State Fiscal Rule

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OVERVIEW

Fiscal policy should prioritize funding the core, beneficial role of government, which is to protect foundational rights necessary for people to earn success. Tax policy should not take more than necessary to fund the core functions of government, while taxes should be broad-based, flat, transparent, simple, and low. Spending and taxes in excess of this role for government create bad incentives. They erect barriers that hold back flourishing and success for individuals, families, and businesses. They lead to cronyism and corporate welfare. And they are a drag on the economy.

Government spending should be sustainable and responsible, without running huge unfunded liabilities or incurring other unaffordable debts. Today, the federal government and many states have strayed from this focused role. As a result, unaffordable spending and debt pose significant budget challenges. Moreover, many states are ill-prepared to deal with situations for which they did not plan, such as recessions, despite the fact that three have occurred in the last 20 years alone.

Strong budgetary rules and procedures should ensure that lawmakers do not submit to pressures to spend, tax, and borrow at unaffordable levels. Done right and followed closely, these rules will put states in a stronger fiscal position while also providing a cushion for the inevitable recessions and extraordinary economic shocks. That cushion will help lawmakers avoid budget cuts or tax increases in the middle of a downturn and free them from the mercies and vagaries of Congress.

Most states have tools that could lead to responsible fiscal policy, including balanced budget requirements, some form of tax expenditure and/or revenue limits, and rainy day funds. But they vary in stringency and have frequently been proven ineffective or even harmful at helping states implement sound policies or preparing for economic downturns.

Our proposal would strengthen the requirements to keep spending growth in check through a strong spending limit that would lower the growth in spending and gradually reduce debt—including from pensions. Our proposal would maintain balanced budget requirements, but provide an additional focus over a longer time horizon than just one year to the next. Fiscal policy should be sustainable over a full economic cycle—not just during periods of growth, but also during downturns. Reserve funds with strict and explicit requirements for regular contributions during growth years and restrictions that limit use of the funds to economic downturns are a key feature. If done right, this would provide lawmakers with better flexibility during recessions.

BACKGROUND

Fiscal Rules

Most states have some form of fiscal rule that limits spending, revenues, or both. These vary widely in how stringent and therefore meaningful they are. For example, one of Oklahoma's fiscal rules limits spending growth to inflation *plus* 12 percent, rendering it meaningless as a tool to control spending.[1] On the other hand, Oklahoma can appropriate only 95 percent of tax revenues, so it has a protection against revenue shortfalls. As another example, Alaska has a constitutional appropriation limit that grows at a rate of population plus inflation—a sustainable growth rate—but the limit is based on a level that is unrelated to actual appropriations or revenues and is so high that it consistently fails to control the growth of spending.[2]

The most successful state fiscal rule is Colorado's Taxpayer's Bill of Rights, which limits spending to revenue growth capped by a factor of population growth plus inflation. Any revenue collected over the cap is refunded to taxpayers, a provision that has helped generate popular support and is one of the keys to its success. TABOR is a strong measure that has generally been followed by lawmakers.

However, as special interests have pressured lawmakers to increase spending, over time TABOR has been weakened by a suspension approved by voters, a conflicting constitutional amendment that requires spending on education to grow faster than the TABOR limit, and by carving out general fund spending into special funds exempt from the cap and with fee increases that currently are not subject to the cap. In November 2020, Colorado voters approved Proposition 117, which would require voter approval of major new fees.[3]

Debt

Fiscal rules have had limited impact on total state debt. Some states require voter approval of new public, or municipal, debt. Total state bonded debt is over $1 trillion.[4] When states spend in excess of revenues, they go to the bond markets to raise the necessary funds. Bonded debt is a fixed amount currently owed—plus interest—to creditors.

But the largest and most unaffordable debt comes from unfunded pensions. Total unfunded state and local pension liabilities are estimated between $1 trillion and $5 trillion.[4] Unlike bonded debt, there is no bond or other debt instrument associated with an unfunded pension obligation. Instead it represents, in today's dollars, the excess over what lawmakers have promised they will pay in future benefits and what they have committed in revenues to fund those benefits. These differ from bonded debt because lawmakers can make changes to pension plans by modifying benefits to reduce the obligations, raising revenues (including taxes) to fully pay *future* benefits, or issuing bonds to pay future benefits So the liability is implicit and could—and should—be reduced by policy changes.

There are a multitude of problems with government pension plans, including skipping annual required contribution payments, using unrealistically rosy earnings assumptions to artificially understate a plan's true liabilities, inadequate employee contributions, and overly generous benefits. These factors have contributed to the crushing budget burdens many states are now facing. Additional unfunded liabilities from other post-employment benefits are similar to unfunded pension obligations and total approximately $1 trillion, predominantly for retiree health care.[6]

Balanced Budget Requirements

Forty-nine states require a balanced budget. These vary in practice, from simply requiring governors to submit a balanced budget to the legislature to allowing states to carry over a deficit to the next year, to requiring balance at

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1. National Association of State Budget Officers, "Budget Processes in the States, Spring 2015" pg 61
2. State of Alaska Office of Management and Budget, "Senate Joint Resolution 6, Alaska Spending History and Appropriations Limits"
3. Ballotpedia, "Colorado Proposition 117, Require Voter Approval of Certain New Enterprises Exempt from TABOR Initiative (2020)"
4. American Legislative Council, "State Bonded Obligations, 2019" February, 2020
5. Pew, "The State Pension Funding Gap: 2018," June 11, 2020; Jonathan Williams, Thomas Savidge, Skip Estes, and Bob Williams, "Unaccountable and Unaffordable 2019," American Legislative Exchange Council
6. Thomas Savidge, Jonathan Williams, and Skip Estes, "Other Post Employment Retirement Liabilities," American Legislative Exchange Council, March 23, 2020; Marc Joffe, "*Survey of State and Local Government Other Post-Employment Benefit Liabilities: 2020* (forthcoming), Reason Foundation

the end of each fiscal year through mid-year spending cuts or tax hikes. States with more rigorous balanced budget requirements spend less.[7]

While annual balance is important, it puts the focus on the short term, and lawmakers typically spend all revenues they are allowed. Periods of strong economic growth result in high spending, creating unrealistic expectations for ever more government. Lawmakers should focus not only on the short term, but on the long term to be prepared for inevitable downturns during the economic cycle.

With this short-term focus, most states are ill-prepared for downturns. When they come, lawmakers must grapple with budget shortfalls at the same time demands for safety net spending are increasing. During recent recessions, the federal government has provided bailout funding to states. But this has resulted in poor policies such as costly federal maintenance-of-effort mandates, spending increases, and accounting gimmicks.[8] In the end, many states still make poor fiscal decisions that are not sustainable, especially when one-time federal funds dry up. Research shows that federal grants increase future state spending rather than filling in the gaps.[9]

Revenue or Budget Stabilization Fund

Nearly every state has some type of revenue or budget stabilization fund (rainy day fund), supposedly to be available in case of an emergency or downturn. However, the stringency of the requirements to both fund these reserves or to tap them varies widely from overly restrictive to essentially none at all. As a result, many states are not adequately prepared to deal with revenue downturns and increased safety net spending. Rainy day funds should be reserved to provide continuity during downturns or dealing with true emergencies, so the criteria for using them should be commensurately strict.

Revenues

Recessions often have a major impact on state revenues. This is particularly true in states that have volatile revenue sources such as high income and sales taxes. Lawmakers in these states face more onerous challenges resolving budget shortfalls. When state budgets become strained, whether from recession or runaway spending pressures, lawmakers frequently look for new forms of revenues. Tax increases are harmful generally as they take resources out of the hands of workers, families, investors, and entrepreneurs to fund less productive government endeavors, leading to slower growth. This impact is even worse during recessions. There are varying requirements for passing tax increases from a simple majority in the legislature to voter referendums.

PROPOSAL

The state should have a strict total spending limit that is allowed to grow over time at a reasonable rate. The budget would generally be required to be balanced or in surplus at a spending level at or below the spending cap. Some or all of the surplus would be deposited in a revenue stabilization fund. When economic downturn criteria are met, the reserve fund could be tapped to meet the balance requirement. Revenues would be constrained by a supermajority and/or voter approval requirement for increases.

Spending Limit

States should adopt a strict limit that will meaningfully constrain the growth in total spending, not just certain kinds of spending. The objective of a fiscal rule is to have a holistic tool to manage state finances and keep the entire state government affordable and sustainable.

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7. Matthew Mitchell and NickTusznyski, "Institutions and State Spending An Overview," The Independent Review, v. 17, n. 1, Summer 2012, ISSN 1086–1653,
8. Pew Research Center, "How the Federal Government and States Coordinate During Recessions," Fact Sheet, September 12, 2019; Jonathan Williams and Lee Shalk, "States Should Say 'No Thanks' to a Federal Bailout," The Hill, April 20, 2020; Evelyne Baumrucker, "Medicaid and CHIP Maintenance of Effort (MOE): Requirements and Responses," Congressional Research Service, May 25, 2011; Eileen Norcross, "Fiscal Evasion in State Budgeting," Mercatus Center, George Mason University, July 2010
9. Russell S. Sobel and George R. Crowley, "Do intergovernmental grants create ratchets in state and local taxes," Working Paper No 10-51, Mercatus Center, George Mason University, August 2010

States should follow Colorado's TABOR approach, but also learn from its challenges. Therefore, the spending limit should limit *total* spending irrespective of whether fees or taxes are paying for it, ideally laid out in the state constitution.

Growth metric

The growth metric should meaningfully constrain spending. TABOR combines population growth plus inflation to calculate its spending growth. While that could be challenging for states that are losing population, it could be an appropriate metric to ensure demands on government do not grow when it is serving fewer people. Other metrics could be real gross state product (GSP) growth or rolling average real GSP growth. Rolling GSP growth would smooth out shorter-term cyclical economic trends so lawmakers avoid structural overspending during periods of frothy growth or abrupt spending cuts during downturns.

But economies are different across the states, so extreme care should be given to ensure an appropriate metric is selected. The objective is to restrain unbridled spending growth with an effective limit. But some metrics might backfire and allow spending to grow even higher, depending on specific state economic factors. For example, high income states with a spending limit linked to income growth actually spend *more* than other states.[10]

Ideally the limit should be based on clearly defined backward-looking metrics that reflect longer-term economic and demographic trends. They should not be based on assumptions of future growth that are subject to political influence and thus rosy or unrealistic.

Revenues over the cap

Any revenues collected over the spending cap would go to the budget stabilization or rainy day fund.

Limit on appropriating all revenues

An extra, prudent step to guard against a revenue shortfall would limit how much of projected revenues can be appropriated. For example, following the Oklahoma model, a state could appropriate only 95 percent of estimated revenues. The unappropriated share of revenues actually collected would also be set aside in the rainy day fund. This is similar to a key feature of the Swiss debt brake, Switzerland's popular and successful fiscal rule.[11]

Emergency spending

Emergency spending not provided for and above the cap could occur, but only with a strict supermajority vote (e.g. 2/3 or 3/4 of the legislature.) Emergency definitions should also be established so only true, unforeseen emergencies qualify, not unfunded programs or pet projects. Additionally, to strengthen this provision and prevent abuse, this emergency spending would need to be paid back in succeeding years by commensurate reductions of the spending cap. This is another feature of the Swiss debt brake.

Balanced Budget Requirement

Ensuring spending does not exceed revenues is important fiscal policy. But focusing exclusively on annual or biannual balance allows the budget to grow too large during boom years while not adequately preparing for economic downturns. A budget that is balanced over the longer-term can backstop revenues during downturns by also keeping a stronger check on spending overall.

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10. Matthew Mitchell, "TEL it like it is: Do State Tax and Expenditure Limits Actually Limit Spending?" Working Paper No 10-71, Mercatus Center at George Mason University, December, 2010

11. Romina Boccia, "Needed: An Effective Fiscal Framework to Restrain Spending and Control Debt in the United States," The Heritage Foundation, December 18, 2019; Ryan Bourne, "Budget Restraints That Work," Cato Institute, February 2018; John D. Merrifield and Barry Poulson, *Can the Debt Growth Be Stopped?*, Lexington Books, 2016

State balanced budget requirements should require total enacted budget legislation to balance each year in addition to a balanced executive branch budget proposal and be enshrined in the constitution. As with the spending cap, the entire state budget must balance, not just some portion of it. The spending cap is a ceiling, not a floor; if revenues are projected to be lower than the spending cap, spending must be lower.

The only exception is if during a slowdown specific economic downturn criteria are reached for tapping the rainy day fund. Only then may spending exceed revenues. Limiting how fast spending can grow in flush times and then reserving excess revenues in a rainy day fund will provide lawmakers a cushion during a recession so they can avoid mid-year budget cuts or tax increases. Adhering to strict limits for deposits and withdrawals from the rainy day fund ensures that those resources will be there and can be used when truly needed.

These criteria should be based on backward-looking metrics rather than forward-looking projections that are easily manipulated or overly rosy. They could include measures such as an increase in unemployment, unforeseen drops in revenue, or downturns in GSP. But any metrics should be explicitly distinguished from merely not reaching projected levels of growth, which would not warrant tapping the fund.

An additional step could require amounts tapped from the rainy day fund to be paid back in forthcoming years, also by reducing the spending cap. This would serve two purposes. It would incentivize lawmakers to prioritize the most important spending and it would limit spending growth in future years while the reserve fund is repaid, similar to a feature of the Swiss debt brake.

Budget or Revenue Stabilization Fund – Updating Rainy Day Funds

A well-managed rainy day fund is a key element of sound fiscal policy. It will provide funds lawmakers can use to close budget gaps during a recession, adding a degree of certainty in uncertain times. States then should refocus their rainy day funds to ensure they have adequate resources to supplement revenues during a recession. They should not be slush funds for pet projects, corporate welfare, or new endeavors the state does not have adequate resources to fund.

There should be rigorous criteria for both deposits and withdrawals, but these should not be so restrictive that they would prevent use in times of true need. Preferably, these criteria would be in the state constitution.

Revenues collected over the spending limit would be dedicated to funding the rainy day fund.

The criteria for using the funds must be stringent to avoid abuse and prevent even worse runaway spending. During downturns, states can and should draw on these funds to maintain critical government functions. The key is to have stringent criteria for both funding and using the reserve fund. An additional step could be to require a supermajority vote to tap the funds.

Accumulating too much in the reserve fund would not be a productive use of taxpayer resources. Creating a state sovereign wealth fund isn't the goal, and there should be a limit on how much should be retained in the fund. There is no hard and fast rule, but reserve levels should be tailored to a particular state's economic circumstances. Adequate funding levels could be determined through stress testing state budgets, similar to what banks are required to do.

Once adequate reserve levels were reached, excess revenues would be returned to the taxpayer as with the TABOR model, and used to pay down debt, again according to strict, specific criteria. This includes paying down unfunded pension liabilities, which should be given priority. And, by requiring unspent revenues to be deposited in the rainy day fund before being returned to the taxpayer, lawmakers will be better held to account to keep spending growth under control.

Taxes

Like spending, taxes should also be limited for the harm they can impose on workers, families, businesses, entrepreneurs, and investors. Even though they are the other side of the budget ledger, taxes should not be thought of as a mere bookkeeping move to pay for more spending. There are fundamental economic and societal reasons to keep taxes low; increasing taxes does not come without a cost.

Despite the inherent harm from tax increases, there is a wide variation on the checks for lawmakers to raise taxes, ranging from a simple majority vote in the legislature to a vote of the people. Legislators often view raising taxes as a solution for addressing strained budgets rather than prioritizing funding for critical government functions and the core, beneficial role of government. But tax increases can have real world consequences, driving away capital, investment, and workers, while also lowering wages and opportunity. They are especially harmful during times of fiscal stress and less effective at balancing the budget than spending cuts.[12]

Given the far-reaching impacts of taxes on the economy, lawmakers should face a high bar for increasing taxes on a state's residents and businesses. Any increase in taxes should, at a minimum, require a supermajority (e.g. 3/4) vote of the legislature, best laid out in the constitution. In some states it could be appropriate to require a vote of the people.

CONCLUSION

Our constitutional system of federalism vested limited functions with the federal government and everything not explicitly a federal function is reserved to the states or to the people. Accordingly, states are free to reap the benefits of their policies in the good times, but also bear responsibility for the lean times. The U.S. has endured three major recessions since 2001. Despite being preceded by periods of prolonged growth, many states did not prepare well for these downturns.

Instead, many spent freely during the good years and did not adequately finance their budget stabilization (rainy day) funds. Lawmakers found themselves in an untenable situation when revenues declined during these recessions, up against balanced budget requirements and without adequate finances to fund regular chronic overspending or the increased costs from safety net programs that arise during a recession. Balanced budget requirements that focus solely on one year incentivize this kind of short-term approach to fiscal policy and better constitutional rules are needed to provide a longer-term focus and prepare for hard times.

Over half the states have some sort of spending or revenue limit, yet frequently these have been inadequate to control spending. Similarly, while nearly every state has some sort of rainy day fund, these too have been inadequate to provide funding levels to bridge the gap during a downturn.

Perhaps one of the silver linings of COVID-19 and the 2020 recession is the growing realization that existing fiscal rules for many states are inadequate and should be strengthened to control spending, debt, and taxes during the boom years and to prepare adequately for the down times.

12. Veronique de Rugy and Jack Salmon, "Flattening the Debt Curve: Empirical Lessons for Fiscal Consolidation," Special Report, Mercatus Center of George Washington University, 2020