA BALANCED BUDGET EXPERIENCES IN THE 1980'S

Close-Ended Requirement

Florida has a stringent balanced budget requirement where the governor must submit a balanced budget and the legislature must pass one. Although the state has a biennial budget, the balanced budget requirement stipulates that there must be an end-of-year balance annually. Not only the budget as a whole must be balanced, but the requirement also applies to each separate fund within the budget. The perception of state officials is that under the requirement local governments must balance their budgets, but the state does not control or monitor the status of local budgets.

Working Capital Fund Is A Rainy Day Fund

In 1959, Florida established a working capital fund (rainy day fund) as a deficit prevention measure. General fund surpluses transfer to the working capital fund up to a maximum amount, specified by law at 10 percent of net general fund revenue for the preceding year. Transfers from the fund occur whenever general fund collections are insufficient to meet appropriations. As of fiscal year 1984, the balance was $25.3 million, or 0.4 percent of general fund expenditures.

STATES TAILORED BUDGET BALANCING ACTIONS TO THEIR SITUATIONS

Depending on the political, economic and budgetary conditions, states reacted to potential deficits by taking different steps as shown on the opposite page either for the combined budget enactment and execution or for budget execution only.

In summarizing the actions taken, we established the following categories of techniques:

--Program reductions - across-the-board or discretionary cuts,

--Tax changes - increasing tax rates, eliminating deductions or exemptions, revising collection schedules,

--Payment shifts - paying bills with next year's funds,

--Budget reserves - rainy day or other reserve funds,

--Accounting changes - revised accounting practices recognizing revenue sooner, expenditures later, or both,

--Borrowing - internal fund transfers or external short-term borrowing, and

--Administrative actions - hiring and promotion freezes, travel cutbacks, and purchasing curtailments.

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Program Reductions and Tax Changes
Were Main Means of Enforcement

All states cut programs and raised taxes in combination with other of the various means mentioned to enforce and thereby balance their budgets. California had already used up its accumulated reserves and so made program reductions as well as raised taxes. New York changed taxes, deferred payments and incurred short-term debt--making few changes after enacting a budget. In contrast, Michigan, Minnesota and Florida made numerous adjustments during budget execution. In addition to program cuts and tax changes, Michigan nearly depleted its rainy day fund, borrowed from trust funds and reported accounting changes. Minnesota postponed payments and also reported accounting changes. Florida opted to use reserves and defer payments while balancing the remainder of its budget through program cuts and tax changes.

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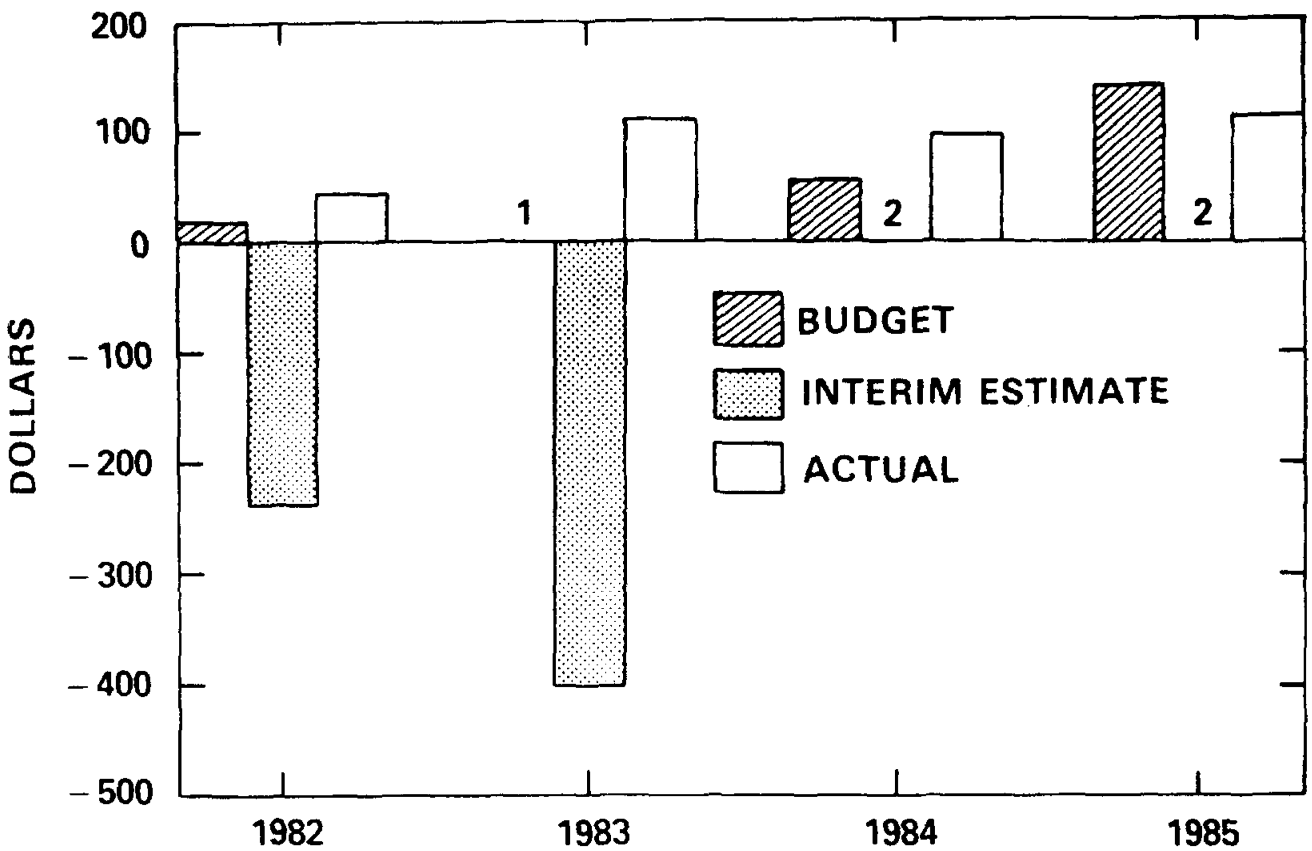
Recent Experience:
Potential Deficits in 1982 and 1983

Although Florida had a potential deficit of about $239 million or 5 percent of general fund expenditures in fiscal year 1982, the state ended the year with a surplus. The governor made across-the-board cuts of 1.3 percent of the general fund, exempting certain essential services such as judiciary, law enforcement, corrections, community care for the elderly, capital outlay, and debt service. The state also used most of its working capital fund ($196 million), and the general fund surplus from the prior year as additional revenue sources.

In fiscal year 1983, the state's potential deficit was about $402 million, or 8 percent of general fund expenditures, but it managed to end the year with a surplus of $110 million. Again, the governor made across-the-board cuts that were a cumulative 4.9 percent of general fund expenditures, this time with no exemptions. Another action by the governor was postponing a major bridge construction project.

FLORIDA GENERAL FUND ENDING BALANCE*

FISCAL YEARS 1982-1985 (MILLIONS)



1 — ZERO BALANCE
2 — NOT AVAILABLE
*GENERAL REVENUE FUND

by 1985 the accumulated budget stabilization reserve had been built up to 6 percent of general fund-general purpose expenditures.

Recent Experience:
Severe Potential Deficits in 1981, 1982, and 1983

Fiscal year 1981 continued a downward economic trend that had started the year before, and the legislature enacted a budget that was lower than in fiscal year 1980. Nevertheless, there was a potential general fund deficit of $346 million, or 8 percent of general fund-general purpose expenditures. To make up for the mid-year shortfall, the governor by executive order initiated a hiring freeze and gave employees options for pay postponements and reductions; made cuts in general assistance and aid to dependent children benefits; reduced aid to local schools, universities and community colleges; decreased local revenue sharing; and cut the budgets of state agencies. The governor also authorized internal borrowing from state trust and special funds by the general fund.

The situation was worse in fiscal year 1982. Michigan faced a potential deficit of over $1.1 billion or about 26 percent of general fund-general purpose expenditures. The governor issued executive orders during the year making more cuts mostly in the areas affected in 1981. During the fiscal year, the legislature also imposed a temporary increase in the personal income tax. On the last day of the legislative session with the state still facing a deficit, the legislature approved a law allowing the state to remain on a cash accounting basis for state Medicaid accounts, thus reducing reported expenditures by about $120 million.

GENERAL FUND EXPENDITURE LEVELS

We visited states to determine the actions they took during the 1980's to keep their budgets in balance when the economy suffered downturns and the states faced deficits. We considered whether the potential deficits resulted from the states' expanding programs being supported by the general fund. We compared general fund expenditures for fiscal years 1981 through 1985 to determine whether they experienced significantly increased levels of support.

The chart on the opposite page summarizes state general fund expenditures, on a constant dollar basis, during 1981-1985. For each state, the general fund expenditures were relatively stable during the period. We believe this indicates that the potential deficits were not necessarily the result of increased support of general fund activities.

STATE OF CALIFORNIA BALANCED BUDGET EXPERIENCES IN THE 1980'S

Open-Ended Requirement

In California, the governor must submit a balanced general fund budget; but there is no explicit requirement that the legislature pass a balanced budget or that the general fund end the fiscal year in balance, as interpreted by the state supreme court. Nevertheless, the governor may take certain actions independent of the legislature when the potential for deficits exists. For example, the governor may impose freezes on hiring and promotions, halt equipment purchases and contracting, and stop approved capital projects. The governor's immediate control, however, extends only to the part of the budget for state operations.

Legislative Action Required To Use Reserve Funds

California established its Reserve for Economic Uncertainties in 1980 as a buffer against unanticipated general fund revenue shortfalls or expenditure increases. While it takes legislative action to permanently transfer funds under deficit conditions, the controller may borrow funds as necessary for cash flow purposes. The goal of state budget officials is to maintain the fund at about 4 percent of general fund expenditures, though the proposed accumulation for fiscal year 1986 of about $1 billion is somewhat less than the policy target.

STATE OF NEW YORK BALANCED BUDGET EXPERIENCES IN THE 1980's

Open-Ended Requirement

The governor must submit a balanced cash budget for the general fund and another based on generally accepted accounting principles (GAAP). The GAAP budget is not required to be in balance. The legislature is not required to pass a balanced budget, nor is the fiscal year required to end in balance. However, the debt rating community encourages New York to pass a balanced budget before borrowing money in the short-term market.

New York has a preference to budget to zero, i.e. develop a budget in which anticipated revenues and planned expenditures are equal. However, a $40 million reserve for supplemental bills is established to provide a "cushion" in the budget for any spending bills passed by the legislature after the budget is enacted.

Official and Unofficial Rainy Day Funds Used in Deficit Situations

By law, any balance remaining in the general fund at year-end must be transferred to the Tax Stabilization Reserve Fund (rainy day fund), up to a maximum of 2 percent of expenditures. Withdrawals for cash flow purposes must be repaid within one year. Withdrawals to cover unanticipated operating deficits must be repaid within six years in no less than three equal, annual, installments. This repayment requirement limits the effectiveness of the fund for any short-term budget problems.

In fiscal year 1983, Michigan's severe financial problems continued with a potential deficit of almost $900 million, or 18 percent of general fund-general purpose expenditures. An increase in the personal income tax rate of 1.75 percentage points or 38 percent, imposed retroactively by three months, was the main step taken to balance the general fund budget in combination with mid-year program reductions made through executive order.

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Consensus Estimating Process
Plays Key Role

Executive and legislative experts in Florida agree to economic and demographic forecasts by consensus. The underlying design of this process is to reach agreement on the estimates for the substantive budget policy debates. Seven different estimating conferences meet in the fall before the governor prepares a budget and in the spring to provide final estimates for the legislative process. Experts from both executive and legislative offices deliberate in open public meetings over estimates for revenue and service delivery units. The fact that each member of a conference has veto power over the final decision of the conference forces the consensus. Any member may call a special session of the conference during the fiscal year if actual economic or budget performance is significantly different from agreed upon estimates. If the conferees report reduced revenue estimates, the governor and elected cabinet officers must take actions, independent of the legislature, to keep the budget in balance.

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SUMMARY OF REPORTED ACTIONS TAKEN DURING FISCAL YEARS WHEN THERE WERE POTENTIAL DEFICITS

TECHNIQUES	CALIFORNIA (1982-84)	NEW YORK (1983-84)	MICHIGAN (1980-83)	MINNESOTA (1981, 1983 BIENNIUMS)	FLORIDA (1982-83)
BUDGET PHASE[1]	ENACTMENT & EXECUTION	ENACTMENT & EXECUTION	EXECUTION ONLY	EXECUTION ONLY	EXECUTION ONLY
PROGRAM REDUCTIONS	43%	3%	40%	30%	53%
TAX CHANGES	49%	41%	29%	40%	9%
PAYMENT SHIFTS	5%	27%	–	18%	3%
BUDGET RESERVES	–	2%	12%	–	35%
ACCOUNTING CHANGES	–	–	16%	12%	–
BORROWING	2%	21%	3%	–	–
ADMINISTRATIVE ACTIONS	1%	6%	–	2/	–
TOTALS	100%	100%	100%	100%	100%

1/THIS TABLE SHOWS THE MAJOR ACTIONS, IDENTIFIED BY STATE BUDGET OFFICIALS, TAKEN DURING BUDGET EXECUTION AND, IN TWO CASES, PARTLY DURING ENACTMENT IN RESPONSE TO POTENTIAL DEFICITS.

2/LESS THAN 1 PERCENT.

Recent Experience:
Deficit For 1980-81 Biennium

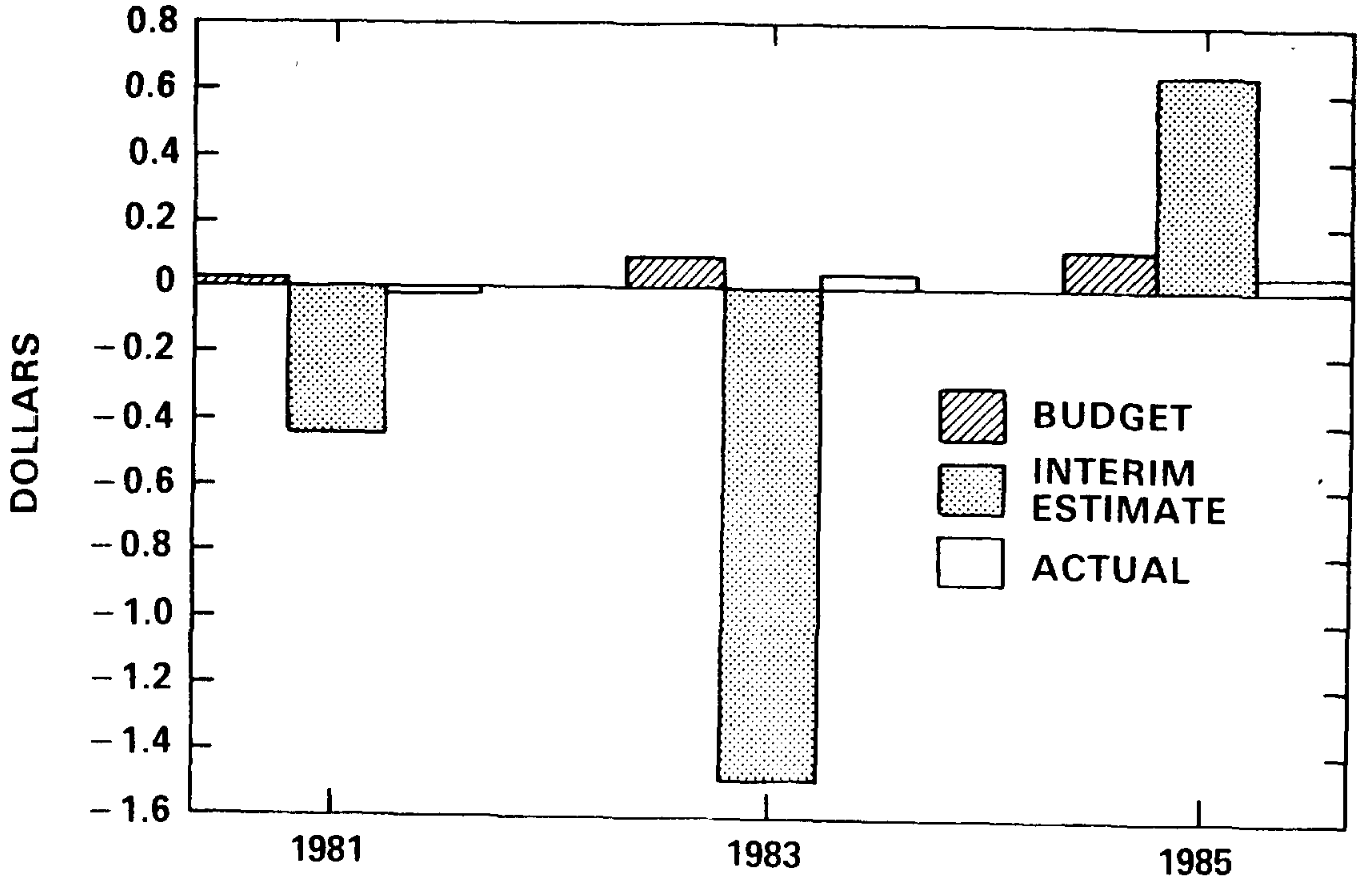
The only breach of the balanced budget requirement during the period 1980 through 1985 occurred in fiscal year 1981 when the ending unrestricted balance in the general fund was a deficit of $22 million. Estimates early in the biennium projected increased revenues of approximately $100 million, and the legislature enacted additional appropriations for the biennium. Shortly thereafter, the revenue increases did not materialize, but instead had fallen by about $91 million. This, in addition to increased expenditures and estimates, created the need to take budget balancing measures. These measures included program cuts, accelerating income tax withholdings, and deferring payments for school aid into the next fiscal year. In addition, the governor directed state departments to curtail expenditures during the remainder of the biennium. Total actions were approximately $425 million, or 6 percent of expenditures for the biennium. Despite these actions, Minnesota still fell short of a balanced budget by $22 million.

Severe Potential Deficit
During 1982-83 Biennium

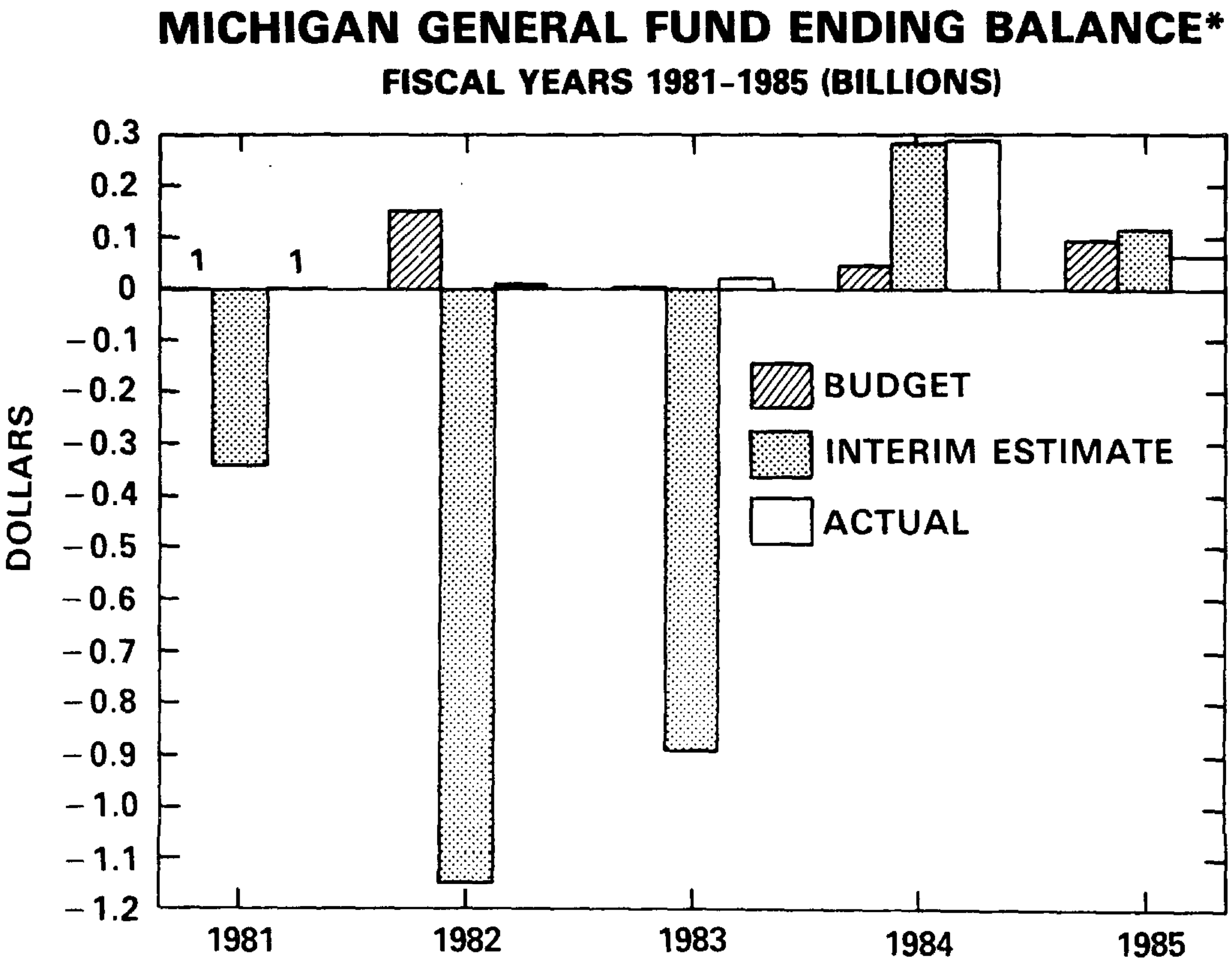
The 1982-83 biennium was the most active budget period for Minnesota. With continued falling revenues, the state was forced to make major budget adjustments on three separate occasions, totalling about $1.5 billion. Among these actions were a number of tax increases such as imposing a surcharge on personal income tax, a temporary extension of the sales tax increase, and accelerating sales tax collections. Other actions included large program cuts, a state hiring freeze, and an accounting change to allow for the early recognition of property taxes. Budget balancing actions totalled about $1.5 billion, or 17 percent of expenditures for the biennium. The resulting unrestricted general fund ending balance was $45.8 million.

MINNESOTA GENERAL FUND ENDING BALANCE*

BIENNIUMS ENDING 1981-1985 (BILLIONS)



*UNRESTRICTED PORTION



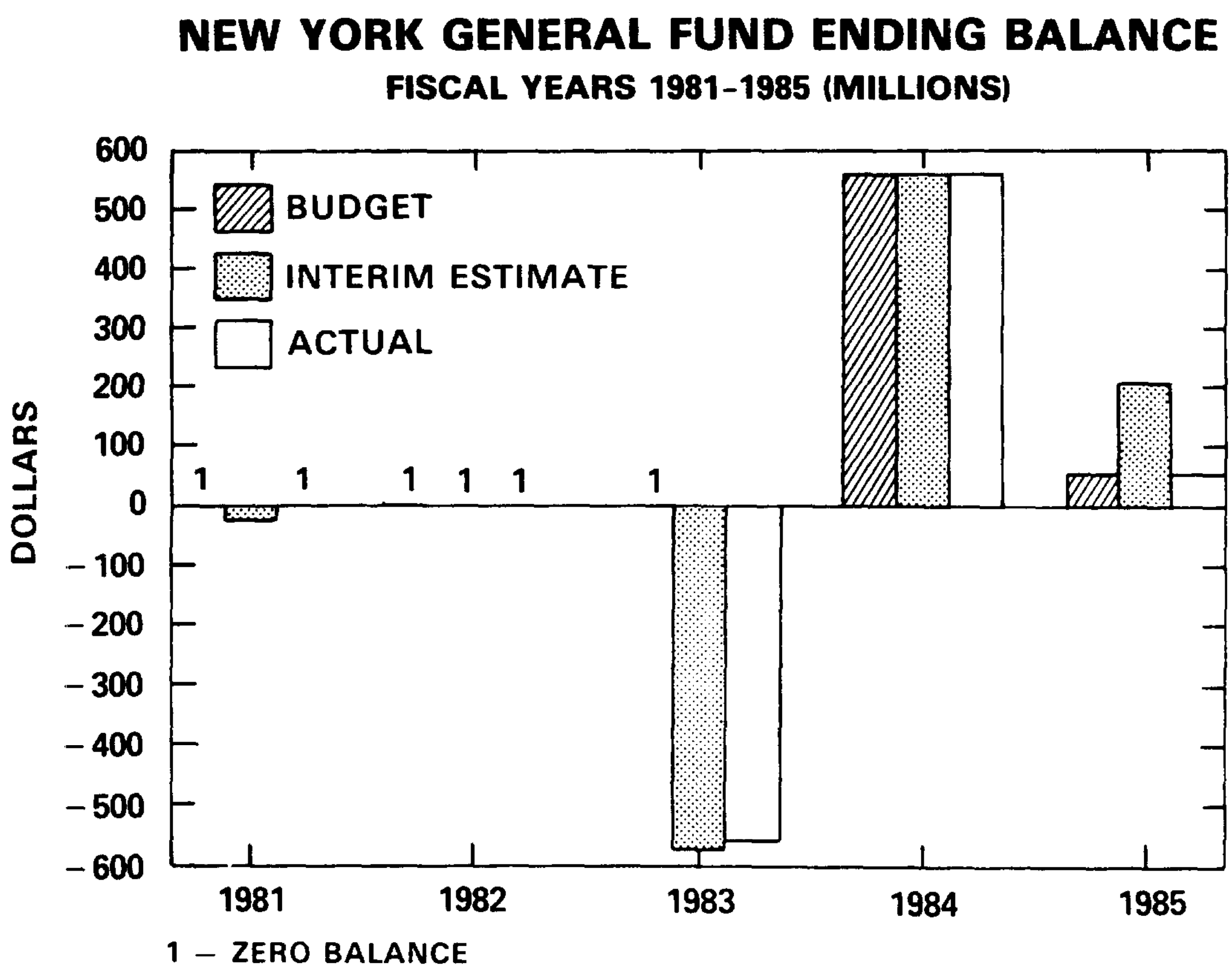
1 – ZERO BALANCE
*GENERAL FUND – GENERAL PURPOSE

In order to avoid having surplus funds at year-end that must by law be transferred to the fund, any possible surpluses are placed in a reserve for income tax refunds before the year ends. This practice avoids showing a surplus at year-end which would necessitate a transfer to the Tax Stabilization Reserve Fund.

Recent Experience:
Deficit in 1983

In light of a potential deficit for fiscal year 1983, the budget as enacted contained a provision to implement a lagged payroll system that resulted in a $150 million payment shift. The last payroll for fiscal year 1983 was shifted into fiscal year 1984. However, shortly after budget enactment and the annual short-term borrowing, the legislature passed additional appropriations totalling $320 million. The governor vetoed the additions, but the legislature overrode all of the vetoes.

As a result of these additions and an unanticipated revenue shortfall, actions taken to minimize the potential deficit in the general fund included nominal reductions in general program expenditures, liquidation of the reserve for supplemental bills, and discontinuing escrowing payroll amounts at year-end. Despite the above actions, fiscal year 1983 ended with a $562 million deficit which was funded by a $50 million internal borrowing from the Tax Stabilization Reserve Fund, a $500 million external borrowing in short-term notes, and $12 million of additional internal resources from other funds.

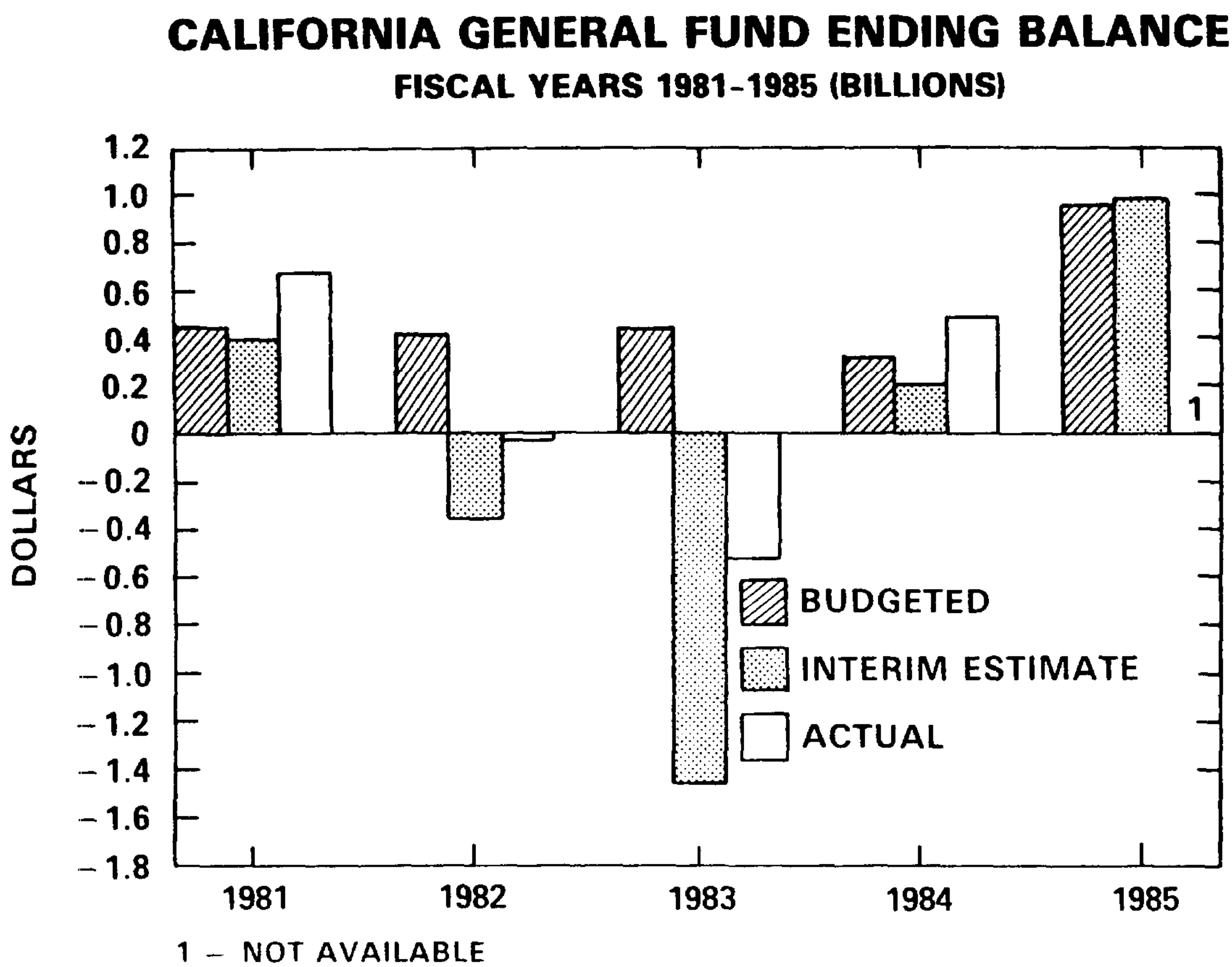

NEW YORK GENERAL FUND ENDING BALANCE
FISCAL YEARS 1981-1985 (MILLIONS)
BUDGET
INTERIM ESTIMATE
ACTUAL
DOLLARS
600
500
400
300
200
100
0
-100
-200
-300
-400
-500
-600
1
1981
1982
1983
1984
1985
1 — ZERO BALANCE

Recent Experience:
Deficits in 1982 and 1983

The reduction in the revenue base as a result of Proposition 13 and depletion of its $3.7 billion accumulated surplus, as well as the recession in the early 1980's, compounded California's deficit problems. The potential deficits were $355 million or 1.6 percent of general fund expenditures in fiscal year 1982 and about $1.5 billion or 6.7 percent of general fund expenditures in fiscal year 1983. By comparison, the actual year-end deficits were smaller (less than 1 percent of general fund expenditures in 1982 and 2.4 percent of general fund expenditures in 1983).

The fiscal year 1982 budget package included over $500 million in additional revenue measures. Tidelands oil royalty funds, normally used for capital outlay, were transferred to the general fund. Vehicle license fees and other receipts were directed to the state rather than provided to local governments. Nevertheless, revenues were still down during the year and the governor responded in executive orders by mandating a 2 percent reduction of most current state operating budgets and by freezing hiring and promotions. The legislature responded in several bills accelerating certain sales and income taxes, reverting unused appropriations back to the general fund, allocating interest earned in an investment fund to the general fund, suspending cost-of-living increases in some aid programs, and stalling transfers from the general fund to a school lease-purchase fund.

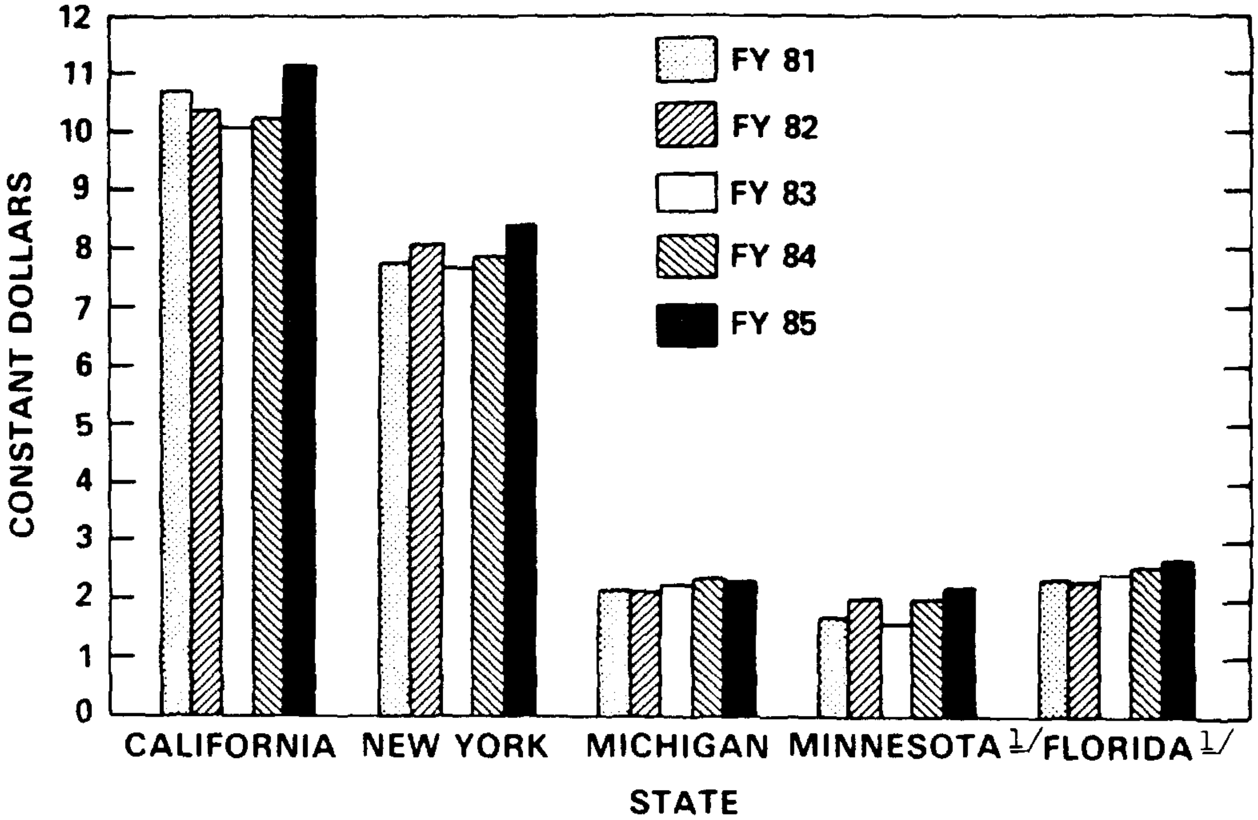
Again in fiscal year 1983, the legislature enacted a budget balancing package during the fiscal year amounting to about $610 million, on top of a 5 percent across-the-board cut in programs that the governor had made in his budget. The governor also made an additional 2 percent across-the-board cut in state


CALIFORNIA GENERAL FUND ENDING BALANCE
FISCAL YEARS 1981-1985 (BILLIONS)
DOLLARS
1.2
1.0
0.8
0.6
0.4
0.2
0
-0.2
-0.4
-0.6
-0.8
-1.0
-1.2
-1.4
-1.6
-1.8
1981
1982
1983
1984
1985
1
BUDGETED
INTERIM ESTIMATE
ACTUAL
1 – NOT AVAILABLE

APPENDIX I

STATE CASE STUDIES

GENERAL FUND EXPENDITURES*
FISCAL YEARS 1981-1985 (BILLIONS)



*1972 CONSTANT DOLLARS

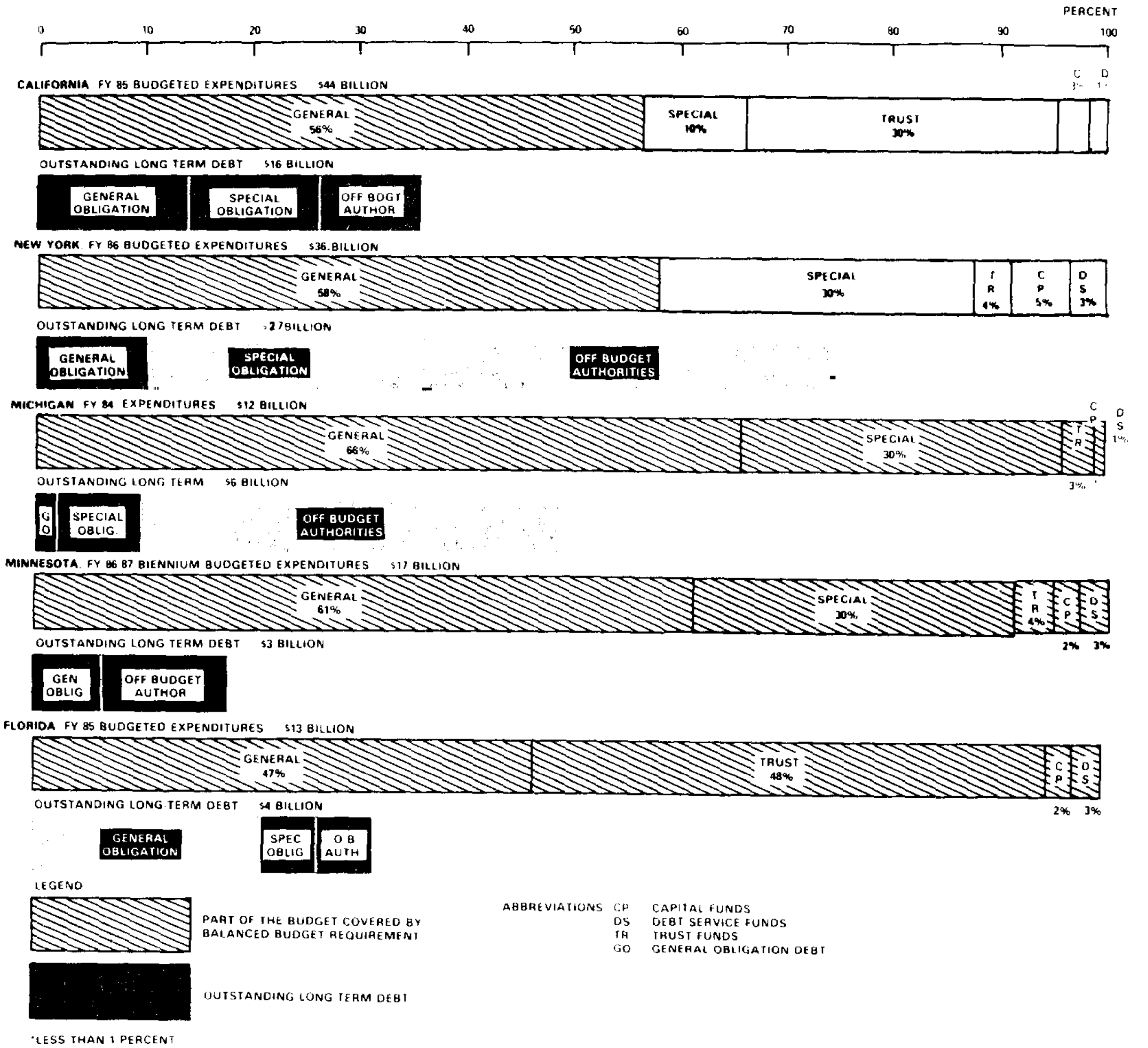
1/ Biennial Budget

STATE DEFICITS

EXTENT OF POTENTIAL DEFICITS

- POTENTIAL DEFICITS RANGED FROM LESS THAN 1% TO 26% OF TOTAL GENERAL FUND EXPENDITURES
- ACTIONS TAKEN GREATLY REDUCED POTENTIAL DEFICITS

STATE BUDGET STRUCTURES



year establishes a ceiling for expenditures. Consequently, the revenue estimates establish the level at which the budget must be balanced. Monitoring revenue during the year allows the states to institute corrective actions when collections fall below projections.

OBSERVATIONS

ON STATES VISITED

- **DEFINITIONS DIFFER FOR BUDGET STRUCTURE AND BALANCED BUDGET REQUIREMENTS**
- **STATES FACED MASSIVE DEFICITS, BUT TOOK STEPS TO BALANCE GENERAL FUNDS**
- **NO SINGLE METHOD USED TO BALANCE BUDGETS DURING ECONOMIC DOWNTURNS**
- **KEY ROLE PLAYED BY FORECASTING PROCESS**
- **MONITORING OF REVENUE COLLECTIONS ENABLED STATES TO REACT DURING FISCAL YEAR**

SECTION 3

STATE COMPLIANCE WITH BALANCED BUDGET REQUIREMENTS

DISADVANTAGES

- Can be detrimental to completion of large capital projects.
- Requires redefinition of priorities during economic downturns.
- Can create large and disruptive fluctuations in program funding.
- Inhibits planning due to funding uncertainty.

IMPLEMENTATION CONSIDERATIONS

- Attitude and determination, i.e., "mind set", to maintain a balanced budget are more important than the actual legal requirement.
- Great difficulty in accurately predicting the level of revenue.

APPENDIX I

STATE VIEWS

ON BALANCED STATE BUDGETS

- ADVANTAGES
- DISADVANTAGES
- IMPLEMENTATION

APPENDIX I

GROWTH IN STATE LONG-TERM DEBT
1981-1984

	PERCENT CHANGE
NONGUARANTEED DEBT	+57.4
FULL FAITH AND CREDIT DEBT	+ 9.1

GOVERNORS' POWER

BUDGET EXECUTION EXAMPLES

- **DETERMINE NEED FOR AND SIZE OF BUDGET CUTS**
- **EMPLOY ACROSS-THE-BOARD CUTS MOST OFTEN**
- **CALL LEGISLATURES FOR SPECIAL SESSIONS**
- **GIVE AGENCIES DISCRETION IN IMPLEMENTING CUTS**

EXECUTION ACTIONS

(RESPONSES OF 44 STATES)

- USED BY MOST STATES 1980-85
  1. SPENDING CUTS
  2. TAX INCREASES
  3. INTERFUND TRANSFERS
  4. ACCELERATED REVENUE COLLECTIONS
  5. STABILIZATION FUND

- RANKED EFFECTIVENESS
  1. ACCELERATED REVENUE COLLECTIONS
  2, TAX INCREASES
  3. SPENDING CUTS
  4. STABILIZATION FUND
  5. INTERFUND TRANSFERS

DEVELOPMENT AND ENACTMENT ACTIONS

(RESPONSES OF 44 STATES)

- USED BY MOST STATES 1980-85
  1. EXPENDITURE LIMITS
  2. LINE ITEM VETO
  3. REVENUE LIMITS
  4. SUPER MAJORITY VOTE FOR TAX INCREASE
  5. LINE ITEM REDUCTION

- RANKED EFFECTIVENESS
  1. LINE ITEM REDUCTION
  2. SUPER MAJORITY VOTE FOR TAX INCREASE
  3. REVENUE LIMITS
  4. EXPENDITURE LIMITS
  5. LINE ITEM VETO

APPENDIX I

TIMING ASPECTS

BALANCED BUDGET REQUIREMENT *WITHIN THE BUDGET PROCESS*

PERIOD BEFORE FISCAL YEAR	FISCAL YEAR
• DEVELOPMENT	
• ENACTMENT	
	• EXECUTION

REPORTING BASIS

BUDGETARY VS ACCOUNTING

- SIGNIFICANT DISCRETION IN BUDGETARY TREATMENT OF FINANCIAL TRANSACTIONS
- GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) ARE AVAILABLE FOR ACCOUNTING TREATMENT OF FINANCIAL TRANSACTIONS
- STATES ARE MOVING TOWARD 'GAAP', BUT DIVERSITY STILL EXISTS

STATE FUNDS COVERED BY BALANCED BUDGET REQUIREMENTS

(RESPONSES FROM 44 STATES)

- **NUMBER OF STATE FUNDS COVERED BY REQUIREMENTS**

* GENERAL FUNDS	43 OF 44
* SPECIAL FUNDS	34 OF 41
* FEDERAL FUNDS	30 OF 41
* CAPITAL FUNDS	25 OF 34
* TRUST FUNDS	22 OF 37

- **RANGE OF EXPENDITURES COVERED 46% - 100%**

BALANCED BUDGET

IMPLEMENTATION FACTORS

- COVERAGE
- REPORTING
- TIMING

STATE PROVISIONS

FOR A BALANCED BUDGET

- 49 STATES HAVE BALANCED BUDGET REQUIREMENTS
- STATE REQUIREMENTS VARY
- INTERPRETATIONS INFLUENCE IMPLEMENTATION

than the so-called "full faith and credit debt" backed by the credit and taxing power of the state.

APPENDIX I

OBSERVATIONS

50 STATE OVERVIEW

- BALANCED BUDGET REQUIREMENTS OFTEN DO NOT APPLY TO ALL FUNDS
- THE REPORTING BASIS INFLUENCES WHETHER STATES COMPLY WITH REQUIREMENTS
- REQUIREMENTS INFLUENCE THE ENTIRE BUDGET PROCESS, BUT ARE MOST APPARENT IN BUDGET EXECUTION
- EXECUTIVE HAS SIGNIFICANT AUTONOMY IN INSTITUTING BALANCING TECHNIQUES
- STATES USE MANY ACTIONS TO BALANCE THEIR BUDGETS

 APPENDIX I

SECTION 2

50 STATE OVERVIEW

STATE ENVIRONMENT

- SEGMENTED BUDGETS
- DEVELOP BALANCED BUDGETS
- BALANCE OF POWER FAVORS EXECUTIVE BRANCH
- OCCASIONAL DEFICITS RESULT FROM UNANTICIPATED CONDITIONS

The condition of the federal financial management systems is another concern in considering balanced budget proposals. The federal financial management process has been characterized as antiquated and fragmented because in many cases support systems are based on outdated technology, and they cannot communicate with other systems, sometimes even in the same agency. Such conditions inhibit the development of timely, reliable, and relevant information which managers would need to comply with balanced budget requirements.

FEDERAL ENVIRONMENT

- UNIFIED BUDGET CONCEPT
- COMPLEX BUDGET PROCESS
- FEDERAL ROLE MAY SOMETIMES REQUIRE DEFICITS
- DEFICITS ALSO RESULT FROM UNANTICIPATED CONDITIONS
- BALANCE OF POWER
- ANTIQUATED AND FRAGMENTED FINANCIAL SYSTEMS

OBSERVATIONS

FEDERAL & STATE ENVIRONMENTS

- **A FEDERAL BALANCED BUDGET REQUIREMENT WILL NOT MAKE THE BUDGET PROCESS MORE EFFICIENT**
- **STATE 'MIND SET' EXPECTS A BALANCED BUDGET--AT LEAST AS PROPOSED BY THE GOVERNOR--AND IN SOME CASES, AT YEAR END**
- **STATE DEFICITS RESULT FROM UNANTICIPATED CONDITIONS**
- **FEDERAL DEFICITS RESULT FROM BOTH UNANTICIPATED CONDITIONS AND PLANNED ACTIONS**

SECTION 1

FEDERAL AND STATE ENVIRONMENTS

OBSERVATIONS

- FEDERAL AND STATE ENVIRONMENTS ARE QUITE DIFFERENT
- 49 STATES HAVE REQUIREMENTS FOR BALANCED OPERATING BUDGETS
- WIDE RANGE OF BUDGET COVERAGE
- STATES USE NUMEROUS TECHNIQUES TO COMPLY WITH REQUIREMENTS
- STATES DO INCUR DEFICITS

OVERVIEW OF PRESENTATION

- FEDERAL AND STATE ENVIRONMENTS
- 50 STATE OVERVIEW
- STATE COMPLIANCE WITH BALANCED BUDGET REQUIREMENTS

We worked on this project from May of this year to December and we have incorporated suggestions by state officials into this briefing report where necessary.

JOB DIMENSIONS

- WHY WE DID THE JOB
- JOB SCOPE
- JOB APPROACH

- State governments have what can be characterized as a "mind set" that their budgets should be balanced, resulting in a cooperative relationship between the executive and legislative branches that does not now exist in the federal government.

- A balanced budget requirement--with its additional decision points and actions--would make a complex federal budget process even more complex.

- States have used a variety of methods to balance their budgets, including reducing programs, increasing revenues, and changing accounting techniques.

The enclosed briefing paper was based on a survey of all 50 states with field visits to 6 states to obtain detailed information on their compliance with balanced budget provisions. In summary, the results of our work disclosed the following points:

1. Forty-nine states have balanced budget requirements, but the range of requirements varies--some only require the governor to submit a balanced budget, some require the legislature to enact a balanced budget, and some require the year to end in balance. In short, not all states are required to balance their budgets during the entire budget cycle.

2. The greatest emphasis is on balancing state operating budgets. Not all state funds are subject to balanced budget requirements. The percentage of funds covered ranges from less than 50 percent to 100 percent. Trust funds, capital accounts, and special funds are those most often excluded.

3. State governors can use techniques to keep the budgets in balance during budget execution that are not currently available to the President. Some of these techniques include impounding funds, using budget reserves or "rainy day" funds, shifting payments from one fiscal year to another, and making accounting changes to delay recognition of expenditures.

4. Despite balanced budget requirements and techniques to keep the budgets in balance, state governments sometimes incur deficits.

5. The ability to effectively comply with a balanced budget requirement will require financial management systems that provide the executive and legislative branches timely, relevant, and reliable information. Such systems are not currently available throughout the federal government.