Tax and Expenditure Limitations as a Tool of Counter Cyclical Fiscal Policy: Post-2001 Recession Fiscal Strategies in Three States

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by

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ABSTRACT

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The central research question for this study is to determine whether state tax and expenditure limitations play a role in fiscal management by constraining growth in state government general fund spending during boom times to mitigate the effects of revenue loss following an economic downturn. There has been much study of tax and expenditure limitations and a separate theme on cyclical instability and how states prepare and react to downturns through reserves, temporizing actions, higher revenues, and spending cuts. While these themes have evolved separately, they are beginning to approach each other. Given the wide ranging characteristics of tax and expenditure limitations, which vary based on how binding they are and whether they restrict revenue, expenditures, or both, the research design in this study adopted an analytical strategy that compared three states before and after the recession of 2001: Delaware, which has a constitutional limit on spending as a percent of revenues; Maryland, which has a non-binding informal limit on spending; and Virginia, which has no tax and expenditure limitations in place.

Three case studies employed qualitative interviews with elected officials and budget personnel to gauge their perceptions of the effectiveness of their respective budget practices relative to quantitative data on revenue and spending trends, as well as general fund and rainy day fund policies and balances prior to and following the 2001 recession. The study concluded that both binding and non-binding tax and expenditure limitations were successful in limiting ongoing general fund operating budget spending during the boom economic times of the late 1990s. Reserve fund balances, which were expected to be larger in states with tax and expenditure limitations, were affected by caps on maximum balances, the ability to use balances for purposes unrelated to fiscal crises, or the age of the fund. Fiscal stress following the 2001 recession was influenced by other factors including revenue and reserve fund policies.

In most instances, interview participants felt that the system under which their state operated (*i.e.*, formal tax and expenditure limit, non-binding limit, or no limit) was the best system. Those in states with limits also opined that their presence did help constrain growth in state government spending in periods of economic growth. Interestingly, the interviewees in Maryland and Delaware also expressed a reluctance to use reserve fund balances below the 5% level over concern for potential credit rating downgrades.

The researcher believes that states may benefit from policies to limit spending growth relative to some measure of economic activity and to maintain an established percent of revenues in general fund balance. With respect to rainy day funds states should determine the optimal balance recognizing that reserves cannot carry a state through a recession. Other considerations include eliminating maximum balance caps, using automatic deposit requirements, and limiting use of balances only for budgetary shortfalls. States need to pay attention to revenue policies during good times, as cumulative tax actions impact financial management. States ought to determine methodologies for allocating surplus funds at closeout to unmet spending needs, PAYGO and other one-time purposes, transfers to reserves, or application to unfunded liabilities.

Further study could assess the effectiveness of tax and expenditure limitations in other states at constraining spending growth, the fiscal management policies of states to ascertain use of funds for one-time purposes, general fund balance requirements, the optimal size of reserve balances, and the effect of bond ratings in decisions to use balances during recessions.

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DEDICATION

This work is dedicated to Warren G. Deschenaux, the Director of the Office of Policy Analysis, for his encouragement and support throughout my tenure in the program. Most of what I learned about budgeting and cash management has come about from working closely with Warren during my career.

ACKNOWLEDGEMENTS

The topic of this project came about largely through my work with the Department of Legislative Services, which supports the work of the Maryland General Assembly, including the joint Spending Affordability Committee. Growth in spending during the boom times of the late 1990s was followed by the adoption of budget reductions and other balancing actions after the recession of 2001. The question of whether tax and expenditure limits played any role in smoothing the cash flow resulting from the business cycle arose from this experience.

My committee chair, Dr. Lenneal Henderson, spent a considerable amount of time as this project was developed, refined, written, and defended. Special thanks go to Drs. Laura Wilson-Gentry and Ed Gibson, members of my committee. Both brought a wealth of knowledge of budgetary theory and methodology.

Corina Eckl and Arturo Perez, staff to the Fiscal Affairs Program of the National Conference of State Legislatures, provided data, suggestions for reference materials, and assistance in identifying staff contacts in the states of Virginia and Delaware. Additional data from NCSL was provided by Tim Storey and Todd Haggerty. In Virginia, much assistance was provided by Betsey Daley and Becky Covey, with additional information provided by Joe Flores, Sarah Herzog, and Bill Echelberger of the Senate Finance Committee and Sara Tatum with the Virginia Department of Education. Data in Delaware was provided by Michael Morton with the Office of the Controller General, Robert Scoglietti with the Office of Management and Budget, and David Gregor with the Department of Finance.

I also owe a debt of gratitude to John Rohrer, who acted as peer reviewer, and Joyce Fowler, Ria Hartlein, and Karen Lehmkuhl, who reviewed the manuscript and corrected many errors. Jill Sage, Monica Kearns, and Claire Rossmark remained enthusiastically interested in my progress. Their continued encouragement helped me to persevere when completion seemed less certain. I look forward to becoming reacquainted with family, friends, and colleagues who saw little of me over the years.

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CHAPTER I –Introduction

Introduction

In the 1960s and 1970s, federal and state government spending grew faster than overall growth in the economy. This upward trend was not lost upon taxpayers, who believe that government is inefficient and wasteful, and is filled with corrupt officials, and employees who are overpaid and underworked. At least since the Progressive Era, efforts have been undertaken to reduce corruption and patronage and improve fiscal responsibility, transparency, and ultimately accountability to the taxpaying public.

Over the last 100+ years, there has been a string of reforms targeted at accounting systems, budgeting, personnel, and procurement, such as the federal Budget and Accounting Act of 1921, budget reforms in the 1940s and 1960s, the State and Local Fiscal Assistance Act of 1972, and more recent federal Office of Management and Budget circulars and guidelines. Reforms have also included state balanced budget requirements, term limits, the voter initiative process, and more recently tax and expenditure limitations.

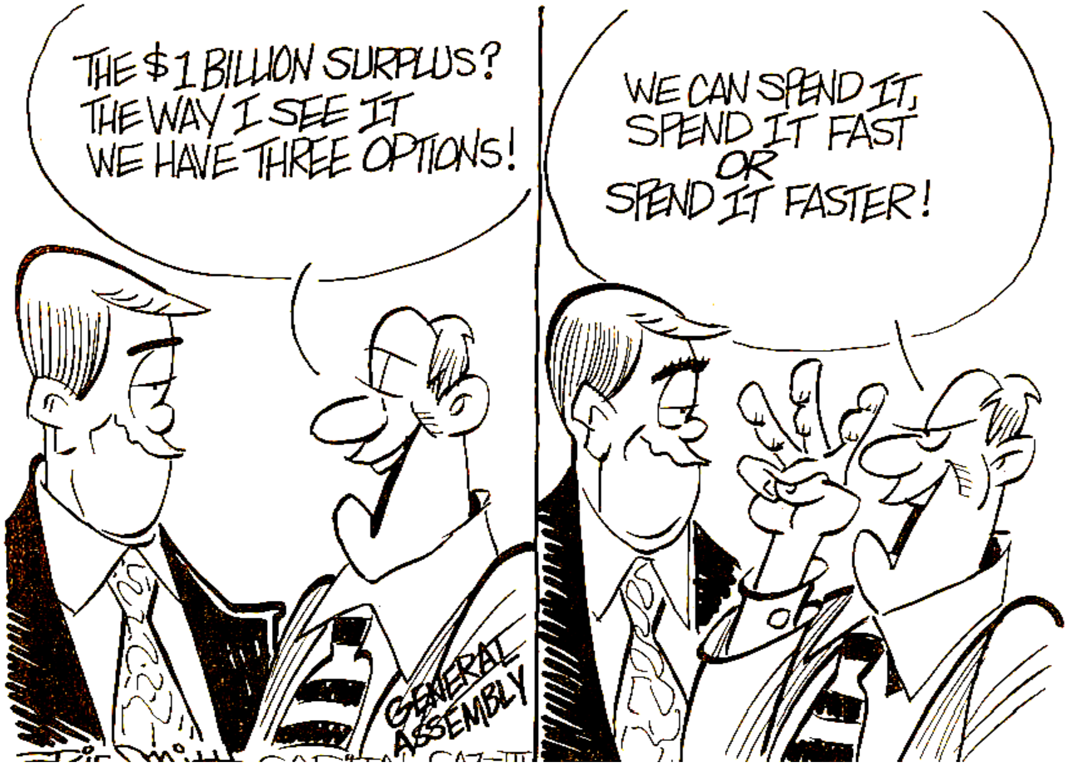
Proposition 13 in California, which imposed constraints on the use and increase of the local property tax, was not the first such limit to be imposed, but its popularity gave rise to a national movement the effects of which are still felt today. As discussed in this study, the literature on tax and expenditure limitations demonstrates mixed results in terms of the effectiveness of these mandates in reducing the size of government. Typically the yardstick for measuring success has been applied against personal income, as a proxy for economic growth, or how well these measures reach their objectives relative to other states without such measures. But could tax and expenditure limits be effective in a way not currently measured? The research question central to this paper is: how effective are tax and expenditure limitations in restraining growth during periods of economic expansion, so as to limit fiscal stress during periods of economic downturn.

Related to this is the question of effectiveness is the question of the appropriateness of tax and expenditure limitations as a tool of accountability, vis-à-vis the amount of discretion that elected officials by state constitutional or statutory mandate should have in managing a state's finances. That is, are tax and expenditure limitations an effective external control placed on elected officials? If so, do they limit their ability to raise revenue or increase spending without allowing government to grow too excessively?

Another perspective in the public administration literature relates to fiscal management throughout the highs and lows of the business cycle. Governments traditionally engage in procyclical actions, cutting taxes and increasing spending at the peak of the business cycle, while cutting spending and raising taxes when the economy turns downward. Much study has been devoted to public sector efforts to manage surpluses, or slack, in ways that do not expand government operations too extensively in order to avoid less palatable actions to regain equilibrium in times of fiscal stress.

Setting aside funds in reserve during good times to serve as a counter cyclical tool of financial management in bad times has been a major development over the past 30 years. As discussed in the literature in Chapter II, there is a philosophical divide over the optimal size of reserves. This is driven in part over whether such funds are intended to act as a cushion until additional budget actions are taken or whether one believes that reserves should be sized to carry a state through an entire economic downturn.

Figure 1.1



A minimum of 5% held in reserve is attributed to credit rating agencies (Hou 2004, 45). Similar suggestions have been echoed by the National Conference of State Legislatures (NCSL). The general guidance to retain a minimum of 5% of general fund spending in reserve has proved to be too small for those who believe that such reserves should obviate the need for any tax or spending actions following recessions. The Center on Budget and Policy Priorities and others maintain that reserves should permit states to ride out recessions without having to raise taxes, cut budgets, or take other actions (Lav and Berube 1999, viii, 7; Zahradnik 2005, 21; Sobel and Holcombe 1996, 42; Joyce 2001, 67; Schunk and Woodward 2005, 119).

In looking at the question of how effective tax and expenditure limitations have been in restraining growth during good times, the implication is that such limitations have a role to play as a tool of counter cyclical fiscal management. Rubin indicates that governments have traditionally undertaken counter cyclical policies that focus on prevention (*e.g.*, accumulating reserves), temporizing (*e.g.*, fund transfers etc.), and balancing (*e.g.*, cutting spending) (Rubin 2005, 47-48). State governments with limitations should theoretically have limited spending growth relative to other states.

Central to this study is a basic understanding of the concepts of budgeting. Operating budgets are supported by revenues, comprising in the public sector the proceeds from ongoing taxes and fees. Nearly all state governments have balanced budget requirements, which stipulate that spending not exceed projected revenues. States appropriate revenue for a variety of programs and purposes including agency operations, aid to local governments, entitlement programs such as Medicaid, and one-time pay-as-you-go (PAYGO) capital purposes. Capital infrastructure is often funded by debt, but it is good fiscal policy to use slack, revenues for one-time purposes such as capital in order to maintain sustainable growth. To assist states in maintaining balanced budgets during periods of economic distress, most states maintain reserve funds, similar to savings accounts, as well as unspent general fund balances. The use of these balances is considered a one-time source of revenue since they are not available in future years once depleted.

A strategy of inquiry that mixes qualitative and quantitative measures is proposed through a comparative case study of the fiscal management practices of three similar states: Delaware, Maryland, and Virginia, in the period prior to and following the 2001 recession. This analysis will include interviews of a total of nine individuals, including one legislator from a budget committee, one executive branch budget director, and one legislative fiscal staff director. These individuals are selected because of their familiarity with the preparation and approval of state budgets through good and bad times. In addition, document review of budgetary data from the 1997 through 2004 period will be used to confirm the findings from the interviews. The degree of fiscal stress experienced by states following the recession will be measured by a variety of indicators including budget reductions, fund transfers, and use of rainy day reserves and other cash balances.

These states were chosen because, though similar in economic and geographical terms, they take very different approaches to limiting revenues and spending. Delaware has binding tax and expenditure limitations on revenue and spending; Maryland has a non-binding advisory limit on spending; and Virginia has no limits on either revenue or spending growth. The approach provides what Patton refers to as "a maximum structural variation of perspectives" (Patton 2002, 109).

This introductory section continues with a review of the evolution of budgetary reform in the United States, a discussion of factors which influence the rise of tax and expenditure limitations, a recap of current state fiscal management practices, and an outline of the purpose of this study.

The Evolution of Budgetary Reforms

"…governments, whatever their other virtues, which fail to provide adequate budget methods will neither reach the maximum of efficiency nor prove to be altogether responsible to the people." – William F. Willoughby (Willoughby 1918, 34).

During the history of the United States, the form and function of budgets in the public sector have evolved, with the stated intent of improving their utility and transparency for decision makers and the taxpaying public. Underpinning the budget are accounting systems, which were the subject of reform in the late 19^{th} and early 20^{th} centuries. Reformers advocated the adoption of double-entry accounting, shifting from cash-book accounting.

Budgetary reforms adopted during the 20^{th} century included formats such as line-item budgeting; program budgeting; Planning, Programming, and Budgeting System (PPBS); Zero-base budgeting; and performance budgeting. In some instances reforms are intended to limit the power and discretion of elected officials in an attempt to institutionalize fiduciary responsibility. Examples of these types of reforms include balanced budget requirements, term limits, voter initiatives, and tax and expenditure limitations.

Accounting System Reform

For much of the nation's history, it was not unusual for many governments to use a cash-book method of accounting, which evolved into single-entry accounting systems which gave a more complete financial record (Cleveland 1909, 164-165). However, as the country grew and the industrial revolution drew the population to urban centers, government was unprepared administratively to provide services (Goodnow 1900, 123-124). Cleveland points out that in the span of just 80 years the percentage of the population living in cities increased from under 5% to nearly 70% (Cleveland 1909, 113-114). He advocated that cities move to a system of double-entry accounting to provide more information to public sector decision makers, to improve economy and efficiency, and to improve transparency. He wrote that "As a means of securing both *economy* and *fidelity*, for the enlightenment of officers and for the satisfaction of citizens and taxpayers, a complete system of accounts is demanded…" (Cleveland 1909, 173).

Line-Item Budgeting

The first comprehensive line-item budget was created in New York City for its Department of Health in 1907. This type of budget was considered to be an important advance for advocates of reform. This was described in *Making a Municipal Budget* by the Bureau of Municipal Research (Martin 1989, 376). The advantage of the line-item budget was increased financial control. The expenditure of funds is classified according to items of expenditure (*e.g.*, office supplies, vehicles, personnel) and ensures that spending is limited to what is appropriated and is used as legally intended (Mikesell 1999, 44-45).

While line-item budgets offer strong control of expenditures, they leave much to be desired from the standpoint of the lay taxpayer trying to understand how funds are spent in terms of the activities pursued or the outcomes achieved. Line-item budgets also do not enable decision makers or outside interests to be able to draw comparisons between activities or to make relative judgments about the costs of different activities.

Program Budgeting

Program budgets were touted as the next advancement in budgetary theory and were recommended at the national level in 1949 by the Hoover Commission (Bell 1957, 13-14). In part, this was due to the growth of the size of government as well as an increase in the number and complexity of programs. Spending at the federal level more than doubled between 1932 and 1940. This would have significantly increased the line items of expenditure in the budget and made it more difficult to understand exactly what activities were being funded (Schick 1966, 306-307). With respect to the advantages of a program budget, the Commission noted that it would "focus attention upon …service to be rendered, rather than the things to be acquired, such as personal services, supplies equipment, and so on. These latter objects are, after all, only a means to an end. The all important thing in budgeting is the work or the service to be accomplished, and what that work or service will cost." (Bell 1957, 14).

Maryland adopted its own version of a program budget in 1952 based on a 1951 report by the Sobeloff-Stockbridge Commission (Bell 1957, 14). Interestingly, even though Maryland adopted and maintained use of a program budget format in its budget bill, it continues to require that line-item budget detail also be submitted both in print and electronic format. Virginia also adopted a program budget format in the 1970s to reduce line-item detail and more logically group governmental activities (Virginia General Assembly Joint Legislative Audit and Review Commission 2008, 36).

Planning, Programming, and Budgeting System

PPBS was developed by the Rand Corporation and implemented in the U.S. Department of Defense (DoD) in the 1960s. Its purpose was to help address deficiencies in budget development and decision making that was focused on the short-term, comprehensively address overall mission requirements of the individual branches of the armed services, and to introduce more systematic analysis (DeCandido 1996, 1-4). Schick notes that this development was aided by the increased use of economic analysis (*e.g.*, systems, operations, cost benefit analysis and the like, information technology, and a melding of planning and budgeting) (Schick 1966, 311).

First used in 1963 as part of the DoD's 1963-1967 five-year plan, PPBS was oriented toward the development of defense programs that contributed to the overall mission of the agency. All resources were divided into 10 force categories (*i.e.*, programs) and then subdivided into program elements (DeCandido 1996, 6-7). PPBS allowed decision makers to compare the costs and alternatives of options to help meet certain objectives (Schick 1966, 308). Ultimately expanded to all federal agencies in 1965, PPBS enjoyed less success in civilian agencies but continues to be used in the military (Shafritz and Hyde 1987, 277).

Zero-Base Budgeting

Budgets are often considered in terms of annual incremental change. Little consideration has typically been devoted to the base. Once created, programs and purposes in the budget usually continue to grow, albeit at different rates. Originally a product of Texas Instruments in the late 1960s, zero-base budgeting was first used in the public sector in the early 1970s by then Governor of Georgia Jimmy Carter (Pyhrr 1977, 495).

The basic concept behind this approach is to evaluate all activities and programs each year. In effect, starting from a zero base and deciding what programs to fund within available revenues. Each activity is segregated into what are called "decision units", which form the basis for "decision packages" to evaluate each unit. Consideration can be given, for example, to costs and benefits, workload measures, and alternatives. Decisions are then made to discontinue, reduce, level-fund, or increase resources devoted to that activity (Pyhrr 1977, 497-499).

Ultimately elected and appointed officials need to rank the different packages to decide what services to provide and at what levels. After his election, President Carter attempted to apply a zero-base approach to federal budgeting, but it did not last. This reform was successful in changing the orientation of decision makers to consider the totality of spending. However, zero-base budgeting was not without its problems, as it was both time and paper intensive. Equivalent information on the performance of each activity was not always available. More importantly, it is extremely difficult to make choices about unlike services and programs.

Performance Budgeting

Performance budgeting at the federal level arose from the work of the National Performance Review, better known as the Gore Commission. Citing examples that demonstrate that the federal government is both inefficient and ineffective, the report indicates that agencies are hamstrung by too much control imposed by budget, personnel, financial management, and information technology systems (Gore 1993, 460-461). Four "key principles" were identified for changing the focus of government. These were to:

- Provide relief from control systems that emphasize "following rules" to instead focus on the achievement of results;
- Listen to customers through focus groups and surveys and develop incentives to meet their needs;
- Decentralize authority to permit front line employees to solve problems and thus improve service; and
- Improve government productivity (Gore 1993, 464-465).

The Government Performance Results Act of 1993 (GPRA) was passed to implement the recommendations of the National Performance Review. It required agencies to develop five-year strategic plans that included mission statements, goals and objectives, and resources needed to meet those goals, among other requirements. It also stipulated that agencies are to develop performance plans each year which establish measurable goals as well as indicators to determine progress by comparing results to the goals (U.S. Office of Management and Budget 2008, 2-3). Rubin notes how performance budgeting changed the focus of accountability. Instead of emphasizing how funds were expended, performance budgeting emphasizes the accomplishments of government and holds administrators and elected officials accountable (Rubin 2000, 19).

After implementation at the federal level, the concept of performance budgeting spread to state governments. The State of Maryland, for example, set up a committee in 1996 to examine the issue. The state's version of performance budgeting, Managing for Results, began implementation in July 1997 and was phased in over a multi-year period (Maryland Department of Budget and Management 2008). Implementation was patterned on the federal structure, requiring agencies to also develop strategic plans with quantifiable time-limited objectives. Performance is measured using indicators that classify activities as inputs (resources used to provide services); outputs (amounts of services produced); outcomes (results produced which benefit the customer); efficiencies (how well resources are used to produce services); and quality measures (how effectively customer needs are met) (Maryland Department of Budget and Management 2003, 21-22).

Additional reforms have been adopted over the years to enhance public sector financial management, which in some cases have been externally imposed by the voters. This includes:

Balanced Budget Requirements

All states except Vermont have some form of balanced budget requirement (Elder 1992, 51). The following four types of balanced budget requirements are cited in the literature and found in various combinations in the states:

1. The Governor's budget must be balanced upon submission to the legislature for its consideration;
2. The budget must be balanced upon completion of legislative action;
3. The budget must be balanced when the Governor signs it; and
4. The budget must be balanced when the fiscal year ends (Hou 2003, 74).

In sum, public sector budgeting has evolved over the years, and a number of reforms have been adopted to improve accountability and transparency. Such reforms prompted a move from line-item budgets to other formats including program budgets, PPBS, zero-base budgeting, and more recently performance budgets. Tax and expenditure limitations represent another type of budget reform. This is important because of the possible effect on restraining growth in good economic times in order for states to be in a better position to lessen the procyclical actions that are adopted during economic downturns.

Political and Institutional Reforms

Term Limits

Term limits constrain the power of state elected officials by requiring them to leave office after serving a set number of terms. The desire for term limits is no doubt related to public perceptions of corruption in office, as demonstrated by survey research cited by Ladd and Wilson and by Rosenthal. Ladd and Wilson cite a Massachusetts survey where 88% of respondents thought that corruption in state government was common, and Rosenthal noted that a poll in Utah found that it was believed that 2/3 of legislators take bribes (Ladd and Wilson 1982, 128; Rosenthal 1996, 43). However, the downside of term limits is the loss of leadership and expertise that comes from continuity in office (Bowser 2007, 1). The work of elected officials is also made more difficult by the steep learning curve associated with ever more complex public policy issues and finances.

From the perspective of financial management, term limits may have unintended consequences. Instead of improving public sector financial management, term limits remove from office those officials who experienced prior downturns and would be in position to understand what worked and what did not work. Instead, newly elected leadership may adopt policies which are procyclical in nature (*e.g.*, a decision to spend down reserves or to enact large tax cuts in good times). In the bureaucratic milieu, leadership must also adapt to macro level changes in fiscal policy. Resource availability can affect the ability of an agency to address its mission, and this in turn can be influenced by the fiscal policy decisions of term limited elected officials.

Notwithstanding these concerns, term limits became a reality in greater numbers within the last 20 years. As shown in **Table 1.1**, 35 states now limit the number of terms served by a Governor, with over 1/3 of those limits being adopted since 1990. Table 1.1 also shows that 15 states also now limit the terms that a state legislator may serve, with all having an effective date between 1996 and 2010.

Table 1.1
Gubernatorial and Legislative Term Limits

Date of Enactment/Effect	States with Gubernatorial Limits (Note 1)	States with Legislative Limits (Note 2)
1787-1969	13	0
1970-1989	9	0
1990-2010	13	15
Total	**35**	**15**

Table Notes
Note 1: Source: U.S. Term limits 2005. This is based on date of enactment.
Note 2: Source: Bowser 2007. This is based on year of first impact.

Voter Initiative

NCSL defines the voter initiative as "a process that enables citizens to bypass their state legislatures by placing proposed statutes and, in some states, constitutional amendments on the ballot." (NCSL Initiative, Referendum and Recall 2008). NCSL indicates that 24 states have citizen initiatives, with nearly all located in states west of the Mississippi River. Two types of initiatives exist:

- ***Direct*** **–** in which proposals go directly to the ballot to be voted upon; and
- ***Indirect*** **–** in which proposals are sent to the legislature to first receive consideration. Measures go to the ballot in some states if the legislature modifies, rejects, or fails to act upon it. Other state legislatures may propose alternatives, and both the original proposal and the alternative would go to the ballot (NCSL Initiative, Referendum and Recall 2008).

The initiative is important because through it, citizens can propose constitutional and statutory changes which impact budget processes and funding. As discussed below, the initiative is a primary vehicle for the proposal and adoption of tax and expenditure limitations. Rueben indicates that the presence of the initiative increases the likelihood of passage of a tax and expenditure limitation by 16% (Rueben 2000, 13).

Tax and Expenditure Limitations

"Caps are neither magic bullets that will cure all the ills of government nor poison apples that will bring instant paralysis to the public sector." – Tyson King-Meadows and David Lowery J. (King-Meadows and Lowery 1996, 110-111).

Overview: Tax and expenditure limitations constrain public sector revenue sources, government spending growth, or both. They represent an effort to slow growth in government spending in an attempt to force fiscal responsibility onto elected officials (Bails 1982, 129).

In 2008, NCSL reported that 31 states had some type of limit, including 25 with spending limits, 4 with revenue limits, and 2 with both revenue and spending limits (Waisanen 2008, 6-8). Many tax and expenditure limitations were adopted through the voter initiative, although in some states legislators put forth their own versions of limitations in lieu of more restrictive constraints from the voters (Mullins and Wallin 2004, 2). There are a variety of theories as to why tax and expenditure limits are supported. These include large periodic spikes in taxes which raise taxpayer ire, the perception of wasteful spending in the public sector, too much emphasis on one type of tax, a perception that government is too big, the desire of taxpayers to cut costs when all prices rise during economic downturns, and resentment of those who do not use many government services yet are required to pay for them. The following discussion provides a brief background of tax and expenditure limitations and an overview of some of the theories which relate to their popularity.

Background: Tax and expenditure limitations date to as early as the 19th century, chiefly applied to the property tax (ACIR 1977, 11). In 1976, New Jersey was one of the first states to adopt a modern-era tax and expenditure limitation. It followed the enactment of law to implement an income tax in order to comply with court ordered requirements to revise the property tax and education finance. The early limitation held spending to the budget's share of personal income in the prior fiscal year. The limit was allowed to sunset in 1983 (Rueben 2000, 4-5).

Proposition 13 was adopted by voters in California in 1978. It reset the assessed value of property to 1975 levels, limited property tax rate increases to 1%, and limited increases in assessments to the lesser of inflation or 2% (Sherwood-Call 1987, 58). What followed was not just a large decrease in property tax revenue, but a nationwide tax revolt movement. Twenty-three states adopted tax and expenditure limitations soon after the passage of Proposition 13, and 43 states adopted a limit just on property taxes between 1978 and 1980 (Danziger and Ring 1982, 47; Stansel 1994, 3).

In Maryland, a state without the initiative, 22 bills were reportedly introduced at the 1979 session alone, of which 8 proposed amending the state constitution, to impose limits on state spending (Maryland Department of Fiscal Services 1995, 8). Between 1978 and 2000, over 100 statewide anti-tax measures were introduced, and 45 were approved (Smith 2004, 88-89).

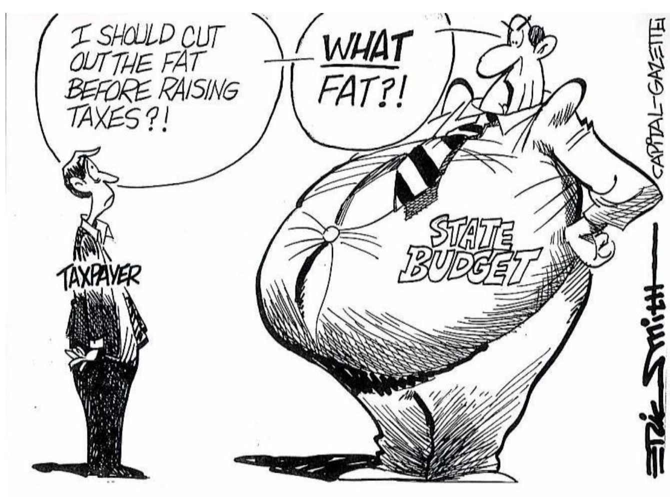
Figure 1.2

Underlying Causes of Tax and Expenditure Limitations: Several themes emerge from the literature as to the causes of the tax revolt in California and the popularity of tax and expenditure limitations since the revolt.

- ***Price Spikes:*** Some studies suggest that Proposition 13 resulted from a lack of taxpayer acceptance following statewide reassessment of property in as much as 15 years in some instances. Assessment levels were increasing from 50% to 100% compared with the last assessment, and at one point the state was ranked second nationally in property taxes per $1,000 of personal income (Danziger 1980, 602; Sherwood-Call 1987, 58). In addition, property tax levies grew by 12% a year on average between 1966 and 1972 (ACIR 1977, 27). Similar sentiments were found in Massachusetts where some supporters of Proposition 2 ½ saw a jump as high as 215% in property assessments levels (Stein, Hamm, and Freeman 1983, 191-193; Danziger and Ring 1982, 48).

- ***Waste & Inefficiency in Government:*** Many think there is (1) widespread corruption in government; (2) inefficiency; and (3) overpaid and under-worked employees. A survey of Massachusetts voters found that 80% believed that a 5% reduction in state spending could occur with no service loss and 73% thought at least 15% could be cut with no effect on services (Ladd and Wilson 1982, 128). In California, 38% of survey respondents believed that up to 40% of spending could be cut without any service loss (Mullins and Wallin 2004, 14).

Figure 1.3



- ***Too Much Emphasis on One Tax Type:*** Proposition 13 was also attributed in part to an over emphasis on one source of tax revenue, in this case the property tax. Property taxes made up 49% of state and local revenue in California in fiscal year 1971 (Sherwood-Call 1987, 58).
- ***Economic Downturns Squeeze Taxpayers:*** When business cycles inevitably cause the economy to contract, public sector service demands increase at a time when tax revenue falls and costs rise due to inflation. In times of rapid cost increases, consumers cannot alter the price of goods and services. So there is an incentive for them to try to cut costs by reducing what they can control, such as where they shop and what they buy. Taxpayers do not have the same ability when it comes to how much they must pay to government (Osborn and Hutchinson 2004, 45; Ladd 1978, 5). This may explain in part why the passage of many revenue or expenditure limits occurred shortly after economic downturns dating from the Panic of 1870, the Great Depression, and the recessions of the early 1980s and 1990s (ACIR 1977, 11; Mullins and Wallin 2004, 11; NCSL 2005,1; Elder 1992, 54).
- ***Tax Liabilities Do Not Match Service Use:*** Two interesting themes emerge here. First the public demands high services and lower taxes without fully understanding the nexus between the two. They want services but are unwilling to pay for them (Meyers and Pilkerton 2003, ii; Mullins and Wallin 2004, 3). A second point relates to the redistributive nature of government. Wealthier citizens generally pay more in taxes but receive less in services than those with lower incomes. Tax and expenditure limitations are supported by those who think that they pay more in taxes than they receive in services (Danziger 1980, 611-612; Ladd 1978, 4).

The foregoing material has served to summarize budgetary reforms and political institutional trends that were adopted over the last 100+ years. Improved transparency in how public funds are spent resulted from the evolution from cash-book accounting to line-item budgets, program budgets, PPBS, zero-base budgeting, and performance budgets. Term limits represent an effort to enhance accountability, while the voter initiative gained popularity as a means of circumventing elected officials. In the last 30 years, tax and expenditure limitations have grown in popularity. These limitations constrain the discretion of elected officials but are viewed as a response to perceptions of too much inefficiency in government, among many reasons. While seen principally as a tool for reducing the size of government, the ensuing discussion on cyclical instability offers another fiscal context within which to view tax and expenditure limitations.

State Fiscal Management Strategies

Normal business cycles can have a big impact on the public sector, as revenues rise and fall as the economy expands and contracts. But government spending requires stability to provide the services that citizens need and in most cases is faced with balanced budget requirements. Service demands increase as unemployment rises when, for example, more citizens become eligible for open-ended entitlement programs.

States have limited fiscal management strategies, which Rubin identifies as prevention (*e.g.*, building up reserves to be used during periods of fiscal stress); temporizing (*e.g.*, use of other balances, sale of assets, accounting gimmicks, and other one-time actions that defer decisions in hopes of eventually growing out of the problem); and balancing – (*e.g.*, taking actions to cut spending and raise revenue) (Rubin 2005, 47-48).

Following the economic downturn of the early 1980s, states began building reserves, partly based on the advice of credit rating agencies and NCSL. Balances on the order of 5% were amassed in time for the downturn of the early 1990s, and balances twice this size were established by the downturn of 2001. In both cases the accrued fund balances were quickly used.

At issue is whether rainy day fund balances should be sufficient to provide the entirety of resources that states need to make it through a recession. Studies have estimated that balances as a percent of general funds would likely have to be in the range of 15% to 20%, though some researchers estimated from 30% to 36% would be necessary (Lav and Berube 1999, 21; Zahradnik 2005, 21; Sobel and Holcombe 1996, 42; Joyce 2001, 67; Schunk and Woodward 2005, 119). Anecdotal evidence suggests that the political will to amass balances of those magnitudes is difficult due to demands from taxpayers, advocates, and agencies to cut taxes and/or meet demands for new or expanded government services.

Absent the political will to amass large fund balances, prevention can only be considered a short-term solution to give elected officials time to deal with the problem with longer term revenue and spending actions. Another counter cyclical alternative to prevention strategies may exist in tax and expenditure limitations, which have been widely studied as tools of restraint and not stability. Many limitations tie growth to either personal income, inflation and population growth, or other factors. In some cases surplus revenues are returned to taxpayers. Studies have questioned their effectiveness at reducing the size of government, although some studies have found nominal reductions in spending relative to states without comparable limits.

In general though, the literature on fiscal management of business cycles and the literature on tax and expenditure limitations have traveled on separate paths with limited exceptions, as Rubin has noted. Martell and Teske have examined how the Taxpayer Bill of Rights (TABOR) has affected fiscal management behavior in Colorado. Schunk and Woodward have proposed spending "rules" which mirror tax and expenditure spending growth tied to population growth and inflation; however, they envision a structure under which surplus revenues would be credited to rainy day fund balances, one-time PAYGO capital, and short-term tax relief.

Can tax and expenditure limitations be viewed as a tool of stability? Although they differ in design, their purpose is to limit growth in spending during good times, which is a counter cyclical approach. As Deschenaux has noted, the underlying concept behind Maryland's spending affordability limit is to hold spending in line with economic growth so that during the good times the state did not build up unsupportable levels of spending in its base budget. (Deschenaux 1997, 100)

Purpose of the Study

Rubin has expressed that the literature on tax and expenditure limitations has evolved separately from the study of fiscal management responses to the business cycle, but that the two threads are beginning to near each other (Rubin 2005, 50). This study's purpose is to fill a gap in the literature by examining tax and expenditure limitations from the perspective of counter cyclical fiscal management. The findings of this research could build upon and add to the body of budgetary literature currently in existence and potentially result in a change in how tax and expenditure limitations are studied and determined to be effective (*i.e.*, do they make a difference in preparing a state for the inevitable downturn of business cycles).

Summary

This Introduction has served to set up and describe the purpose of this study. It has reviewed the history of budgetary reform which has included a variety of formats and institutionalized controls such as balanced budget requirements, term limits, and tax and expenditure limitations. Tax and expenditure limitations became popular following the Proposition 13 tax revolt in California and are now present in some form in 31 states. Additional proposals continue to be considered to expand their usage; however, their effectiveness in constraining the size of government seems limited.

The Introduction also discusses the theme of fiscal management and state efforts to address the highs and lows of the business cycle with strategies aimed at building reserves, taking action to balance budgets, or to temporize through the use of one-time strategies. This study examines whether different types of tax and expenditure limitations in three comparable states had an effect in constraining growth during the peak of the late 1990s business cycle, in preparation for the 2001 recession.

CHAPTER II – Literature Review

Introduction

This chapter addresses three separate aspects of literature in the field of public administration. First it reviews studies of tax and expenditure limitations, which comprises descriptions; analysis of those who supports limitations and why; projected impacts and characteristics; and studies of the various impacts of limitations. This is followed by a brief review of literature pertaining to cyclical instability – *i.e.*, the actions that state governments adopt to deal with the highs and lows of the business cycle. In good times surplus revenue leads to conditions of slack and in recessionary times states are faced with lower revenue and higher expenses and thus must consider spending cuts and revenue increases.

In the vein of fiscal management, states chiefly have at their disposal two sources of cash – general fund balances and reserve funds (a.k.a. rainy day funds). While balances are self explanatory, there is some literature that reviews the best practices for rainy day funds and their use during times of economic downturn. Finally, the topic of accountability is reviewed principally in the context of the actions and institutional restraints on elected officials who have a responsibility to the taxpayer.

Tax and Expenditure Limitations

Descriptions of Limitations

Numerous works have been published on tax and expenditure limitations. Mullins and Joyce classify the studies of tax and expenditure limitations into the following categories: (1) those who support tax, expenditure, or both revenue and spending limitations and why;

(2) what types of limitations exist and how they are structured and/or how they were expected to work; and (3) the impacts of limitations (Mullins and Joyce 1996, 78).

One of the early efforts to classify the types of limits adopted and to compile a summary of the research was undertaken by Danziger and Ring. Following Proposition 13's adoption in California the nation was swept by a wave of limitation proposals. By the end of that decade nearly half of all states had adopted some type of limitation, which Danziger and Ring characterized as limits on (1) revenue, (2) expenditures, or (3) the policy process (Danziger and Ring 1982, 47-48). They reviewed some of the reasons that voters support limitations and summarized the research to date.

Mullins and Cox prepared a more comprehensive review of tax and expenditure limitations in 1994. Their work provided an overview of the types of studies completed to date, which fell into the broad categories of why voters supported such limitations, descriptions of limitations, and studies of their impacts. Studies were further delineated into those focusing on effects on tax burdens, case studies involving single jurisdictions, and case studies analyzing cross sectional effects (Mullins and Cox 1994, 62-65).

NCSL similarly prepared an issue summary in 1996 which classified limitations under one of the following six categories: (1) revenue limits; (2) spending limits; (3) limits on appropriations as a percent of expected revenue; (4) tax increases that require voter approval; (5) tax increases that require a supermajority of legislators; and (6) hybrid approaches that combine some elements of the first five categories (Rafool 1996, 1). NCSL also summarized the reasons for support, and research and studies, noting that most studies found that limitations were not particularly effective, which was in part due to states' ability to circumvent the limits.

Finally, state-by-state case studies illustrated the specifics of the limitations that had been adopted (Rafool 1996, 2-7).

A broader typology of tax and expenditure limitations includes (1) broad based limits on property taxes which apply to entire local governments; (2) narrow limits focused on specific local governments; (3) revenue limits on property taxes; (4) revenue limits generally; (5) spending limits generally; (6) limits that stipulate how much assessments can increase; and (7) accountability measures which require hearings or special votes by elected officials prior to the adoption of increases in tax levels (Mullins and Joyce 1991, 242; ACIR 1995, iii; Mullins and Wallin 2004, 6-7). Mullins and Wallin also address a concern raised in the 1996 study by NCSL which noted that limitations were not working as expected due to the ability to circumvent them, by reporting whether each limit was binding or non-binding. Finally, their work also provides a comprehensive review of the salient features of limitations in each state where they have been adopted (Mullins and Wallin 2004, 11).

NCSL prepared an updated assessment of tax and expenditure limitations in 2008, at which time it noted that 31 states had some form of limitation. It provided the latest detail on the limits adopted in each state, and summarized the relevant literature (Waisanen 2008, 6-8). **Table 2.1** provides state-by-state detail for the tax and expenditure limitations reported by NCSL in 2008. In prior work, NCSL noted that there were two schools of thought regarding limitations: those who supported strict limits built around growth for population and inflation; and those who favored the additional flexibility where limits were tied to personal income growth (NCSL 2005, 1-2).

Table 2.1
State-by-State Tax and Expenditure Limits as of 2008 (Note 1 and Note 2)

State	Year Adopted	Constitution or Statute	Type of Limit	Main Feature
Alaska	1982	Constitution	Spending	A cap on appropriations grows yearly by the increase in population and inflation.
Arizona	1978	Constitution	Spending	Appropriations cannot be more than 7.41% of total state personal income.
California	1979	Constitution	Spending	Annual appropriations growth linked to population growth and per capita personal income growth.
Colorado	1991	Statute	Spending	General fund appropriations limited to the lesser of (a) 5% of total state personal income or (b) 6% over the previous year's appropriation.
	1992	Constitution	Revenue & Spending	Most revenues limited to population growth plus inflation. Changes to spending limits or tax increases must receive voter approval.
	2005	Referendum	Revenue & Spending	Revenue limit suspended by voters until 2011, when new base will be established.
Connecticut	1991	Statute	Spending	Spending limited to average of growth in personal income for previous five years or previous year's increase in inflation, whichever is greater.
	1992	Constitution	Spending	Voters approved a limit similar to the statutory one in 1992, but it has not received the three-fifths vote in the legislature needed to take full effect.
Delaware	1978	Constitution	Appropriations to Revenue Estimate	Appropriations limited to 98% of revenue estimate.
Florida	1994	Constitution	Revenue	Revenue limited to the average growth rate in state personal income for previous five years.
Hawaii	1978	Constitution	Spending	General fund spending must be less than the average growth in personal income in previous three years.
Idaho	1980	Statute	Spending	General fund appropriations cannot exceed 5.33% of total state personal income, as estimated by the state Tax Commission. One-time expenditures are exempt.
Indiana	2002	Statute	Spending	State spending cap per fiscal year with growth set according to formula for each biennial period.
Iowa	1992	Statute	Appropriations	Appropriations limited to 99% of the adjusted revenue estimate.
Louisiana	1993	Constitution	Spending	Expenditures limited to 1992 appropriations plus annual growth in state per capita personal income.
Maine	2005	Statute	Spending	Expenditure growth limited to a 10-year average of personal income growth, or maximum of 2.75%. Formulas are based on state's tax burden ranking.
Massachusetts	1986	Statute	Revenue	Revenue cannot exceed the 3-year average growth in state wages and salaries. The limit was amended in 2002 adding definitions for a limit that would be tied to inflation in government purchasing plus 2%.
Michigan	1978	Constitution	Revenue	Revenue limited to 1% over 9.49% of the previous year's state personal income.

State	Year Adopted	Constitution or Statute	Type of Limit	Main Feature
Mississippi	1982	Statute	Appropriations	Appropriations limited to 98% of projected revenue. The statutory limit can be amended by majority vote of the legislature.
Missouri	1980	Constitution	Revenue	Revenue limited to 5.64% of previous year's total state personal income.
	1996	Constitution	Revenue	Voter approval required for tax hikes over approximately $77 million or 1% of state revenues, whichever is less.
Montana	1981	Statute	Spending	Spending is limited to a growth index based on state personal income. In 2005 the Attorney General invalidated the statute, and it is not in force at this time.
Nevada	1979	Statute	Spending	Proposed expenditures are limited to the biennial percentage growth in state population and inflation.
New Jersey	1990	Statute	Spending	Expenditures are limited to the growth in state personal income.
North Carolina	1991	Statute	Spending	Spending is limited to 7% or less of total state personal income.
Ohio	2006	Statute	Spending	Appropriations limited to greater of either 3.5% or population plus inflation growth. To override need 2/3 supermajority or gubernatorial emergency declaration.
Oklahoma	1985	Constitution	Spending	Expenditures are limited to 12% annual growth adjusted for inflation.
	1985	Constitution	Appropriations	Appropriations are limited to 95% of certified revenue.
Oregon	2000	Constitution	Revenue	Any general fund revenue in excess of 2% of the revenue estimate must be refunded to taxpayers.
	2001	Statute	Spending	Appropriations growth limited to 8% of projected personal income for biennium.
Rhode Island	1992	Constitution	Appropriations	Appropriations limited to 98% of projected revenue (becomes 97% July 1, 2012).
South Carolina	1980 1984	Constitution	Spending	Spending growth is limited by either the average growth in personal income or 9.5% of total state personal income for the previous year, whichever is greater. The number of state employees is limited to a ratio of the state population.
Tennessee	1978	Constitution	Spending	Appropriations limited to the growth in state personal income.
Texas	1978	Constitution	Spending	Biennial appropriations limited to the growth in state personal income.
Utah	1989	Statute	Spending	Spending growth is limited by formula that includes growth in population, and inflation.
Washington	1993	Statute	Spending	Spending limited to average of inflation for previous 3 years plus population growth.
Wisconsin	2001	Statute	Spending	Spending limit on qualified appropriations (some exclusions) limited to personal income growth rate.

Table Notes
Note 1: Source: Waisanen 2008, 6-8.
Note 2: NCSL does not classify Maryland as a state with a tax and expenditure limitation, due to the non-binding design which does not feature a statutory or constitutional formula (Deschenaux 1997, 99).

A number of studies note that state level tax and expenditure limitations do not cover the entire budget, but instead exempt portions. For example, it is noted that several states exclude certain categories of spending (*e.g.*, debt service); a number of others exclude certain classes of revenue such as federal sourced revenue, or conversely apply their limit only to state-sourced tax revenue (for example, Tennessee) (Abrams and Dougan 1986, 113). Merriman cites New Jersey, which had a limitation in place from 1976 to 1983 that excluded portions of the budget related to pensions, as well as spending tied to revenue that came from fees or the sale of capital assets (Merriman 1986, 355). In 1989 Howard listed the percent of the budget that was exempt from tax and expenditure limitations in 19 states. This ranged from 22% exempt in Massachusetts to 71% exempt in Oregon (Howard 1989, 88).

Shortly after the adoption of Proposition 13 in California, tax limitations received national attention and consideration, and in some cases, adopted in many states. California, Massachusetts, and Michigan are three states that were the subject of early research on aspects of tax limitations.

Who Supports Tax and Expenditure Limitations and Why

The literature relating to support or opposition to tax and expenditure limitations is summarized here because of its relationship to accountability. When taxes are raised at high rates, voters may have concerns about the levels of services provided or the efficiency of service provision. Support for limitations ties into the concept, discussed later in this chapter, of the desirability of external controls imposed upon decision makers to reduce administrative discretion.

Voters have different values, interests, and opinions. How they vote on a specific issue can be influenced by many variables. Tax and expenditure limitations can pose a problem for a voter who may support or receive government services (*e.g.*, education provided to their children) but may conversely be concerned about their tax burden. A family which rents may not be concerned about limits on property taxes. Based on random phone surveys of 1,561 homes in 58 cities in Massachusetts, Ladd and Wilson found that questions of tax and expenditure limitations are made more complicated by voters with different attributes who find themselves pulled in opposing directions (Ladd and Wilson 1983, 257, 274).

Certain widely held beliefs can transcend the issues on tax and expenditure limitations and shape public opinion on this issue regardless of their veracity. One prevailing theme found in the literature is that voters believe by surprisingly large margins that there is widespread corruption and inefficiency in government (Ladd and Wilson 1982, 128, 140; Rosenthal 1996, 42-43, 117-118; Wallin 2004, 40-41; Thompson and Green 2004, 84). This theme is discussed in more detail under the Accountability section of this chapter.

Related to this is the sentiment that public sector employees are overpaid and do not work as hard as corresponding employees of the private sector, which Ladd and Wilson found using data from random phone surveys of 1,561 homes in 58 cities in Massachusetts (Ladd and Wilson 1982, 121, 128). These views illustrate how voters can support tax and expenditure limits under the belief that their adoption will lead to greater efficiency without a loss of services or a shift to another source of revenue (Gramlich, Rubinfeld, and Swift 1981, 115; Ladd and Wilson 1982, 121-124).

Looking first at supporters of tax and expenditure limitations, the literature yields a number of interesting observations. First, there is a greater likelihood of tax and expenditure limitations being adopted if there is access to the ballot by voter initiative (Wallin 2004, 35; Rubin 2005, 50). Smith noted that 24 states permit initiatives, which are viewed as an important element for those who support direct democracy (Smith 2004, 88, 109-110). One would assume that this means that in those states where the initiative is available as an option, grassroots organizations of disgruntled voters were the principal driving force behind the tax and expenditure limitation initiatives. However, Smith's case study research of 6 anti-tax ballot initiatives suggests that in some instances, funding and organization behind tax and expenditure limitations was orchestrated by outside special interests (Smith 2004, 88, 90, 107).

Support for a tax and expenditure limitation in Florida, for example, was found to be backed strongly by the sugar industry, and in Oregon by a conservative leaning tax limit advocacy group based in Washington, DC (Smith 2004, 105-106). California's Proposition 13 is an example of an ongoing grassroots organization which enjoys a broad base of voter support and funding (Smith 2004, 107). The amount of spending in support of a tax and expenditure limitation was also found to be an important factor. The side that spent the most invariably was more successful, as was found in 4 of 6 cases studied (Smith 2004, 91).

Consistent with the concerns and views expressed in other studies, supporters of limitations viewed them as a means of reducing the scope of government while simultaneously addressing concerns over their tax burdens. Using data from the Advisory Commission on Intergovernmental Relations (ACIR), Ladd employed a regression analysis to look at the conditions which made adoption of tax and expenditure limitations more likely. She focused on rapid growth in spending accompanied by high tax burdens, as well as a high reliance on the property tax (Ladd 1978, 1, 16). Another study which echoed these concerns drew from a random sample of 1,450 out of 29,000 petition signers in Wisconsin who supported a property tax cap (Stein, Hamm, and Freeman 1983, 187-188).

In Massachusetts and in California, support for limits on property taxes followed a large jump in assessment levels. For example, some supporters of a property tax limit in

Massachusetts experienced a 215% increase in their assessments between 1974 and 1978 (Stein, Hamm, and Freeman 1983, 191), and California's Proposition 13 followed a statewide property reassessment that in some cases was the first in more than 15 years (Stein, Hamm, and Freeman 1983, 193).

Looking at the characteristics of those who supported limitations, not surprisingly supporters of limitation movements are also those who are more likely to be paying higher levels of taxes. Various studies have found that supporters have high incomes, are educated, are white, own and stay in their homes for long periods, and have school aged children (Ladd and Wilson 1983, 267; Gramlich, Rubinfeld, and Swift 1981, 122-123; Stein, Hamm, and Freeman 1983, 188-192). Political orientation was also an important factor as those who were more conservative and were affiliated with the Republican Party were also more likely to be supporters of limitations (Ladd and Wilson 1983, 265; Gramlich, Rubinfeld, and Swift 1981, 122-123). These are also the voters who are more likely to be true believers in the issue since they have a strong stake in how much they pay. Gramlich, Rubinfeld, and Swift based their findings on a survey of approximately 2,000 households in Michigan on why they were for or against tax and expenditure limitations (Gramlich, Rubinfeld, and Swift 1981, 115, 120).

Those who voted against the adoption of tax and expenditure limitations, or who chose to not vote, were found to either be uninformed, uncertain of the issue, indifferent, or simply did not care (Gramlich, Rubinfeld, and Swift 1981, 115, 120, 123). Those who voted against or did not support tax and expenditure limitations were also found to be direct beneficiaries of services, such as welfare recipients or providers of services such as public sector employees. As noted, renters also represent a class of voter that would be ambivalent to limitations on property taxes (although there is a relationship between property taxes and the level of rent which one assumes is not directly borne by the renter) (Ladd and Wilson 1983, 271; Gramlich, Rubinfeld, and Swift 1981, 122-123).

Projected Impacts and Characteristics of Tax and Expenditure Limitations

The passage of Proposition 13 in California and Proposition 2½ in Massachusetts (and other measures subsequent to these) spurred research to either describe tax and expenditure limitations or to examine their likely effects. This includes prospective models and retrospective models of spending limit dynamics relative to actual spending history.

Danziger and Ring note a study by Wolfman and Peterson in 1980 that hypothesized that tax and expenditure limitations would cause local governments to seek additional revenue first, (*e.g.*, in this case from the state but other studies have noted a prevalence of fee increases) followed by deferred purchases (*e.g.*, equipment etc.), and then reductions to try to reduce waste and inefficiency (Danziger and Ring 1982, 50).

Using data from 40 counties in California between 1967 and 1975, Shapiro and Morgan constructed a revenue model to examine the overall impact on total state and local revenues in California, given that Proposition 13 held property taxes to a rate that is no higher than 1% of their property's market value when initially assessed in 1975, and permitted growth of 2% per year to account for inflation (Shapiro and Morgan 1982, 119-120, 125). Their study focused on the interrelationships between state and local revenues and hypothesized that lower property tax revenues would likely cause local governments to seek greater state aid, that state income tax attainment would increase slightly since property tax limits would reduce growth in deductions, and that the higher spending power of consumers could increase property values by driving up values and thus property assessments. They concluded that there were strong interrelationships between revenue sources and that a limit on property taxes would have effects on other revenue sources (Shapiro and Morgan 1982, 119, 125).

Bails conducted an historical time series analysis of actual 1972 spending in all 50 states using data from the U.S. Department of Commerce, which compared what the spending levels would have been if growth had been constrained in tandem with either the Consumer Price Index (CPI) or personal income. He also studied the dynamics of emergency spending provisions, which were contained in some tax and expenditure limitation measures (Bails 1982, 130, 133). In the first test, Bails grew spending in every state by CPI to 1978 and found that 2 states could actually have spent more under that limit than they actually spent; that 6 states would have been required to spend less than actually spent; but that the differences were insignificant for the remaining states (Bails 1982, 133). Performing the same analysis using personal income, he found that 6 states could have spent more and that 5 states would have been required to cut back relative to actual spending (Bails 1982, 136).

A 1986 study by Abrams and Dougan sought to look at the effectiveness of limitations and other institutional constraints such as balanced budget requirements, the line-item veto, and term limits. Using 1980 data for all 50 states from the U.S. Census Bureau and the ACIR, they estimated state spending per capita and aggregated state and local spending. They concluded that tax and expenditure limitations, nor any of the institutional controls tested, seemed to have any effect on limiting growth in government spending (Abrams and Dougan 1986, 107, 112, 114-116).

The University of Wisconsin modeled the 1986 through 2003 period based on tax and expenditure limitation assumptions of growth constrained by inflation and population. They found that such limits would have required large reductions in Wisconsin of nearly $9 billion (NCSL 2005, 3).

Impacts of Tax and Expenditure Limitations

As noted, Proposition 13 spawned a number of tax and expenditure limitation measures in states across the country. While the study of some elements of this phenomenon began in the late 1970s, such as analyses of who supported the measures, the analysis of the impacts of limitations began in the 1980s and continues. As outlined below, the review of the effects of limitations falls under the following major themes to assess:

- whether caps work to slow the growth of government spending, either relative to states without caps or as a share of the economy (typically measured as a percentage of personal income);
- whether limitations change the fiscal management behaviors of elected decision makers to seek ways to circumvent them. Options include the cultivation of other sources of revenue (*e.g.*, a shift from broad based taxes to narrower user fees and charges, increased debt, dedicated special funds, or nonbudgeted funds); accounting gimmicks; earmarking of new revenues for specific purposes; mandatory spending; or privatization/shifts to enterprise activities;
- whether there are effects on the amount of, or quality of services provided by the public sector. Opponents of measures often suggest that limitation measures significantly reduce the quality of services provided; or
- whether there were changes with respect to intergovernmental relationships. This includes vertical, horizontal, or distributional impacts.

As described below, the literature suggests that there is some evidence that tax and expenditure limitations have constrained government spending growth, albeit on a limited basis; that property tax limitations resulted in shifts to user fees and other sources of revenue; that limitations cause changes in fiscal management strategies; that constrained spending has affected the quantity and quality of publicly provided services; and that limitations have caused various mutations in intergovernmental relations.

Do Caps Work to Slow the Growth of Government Spending: It was expected that it would take time for tax and expenditure limitations to have any effect (Cox and Lowery 1990, 493). While it is logical to think that early studies would not yield much in the way of results and that later studies would demonstrate constraint, the results are mixed.

A 1977 study by the ACIR found a 6% to 8% reduction in local government spending where property tax limits were adopted (ACIR 1977, 21). Kenyon and Benker used 1984 data from a survey conducted by the ACIR of state budget officers and tax groups, in conjunction with actual general fund spending for the period from 1977 to 1983 from National Association of State Budget Officers (NASBO) surveys. The survey results were mixed with 2 states believing that limitations had altered spending patterns, 5 states believing that the limits could be effective, and 10 states reporting no effect. In examining general fund spending, they compared states that had limitations in effect with those that did not. They determined that the taxing and spending trends in state governments were unaffected by the presence of limitations (Kenyon and Benker 1984, 438, 444-445).

Lowery was another early voice, who, in 1983 prepared a time series regression analysis of property tax levels in 4 states which had adopted limits in the 1970s, compared against 8 states without such limits. He gathered revenue, spending, and personal income data for the 1957 –

1976 period from the U.S. Census Bureau for Kansas (matched with Nebraska and South Dakota), Florida (matched with Georgia and Alabama), Montana (matched with Wyoming and Idaho), and Indiana (matched with Illinois and Kentucky). He concluded from his analysis using OLS regression on an interrupted time series design that property tax limitations had not had an effect on reducing local government spending (Lowery 1983, 252-256).

In 1986, Merriman gathered expenditure data on 108 municipalities in New Jersey for the period covering 1975 to 1980, representing two years prior and four years following implementation of that state's limit. Using the data from prior to the cap, he performed a regression analysis to compare predicted spending versus actual spending. He found a reduction in spending in almost 2/3 of the municipalities (Merriman 1986, 355, 360).

In 1990, Cox and Lowery compared three states that had adopted limitations for at least 10 years with three comparable states without limits to see if there was a difference in terms of their relative share of the economy. They reviewed spending from 1965 to 1986 as a percent of personal income in Tennessee, Michigan, and South Carolina, compared with North Carolina, Ohio, and Kentucky. Based on a time series regression analysis, they found little change between the states with and without limits and concluded that limitations were relatively ineffective at limiting growth in spending (Cox and Lowery 1990, 494-503).

Six years later this study was replicated by King-Meadows and Lowery using the same time series regression methodology. While they found no apparent difference in Tennessee and Kentucky (2 of the states that were matched for similarity, representing a state with and a state without a limitation), they did conclude that there was weak evidence to suggest that limitations had some effect in reducing the size of state spending (King-Meadows and Lowery 1996, 103-105).

The impact of limitations on the structure of government was again reviewed by Mullins and Joyce in 1996. The authors reviewed data in 48 states from 1970 to 1990 from the U.S. Department of Commerce. Using a time series regression analysis they found little evidence of any effects on the size of state or local government (Mullins and Joyce 1996, 79, 84, 99).

Shadbegian studied tax and expenditure limitations in 1996 by using a regression model of state government spending from 1972 to 1987, with data from the U.S. Census Bureau. He compared states with limits against those without limits and found that growth in the budget was slightly smaller for states with limitations than for those without (Shadbegian 1996, 22, 25, 26).

Rueben prepared OLS regression equations of state and local general fund revenues and spending using U.S. Census data from 1970 to 1991 and NASBO survey data from 1982 to 1990. She determined that tax and expenditure limitations did have an impact in reducing spending as a share of the economy; that state and local limitations had a greater likelihood of reducing overall spending; that revenue limits were more constraining than spending limits; and that binding constitutional constraints were more effective than ones set out only in statute (Rueben 1997, 32, 43).

Using U.S. Census Bureau data as well as survey data from budget officers, Howard examined general fund revenue relative to personal income and state spending relative to personal income to see if limitations had an effect. She theorized that if a government's share of the economy grows then limitations do not work. That is, the expectation is that limitations would cause government spending to remain at the same share of the economy.

First, she looked at state tax collections as a percent of personal income in states that had limits compared with states that do not have limits. In 1980 and 1981, she found that states with limits collected more in revenue relative to states without limits. However, from 1982 to 1987, the opposite was true, so that by 1987 the ratio of revenue to personal income was nearly identical. The problem as she sees it relates to the tie-in to personal income. Comparisons of revenue to personal income might make sense when general funds grow faster than personal income, but she indicates that they do not. She points out that most state sales taxes, for example, do not tax services. Thus, if personal income grows faster than state tax revenues, then personal income will never limit spending. Second, she looked at general fund spending relative to personal income. Here she found that states with limitations spent less than states without limitations as a percent of personal income, but the differences were minimal (Howard 1989, 85-87).

Both Howard and Kenyon and Benker suggest that limitations as a share of personal income are not effective and that the only real constraint on spending is a lack of revenue (Kenyon and Benker 1984, 439; Howard 1989, 88). Conversely, James and Wallis note that in Colorado tax revenue did grow much faster than personal income in the 1990s, but the TABOR limitations in effect served to limit government growth and resulted in Colorado refunding over $3 billion to taxpayers between 1996 and 2001. In addition to reviewing academic literature, they also analyzed voter attitudes toward TABOR gleaned from survey data from the Wells Fargo Public Opinion Research Program. Seven years after passage, roughly ⅔ of respondents still supported TABOR, with the most support received from voters registered Republican and Independent. In 2000, approximately 30% of voters surveyed said that they would vote to repeal TABOR. However, by 2003, support for the measure had decreased to 50%, and about 67% thought that TABOR should be modified to allow government services to return to levels prior to the 2001 recession (James and Wallis 2004, 25, 29).

Elder looked at statutory and constitutional constraints on both revenue and spending to see if there was any impact on tax burdens or the growth of government. He used U.S. Census Bureau data on state-sourced tax revenue for the 19 states that then had tax and expenditure limitations and utilized a model to assess public service demands using data from 1950 through 1985. He ultimately concluded that limits on revenues had little apparent effect on tax burdens but that spending limits had resulted in a reduction in tax burdens (Elder 1992, 52, 58).

Stansel examined U.S. Census Bureau data for 18 states with tax and expenditure limitations in place by 1986 and determined that spending on a per capita basis had been reduced when compared to the average in the U.S. He also outlined nine factors that can enhance the effectiveness of limitations (Stansel 1994, 4-5; 10-14, 20).

Rueben found that there was a reduction in spending of roughly 2% as a share of personal income in states with tax and expenditure limitations relative to states that do not have limitations. However, she found that where there was only a state limit, there was an increase in local spending. States with both state and local level limits had lower overall growth. She also determined that more binding constitutional limits were more effective than just limits set in statute and that revenue limits had a greater impact than spending limits (Rueben 1997, 41-43).

Several studies looked at the effects of tax and expenditure limitations in California. The ACIR noted that in response to rising property tax levies in the 1960s and early 1970s, California adopted limits in 1972 which held property tax rates to the greater of the rate in place in 1972 or 1973. Beginning in 1974, localities had the option of choosing an alternative limit which allowed growth in revenue from the prior year adjusted for population and inflation. After the adoption of these limits, there was a noted decline in property tax levies (ACIR 1977, 27).

Other studies examined the effects of Proposition 13, following its enactment in 1978. Reid reviewed the impact of Proposition 13 on cities in California by examining changes in revenue sources under direct local control and revenue trends in cities. Data was derived from the U.S. Census Bureau and California State Comptroller Annual Reports for the 1977 to 1978 fiscal period compared with the 1984 to 1985 fiscal period. He found that overall spending trends remained the same (Reid 1988, 20-34).

Hoene reviewed U.S. Census Bureau spending and revenue data for every city in California between 1972 and 2002. He specifically looked at 7 different sources of revenue and 10 different spending categories to assess the dynamics of change. He found that overall spending levels and demand for services had demonstrated little change. Instead, there was a greater reliance on user charges and state revenue (Hoene 2004, 61, 70-72).

In Maryland, the Department of Fiscal Services was charged with reviewing the implementation of that state's non-binding spending limitation to analyze its effectiveness at reducing spending as a share of the economy. The department's 1995 study determined that spending as a share of personal income had decreased following implementation on the basis that growth in spending had exceeded personal income growth in 8 of the 11 years just prior to adoption in 1982 but only in 3 of 12 years subsequent to adoption. The report also found that the state's reserve fund, which had been fully used to mitigate the loss of revenue following the economic downturn of the early 1990s, was quickly replenished because appropriations to the fund were exempt from the state's spending limits (Maryland Department of Fiscal Services Assessing Affordability 1995, 12, 15).

Deschenaux examined the non-binding spending affordability process in Maryland, specifically focusing on growth in the economy relative to personal income. He noted that prior to the adoption of legislation in 1982, state government had grown in excess of economic activity. Following adoption, he demonstrated that average state tax supported spending was reduced as a share of personal income (Deschenaux 1997, 101-102).

Meyers and Pilkerton reviewed the history of Maryland's budget structure and spending affordability process. At the time of publication, Maryland had elected a Republican Governor for the first time since Spiro Agnew was Governor in the 1960s. Because the state was facing budget deficits following the 2001 recession, they questioned the constitutional budget structure which centralized power in the executive branch and whether the balance should be shifted more toward the legislative branch to permit increases to the budget.

As to the spending affordability process, they noted that it only addressed limits on spending growth and did not include revenue actions. Thus, they suggested that revenues also be included in the committee's recommendations. Further, they recommended modifications to the committee's responsibilities to also include budget priority setting through a greater use of statewide performance measures (Meyers and Pilkerton 2003, 1, 23, 42-44).

Changes in Revenue Sources: Do tax and expenditure limitations cause a shift from broad based taxes to user charges and fees, result in more debt, or cause shifts to either nonbudgeted or special dedicated funds? In studies of California, the literature seems to agree that following the imposition of Proposition 13 local revenue from the property tax fell sharply and was replaced by a combination of state aid and a greater reliance on user fees and other sources of revenue (Danziger 1980, 605-607; Sherwood-Call 1987, 58-64; Hoene 2004, 70-72). Examples of the fees and user charges that were increased included utility taxes, franchise fees, lodging fees, and others (Reid 1988, 20-34).

Sherwood-Call found that user fees were up 13% between 1978 and 1985 (Sherwood-Call 1987, 64). The impact of several measures in Oregon which limit property taxes (Measures 5, 47, and 50) also resulted in a reduction in property tax revenue (from 5% of personal income to under 3%) and an increase in fees as a percent of local government revenue, from less than 5% to 35%. The development impact fee alone was set at $12,000 per house (Thompson and Green 2004, 78-79).

Mullins and Joyce more broadly analyzed the effects of tax and expenditure limitations on the structure of state and local governments with their analysis of U.S. Census Bureau revenue and spending trends for 50 states from 1960 through 1988. They specifically looked at whether there were shifts to more focused revenue sources away from broad based taxes (Mullins and Joyce 1991, 244). The authors found little evidence of a movement away from broad based taxes in states with state level limitations, nor did state limitations appear to significantly constrain tax revenue (Mullins and Joyce 1991, 250-251).

In 1996, the same authors further explored whether there was any evidence of a shift to narrower revenue sources. At the local level they found evidence of a shift from broad based taxes to fees and user charges (Mullins and Joyce 1996, 88, 95). Rueben found little evidence that states shifted to more special funds or to nonbudgeted funds (Rueben 2000, 20-21).

Over the years, several researchers expressed the view that tax and expenditure limitations would lead to the issuance of more debt as an alternative revenue source. Cox and Lowery looked for the incidence of greater issuance of debt in their study of three limitation states and three comparison states; however, they could not find significant differences between the states with and without limitations as to the level of debt (Cox and Lowery 1990, 503-506). While not an indicator of greater use of debt, NCSL identified an interesting result from the imposition of spending limits, in that they brought about lower interest costs on debt, but limits on revenue caused higher interest rates (NCSL 2005, 3).

Martell discussed the proliferation of special districts in Colorado, each with the capability of issuing debt, as an apparent circumvention of limits imposed by TABOR. She examined the effect of aggregate debt levels vis-à-vis overlapping districts using Colorado Department of Local Affairs fiscal data for Jefferson County, Colorado, which has 13 overlapping special districts. There was an increase in more revenue bonds in lieu of general obligation debt (Martell 2004, 4-9).

Further study of the Jefferson County special district data was completed by Martell in 2007. She found that citizens living in metropolitan areas had more debt per capita and paid more in debt service per capita, but overall she found negative relationships between overall debt and overlapping special districts. She surmised that the debt issued by the districts was influenced by the knowledge of the number of districts authorized to issue debt and that too much debt collectively could lead to lower credit ratings (Martell 2007, 17).

Martell and Teske point out that in Colorado there was a 56% jump in the creation of special districts for the purposes of being able to sell more debt and avoid the TABOR limits, but this also resulted in additional levels of government being created (Martell and Teske 2007, 682).

Changes in Fiscal Management: Limitations in Colorado include a mix of initiatives that bring interesting dynamics for the elected officials charged with establishing priorities and managing the state’s finances. This includes the Arveschough-Bird Amendment (adopted in 1977 but made more restrictive in 1991) that limits increases in state spending to not more than 6% over the prior year, or not more than 5% of personal income; the TABOR which passed in 1992 to limit revenues to the amount attained in the prior year plus growth for population and inflation; and Amendment 23 that was passed in 2000 and requires that schools get funding equal to 1% over inflation for a 10-year period. The latter initiative was put into place to address the fact that education spending had fallen to nearly the bottom of the rankings in the U.S.

TABOR also requires surplus revenues to be returned to taxpayers and stipulates that tax increases require voter approval (James and Wallis 2004, 21-25; Martell and Teske 2007, 675-676). The recession of 2001 caused revenue to fall, which became the new base of spending in the next year, adjusted for population and inflation, although there have been attempts to modify the situation (James and Wallis 2004, 30-32). Changes in fiscal management include increased earmarking of new revenues for specific purposes, mandatory spending, shifts to enterprise activities, and accounting gimmicks (*e.g.*, involving Medicaid accruals, sweeping balances into the general fund, and changing the date of employee pay to get a one-time savings) (Martell and Teske 2007, 675-682). In California, Hoene also notes that post-Proposition 13 effects have resulted in more earmarking of revenues for specific purposes to give elected officials less discretion (Hoene 2004, 70-72).

Effects on Public Sector Services: Studies of the impacts of limitations suggest that the evidence of reductions in the size of government is slight. Nonetheless, limitations appear to be having an effect on services based on anecdotal evidence gathered from Colorado, California, and Oregon as well as more general research. In his study of cities in California, for example, Reid found that limitations did bring about spending reductions largely in the areas of general government, public works, and parks. These were made in lieu of any reductions to police or fire services, suggesting a level of priority setting (Reid 1988, 20-34).

Martell and Teske note a number of impacts of TABOR in Colorado. They found that child immunization, pre-natal services, state support for higher education, and transportation highway maintenance had all fallen to the bottom in U.S. rankings. As a percent of the general fund budget, higher education spending decreased from 19% to 10%. They also cite reductions in capital maintenance, and the number of children without health insurance nearly doubled (Martell and Teske 2007, 678-679).

Danziger and Ring observed that impacts generally are threefold for recipients of government services:

- the amount of services may be reduced;
- service quality may be impaired; and
- additional fees may be imposed that recipients may be hard pressed to pay including "female-headed families, most non-white racial groups, the handicapped, the unemployed, the underemployed, and the aged." (Danziger and Ring 1982, 52).

Impacts on primary and secondary education services are also cited in the literature. While education is generally viewed as a priority, impacts should come as no surprise given the large percentage of local government budgets dedicated to education. Moreover, many limitations constrain property taxes which are a major revenue source for local jurisdictions. The imposition of limits have been found to increase class sizes and to reduce teacher salaries compared to median income (Thompson and Green 2004, 76).

Rueben's analysis in 1997 of the impact of Proposition 5 in Oregon focused on the effects of less revenue on the educational system. Where prior studies had demonstrated lower spending per pupil and higher teacher to student ratios, she examined teacher quality. She found that education majors had lower ability than non-education, majors that states with tax and expenditure limitations were less likely to hire education majors from elite programs, and that education majors with high ability were less inclined to seek employment where limitations were in effect. She further suggests that lower teacher quality will equate to diminished student performance (Rueben 1997, 112-113). Martell and Teske also indicate that inflation adjusted spending for primary and secondary education in Colorado fell to 40th in the U.S., from a ranking of 25th (Martell and Teske 2007, 676).

Changes in Intergovernmental Relationships: Another theme highlighted by the literature reflects the impact of tax and expenditure limitations on the relationships of different levels of government to each other. Whether intended or not, limitations have been shown to have had the effect of causing vertical shifts in responsibilities from state to local or local to state; horizontal shifts resulting in the creation of additional government entities; or distributional effects which have the consequences of affecting governments' ability to raise revenue or deliver services.

The first subset of intergovernmental relationship changes relates to vertical shifts of power. Studies have shown that after the passage of Proposition 13 in California, local governments sought state aid to make up the gap. One of the effects of Proposition 13 was found that in the short-term there was a tremendous loss of local-sourced property tax revenue, in the range of $7 billion, constituting more than ½ of local government revenue. The property tax fell as a source of revenue for local governments by $47 per capita. That is, as a source of state and local government tax revenue, the property tax decreased from providing 40% of revenue to 25% of revenue (Danziger 1980, 605; Sherwood-Call 1987, 61; Reid 1988, 33).

Most of the loss of property tax revenue was made up in the short-term by additional state education aid. The state share of the education budget grew from 40% to 70% (Danziger 1980, 607; Sherwood-Call 1987, 62). However, Reid confirms that additional state education aid to make up for the property tax loss was limited until the state's surplus was diminished

(Reid 1988, 25). Hoene further observed that the additional state aid resulted in an increase in the state's role in local education fiscal policy (Hoene 2004, 70-72).

As part of their study of three states with limitations matched with three states that did not, Cox and Lowery looked for evidence that states decentralized services to local levels of government. While they found some limited evidence of decentralization in South Carolina, the state with the least restrictive limitations in their study, they concluded that it was not compelling (Cox and Lowery 1990, 504-506).

Mullins and Joyce specifically looked at whether or not there were vertical shifts from local to state sources of revenues and whether local limitations caused functional responsibilities to migrate to the state, or if state limitations caused a devolution of responsibility to local jurisdictions. The authors analyzed the effects of tax and expenditure limitations on the structure of state and local governments by examining revenue and spending trends from 1960 through 1988. They found that states with limitations only on local governments did have a lower reliance over time on local revenue sources in favor of more state funding (Mullins and Joyce 1991, 244, 250-251).

Additional study by the same authors in 1996 continued to explore whether there was any evidence of a shift to other levels of government. They did find that there was increased centralization of revenue collection and spending at the state level, including a greater state role in education funding and in decision making. They assert that this greater control impacts the ability of local governments to be more responsive to specific local needs (Mullins and Joyce 1996, 79, 84, 95). This effect of tax and expenditure limitations to centralize public sector services, causing less responsiveness to local preferences, was affirmed in a large study of states by the ACIR (ACIR 1995, iv).

Horizontal shifts in responsibility occur, for example, by the creation of additional service-providing governmental entities. Mullins observed that one of the effects of Proposition 13 was the creation in California of an overlapping structure of “disjointed revenue jurisdictions” (Mullins 2004, 145). Martell has also noted a significant increase in special taxing districts in Colorado following the enactment of TABOR. The ACIR reported that states having tax and expenditure limitations had more special taxing districts than did states with no limits (ACIR 1977, 4).

Finally, distributional changes relate to modifications in how services are paid for or delivered. Privatization, or the use of private sector contractors to provide all or a portion of publicly provided services is one offshoot of distributional change resulting from tax and expenditure limitations. As noted, surveys of taxpayers suggest that greater efficiency is the driving force behind limitation movements and not a desire for less services; a theme confirmed by Danziger and Ring. They view privatization as a signal to the public that the public sector is taking the limitation movement seriously and thus attempting to provide services at lower cost and with greater efficiency (Danziger and Ring 1982, 49-50).

In Colorado, Martell and Teske noted that under TABOR an entity is considered “privatized” if it gets less than 10% of its revenue from the state. While not privatization in the traditional sense, TABOR has had the apparent effect of inducing higher education institutions to reduce their reliance on state assistance in order to be exempt from the strictures of that limitation (Martell and Teske 2007, 681).

Another aspect of distributional impacts is found in the apparent shift from broad based taxes to user charges and fees as noted by Mullins and Joyce (Mullins and Joyce 1996, 88). There are different facets of this issue. On one hand a greater reliance on user charges and fees, as noted, reflects a philosophical shift away from broad based taxes with the intent of having government services paid more by the direct users of services. As discussed in Chapter I of this paper, one of the drivers of tax and expenditure limitations is the apparent disconnect between those who pay disproportionately higher taxes versus the services they receive. Conversely, the disadvantaged populations who are the main recipients of public sector services may be disproportionately affected as they must pay taxes and additionally pay more regressive fees (ACIR 1995, iv). This saps a larger share of their net income.

A final distributional element relates to the effects of limitations on lower versus higher wealth jurisdictions. Merriman studied 108 municipalities in New Jersey prior to and after the implementation of a limitation adopted in 1976, comparing actual to projected spending. He found that spending reductions were greater in lower density municipalities with high tax capacity relative to higher density jurisdictions (Merriman 1986, 359-360).

Shadbegian also found, similarly, that tax and expenditure limitations constrain states with low personal income growth while states with high personal income growth were able to increase spending (Shadbegian 1996, 31). A similar finding was reported by Mullins and Joyce who suggest that this dynamic would affect services provided to disadvantaged populations (Mullins and Joyce 1996, 75).

In 2004, Mullins further examined the changes in municipal level governments from 1972 to 1997 through a time series regression, specifically focusing on school districts and general government expenditures. U.S. Department of Commerce data was used for nearly 32,000 units of local government in approximately 800 municipalities. He found that distributional effects resulted from tax and expenditure limitations, such that lower wealth jurisdictions were more constrained from raising revenue to provide services but that higher wealth jurisdictions were not as constrained. He also concluded that limitations incur a disproportionate effect on lower income populations who receive government services (Mullins 2004, 143-146).

To recap, this section has summarized the major literature pertaining to various facets of tax and expenditure limitations. This included descriptions of the various types of limitations; studies which focused on who supported the adoption of limitations and why they supported them; the projected impacts of limitations on the size of government using historical data; and the impacts of limitations on slowing the growth of government, changes in the behavior of elected officials to circumvent limits, effects on services, and changes in intergovernmental relationships.

As noted in Chapter I, none of the literature examines the effectiveness of tax and expenditure limitations in constraining spending growth in good times, so as to mitigate the need for procyclical actions during recessionary periods. The next section of this literature review focuses upon the effects of cyclical instability on public sector revenues and what counter cyclical and procyclical options are available to states. This is important in order to have a better understanding of whether tax and expenditure limitations represent a potential tool of counter cyclical fiscal policy.

Cyclical Instability

Background

There have been four cycles of economic expansion and contraction in the United States since 1970, which have brought state governments unexpected surpluses (a.k.a. slack) as well as revenue shortfalls (Schunk and Woodward 2005, 109). These highs and lows are exacerbated in part by conservative revenue forecasting in the public sector and procyclical fiscal policies where spending is increased and taxes cut during good times, followed by tax increases and spending cuts in bad times (Gonzalez and Levinson 2003, 444). Such policies can actually worsen fiscal stress, and disrupt services to lower income recipients (Rubin 2005, 47; McNichol and Lav 2007, 3). Moreover, state economies can be affected by the broader U.S. economy, federal macroeconomic policies, and the role and presence of federal facilities and spending. The challenge for states is how to maintain consistent services, particularly in light of balanced budget requirements which generally do not permit deficit spending.

During times of fiscal stress, elected officials have the following options: raise revenue; reduce spending, borrow funds, or use contingency reserves (Joyce 2001, 62-63). Thompson and Green list some strategies that state governments pursue in dealing with cyclical instability. This includes using PAYGO capital funding during good times while using debt during lean times, keeping a rainy day fund, allowing flexibility to transfer monies between special funds and general funds, and cutting services (Thompson and Green 2004, 81).

Rubin groups fiscal management strategies under the rubric *prevention*, which relates to the efforts to save surpluses in reserve funds during good times, which can then be used to maintain spending during downturns; *temporizing*, or one-time actions which can delay more difficult decisions by transferring dedicated fund balances, employing accounting gimmicks, or other actions such as selling assets or securitizing revenue streams; and *balancing*, which entails structural revenue increases or spending reductions which bring budgets into accord with current economic conditions (Rubin 2005, 47-48).

Business Cycles: Periodic expansion and contraction of the economy impacts governments as revenues rise during “boom” periods and fall during “busts” (Joyce 2001, 62). Services need to continue to be provided without disruption, and the demand for services increases during periods of fiscal stress (Lav and Berube 1999, 28; Joyce 2001, 63; Schunk and Woodward 2005, 123). Higher unemployment can lead to higher caseloads for Medicaid and other entitlement programs, and losses in the stock market can impact pension liabilities since many pension funds maintain a large share of assets in equities (Boyd and Dadayan 2008, 17).

Revenue Forecasting: Governments tend to be conservative in forecasting revenue, largely because of the repercussions attendant to exuberance. Elected officials may reduce taxes or embark on spending commitments to address needs when times are good. When revenue attainment is significantly lower than estimated, commitments have to be revisited. Raising additional revenue offers its own set of perils for politicians.

Penner notes the difficulty in forecasting at the federal level by the Congressional Budget Office (CBO). He cites an instance when CBO increased the estimated federal surplus by $95 billion between April and July 2000, based on technical and economic factors (Penner 2002, 1). Forecasts are never exactly correct. Several factors can affect just how wrong a forecast will become. First, historical trend data provides actual experience and often serves as the basis for supporting future projections. However, Penner notes that forecasters cannot predict recessions, natural disasters, or major changes in technology which can all affect revenues and spending. A recession can result in lost revenue and greater service demands, while high inflation can yield more revenue but also higher costs to run government (Penner 2002, 2, 7, 9-11).

Circumstances also change, as new laws or policies are enacted or modified every year at each level of government. This can include tax cuts, new spending programs, unexpected changes in caseloads, expanded entitlement eligibility, stricter sentencing guidelines, or other effects that were not anticipated when a forecast was originally developed. The longer the term of the forecast the more likely that its underlying assumptions will be incorrect (Penner 2002, 1).

Procyclical Fiscal Management: In good economic times, states accrue slack balances due partly to conservative forecasting practices and the inability to predict the timing of economic rebound or expansion. As balances rise, so too does pressure from the public, agencies, and special interests to increase spending or to cut taxes. During the late 1990s, in the peak of that business cycle, California expanded spending on health care, human services, and education, and cut taxes (Musso, Graddy, and Grizard 2006, 15). The Center on Budget and Policy Priorities reports that state governments cut taxes by $34 billion between 1993 and 1997 (Lav and Berube 1999, vi).

Conversely, during periods of fiscal stress, states raise revenue and cut spending to help bring budgets back into equilibrium. Following the downturn of the early 1990s, states increased taxes by $14 billion at the 1991 session, in addition to $7.6 billion in spending reductions. This was followed by another $4.5 billion in spending cuts at the 1992 session. Many of these reductions affect low income service recipients. Cash assistance to the poor was reduced or held constant in 40 states in 1992 and in 44 states in 1993, and reductions were effected in general assistance and Supplementary Security Income. Even when spending is level funded, inflation erodes the purchasing power of governments, effectively reducing the budget (Lav and Berube 1999, 3-5).

Strategies for Addressing Cyclical Instability

Strategies to address the imbalance between revenues and spending can be procyclical (*e.g.*, cutting spending or raising taxes), or counter cyclical (*e.g.*, use of balances or reserves). The strategies of prevention, temporizing, and balancing are discussed here so that the reader understands the distinctions between each strategy. This is important in understanding the concept of fiscal stress in the three case studies, which shows the extent to which these strategies were used. This study hypothesizes that states with binding tax and expenditure limitations will have needed to adopt fewer procyclical actions than did states with non-binding or no limitations.

Prevention: There are several aspects that can be considered to be prevention-based fiscal strategies. The first relates to the structure of a government's revenues, to ensure that there is not an over reliance on one source of revenue or those that exhibit a high degree of elasticity. The second, more commonly used reference is to the establishment of contingency reserves to help offset revenue losses resulting from a downturn of a business cycle (Meyers and Pilkerton 2003, 35). Finally, Schunk and Woodward offer proposed spending "rules" which they suggest could have obviated the fiscal stress of the early 2000s by constraining spending and crediting revenue surpluses to reserves, PAYGO capital, and short-term tax relief (Schunk and Woodward 2005, 113-115).

Revenue Structure: A well designed revenue structure can mitigate the effects of the business cycle. The Government Finance Officers Association (GFOA) suggests approaches to designing revenue systems to achieve greater fiscal stability. This includes first, a diversified portfolio of taxes and fees. Jurisdictions that rely on one large revenue source could be subjected to greater fiscal stress depending on its elasticity. For example, the property tax is very inelastic while corporate income taxes are very volatile. Second, the GFOA believes that a mix of revenues that includes elastic and inelastic sources is advisable (Blom and Guajardo 2001, 19).

A second facet of prevention is a strategy geared around building cash balances in good times which can then be accessed during periods of fiscal stress (Thatcher Legisbrief 2008, 1). Unreserved undesignated general fund balances (*i.e.*, those not applied against future liabilities or encumbrances) served for many years as the only mechanism for reserving surplus fund balances (Hou 2004, 39; Hendrick 2006, 17). But large general fund balances become targets for interests that would like to cut taxes or increase public sector spending levels (Sobel and Holcombe 1996, 42).

Budget stabilization or “rainy day” funds have become a popular tool for segregating slack revenue from the general fund balance. It has been found that states that maintain separate rainy day funds save more than if they just relied upon general fund balance, based on a regression of rainy day fund balances and deviations in long-term spending trends (Gonzalez and Levinson 2003, 443-444, 451). While they have existed for over 60 years, very few states maintained such contingency accounts until the period following the economic downturn of the early 1980s. Inasmuch as both general fund balances and rainy day funds represent cash, the two are often combined to represent a jurisdiction’s cash position.

The first rainy day fund was created in New York in 1946, followed by Florida in 1959. Another 7 states created funds in the 1970s, but the period after the economic downturn of the early 1980s saw funds established in another 20 states (Hou 2004, 63-64; Sobel and Holcombe 1996, 28). The increased popularity of the funds is often attributed to “wall street analysts”, but appears to be attributed to Robert H. Muller, a Vice-President of the credit rating agency Standard & Poor’s who suggested in the 1970s that 5% was a “good solid number for a state surplus, unless you have a cyclical economy” (Lav and Berube 1999, 7; Joyce 2001, 66; Hou 2004, 45). In 2008, NCSL indicated that all but 3 states (Arkansas, Kansas, and Montana) have established such funds (Thatcher Legisbrief 2008, 1). Reserve funds represent one counter cyclical fiscal option. As outlined below, there is some question as to whether reserve funds should be sized to carry a state through an economic downturn. Tax and expenditure limitations may act to limit spending growth in good times, which is the purpose of this research.

The literature pertaining to rainy day funds describes their characteristics, discusses their purpose and optimal size, and assesses their effectiveness in mitigating the effects of the economic downturns in the 1990-1991 and 2001 periods.

Hou defines rainy day funds as those which have a legal basis; are non-lapsing special funds; and have the broad purpose of government-wide support to address shortfalls in revenue, cash flow needs, or emergencies (Hou 2003, 66; Hou 2004 40). NCSL has identified the following six elements which describe and explain the similarities and differences in budget stabilization funds:

- A constitutional or statutory legal basis. It is noted that the funds in 11 states have a constitutional basis;
- The number of reserve funds or accounts. While many states have one fund, several have more than one;
- Methods for crediting monies to the funds. This is comprised of discretionary appropriations or formula-based mandated appropriations;
- Methods for utilizing balances from the funds, whether for any purpose or limited to budget shortfalls. A number of states have established supermajority vote requirements. Others limit the amount of the balance that can be used at one time;
- Methods for replenishing the funds once used. This can vary with some states requiring rapid repayment while others allow repayment over multiple years; and
- Limits on maximum balances. There are 37 states listed as having a maximum ceiling in the fund as a percent of general fund spending (Thatcher 2008, 1-4). Hou categorizes these as low (2%-4% of general fund budgets), medium (4%-7%), high (7%-12%), and no cap (Hou 2004, 45).

There is agreement that rainy day funds are intended to serve as counter cyclical fiscal management tools (Sobel and Holcombe 1996, 38; Douglas and Gaddie 2002, 19; Hou 2003, 82-83; Schunk and Woodward 2005, 113). However, there is debate in the literature over the purpose and optimal size of rainy day funds. At issue is whether such funds should contain sufficient balances to carry a state through a period of fiscal stress without the need to raise taxes or cut spending *or* whether balances represent a short-term strategy to maintain operations until longer term strategies can be implemented (Joyce 2001, 86).

There seems to be no question that slack is an important component of fiscal management, but as discussed below it has been found that combined reserve fund and general fund balances were not at sufficient levels to carry states until good times returned. Hendrick reviewed spending and unreserved fund balance data from 1997 to 2003 for 264 municipal governments in the Chicago area in reaching this finding (Hendrick 2006, 19-21).

NCSL's Fiscal Affairs and Oversight Committee suggests that states maintain a combined general fund and rainy day fund balance of at least 5% (Thatcher 2008, 4). However, based on a 1999 study which was based in part on NASBO fiscal survey data, the Center on Budget and Policy Priorities suggested that the 5% recommendation by NCSL was being misperceived as the amount needed to carry states through an economic downturn when it was really intended to "carry states through normal economic contingencies" (Lav and Berube 1999, viii, 7).

The concept of the 5% level serving as a nominal contingency is supported by Vasche and William, who found that forecasting errors in California over 12 years led to revenue shortfalls of 6% annually (Joyce 2001, 66). If, however, the purpose of the rainy day fund is to fully cover revenue needs in the period following a recession, the Center on Budget and Policy

Priorities has proposed that balances needed to be closer to 18% of general fund spending, although more recent research by the Center suggests a level of 15% (Lav and Berube 1999, 21; Zahradnik 2005, 21).

A 1999 study in Maryland confirmed that between 15% and 20% would be needed to ride out a recession (Maryland Department of Legislative Services Analysis of the Maryland Executive Budget 2000, 731). Other researchers found that rainy day fund levels would need to be as high as 30%, 34% or 36% of general fund budgets (Sobel and Holcombe 1996, 42; Joyce 2001, 67; Schunk and Woodward 2005, 119).

While higher balances in reserve can be desirable, at issue is whether large reserve fund balances can be achieved and sustained. Maryland's Department of Legislative Services (DLS) notes that surplus balances compete against demands for more services or tax relief. At Maryland's 2000 legislative session, the presence of large general fund and rainy day fund balances resulted in proposals to spend more for education and transportation, reduce income taxes, and enhance an Earned Income Tax Credit. The Governor's out-year forecast anticipated spending down the rainy day fund balance from its 12% of general fund revenues level to the minimum 5% level (Maryland Department of Legislative Services Analysis of the Maryland Executive Budget 2000, 731).

Large unreserved undesignated general fund balances have been found to lead to more spending (Hou 2003, 81). Other studies note that most states lack the political will to accrue large cash balances (Douglas and Gaddie 2002, 20; Hou 2003, 82; Lav and Berube 1999, 28; Schunk and Woodward 2005, 119). Instead, DLS suggests that the purpose of a rainy day fund is to permit decision makers to address a deficit that has arisen during the fiscal year, with a short-term cash balance, while buying time for the formulation of longer term revenue and spending actions (Maryland Department of Legislative Services Analysis of the Maryland Executive Budget 2000, 731).

Joyce adopted a different approach on optimal size, by examining the volatility of state finances in 1997 based on such factors as reliance on federal aid, gambling revenue, and corporate income taxes; Medicaid spending; and sectors of the economy. He concluded that there is no "one-size fits all" approach, and that instead of a 5% goal, states should establish their own reserve fund levels based on individual circumstances (Joyce 2001, 62, 86). The concept of variable balance requirements for rainy day funds based on the degree of revenue volatility was echoed by NCSL (Thatcher 2008, 4).

A number of studies have assessed the effectiveness of rainy day funds in times of fiscal stress. Prior to the 1990-1991 recession, rainy day fund balances nationally were estimated to hold less than 1% of general fund budgets. When added to general fund balances, they contained less than 5% of general fund budgets (Gonzalez and Levinson 2003, 441; Lav and Berube 1999, 6).

Sobel and Holcombe used NASBO fiscal survey data to examine rainy day fund balances relative to the 1990-1991 downturn to gauge their effectiveness at easing fiscal stress. Their regression analysis of 48 states determined that structural requirements of the funds were important, such as requirements for appropriations. However, they concluded that while the presence of funds did mitigate fiscal conditions, the balances were too small (Sobel and Holcombe 1996, 37-45, 47).

Douglas and Gaddie built upon the work by Sobel and Holcombe by also analyzing data for 48 states from the 1990-1991 recession. They used slightly different variables to test for correlations between fund balance levels and the degree to which fiscal stress was mitigated.

They concluded that the existence of multiple funds and large contingency reserve balances were important in reducing fiscal stress (Douglas and Gaddie 2002, 21, 26, 30).

In 1999, the Center on Budget and Policy Priorities modeled the impacts of a recession over the 2001-2003 timeframe, using revenue and spending data for 48 states from NASBO fiscal surveys. The Center projected an $80 billion shortfall in cash reserves across all states, assuming no tax increases or cuts to services. Based on this analysis, it was determined that states would need 18% of general fund spending in reserve and that a 5% savings level would provide sufficient resources for only three states to weather the projected recession.

Due in part to a large decline in the stock market in 2000, the next downturn did occur in 2001 (Hendrick 2006, 14; Musso, Graddy, and Grizard 2006, 15). At that time, states held over 5% on average in reserve, and when added to general fund balances, they held 12% of general fund budgets (Gonzalez and Levinson 2003, 441). Following the recession, the Center on Budget and Policy Priorities indicates that states used over $30 billion from combined general fund and rainy day fund balances, but the shortfalls they faced totaled more than $250 billion (Zahradnik 2005, 1; Maag and McCarthy 2006, 79). Despite the presence of much larger combined general fund and rainy day fund balances, the level of reserves was found to be insufficient to carry states through the period of fiscal stress.

Hou examined rainy day funds in 2003 and 2004, looking first at the separate effects of these reserves compared with unreserved undesignated general fund balances, and later at the elements that contribute to larger reserve balances. In both cases he used data from 1979-1999 from state Comprehensive Annual Financial Reports (CAFRs). Using regression analysis, he determined that rainy day funds are counter cyclical but that general fund balances are not. That is, he concluded that general fund surpluses lead to more spending (Hou 2003, 61, 67, 81-83).

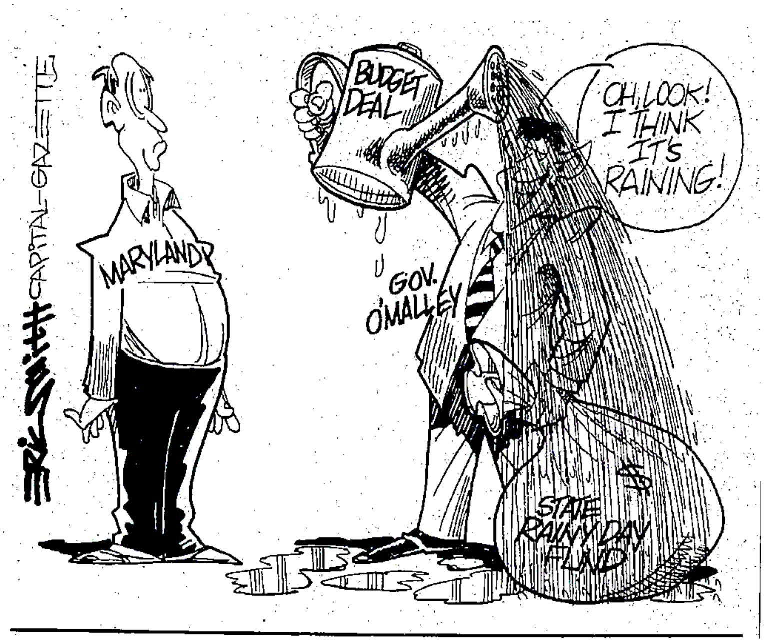
In 2004, he again used 1979 to 1999 data from states' CAFRs to look at the relationship of rainy day fund balances to purposes, funding sources, maximum balances, and usage procedures in the 39 states that had rainy day funds at that time. He found that states do set aside slack resources under stronger economic conditions and that certain structural elements of rainy day funds do have an impact on balance levels. For example, he notes that funds that can be used for broad purpose (as opposed to being restricted only to deficit reduction) experience the highest loss of balances (Hou 2004, 40-47, 53, 57).

The literature also offers proposals for improving rainy day funds and ensuring that higher balances are available in times of fiscal stress including:

- Instead of a maximum limit on fund balances, which many states currently have adopted, the suggestion is to either have no caps or to raise the ceiling on existing caps;
- More formalized approaches to building balances are recommended, so that saving surplus funds becomes automatic and does not compete with proposals to cut taxes or increase spending. An example is when surplus end-of-year balances are "swept" into rainy day fund balances;
- Improve access to balances by eliminating supermajority requirements which can be subject to political maneuvering;
- Lengthen the time to replenish funds once balances are used to account for the time it takes revenues to rebound from a downturn;
- Eliminate limits on the level of fund balance that can be used at one time; and
- Dedicate fund balances to only be used for budget shortfalls instead of broader purposes. Some states permit balances to be used for any purpose, which can lead to their use

during good times and reduce balances when they are needed to protect services in bad times (Joyce 2001, 65; Hou 2004, 61-62; Zahradnik 2005, 5-9).

Figure 2.1



The question of whether tax and expenditure limitations can be viewed as a counter cyclical measure has not been explored in the literature. Based on an analysis of articles in Public Budgeting and Finance, Rubin alluded to the merging of the study of tax and expenditure limits with the study of fiscal management during boom and bust cycles (Rubin 2005, 46, 50). One example that she cites relates to the relationship between tax and expenditure limitations and how they affect fiscal behavior in Colorado. Based on the structure of TABOR, when revenues fall (as they do during economic downturns), the base of spending drops to that new level. Spending cannot spring back to its prior level even when revenues fully recover, which ratchets spending down. Because of this effect, fiscal management behaviors of elected officials change in response (Rubin 2005, 49).

Thus, as Martell and Teske have stated, tax and expenditure limitations are one strategy and are not independent of other fiscal management tools (Martell and Teske 2007, 685). While Howard found little to suggest that tax and expenditure limitations were effective at reducing the size of government, she does provide an indirect reference to their ability to limit spending in good times. Specifically, she notes that "in a state where the limitation has been triggered, it is judged partly unsuccessful because its structure can restrict state expenditures when the economy is growing and fail to restrict them when the economy is contracting" (Howard 1989, 87).

Using spending data from NASBO fiscal surveys along with CPI and population data, Schunk and Woodward proposed "rules" for spending growth based on increases in population and inflation, which is similar to the restrictions imposed by TABOR in Colorado. They also examined a variation where spending growth is limited to inflation and population growth plus 1%. The distinction that they draw between tax and expenditure limitations and their spending growth "rules" is that any surplus revenues under their model would be directed to rainy day funds, PAYGO capital, and tax rebates.

In their study, they chose to allocate ⅓ of surpluses equally to these three purposes. Under tax and expenditure limitations, they note that surplus revenues must be returned to taxpayers, which deprives governments of the funds needed to pursue counter cyclical fiscal management strategies (Schunk and Woodward 2005, 114-119). While this is certainly the case in Colorado, it is not necessarily the case in all states with tax and expenditure limitations. Thus, they suggest that the purpose of their "rules" is to stabilize while the purpose of tax and expenditure limitations is to restrain spending (Schunk and Woodward 2005, 107).

The key element for purposes of this discussion is the focus on the extent to which ongoing spending growth is limited during boom economic times. What is important is whether spending growth was limited in good times and if this restraint better positioned states without similar limits for the bust portion of the business cycle. Under their "rules" and even with a 1% growth factor applied, they found that states would not have been required to cut spending or raise taxes throughout the period following the 2001 recession (Schunk and Woodward 2005, 119).

***Temporizing*:** This involves adopting actions to find and transfer funds from other sources to defer more difficult spending or revenue decisions. It has been suggested that elected decision makers are inclined to temporize during periods of fiscal stress, adopting the least painful options until slack resources are exhausted (Hendrick 2006, 27). A good example of temporizing is provided by Musso, Graddy, and Grizard who examined California following the 2001 recession. They found that the state's estimated $38 billion shortfall was addressed through a combination of borrowing, deferrals, one-time transfers of fund balances, and budget cuts (Musso, Graddy, and Grizard 2006, 2).

Juppe detailed the actions of the Maryland General Assembly in balancing the budget at the 2002 session, which included one-time transfers, withdrawn appropriations, short-term and ongoing revenues, and mandate relief. Over $230 million in dedicated special fund balances was transferred to the general fund by budget reconciliation legislation; $457 million in prior year PAYGO appropriations was withdrawn; revenues were increased by $161 million, though many were put into effect for only two years; several statutorily mandated appropriations were modified to ease future funding requirements; and accounting changes were adopted such as decreasing the time period for property to be considered abandoned from four to three years, which raised an estimated $25 million (Juppe 2003, 14-23).

***Balancing*:** (cutting spending and raising taxes and fees) The third option that Rubin discuses is balancing the budget, which entails cutting spending and/or raising taxes (Rubin 2005, 47-48).

Accountability

"The people, the ultimate sovereign in a popular government, must, however, have a control over the officers who execute their will, as well as over those who express it. Such executive officers are therefore given short terms, are thus subject to a popular control which may be frequently exercised because of frequent elections." – Frank J. Goodnow (Goodnow 1900, 98).

Tax and expenditure limitations represent a tool of accountability designed to limit the ability of elected officials to increase spending beyond the limits of taxpayer affordability. While such limitations are a fairly recent phenomenon, they are yet another in a long line of historical attempts to hold officials accountable by imposing limits. The purpose of this section is to outline historically the accountability measures adopted since the Progressive Era. These include the reform of budgeting, personnel, and accounting systems and formats, term limits, voter initiatives and referenda, and tax and expenditure limitations.

Historical Treatment of Accountability Theory in the Public Sector

The following outlines the key political, fiscal, and administrative dimensions of accountability to place the discussion of tax and expenditure limitations in a larger historical context. The crux of the issue relates to the degree of discretion that elected officials should have in order to ensure the provision of public sector services and to be able to undertake the measures necessary to address fiscal problems.

The size and complexity of government in the United States was limited for much of the first 100 years or so, but conditions changed as the industrial revolution brought an influx of citizens to urban centers. The ability to provide police, fire, health, and basic sanitation services strained the capacity of government institutions. Matters were not helped by long standing traditions of political patronage, where large numbers of public sector employees were replaced with each change in the political party in power.

The Progressive Era of the late 19^{th} and early 20^{th} centuries was dedicated to government reform, and personnel reform was one of its early targets. Although the federal Civil Service Reform Act was enacted in 1883, only about 25% of the federal workforce was covered 10 years later and employees selected based on qualification (Schurz 1893, 9). The National Civil Service Reform League viewed reform as a means of reducing the influence of political machines and party bosses, noting that scandal arising from the spoils system was of growing concern to the public (Schurz 1893, 27).

Efforts to improve the professionalism of the public sector and service delivery also resulted in calls to separate politics from administration. Both Woodrow Wilson and Frank Goodnow were proponents of the politics/administration dichotomy, arguing that the role of politics was to establish the priorities and policies to be pursued, while the role of the bureaucracy was to implement laws in the most effective and efficient manner – *i.e.*, to run government like a business (Wilson 1887, 13-19; Goodnow 1900, 8-20). These early efforts sought to improve the accountability of government in part by attempting to instill greater administrative professionalism.

Wilson contemplated that once civil service reform was completed the focus should turn to reforming both the organizational and administrative methods of the public sector (Wilson 1887, 8-10). Patterned heavily on the business models of the day, bureaucracies soon developed structures and controls designed to ensure that administrators were responsive and responsible. Henri Fayol outlined 14 management principles, such as lines of authority, the division of work, and unity of command, which dictated effective performance within hierarchical organizational structures. Part of management's efforts to impose accountability, according to Fayol, is to apply sanctions (Fayol 1916, 48-49).

Much of the literature in the field of public administration focuses on administrative accountability, but the prevalent themes are applicable to both administrators and elected officials. The Friedrich and Finer debate of the 1940s established the parameters of a major philosophical divide that continues to be discussed.

Friedrich argued that undertaking efforts to prevent government from doing wrong was not related to improved responsibility. He cited public servants in Switzerland who believed that responsibility and accountability were based on a sense of duty and an interest in peer acceptance. In other words, Friedrich believed that controls were less effective in enforcing responsibility than the standards and ideals of the profession (Friedrich 1940, 4, 8, 12-13, 19).

Finer, on the other hand, asserted that power is always abused unless external controls are in place to prevent malfeasance. Only through such controls, he proposed, can responsibility be enforced through sanctions. In his view this could include actions as extreme as dismissal of administrators or politicians (Finer 1941, 335-338).

The Friedrich – Finer debate is critical to this paper because tax and expenditure limitations represent an external control which constrain elected officials from increasing the size of government too rapidly. However, it can be argued that decision makers require discretion when balancing demands for services against the burdens imposed upon those who must pay for services.

This theme of two philosophical dimensions of accountability is addressed by Cooper, Harmon and Mayer, and Gil Garcia. Rather than viewing these perspectives as ends of a continuum, however, all three authors suggest that internal and external controls are integral elements of public sector responsibility.

Cooper restates the arguments of Friedrich and Finer, categorized as objective and subjective types of responsibility. Objective responsibility relates to the formal organizational, as well as external formal and legal requirements that impose authority over the public administrator. Examples of such objective obligations includes laws and constitutional provisions; organizational policies and rules; responsibility to superiors in the hierarchy; and formal job descriptions.

He defines subjective responsibility as that which comes from within the administrator in part shaped by the beliefs and values accrued through socialization (Cooper 1982, 43-51). Objective and subjective responsibility, he suggests, are not mutually exclusive. Instead, both exist together, and it is a question of how much one is emphasized over the other. If actions by the bureaucracy do not comport with public wishes, the issue becomes one of whether more external controls are needed or whether additional education or socialization is warranted (Cooper 1982, 95).

In balancing objective and subjective responsibility, Cooper proposes a set of primary links between the public and the development of laws and policies, as well as secondary links between organizations and the public (Cooper 1982, 134-138).

Harmon and Mayer describe 3 types of responsibility. When guided by professional responsibility, administrators act within the bounds of formal organizational responsibilities and do not make subjective decisions. When acting within the realm of political responsibility, administrators are cognizant of not only social and community expectations but also legal requirements. Personal responsibility is in effect when the administrator acts in the knowledge that his or her decisions affect people's lives and that responsibility cannot be shifted to the organization, rules and procedures, or other people.

Similar to Cooper, Harmon and Mayer view these facets of accountability and responsibility as interdependent and not mutually exclusive. All need to co-exist as required elements of responsibility (Harmon and Mayer 1986, 400-403).

Gil Garcia cites the work of R.D. Behn, who discussed three types of administrative accountability relating to finances, equity, and agency performance. Responsibility for finances and fairness are similar to the objective, or external control measures discussed by both Finer and Cooper in that they require rules, record keeping, and audits to ensure compliance. However, Gil Garcia suggests that if administrators are to be held accountable for performance, then they need latitude (*i.e.*, fewer external controls.

Thus as espoused by the prior authors, it is suggested that there need to be external controls as demanded by the public over public sector officials, balanced against the flexibility required to produce results (Gil Garcia 2003, 286-287). This perspective mirrors the findings of the report of the National Performance Review, in which Al Gore describes the performance challenges of the federal government. He cites budget, personnel, procurement, and financial management system controls which make it difficult for employees to focus on innovation and improved performance (Gore 1993, 460-463).

The Political Dimensions of Accountability

The political system of the United States is built around representative democracy. Voters elect representatives based on the nexus between the public policy views of the candidates and their own. Once in office, elected officials are expected to vote in a manner that represents the interests of their respective jurisdictions. However, as a member of a larger executive or legislative institution, they also have a responsibility to the collective interests of the population they serve. The end result is laws and policies that protect, regulate, and serve the public.

Overarching decisions must be made regarding the sources and levels of public sector revenue relative to the type and scope of services provided. Administrators in the bureaucracy implement the policies, but there is a confluence of politics in the administrative function. Gil Garcia describes the democratic system of government as a series of Principal-Agent relationships which connect the voters to those they elect, to the heads of bureaucratic organizations, and on to the administrators responsible for direct service delivery (Gil Garcia 2003, 284-285).

Politics and the Budget: There is a direct connection between the electoral mandate given to those installed in office, and the programs and services provided by government. The government has the legal authority to impose taxes and fees to pay for services, deciding who pays and how much they pay. The decisions over what services to provide and at what levels are ultimately political ones. This can range from broad collective benefits such as national defense, environmental protection, and regulated financial markets, to individualized fee-based services such as admission to a park.

Rubin identifies seven decision areas around which political decisions are made with respect to the budget. This includes:

- services provided by government;
- areas of emphasis, such as more or less of health care, education, or public safety;
- a balance between efficiency, effectiveness, and collective goals against parochial goals to benefit local constituencies;
- the extent to which voter articulated demands are met; an element of accountability;
- issues of who pays and how much, as well as the degree to which wealth is redistributed;
- national economic policy, which affects the availability of credit and levels of unemployment; and
- access and power dynamics of individuals and groups seeking to influence budgetary and revenue decisions, and of elected officials as they work within legal and constitutional/institutional power structures (Rubin 2000, 1-2).

In the context of tax and expenditure limitations, political decisions must be made about the aggregate levels of services provided relative to how much the public is willing to pay. Osborne and Hutchinson suggest that there is a zone of fiscal tolerance as a share of personal income. They suggest that this range is between 35 cents and 37 cents of each dollar of personal income for all levels of governments; 20 cents to 22 cents on the dollar at the federal level; 7.3 cents to 8.3 cents at the state level; and 6 cents to 6.6 cents at the local level (Osborne and Hutchinson 2004, 44).

When government spending exceeds the range of spending that the public wants to commit to public sector services the public reacts. If the price of government is too high the reaction can range from voting incumbents out of office to adopting tax and expenditure limits.

When the price of government falls too low, citizens demand more or better services (Osborne and Hutchinson 2004, 42).

However, the authors note, importantly, that the public has a limited pool of resources to spend. Factors external to the public sector impact both the level of services desired and the ability to pay. When economic conditions are favorable and personal income rises, more services are desired. Conversely when the economy turns downward and both inflation and unemployment increase, consumers limit spending.

Ladd suggests that the government lacks a market mechanism like in the private sector which tells elected officials that the government is providing more services than taxpayers are willing to bear. She states that when costs go up for taxpayers (as seen during periods of high inflation) consumers can modify their behavior with respect to what they buy and how much they consume because they cannot affect prices of products which are driven to a large extent by issues of supply and demand. In the public sector, however, taxpayers can impact how much they pay to some extent by letting their elected representatives know that they demand to pay less. Ladd also says that the absence of market mechanisms (which would cause private sector companies to maximize efficiencies) could cause the public sector to experience a greater likelihood of mismanagement, inefficient service delivery, and possibly corruption (Ladd 1978, 5).

***The Public Will*:** One of the inherent tensions of the democratic system of government is the fact that desires and interests of the voters can fall along the entire length of a continuum on any particular issue. Depending on their affiliations and interests, individual voters may support one issue with a majority, but then be opposed to the next issue. When an elected official votes, he/she must choose between options that benefit the larger community or specific constituencies. However, regardless of that vote, not everyone will support any particular decision.

The power of elected officials is derived and authorized by the people. Once elected, those in office are put there with the expectation that they will respond to public demands by putting into effect the actions that are wanted (Burke 1986, 197, 234; Finer 1941, 343, 337-338). Similar to the Principal-Agent model discussed by Gil Garcia, Burke indicates that the administrators in the bureaucracy are also “instruments of the people” who subordinate their own interests in order to implement the direction provided by political authorities (Burke 1986, 11).

One of the mechanisms proposed by Finer to assure responsibility by both administrators and elected officials is a mechanism for the public to alert officials of what is wanted as well as enforcement mechanisms to exact obedience to that will (Finer 1941, 337). For the elected, periodic elections serve to replace those whose actions stray too far from the views of the represented, and impeachment procedures exist for those who have committed worse transgressions. Administrative procedures also exist to ensure some degree of bureaucratic conformance with legal and policy requirements. But the quandary is that there can be a public majority on one issue and conflicting majorities on others.

For example, the public may support lower taxes but more spending on education. Friedrich lamented that responsibility will always be fragmented because it is hard to know what the will of the people is, given the heterogeneity of viewpoints (Friedrich 1940, 24). The shifting nature of the public will certainly call into question the discussion of what have been called objective, or external controls and the extent to which they restrict both elected and administrative officials in the exercise of discretion.

The Degree of Discretion: Vis-à-vis the bureaucracy, Gore notes that “We assume that we can’t trust employees to make decisions, so we spell out in precise detail how they must do virtually everything, then audit them to ensure that they have obeyed every rule” (Gore

1993, 462). The expectation is that administrators are limited in the exercise of discretion and must be strictly obedient to supervisors in the hierarchy. This works well when tasks are uniform and problems are relatively straightforward (Burke 11-13; Cooper 1982, 99). However, administrators need discretion and decision making authority in implementing policy (Harmon and Mayer 1986, 402; Burke 1986, 32, 38-39; Cooper 1982, 107).

Burke outlines two principles under which he believes administrative discretion is necessary. Under the first principle bureaucrats must be able to act when others in the process have failed to meet their responsibilities, even if they are not legally required to intervene. For those "responsible agents" who take action, he states that "they must be able to exercise free will, possess knowledge of those conditions that call for them to take some corrective action, and be capable of taking that action" (Burke 1986, 45-46). This point is important to the research question within this paper because tax and expenditure limitations are one form of external control which reduces administrative discretion. If such limits are not effective in limiting spending during good economic times, then they effectively only serve to inhibit elected officials from using the discretion necessary to determine how much government should expand to meet service delivery needs.

A second point about administrative discretion is the use of discretion in policy formulation. Administrators can provide knowledge and expertise to policymakers when initially developing programs and in providing feedback during implementation in case corrective legal action is needed. Often, Burke notes, policy is not defined adequately. Because administrators have technical expertise they are also granted the power to set goals and standards and determine resource needs. More importantly, he indicates that bureaucrats need creativity and flexibility because strict compliance with rules and regulations could impede policy objectives (Burke 1986, 56-66, 81). The point here is that if bureaucrats need administrative flexibility to ensure that policy objectives are implemented as intended, so too may elected officials require discretion in making fiscal policy decisions when facing good and bad economic conditions.

As has been noted throughout this paper, a number of reforms have been adopted over the years to improve transparency of government and to improve the accountability of elected officials. As the foregoing material addressed, one of the challenges of enhanced accountability revolves around the question of whether and how much discretion is afforded elected officials. It is important to understand the institutional external controls that promote accountability and how tax and expenditure limitations fit within this context.

Elected officials are arguably subject to a high degree of accountability since they must run for election and re-election. However, reforms adopted over the years, suggests that elections are deemed insufficient, leading increasingly to external controls to constrain the actions of politicians.

Over the last 125 years, the United States has witnessed reforms to personnel, accounting, and budget systems in order to increase professionalism and reduce political interference. Term limits discourage long-term political careers. The referendum and initiative process permit citizens to circumvent political institutions and become more directly involved in law making. Tax and expenditure limitations are another external control over elected officials who are largely perceived to be inept or corrupt.

A New Jersey poll found that 58% of respondents thought that legislators were willing to sell out, and over 1/3 thought that at least 1/2 of legislators take bribes. In Utah, 2/3 of respondents thought that legislators take bribes. In a Gallup poll on trust in government, only

14% of respondents thought that officeholders merited a rating of high or very high on honesty and ethical standards (Rosenthal 1996, 42-43; 117-118). In Massachusetts, 88% of respondents thought that corruption was rampant in state government, and 66% thought the same for local government. (Ladd and Wilson 1982, 128).

Moreover, almost 1/2 thought that government employees were overpaid, and 2/3 felt that government employees do not work as hard as their private sector counterparts. The Gore Commission noted that most citizens believe that nearly 1/2 of every dollar is wasted by the federal government, and that only 1/5 believe the government acts in their best interests (Gore, 1993, 460).

Tax and Expenditure Limitations in the Context of Accountability

At the heart of the concept of tax and expenditure limitations is a fundamental criticism of representative democracy; namely, such limits suggest a fundamental concern that "left to their own devices, government institutions lack the discipline to live within the people's means" (Deschenaux 1997, 101). A similar theme is echoed by other authors. It has been suggested that tax and expenditure limitations cause more centralization and a lowered ability of local governments to be responsive (Mullins and Joyce 1996, 75).

For example, California's Proposition 13 gave elected officials less discretion because there was less autonomy at the local level to raise revenue for services (Hoene 2004, 70). Moreover, any new taxes in Colorado require voter approval, and those that do get approved are earmarked for specific purpose acting to restrict discretion and flexibility. This impedes, for example, the ability to restructure the tax system to make it more progressive or to shift taxes to more services and away from manufacturing (Martell and Teske 2007, 680-684). Binding limitations tie the hands of elected officials and makes it more difficult to act (Meyers and Pilkerton 2003, 31).

Following on the heels of Proposition 13, Maryland was one of many states confronted by the possibility of legislation to impose automatic spending caps (Deschenaux 1997, 100). Then Governor Harry Hughes engineered efforts to overturn legislation at the 1980 legislative session. Hughes noted that "Such an arbitrary limit would have undoubtedly limited the state's ability to respond to crises, changing times and the inevitable fluctuations of the state and national economy." (Hughes and Frece 2006, 150).

The literature also offers a cynical perspective on the response of elected officials to proposed tax and expenditure limitations. After the adoption of Proposition 13, a wave of anti-tax sentiment swept the country. Tax and expenditure limitations proposed via voter initiatives are a strong message to elected officials that they are spending too much and better respond to taxpayers and slow the growth of spending to affordable levels (Kenyon and Benker 1984, 444).

Between 1978 and 1982, 15 states cut the income tax rate, 10 indexed their income taxes, 7 repealed the gift tax, and 6 repealed the estate tax (Stansel 1994, 3). Rosenthal notes that "especially after a major scandal, most legislators will do whatever they have to do to get off the hook and hope that in time the heat will subside" (Rosenthal 1996, 7-8). This is one reason that cynics suggest that elected officials will do just about anything to sabotage a tax and expenditure limitation so that they can continue unrestrained spending, or as Bails puts it, "Politicians will design the legislation so as to minimize the real world impact of these limitations" (Bails 1982, 129).

Shadbegian also asserts that adoption of a legislative tax and expenditure limitation provides political cover. It says to voters that government is not growing too fast because there is a limit (Shadbegian 1996, 31).

Studies suggest that elected officials will look for ways to circumvent limits (Danziger and Ring 1982, 49; Lowery 1983, 250). In some states legislators put forth their own versions of limitations before being forced to deal with more restrictive limitations from the voters (Kenyon and Benker 1984, 444; Howard 1989, 85; Rueben 2000, 3-6; Mullins and Wallin 2004, 2; Rubin 2005, 49).

The example of Proposition 6 in Nevada is illustrative of this assertion. Proposition 6 was a voter backed initiative with many of the same elements as Proposition 13. Voters passed it, but state law required a second confirming vote in the next year. However, the legislature put forth its own bill to reduce property taxes and to repeal the sales tax on food, all contingent on failure of the citizen backed initiative. The citizen initiative failed (Rueben 2000, 5).

A different result was experienced in Colorado, where TABOR was offered by citizen initiative in 1986, 1988, and 1990 but failed each time. The legislature passed legislation referred to as the Arveschoug-Bird Amendment to limit state spending so that it could not grow more than 6% over the prior year. In any case spending could not exceed 5% of personal income. Despite these efforts TABOR was still introduced again in 1992 and passed (Martell and Teske 2007, 675).

Stansel suggests that government imposed tax and expenditure limitations are established to minimize effectiveness and are designed by elected officials to be weak and easy to get around (Stansel 1994, 3). According to NCSL, the ease with which limitations can be circumvented is a factor that explains why tax and expenditure limitations do not work as expected (NCSL 1996, 2).

This led Stansel to suggest nine factors which ought to be adopted when establishing tax and expenditure limitations, to ensure maximum constraint and accountability. This included:

- ***Origination:*** Was the limit offered by the citizens or the legislature? Stansel suggests that citizen initiatives are stronger and more binding;
- ***Constitutional or Statutory:*** Because statutory limits can be redefined or repealed, Constitutional limits are considered more binding;
- ***Level of Exemption:*** As noted the percentage of the budget which is subject to limitation varies by state. Stansel believes that 100% of each budget should be subject to limitation;
- ***Spending v Revenue Limits:*** It was intimated that revenue forecasts can be easily manipulated, and thus expenditures should be used as the basis for limitations;
- ***Limitation Criteria:*** Many states use personal income as the criteria for limiting spending or revenues, on the basis that it is the best available measure of economic activity. A few states, such as California and Colorado, limit growth in spending to population and inflation. The latter is recommended as a more restrictive restraint;
- ***Waiver Provisions:*** Several states have limitations that can be waived either in an emergency, or upon a simple or super majority vote in the legislature. To avoid any efforts to circumvent limitations the author advocates no ability to waive limitations;
- ***Intergovernmental Redistribution:*** Ideally limitations should be constructed to prevent states from shifting or mandating responsibilities to local levels of government;
- ***Implementation:*** In limited instances it was noted that tax and expenditure limitations would not go into effect unless certain elements were further defined by additional legislative action. This allowed Connecticut, for example, to defer implementation of a limitation pending the definition of certain terms; and

- ***Enforceability:*** Stansel suggest that taxpayers be given the right to sue a state if its limitation is violated, including the right to seek injunctive relief (Stansel 1994, 5; 10-14).

In sum, this chapter has addressed several key elements found in the literature pertaining to tax and expenditure limitations, cyclical instability, and the accountability of elected officials. The relationship of these concepts turns on the degree of discretion allowed to officeholders in balancing the competing demands for public sector services versus the burden of paying for those services. Tax and expenditure limitations are one form of external control that limits the discretion of elected policymakers. The literature questions the ability of tax and expenditure limitations to reduce the size of government, instead suggesting that effects have been more readily observed on the quality of services, the behavior of elected officials, and intergovernmental relationships.

This paper explores tax and expenditure limitations in a different light – namely in the context of cyclical instability. As noted, governments typically pursue procyclical policies to cut taxes and increase spending in good times followed by cuts in services and tax hikes under less favorable economic conditions. The literature highlights the counter cyclical fiscal tools available, including maintaining reserve fund balances as a tool for prevention, temporizing actions such as one-time fund transfers, or budget reductions. Tax and expenditure limitations may also serve as counter cyclical tools to the extent that they limit growth during good times.

However, tax and expenditure limitations also conflict with the need for administrative discretion. There are conflicting perspectives in the literature as to the degree to which officials should be permitted to exercise discretion or to be constrained by external controls.

The next chapter outlines the methodology for this study, which consists of a mix of qualitative and quantitative measures. The selection of a mixed methods approach was influenced in part by the methodologies used by the roughly 60 journal articles perused by the author on the topics of tax and expenditure limitations, cyclical instability, and counter cyclical cash management measures such as use of reserve funds. The authors utilized a variety of qualitative and quantitative approaches ranging from case studies to the analysis of revenue and spending data from NCSL surveys, other surveys, and personal income and other data reported by the ACIR or the U.S. Census Bureau. However, in most instances the use of data was confined to efforts to assess the effectiveness of tax and expenditure limitations in reducing the relative size of government or in the cases of those with a qualitative focus, to determine, for example why voters support limitations. Howard did use a mixed methods approach by combining a quantitative analysis of state tax collections relative to personal income in states with and without tax and expenditure limitations, to assess the success of tax and expenditure limitations in constraining government, along with surveys of budget officials to assess their perceptions of the effectiveness of the limits (Howard 1989, 85-97).

CHAPTER III – Methodology

Introduction

This chapter describes the research methodology of this study. The research question central to this paper critically examines how effective tax and expenditure limitations have been in restraining growth during periods of economic expansion, so as to limit fiscal stress during periods of economic downturn.

The strategy of inquiry involves a mixed methods approach combining elements of qualitative and quantitative research design to generate data enabling the most effective explanation of dynamics related to the research question. Many studies, particularly in public policy and administration, utilize either a quantitative or qualitative research design. Quantitative designs may involve survey research or the traditional post positivist experimental design. Quantitative designs are also appropriate for critical studies of fiscal data on public expenditure patterns, taxation and revenue, and capital spending.

Qualitative designs offer many variations including ethnographic research (study of cultural groups in natural settings), grounded theory (development of inductive theories derived from participants in a study), case studies (in depth exploration of events, actions, or processes), phenomenology (study of human experiences relating to a phenomenon), or narrative research (study of the stories of lives of individuals). Each design offers different strengths and weaknesses. For example, one of the strengths associated with qualitative design is that it enables elected officials to describe their experiences in the public policy process through their own stories and constructions.

As discussed below, a case study of three states is used as a means of effectuating an in-depth exploration of tax and expenditure limitations. As noted in the literature review, there have been many studies of tax and expenditure limitations. These have included qualitative single and cross sectional case studies as well as quantitative research using survey data or revenue and spending growth relative to economic activity. Evidence for this study, comes from a combination of sources.

The five-year period of time from fiscal year 1997 through fiscal year 2001 is the most recent example of the period leading up to a recession (in this case 2001), followed by the three-year, post-recessionary period from fiscal year 2002 through fiscal year 2004. The overarching goal was to develop a time series case study to review the impact of tax and expenditure limitations on fiscal management for the period from state fiscal year 1997 through fiscal year 2004 to ascertain whether limitations acted to constrain spending during the economic boom times of the late 1990s in order to mitigate the use of procyclical budget actions following the 2001 recession. Sources of data used in this case study consist of both qualitative interviews and quantitative budgetary data obtained via documents.

Research Questions – Hypotheses

This paper sets forth four hypotheses for study to operationalize the research question, to determine the effectiveness of tax and expenditure limitations in restraining growth during periods of economic expansion to limit fiscal stress during periods of economic downturn.

The first hypothesis measures slack as evidenced by accumulated cash and reserve fund balances compared against total general fund spending. This demonstrates how much budgets grew and how much cash was set aside for future downturns.

The second and third hypotheses measure the fiscal stress in states with different types of tax and expenditure limitations (including a state with no limitation) after the 2001 recession by aggregating budget balancing actions. This includes use of general fund balances and reserves, non-general fund transfers, new revenues, and budgetary reductions. The fourth hypothesis ascertains the extent that reserve balances were not spent during good times, in order to be available during the period of fiscal stress.

The four hypotheses are related for purposes of this study to explore the extent to which tax and expenditure limitations were effective in slowing general fund spending growth and building fund balances between fiscal year 1997 and fiscal year 2001, then assessing the extent of fiscal stress from fiscal year 2002 through fiscal year 2004. The hypotheses are:

- **Hypothesis 1 – Degree of Formalization of Tax and Expenditure Limitations –** States with institutionally formalized tax and expenditure limitations will have accumulated larger combined cash balances (defined as reserve fund balance and general fund balance) during periods of slack which will have been available to mitigate the impact of the 2001 recession;
- **Hypothesis 2 – Effectiveness of Binding vs. Non-Binding Tax and Expenditure Limitations** – States with binding constitutional tax and expenditure limitations will have experienced less fiscal stress in the fiscal year 2002 through fiscal year 2004 post-recessionary period than states with non-binding tax and expenditure limitations. Fiscal stress is defined as the total of spending reductions relative to a pre-recession spending trend, transfers from reserves and non-general funds, new revenues, use of fund balance, and use of federal aid which supplanted general fund spending as a percent of general fund spending;
- **Hypothesis 3 – Effectiveness of Non-Binding vs. No Tax and Expenditure Limitations** – States with non-binding tax and expenditure limitations will have

experienced less fiscal stress in the fiscal year 2002 through fiscal year 2004 post-recessionary period than states with no tax and expenditure limitations in place; and

- **Hypothesis 4 – Rainy Day Fund Requirements** – States that limit reserve funds to be used only during times of economic crisis will have maintained larger reserve fund balances for use following the 2001 recession than states that permit reserves to be used for broader purposes.

Qualitative Data

Qualitative data was collected through a series of interviews with state budget officials to ascertain their perceptions of the effectiveness of their respective states' fiscal policies during the peak economic activity of the late 1990s; use of reserve fund balances prior to the recession of 2001; the extent of fiscal stress following the recession; and their preference for a formal, legal tax and expenditure limitation, a non-binding limitation, or no limitation. These interviews were used to corroborate the data collected from archival materials. A sequential exploratory strategy is used involving collection of qualitative data followed by quantitative data. The findings of the two phases are integrated during the interpretation phase.

Quantitative Data

Quantitative data were compiled through a combination of direct research collection from documents from the state governments of Maryland, Delaware, and Virginia and a review of secondary survey data collected by NCSL, which separately reports state tax and budget actions in each of fiscal year 1997 through fiscal year 2004. All of the data are publicly available which did not require written permission to access and use. This included general fund and rainy day fund balances and activity, tax cuts and spending growth prior to the recession of 2001, and budget balancing actions following the recession. Further explanatory detail on the quantitative methodology relating to the analysis of pre-recession foregone revenue, post-recession fiscal stress, and mandated spending is provided below.

Foregone Revenue

It is important to review the cumulative effect of revenue decisions made during boom economic times. Large fund balances can build up unexpectedly – a fact not lost on key stakeholders. Advocates for public services demand additional spending to address unmet needs, but revenue actions also play a major role by influencing behavior and amassing political capital. Tax credit programs can, for example, provide incentives to attract businesses, help retirees and veterans, aid homebuyers, and assist those on low or fixed incomes.

In any particular year, tax relief may not have a significant effect on a state's cash balance. But over a series of years, the aggregate effect can erode a government's revenue base. Measuring revenue loss related to incremental legislation, particularly for major ongoing revenue sources, is difficult. At the time of enactment of legislation, states may provide fiscal note estimates which project the amount of revenue expected to be attained or reduced. NCSL's *State Tax Actions* provides annual state-by-state estimates of the impact on the recently enacted budget and a subsequent fiscal year. The limitation of this data is that the estimated revenue losses from changes that are phased in over a multi-year period are not easily obtainable unless updated fiscal notes to reflect final enactment can be found.

In the years following enactment, a host of intervening factors can influence the actual impact on revenue, due in part to changes in taxpayer and consumer behavior. States rarely report the actual effect of major revenue changes. The effect of tax credits can at least be ascertained retrospectively once tax returns are received and analyzed.

For purposes of this paper, revenue losses or gains due to legislation were taken from NCSL's *State Tax Actions*. Legislative staff in Maryland, Delaware, and Virginia were consulted to determine which revenue measures affected the general fund and which revenue actions were expected to result in an ongoing effect. In instances where fiscal notes were available, a five-year estimate was used. Otherwise, ongoing revenue actions were held level at the highest reported amount. This approach provided a rough order of magnitude of the cumulative loss or gain during the fiscal year 1997 to fiscal year 2004 study period.

Prior to the recession, data were collected on general fund revenue actions, reserve fund balances, general fund balances, and general fund spending. These data illustrate how quickly general fund spending grew, as well as to the level of slack resources that were allowed to accrue.

Assessing Fiscal Stress

For the 2002 through 2004 post-recessionary period, data were collected to demonstrate the level of fiscal stress. Fiscal stress has been measured differently in a variety of studies, and there is not one readily accepted approach to measuring it. This has included a state's ability to remain in structural balance (*i.e.*, wherein operating revenues equal or exceed operating spending), the aggregate of discretionary tax increases and budget reductions relative to long-term growth trends, or end of year cash and reserve fund balances as a percent of general fund spending (Rubin and Willoughby 2009, 54-57).

For the purposes of this study, fiscal stress is measured by analyzing the temporizing actions that states adopt to support actual general fund spending and by estimating the extent to which general fund spending was reduced from a pre-recession growth trend. This helps to account for spending reductions made by the legislature, mid-year spending cuts imposed by the

Governor (either through direct withdrawals or by limiting spending in order to boost end of year reversions), and in the 2003-2004 period for federal aid that was received for the purpose of supplanting general fund spending.

The following temporizing actions that support base spending were collected, including use of fund balance (measured as the difference between the beginning balance and the end of year balance): reserve fund transfers, transfers from other non-general funds, and newly enacted tax and fee revenues.

Data on general fund balances and transfers are available from surveys compiled by NCSL. Reserve fund and non-general fund transfers are also reported by NCSL but required assistance from each state's budget offices to disaggregate. New taxes and fees are reported in NCSL's annual *State Tax Actions* survey. Ongoing general fund spending was collected from state budget offices, separating out one-time PAYGO capital appropriations as well as appropriations to reserve funds (where applicable).

Ascertaining the level of reductions from the historical spending trend is more nebulous. Spending could have grown at any amount had there not been an economic downturn. Using historical rates of growth may under or overstate actual spending trends. For this study ongoing general fund spending was increased from the fiscal year 2001 base (the last year before state budgets began reflecting the impact of the recession through midyear actions during fiscal year 2002) by 5% each year. This amount is used to conservatively model spending growth for each of the three states under study, and is an amount below the average annual spending growth from fiscal 1997 through fiscal year 2001 for all three states.

Finally, all states received federal assistance in fiscal year 2003 and fiscal year 2004 through the Jobs and Growth Tax Relief Reconciliation Act of 2003, including general government assistance and an enhanced Medicaid match (Federal Fund Information for States 2004, 1). Since the additional aid was used by states to supplant general funds, counting the amount of aid received on top of cuts from the spending trend is appropriate to reflect total foregone general fund spending. Had the federal aid not been provided, states would have had to adopt other revenues, transfers, or spending reductions.

Figure 3.1 illustrates the fiscal stress concept using data from Maryland for fiscal year 2003. Actual reported ongoing spending of $10.2 billion was supported by $9.1 billion in existing tax and fee revenue, $0.2 million in fund balance, $0.2 million from the rainy day fund, $0.5 million in non-general fund transfers, and $0.1 million in new taxes and fees. Another $0.1 million in federal aid was received to supplant general fund spending, and $0.1 million in assumed spending reductions represents additional stress above actual spending levels. Actual and assumed spending totals $10.4 billion, of which $1.3 billion (12.7%) represents all budget balancing actions (*i.e.*, the amount of fiscal stress).

Note that legislation enacted in the late 1990s which resulted in the loss of general fund tax revenue is *not* counted in the calculation of fiscal stress. The reason for this omission is that it is assumed that had such legislation not been enacted then the revenue attributable to those taxes would have been spent for either ongoing or one-time purposes. In states with reserve fund provisions that require surplus revenues to be swept into reserve, it is possible that those revenues may have been withheld, but only if reserve funds are not capped or balances were below the cap.

Figure 3.1
Example of Fiscal Stress Methodology
Maryland General Fund Fiscal Year 2003 (Note 1 and Note 2)
($ in Millions)

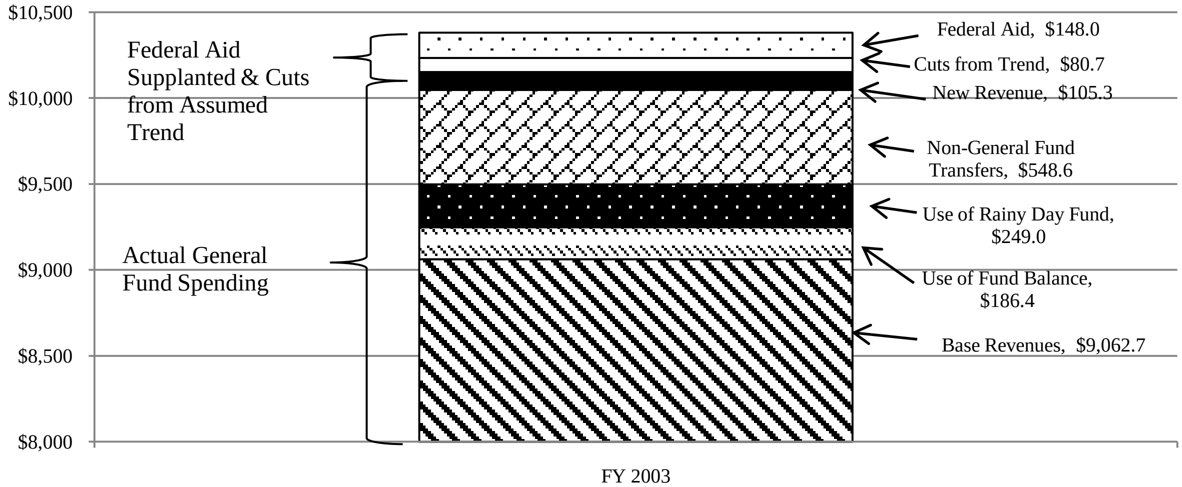


Table Notes
Note 1: Sources: Zelio, Mackey, and Rafool 1999, 21; Rafool 2000, 23-24; Rafool 2003, 21; Federal Fund Information for States 2004, 5; Maryland Department of Legislative Services 90 Day Report, 2003, A-43; Todd Haggerty email to author, August 20, 2009, with attached file "DE, MD, VA general fund data (FY 1996 to FY 2005).xls"; Maryland Department of Legislative Services spreadsheet "FY 2002–2006 Transfers.xls"; Maryland Department of Legislative Services spreadsheet "Frank_reserve fund_FY 2010.xls".
Note 2: Cuts from trend was calculated by the author by increasing actual fiscal year 2001 general fund operating spending by 5% annually.

In Maryland, balances above 5% can be appropriated in the budget bill; in Delaware, the funds is capped at 5%, and surplus amounts support the budget; and in Virginia, once the 10% cap is reached, surplus funds are credited to the general fund.

Mandated Spending

Mandated spending is an important driver of general fund spending. Constitutional or statutory provisions can require a Governor to allot a certain amount in the budget for various programs and purposes. The federal government can also mandate state spending (*e.g.*, additional education spending associated with the No Child Left Behind Act) or typically requires a match of federal dollars for programs where states choose to participate (*e.g.*, Medicaid).

In the context of tax and expenditure limitations, mandated spending can complicate efforts to limit growth in general fund spending. Two of the larger mandated spending programs, K-12 educational spending and Medicaid, can be driven by enrollment increases as well as inflation, program expansions, and initiatives. Moreover, certain programs tend to require larger funding increases during periods of economic downturns as, for example, higher unemployment can increase Medicaid eligibility and parents can move children from private schools to public schools to save money.

The state of Maryland began regularly preparing estimates in 2004 for how much of the budget was mandated. For example, in fiscal year 2004 it was estimated that 63% of the general fund budget was mandated (Maryland Department of Legislative Services Mandated Appropriations 2004, 3). However, comparable information for prior years is not available. Delaware and Virginia also do not estimate to what extent their general fund budgets are mandated.

For purposes of this study, comparable spending data for the beginning and ending period of this analysis is available for the Medicaid program and K-12 education spending. These two major budgetary drivers illustrate the extent of these two mandates on budgetary growth.

Data Collection Strategy

Implementation

Data were collected sequentially, so that interviews could be conducted first, followed by the aggregation of fund balance and budgetary activity afterward. In this way the researcher was not influenced by any knowledge of the budgetary actions or performance within any state and was not in a position to inadvertently bias the questions posed during the interview stage.

Priority

Since the aim of this study was to assess the level of procyclical activity after the 2001 recession, data on fund balances, increases in revenue, fund balance transfers and use of reserves – *i.e.*, the quantitative elements – were assigned primary weighting in determining the outcomes relative to the stated hypotheses.

Integration

After all data from interviews and from the budgetary data sources were collected, it was integrated in the interpretation phase of the study.

Case Study Approach

As noted by Agranoff and Radin, comparative case studies are unlike single case studies because they have the advantage of examining multiple observations of a phenomenon in the context of a larger framework. Once data gathering is completed, the researcher can conduct analysis to identify trends, patterns, and relationships (Agranoff and Radin, 1991, 204). In order to focus on the effect of tax and expenditure limitations on fiscal management, a case study framework is used within which quantitative data and qualitative interviews are compared and contrasted.

Miles and Huberman suggest that the purpose of cross-case analysis is to improve generalizability as well as to enhance explanations and understanding of the phenomena under study. Three approaches that they recommend include a case oriented strategy, a variable oriented strategy, or a mixed methods approach. A case oriented approach has the advantage of identifying patterns among cases, but the findings may not be very generalizable. A variable oriented approach can find relationships among variables but can miss the larger picture. The benefit of a mixed strategies approach includes the ability to examine each case in-depth, followed by the identification of cross-cutting variables that enable the testing of hypotheses.

Three states were selected for study: one state with binding constitutional and/or statutory tax and expenditure limitations; one state with non-binding limitations; and one state with no limitations. The characteristics of the three states were matched to the extent possible as a means of reducing the effect of other variables that could influence observed outcomes as they relate to the hypotheses.

The following criteria have been employed for the purposes of developing matched cases:

- strong fiscal management;
- high wealth/personal income;
- similar revenue structures; and
- geographic proximity.

After reviewing data from all 50 states, there are 3 states which appear to have many similar factors. Delaware, Maryland, and Virginia are located adjacent to each other in the mid-Atlantic region. All 3 receive a “AAA” bond rating from the three major credit rating agencies (Fitch, Moody’s, and Standard & Poor’s), suggesting strong financial management.

Use of Documents

State constitutions and/or statutes were consulted to obtain basic information on the structure and operation of each state’s tax and expenditure limitation and reserve funds. State legislative fiscal offices were also contacted to obtain data on reserve fund activity for fiscal year 1997 through fiscal year 2004, as well as the actions taken each year to raise revenues, cut spending, transfer non-general funds to the general fund, or other actions.

Annual survey data reported to NCSL were examined for the fiscal year 1997 through fiscal year 2004 period. NCSL conducts annual surveys which are published under the titles *State Tax Actions* and *State Budget Actions*. These surveys provide actual general fund balances and rainy day fund balances, transfers, revenues, and tax actions.

Analysis of the quantitative data involved a trend analysis of the fiscal year 1997 through fiscal year 2001 period, to examine annual levels of tax cuts as a percent of general fund revenue and spending growth as a percent of each year's general fund appropriations. End of year fund balances and reserve fund balances were also charted. For the fiscal year 2002 to fiscal year 2004 period, data were collected on the level of general fund spending reductions, tax and fee increases, the level of transfers from reserves and other dedicated funds, and other budget balancing actions as a percent of each year's general fund spending.

Once all data were collected, it was charted to illustrate the extent of tax reductions and spending growth by state during the boom period of the late 1990s, compared against the extent of budget balancing actions following the 2001 recession. This data will help to assess whether the presence of tax and expenditure limitations constrained spending growth in good times and thus mitigated the procyclical budget balancing actions that were adopted following the recession.

Interviewing

Selection of State Legislators and Fiscal Staff

A pool of interview candidates was drawn from the institutional roles which play a part in developing and approving budgets. Specifically, executive branch budget offices prepare budgets for consideration by legislatures. Legislators on budget committees review and approve budgets, and legislative fiscal directors provide assistance in that endeavor. Thus all three actors are familiar with tax and expenditure limitations, general fund spending trends, and cash management strategies.

Nine interviews were conducted for this study, of public sector officials from the states of Delaware, Maryland, and Virginia. Directors of each state's executive branch budget office were selected because they have primary responsibility for annual budget administration. This includes assembling a budget to be submitted for legislative consideration. Their work must account for the amount of revenue that is projected, state agency spending needs, and the laws and fiscal management tools that pertain to the development and implementation of the budget. They must also be responsive to the Governors and the political environment.

Legislators who serve on the budget committees within each state were identified since they must take action on the budget annually. Interviews targeted legislators who serve on a Senate Budget and Taxation Committee (or its equivalent) which has jurisdiction over both revenues and spending. Legislators must also consider the broader political context which can include demands for tax cuts and spending increases in good times and the need to preserve services and find revenues in bad times.

Finally, legislative fiscal staff Directors in each state were interviewed to gain the perspectives of those who are not front-line decision makers but who often support the decision making process. NCSL was contacted to identify interview candidates in Delaware and Virginia. The researcher identified interview candidates within the state of Maryland. An emphasis was placed on selecting candidates who were familiar with each state's finances during the period of inquiry. The interviewees were questioned using a combination of a general interview guide and standardized open-ended questions.

Problems in Interview Question Development

Patton offers several suggestions pertaining to the sequence and wording of interview questions that were referenced in the development of this segment of the methodology. Open-ended questions may provide the researcher with the maximum flexibility but can result in additional work when analyzing responses for trends and similarities. Singular questions are also important to ensure that only one idea is probed in a given question. To ensure clarity, questions must have singularity, but the researcher must also be cognizant of special terms or language that may be used by interviewees. To develop rapport and maintain neutrality, it is recommended that interviewers use illustrative examples, prefactory statements (*i.e.*, giving a sense of the question that is about to be asked), and other transitions.

To avoid the pitfalls noted by Patton, the researcher had the interview questions reviewed by a peer.

Hypotheses and Interview Questions

The table below reiterates the hypotheses that were examined in this study, and the interview questions which were administered for the purpose of testing each hypothesis.

Hypotheses	Related Interview Questions
Hypothesis 1 – Degree of Formalization of Tax and Expenditure Limitations – States with institutionally formalized tax and expenditure limitations will have accumulated larger combined cash balances (defined as reserve fund balance and general fund balance) during periods of slack which will have been available to mitigate the impact of the 2001 recession.	During the good times of the late 1990s, what types of actions did your state take with respect to taxes, creating or increasing a reserve fund balance, or increasing spending for either new initiatives or program expansion?
Hypothesis 2 – Effectiveness of Binding vs. Non-Binding Tax and Expenditure Limitations – States with binding constitutional or statutory tax and expenditure limitations will have experienced less fiscal stress in the fiscal year 2002 through fiscal year 2004 post-recessionary period than states with non-binding tax and expenditure limitations. Fiscal stress is defined as the total of spending reductions relative to a pre-recession spending trend, transfers from reserves and non-general funds, new revenues, use of fund balance,	From the standpoint of fiscal management, do you think that it is better to have a constitutional or statutory limit on revenue or spending, a non-binding limit on revenues or spending, or no limit? Were there discussions that spending growth should be limited? What efforts, if any, were taken to limit growth? What was your role?

Hypotheses	Related Interview Questions
and use of federal aid which supplanted general fund spending as a percent of general fund spending.	Did the presence or absence of spending limits in your state play any role in limiting spending growth? Were there any other budgetary processes or institutional controls that may have acted to limit spending growth during this period?
Hypothesis 3 – Effectiveness of Non-Binding vs. No Tax and Expenditure Limitations – States with non-binding tax and expenditure limitations will have experienced less fiscal stress in the fiscal year 2002 through fiscal year 2004 post-recessionary period than states with no tax and expenditure limit in place;	Following the 2001 recession what types of actions did your state take to address the downturn in the economy? For example, did your state: Raise taxes or fees? Use the balance in the rainy day fund below its required minimum? Adopt other one-time actions such as sale of assets? Transfer balances from dedicated funds? Cut spending? What areas of the budget were cut? How difficult was it to decide where to cut and how much to cut? Adopt accounting gimmicks, such as delaying payment of bills to a future fiscal year, for example? Based on the experiences of the last recession, what actions do you think your state might undertake during the next period of economic expansion? Do you think the presence or absence of tax and expenditure limitations had any effect in restraining state general fund spending from 1997 until 2001? Do you think that the presence or absence of tax and expenditure limitations had any effect in mitigating the extent to which actions were taken to balance the budgets following the 2001 recession?
Hypothesis 4 – Rainy Day Fund Requirements – States that limit reserve funds to be used only during times of economic crisis, will have maintained larger reserve fund balances for use following the 2001 recession, than states that permit reserves to be used for broader purposes.	Prior to the 2001 recession were rainy day fund balances accessed, transferred, or spent for purposes other than deficit reduction? What were the funds used for? Who initiated their use? Was there any controversy about their use? If reserve funds were not used, but instead retained as fund balance, what pressures kept those funds from being used?

Confidentiality

After being contacted, individual interview participants were advised that their responses will remain confidential. Each interview is discussed as an anonymous case. No statement, view, or response by any individual participant is attributed to them either directly or indirectly. The researcher taped each interview to ensure accuracy. Participants were also informed that the tapes would be destroyed at the conclusion of the project. Each participant was given a consent form that documents these confidentiality policies.

Instrumentation and Analytical Questions

An identical interview was administered to each participant. A sample copy of the cover letter and the interview questions are included in the Appendices. The researcher contacted each participant to arrange a date and time for the interview. Interviews were generally held in the capital of each state: Annapolis, Maryland; Dover, Delaware; and Richmond, Virginia. A reminder was provided prior to each interview. At the interview, the researcher discussed the purpose of the study, the voluntary nature of participation, and confidentiality. Participants were given copies of notes and materials to ensure accuracy.

Units of Analysis

Both Miles and Huberman and Agranoff and Radin provide direction to the researcher in methodologies for compiling and analyzing data from interviews. Miles and Huberman suggest developing a contact summary sheet, give advice on coding and memoing, outlining, and ultimately analyzing field notes. Agranoff and Radin provide guidance on developing notes in preparation for writing case studies. Thus, in the case of the interviews the unit of analysis is the state. The purpose was to look for patterns and relationships in the interview responses.

The documents reviewed, which included primarily survey data reported to NCSL on fund balances and rainy day fund balances, are also units of analysis. The data was collected and organized by fiscal year.

Limitations

As a case study of Delaware, Maryland, and Virginia, there are limitations involved with comparisons among the three states, and with comparisons of those three states to other states.

Looking first at the three states chosen for this study, every effort was made to select states that could be matched on as many factors as possible to reduce the number of extraneous variables that may influence the findings or give rise to spurious relationships. As discussed, the primary similarities between these three states are as follows:

- geographic proximity;
- strong fiscal management;
- high wealth/personal income; and
- high reliance on the income tax as a source of general fund spending.

Despite the similarities, the three states are not similar in population size, have different institutional budget processes (*e.g.*, Maryland's legislature is prohibited from adding to the budget), and throughout the period of study experienced different political party control of the executive and legislative branches. Moreover, actions adopted by the three states during the study period reflect decisions made specifically prior to and subsequent to the 2001 recession.

As reported by NCSL, 31 states have different types of tax and expenditure limitations in place affecting revenues and/or spending. Some states like Oregon and Colorado have more than one type in effect. These limits have either a constitutional or statutory basis. **Table 3.1** summarizes the types of limits. Some of the findings of this research may not be generalizable based on specific circumstances. Findings relating to cash management, specifically on revenue actions, use of surpluses for one-time purposes such as PAYGO, and spending growth relative to economic activity, may be applicable to every state regardless of the presence or absence of tax and expenditure limitations.

Table 3.1
Summary of Types of Tax and Expenditure Limitations
As of 2008 (Note 5)

Number of States	Legal Basis of Limit	Type of Limit	
12	Constitutional	Spending/Appropriations	Note 1 & 3
16	Statutory	Spending/Appropriations	Note 1 & 2
5	Constitutional	Revenue	Note 1 & 2
1	Statutory	Revenue	
31			Note 4

Table Notes
Note 1: Colorado is listed as having a statutory spending limit, a constitutional revenue limit and a constitutional spending limit in effect.
Note 2: Oregon is listed as having a statutory spending limit and a constitutional revenue limit in effect.
Note 3: Connecticut is listed as having a constitutional spending limit that is pending legislative approval.
Note 4: NCSL reports 31 states having some form of revenue of spending limit. Table 3.1 lists 34 states because Colorado and Oregon have more than one type of limit in effect.
Note 5: Source: Waisanen 2008, 6-8.

The study is also based on the perspective that constraining government spending in line with economic growth is a desirable goal; however, this is just one outlook. Another equally valid outlook could be based on the desire to increase government spending faster than economic activity in order to achieve desired aims. This could include improving educational systems, additional health care, enhanced social services, efforts to attract businesses, improved transportation, or any of a number of societal needs.

Another weakness of this study lies in the fact that the researcher is employed as a Senior Operating Budget Manager for the Maryland General Assembly's Department of Legislative Services. In this capacity, the author provides technical and policy data and recommendations to support the legislature's coordination of the budget and assists the Spending Affordability Committee during the fall of each year when it considers setting the non-binding limit on growth and makes other fiscal policy recommendations. While the author made every effort to view the data independently and produce objective findings, the author's position may give the appearance of bias toward the state of Maryland.

Survey data for state tax and budget actions provided to NCSL by each state are self reported data and are not audited to ensure accuracy. However, the researcher attempted to confirm annual data with each state's legislative fiscal staff. Finally, the opinions from the interviews reflect information from a limited number of individuals.

Validating the Accuracy of Findings

A number of measures were adopted to ensure the accuracy and validity of the findings of this study. Reliability and generalizability are not typically strong features of a qualitative analysis. The mixed methods approach to collect data on fund balances and budget balancing activities, as well as the effort to select states with as many similar factors as possible, improves the external validity of the findings.

With respect to internal validity, the following steps were adopted:

- ***Triangulation:*** use of primary and secondary documents was utilized, in addition to interviews of key legislative and executive branch participants in Delaware, Maryland, and Virginia to confirm or counter the findings from documents;
- ***Member Checking:*** Those who participate in the interviews were given the opportunity to read and confirm the accuracy of what they reported as well as to review the overall findings;
- ***Rich, Thick Description:*** Detail was provided on the states of Delaware, Maryland, and Virginia's revenue structure and budget processes, tax and expenditure limitations, rainy day funds, and revenue spending actions for each fiscal year from 1997 through 2004. This includes annual limits on growth, fund balances, budgetary and spending limitation

processes (if applicable), and participant assessments of how well actions taken in the late 1990s prepared their respective states for the recession of 2001;

- ***Clarify Researcher Bias:*** While already noted in the limitations section of this chapter, the role of the author as part of the process is noted;
- ***Presentation of Negative Information That Counters Themes:*** The hypotheses for this study expected to find that more formalized tax and expenditure limitations were more effective in constraining general fund spending growth during good economic times, and required fewer revenue, transfer, and reduction actions after the 2001 recession. Data found during this study that runs counter to the expectations are explored;
- ***Spend Time in the Field:*** The author conducted interviews with participants in Delaware, Maryland, and Virginia (*i.e.*, field research), and reviewed key documents. Interviews with key participants provided additional context; and
- ***Peer Debriefing/Use of External Auditor to Review Entire Project:*** The suggestion by Creswell to identify a peer to review the study was adopted. The peer reviewer provided numerous suggestions and asked a variety of questions about it to ensure that it makes sense to others.

Summary

In addition to the methodological discussions in the literature review, the primary reference materials that were consulted to generate the proposed methodology were John W. Creswell's *Research Design: Qualitative, Quantitative, and Mixed Methods Approaches, 2nd edition* and Matthew B. Miles and A. Michael Huberman's *Qualitative Data Analysis, 2nd edition*. Guidance on structuring interview questions was gleaned from Michael Quinn Patton's *Qualitative Research & Evaluation Methods, 3rd edition*. Finally, Robert Agranoff and Beryl A. Radin's "The Comparative Case Study Approach in Public Administration" was also referenced.

Data were collected through a mixed methods approach using sources of qualitative and quantitative data from the states of Maryland, Virginia, and Delaware. This includes an analysis of primary and secondary sourced documents such as self reported survey data on budget actions and tax actions provided annually by each state to NCSL, state constitutional and statutory reference materials as pertains to rainy day funds and tax and expenditure limitations; and supplementary fiscal materials including but not limited to general fund balances, non-general fund transfers, and other actions taken by each state to balance general fund budgets during the state fiscal year 1997 through fiscal year 2004 period.

A trend analysis of the data collected illustrates the extent to which budget growth and revenue reductions were adopted during good economic times, in states with and without tax and expenditure limitations. It further demonstrates the extent of procyclical budget actions adopted by each state following the 2001 recession, which support or refute the hypotheses of the effect of tax and expenditure limitations on cyclical instability.

A list of the specific data obtained is included as an Appendix to this study. A sequential transformative strategy was adopted, under which qualitative interviews were conducted first, followed by the collection of budgetary data. The budgetary data assumed primary weighting, and all data will be integrated as part of the interpretation and analysis process.

Qualitative interviews were conducted with one legislator, one legislative staff director, and one executive budget staff director in each state, for a total of nine interviews. Guidance on interviewing techniques came from Patton. This included a review of question types such as informal conversational, general interview guide, standardized open ended interviews, and combinations of one or more approaches.

Other topics directly referenced from the work of Patton relate to question options, the timeframe of the interview, question sequencing, and using probes to clarify responses. Patton also offers advice on how to avoid problems with wording of questions in interviews if they are open ended, not singular, or lack clarity. The interviewees were questioned using a combination of a general interview guide and standardized open-ended questions. Specific questions asked are included as an Appendix to this study. Triangulation was used to connect the data to the experiences and viewpoints of actors involved in the process.

Limitations of the research have also been identified. The researcher is employed by the Maryland General Assembly's Department of Legislative Services as a Senior Operating Budget Manager, providing non-partisan fiscal data and recommendations to legislators and legislative committees. While the author made all efforts to view the data independently and produce objective findings, he is cognizant of the appearance of bias toward the fiscal management approaches of the state of Maryland. Opinions from the interviews also reflects information from a limited pool of individuals.

The study also reflects the view that limiting growth in government spending to growth in the economy is a desirable goal. However, this is not intended as a normative prescription, as other perspectives and societal needs may desire additional government spending growth beyond projected growth in the economy.

This study focuses on the tax and expenditure limitations and fiscal management policies of Maryland, Virginia, and Delaware during the fiscal year 1997 through fiscal year 2004 timeframe, thus its findings may not be generalizable to other states in other regions of the

United States under the same or other time periods. However, lessons on cash management, use of surplus revenue, and spending growth relative to economic activity may provide lessons for any state government.

CHAPTER IV – Case Studies

Introduction

This chapter includes three cases covering the states of Delaware, Maryland, and Virginia. The first section provides an overview of the justification for the selection of these three cases. Each section is further divided into three parts. The first part discusses the legal framework within each state pertaining to its budgetary processes, tax and expenditure limitations, reserve funds, mandated spending, and political demographics.

The second part consists of narrative summaries of interviews of key budgetary players in each state. As noted in the chapter on methodology, there are a total of nine interviews with three in each state. Within each state, interviews were conducted with a legislator on a Senate budget committee, which is a committee that deals with both revenue and spending policy; a Director of the Governor's budget office with responsibility for preparing and administering state budgets; and a legislative staff director charged with working with legislators in developing and approving that branch's budget and overall fiscal policy.

The specific questions and the order that they were asked appear in Appendix B and focus on actions that each state took in the good economic times of the late 1990s; what efforts were taken to constrain growth through tax and expenditure limitations or other institutional or administrative means; how accessible reserve fund balances are and whether they were used prior to the recession; and how effectively tax and expenditure limitations or other efforts were in reducing the amount of fiscal stress experienced after the recession of 2001.

The third part provides quantitative data pertaining to general fund revenue actions, general fund operating and PAYGO budget trends, cash balances in the general fund and state reserve funds, and discussion of the fiscal stress experienced by each state in the fiscal year 2002 to fiscal year 2004 post-recession period.

Criteria for Selection of Cases

The following criteria have been employed for the purposes of developing matched cases:

- ***Strong Fiscal Management:*** States that are considered to have strong fiscal management will tend to be more conservative, have planning processes in place to guide budget growth and the issuance of debt, and be more inclined to resolve fiscal problems expeditiously. One measure of good fiscal management is provided by the three major credit rating agencies. The highest possible rating, "AAA" is provided by all three credit rating agencies to only seven states as of 2010 (Utah, North Carolina, Delaware, Maryland, Virginia, Georgia, and Missouri);
- ***High Wealth/Personal Income:*** States with high wealth will have ready access to resources to pay for government services. Osborne and Hutchinson have suggested that citizens demand services from government at least equal to a percentage of personal income. At the state level, they indicate a level of the price of government ranging from 7.3 cents to 8.3 cents per dollar of personal income (Osborne and Hutchinson 2004, 44). If states have similar levels of personal income per capita, they are also likely to have similar levels of government spending per capita and/or demands for services;
- ***Similar Revenue Structures:*** States with similar general fund revenue structures were also sought, as like revenue structures exhibit comparable elasticities during business cycles; and
- ***Geographic Proximity:*** States that are located in proximity to each other may be expected to have somewhat comparable economies, which may experience the same

effects during business cycles. For example, it would not be desired to compare a state which has more of a service-based economy with a state which has an economy with sectors that emphasize the extraction of natural resources.

As shown in **Table 4.1**, all three states have high personal income, and as expected the three states exhibit a high per capita level of state general fund spending.

Table 4.1
Delaware, Maryland, and Virginia
Comparison of General Fund Spending and Average Per Capita Income

State	Est. FY 2007 GF Budget (Millions)	Rank for Avg. Per Capita Personal Income Ranking (Note 1)	GF Spending Per Capita (Note 2)
Delaware	$3,421.6	17	$3,957
Maryland	14,192.1	6	2,526
Virginia	17.933.6	11	2,325

Table Notes
Note 1: Source: U.S. Department of Commerce Bureau of Economic Analysis 2008. Rankings were derived by the researcher.
Note 2: Source: Eckl 2008, 32. U.S. Census Bureau 2008. Estimated FY 2007 general fund expenditures per capita were derived using population estimates by state from the U.S. Census Bureau.

Table 4.2 illustrates that the three states have a high reliance on personal and corporate income taxes. Maryland and Virginia have a similar reliance on a state sales tax, which constitutes the second largest source of general fund revenue in those states. Delaware does not have a sales tax, but has a gross receipts tax imposed on service providers and sellers of goods.

Table 4.2
Delaware, Maryland, and Virginia
Comparison of Revenue Sources (Note 1)

State	% of Revenue from Income Tax (Note 2)	% of Revenue from Sales Tax	% Other Revenues
Delaware	45.7%	0.0%	54.3%
Maryland	49.4%	22.8%	27.8%
Virginia	60.8%	18.7%	20.5%

Table Notes
Note 1: Source: Federation of Tax Administrators 2007.
Note 2: Includes both corporate and personal income taxes.

Finally, **Table 4.3** lists the tax and expenditure limits in each of the three states. Delaware has a constitutional limit on revenue and a limit on spending, Maryland has a statutorily based, non-binding spending limit, and Virginia has no limits in place. The approach provides what Patton refers to as “a maximum structural variation of perspectives.” (Patton 2002, 109).

Table 4.3
Delaware, Maryland, and Virginia
Comparison of Tax and Expenditure Limitations (Note 1)

State	Tax and Expenditure Limitation	Limit Type
Delaware	Yes – Binding	Revenue and Spending
Maryland	Yes – Non-binding	Spending
Virginia	No	NA

Table Notes
Note 1: Source: NCSL 2005, 5-7.

Case No. 1 – Maryland

Legal Framework

Budgetary Processes

The state of Maryland operates on an annual fiscal year (State Finance and Procurement Article Section 2-101). Following the distribution of detailed instructions on budget preparation, agencies submit requests to the Maryland Department of Budget and Management (DBM) in late summer and into the fall of each year. Closed door hearings with each agency are held with DBM throughout the fall. As discussed in more detail under the tax and expenditure limitations section, a joint legislative Spending Affordability Committee meets and recommends to the Governor a non-binding spending limit for the next year in December (Maryland Department of Legislative Services Assessment of the Maryland Budget Process 2003, 9-10).

The Governor must submit a proposed budget to the legislature on the third Wednesday of January, except that the submission may occur on the tenth day of session in the first year of the term of a new Governor (Maryland Department of Legislative Services Assessment of the Maryland Budget Process 2003, 10).

Maryland's legislative session begins on the second Wednesday of January for a consecutive 90-day period unless the business of the legislature concludes earlier (Maryland State Archives Maryland Constitution Article III Legislative Department Sec. 15). Upon submission, the budget is reviewed by the House and Senate budget committees through public hearings. Until the legislature completes its work, the Governor may amend the budget through supplemental budgets to address oversights, emergencies, or the need to fund pending legislation. The legislature may also pass supplementary appropriations bills to provide funding for a single purpose with a dedicated source of revenue (Maryland Department of Legislative Services Assessment of the Maryland Budget Process 2003, 13-14).

Action by the legislature is limited to reducing the executive branch budget; it cannot add to or transfer funds. However, the legislature can add to its own budget and the budget of the Judicial Branch (Maryland State Archives Maryland Constitution Article III Legislative Department Sec. 52(6)). Action on the budget is to be completed by the 83rd day, otherwise the Governor issues a proclamation calling for an extended session if action is not completed by the 90th day of session (Maryland State Archives Maryland Constitution Article III Legislative Department Sec. 52(10)). Upon adoption of the conference committee report the operating budget is enacted. The Governor does not sign, nor may he veto the operating budget bill (Maryland Department of Legislative Services Assessment of the Maryland Budget Process 2003, 16-17).

Tax and Expenditure Limitations

Legislation creating a Spending Affordability Committee (SAC) was enacted in 1982 and codified as Title 2, Subtitle 10 of the State Government Article. The statute sets a goal for the process to limit the rate of growth in state spending "so that the level of state spending is consistent with the economic growth of the state" (State Government Article Section 2-1002).

Sections 2-1001 through 2-1008 of the State Government Article outlines the composition and duties of the joint committee. It must include an equal number of Senators and Delegates and may include public members. In 2009, the committee had 11 Senators, 11 Delegates, and 3 citizen members (Spending Affordability Committee 2009 Interim Report 2009, vii). The committee meets annually in the fall, typically holding three public meetings to consider projections of revenues and expenditures. On or before December 1 the committee is charged with making recommendations to the Legislative Policy Committee and the Governor regarding a non-binding recommended level of operating budget growth, new debt authorization, state personnel, a recommended use of any anticipated surplus, and other appropriate findings and recommendations (State Government Article Section 2-1005).

In formulating its recommendations, the committee is directed by statute to "consider economic indicators such as personal income, gross state product, or other data" (State Government Article Section 2-1004). In setting a limit on growth in state spending, the committee reviews total appropriations approved at the prior legislative session (including the most recently enacted budget and prior year deficiency appropriations) against projected appropriations for the upcoming budget year and deficiencies for the current fiscal year. In other words, total spending approved at each session regardless of the specific fiscal year is used as the basic unit of measurement.

Appropriations that are subject to the limit include all those of an ongoing nature funded from state-sourced revenues. This includes general funds, which are comprised of all tax and fee revenues that are not earmarked for specific purposes; special funds, which are those revenues dedicated by statute to specific purposes; and current unrestricted funds, which are higher education revenues from student tuition, fees, and other income. Excluded from the calculation are items which represent spending from non-state sourced revenues; the pass-through of non-state sourced backed appropriations to local governments or other entities; spending for one-time purposes; technical double-counting of appropriations; self-supporting enterprise activities; transfers; and the incorporation of new revenues into the base.

Non-state Sourced Revenues **–** Spending that is backed by federal funds and higher education current restricted funds (largely spending for contracts paid by federal and private sources) is excluded. These fund sources do not represent state-sourced revenues over which the state has control;

Non-state Sourced Pass-through – Pass-through funding represents monies that are collected from local governments or the private sector, that are then appropriated through a state agency for distribution back to the local government level or other private entities. For example, the locally imposed 9-1-1 emergency number system fee is appropriated through the budget of the Maryland Department of Public Safety and Correctional Services. Other examples include hospital uncompensated care revenue which flows through the Maryland Department of Health and Mental Hygiene and debt service for Certificates of Participation paid by non-state entities;

One-time Spending – Spending for one-time purposes is excluded since it does not contribute to the base budget nor require ongoing support. An example of large one-time spending was for appropriations made in the late 1990s to address the Year 2000 computer issue. PAYGO capital is also excluded from the limit because it is for one-time purposes, there are large variations in annual project cash flow needs, and it is good policy to encourage use of cash for capital purposes in lieu of debt;

Technical **–** Technical adjustments are made to ensure that state spending is not double counted in the affordability calculation. State support for higher education, for example, is budgeted both as general funds and within higher education institution budgets as current unrestricted funds. The budget of the Maryland Correctional Enterprises is similarly excluded since its goods and services are mostly purchased by state agencies;

Enterprise Activities **–** Business-like entities such as the Maryland Port Administration and the Maryland Aviation Administration began to be excluded at the 2002 session since their operations were funded by airlines and shipping lines. If business activity falls, which would occur during a recession, spending is adjusted downward to reflect lower revenue. Similarly, the Lottery Agency was also excluded since its revenues from lottery sales support its operating expenses (Spending Affordability Committee, Report of the 2001 Interim 2001, 6);

Transfers **–** Appropriations that are credited to other accounts that may be spent later in the state budget or which are used to address long-term liabilities are also excluded because of their one-time nature and for policy considerations. Appropriations to the Rainy Day Fund are not counted as state spending but are reflected as spending when withdrawn in support of operations. The state also has appropriated funds in the past toward long-term workers' compensation and retiree health care liabilities;

New Revenue **–** One-time exclusions have also been made to incorporate large increases supported by new state-sourced revenues. This was the case at the 2000 session when settlement revenues were received from the tobacco companies for the first time (Spending Affordability Committee Report of the 2000 Interim 2000, 4-5).

After the committee issues its recommendation in December, the Governor submits the proposed budget to the General Assembly on the third Wednesday of January. If the proposed budget exceeds the spending affordability recommendations, state law requires the Governor to include in supporting budget materials the degree to which the proposed budget and recommendations differ, and to set forth the reasons for exceeding the recommendations (State Finance and Procurement Article Section 7-116). In the study period, which covers 1996 session spending (fiscal year 1997) through the 2003 session (fiscal year 2004), the Governor's budget exceeded the spending affordability recommendation in five of the eight years (Maryland Department of Legislative Services spreadsheet "History of SAC limit vs. Gov Allowance.xls").

After completing action on the budget, each chamber passes its own version of the operating bill. When reporting to the floor of their respective chambers, the budget committees must report a budget that complies with the spending affordability recommendations, or if the amended budget exceeds the recommendations, they must explain the rationale for doing so. On or before June 1 of each year, the Maryland Department of Legislative Services must report to the Legislative Policy Committee on the extent to which final action on the state budget conformed with the spending affordability recommendations (State Government Article Sections 2-1006 and 2-1008).

Table 4.4 illustrates the spending affordability calculation for spending approved at the 1996 through 2003 sessions, covering fiscal year 1997 through fiscal year 2004. It begins with the Governor's initial proposed budget plus any supplemental budgets introduced during each session, and excludes non-state sourced federal and current restricted fund backed spending. This is followed by the exclusion of spending under various categories discussed earlier in this section. Finally, reductions adopted by the legislature to items which count under the limit are also reflected.

As the table shows, SAC made spending growth recommendations ranging from a low of 4.15% to a high of 6.95% during this period. In each case the legislature made sufficient reductions to bring spending below the recommended limit.

Table 4.4
Tax and Expenditure Limitation: Maryland
Calculation of Maryland's Spending Affordability Limit
1996 Session – 2003 Session (Note 1 and Note 2)

	1996 Session	1997 Session	1998 Session	1999 Session	2000 Session	2001 Session	2002 Session	2003 Session
Appropriations								
Allowance and Supplemental Budgets	15,501.5	16,281.9	17,525.5	18,700.5	20,670.7	22,533.2	23,288.8	23,816.7
Deficiencies	10.7	-31.7	23.2	65.4	324.9	163.4	374.0	81.6
Minus Federal Funds	-3,155.7	-3,434.8	-3,676.7	-3,882.0	-4,453.3	-4,858.8	-5,377.7	-5,502.5
Minus Current Restricted Funds	-421.2	-431.7	-498.2	-543.0	-601.5	-653.7	-716.9	-917.0
Subtotal State Tax and Fee Supported Spending	**11,935.4**	**12,383.7**	**13,373.8**	**14,340.8**	**15,940.9**	**17,184.1**	**17,568.2**	**17,478.7**
Exclusions								
Non-state Pass-through	-85.6	-31.8	-125.3	-119.5	-178.4	-182.3	-173.9	-177.8
Capital and Maintenance	-860.4	-812.7	-971.3	-1,234.5	-1,524.3	-1,752.3	-1,130.8	-984.9
One-time	0.0	0.0	-105.1	-68.1	-24.5	-64.3	-75.1	0.0
Double-count	-679.6	-705.4	-756.6	-833.7	-932.2	-1,058.6	-1,058.2	-958.5
Enterprise Activities	0.0	0.0	-15.5	-32.0	-31.3	-40.0	-233.6	-248.9
Unfunded Liabilities and transfers	-37.1	-32.5	-33.1	-35.3	-35.9	-16.0	-16.0	0.0
New Revenue Source	0.0	0.0	0.0	0.0	-234.2	0.0	0.0	0.0
State Reserve Fund	0.0	-69.5	-259.4	-90.2	-431.3	-231.6	-206.4	0.0
Subtotal Adjustments	**-1,662.7**	**-1,651.9**	**-2,266.2**	**-2,413.3**	**-3,392.1**	**-3,345.1**	**-2,894.0**	**-2,370.2**
Reductions								
Cost Containment Reversions and Withdrawals	0.0	0.0	0.0	0.0	0.0	0.0	-80.8	-430.3
SAC Eligible Legislative Budget Cuts	-128.6	-207.9	-91.9	-289.4	-110.7	-216.1	-369.2	-217.4
Subtotal Reductions	**-128.6**	**-207.9**	**-91.9**	**-289.4**	**-110.7**	**-216.1**	**-450.1**	**-647.7**
Net Change in SAC Spending	**10,144.1**	**10,524.0**	**11,015.7**	**11,638.1**	**12,438.0**	**13,622.9**	**14,224.1**	**14,460.9**
Percent Growth Over Prior Year	3.82%	4.00%	4.82%	5.82%	6.86%	6.95%	3.43%	0.94%
SAC Recommended Limit	4.25%	4.15%	4.90%	5.90%	6.90%	6.95%	3.95%	2.50%
Over/Under Limit	(42.5)	(15.3)	(8.4)	(8.3)	(4.2)	(0.3)	(71.5)	(224.1)
Spending All Sources Net of Reductions	15,383.6	16,042.3	17,456.8	18,476.5	20,884.9	22,480.5	23,212.8	23,250.6
Total Exclusions	-5,239.5	-5,518.4	-6,441.1	-6,838.4	-8,446.9	-8,857.6	-8,988.6	-8,789.7
Net State Spending	10,144.1	10,524.0	11,015.7	11,638.1	12,438.0	13,622.9	14,224.1	14,460.9
	1996	1997	1998	1999	2000	2001	2002	2003
Percent of Total Excluded	34%	34%	37%	37%	40%	39%	39%	38%

Table Notes

Note 1: The Spending Affordability calculation is based on all current year deficiency spending and all applicable spending in the forthcoming fiscal year that is considered at that session. Thus, fiscal year 1996 deficiencies and the fiscal year 1997 budget were considered at the 1996 session, and on through the fiscal year 2004 budget which was considered at the 2003 session along with fiscal year 2003 deficiencies.

Note 2: Sources: William S. Ratchford, II to the Honorable Thomas V. Mike Miller, Jr., and the Honorable Casper R. Taylor, Jr., 30 June 1996; William S. Ratchford, II to the Honorable Thomas V. Mike Miller, Jr., and the Honorable Casper R. Taylor, Jr., 15 May 1997; Warren G. Deschenaux to the Honorable Thomas V. Mike Miller, Jr., and the Honorable Casper R. Taylor, Jr., 1 June 1998; Warren G. Deschenaux to the Honorable Thomas V. Mike Miller, Jr., and the Honorable Casper R. Taylor, Jr., 1 June 1999; Warren G. Deschenaux to the Honorable Thomas V. Mike Miller, Jr., and the Honorable Casper R. Taylor, Jr., 1 June 2000; Warren G. Deschenaux to the Honorable Thomas V. Mike Miller, Jr., and the Honorable Casper R. Taylor, Jr., 18 May 2001; Warren G. Deschenaux to the Honorable Thomas V. Mike Miller, Jr., and the Honorable Casper R. Taylor, Jr., 8 May 2002; Warren G. Deschenaux to the Honorable Thomas V. Mike Miller, Jr., and the Honorable Michael E. Busch, 1 May 2003; Spending Affordability Committee Report of the 2001 Interim 2001, 5-7; Maryland Office of the Governor Supplemental Budget No. 1 – Fiscal Year 1997 1996, 4; Maryland Office of the Governor Supplemental Budget No. 2 – Fiscal Year 1997 1996, 31; Maryland Office of the Governor Supplemental Budget No. 3 – Fiscal Year 1997 1996, 10; Maryland Office of the Governor Supplemental Budget No. 4 – Fiscal Year 1997 1996, 6; Maryland Office of the Governor Supplemental Budget No. 5 – Fiscal Year 1997 1996, 5; Maryland Office of the Governor Supplemental Budget No. 6 – Fiscal Year 1997 1996, 4; Maryland Office of the Governor Supplemental Budget No. 1 – Fiscal Year 1998 1997, 15; Maryland Office of the Governor Supplemental Budget No. 2 – Fiscal Year 1998 1997, 26; Maryland Office of the Governor Supplemental Budget No. 1 – Fiscal Year 1999 1998, 6; Maryland Office of the Governor Supplemental Budget No. 2 – Fiscal Year 1999 1998, 20; Maryland Office of the Governor Supplemental Budget No. 3 – Fiscal Year 1999 1998, 17; Maryland Office of the Governor Supplemental Budget No. 1 – Fiscal Year 2000 1999, 1; Maryland Office of the Governor Supplemental Budget No. 2 – Fiscal Year 2000 1999, 14; Maryland Office of the Governor Supplemental Budget No. 3 – Fiscal Year 2000 1999, 38; Maryland Office of the Governor Supplemental Budget No. 1 – Fiscal Year 2001 2000, 10; Maryland Office of the Governor Supplemental Budget No. 2 – Fiscal Year 2001 2000, 51; Maryland Office of the Governor Supplemental Budget No. 1 – Fiscal Year 2002 2001, 9; Maryland Office of the Governor Supplemental Budget No. 2 – Fiscal Year 2002 2001, 25; Maryland Office of the Governor Supplemental Budget No. 1 – Fiscal Year 2004 2003, 12; Maryland Department of Budget and Management *Fiscal Digest of the State of Maryland for the Fiscal Year 1998* 1997, F.4; Maryland Department of Budget and Management *Fiscal Digest of the State of Maryland for the Fiscal Year 1999* 1998, F.5; Maryland Department of Budget and Management *Fiscal Digest of the State of Maryland for the Fiscal Year 2000* 1999, F.5; Maryland Department of Budget and Management *Fiscal Digest of the State of Maryland for the Fiscal Year 2001* 2000, F.5; Maryland Department of Budget and Management *Fiscal Digest of the State of Maryland for the Fiscal Year 2002* 2001, F.5; Maryland Department of Budget and Management *Fiscal Digest of the State of Maryland for the Fiscal Year 2003* 2002, F.4; Maryland Department of Budget and Management *Fiscal Digest of the State of Maryland for the Fiscal Year 2004* 2003, F.3; Maryland Department of Budget and Management *Fiscal Digest of the State of Maryland for the Fiscal Year 2005* 2004, F.3; Maryland Department of Legislative Services spreadsheet "SAC exclusion summary 1996 to 2003 sessions.xls"; Maryland Department of Budget and Fiscal Planning *Maryland Operating Budget: Part II Fiscal Year 1997* 1996, II-863, II-864; Maryland Department of Budget and Management *Maryland Operating Budget: Part Two Fiscal Year 1998* 1997, II-902, II-903; Maryland Department of Budget and Management *Maryland Operating Budget: Part Two Fiscal Year 1999* 1998, II-926, II-927; Maryland Department of Budget and Management *Maryland Operating Budget: Part Two Fiscal Year 2000* 1999, II-955, II-956; Maryland Department of Budget and Management *Maryland Operating Budget: Part Three Fiscal Year 2001* 2000, III-891, III-892; Maryland Department of Budget and Management *Maryland Operating Budget: Part Three Fiscal Year 2002* 2001, III-878, III-879; Maryland Department of Budget and Management *Maryland Operating Budget: Part Three Fiscal Year 2003* 2002, III-912, III-913; Maryland Department of Budget and Management *Maryland Operating Budget: Part Three Fiscal Year 2004* 2003, III-907, III-908.

Although the spending affordability limit applies to combined general, special, and current unrestricted fund backed spending, detail for each fund source is shown in **Table 4.5**.

Figure 4.1 shows how much of the entire budget is excluded from the spending affordability process. This accounts for all federal and current restricted fund backed spending as well as the various categories of exclusions. Through the 1999 session, roughly 34% to 37% of the budget was excluded. With the change in methodology to exclude enterprise agencies at the 2000 session, the amount excluded rose to over 40% of the budget.

Table 4.5
Tax and Expenditure Limitation: Maryland
Spending Affordability Limit by Fund Source
1996 Session – 2003 Sessions (Note 1 and Note 2)

	1996 Session	1997 Session	1998 Session	1999 Session	2000 Session	2001 Session	2002 Session	2003 Session
General	$7,346.0	$7,626.5	$7,991.6	$8,565.4	$9,193.0	$10,219.5	$10,558.2	$10,421.5
Special	1,906.0	1,951.3	2,017.8	2,043.0	2,454.2	2,333.7	2,492.6	2,679.6
Current Unrestricted	867.0	931.3	988.2	1,030.7	1,090.8	1,199.2	1,276.0	1,433.6
Total	**$10,119.0**	**$10,509.1**	**$10,997.5**	**$11,639.1**	**$12,738.0**	**$13,752.4**	**$14,326.8**	**$14,534.7**

Table Notes
Note 1: Note that total amounts shown differ slightly from the totals reported by the Spending Affordability Committee in its annual interim reports due to corrections and base adjustments made between sessions. Corresponding detail by fund type for final adjusted amounts is not available.
Note 2: Sources: Maryland Department of Fiscal Services Sine Die Report 1997, 8; Maryland Department of Legislative Services 90 Day Report 1998, A-12; Maryland Department of Legislative Services 90 Day Report 1999, A-20; Maryland Department of Legislative Services spreadsheet “00 Session SAC.123”; Maryland Department of Legislative Services spreadsheet “01 Session SAC calculation.xls”; Maryland Department of Legislative Services 90 Day Report 2002, A-10; Maryland Department of Legislative Services 90 Day Report 2003, A-11; Maryland Department of Legislative Services 90 Day Report 2004, A-11.

From the 2001 to the 2003 sessions, the amount excluded declined to about 38% based on progressively smaller appropriations for PAYGO capital and transfers to the Rainy Day Fund.

Figure 4.1
Tax and Expenditure Limitation: Maryland
Amount of General, Special, and Current Unrestricted
Revenue Excluded from the Limit
1996 – 2003 Legislative Sessions (Note 1 and Note 2)

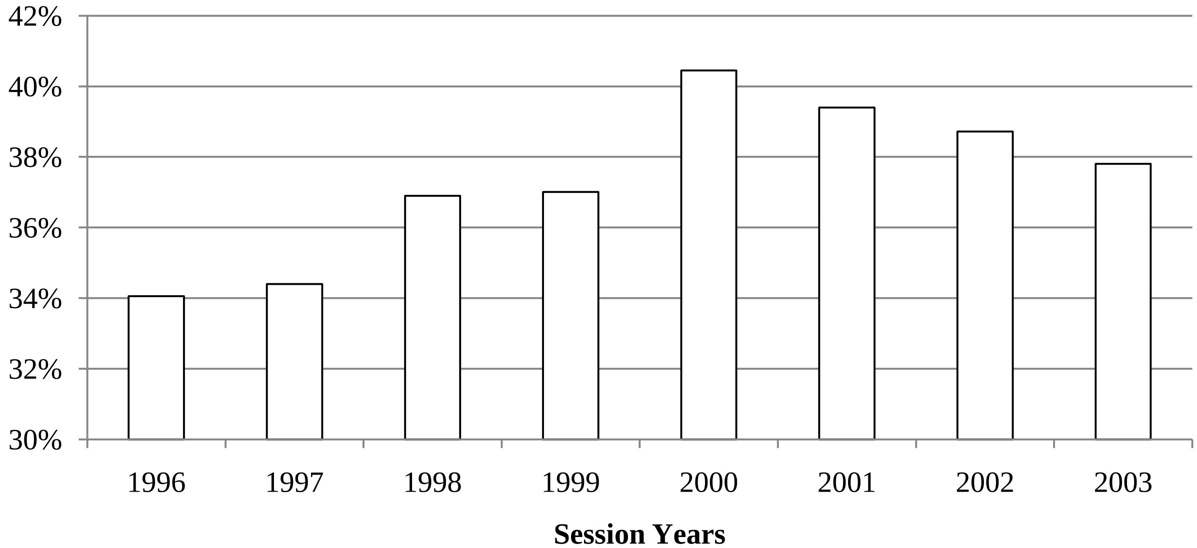


Figure Notes
Note 1: The Spending Affordability calculation is based on all current year deficiency spending and all applicable spending in the forthcoming fiscal year that is considered at that session. Thus, fiscal year 1996 deficiencies and the fiscal year 1997 budget were considered at the 1996 session, and on through the fiscal year 2004 budget which was considered at the 2003 session along with fiscal year 2003 deficiencies.
Note 2: Sources: William S. Ratchford, II to the Honorable Thomas V. Mike Miller, Jr., and the Honorable Casper R. Taylor, Jr., 30 June 1996; William S. Ratchford, II to the Honorable Thomas V. Mike Miller, Jr., and the Honorable Casper R. Taylor, Jr., 15 May 1997; Warren G. Deschenaux to the Honorable Thomas V. Mike Miller, Jr., and the Honorable Casper R. Taylor, Jr., 1 June 1998; Warren G. Deschenaux to the Honorable Thomas V. Mike Miller, Jr., and the Honorable Casper R. Taylor, Jr., 1 June 1999; Warren G. Deschenaux to the Honorable Thomas V. Mike Miller, Jr., and the Honorable Casper R. Taylor, Jr., 1 June 2000; Warren G. Deschenaux to the Honorable Thomas V. Mike Miller, Jr., and the Honorable Casper R. Taylor, Jr., 18 May 2001; Warren G. Deschenaux to the Honorable Thomas V. Mike Miller, Jr., and the Honorable Casper R. Taylor, Jr., 8 May 2002; Warren G. Deschenaux to the Honorable Thomas V. Mike Miller, Jr., and the Honorable Michael E. Busch, 1 May 2003; Spending Affordability Committee Report of the 2001 Interim, 5-7.

Reserve Fund

Establishment and Structure – The Revenue Stabilization Account was established in 1986 requiring a fund balance of the greater of 2% of general fund revenues or $100 million (modified to be just 2% in 1991) (Maryland Department of Legislative Reference Laws of

Maryland Chapter 655 of 1986, 2472; Maryland Department of Legislative Reference Laws of Maryland Chapter 470 of 1991, 2771). After depletion following the early 1990s recession, the minimum balance was increased to 5% (Maryland Department of Legislative Reference Laws of Maryland Chapter 204 of 1993, 1502).[1]

Deposits – Initially $5 million in appropriations were required to be made annually until the minimum balance was achieved, but this was increased to $25 million in 1991, and then to $50 million in 1993 (Maryland Department of Legislative Reference Laws of Maryland Chapter 655 of 1986, 2472; Maryland Department of Legislative Reference Laws of Maryland Chapter 470 of 1991, 2771; Maryland Department of Legislative Reference Laws of Maryland Chapter 204 of 1993, 1503). The concept of automatically "sweeping" unappropriated general fund revenues at closeout into the Rainy Day Fund was first adopted for the fiscal year 1993 budget only but was later enacted for a four-year period from fiscal year 1998 through fiscal year 2001 for unappropriated surpluses in excess of $10 million. This "sweeper" was made permanent for amounts in excess of $10 million beginning in fiscal year 2002 (Maryland Department of Legislative Reference Laws of Maryland Chapter 269 of 1992, 2434; Maryland Department of Legislative Reference Laws of Maryland Chapter 4 of 1998, 59; Maryland Department of Legislative Reference Laws of Maryland Chapter 440 of 2002, 3583). There is no cap on the maximum amount of the balance in Maryland's Rainy Day Fund.

Withdrawal Requirements – Initially, transfers to the general fund from the Rainy Day Fund were restricted only if "for the period of April through September preceding the General Assembly session in which the budget is to be considered: (1) the average State unemployment rate was greater than 6.5%; and (2) the average State unemployment rate for that period was

[1] The minimum funding level has since been increased to 7.5% in 2006.

greater than the average State unemployment rate for that same period one year earlier." (Maryland Department of Legislative Reference Laws of Maryland Chapter 655 of 1986, 2472).

However, this was modified to permit balances to be used following the 1991 recession because revenues fell but unemployment rates had not met the criteria in statute (Maryland Department of Legislative Reference Laws of Maryland Chapter 470 of 1991, 2771). The unemployment criteria was repealed in 1993 and replaced by a provision that permits transfers from the fund authorized either in the budget bill or separate legislation (Maryland Department of Legislative Reference Laws of Maryland Chapter 204 of 1993, 1503).

Mandated Spending

Mandated spending is an influential driver in general fund spending, based on federal, state constitutional, or state statutory provisions. Maryland has prepared annual reports on mandated spending since 2004. For fiscal year 2004, for example, it was reported that 63% of general funds are mandated (Maryland Department of Legislative Services Mandated Appropriations 2004, 3). Data for the Maryland budget for the study period are not available, but consistent data is available from all three case study states for two of the largest mandated programs: Medicaid and K-12 education spending.

As **Figure 4.2** demonstrates, spending for these two programs increased from 45% of Maryland's general fund budget, to 49% of the budget. This is an increase from $3.2 billion in fiscal year 1996 to $5.0 billion in fiscal year 2004; an average annual increase of 5.9%. K-12 spending increased an average of 5.9%, and Medicaid spending grew by 5.7% on average.

Figure 4.2
Mandated Appropriations: Maryland
Percent of General Fund Budget Spent on Medicaid and K-12
Fiscal Year 1996 vs. Fiscal Year 2004 (Note 1)

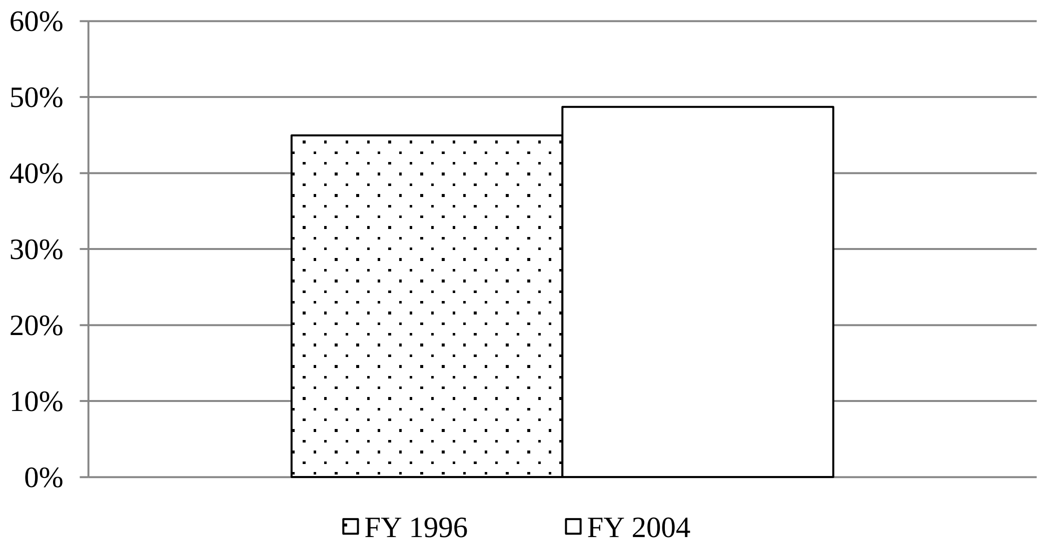


Table Notes
Note 1: Sources: Maryland Department of Fiscal Services Sine Die Report 1997, 11; Maryland Department of Legislative Services 90 Day Report 2005, A-34.

Political Demographics

The role of political parties in a state represents another dimension that can help explain fiscal management patterns. The Democratic Party is often characterized as supporting larger government and social programs, while Republicans are considered pro-business, anti-tax, and advocates of smaller government. It is useful to illustrate the distribution of each party for the House, Senate, and Governor to see whether dominance by one party or the other played a role.

As **Table 4.6** demonstrates, Maryland had a Democratic Governor throughout the study period. The Democratic Party also dominated both chambers of the legislature. Further discussion of political demographics relative to revenue and spending patterns is included in Chapter V.

Table 4.6
Gubernatorial and Legislative Political Party Distribution: Maryland
1996 – 2002 (Note 1 and Note 2)

	House		Senate		Governor
	# Democrat	**# Republican**	**# Democrat**	**# Republican**	**Party**
1996	100	41	32	15	D
1998	107	34	33	14	D
2000	106	35	33	14	D
2002	98	43	33	14	D

Table Notes
Note 1: Sources: NCSL "Legislative Party comp tables 96-02.xls"; Marck Governors 1777 to Present Day.
Note 2: Maryland elected a Republican Governor in 2002, who was responsible for preparation of the fiscal year 2004 budget.

Qualitative Data

Interviews

Interviews were conducted with three individuals who played instrumental roles in shaping fiscal policy in Maryland during the growth period of the late 1990s. This includes a former Republican legislator who was first elected in the early 1970s and who served on the Senate Budget and Taxation Committee from 1996 through 2003; the non-partisan Director of the Office of Policy Analysis in the Maryland Department of Legislative Services, incumbent since 1997; and the former Director of the Maryland Department of Budget and Management who served under Democratic Governor Parris Glendenning between 1996 – 2000.

Interview No. 1

State Fiscal Actions in the Late 1990s – The first interview participant recalled during the late 1990s that the state enacted a 10% income tax reduction that was phased in over a five-year period. During periods of slack, it seems intuitive that states would be lobbied by advocates for more services or by taxpayers demanding rate relief. In this case, however, the interviewee offered that the purpose of the tax cut was to deprive the Governor of extra revenue to spend. It was noted that "[t]he reason for the big tax push to reduce the income tax was because we had a Governor who was a spendthrift. If the money came in the door he felt compelled to spend it….so it seemed like the only way to keep him from spending was to not give him the money in the first place, which was the reason for the tax cut." There was additional spending growth permitted, which the interviewee viewed as "aggressive." With respect to setting aside a portion of surplus funds in reserve, the interviewee believed that "[t]he reserve fund…was 5%." As noted earlier in this case, Maryland had a rainy day fund balance requirement equal to 5% of estimated general fund revenues.

Efforts to Limit Growth During Good Times – Maryland has a balanced budget requirement, which was highlighted in the interview as a limitation, especially when revenue falls. During the interview, it was stated that "having it is better than not having it because at least some tough budget balancing decisions are made before the legislature even sees the budget." It was also reiterated that discussions surrounding the decision to adopt an income tax reduction also focused on that measure as a means of limiting spending growth.

Use of Reserve Fund Balance in Good Times – Because of statutory restrictions and state fiscal policy, the interviewee stated that funds were not used prior to 2001. It was further noted that a sweeper provision had been adopted at some point in the late 1990s, which required that unappropriated balances at closeout must be appropriated to the rainy day fund. Moreover, proposed uses of rainy day reserves by the Governor had to be appropriated in the budget bill as well. This gave the legislature the opportunity to reduce spending if it was supported by reserve balances. Ultimately though, it was felt that balances were not used because of the need to retain 5% in reserve as a component of the "AAA" rating received from the credit agencies. It was stated that “you couldn’t go below a certain amount or you’d go on credit watch….I don’t think that had anything to do with structure or policy…just…anything that looked like it might threaten the bond rating…”

Actions Taken Following the 2001 Recession – When asked what actions the state adopted after the 2001 recession, examples cited as having been adopted in Maryland included increased taxes and fees, spending cuts, transfers from dedicated funds and reserves, various one-time actions and gimmicks.

Prospective Fiscal Policy Modifications – Would Maryland modify its fiscal policies in any way to better position itself for future economic downturns? The interviewee hoped so but was not optimistic, having seen a number of business cycles. One problem that was identified was that “it just seems like once times get good, you think that’s the way it’s gonna be forever.”

Effect of Tax and Expenditure Limitations – Reflecting on Maryland’s spending affordability process, it was noted in the interview that it had been a response to a proposed “constitutional cap on revenue growth.” Adoption of a non-binding spending limit was intended more as a way to monitor public sector growth in relation to the economy. It was stated that “I don’t think it was a spending constraint thing as much as it was a spending balance thing. In other words, I think a lot of people felt alarm bells should go off when the government’s growing faster than the growth of the revenues that support it.”

As discussed in the section on spending affordability, one of the benchmarks for setting the limit is based on growth in personal income. Logically then, when the economy is performing well, personal income growth can be expected to increase also. Having a limit that is tied to personal income would mean that spending growth would also be expected to be strong during growth cycles. For this reason the interviewee felt that spending affordability would have had only a “modest effect” in constraining growth during the good times. Asked if spending affordability had mitigated the extent of budget balancing actions adopted after the recession, the interviewee felt it had not “played a role.”

With respect to the preferred tax and expenditure limitation, if any, it was expressed that “I don’t think that systems succeed or fail, people succeed or fail. You can have a crappy…fiscal system and good people can make it work and you can have…the ultimate in good fiscal framework…and a group of wrong minded people can screw it up. So people do make the difference and how they adhere to it.” Thus the interviewee felt that the system in Maryland was good from “an economic balance standpoint” but thought that no limit was best because “[p]eople should choose informed representatives to represent them and to make sound decisions on their behalf.” Formal constitutional limitations were viewed as a problem because “[w]hen the economy goes down, that’s when Medicaid rolls and welfare rolls and student assistance, all those demands go up.”

Interview No. 2

State Fiscal Actions in the Late 1990s **–** Actions in the late 1990s involved all three discussion topics: tax cuts, spending growth, and setting aside funds in reserve. The biggest cut to taxes was a 10% income tax reduction split between the rate and a higher personal exemption, phased in over five years. There was spending growth, including employee cost-of-living adjustments, but a lot of surplus funds were diverted to one-time purposes. It was noted that “there was significant investment in PAYGO, particularly as we got to the end of that period…” Funds were also put into reserve automatically. “[B]ecause we had a sweeper provision…the balance in the Rainy Day Fund grew considerably.”

Efforts to Limit Growth During Good Times – This participant noted that institutionally the state has a balanced budget requirement, in addition to the spending affordability process. It was also suggested that "political dynamics between the legislature and the executive can have a salutary effect on the budget…" Were there other discussions to limit spending growth in this period? Apparently it was difficult to do so in the face of high revenue growth, as this quote illustrates: "We were in a transformational period in our economy where it could grow indefinitely because of improvements in productivity and the virtuous cycle therein….but it proved not to be true. Even though we knew capital gains…was an unreliable source, the temptation to put it to work with the excess generated was irresistible."

Use of Reserve Fund Balances in Good Times – This participant did not believe that reserve fund balances were used prior to the recession, and also expressed concern about retaining the state's bond rating. "Well…we're very concerned about invading the 5% and…the bond rating agencies is the only reason we didn't invade that for frivolous purposes."

Actions Taken Following the 2001 Recession – In recapping the actions taken to balance the budget after the recession, this interviewee cited new taxes and fees, use of reserve fund balances, transfers from dedicated special funds, spending cuts, and sales of assets. The participant did not think that the state had employed any accounting gimmicks during this period.

Prospective Fiscal Policy Modifications – In response to the actions that the state may take during the next period of economic expansion, this participant thought the state would build up a higher balance in reserves, but also thought that improvements are needed in the tax system. [A]ll the…variability stems from the wide swings of wealth among the wealthy." Ways to reduce this variability were thought to include cutting the capital gains tax rate in lieu of a permanently higher income tax rate in the upper brackets.

***Effect of Tax and Expenditure Limitations* –** This participant thought that on one hand, the spending affordability process did limit spending because Governors often submitted budgets in excess of the recommended limit and the legislature consistently acted to reduce spending to the limit. Was it enough? It was thought that "[a]rguably not. The problem…is that…there's no provision for holding onto the balance as a reserve against bad times…we use PAYGO [but] we are really not advancing our fiscal status. We're just spending it in less destructive ways." Did spending affordability limit spending growth in the late 1990s? It was thought that it did. Was it sufficient to ease the actions taken after the recession? "Maybe."

When asked whether a legally binding, non-binding, or no limit approach was preferable, this interviewee opted for the non-binding option. The problem with formulas is that they "can't address needs" but also "create opacity as people struggle to circumvent them." The perceived advantages of the non-binding approach are that it serves as "an educational process for our fiscal leaders" and "helps set a tone for decision making." In advocating flexibility, it was also stated that "folks who are responsible for governing can and should."

Interview No. 3

***State Fiscal Actions in the Late 1990s* –** In the late 1990s, Maryland had large surpluses due to conservative revenue forecasting and the unexpected technology boom. Income taxes were cut by 10% with a five-year phase-in to politically position the Democratic Governor for the 1998 election. He had narrowly defeated a Republican candidate in 1994 who ran on the platform of tax reduction. The interviewee noted the statutory mechanism for sweeping unappropriated general fund balance into the rainy day fund, leading to a balance where "FY 2000 had almost a billion dollars in [the] rainy day. And that was all automatic." Spending growth was provided across-the-board, but particularly for education.

***Efforts to Limit Growth During Good Times* –** There were proposals to enact more formal tax and expenditure limitations, but this interviewee noted that none were adopted. The spending affordability process serves as a "check between the Legislature and the Executive on…growth of spending…[in] the state supported budget."

***Use of Reserve Fund Balances in Good Times* –** The interviewee did not recall rainy day fund balances being used prior to the recession, except that balances above the 5% limit may have been used. They also felt that the reason funds were not used further was the "AAA" bond rating. The power of this financial rating is illustrated by the comment that "no Governor…that I have known…and no set of legislative leaders that I worked for or worked with…wanted to lose the "AAA" bond rating on their watch."

***Actions Taken Following the 2001 Recession* –** It was noted that as the recession unfolded easier actions were adopted first, such as across-the-board cuts, holding positions vacant, funding transfers, hiring and travel freezes, etc. As the problem worsened there were furloughs, layoffs, and program cutbacks. Eventually they noted, revenue increases included a "temporary income tax surcharge, which expired three years later."

***Prospective Fiscal Policy Modifications* –** When procyclical spending pressures abate (*e.g.,* Medicaid rolls etc.) this interviewee hoped that more surplus balances would be put into reserve. The problem with doing so is twofold, including demands from taxpayers for relief during good times as well as "pressure to spend on what are very good and needed programs."

***Effect of Tax and Expenditure Limitations* –** Yes, this participant thought the spending affordability process had acted to limit growth, especially during years of strong revenue growth. One indicator of the effectiveness of the process was thought to be the balances in reserve, which in theory would grow if the Governor was unable to spend up to the extent of revenues. When asked if the limits in the late 1990s eased the effects of budget balancing actions after the recession, it was thought that it had no impact.

This participant preferred a non-binding limit over no limits or automatic formula-based limits. The interviewee thought that no limits "puts no governing on it" and formulaic limits are inflexible. "To put something on automatic pilot, that is supposed to be unchanged and unwavering over a period of time where situations change and things happen, really makes no sense to me." Instead he/she thought that the spending affordability process provides flexibility to address needs and provides a measure of accountability through elections. "At the end of the day" he/she opined, "which is every four years, folks get to decide…[if] they've liked what's being done at the state level in terms of the budget and how much they're being taxed."

Quantitative Data

Revenue Actions

During the economic expansion of the late 1990s Maryland enacted legislation that affected the income tax, inheritance tax, created a refundable earned income tax credit (EITC), established or expanded other tax credits, decreased the horse racing wagering tax, and created sales tax exemptions. The largest revenue impact was due to a 10% reduction in the personal income tax, which was implemented through a reduction in income tax rates and by increasing the personal exemption amount. Estimates of the fiscal impact of the full phase-in, including an acceleration of the reduction passed in 1999, exceeded $500 million (Zelio 1997, 28; Rafool 2000, 23). In 2007 the Maryland Department of Legislative Services retrospectively estimated the tax year 2002 revenue loss at $507 million, increasing to $564 million by tax year 2005 (Rehrmann and Sanelli to the Honorable Robert J Garagiola).

Other significant revenue reductions resulted from the enactment of legislation to create an EITC equal to 10% of the federal tax credit for tax year 1999. At the subsequent session the credit was increased to 12.5% for tax year 2000 and 15% thereafter, but was accelerated to 15% for tax year 2000 at the 2000 session. It was again expanded at the 2001 session to 16% for tax year 2001 increasing to 20% by tax year 2004 (Zelio, Mackey, and Rafool 1999, 21; Rafool 2000, 23; Rafool 2001, 29; Rafool 2002, 22).

Figure 4.3 demonstrates that the cumulative loss of general fund revenue from the combined tax actions adopted in the late 1990s totals a projected $724 million by fiscal year 2004.

Figure 4.3
State Tax Actions: Maryland
Cumulative General Fund Loss Due to Enacted Legislation
Fiscal Year 1997 – Fiscal Year 2004 (Note 1)

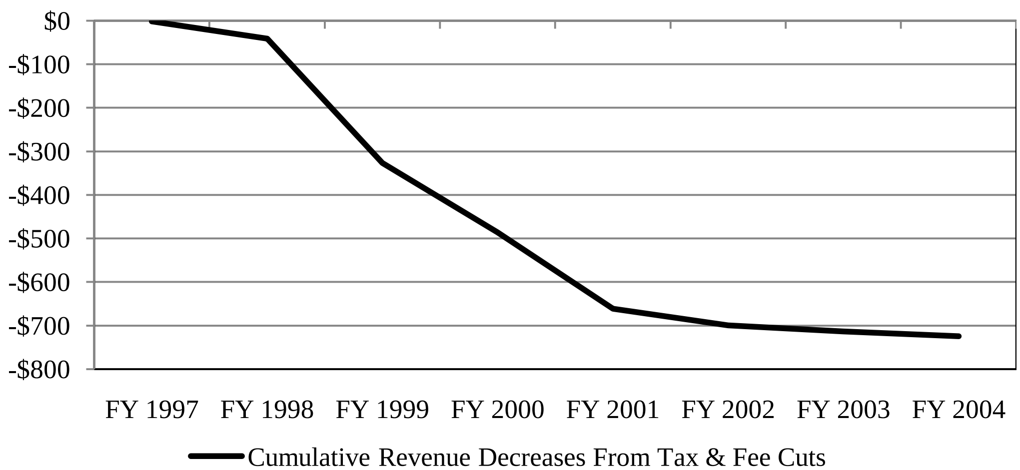


Table Notes
Note 1: Sources: Maryland Department of Legislative Services Effects of the Legislative Program 1997, 55; Maryland Department of Legislative Services Effects of the Legislative Program 1998, 51-52, 55; Maryland Department of Legislative Services Effects of the Legislative Program 2000, 50; Maryland Department of Legislative Services Effects of the Legislative Program 2001, 56; Maryland Department of Legislative Services HB 599 Fiscal Note 1998, 8; Maryland Department of Legislative Services HB 190 Fiscal Note 1999, 1; Maryland Department of Legislative Services HB 423 Fiscal Note 1999, 1; Maryland Department of Legislative Services SB 344 Fiscal Note 1999, 9; Maryland Department of Legislative Services SB 56 Fiscal Note 2000, 1; Maryland Department of Legislative Services SB 309 Fiscal Note 2000, 4; Mackey 1996, 27; Zelio 1997, 28; Zelio, Mackey, and Rafool 1999, 21; Rafool 2000, 23-24; Rafool 2001, 28-29; Rafool 2002, 22; Rafool 2003, 21; Rafool 2004, 21-22.

The annual percentage change in general fund revenue relative to personal income is shown in **Figure 4.4**. Between 1997 and 2001 personal income growth ranged from 6% to 8% per year. Growth in general fund revenue, which is dominated by the income tax, tracked personal income growth very closely during this period.

General fund revenues decreased year-over-year in fiscal year 2002 and fiscal year 2003, following the recession. Much of this can be attributed to a drop in the major tax sources, including capital gains. Personal income growth remained positive for those years, in part buoyed by transfer payments, including unemployment compensation, income maintenance benefits, Medicare and Medicaid, etc. General fund revenue rebounded strongly in fiscal year 2004 along with the economic recovery.

Figure 4.4
Percent Change in General Fund Revenues and Personal Income: Maryland
Fiscal Year 1997 – Fiscal Year 2004 (Note 1)

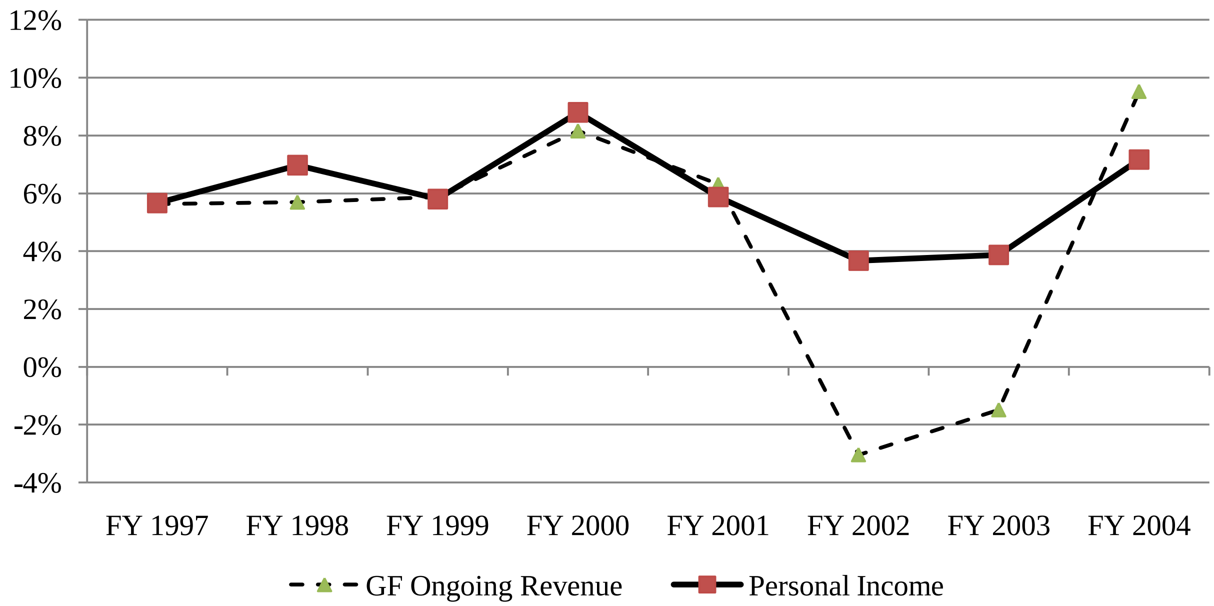


Figure Notes
Note 1: Sources: U.S. Department of Commerce Bureau of Economic Analysis State Annual Personal Income; Maryland Board of Revenue Estimates 1998, 20; Maryland Board of Revenue Estimates 2001, 25; Maryland Board of Revenue Estimates 2004, 27.

Operating Budget Trends

Operating budget growth, excluding appropriations for PAYGO capital, transfers, and reserves, is shown in **Table 4.7** for fiscal year 1997 through fiscal year 2004. Growth was fairly moderate in ongoing general fund operations, ranging from 4% to 7% between 1997 and 2000. As the economic expansion hit its peak, growth spiked to approximately 8% in fiscal year 2001 and fiscal year 2002. Following the recession, the ongoing budget only grew in the 1% range for 2003 and 2004.

It is notable that at the 2002 session the state adopted legislation to increase state support of K-12 education aid by $1.3 billion beginning in fiscal year 2003 and phasing in through fiscal year 2008. The first year of spending was paid for by an increase in the tobacco tax, but for fiscal year 2004 through fiscal year 2008, no additional revenue source was identified (Maryland Department of Legislative Services SB 856 Fiscal Note 2002, 2).

Table 4.7
General Fund Expenditures: Maryland
Fiscal Year 1997 – Fiscal Year 2004 (Note 1)

	FY 1997 Actual	**FY 1998 Actual**	**FY 1999 Actual**	**FY 2000 Actual**	**FY 2001 Actual**	**FY 2002 Actual**	**FY 2003 Actual**	**FY 2004 Actual**
Operations	$7,307.4	$7,620.6	$8,133.8	$8,600.6	$9,281.4	$10,029.5	$10,152.0	$10,250.6
PAYGO Capital	66.8	90.4	223.1	315.4	638.4	321.1	31.3	0.9
Transfers	6.0	23.0	17.1	-	2.0	-	-	-
Reserves	-	125.1	170.0	115.5	315.8	221.8	181.0	10.0
	$7,380.2	**$7,859.1**	**$8,544.0**	**$9,031.5**	**$10,237.6**	**$10,572.4**	**$10,364.3**	**$10,261.5**
% Change Operations	3.8%	4.3%	6.7%	5.7%	7.9%	8.1%	1.2%	1.0%

Table Note
Note 1: Sources: Maryland Department of Fiscal Services Sine Die Report 1997, 8; Maryland Department of Legislative Services 90 Day Report 1998, A-15; Maryland Department of Legislative Services 90 Day Report 1999, A-23; Maryland Department of Legislative Services 90 Day Report 2000, A-23; Maryland Department of Legislative Services 90 Day Report 2001, A-30; Maryland Department of Legislative Services 90 Day Report 2002, A-38; Maryland Department of Legislative Services 90 Day Report 2003, A-38; Maryland Department of Legislative Services 90 Day Report 2004, A-43; Maryland Department of Legislative Services 90 Day Report 2005, A-34.

General fund spending as a percent of personal income in Maryland generally ranged from 4.8% to 4.9% of personal income, as illustrated in **Figure 4.5**. Personal income growth is generally used as a proxy for economic activity at the state level.

Figure 4.5
General Fund Operating Expenditures as a Percent of Personal Income: Maryland
Fiscal Year 1997 – Fiscal Year 2001 (Note 1 and Note 2)

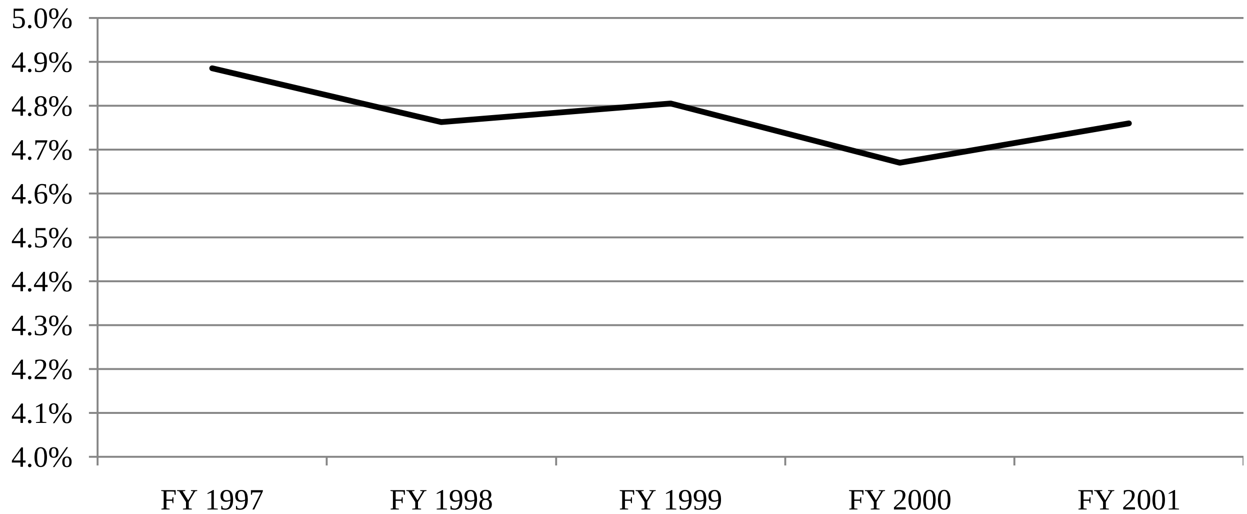


Figure Notes
Note 1: Sources: U.S. Department of Commerce Bureau of Economic Analysis State Annual Personal Income; Maryland Department of Fiscal Services Sine Die Report 1997, 8; Maryland Department of Legislative Services 90 Day Report 1998, A-15; Maryland Department of Legislative Services 90 Day Report 1999, A-23; Maryland Department of Legislative Services 90 Day Report 2000, A-23; Maryland Department of Legislative Services 90 Day Report 2001, A-30; Maryland Department of Legislative Services 90 Day Report 2002, A-38; Maryland Department of Legislative Services 90 Day Report 2003, A-38; Maryland Department of Legislative Services 90 Day Report 2004, A-43; Maryland Department of Legislative Services 90 Day Report 2005, A-34.
Note 2: Calculation of general fund operating spending as a percent of personal income was prepared by the author.

Figure 4.6 provides a comparison of ongoing general fund revenue and spending for fiscal year 1997 through fiscal year 2004. Strong revenue growth was experienced at about 6% per year or greater through fiscal year 2001. The figure illustrates the lag effect between revenue performance and the budgetary decision making schedule. As revenue growth peaked in fiscal year 2000, correspondingly high budget growth was included for the fiscal year 2001 and fiscal year 2002 budgets. Conversely, when revenue fell in fiscal year 2002 adjustments to spending growth were adopted in fiscal year 2003 and fiscal year 2004. Revenue growth from the economic recovery appears in fiscal year 2004.

Figure 4.6
Annual Percentage Change in General Fund Operating Expenditures and Ongoing General Fund Revenue: Maryland
Fiscal Year 1997 – Fiscal Year 2004 (Notes 1 and 2)

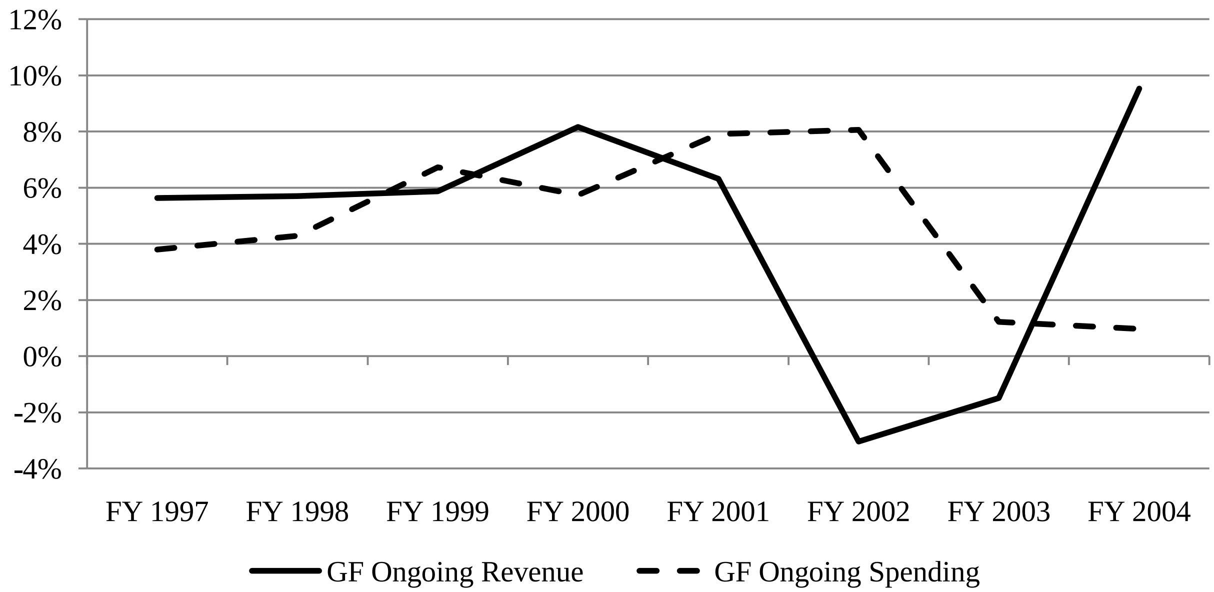


Figure Notes
Note 1: Sources: Maryland Department of Fiscal Services Sine Die Report 1997, 8; Maryland Department of Legislative Services 90 Day Report 1998, A-15; Maryland Department of Legislative Services 90 Day Report 1999, A-23; Maryland Department of Legislative Services 90 Day Report 2000, A-23; Maryland Department of Legislative Services 90 Day Report 2001, A-30; Maryland Department of Legislative Services 90 Day Report 2002, A-38; Maryland Department of Legislative Services 90 Day Report 2003, A-38; Maryland Department of Legislative Services 90 Day Report 2004, A-43; Maryland Department of Legislative Services 90 Day Report 2005, A-34; Maryland Board of Revenue Estimates 1998, 20; Maryland Board of Revenue Estimates 2001, 25; Maryland Board of Revenue Estimates 2004, 27.
Note 2: Calculation of annual percent change in general fund operating spending and general fund revenue was prepared by the author.

PAYGO Capital Trends

By limiting operating budget growth during the good economic times, Maryland applied surplus funds to its reserve fund balances as discussed below but also used increasing amounts for one-time purposes. One such purpose is PAYGO capital spending, either in lieu of or in addition to general obligation and other debt issuances. Use of cash for PAYGO is a prudent use of surplus funds because it does not build in annual spending in the base operating budget. **Figure 4.7** illustrates how cash used for PAYGO increased from $67 million in fiscal year 1997 to $638 million in fiscal year 2001. As a percent of combined operating and PAYGO spending, PAYGO spending increased from about 1% of the budget in fiscal year 1997 to slightly over 6% by fiscal year 2001.

Figure 4.7
General Fund PAYGO Capital Spending: Maryland
Fiscal Year 1997 – Fiscal Year 2001 (Note 1)
($ in Millions)

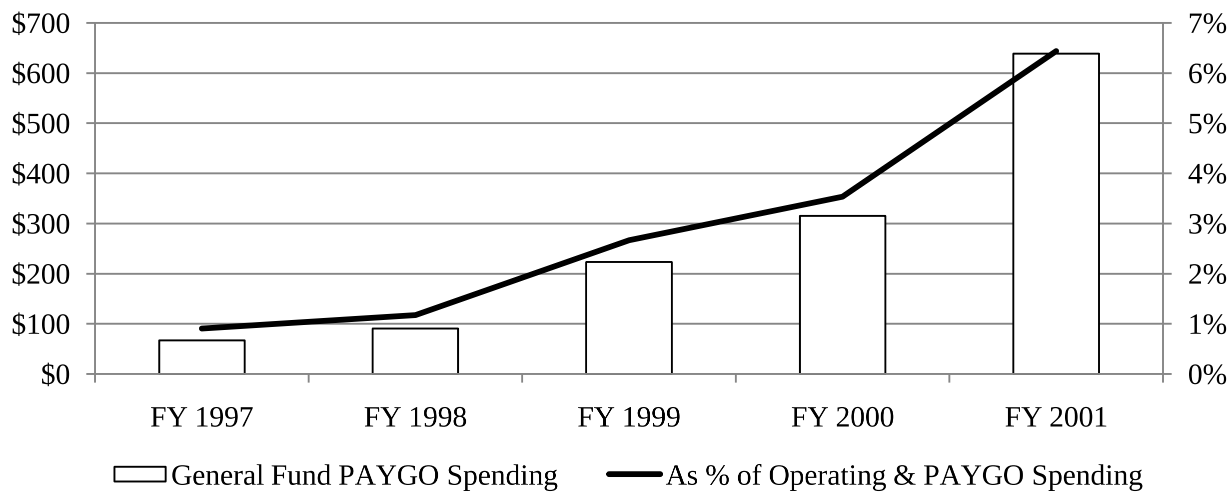


Table Notes
Note 1: Sources: Maryland Department of Legislative Services 90 Day Report 1998, A-15; Maryland Department of Legislative Services 90 Day Report 1999, A-23; Maryland Department of Legislative Services 90 Day Report 2000, A-23; Maryland Department of Legislative Services 90 Day Report 2001, A-30; Maryland Department of Legislative Services 90 Day Report 2002, A-38.

Cash Balances

The amount of cash in fund balance and in reserve is an important barometer of a state's fiscal health. During good times a large amount of cash in fund balance can result in pressure from a variety of interests for greater spending, as well as demands for tax relief. Following an economic downturn, states need as much cash as possible on hand to avoid adopting procyclical actions such as tax increases and spending cuts. Cash on hand is measured by the combined general fund balance and Rainy Day Fund balance.

***General Fund Balance* –** As seen in **Figure 4.8**, the general fund balance grew rapidly in the late 1990s to a peak of $900 million by fiscal year 2000. Relative to the general fund budget this equaled about 11%. As tax cuts were phased in and the economy weakened, the level of balances fell. Balances were also used to help maintain spending in 2002 and 2003. When revenues rebounded in 2004 the general fund balance began to grow again, reaching about 5% of expenditures.

Figure 4.8
Ending General Fund Balance: Maryland
As a Percent of General Fund Operations
Fiscal Year 1997 – Fiscal Year 2004 (Note 1 and Note 2)
($ in Millions)

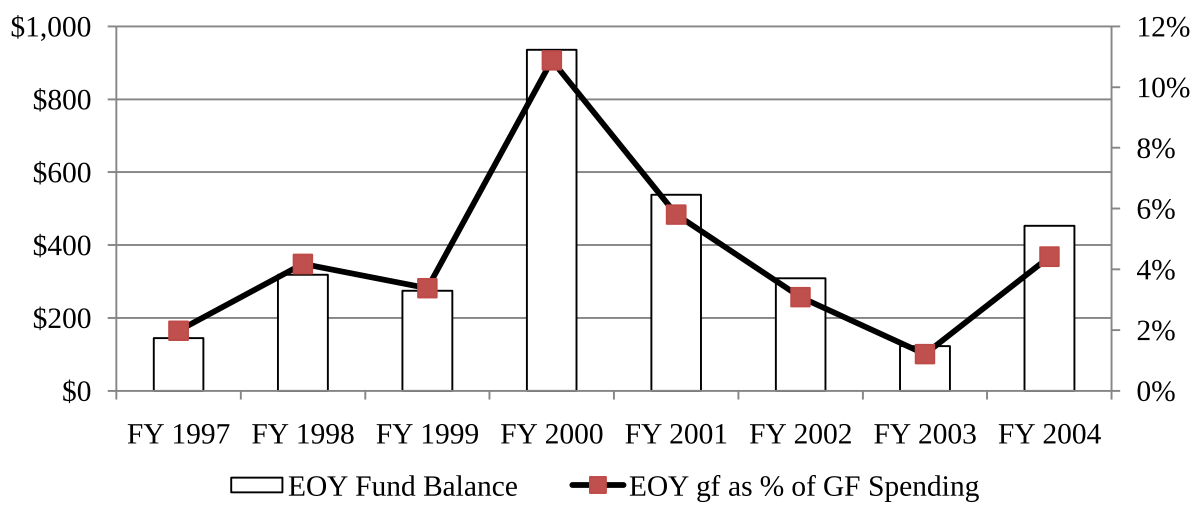


Figure Notes
Note 1: Sources: Todd Haggerty email to author, August 20, 2009 with attached file "DE, MD, VA general fund data (FY 1996 to FY 2005).xls"; Maryland Department of Fiscal Services Sine Die Report 1997, 8; Maryland Department of Legislative Services 90 Day Report 1998, A-15; Maryland Department of Legislative Services 90 Day Report 1999, A-23; Maryland Department of Legislative Services 90 Day Report 2000, A-23; Maryland Department of Legislative Services 90 Day Report 2001, A-30; Maryland Department of Legislative Services 90 Day Report 2002, A-38; Maryland Department of Legislative Services 90 Day Report 2003, A-38; Maryland Department of Legislative Services 90 Day Report 2004, A-43; Maryland Department of Legislative Services 90 Day Report 2005, A-34.
Note 2: Calculation of general fund balances as a percent of general fund operations was prepared by the author.

Reserve Fund Activity – Activity in Maryland's Rainy Day Fund is shown in **Table 4.8**. Legislation adopted at the 1998 session required that unappropriated general fund surpluses in excess of $10 million at closeout were to be appropriated into the fund. As a result, amounts ranging from $92 million to $235 million were swept into the fund each year. Because the criteria for withdrawing funds was modified in 1993, the Governor was able to spend nearly $400 million of the balance prior to the recession by including funds from the Rainy Day Fund in the budget bill.

Table 4.8
Rainy Day Fund Activity: Maryland
Fiscal Year 1997 – Fiscal Year 2004 (Note 1)

	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004
Starting Balance	**$461.2**	**$490.0**	**$617.9**	**$634.9**	**$581.9**	**$888.2**	**$547.9**	**$490.2**
Appropriation	0.0	92.0	163.2	82.2	235.0	171.8	181.0	0.0
Transfer to GF	0.0	0.0	-185.2	-174.0	-30.0	-533.2	-249.0	0.0
Other Transfers	0.0	0.0	0.0	0.0	38.9	0.0	0.0	0.0
Interest Earnings	28.8	35.9	39.1	38.8	62.4	21.2	10.3	6.4
Ending Balance	**$490.0**	**$617.9**	**$634.9**	**$581.9**	**$888.2**	**$547.9**	**$490.2**	**$496.6**

Table Notes
Note 1: Source: Maryland Department of Legislative Services spreadsheet "Frank_reserve fund_FY 2010.xls".

Balances in the reserve fund grew each year in the late 1990s as surpluses were swept into the account, increasing from about $500 million in 1997 to nearly $900 million in fiscal year 2001. As a percent of general fund spending the Rainy Day Fund balance was in the 7% to 8% range through fiscal year 2000, before reaching nearly 10% in fiscal year 2001. Balances relative to general fund spending are shown in **Figure 4.9**. At no point did Maryland's Rainy Day Fund balance fall below 5%, based in part on concerns that use of that amount could endanger the state's credit rating.

Figure 4.9
Rainy Day Fund: Maryland
Balance as a Percent of General Fund Operations
Fiscal Year 1997 – Fiscal Year2004 (Note 1)
($ in Millions)

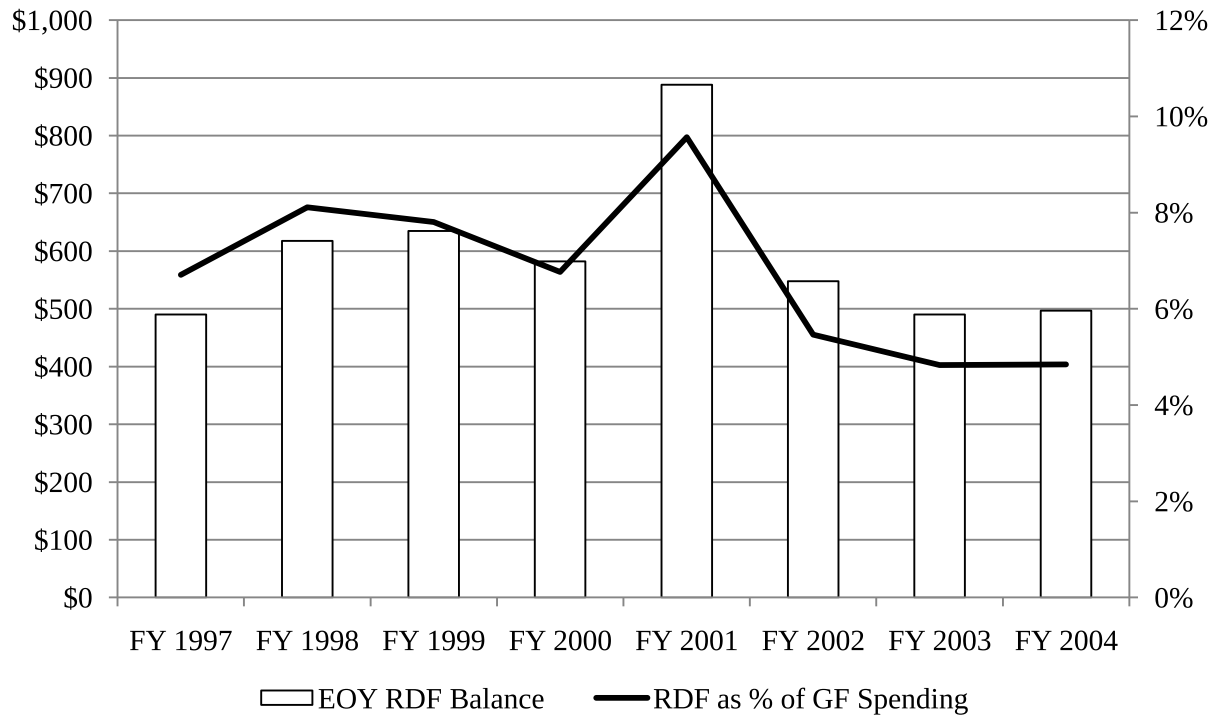


Figure Notes
Note 1: Sources: Maryland Department of Fiscal Services Sine Die Report 1997, 8; Maryland Department of Legislative Services 90 Day Report 1998, A-15; Maryland Department of Legislative Services 90 Day Report 1999, A-23; Maryland Department of Legislative Services 90 Day Report 2000, A-23; Maryland Department of Legislative Services 90 Day Report 2001, A-30; Maryland Department of Legislative Services 90 Day Report 2002, A-38; Maryland Department of Legislative Services 90 Day Report 2003, A-38; Maryland Department of Legislative Services 90 Day Report 2004, A-43; Maryland Department of Legislative Services 90 Day Report 2005, A-34; Maryland Department of Legislative Services spreadsheet "Frank_reserve fund_FY 2010.xls".

While many reserve funds are pegged to a percent of general fund revenues, comparing balances to general fund spending is more appropriate since reserves are used to support spending when revenues decline during a recession. A secondary problem with balances as a percent of revenues is that as revenues fall, a state could actually reduce funds from balance and still meet funding level requirements.

The total combined cash in the general fund balance and the Rainy Day Fund is illustrated in **Figure 4.10**. Combined cash grew to a level in excess of $1.4 billion in fiscal year 2000, equal to about 18% of the operating budget. Balances were drawn down as the income tax and other revenue actions took effect because the Governor was able to spend nearly $400 million from reserves in the operating budget, and as revenues weakened due to the recession causing Maryland to use portions of the balance to maintain operations. The combined cash balances did not go below $600 million due largely to the decision to maintain 5% in the Rainy Day Fund balance.

Figure 4.10
Total Available Cash: Maryland
Rainy Day Fund and General Fund Balance as a Percent of General Fund Operations
Fiscal Year 1997 – Fiscal Year 2004 (Note 1)
($ in Millions)

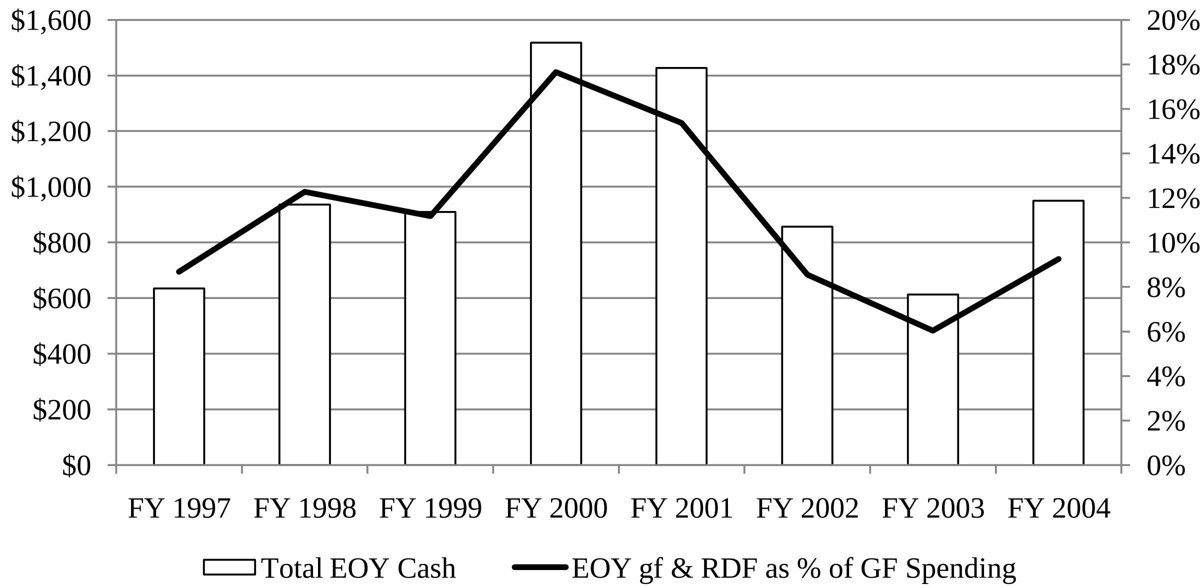


Figure Notes
Note 1: Sources: Todd Haggerty email to author, August 20, 2009 with attached file "DE, MD, VA general fund data (FY 1996 to FY 2005).xls"; Maryland Department of Fiscal Services Sine Die Report 1997, 8; Maryland Department of Legislative Services 90 Day Report 1998, A-15; Maryland Department of Legislative Services 90 Day Report 1999, A-23; Maryland Department of Legislative Services 90 Day Report 2000, A-23; Maryland Department of Legislative Services 90 Day Report 2001, A-30; Maryland Department of Legislative Services 90 Day Report 2002, A-38; Maryland Department of Legislative Services 90 Day Report 2003, A-38; Maryland Department of Legislative Services 90 Day Report 2004, A-43; Maryland Department of Legislative Services 90 Day Report 2005, A-34; Maryland Department of Legislative Services spreadsheet "Frank reserve fund_FY 2010.xls".

Fiscal Stress

As discussed in Chapter III, fiscal stress is measured using a variety of factors. This includes the extent the budget is assumed to be reduced had spending continued to have grown at an average rate of 5% following the recession; the extent spending was supported by general fund balance and use of transfers from reserves and non-general funds; new taxes and fees; and federal aid during fiscal year 2003 and fiscal year 2004 which allowed states to supplant spending.

In the 2002-2004 post-recessionary period, Maryland experienced fiscal stress in the 12% range, as shown in **Figure 4.11**. This consists of roughly $2.3 billion over the three years in transfers from the Rainy Day Fund and non-general fund transfers from dedicated special funds such as the Transportation Trust Fund; approximately $600 million in spending cuts from the pre-recession growth trend; over $500 million in new tax and fee revenue; and over $300 million in federal aid provided in fiscal year 2003 and fiscal year 2004 to supplant general fund spending.

Figure 4.11
Fiscal Stress as a Percent of Ongoing General Fund Spending: Maryland
Fiscal Year 2002 – Fiscal Year 2004 (Note 1)

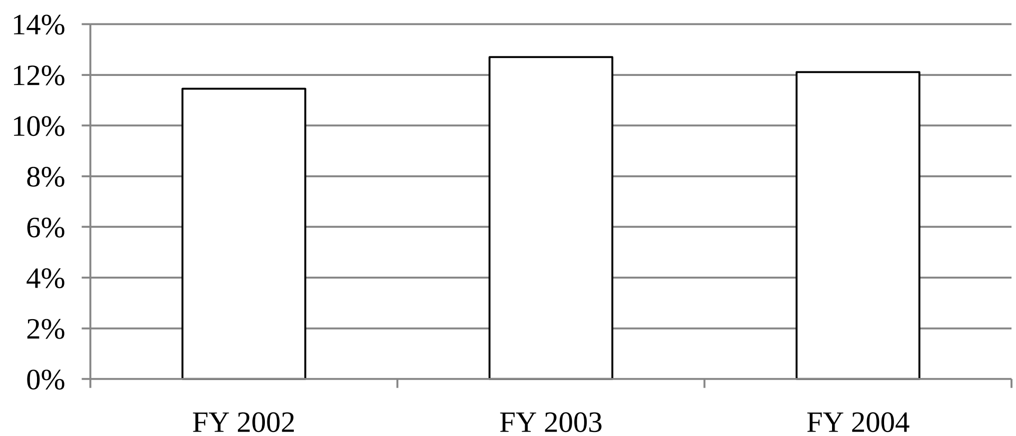


Figure Notes
Note 1: Sources: Zelio, Mackey, and Rafool 1999, 21; Rafool 2000, 23; Rafool 2001, 24; Rafool 2002, 22; Rafool 2003, 21; Rafool 2004, 21-22; Federal Fund Information for States 2004, 5; Todd Haggerty email to author, August 20, 2009, with attached file "DE, MD, VA general fund data (FY 1996 to FY 2005).xls"; Maryland Department of Legislative Services spreadsheet "Frank_reserve fund_FY 2010.xls"; Maryland Department of Legislative Services spreadsheet "FY 2002-2006 Transfers.xls".

Case Data Integration

Table 4.9 summarizes the combined responses of the three interviews for Maryland and integrates the quantitative data to assist in the interpretation of the qualitative responses:

Table 4.9
Maryland Case Study
Integration of Qualitative and Quantitative Data

Category	Interview Responses	Data
Late 1990s actions	The three participants all cited a 10% phased reduction in the income tax as one of the major actions in the late 1990s, due in part to political pressure. Surplus revenues were diverted to the Rainy Day Fund based on a statutory sweeper provision which directs unappropriated surplus amounts over $10 million at closeout. Spending increases were also adopted, particularly in education.	Numerous revenue actions adopted which eroded the tax base by a cumulative $700+ million by fiscal year 2004, including a phased-in 10% income tax cut. The Rainy Day Fund balance grew to almost $900 million in part due to automatic appropriation provision at closeout. Combined cash balances grew to $1.4 billion by fiscal year 2000; equal to over 18% of the operating budget. General fund spending increased in the 4% to 7% range through 2000, then 8% in 2001 and 2002. Mandated spending for K-12 education and Medicaid grew from 45% to 49% of general fund spending from 1996 to 2004.
Budgetary processes that limit spending	Discussions to limit growth centered on the non-binding spending affordability process in terms of setting annual limits and directing surplus revenue to one-time PAYGO. The decision to reduce income taxes was described by one interviewee as a means of limiting spending growth by taking away the revenue. The balanced budget requirement was noted. One participant thought that it was important to have active fiscal management and leaders who are willing to say no.	Maryland's statutory non-binding Spending Affordability Committee recommended operating budget growth ranging from a low of 4.15% to 6.9% prior to the recession. Rainy Day Fund balances grew from about $500 million to almost $900 million, equal to about 10% of the operating budget. One-time PAYGO spending also increased from under $100 million in 1997 to over $600 million in 2001 (from 1%

Category	Interview Responses	Data
		to about 6% of the combined operating/PAYGO budget). Politically Democrats held the Governor's office and both chambers of the legislature throughout the study period.
Reserve funds	None of the participants thought that the reserve fund balance was tapped prior to the recession. However, all three expressed that the base 5% was an important consideration in the state's "AAA" bond rating from all three credit rating agencies. There was concern that using any part of the 5% would result in the state being placed on a credit watch.	Nearly $400 million was appropriated from the Rainy Day Fund balance prior to the recession (1999 through 2001), representing amounts above the minimum 5% of revenues.
Pre-recession effect of tax and expenditure limitations	It was thought that Maryland's spending affordability process did help to constrain spending growth in the late 1990s. In several years, the Governor introduced budgets that exceeded the limit but the legislature always reduced spending in line with the recommended limit. One interviewee thought the Rainy Day Fund balances would be an indicator of successful spending restraint.	Operating budget spending on average grew 6.2% per year between 1997 and 2001. General fund operating spending as a percent of personal income ranged from 4.7% to 4.9%.
Post-Recession Budget Balancing Actions/Fiscal Stress	Budget balancing actions included incremental budget reduction, transfers from the Rainy Day Fund and other non-general fund sources, and new tax and fee revenues. Following the 2001 recession, it was thought that the constraint imposed by spending affordability did not mitigate the budget balancing actions that were required. One interviewee thought that growth would have had to have been limited to 1% below personal income with the surplus put into reserve, in order to make an appreciable difference after the recession.	Fiscal stress for the Maryland budget approximated 12% a year. Largest actions included transfers from the Rainy Day Fund and non-general funds, spending reduced from the pre-recession trend, and new tax and fee revenues.

Category	Interview Responses	Data
	Asked if a formal legal tax and expenditure limit, a non-binding limit, or no limit was the optimal approach, two participants thought Maryland's non-binding approach was preferred. The third interviewee opted for no limit. None favored a formal legal approach because of concerns over flexibility to address unexpected spending needs, particularly during economic downturns. It was stated that officials are elected to make decisions. There was also concern that strict limits will spur creative ways to circumvent them. One participant noted that good people can make a bad fiscal system work and wrong minded people can subvert the best fiscal system in the world. Generally thought the state should have more balance in reserve but there is pressure to address unmet needs and to give tax relief. One interviewee thought there was too much variability in the revenue structure, which could be smoothed by less reliance on capital gains. Another was pessimistic that any changes would be adopted based on experience with several business cycles, because people tend to think the good times will go on forever.	

Case No. 2 – Delaware

Legal Framework

Budgetary Processes

The state of Delaware operates on an annual fiscal year (Delaware.gov Online Delaware Code Chapter 65 Section 6507). Agency requests are submitted to the Office of Management and Budget (OMB) for public hearings beginning by November 15 of each year. OMB must complete its review and recommendation to the Governor by December 15 in a zero-based budget format. The Governor must submit the proposed budget to the legislature by February 1 (Delaware.gov Online Delaware Code Chapter 63 Sections 6332 - 6335).

Delaware's legislative session begins on the second Tuesday of January and ends upon the earlier of the completion of all business or June 30 (Delaware.gov Delaware Constitution Article II Section 4). Legislative consideration by joint hearings of the budget committees begins FIVE days within submission, and the legislature may add to or reduce the budget. Until the legislature completes its work, the Governor may submit supplemental budgets to address errors or oversights. The legislature may also pass supplementary appropriations limited to a single object of spending with a designated source of revenue (Delaware.gov Online Delaware Code Chapter 63 Sections 6336 – 6339).

Tax and Expenditure Limitations

In 1978, Delaware adopted a constitutional amendment that restricts appropriations to 98% of estimated revenue (Waisanen 2008, 7). It appears both in Article VIII of the Delaware Constitution and Title 29, Chapter 65, Section 6533 of the Delaware Annotated Code. Functionally, the limit starts with the end of year general fund cash balance and deducts prior year encumbrances and continuing appropriations as well as revenue deductions to the Rainy Day Fund. The remaining unencumbered cash balance is then added to the next year's estimated general fund revenues and the product is multiplied by 98%. The remaining 2% stays in the general fund balance providing a cushion during the year in case of revenue under attainment or may be appropriated in the next budget. However, there is a provision that permits the 2% portion to be appropriated in case of emergency if approved by a 3/5 majority of the legislature

(Delaware.gov Delaware Constitution Article VIII Section 6; Delaware.gov Title 29 Chapter 65 Section 6533).

Delaware also has a constitutional limit pertaining to tax increases that was adopted in 1980-1981, which requires a 3/5 vote in the legislature (Mullins and Wallin 2004, 11; Delaware.gov Delaware Constitution Article VIII Section 10).

Table 4.10 illustrates the calculation of the 98% limit based on Fiscal Overview materials that accompanied the Governor's annual budget submission.

Reserve Fund

Establishment and Structure – Delaware established a Budget Reserve Account in 1977 with funds first set aside in 1979 (Hou 2004, 63). The fund is capped at 5% of estimated general fund revenues. The balance above 5% is used to fund the general fund budget.

Deposits – Funds are credited to the Reserve Account as a revenue deduction each year, based on the amount necessary to attain a 5% balance from unencumbered funds remaining at the end of each fiscal year.

Withdrawal Requirements – The balances in the Rainy Day Fund may be accessed to address an "unanticipated deficit in any given fiscal year or to provide funds required as a result of any revenue reduction enacted by the General Assembly" (Delaware.gov Delaware Constitution Article VIII Section 6; Delaware.gov Title 29 Chapter 65 Section 6533).

Table 4.10
Tax and Expenditure Limitation: Delaware
Calculation of Delaware's 98% of Revenue Spending Limit
In Conjunction with Governor's Proposed Budget
Fiscal Year 1997 – Fiscal Year 2004 (Note 1 and Note 2)
($ in Millions)

	FY 1997 Projected	FY 1998 Projected	FY 1999 Projected	FY 2000 Projected	FY 2001 Projected	FY 2002 Projected	FY 2003 Projected	FY 2004 Projected
Appropriation Limit:								
Cumulative Prior Year Cash Balance	$302.3	$332.8	$392.1	$476.9	$541.3	$468.8	$320.0	$303.8
Less: Prior Year C & E	-123.7	-174.4	-164.8	-239.0	-320.1	-314.1	-147.7	-124.9
Prior Year Reserve	-87.2	-92.9	-100.9	-114.1	-119.8	-126.2	-128.0	-128.9
Unencumbered Cash Balance	91.4	65.5	126.4	123.8	101.4	28.5	44.3	50.0
+NFY Revenue	1,697.6	1,808.3	1,985.4	2,165.2	2,325.4	2,432.6	2,394.1	2,476.1
Total (100% Limit)	1,789.0	1,873.8	2,111.8	2,289.0	2,426.8	2,461.1	2,438.4	2,526.1
X 98% Limit	98%	98%	98%	98%	98%	98%	98%	98%
Appropriation Limit	**$1,753.2**	**$1,836.3**	**$2,069.6**	**$2,243.2**	**$2,378.3**	**$2,411.9**	**$2,389.6**	**$2,475.6**
Appropriations:								
Budget	$1,691.8	$1,780.4	$1,870.9	$1,992.7	$2,146.1	$2,298.7	$2,352.4	$2,432.7
Grants	25.1	26.3	28.0	33.5	34.1	36.5	37.3	35.5
Estimated Supplementals	36.3	29.6	166.7	168.5	198.0	52.1	0.0	7.3
Subtotal	**$1,753.2**	**$1,836.3**	**$2,065.6**	**$2,194.7**	**$2,378.2**	**$2,387.3**	**$2,389.7**	**$2,475.5**

Figure Notes
Note 1: Source: Robert Scoglietti, email message to author, December 4, 2009 with attached file "2645_001.pdf" which contained the Fiscal Overview from each Governor's budget submission materials for fiscal 1997 through fiscal 2004".
Note 2: C&E=Continuing and Encumbered; NFY=New Fiscal Year.

Mandated Spending

Delaware does not presently prepare a report on general fund spending mandates; however, staff from the Office of the Controller General was able to provide spending information for Medicaid and K-12 education; two of the larger mandated spending programs.

Figure 4.12 shows general fund mandated spending for K-12 education and Medicaid in fiscal year 1996 compared to what was spent in fiscal year 2004. As the figure shows, the two programs increased from about 58% of the general fund budget in fiscal year 1996 to about 67% of the general fund budget in fiscal year 2004. In total, the programs grew from $0.9 billion up to $1.6 billion. This was an average rate of growth of 7.5%. Medicaid grew faster at 8.9% a year between fiscal year 1996 and fiscal year 2004, while K-12 education spending growth averaged 6.4%.

Figure 4.12
Mandated Appropriations: Delaware
Percent of General Fund Budget Spent on Medicaid and K-12
Fiscal Year 1996 vs. Fiscal Year 2004 (Note 1)

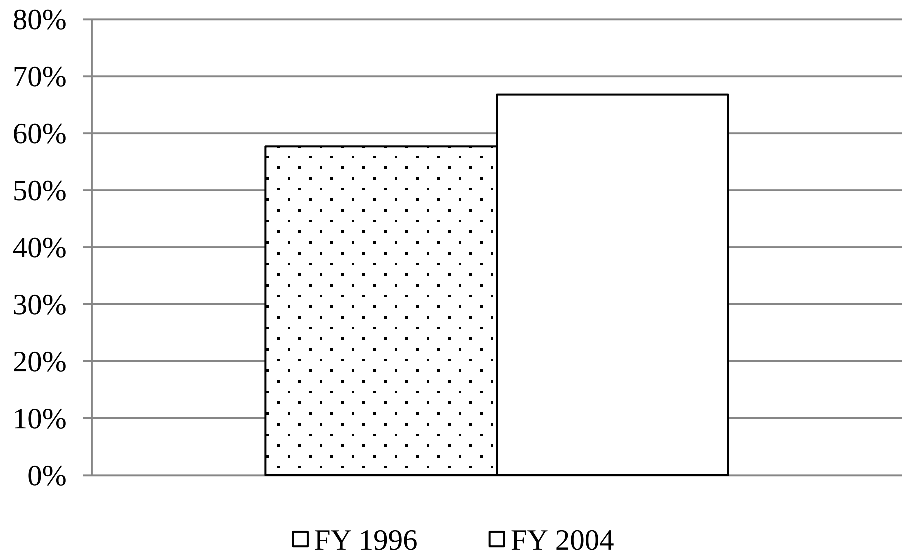


Figure Notes
Note 1: Sources: Michael Morton, email message to author, November 17, 2009; Michael Morton, email message to author, December 4, 2009.

Political Demographics

As **Table 4.11** demonstrates, Delaware had a Democratic Governor throughout the study period. In the legislature, Republicans controlled the House while Democrats controlled the Senate. Further discussion of the role of political demographics relative to revenue and spending patterns is included in Chapter V.

Table 4.11
Gubernatorial and Legislative Political Party Distribution: Delaware
1996-2002 (Note 1)

	House		Senate		Governor
	# Democrat	# Republican	# Democrat	# Republican	Party
1996	14	27	13	8	D
1998	15	26	13	8	D
2000	15	26	13	8	D
2002	12	29	13	8	D

Table Notes
Note 1: Source: NCSL "Legislative Party comp tables 96-02"; Delaware's Governors 1949 to Present.

Qualitative Data

Interviews

Interviews were conducted with three individuals who played instrumental roles in shaping fiscal policy in Delaware during the growth period of the late 1990s. This includes a current Democratic legislator who was first elected in the late 1970s and who has served as the Chair of the Senate Finance Committee and Co-Chair of the Joint Committee; the non-partisan Chief of Fiscal Policy and Policy Analysis with the Office of the Controller General; and a former Director of Budget Development, Planning, and Administration.

Interview No. 4

***State Fiscal Actions in the Late 1990s* –** This participant noted that the state had enacted a number of tax cuts over a multi-year period. In addition there was growth in operating budget spending, plus a large application of surplus funds for PAYGO capital purposes. There is also a statutory requirement for 5% in reserve, so automatic deductions were made.

***Efforts to Limit Growth During Good Times* –** It was noted that "Governor Carper, typically…would come out with a budget that restrained growth to 5%….and put as much cash into the bond bill." This administrative policy decision served to further reduce ongoing spending growth. The state also has a balanced budget requirement.

Use of Reserve Fund Balance in Good Times **–** The reserve fund balance has never been used, according to the interviewee. One reason that the balance has never been accessed is a "very strong desire to maintain the state's "AAA"…rating".

Actions Taken Following the 2001 Recession **–** At the time of the downturn, Delaware was required to undertake actions to balance the current budget in mid-year and to adopt a balanced budget for the upcoming one. For the current year, this entailed across-the-board cuts and use of non-general fund balances. It was noted that there were no layoffs. For the upcoming budget, a projected deficit of $300 million was addressed through a combination of new revenues to address 1/2 of the problem while identifying spending cuts and available non-general fund balances for the remainder.

Prospective Fiscal Policy Modifications **–** This participant thought that the state ought to consider proposals to avoid using known one-time fluctuating revenue sources to support operating budget spending. For example, they noted that the state receives a significant amount of revenue from escheat (*i.e.*, abandoned property). It was noted that there had been some consideration for "capping escheat at a certain level, and anything above the cap is gonna go toward paying for other post-employment benefits liability…debt defeasance…[and] other types of one-time…capital construction projects."

Effect of Tax and Expenditure Limitations **–** With respect to limiting operating spending growth in the late 1990s, this participant thought that the 98% limitation was effective in constraining growth. In particular, it resulted in "unprecedented levels of…PAYGO spending." The interviewee went on to note that had the limitation not been in place, Delaware could easily have had a much larger operating budget problem than the $300 million shortfall that had been experienced after the recession. "[I]t could have been $700-$800 million at that time."

As to the issue of which type of limitation might be preferable, the interviewee thought that a formal constitutional limit was better than either a non-binding limit or no limit. The participant believed that "the constitutional limit…focuses discipline, and it invokes it into the process to create as much balance between the good times and the bad times." Having the 98% limit also helps with cash management, as it maintains 2% in fund balance during the year. This amount can provide something to fall back on if revenues fall or may be appropriated in the next year for one-time purposes.

Interview No. 5

State Fiscal Actions in the Late 1990s **–** This interviewee began by citing strong revenue growth in the late 1990s. In terms of revenue actions, he/she noted that the state adopted multiple years of income tax cuts. Operating spending did grow but not at the same rate as revenues. Much of the funding was directed to one-time purposes including "school construction....ag land preservation....open space….money into non-profit organizations for capital expenses." Moreover, it was noted that a large one-time revenue from an escheat settlement was also used for one-time projects so as to not build up the base budget. Revenues were automatically deducted for reserves also, to satisfy a 5% rainy day fund balance requirement.

Efforts to Limit Growth During Good Times **–** While legislation to enact more stringent limits has not been enacted, the interviewee noted that "there…had been talk…to limit budget growth to inflation plus population growth." There was also a conscious decision to not spend all that could have been spent and to use funds for one-time purposes such as PAYGO.

Use of Reserve Fund Balances in Good Times **–** Reserve fund balances have not been used since the fund's inception. Concern over maintaining the state's "AAA" bond rating appears to be one reason, according to this interviewee, who noted that "everybody fears…the impact it'll have on our bond rating." There had been discussions of potentially using the fund following the 2001 recession when other budget actions were being adopted. Republican legislators wondered "why can't we use this to…get us through this…issue rather than raise taxes?"

Actions Taken Following the 2001 Recession **–** The state adopted several budget balancing strategies including hiring freezes, across-the-board spending reductions (except for K-12 education), and a transfer of a transportation-related general funded program to the transportation trust fund. A $300 million shortfall following the recession was addressed 1/2 by revenues and 1/2 by spending cuts. The decision to address the problem in this manner was made by leadership.

Prospective Fiscal Policy Modifications **–** Delaware has "always been very conservative from a fiscal standpoint" thought this participant. Thus, prior policies, such as using surplus cash for one-time purposes, are likely to be pursued again in the future. This type of action is viewed as mitigating growth to ease the level of budget balancing decisions made following a downturn.

Effect of Tax and Expenditure Limitations **–** The spending limit in Delaware was viewed as effective in constraining growth in the late 1990s, primarily because a portion of that was allocated to one-time PAYGO capital. The interviewee thought that if the state "didn't have the 98% it would get out of hand." In addition this spending rule provides a 2% fund balance during the year to act as a cushion. This also removes any question about how much fund balance to leave during budget action. Did the 98% limit also better position the state for the post-recessionary period? Yes, thought the interviewee, as "it keeps us from over budgeting in the good years."

With respect to the option of a formal legal limit, a non-binding limit, or no limit, this participant felt that the 98% constitutional limit was ideal. They thought that "It just makes it clean…you take your revenue and multiply by 98%; that's all you can go." The state can also budget that remaining 2% in emergencies with a 3/5 majority vote. This has apparently occurred in the past when needed. In summing up, it was noted that "I just think the constitutional amendment keeps everybody honest."

Interview No. 6

State Fiscal Actions in the Late 1990s – Additional funds in reserve, spending enhancements, and tax actions took place in the late 1990s. Starting with tax cuts, the interviewee noted that Delaware had adopted a series of income tax reductions over a multiple year period. Deposits were automatically made to the rainy day fund in accordance with legal requirements for 5% balance. A lot of the spending was one-time in nature, including agency enhancements that were not included as part of their base and PAYGO capital. Operating spending growth provided new funding for K-12 education for full day kindergarten, higher education tuition support based on a student's grade point average, and Medicaid benefits, for example.

Efforts to Limit Growth During Good Times – It was noted by the participant that there had been discussions in prior years for alternative tax and expenditure limitations based on inflation and population growth, but they had not been adopted. During the late 1990s, it was noted that an administrative policy decision had been reached to spend less than the full 98% permitted; therefore, more funds were allocated to one-time PAYGO capital purposes. Tax cuts were also adopted as a means of reducing available revenues to be spent by government. The balanced budget requirement is also an institutional limit. Other administrative policies exist as well, such as the Governor's ability to direct agencies to reduce spending if the economy is under performing, as a method of increasing year end reversions.

Use of Reserve Fund Balances in Good Times – Delaware has not used its Rainy Day Fund balance, though there had been discussion of using it in bad times. One reason the balance has not been used is because maintaining 5% in reserve is a factor in the state's "AAA" bond rating.

Actions Taken Following the 2001 Recession – Actions adopted to balance the budget after the recession included new revenues, a hiring freeze, spending cuts, non-general fund transfers, and agency reversions. There had not been employee layoffs or use of reserve fund balances.

Prospective Fiscal Policy Modifications – The interviewee thought that the state would continue fiscally conservative measures such as directing surplus funds to one-time uses such as PAYGO capital.

Effect of Tax and Expenditure Limitations – Yes, it was thought that the limit in place in Delaware had acted to constrain spending growth in the late 1990s. Prior to the adoption of the limit, it was noted that there had been greater mid-year supplemental spending of new or unexpected revenue. The interviewee also thought that the state had been better positioned to weather the post-2001 recession, though also noted that when revenue falls, it falls and any state will have to adopt actions to balance the budget.

When asked about the preferred option among a legal limit, non-binding limit, or no limit, this participant thought Delaware's constitutional 98% limit worked the best at controlling spending. Having no limit was not viewed as a good idea. A non-binding limit would, it was thought, provide some flexibility but would not be ideal.

Quantitative Data

Revenue Actions

During the late 1990s, Delaware enacted legislation at the 1996 through the 1999 sessions that reduced revenue that largely impacted the income tax. One of the largest changes was enacted at the 1998 session affecting income tax rates and exclusion amounts, including a higher pension income exclusion for persons over the age of 60. This legislation was estimated to result in a loss of about $46 million in fiscal year 1999 and $119 million in fiscal year 2000 (Zelio, Mackey, and Rafool 1999, 18). Another income tax reduction was enacted at the 1999 session costing an estimated $28 million in fiscal year 2000 and $65 million in fiscal year 2001 (Rafool 2000, 18). The pension income tax exclusion was again increased at the 1999 session for an estimated $11 million revenue loss in fiscal year 2001.

During this period, legislation also repealed or modified business taxes, alcoholic beverage taxes, taxes on cable television, inheritance taxes, and gross receipts taxes (Mackey 1996, 25; Zelio, Mackey, and Rafool 1999, 18; Rafool 2000, 18). **Figure 4.13** illustrates the estimated cumulative impact of legislation enacted at the 1996-1999 sessions which resulted in the loss of general fund revenue. As shown, by fiscal year 2004 the effect was an aggregate loss of about $250 million.

Figure 4.13
State Tax Actions: Delaware
Cumulative General Fund Loss Due to Enacted Legislation
Fiscal Year 1997 – Fiscal Year 2004 (Note 1)
(% in Millions)

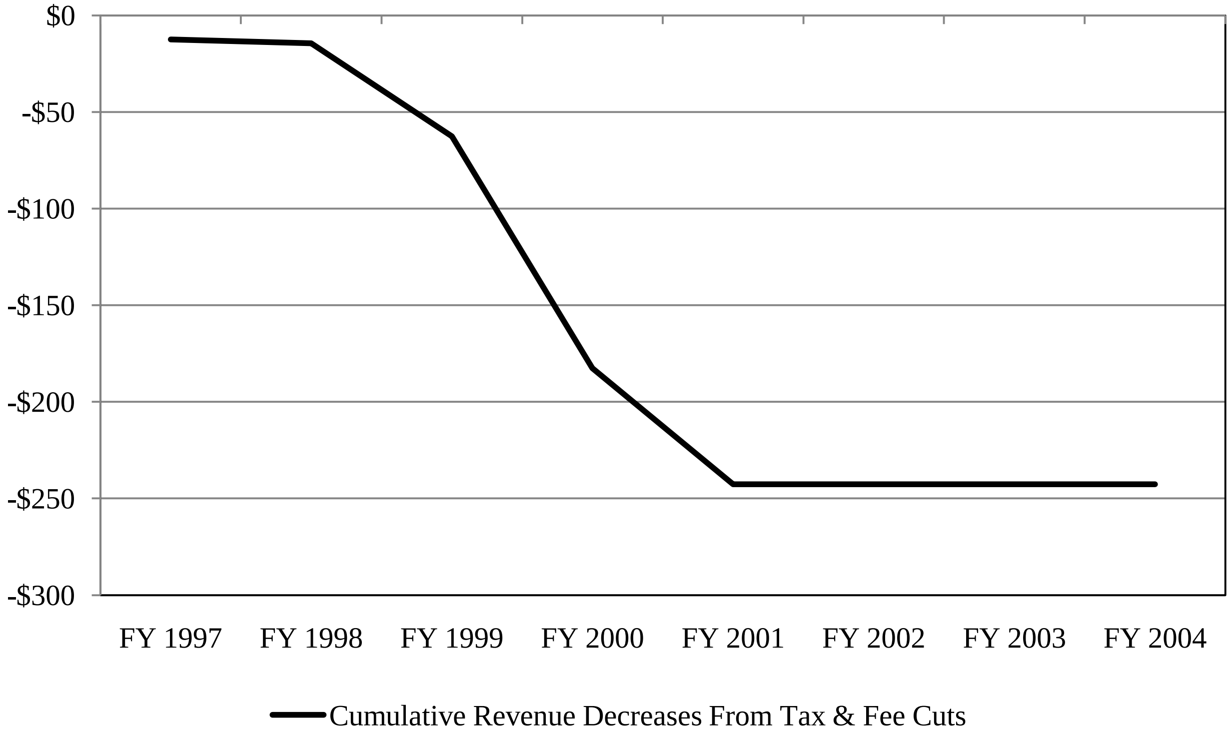


Figure Notes
Note 1: Sources: Mackey 1996, 25-26; Zelio 1997, 26; Zelio, Mackey, and Rafool 1999, 18; Rafool 2000, 18; Rafool 2003, 17; Rafool 2004, 17.

Figure 4.14 provides the annual percentage change in personal income relative to general fund revenue growth. Between fiscal year 1997 and fiscal year 2001, personal income growth ranged from 4% to 8%. During fiscal year 1997 through fiscal year 1999, growth in general fund revenues was between 7% and 15% with large increases in business taxes and the lottery/video lottery terminal expansion. (John C. Carney 1998, Exhibit A-1a; John C. Carney 1999, Exhibit A-1a).

Figure 4.14
Percent Change in General Fund Revenues and Personal Income: Delaware
Fiscal Year 1997 – Fiscal Year 2004 (Note 1)

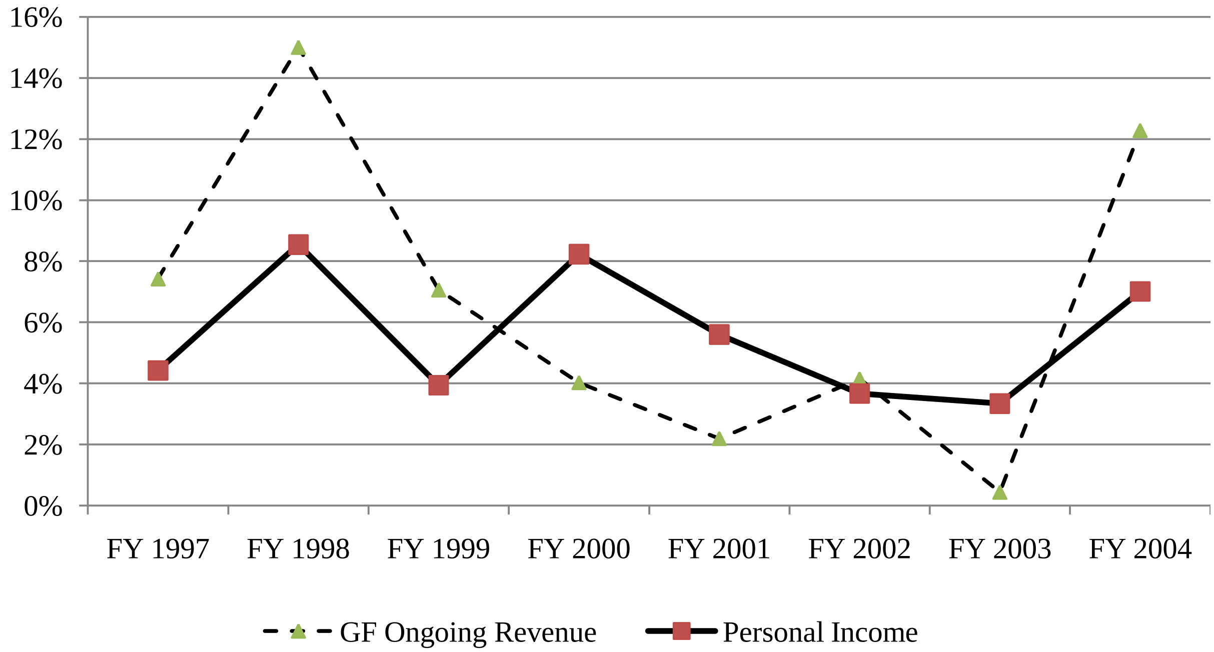


Figure Notes
Note 1: Sources: U.S. Department of Commerce Bureau of Economic Analysis State Annual Personal Income; David Gregor email to author, November 17, 2009 with attached files providing Delaware's closing Financial Reports for fiscal year 1997 through fiscal year 2004 "FY97 Final Accounting Report0001.pdf", "FY98 Final Accounting Report0001.pdf", "FY99 Final Accounting Report0001.pdf", "FY00 Final Accounting Report0001.pdf", "FY01 Final Accounting Report0001.pdf", "FY02 Final Accounting Report0001.pdf", "FY03 Final Accounting Report0001.pdf", "FY04 Final Accounting Report0001.pdf".

Growth began to weaken in fiscal year 2000, a likely precursor to the recession based on the large representation of business taxes in Delaware's revenues. Revenue growth remained positive throughout the post-recessionary period, with a strong rebound in fiscal year 2004.

Operating Budget Trends

Table 4.12 contains general fund actual expenditure data for Delaware for the fiscal year 1997 through fiscal year 2004 period. The operations category aggregates the budget bill, grants-in-aid, encumbrances, and continuing appropriations net of reversions. Excluding one-time PAYGO (cash to the Bond Bill), ongoing operations grew at 9% in 1997, followed by moderate growth in the 4%-5% range from fiscal year 1998 through fiscal year 2000. Fiscal year 2001 and fiscal year 2002 both grew above or near double digit levels.

Table 4.12
General Fund Expenditures: Delaware
Fiscal Year 1997 – Fiscal Year 2004 (Note 1)

	FY 1997 Actual	FY 1998 Actual	FY 1999 Actual	FY 2000 Actual	FY 2001 Actual	FY 2002 Actual	FY 2003 Actual	FY 2004 Actual
Operations	$1,706.6	$1,801.7	$1,893.5	$1,967.2	$2,231.5	$2,442.4	$2,434.8	$2,411.7
PAYGO Capital	59.1	98.3	259.0	279.0	197.5	11.5	19.3	142.0
	$1,765.7	**$1,900.0**	**$2,152.5**	**$2,246.2**	**$2,429.0**	**$2,453.9**	**$2,454.1**	**$2,553.7**
% Change Operations	9.0%	5.6%	5.1%	3.9%	13.4%	9.5%	-0.3%	-0.9%

Table Notes
Note 1: Sources: Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1994 - 1997); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1998 - 2001); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 2002 - F.Y. 2005); Delaware.gov Capital Budget Authorizations by Funding Source.

Figure 4.15 demonstrates that general fund operating expenses were fairly high from 1997 through 2004 as a percent of personal income, starting at nearly 8.6% in fiscal year 1997 before falling to below 8.1% in fiscal year 2000 before growing again to nearly 8.7% in 2004. The ratios are likely higher because a large portion of Delaware's revenue comes from business taxes, escheat, and video lottery terminals.

Figure 4.15
General Fund Operating Expenditures as a Percent of Personal Income: Delaware Fiscal Year 1997 – Fiscal Year 2001 (Note 1 and Note 2)

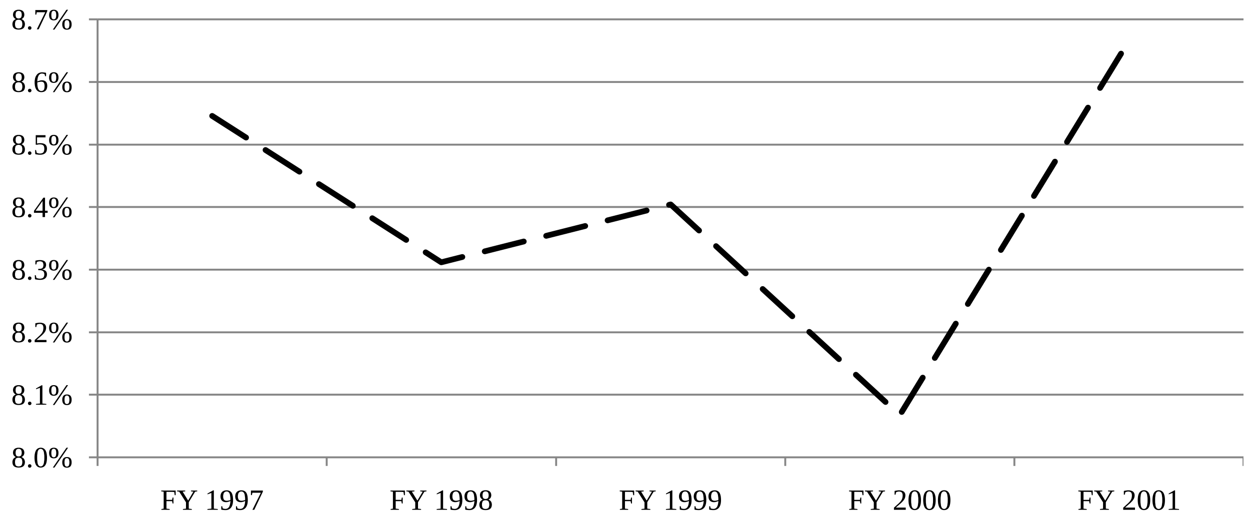


Figure Notes
Note 1: Sources: U.S. Department of Commerce Bureau of Economic Analysis State Annual Personal Income; Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1994 - 1997); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1998 - 2001); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 2002 - F.Y. 2005).
Note 2: Calculation of general fund operating spending as a percent of personal income was prepared by the author.

The trends in ongoing general fund revenues and spending from 1997 to 2004 are shown in **Figure 4.16**. There was strong revenue growth in through 1999 followed by a lag effect in spending growth in fiscal year 2001 and fiscal year 2002. Following the recession, revenue growth remained positive, buoyed by a surge in the corporate income tax, bank franchise fees, and lottery revenue. Revenue growth displayed strong performance in 2004; however, the operating budget declined about 1% based on the timing of the enactment of the budget and the unexpected nature of the recovery after the budget was approved.

Figure 4.16
Annual Percentage Change in General Fund Operating Expenditures and Ongoing General Fund Revenue: Delaware
Fiscal Year 1997 – Fiscal Year 2004 (Notes 1 and 2)

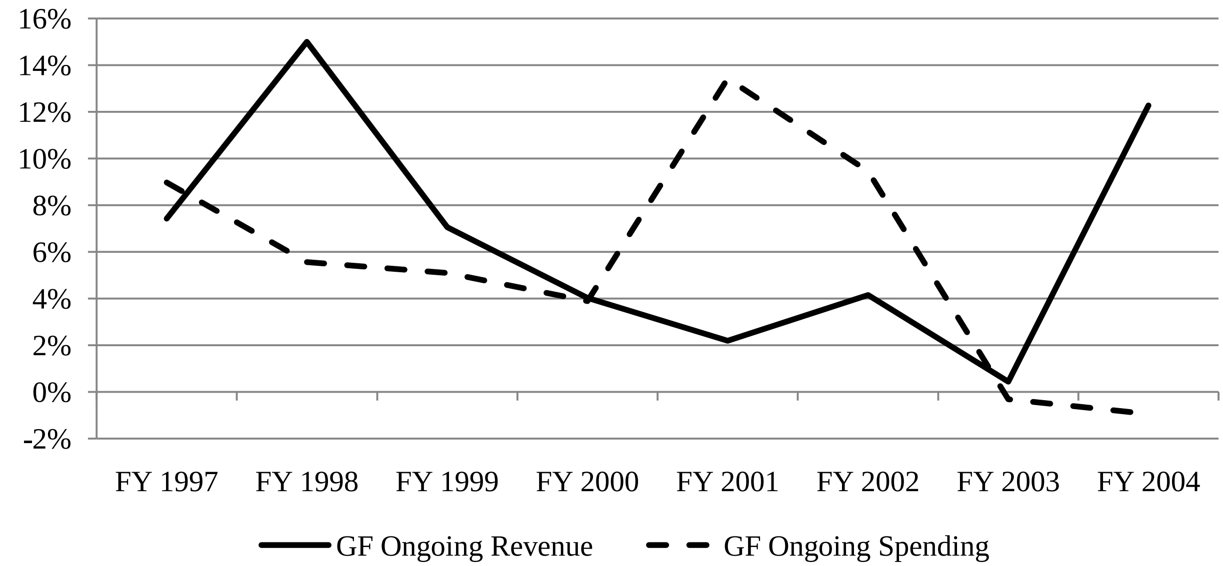


Figure Notes
Note 1: Sources: Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1994 - 1997); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1998 - 2001); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 2002 - F.Y. 2005); David Gregor email to author, November 17, 2009 with attached files providing Delaware's closing Financial Reports for fiscal year 1997 through fiscal year 2004 "FY97 Final Accounting Report0001.pdf", "FY98 Final Accounting Report0001.pdf", "FY99 Final Accounting Report0001.pdf", "FY00 Final Accounting Report0001.pdf", "FY01 Final Accounting Report0001.pdf", "FY02 Final Accounting Report0001.pdf", "FY03 Final Accounting Report0001.pdf", "FY04 Final Accounting Report0001.pdf.
Note 2: Calculation of annual percent change in general fund operating spending and general fund revenue was prepared by the author.

PAYGO Capital Trends

After the strong revenue growth in the 1997 to 1999 period, shown in Figure 4.16, Delaware appropriated a large portion of the surplus revenue in one-time PAYGO capital. Funding for PAYGO grew from $50 million in 1997 to over $250 million in fiscal year 1999 and fiscal year 2000, as seen in **Figure 4.17**. As a percent of combined PAYGO and operating spending, appropriations for PAYGO increased from 3% in fiscal year 1997 to a peak of 16% in fiscal year 2000 before dropping to 11% of the combined budget in fiscal year 2001.

Figure 4.17
General Fund PAYGO Capital Spending: Delaware
Fiscal Year 1997 – Fiscal Year 2001 (Note 1)
($ in Millions)

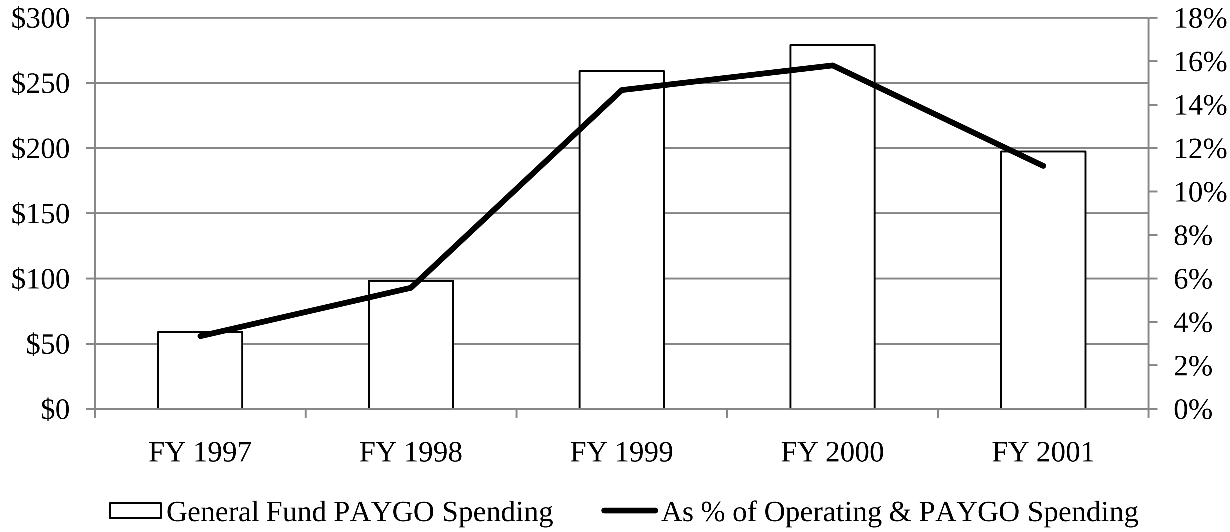


Figure Notes
Note 1: Source: Delaware.gov Capital Budget Authorizations by Funding Source.

Cash Balances

***General Fund Balance* – Figure 4.18** displays the amount of general fund balance at the end of each fiscal year from 1997 to fiscal year 2004 in Delaware and also includes the level of balance as a percent of general fund operating spending. General fund balances reached nearly $250 million at the close of fiscal year 1999; over 12% of ongoing general fund spending. The amount of cash fell sharply in 2000 and 2001 due in part to tax reductions and lower revenue growth. Because of the dynamics of Delaware's spending limit, a portion of revenue is always maintained in general fund balance.

Figure 4.18
Ending General Fund Balance: Delaware
As a Percent of General Fund Operations
Fiscal Year 1997 – Fiscal Year 2004 (Note 1 and Note 2)
($ in Millions)

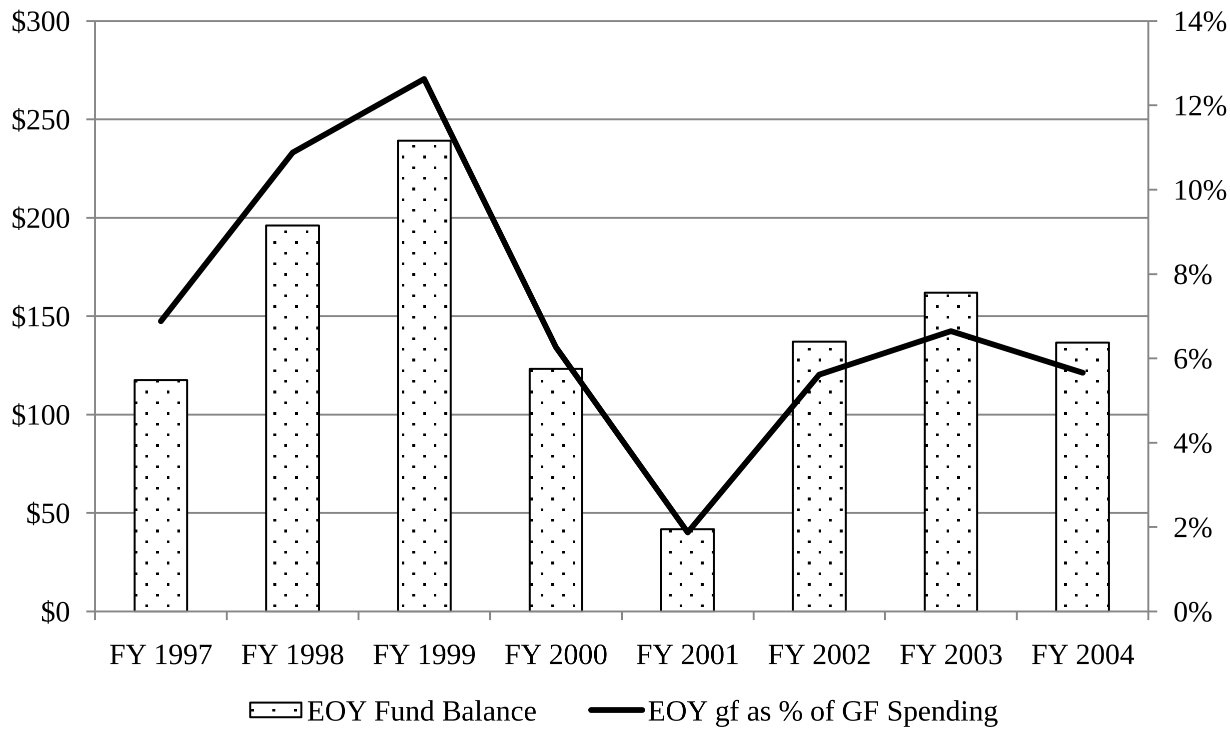


Figure Notes
Note 1: Sources: Todd Haggerty email to author, August 20, 2009 with attached file "DE, MD, VA general fund data (FY 1996 to FY 2005).xls"; Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1994 - 1997); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1998 - 2001); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 2002 - F.Y. 2005).
Note 2: Calculation of general fund balances as a percent of general fund operations was prepared by the author.

***Reserve Fund Activity* – Table 4.13** shows the balances in the Budget Reserve Account in Delaware from 1997 to 2004. Each year at closeout an amount equivalent to 5% of revenues is maintained in reserve. As noted by the interview participants, no balances from reserves had been used since its inception.

Table 4.13
Rainy Day Fund Activity: Delaware
Fiscal Year 1997 – Fiscal Year 2004 (Note 1)
($ in Millions)

	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004
Beginning Balance	**$92.9**	**$100.9**	**$114.1**	**$119.8**	**$126.2**	**$128.0**	**$128.9**	**$136.5**
Revenue Deduction	8.0	13.2	5.7	6.4	1.8	0.9	7.6	11.7
Ending Balance	**$100.9**	**$114.1**	**$119.8**	**$126.2**	**$128.0**	**$128.9**	**$136.5**	**$148.2**

Table Notes
Note 1: Source: Michael Morton email to author, September 29, 2009.

Figure 4.19 demonstrates that the Rainy Day Fund balance continued to grow over the study period, from about $100 million in fiscal year 1997 to about $150 million by fiscal year 2004. Although Delaware maintains 5% of revenues in reserve, as compared to spending the balances equate to roughly 6% of the operating budget.

Figure 4.19
Rainy Day Fund: Delaware
Balance as a Percent of General Fund Operations
Fiscal Year 1997 – Fiscal Year 2004 (Note 1)
($ in Millions)

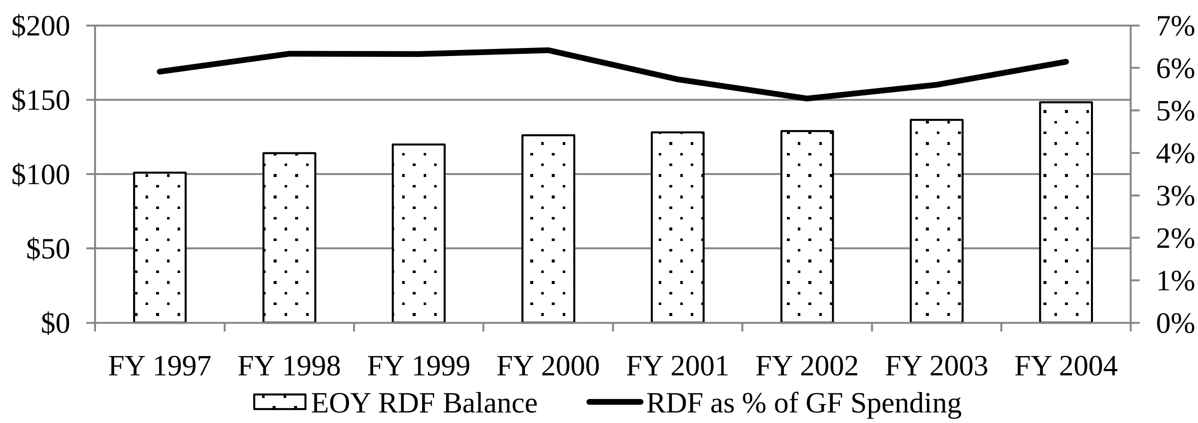


Figure Notes
Note 1: Sources: Michael Morton email to author, September 29, 2009”; Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1994 - 1997); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1998 - 2001); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 2002 - F.Y. 2005).

The total combined cash in the general fund balance and Budget Reserve Account is shown in **Figure 4.20**. Combined cash grew in excess of $350 million in fiscal year 1999, or 19% of the operating budget. As discussed by the interviewees, significant amounts of these surplus revenues were spent for one-time PAYGO and other purposes, and income tax reductions were adopted in multiple years. The combined balances were drawn down in fiscal year 2000 and fiscal year 2001, before increasing moderately in the fiscal year 2002 to fiscal year 2004 period. Revenue growth remained positive following the recession and Delaware's spending limit maintained its cash balances.

Figure 4.20
Total Available Cash: Delaware
Rainy Day Fund and General Fund Balance
As a % of General Fund Operations
Fiscal Year 1997 – Fiscal Year 2004 (Note 1)
($ in Millions)

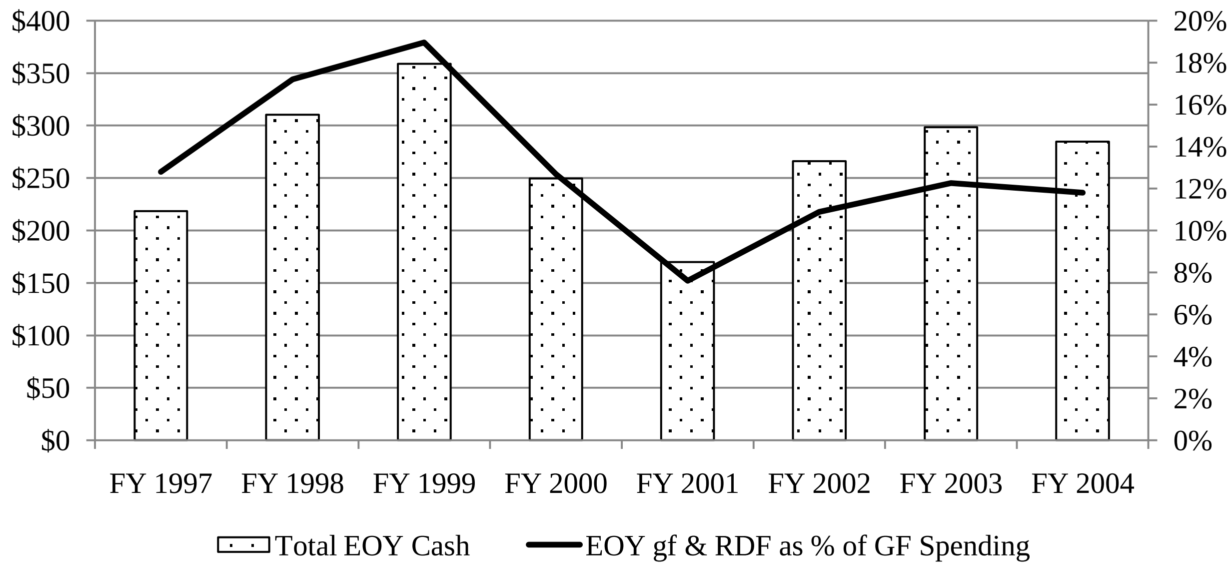


Figure Notes
Note 1: Sources: Michael Morton email to author, September 29, 2009"; Todd Haggerty email to author, August 20, 2009 with attached file "DE, MD, VA general fund data (FY 1996 to FY 2005).xls"; Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1994 - 1997); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1998 - 2001); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 2002 - F.Y. 2005).

Fiscal Stress

In the 2002-2004 post-recessionary period, Delaware experienced fiscal stress of approximately 4% in fiscal year 2002 increasing to about 12% in fiscal year 2004, as shown in **Figure 4.21**. The majority of this, particularly in fiscal year 2003 and fiscal year 2004, is due to estimated budget reductions from the trend. In fiscal year 2004, there was also an increase of about $130 million in new tax and fee revenues, chiefly tied to an increase in the corporate franchise tax (Rafool 2004, 17). Federal aid that supplanted general fund spending and transfers reported to NCSL in its annual budget survey round out the remaining amounts.

Figure 4.21
Fiscal Stress as a Percent of Ongoing General Fund Spending: Delaware
Fiscal Year 2002 – Fiscal Year 2004 (Note 1)

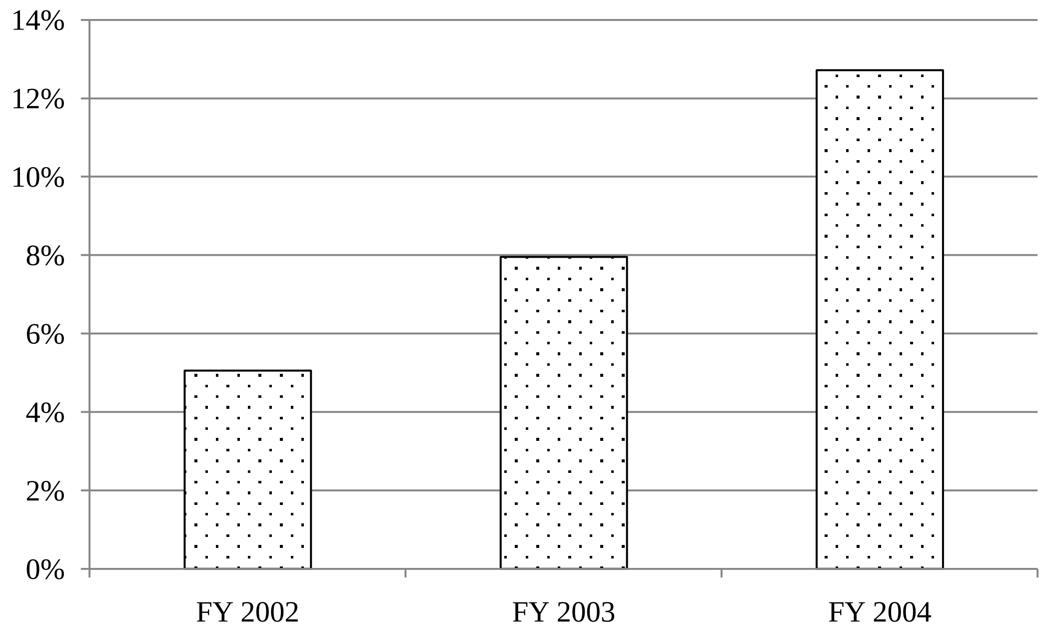


Figure Notes
Note 1: Sources: Rafool 2003, 17; Rafool 2004, 17; Federal Fund Information for States 2004, 5; Todd Haggerty email to author, August 20, 2009 with attached file "DE, MD, VA general fund data (FY 1996 to FY 2005).xls"; .Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1994 - 1997); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1998 - 2001); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 2002 - F.Y. 2005).

Case Data Integration

Table 4.14 summarizes the combined responses of the three interviews for Delaware and integrates the quantitative data to assist in the interpretation of the qualitative responses:

Table 4.14
Delaware Case Study
Integration of Qualitative and Quantitative Data

Category	Interview Responses	Data
Late 1990s actions	The three interviewees cited multiple years of income tax reductions as one of the features of the late 1990s in Delaware. A portion of surplus funds were set aside in reserve as required. Spending initiatives were adopted, notably for Medicaid, higher education, and K-12 education. It was also noted by all three interviewees that there was specific one-time agency spending so as to not increase the spending base, and a significant amount of surplus funding was spent on one-time PAYGO capital.	Numerous revenue actions adopted which affected the income tax base by a cumulative $250 million by fiscal year 2004, including tax rate reductions and pension exclusions. The Rainy Day Fund balance grew to $128 million in part due to automatic appropriation provisions at closeout but is capped at 5% of revenues. Combined cash balances grew to over $350 million by fiscal year 1999; equal to over 18% of the operating budget. General fund spending increased from a low of 4% in fiscal year 2000 to highs of 13% in fiscal year 2001 and 9.5% in fiscal year 2002. Mandated spending for K-12 education and Medicaid grew from 58% to 67% of general fund spending from 1996 to 2004.
Budgetary processes that limit spending	Two of the participants indicated that Delaware had discussed more restrictive tax and expenditure limitation measures, such as used by Colorado which limits spending growth to inflation and population, but that no measure had been passed. One interviewee also stated that the Governor made administrative decisions in the late 1990s to not spend to the full 98%, instead putting more funds into PAYGO.	Delaware's constitutional tax and expenditure limit holds spending growth to 98% of available combined projected revenues and unencumbered cash balances. Rainy Day Fund balances grew from about $101 million to $128 million, equal to about 6% of the operating budget. One-time PAYGO spending also increased from about $50 million in 1997 to over $250 million in 2000 (from 3%

Category	Interview Responses	Data
	Apart from the 98% limit the state has a balanced budget requirement. Administrative decisions made to spend on one-time purposes such as PAYGO. Legislation to enact tax cuts was viewed by one of the interviews as a process to reduce revenue so that it cannot be spent.	in 1997 to about 16% in 2000 of the combined operating/PAYGO budget). Politically Democrats held the Governor's office and the Senate, while Republicans controlled the House throughout the study period.
Reserve funds	All of the participants stated that Rainy Day Fund balances had never been accessed since inception, before or after any recession. Part of the reason for this was concern over maintaining the state's "AAA" bond rating from all three credit rating agencies.	Delaware's Rainy Day Fund was never accessed since its inception in the late 1970s.
Pre-recession effect of tax and expenditure limitations	When asked if tax and expenditure limitations had constrained spending growth in the late 1990s, all interviewees affirmed the benefits of Delaware's 98% limit. The state maintained a 2% balance, more revenue was used for one-time purposes, and there were fewer supplemental budgets.	Operating budget spending on average grew 6.9% per year between 1997 and 2001. Operating spending as a percent of personal income ranged from 8% to 8.7%.
Post-Recession Budget Balancing Actions/Fiscal Stress	All interviewees noted that there were spending cuts including a hiring freeze. There were no layoffs and no mid-year reductions to K-12 education programs. A formal decision was made that the shortfall would be addressed by 1/2 spending reductions and 1/2 revenue enhancements. There were also transfers of non-general funds but the Rainy Day Fund was never tapped. After the 2001 recession, it was also unanimously thought that the 98% limit had better positioned the state to adopt fewer budget balancing actions, which always have to be put into place to some extent after a recession. One participant thought that the shortfall after the recession would have been much higher had growth not been limited.	Fiscal stress for the Delaware budget increased from about 4% in fiscal year 2002 to 12% in fiscal year 2004. Largest actions included estimated reductions from the pre-recession trend, and new tax and fee revenues.

Category	Interview Responses	Data
	When queried about the optimal type of tax and expenditure limit (formal legal, non-binding, or no limit), all three cited Delaware's constitutional 98% limit on revenues as the optimal approach. They all thought it limited spending in good times, is easy to calculate, and provides flexibility to use the remaining 2% in emergencies. There was no consensus on a non-binding limit, with some viewing it as an ineffective approach and some believing that such an approach could work in Delaware given its conservative fiscal outlook. But the 98% was still viewed as a cleaner approach. None of the interviewees favored having no limit in place. It was thought that Delaware would continue its conservative approach by directing surplus cash to one-time purposes such as PAYGO. Consideration might also be given to identifying volatile large one-time revenue sources, such as escheat, and using that revenue for long-term liabilities instead of using it to support the operating budget.	

Case No. 3 – Virginia

Legal Framework

Budgetary Processes

The state of Virginia operates with a biennial budget. In even numbered years, the Governor submits a budget proposal by December 20. The legislature is required to hold budget hearings at different locations throughout the state and acts on the budget to increase or decrease appropriations when first considered and then at each of the subsequent two legislative sessions. (Virginia General Assembly Joint Legislative Audit and Review Commission 2009, ii).

When the proposed biennial budget is first submitted, Virginia holds a 60-day session, and in odd years, a 30-day session is held. In both instances, the session may be extended by up to 30 days (Virginia General Assembly Sessions 2009). Having the ability to modify the budget in multiple years distinguishes Virginia from other states having biennial budgets where the budget is not changed once enacted (Virginia General Assembly Joint Legislative Audit and Review Commission 2009, ii).

Tax and Expenditure Limitations

Virginia has no tax and expenditure limitations in effect.

Reserve Fund

***Establishment and Structure* –** Virginia established a Revenue Stabilization Fund (a.k.a. Rainy Day Fund) by constitutional amendment in 1992, effective January 1, 1993 (Hou 2004, 64; Virginia General Assembly Legislative Information System Constitution of Virginia, 27). The fund is capped at 10% of the average of the revenue from the sales and corporate and personal income taxes for the preceding three years. Amounts in the fund above 10% are transferred to the general fund balance (Virginia General Assembly Legislative Information System Constitution of Virginia, 27).

***Deposits* –** Appropriations to the fund are governed by constitutional provisions and additional statutory requirements that were enacted in 2003. Under the constitutional formula, the percentage increase in revenue from the sales and personal and corporate income taxes for the most recently completed fiscal year is compared with the average annual increase for the preceding six fiscal years and 50% of the difference must be appropriated to the fund in the next proposed budget (*i.e.*, in the second fiscal year subsequent to the most recently closed fiscal year). Exemptions are allowed for revenue realized from tax rate increases or additional revenue from the repeal of tax exemptions, for up to a six-year period (Virginia General Assembly Legislative Information System Constitution of Virginia, 27; Virginia General Assembly Legislative Information System Chapter 759 2003, 1).

The statutory formula goes into effect when the sales and personal and corporate income tax revenue for the most recently completed fiscal year is at least 8% greater than the prior fiscal year and is 1½ times greater than the average annual percentage increase over the prior six fiscal years. If these conditions hold true, then another 25% of the difference between the actual revenue increase over the six-year average revenue increase is to be deposited. Mathematically, this equates to 1/2 of the constitutionally mandated deposit, and it is deposited a year earlier. However, projected revenues for the next fiscal year must also be 5% greater than the actual general fund revenue from the most recently completed fiscal year (Virginia General Assembly Legislative Information System Chapter 759, 1).

Withdrawal Requirements – Use of the Rainy Day Fund balance is strictly limited in the state constitution. Funds cannot be accessed unless total general fund appropriations in the current fiscal year exceed the revised total general fund revenue estimate by more than 2% of the actual sales and personal and corporate income tax revenue for the most recently completed fiscal year. If this condition is met, however, use of the balance is limited to the lesser of 1/2 of the budget shortfall or 1/2 of the Rainy Day Fund balance (Virginia General Assembly Legislative Information System Constitution of Virginia, 27).

Mandated Spending

Virginia does not presently prepare a report on general fund spending mandates; however, staff with the Virginia Department of Education and the Virginia Department of

Medical Assistance Services, were able to supply spending information for Medicaid and K-12 education – two of the largest mandated spending programs.

Figure 4.22 illustrates general fund mandated spending for K-12 education and Medicaid in fiscal year 1996 relative to fiscal year 2004 actual outlays. Overall, these two programs remained at about 47% of the general fund budget in Virginia. In the aggregate, they grew from $3.6 billion to $5.8 billion. On average, this resulted in a rate of growth of 6.2%. Medicaid grew at the fastest rate; about 7.2% annually from fiscal year 1996 to fiscal year 2004, while K-12 grew at 5.8% annually.

Figure 4.22
Mandated Appropriations: Virginia
Percent of General Fund Budget Spent on Medicaid and K-12
Fiscal Year 1996 vs. Fiscal Year 2004 (Note 1)

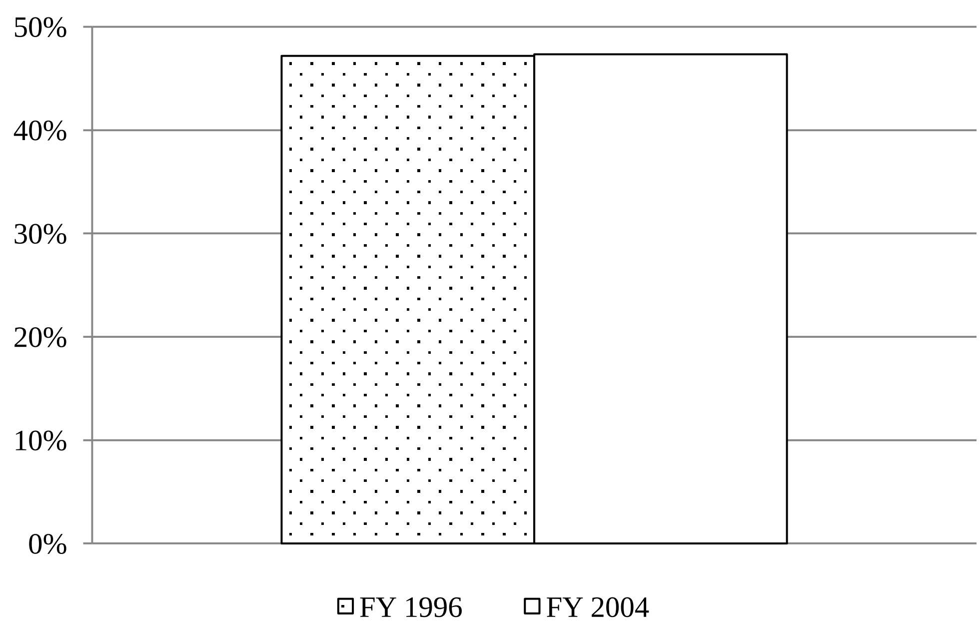


Figure Notes
Note 1: Sources: Joe Flores, email message to author, December 14, 2009; Sara Tatum, email message to author, December 23, 2009.

Political Demographics

As **Table 4.15** demonstrates, Virginia had Republican Governors until 2002 after which a Democratic Governor was elected. In the House, Democrats had an edge in party control until 2000 after which Republicans secured a majority. The parties were split in the Senate in 1996 before Republicans assumed control in 1998 through the 2002 election. Further discussion of the role of political demographics relating to revenue and spending trends is included in Chapter V.

Table 4.15
Gubernatorial and Legislative Political Party Distribution: Virginia
1996-2002 (Note 1)

	House		**Senate**		**Governor**
	# Democrat	**# Republican**	**# Democrat**	**# Republican**	**Party**
1996	52	48	20	20	R
1998	52	48	19	21	R
2000	47	53	18	22	R
2002	33	65	17	23	D

Table Notes
Note 1: Sources: NCSL "Legislative Party comp tables 96-02.xls"; Virginia.gov Governors of Virginia.

Qualitative Data

Interviews

Interviews were conducted with three individuals who played instrumental roles in shaping fiscal policy in Virginia during the growth period of the late 1990s. This includes a current Republican legislator with 28 years experience who serves on the Senate Finance Committee; a non-partisan former Director for the House Appropriations Committee from 1990 to 2000; and the former non-partisan Deputy Budget Director and Budget Director for the executive branch spanning the 1990s and 2000s.

Interview No. 7

State Fiscal Actions in the Late 1990s – The interviewee noted that strong revenue growth resulted in large deposits to the Rainy Day Fund based on constitutional requirements. Statutory requirements were later adopted in 2001 that accelerated deposits under certain conditions of higher surpluses. Even after the 2001 recession, deposits had to be made in accordance with legal provisions based on prior year activity.

Numerous tax credits were adopted, with three of the largest being provided for land preservation, historic rehabilitation, and the car tax (which is really a State expenditure to subsidize local governments for the local revenue loss from the amount formerly paid by taxpayers). The car tax ended up costing far more than estimated and was eventually capped at $950 million, it was noted. Other smaller tax actions were provided for the coal industry, military pay exclusions, repeal of the sales tax on food, and changes in the corporate income tax.

The participant explained that spending initiatives were funded during this period, including K-12 education spending to reduce class sizes, school construction, diverting lottery revenues for local education (which then required additional State funds to satisfy education funding requirements), mental health services, higher education support, and additional PAYGO capital spending.

Efforts to Limit Growth During Good Times – There has been legislation in some years to impose formal tax and expenditure limits but nothing passed. There is a limit on the level of debt service at 5% of revenues, and the interviewee opined that the requirement to distribute a portion of surplus revenue to the Rainy Day Fund acts as a limit by reducing available revenue that could be spent. Mandated spending for high growth expenditures like K-12 education and

Medicaid were also characterized in this interview as a limit on spending in the sense that these mandated costs crowded out spending for other purposes.

***Use of Reserve Fund Balance in Good Times* –** No reserve funds had been accessed prior to the recession because, as was noted in the interview, the legal requirements for when balances may be accessed are very prescriptive. Access to the Rainy Day Fund balance may only occur when there are large deficits, and only then can 1/2 of the balance be used toward deficit reduction.

***Actions Taken Following the 2001 Recession* –** Rainy Day Fund balances were used to their prescribed limits in 2003 and more was intended to be used in 2004 but the economy began to improve and additional federal aid was received. Taxes were not increased but some fees were raised. There is also a fund that is applied to public school construction, but in times of economic downturn, the funds have been used to supplant state contributions toward teacher retirement costs.

The interviewee also stated that dedicated transportation revenues had been diverted to the general fund for one year and the cash was replaced with debt. There were also diversions of non-general funds to the general fund. Actuarial assumptions were modified, and there was an assumption that some dormant retirement accounts might never be claimed. Later, however, it turned out that the dormant accounts were claimed, so the retirement system ended up being under funded.

On the spending side, there were across-the-board cuts, a prison was closed, and cuts were implemented in the higher education area. Medicaid and K-12 educational programs were generally protected. Finally, a one-time retroactive Medicaid charge to the federal government also helped provide some additional revenue.

***Prospective Fiscal Policy Modifications* –** The interview participant thought that prior over exuberance in enacting tax cuts and credits had made it less likely that such actions would be adopted in the future. There may be attempts to constrain mandated spending drivers. Based on reductions to employee salaries and higher education, the interviewee thought that some additional future spending might be targeted to those areas. There may also be an attempt to direct surplus general funds to one-time PAYGO capital in the transportation area.

***Effect of Tax and Expenditure Limitations* –** With respect to actions to constrain spending growth in the late 1990s, Virginia has no spending limits in place. The interviewee explained that the revenue structure cannot take in more than is needed to operate the budget. Mandated spending grew and crowded out other spending. After the recession of 2001, revenues fell, and for states that are heavily reliant on income and sales taxes, hard decisions will always have to be made.

When asked which type of process might be preferred, including no limit, a non-binding limit, or a formal legal limit, this interviewee thought that either a non-binding limit or no limit might be the best. It was felt that formal legal limits can have unintended consequences, either by limiting flexibility to meet unforeseen spending demands or to make it more difficult to manage a state's finances. It was also noted that well managed states, as evidenced by earning a "AAA" bond rating, have a demonstrated track record of good management and should not need to have constitutional limits imposed.

Interview No. 8

***State Fiscal Actions in the Late 1990s* –** Virginia established a reserve fund after the recession of the early 1990s, with automatic deposits based on actual collections in the major revenue sources relative to the average growth rate over the last six years. The state enacted a number of sales tax exemptions, with the largest being a phased-in reduction in the local personal property tax on automobiles. It shows up as a state expenditure. It was originally thought to cost $650 million, but it grew more and was eventually capped at $950 million. The interviewee noted that Virginia had abolished parole in the mid-1990s, which required more prisons. Spending increases were provided for K-12 education, and there was a higher education tuition freeze.

Efforts to Limit Growth During Good Times – The interviewee noted that "There were proposals from time to time, none of which ever got passed by the General Assembly." Spending is controlled by the General Assembly. Virginia is fairly conservative in terms of tax burdens as well as spending per capita. There is also a balanced budget requirement, and a self imposed limitation on debt service of 5% of tax supported revenue. Department heads are also liable for either running a deficit or over obligating spending that may cause a future deficit. This is a statutory requirement in the appropriations act.

Use of Reserve Fund Balances in Good Times – The reserve fund cannot be accessed in good times, so it was not used prior to 2001. If there is a shortfall from an enacted budget greater than 2% of the major revenue sources collected in the prior fiscal year, then the Governor can recommend withdrawing the lesser of 1/2 of the fund balance or 1/2 of the shortfall. So it requires other budget balancing actions.

Actions Taken Following the 2001 Recession – The interview participant indicated that budget balancing actions included agency budget cuts, transfers from the reserve fund balance as well as from non-general funds, and some revenue enhancements. A portion of an automobile rental tax which had been dedicated was permanently distributed to the general fund.

Prospective Fiscal Policy Modifications – "[T]he candidate running for Governor is saying rather than 10% that [the Rainy Day Fund balance requirement] ought to be 15%."

However, the interviewee emphasized that under current law the balance will be built up quickly through any surplus revenue growth in the future. Additional provisions stipulate that surplus funds go into one-time capital projects such as water quality, waste water, or transportation. These mechanisms will address the future use of surplus funds.

Effect of Tax and Expenditure Limitations – Virginia's growth in the late 1990s was probably greater, driven by technology growth, defense, and the federal government. Economic differences are at play. The biggest initiatives were parole abolition and the car tax. Apart from those, the interviewee stated that "Virginia…doesn't have a big history of really big time spending even in…times of economic growth." Had the growth in the good times had an effect on the extent of budget balancing actions after the 2001 recession? The participant felt that "maybe on the margins that's probably true," but that a lot of surplus revenue was automatically removed from being available for spending by being diverted to the reserve fund. "So", they noted "while we don't explicitly have…expenditure limitations…we indirectly get there through…another means."

When asked which type of tax and expenditure limitation might be preferred (formal legal, non-binding, or no limit), the interviewee thought that no limit was best. "I think that's what legislators are elected to do." The concern over limitations is that it was felt that no matter how they are constructed they cannot be "a good substitute for good judgment." So maybe more formal limits are needed where "you don't have a…faith in good judgment." However, it was felt that was not part of the culture in Virginia and so no limit was preferred.

Interview No. 9

State Fiscal Actions in the Late 1990s – The interviewee noted that Virginia had undertaken a series of steps to successfully attract businesses and high paying jobs. This included adoption of tax credits, such as the major facilities tax credit, to encourage business expansion. In their words, Virginia "used tax policy very effectively to influence…corporate behavior." As a result, general fund revenue growth during this period was characterized as being very strong. There is also a statutory requirement to put surplus funds into reserve, resulting in a balance in the Rainy Day Fund of more than $1.5 billion.

Efforts to Limit Growth During Good Times – One of the limits on growth mentioned by the interview participant was the level of revenue in conjunction with a balanced budget requirement. It was noted that "The way Virginia budgets…whatever revenues come in the question is where do you spend it? There's not much science to it other than spend what you have available." As noted, surplus revenues were also put into reserve, and additional infrastructure spending with PAYGO instead of debt.

Use of Reserve Fund Balances in Good Times – The Rainy Day Funds cannot be accessed except "when there is a measurable decline in revenues." Funds are set aside automatically based on formulas in statute. There is a lag between the actual surplus and when the appropriation is made, which as the interviewee noted "[e]ven in declining years we have to make deposits." Funds set aside in reserve are used counter cyclically, to provide a source of revenue to support the budget following economic downturn. The participant stated that "It's to allow us to meet the commitments we've made in advance in tough years. And then we rebuild it again."

Actions Taken Following the 2001 Recession – Asked about the measures adopted by Virginia following the recession, the interviewee noted that actions adopted included spending cuts, transfers from reserves and non-general fund balances, and new revenues. However, the state also continued to adopt actions "to work towards maintaining and improving our relationship with business." Examples of these actions included a Governor's Opportunity Fund to provide business incentives, eliminating the death tax, continuing investments in schools and higher education, and using public-private partnerships. A major revenue package was adopted to increase the sales tax rate, but this was offset slightly by reducing the sales tax on food and the income tax on elderly taxpayers earning below $60,000. The entire package raised $750 million. One result of the budget balancing actions was the delay in setting aside funds for liabilities like other post employment benefits, or the pension system being slightly under funded.

***Prospective Fiscal Policy Modifications* –** The use of surplus funds ought to be dedicated to off balance sheet liabilities like other post employment benefits and ensuring that the pension system was fully funded. Other actions could entail defeasing debt and using cash for infrastructure.

Effect of Tax and Expenditure Limitations – While Virginia has no formal spending limit, spending is limited to a certain extent by the following: First, constitutional and statutory provisions require that a portion of surplus revenues be set aside in a Rainy Day Fund. Secondly debt service cannot exceed 5% of tax supported revenues. Finally, the state cannot spend more revenue than it receives. The reserve fund requirement effectively works as a spending limit. Had a more restrictive tax and expenditure limit been in place, it would have handcuffed the state's ability to meet needs. For example, the interviewee thought a limit "may have…limited the substantial expansion we made in K-12." The investments that the state made in education attracted people to Virginia.

Asked the preferred type of limit (formal legal, non-binding, or no limit) the interviewee thought that Virginia's system worked best. A formal legal limit was thought to impose limits that would impede the state from addressing unforeseen needs. There also did not seem to be much difference between having no limit compared with a non-binding one. Ultimately, it was thought that accountability exists between the elected representatives and the voters. The interviewee stated that “I prefer our system which means 140 representatives of the people look at the needs of public policy and all of the pieces of the budget puzzle and make those decisions.”

Quantitative Data

Revenue Actions

At the peak of the economic boom in the late 1990s, Virginia enacted legislation at the 1998, 1999, and 2000 sessions that impacted general fund revenues through modification to the personal income tax, sales tax, corporate income tax, and the personal property tax on vehicles.

The largest item reported to NCSL was the phased state subsidy of the personal property tax on vehicles, which is a local tax. The state’s action provides a subsidy to local government in lieu of taxpayer revenue; however, it is listed in *State Tax Actions* as a tax relief measure (Zelio, Mackey, and Rafool 1999, 26; Rafool 2001, 43). Since the actual effect of the car tax subsidy appears in the operating budget, it is excluded from the revenue action discussion and is included in the discussion of operating spending trends.

Other large revenue reductions pertained to a reduction of the sales tax on food, changes to the corporate income tax, a variety of tax credits for businesses and technology investment, and a low income tax credit (Zelio, Mackey, and Rafool 1999, 25-26; Rafool 2000, 39; Rafool 2001, 42-43). **Figure 4.23** illustrates the estimated cumulative impact of legislation enacted at the 1998 through 2000 sessions which resulted in the loss of revenue. As shown, by fiscal year 2004 the effect was an aggregate loss of about $300 million.

Figure 4.23
State Tax Actions: Virginia
Cumulative General Fund Loss Due to Enacted Legislation
Fiscal Year 1999 – Fiscal Year 2004 (Note 1)
($ in Millions)

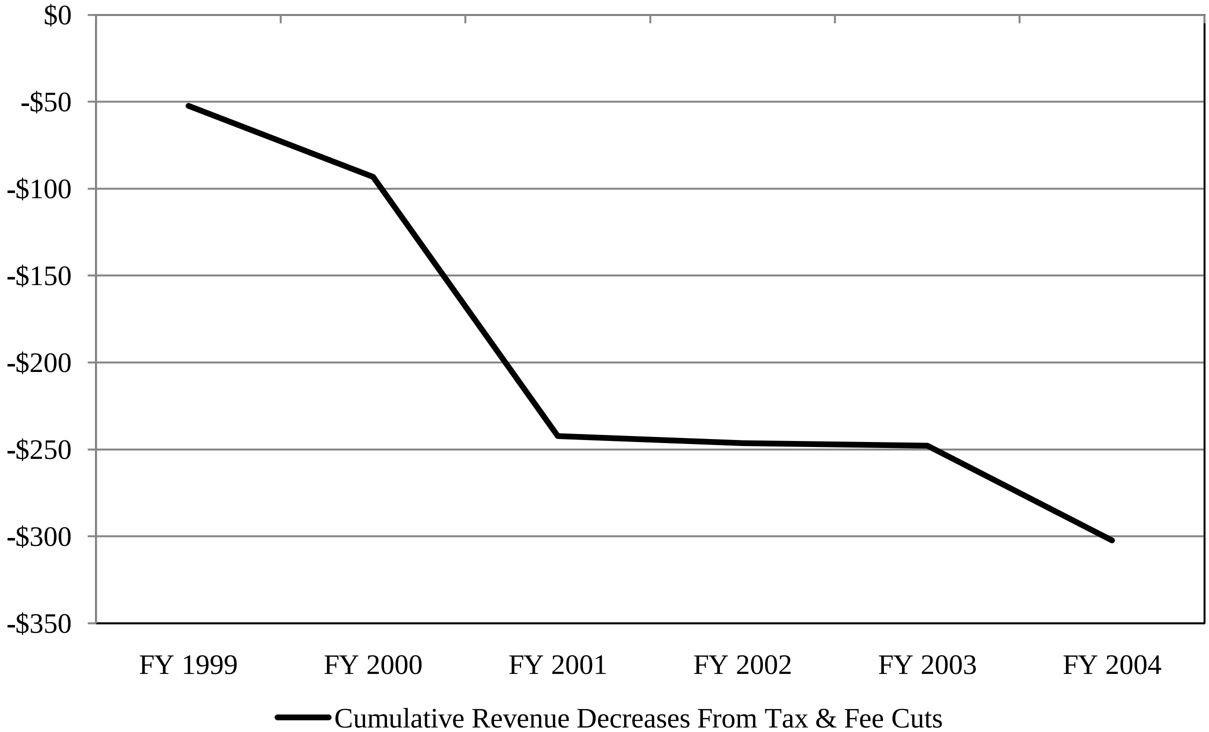


Figure Notes
Note 1: Sources: Mackey 1996, 30; Zelio 1997, 34; Zelio, Mackey, and Rafool 1999, 25-26; Rafool 2000, 38-39; Rafool 2001, 42-43; Rafool 2002,32; Rafool 2003, 30; Rafool 2004, 37-38.

Figure 4.24 shows the annual percentage change in personal income compared to general fund revenue. Between fiscal year 1997 and fiscal year 2000, personal income growth remained above 6% while general fund revenue grew above 8% each year. However, general fund revenue only grew 2% in fiscal year 2001 as the recession began and declined to negative 4% growth in fiscal year 2002. Personal income growth remained positive in the post-recession period due in part to growth in transfer payments.

Figure 4.24
Percent Change in General Fund Revenues and Personal Income: Virginia
Fiscal Year 1997 – Fiscal Year 2004 (Note 1)

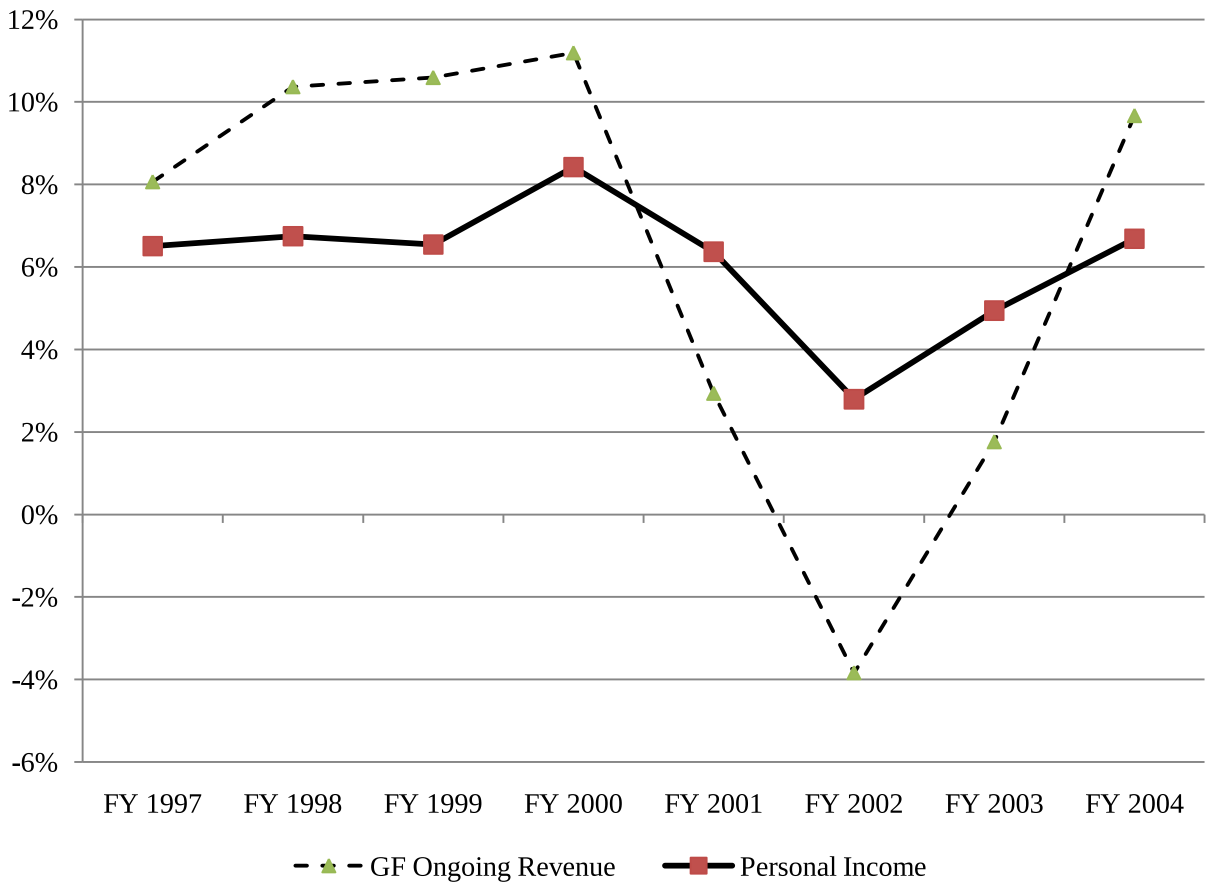


Figure Notes
Note 1: Sources: U.S. Department of Commerce Bureau of Economic Analysis State Annual Personal Income; Virginia Secretary of Finance 2009.

Operating Budget Trends

Table 4.16 provides actual general fund expenditure data for Virginia for the fiscal year 1997 through fiscal year 2004 period. Excluding one-time PAYGO and appropriations to the Rainy Day Fund, ongoing operations grew significantly during good economic times. On average, operating spending grew by 10.8% per year between fiscal year 1997 and fiscal year 2001. This large growth is mainly due to the car tax subsidy originally passed in 1998 and phased in over multiple years. By the 2002 biennium, the phase-in for vehicles valued at under $20,000 was to increase to 100% of assessed value, from 47.5%. The 2002-2004 budget included $1.4 billion for this purpose (Virginia General Assembly Summary of the 2000-2002 Budget 2000, O-12).

Table 4.16
General Fund Expenditures: Virginia
Fiscal Year 1997 – Fiscal Year 2004 (Note 1)
($ in Millions)

	FY 1997 Actual	**FY 1998 Actual**	**FY 1999 Actual**	**FY 2000 Actual**	**FY 2001 Actual**	**FY 2002 Actual**	**FY 2003 Actual**	**FY 2004 Actual**
Operations	$8,067.7	$8,657.2	$9,843.6	$10,899.3	$12,180.3	$11,826.7	$12,105.2	$12,283.2
PAYGO Capital	48.6	135.1	226.2	188.3	208.2	28.9	13.1	16.4
Reserves	66.6	58.3	123.8	194.1	103.3	187.1	-	87.0
	$8,183	**$8,851**	**$10,194**	**$11,282**	**$12,492**	**$12,043**	**$12,118**	**$12,387**
% Change Operations	6.3%	7.3%	13.7%	10.7%	11.8%	-2.9%	2.4%	1.5%

Table Notes
Note 1: Source: Bill Echelberger email to author, August 10, 2009 with attached file "Growth by Year to Chapter 781 (2009 Session) FY 06 Base.xls."

By the 2002-2004 budget, Virginia adopted actions to reduce spending for the car tax subsidy by limiting the amount to 70% of assessed value (Virginia General Assembly Summary of 2002-2004 budget 2002, O-4). As indicated by the case interviews, the cost of the program was greater than anticipated. Thus, at a 2004 special session the funding level provided by the state was capped at $950 million beginning with tax year 2006, by SB 5005 (Virginia General Assembly SB 5005).

Figure 4.25 demonstrates that ongoing general fund spending in Virginia grew as a percent of personal income from just above 4.4% in fiscal year 1997 to over 5% of personal income by fiscal year 2001. Personal income is a widely used proxy for growth in a states' economy.

Figure 4.25
General Fund Operating Expenditures as a Percent of Personal Income: Virginia
Fiscal Year 1997 – Fiscal Year 2001 (Note 1 and Note 2)

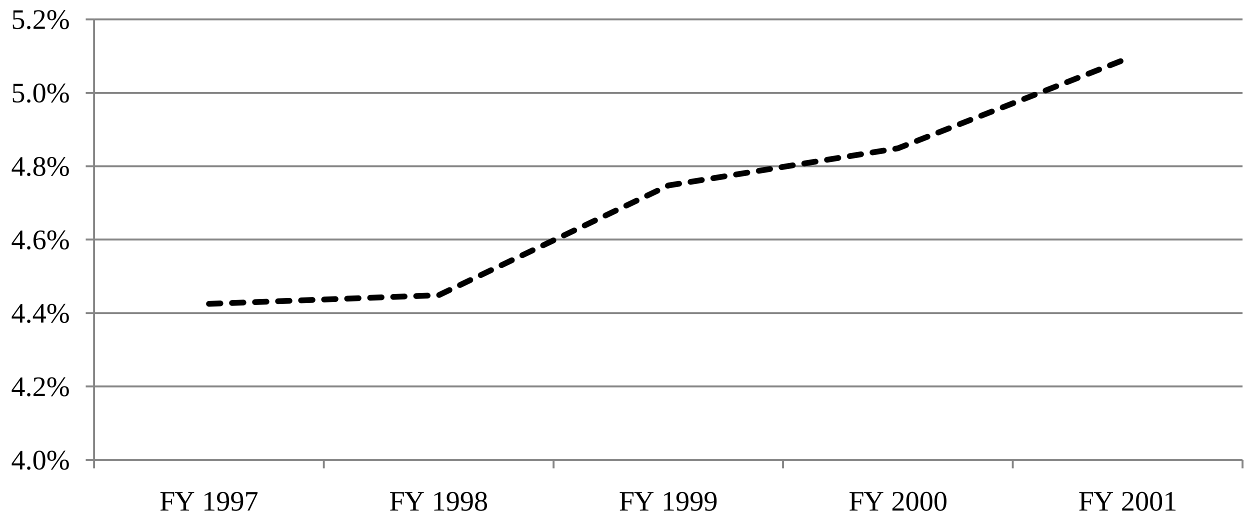


Figure Notes
Note 1: Sources: Bill Echelberger email to author, August 10, 2009 with attached file "Growth by Year to Chapter 781 (2009 Session) FY 06 Base.xls"; U.S. Department of Commerce Bureau of Economic Analysis State Annual Personal Income.
Note 2: Calculation of general fund operating spending as a percent of personal income was prepared by the author.

Finally, **Figure 4.26** shows the interplay between ongoing general fund revenues and spending during the study period. Based on the timing of information received by elected decisionmakers, there is a lag effect between actual revenue performance and the timing of budgetary decisionmaking. As shown, strong spending growth continued through fiscal year 2001. After revenue fell, adjustments were made to the spending program in fiscal year 2002. Revenue began to rebound in fiscal year 2004, but spending growth remained at a low level as the revenue growth was undoubtedly unanticipated in revenue forecasts used when the budget was approved.

Figure 4.26
Annual Percentage Change in General Fund Operating Expenditures and Ongoing General Fund Revenue: Virginia
Fiscal Year 1997 – Fiscal Year 2004 (Notes 1 and Note 2)

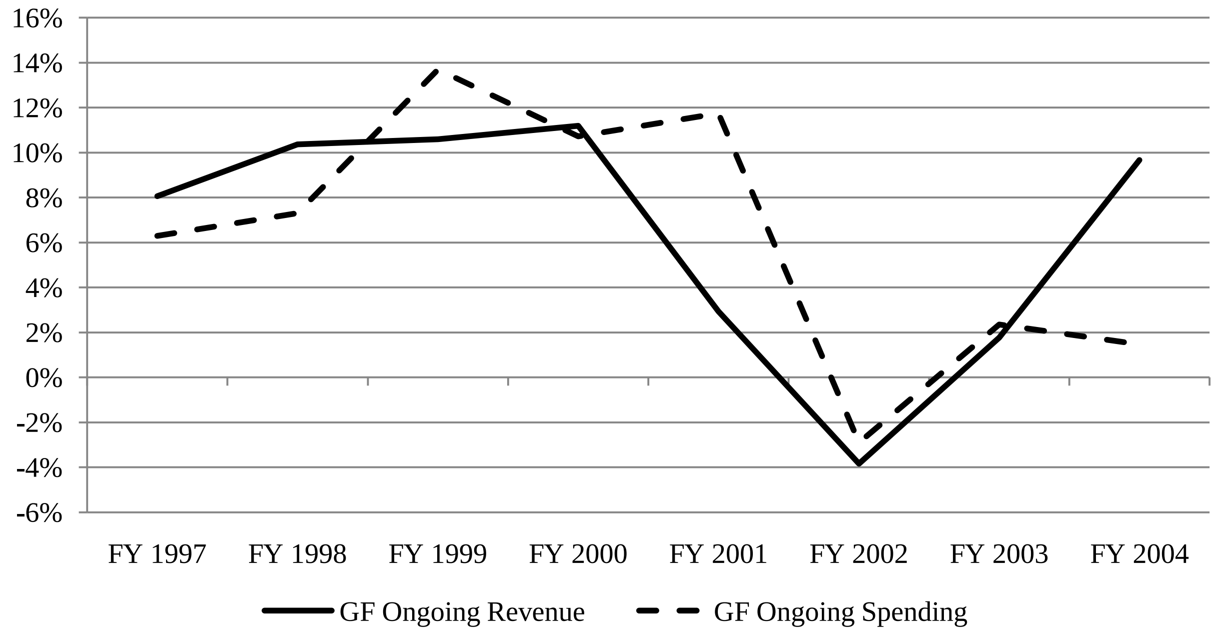


Figure Notes
Note 1: Sources: Bill Echelberger email to author, August 10, 2009 with attached file "Growth by Year to Chapter 781 (2009 Session) FY 06 Base.xls"; Virginia Secretary of Finance 2009.
Note 2: Calculation of annual percent change in general fund operating spending and general fund revenue was prepared by the author.

PAYGO Capital Trends

In addition to spending surplus revenues in the operating budget and transferring a portion of revenue to reserves, Virginia used surplus revenues for one-time PAYGO capital as shown in **Figure 4.27**. PAYGO spending grew from about $50 million in fiscal year 1997 to approximately $200 million in the fiscal year 1999 to fiscal year 2001 period. As a percent of combined PAYGO and operating spending, appropriations for PAYGO increased from 1% in fiscal year 1997 to about 2% in the fiscal year 1998 to fiscal year 2001 period.

Figure 4.27
General Fund PAYGO Capital Spending: Virginia
Fiscal Year 1997 – Fiscal Year 2001 (Note 1)
($ in Millions)

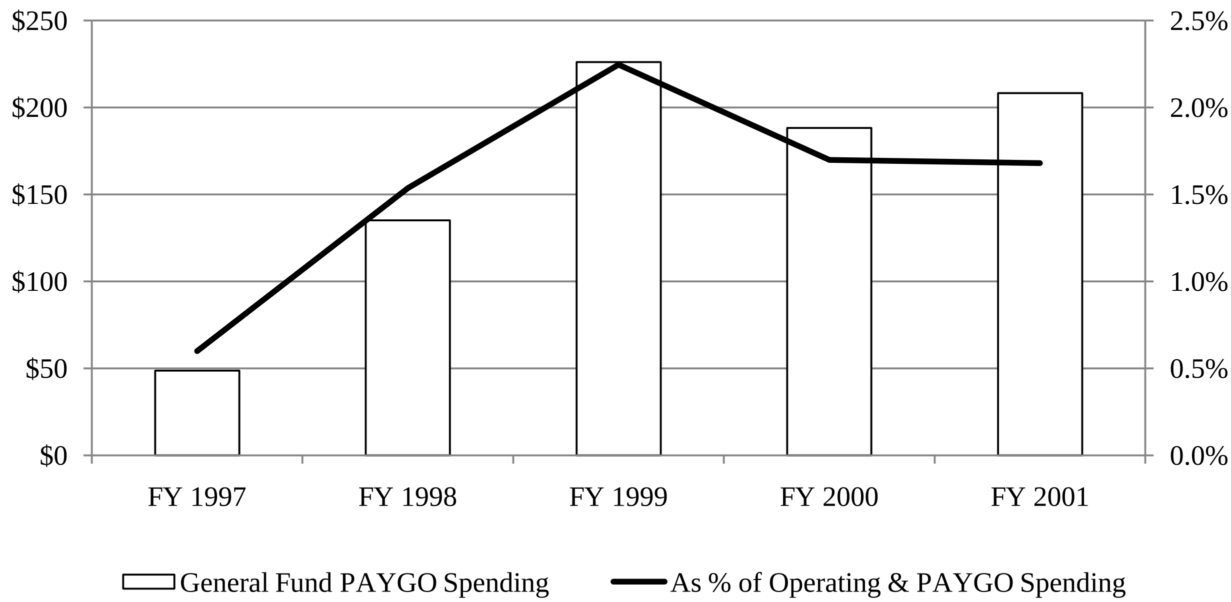


Figure Notes
Note 1: Source: Bill Echelberger email to author, August 10, 2009 with attached file "Growth by Year to Chapter 781 (2009 Session) FY 06 Base.xls".

Cash Balances

***General Fund Balance* – Figure 4.28** shows the amount of general fund balance at the end of each fiscal year from 1997 through 2004 in Virginia, and also shows the amount as a percent of general fund operating spending. General fund balances approached $500 million in fiscal year 1998 and fiscal year 1999, which equaled 6% and 5% of ongoing spending, respectively. The amount of cash was drawn down following the recession before increasing once the recovery began in fiscal year 2004.

Figure 4.28
Ending General Fund Balance: Virginia
As a Percent of General Fund Operations
Fiscal Year 1997 – Fiscal Year 2004 (Note 1 and Note 2)
($ in Millions)

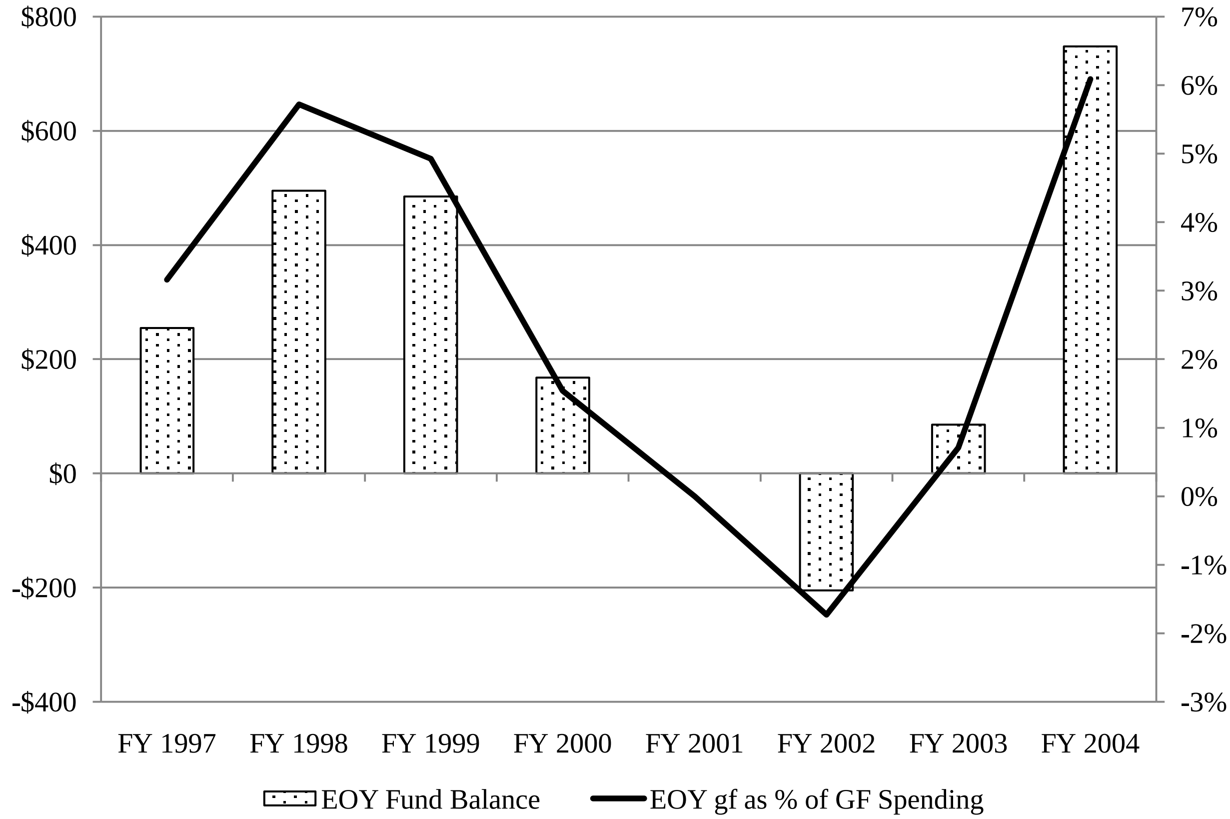


Figure Notes
Note 1: Sources: Bill Echelberger email to author, August 10, 2009 with attached file "Growth by Year to Chapter 781 (2009 Session) FY 06 Base.xls"; Todd Haggerty email to author, August 20, 2009 with attached file "DE, MD, VA general fund data (FY 1996 to FY 2005).xls".
Note 2: Calculation of general fund balances as a percent of general fund operations was prepared by the author.

***Reserve Fund Activity* – Table 4.17** contains Rainy Day Fund activity for Virginia from 1997 to 2004. As noted in the case interviews, appropriations were made to the fund in each year with the exception of fiscal year 2003. Because of the restrictive conditions on use of the balance, no funds were withdrawn for use during the economic boom years. Funds were withdrawn to address budgetary shortfalls in fiscal year 2002 and fiscal year 2003.

Table 4.17
Rainy Day Fund Activity: Virginia
Fiscal Year 1997 – Fiscal Year 2004 (Note 1)
($ in Millions)

	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004
Beginning Balance	**$85.0**	**$156.6**	**$224.3**	**$361.5**	**$574.6**	**$715.6**	**$472.4**	**$247.5**
Appropriation	66.6	58.3	123.8	194.1	103.3	187.1	0.0	87.0
Transfer to General Fund	0.0	0.0	0.0	0.0	0.0	-467.7	-247.5	0.0
Interest Earnings	5.0	9.4	13.4	19.0	37.7	37.4	22.6	5.6
Ending Balance	**$156.6**	**$224.3**	**$361.5**	**$574.6**	**$715.6**	**$472.4**	**$247.5**	**$340.1**

Table Notes
Note 1: Source: Becky Covey email to author, July 10, 2009 with attached file "RDF History for Senator Whipple1.xls".

Figure 4.29 shows the Rainy Day Fund balance as a percent of general fund ongoing spending. By fiscal year 2001, the fund's balance eclipsed $700 million and reached nearly 6% of ongoing operations before being drawn down to address the revenue shortfall.

Figure 4.29
Rainy Day Fund: Virginia
Balance as a Percent of General Fund Operations
Fiscal Year 1997 – Fiscal Year 2004 (Note 1 and Note 2)
($ in Millions)

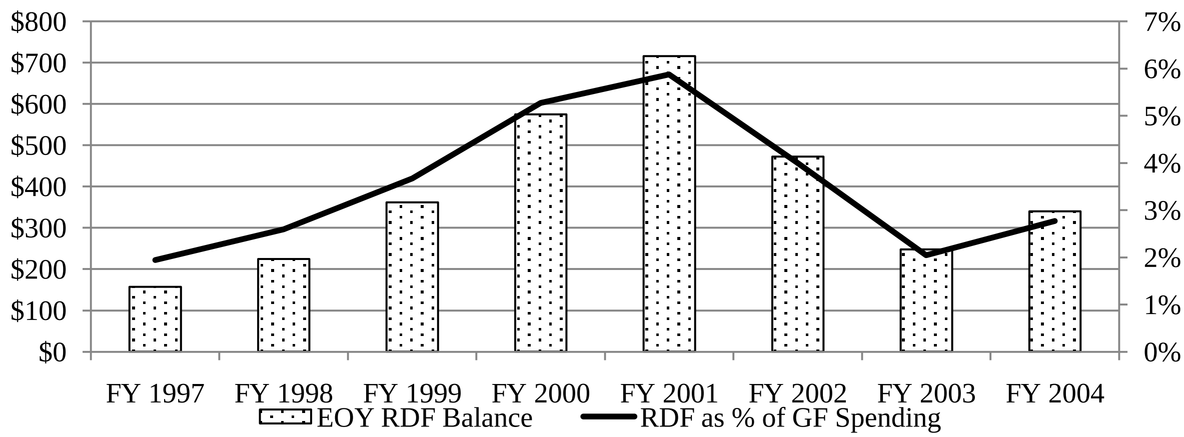


Figure Notes
Note 1: Sources: Becky Covey email to author, July 10, 2009 with attached file "RDF History for Senator Whipple1.xls"; Bill Echelberger email to author, August 10, 2009 with attached file "Growth by Year to Chapter 781 (2009 Session) FY 06 Base.xls".
Note 2: Calculation of Rainy Day Fund balances as a percent of general fund operations was prepared by the author.

The total combined cash in the general fund balance and the Rainy Day Fund is shown in **Figure 4.30**. Combined cash exceeded $700 million in fiscal year 1998 through fiscal year 2001. Thus, it is no surprise that the state increased spending for both operations and PAYGO put funds into reserve and adopted tax reduction measures. Funds were significantly reduced after the recession, except for small balances in reserve.

Figure 4.30
Total Available Cash: Virginia
Rainy Day Fund and General Fund Balance
As a Percent of General Fund Operations
Fiscal Year 1997 – Fiscal Year 2004 (Note 1)

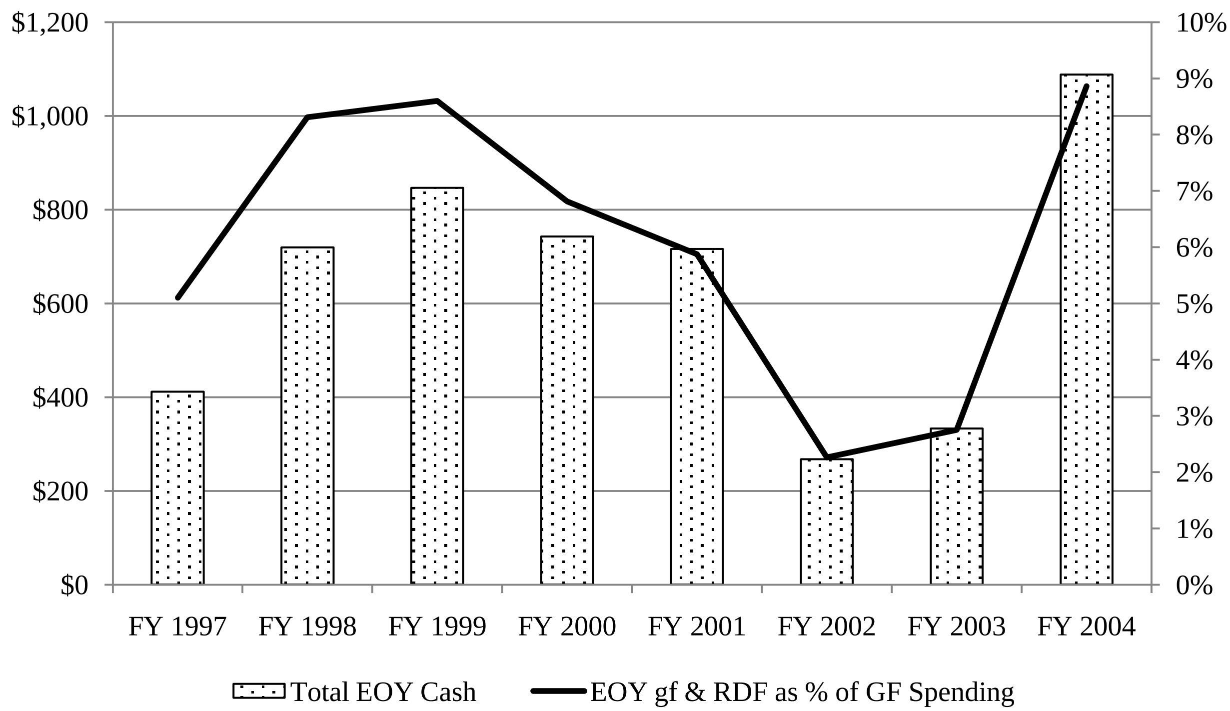


Figure Notes
Note 1: Sources: Becky Covey email to author, July 10, 2009 with attached file "RDF History for Senator Whipple1.xls"; Todd Haggerty email to author, August 20, 2009 with attached file "DE, MD, VA general fund data (FY 1996 to FY 2005).xls"; Bill Echelberger email to author, August 10, 2009 with attached file "Growth by Year to Chapter 781 (2009 Session) FY 06 Base.xls".

Fiscal Stress

In the 2002-2004 post-recessionary period, Virginia experienced fiscal stress amounting to roughly 15% to 20% of its budget, as shown in **Figure 4.31**. This consists of over $4 billion in estimated budget reductions from the trend, the use of $2.6 billion in transfers, $0.7 billion in new tax and fee revenue, and $0.4 billion in federal aid.

Figure 4.31
Fiscal Stress as a Percent of Ongoing General Fund Spending: Virginia
Fiscal Year 2002 – Fiscal Year 2004 (Note 1)

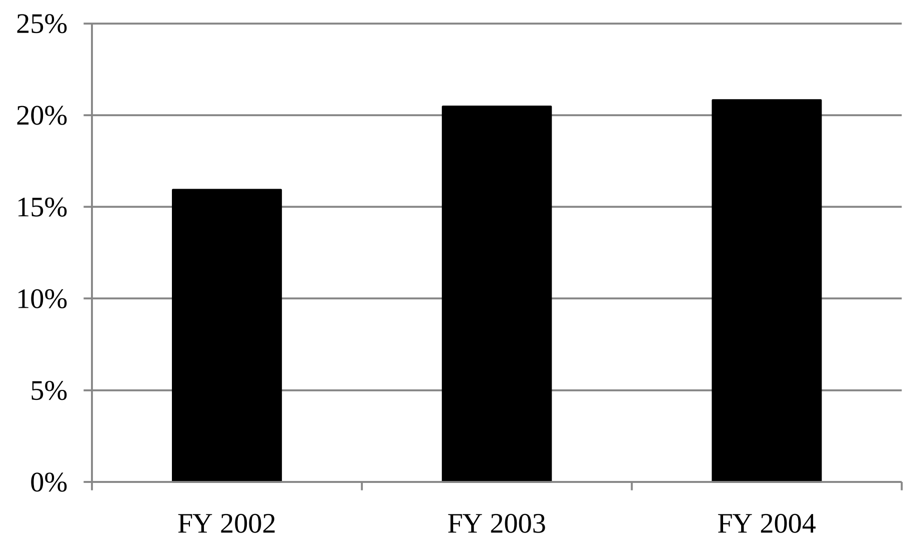


Figure Notes
Note 1: Sources: Rafool 2003, 30; Rafool 2004, 37-38; Federal Fund Information for States 2004, 5; Bill Echelberger email to author, August 10, 2009 with attached file “Growth by Year to Chapter 781 (2009 Session) FY 06 Base.xls”; Senate Finance Committee staff provided a copy of a table entitled “Actual GF Revenue and Transfer History” which included non-general fund transfers in the Appropriations Act; Becky Covey email to author, July 10, 2009 with attached file “RDF History for Senator Whipple1.xls”; Todd Haggerty email to author, August 20, 2009 with attached file “DE, MD, VA general fund data (FY 1996 to FY 2005).xls”.

Case Data Integration

Table 4.18 summarizes the combined responses of the three interviews for Virginia and integrates the quantitative data to assist in the interpretation of the qualitative responses.

Table 4.18
Virginia Case Study
Integration of Qualitative and Quantitative Data

Category	Interview Responses	Data
Late 1990s actions	With respect to revenues, all three participants recalled the major change being the decision to provide a state subsidy of the local car tax that was phased-in over multiple years. In addition, there were a lot of tax credits and sales tax exemptions that were enacted. There was also a phased reduction in the sales tax on food. Deposits were made regularly to the reserve fund in accordance with constitutional and statutory formulas. Spending enhancements were provided in the areas of K-12 education, higher education, health, and parole was abolished.	Numerous revenue actions were adopted which included tax credits, reduction in the sales tax on food, and changes in the corporate income tax eroding the tax base by a cumulative $300 million by fiscal year 2004. The Rainy Day Fund balance grew to $716 million in part due to automatic appropriation provision at closeout but is capped at 10% of revenues. Combined cash balances grew to over $800 million by fiscal year 1999; equal to nearly 9% of the operating budget. General fund spending increased from a low of 6% in fiscal year 1997 to highs of 11% to 14% in the fiscal year 1999 to fiscal year 2001 period. Mandated spending for K-12 education and Medicaid accounted for about 1/2 of general fund spending from 1996 to 2004.
Budgetary processes that limit spending	Two of the interviewees noted that tax and expenditure legislation had been considered in past years but not enacted. The third interviewee indicated that Virginia did apply surplus cash to one-time PAYGO capital purposes. It was stated that Virginia budgets to its revenue and also has a balanced budget requirement. The requirement to divert a portion of surplus revenue to reserves was considered a limit on spending. Debt service cannot exceed 5% of state revenues, which acts more as a limit on debt issuance. Agency heads are also held personally liable if their agencies run deficits.	Virginia has no tax and expenditure limit. Rainy Day Fund balances grew from about $157 million in 1997 to $716 million in 2001, equal to about 6% of the operating budget. One-time PAYGO spending also increased from about $50 million in 1997 to over $200 million in 2000 (from 1% in 1997 to about 2% through 2001. Politically, Republicans held the Governor's office until 2002, when the Democrats gained control. In the legislature, the Democrats held

Category	Interview Responses	Data
		control of the House until 2000 while the Republicans held the House from 2000 forward. In the Senate, there was an even party split in 1996 and Republicans held control through the end of the study period.
Reserve funds	Prior to 2001, reserve fund balances were not used because of strict limits on when balances can be accessed.	Virginia did not access its Rainy Day Fund prior to the recession, per restrictive constitutional limits which govern use.
Pre-recession effect of tax and expenditure limitations	In the late 1990s, it was noted that growth in Virginia may have been higher but the state always had a balanced budget and could not spend beyond its revenues. One interviewee thought that limits would have handcuffed its pro-business and other investments. The Rainy Day Fund diverted some revenue and surplus cash was used for one-time purposes.	Operating budget spending on average grew 10.8% per year between 1997 and 2001. Operating spending as a percent of personal income increased from 4.4% to slightly over 5% as the car tax subsidy was phased in.
Post-Recession Budget Balancing Actions/Fiscal Stress	Budget balancing actions included budget cuts, transfers of balances from the Rainy Day Fund and non-general funds, an increase in the sales tax rate and other revenue enhancements, a permanent transfer of a dedicated transportation revenue to the general fund, and short-term actions which included a sales tax acceleration and use of the Literary Fund for teacher retirement costs instead of school construction. After any recession, it was thought that all major revenues fall, which necessitates budget balancing actions regardless of whether or not a tax and expenditure limit is in place. All three interviewees thought that Virginia's policy of no spending limit was the preferred option. They thought that formal legal limits were too restrictive and would impede the	Fiscal stress for the Virginia budget increased from about 15% in fiscal year 2002 to about 20% in fiscal year 2003 and fiscal year 2004. The largest causes included estimated reductions from the pre-recession trend and transfers from non-general funds and the Rainy Day Fund.

Category	Interview Responses	Data
	flexibility to meet unforeseen spending needs. There was no perceived difference between no limit and a non-binding limit. From the standpoint of accountability, it was expressed that elected officials have a responsibility to assess public policy needs and make decisions on how much revenue to raise and how much to spend. All three participants thought that Virginia would continue to use surplus funds for one-time PAYGO. Other ideas expressed, included a lower likelihood of adopting tax credits, a possible increase in the Rainy Day Fund cap from 10% to 15%, and use of surplus funds for unfunded pension and retiree health liabilities. It was also acknowledged that some funds would be used to provide spending enhancements.	

Summary

This chapter covered three cases in geographically proximate, well managed states that differ in their adoption of tax and expenditure limitations. One has no tax and expenditure limitation, another has adopted a statutory non-binding limit, and the third state has a restrictive constitutional limit on spending. The fiscal policy actions of each state was reviewed during the economic expansionary period of the late 1990s to determine the extent to which each state experienced fiscal stress that required a variety of budget balancing actions in the fiscal year 2002 to fiscal year 2004 period.

Within the cases, specific topics of review included the legal budgetary framework pertaining to budget processes, tax and expenditure limitations, reserve funds, mandated spending, and political demographics. Interviews of key budgetary players in each state focused on pre- and post-recession actions, the accessibility of reserve funds, and the effectiveness of tax and expenditure limitations or other administrative or institutional budget constraints. Quantitative data was presented on revenue and spending trends, cash balances, and fiscal stress.

Chapter V analyzes the case data relative to the four hypotheses, and the summary and conclusions are provided in Chapter VI.

CHAPTER V – Analysis

Introduction

The purpose of this chapter is to review and analyze the three case studies included in Chapter IV. It also examines the major themes found in the literature review pertaining to tax and expenditure limitations, strategies for addressing cyclical instability, and accountability. The chapter will conclude with discussion of the four hypotheses presented in Chapter III to determine to what extent they are supported by the three case studies.

Data Analysis

Miles and Huberman suggest that the purpose of cross-case analysis is to improve generalizability as well as to enhance explanations and understanding of the phenomena under study. Three approaches that they recommend include a case oriented strategy, a variable oriented strategy, or a mixed methods approach. A case oriented approach has the advantage of identifying patterns among cases, but the findings may not be very generalizable. A variable oriented approach can find relationships among variables but can miss the larger picture. The benefits of a mixed strategies approach include the ability to examine each case in-depth, followed by the identification of cross-cutting variables that enable the testing of hypotheses.

As Agranoff and Radin had suggested, data was gathered for each case and analyzed to identify trends, patterns, and relationships. The specific variables that are examined more closely in this chapter include pre-recession revenue actions, general fund operating and PAYGO spending trends, and reserve fund activity, and the post-recession level of fiscal stress experienced by each state in the fiscal year 2002 to fiscal year 2004 timeframe.

Relationship of Findings to the Literature

Chapter II presented a discussion of the literature as it pertained to three themes which relate to the topic of study. This included the effectiveness of tax and expenditure limitations in constraining growth in the size of government; the size and characteristics of rainy day funds as a component of cash management; and the accountability of administrators and elected officials.

The purpose of this study was to determine if tax and expenditure limitations had an effect in limiting growth during the boom economic times of the late 1990s, acting effectively as a counter cyclical fiscal policy. Tax and expenditure limitations relate to all three topics in the literature in assessing growth in government in all three case study states, in determining if the presence or absence of tax and expenditure limitations led to higher reserve fund balances, and in assessing how limits are perceived from the perspective of accountability since they are often externally imposed controls on the latitude of elected officials.

Of the 22 studies cited in Chapter II which either projected or sought to determine the actual effect of tax and expenditure limitations on size of government, 10 determined that growth was limited; 9 found minor or negligible differences; and 3 found mixed results.

Studies which found a reduction in spending did so using a variety of methodologies. This included comparing actual spending trends with projected spending limited by population and inflation (or as a share of personal income or the economy), and comparisons of states with limitations against the revenue or spending performance of states without limits (ACIR 1977, 21; Merriman 1986, 355, 360; Stansel 1994, 4-5, 10-14, 20; Maryland Department of Fiscal Services 1995, 12, 15; Deschenaux 1997, 101-102; Rueben 1997, 32, 43; James and Wallis 2004, 25, 29; NCSL 2005, 3).

Little or no effect of limitations was found in a number of studies that also looked at states with and without limitations. Studies that examined spending per capita or spending as a percent of personal income showed negligible results. A study of California cities before and after the adoption of spending limits also found little change in spending levels (Kenyon and Benker 1984, 438, 444-445; Lowery 1983, 252-256; Abrams and Dougan 1986, 107, 112-116; Reid 1988, 20-34; Howard 1989, 85-87; King-Meadows and Lowery 1996, 103-105; Mullins and Joyce 1996, 79, 84, 99; Hoene 2004, 61, 70-72).

Mixed results were found in studies that looked at spending compared to inflation or personal income, or which compared states with and without limits (Bails 1982, 130-136; Elder 1992, 52, 58; Shadbegian 1996, 22, 25, 26).

Although the findings in the literature are mixed, government spending as a share of the economy does appear to be an often cited measure. While the purpose of this study was to examine the extent of fiscal stress following the 2001 recession, a contributing element to stress is growth in ongoing general fund spending. As shown earlier in this analysis, ongoing growth was mitigated to an extent by reduced revenue from tax actions and reserve fund deposit provisions, as well as increased spending for one-time purposes such as PAYGO capital.

Notwithstanding these actions, it is also useful to examine ongoing general fund spending in the three case study states to assess the extent to which they consumed a larger share of the economy. As seen in **Figure 5.1**, between fiscal year 1997 and fiscal year 2001, ongoing general fund spending in Delaware increased from 8.5% of personal income to 8.7%. In Maryland, the share of spending decreased from 4.9% in fiscal year 1997 to 4.8% in fiscal year 2001, and in Virginia spending grew from 4.4% to 5.1%.

Figure 5.1
Ongoing General Fund Spending in Delaware, Maryland, and Virginia
As a Share of Personal Income (Note 1)
Fiscal Year 1997 – Fiscal Year 2001

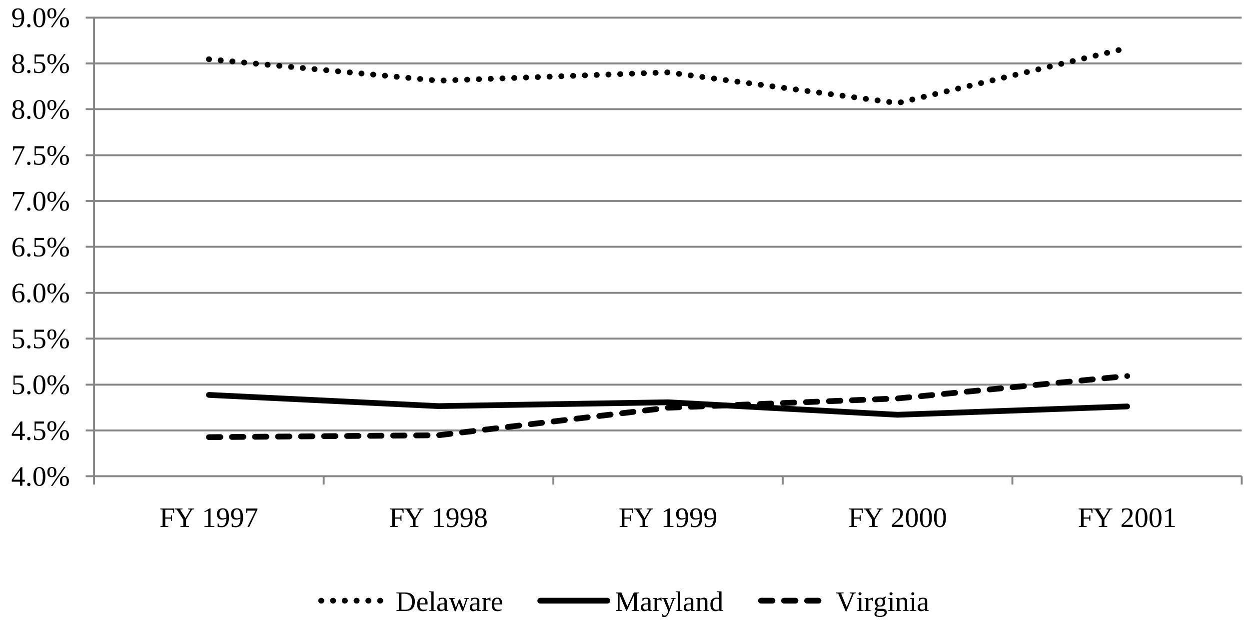


Figure Notes
Note 1: Source: U.S. Department of Commerce Bureau of Economic Analysis State Annual Personal Income; Maryland Department of Fiscal Services Sine Die Report 1997, 8; Maryland Department of Legislative Services 90 Day Report 1998, A-15; Maryland Department of Legislative Services 90 Day Report 1999, A-23; Maryland Department of Legislative Services 90 Day Report 2000, A-23; Maryland Department of Legislative Services 90 Day Report 2001, A-30; Maryland Department of Legislative Services 90 Day Report 2002, A-38; Maryland Department of Legislative Services 90 Day Report 2003, A-38; Maryland Department of Legislative Services 90 Day Report 2004, A-43; Maryland Department of Legislative Services 90 Day Report 2005, A-34; Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1994 - 1997); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1998 - 2001); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 2002 - F.Y. 2005); Bill Echelberger email to author, August 10, 2009 with attached file “Growth by Year to Chapter 781 (2009 Session) FY 06 Base.xls”.

The amount of change in spending relative to personal income over the five years leading up to the 2001 recession is minor in both Delaware and Maryland. A different story is seen in Virginia where ongoing general fund spending increased by 0.7 percentage points of personal income. One of the main drivers of this growth was the decision to enact car tax relief, which was a budgeted expenditure to local governments to offset the revenue loss associated with that policy change.

The literature also discussed rainy day fund policy as a component of cash management. Three aspects of these studies are directly observed in the three cases, relating to overall caps on the level of balance, the proper size of reserves to carry a state through a recession, and the criteria under which reserve balances can be tapped.

First, it was noted that 37 states have caps on the maximum balance of their rainy day funds (Thatcher 2008, 1-4). Delaware's balance is capped at 5%, Virginia's at 10%, and Maryland has no cap. As noted earlier, Delaware has never used reserve fund balances and a flat 5% is set aside as part of each year's balance calculation. Virginia's fund was established in the early 1990s and began growing as surpluses were realized at closeout; however, the balances were far below the 10% limit, and the cap never came into play. Maryland's uncapped balance grew to nearly 10% just prior to the recession.

When asked about fiscal policy changes that their state may adopt in the future, following the budget balancing actions after the 2001 recession, several interview participants expressed an interest in building larger rainy day fund balances.

The question of caps is noteworthy because of the second issue, which pertains to the proper size of reserves. There is not a consensus in the literature over whether rainy day fund balances exist to assist with normal cash flow variances or whether fund balances need to be large enough to carry a state through a recession. Research has suggested that the balance should be anywhere from 5% to over 30% of spending (Thatcher 2008, 4; Lav and Berube 1999, 21; Zahradnik 2005, 21; Maryland Department of Legislative Services Analysis of the Maryland Executive Budget 2000, 731; Sobel and Holcombe 1996, 42; Joyce 2001, 67; Schunk and

Woodward 2005, 119). It was alternatively suggested that each state's balance should be based on its revenue volatility (Joyce 2001, 62, 86).

Following the recession of 2001, general fund revenues generally fell significantly in fiscal year 2002 and fiscal year 2003 in all three states before rebounding in fiscal year 2004. Based on the level of fiscal stress observed in all three states, a 5% balance was not sufficient to cover spending needs as the states had to cut spending, raise revenue, and transfer non-general funds to their general funds.

It is also important to note that reserve fund balances are only available as a one-time action. Since each of the three case study states experienced fiscal stress and had to adopt extraordinary budget balancing actions over three years, much larger fund balances would be needed if the purpose of a rainy day fund was to carry a state through a recession. This is an aspect that appears to not be contemplated in the literature. Based on the findings of this study, Maryland would have required a fund balance equal to 36% of general fund operations, Delaware would have needed 26%, and Virginia 57%.

Related to the size of reserve balances was the finding by Hou that rainy day funds should be narrowly focused, to only be accessed during lagging economic times instead of being available for broader purposes (Hou 2004, 40-47, 53). As shown in the Maryland case, nearly $400 million was transferred to the general fund prior to fiscal year 2001 in the operating and PAYGO budgets. The state previously had a withdrawal criterion that was too restrictive, replaced by the open ended ability to transfer balances directly into the budget bill. The case of Maryland also demonstrates the difficulty in building large fund balances, as the Governor chose to spend balances above statutory requirements to address needs.

The experience in Maryland and Delaware also resulted in an observation that neither state was willing to use reserve balances below the 5% level based on concern over each state's "AAA" bond rating. The six interviewees from those sates indicated that 5% balance in reserve was a component of their bond rating, and all were concerned that use of the balance would endanger the rating. In Virginia, balances reached nearly 6% of general fund spending by fiscal year 2001 but were used in 2002 and 2003 to aid in balancing the budget. By fiscal year 2003, the reserve fund balance had dropped to 2% of spending without the state losing its bond rating.

The final aspect of the literature that was reviewed pertained to the issue of accountability. The Friedrich-Finer debate centered on whether accountability of administrators was a function of professional standards and ideals gained through socialization, or required external controls and sanctions to enforce responsibility. Later authors saw the two concepts as co-existing instead of opposite ends of a continuum.

With respect to elected officials and fiscal management, external controls have increasingly been adopted over the years to improve accountability to the taxpayer. This has included balanced budget requirements and different budget formats to demonstrate performance. Many other institutional controls serve to constrain the actions of elected officials, such as term limits, voter initiatives, and tax and expenditure limitations.

Aspects of accountability vis-à-vis tax and expenditure limitations which bear further examination include political dimensions of accountability and issues associated with the implementation of caps.

Political Dimensions of Accountability

In Chapter IV, the case studies noted the control of the Governor, Senate, and House by each political party. The underlying assumption is that taxing and spending would be greater under Democratic dominance and tax cuts and reduced spending would be seen under Republican control. **Table 5.1** summarizes the political party affiliation of the Governor, as well as the majority parties in the House and Senate in each of the three case study states.

Table 5.1
Political Party Control in Delaware, Maryland, and Virginia (Note 1)

	1996	1998	2000	2002
Delaware Governor	D	D	D	D
Delaware Senate	D	D	D	D
Delaware House	R	R	R	R
Maryland Governor	D	D	D	D
Maryland Senate	D	D	D	D
Maryland House	D	D	D	D
Virginia Governor	R	R	R	D
Virginia Senate	Even	R	R	R
Virginia House	D	D	R	R

Table Notes
Note 1: Sources: NCSL "Legislative Party comp tables 96-02.xls"; Marck Governors 1777 to Present Day; Delaware's Governors 1949 to Present; Virginia.gov Governors of Virginia.

In Delaware, the Governor was a Democrat, and the same party held the House throughout the period leading up to the recession, while Republicans controlled the Senate. As discussed within this chapter, Delaware's expenditure growth averaged 6.9% per year while significant amounts of surplus revenues were directed to one-time spending including PAYGO capital. Tax reductions and tax credits eroded the state's revenue base by an estimated 10% between 1997 and 2001. Delaware had the least amount of fiscal stress after the recession.

Democrats controlled the Maryland legislature and the Governor's Office throughout the period. Similar to Delaware, Maryland had moderate spending growth of 6.2% per year and directed additional cash to PAYGO and to reserves. In addition to other tax actions, Maryland enacted a 10% income tax cut that eroded its tax base by nearly 7% by 2001. Maryland experienced moderate fiscal stress after the recession.

Virginia, which had more Republican control of the House, Senate, and Governor's Office than the other two states, experienced the highest level of spending growth, averaging 10.8% per year. Surplus cash was directed to reserves, and relatively nominal sums were directed to PAYGO. Tax credits and other actions resulted in minor revenue losses. Based on its spending growth, including the car tax subsidy, Virginia had the highest level of fiscal stress after the recession.

Political party dominance does not appear to have been a major influence on fiscal policy actions in the three states in the late 1990s. Delaware and Maryland both saw moderate spending growth and large amounts of foregone revenue due to tax actions during periods of Democratic control. Virginia experienced large spending growth and minimal revenue loss due to tax actions under largely Republican control.

The relationship of political institutions is an influencing factor that bears consideration. In Delaware and Virginia, the legislative body can increase spending in the budget. However, Maryland has a strong executive model of budgeting under which the legislature can only reduce spending. If the Maryland legislature had the ability to increase spending, or conversely if the legislatures in Delaware and Virginia could only reduce spending, budget growth outcomes may have been different. Similarly, the influence of political control may have also turned out differently under alternative institutional arrangements.

Transparency

Issues of cap implementation relate to transparency. This portion concludes with a brief discussion of unforeseen problems that can arise from overly restrictive limitations.

Transparency in budgeting relates to how easily taxpayers can determine how funds are spent and whether this complies with their desires. It helps if the rules are easy to understand and administer, clear formats are used to present information, and outcomes can be determined. So too is the case with tax and expenditure limitations.

As discussed in Chapter IV, Delaware has a limit under which it can expend 98% of revenues. This is calculated using projections of the next fiscal year's revenue, plus the prior year ending fund balance (less prior year continuing and encumbered appropriations and the 5% reserve fund set aside), times 98%. Data on the elements of the calculation are included in the Governor's Fiscal Overview. This maintains a 2% general fund balance, in addition to the required 5% rainy day fund balance. The calculation is easy to understand.

Under Maryland's non-binding spending affordability process, a joint Spending Affordability Committee makes a recommendation on spending growth for the next year to the Governor by December 1. The calculation is based on total session spending, which includes total state supported general, special, and current unrestricted fund spending for the next year plus current year deficiencies, compared against similar spending for the prior year. Federal funds and current restricted funds are excluded.

The committee's recommendation is not limited to a single factor but can include personal income, gross state product, or other data. If the Governor's allowance exceeds the limit, there must be a justification for doing so, and if the limit is not adhered to following legislative action, justification from the budget committees is also required. Formal budget materials show how the calculation is determined each year, allowing for some transparency. However, the base upon which the calculation is made has narrowed over time, spending exclusions vary from year to year, and the formula is difficult to understand and to replicate.

The limits in Delaware and Maryland can both be formally circumvented if needed. In Delaware, a 3/5 majority vote can permit the remaining 2% of expenditures to be spent. Under Maryland law, the limit is non-binding, and the Governor's budget submission has often exceeded the limit, though legislative action reduced spending to the recommended level in all but one year since adoption.

What makes limits more difficult as an external accountability control, is the ease with which they can be circumvented. Examples include multi-year spending authorizations, revenue distributions, non-general fund spending, and consequences associated with the construction methodology of specific limits.

Most state budgets are adopted for a one-year period, but several states such as Virginia adopt a biennial spending plan. Consequently, most tax and expenditure limits are designed to limit spending in accordance with the budget cycle. However, legislation can be enacted which may mandate large spending increases in future years without sufficient revenue to pay for it. Such actions would place more pressure on decisionmakers to exceed limits in order to accommodate the additional spending or to raise additional revenues.

As shown in **Figure 5.2**, at the 2002 session, Maryland passed legislation which significantly increased spending on local aid for primary and secondary education. Revenue from a tobacco tax increase was sufficient to pay for the program in its first year but was not expected to keep pace with the hundreds of millions added to the budget in subsequent years.

It should also be noted in this example from Maryland that the expanded growth in education spending ultimately propelled the state to a top national ranking of its educational system. Thus, growth in government spending beyond growth in the economy may be an important objective for elected officials just as limited spending is an objective for those who support tax and expenditure limitations.

Figure 5.2
Chapter 288 of 2002, Maryland's Bridge to Excellence in Public Schools Act
Fiscal Note Estimate of Revenues and Expenditures (Note 1)
Fiscal Year 2003 – Fiscal Year 2007
($ in Millions)

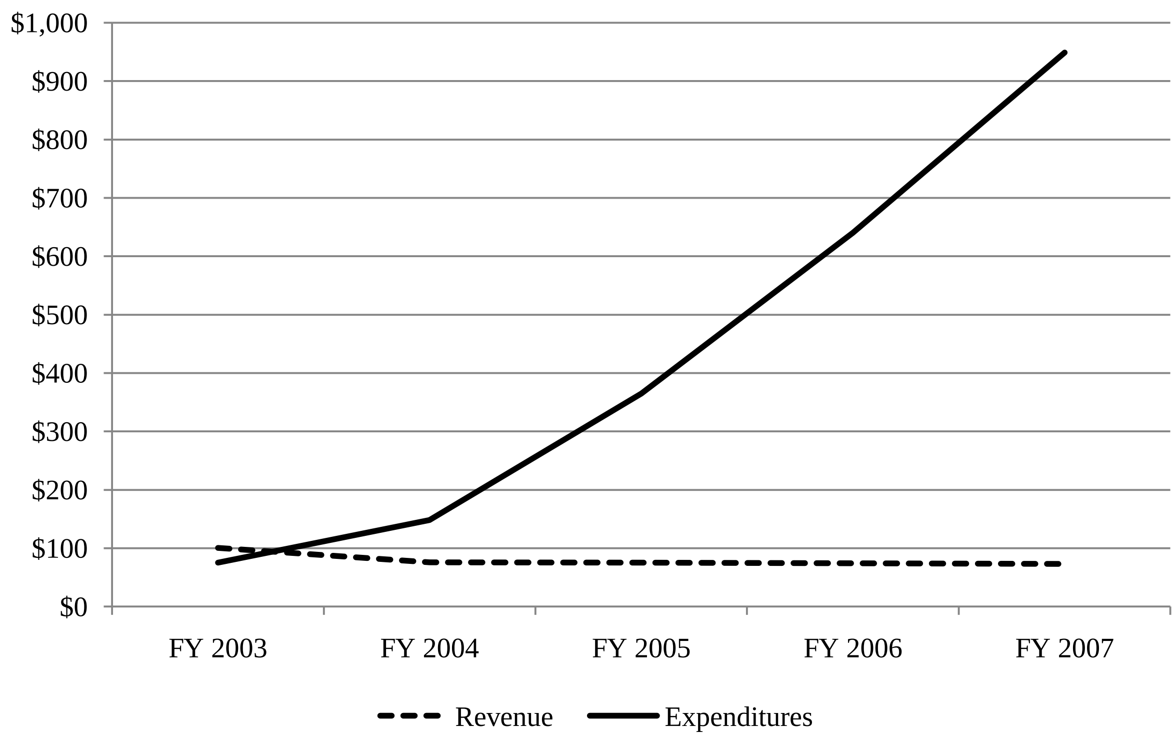


Figure Notes
Note 1: Source: Maryland Department of Legislative Services SB 856 Fiscal Note, 2.

Since tax and expenditure limits only pertain to either increases in revenue or spending, they also cannot prevent tax changes that erode a government's revenue base. As noted in each of the cases, during the boom times of the late 1990s, all three states enacted legislation each year that cumulatively impacted general fund revenues. This included income tax rate reductions and exclusions, sales tax exclusions, adoption of tax credits, and other actions. Revenue can also be redistributed by dedicating portions to non-general funds or to allocate a share to local jurisdictions. Virginia, for example, could have dedicated a portion of tax revenue to local governments in lieu of the car tax subsidy in its general fund budget.

Non-general funds represent another avenue to circumvent spending limits, unless they apply to all state sourced revenues as is the case in Maryland. Spending growth during good times would be limited only by increases in revenue. But even if all state-sourced revenue is counted, there is no guarantee that spending will be limited. As illustrated in **Figure 5.3**, even though Maryland set a growth limit on all state-sourced revenue each year, ongoing general fund spending grew faster than the limit in fiscal year 1999 through fiscal year 2001. This was accomplished by constraining growth in special and current unrestricted fund spending, which could later be increased during the fiscal year via budget amendments which are not captured in the calculation.

Finally, the methodology for calculating limits may also have unintended consequences which permit excessive growth. In the case of Delaware, its limit holds spending growth to 98% of revenue. However, the calculation also includes prior year fund balance. During good times, the combination of projected revenue and balance permits general fund spending to grow faster than actual revenues as seen in **Figure 5.4**. Ongoing general fund spending outpaced actual revenue in each year between fiscal year 1997 and fiscal year 2001, and by an even larger amount if only projected revenue were multiplied by 98%.

As these examples illustrate, tax and expenditure limits can be easily circumvented regardless of whether they are binding or non-binding. The first case participant summarized it best when they stated that "I don't think that systems succeed or fail, people succeed or fail." "You can have a crappy…fiscal system and good people can make it work and you can have…the ultimate in good fiscal framework…and a group of wrong minded people can screw it up. So people do make the difference and how they adhere to it."

Figure 5.3
Maryland's Spending Affordability Limit
General Fund Spending Growth Relative to Overall Limit (Note 1)
Fiscal Year 1996 – Fiscal Year 2003

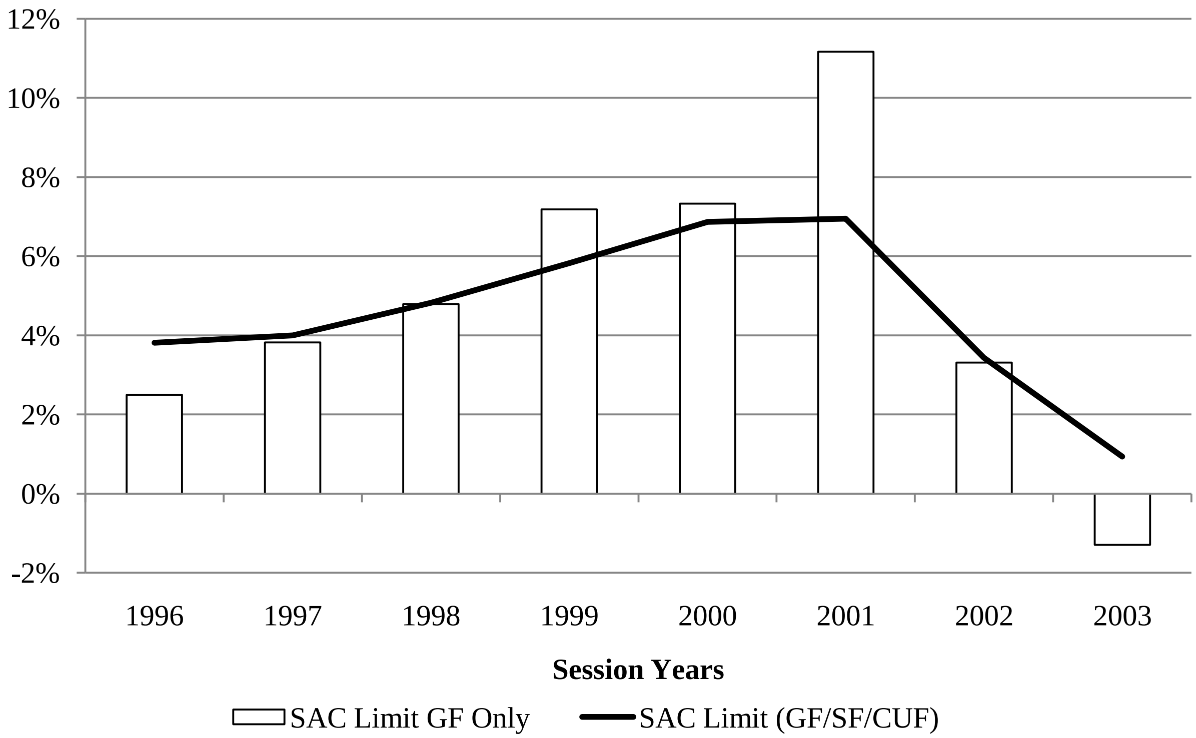


Figure Notes
Note 1: Source: Maryland Department of Fiscal Services Sine Die Report 1997, 8; Maryland Department of Legislative Services 90 Day Report 1998, A-12; Maryland Department of Legislative Services 90 Day Report 1999, A-20; Maryland Department of Legislative Services spreadsheet "00 Session SAC.123"; Maryland Department of Legislative Services spreadsheet "01 Session SAC calculation.xls"; Maryland Department of Legislative Services 90 Day Report 2002, A-10; Maryland Department of Legislative Services 90 Day Report 2003, A-11; Maryland Department of Legislative Services 90 Day Report 2004, A-11.

Figure 5.4
Calculation of 98% General Fund Limit in Delaware
Actual Revenue, 98% of Actual Revenue and 98% of Revenue and Fund Balance (Note 1)
Fiscal Year 1997 – Fiscal Year 2001
($ in Millions)

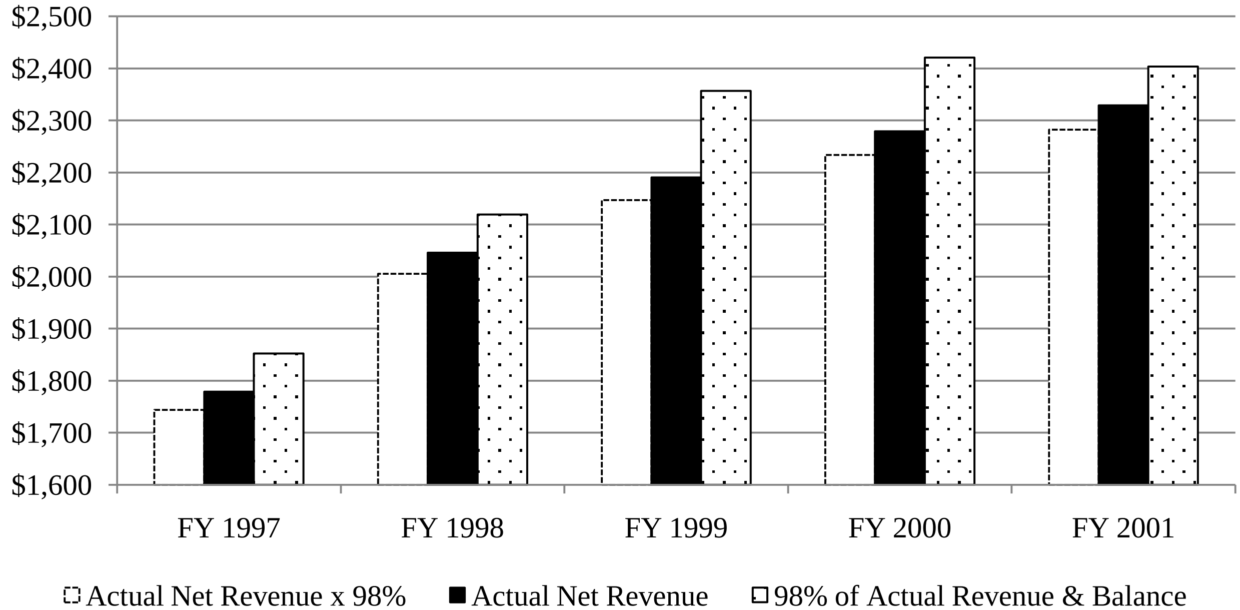


Figure Notes
Note 1: Source: Delaware Office of the Controller General.

A final aspect of tax and expenditure limitations in the context of accountability relates to mechanisms that impede the ability of government to fund current services and future needs. This analysis focused on Delaware's expenditure limit tied to 98% of revenue and Maryland's non-binding limit based various economic factors. Other states have limits that constrain spending to factors such as inflation and population growth. There are many factors which drive government spending.

- Current services spending includes personnel and operating costs, entitlements such as Medicaid, and local aid programs for primary and secondary education, etc.

- Salary/benefit increases are necessary to attract and retain competent employees and executives. Health care, retiree health care, and retirement are large cost drivers. The latter two have unfunded liabilities for most states (Ladd 1978, 6);
- Operating expenses rise with inflation. High inflation can squeeze operating budgets and outpace revenue growth. Construction supplies, utilities, fuel for vehicles, and asphalt have all seen large jumps in recent years. When gas prices rose in 2008, the Maryland Transit Administration saw an 11% surge in ridership (Hartley 2008, C1; Keen 2008, 1; Baltimore Business Journal 2008, 1; Riccardi 2008, 1; Boyd and Dadayan 2008, 17);
- Medicaid is one of the largest categories of state spending, with increases for health inflation, provider rate increases, and utilization. In recessionary times, greater unemployment can increase caseloads as more people qualify for this income based entitlement (Boyd and Dadayan 2008, 17);
- Local education aid increases are typically based on formulaic mandates and enrollment growth. Courts can order education funding enhancements if spending levels are deemed inadequate (Mullins and Wallin 2004, 3);
- Caseload/population growth changes affect higher education institutions, prisons, mental health facilities, and veterans populations under state care, for example. During recessions caseloads can surge for unemployment benefits, temporary cash assistance, Medicaid, and other programs. The Washington, DC Metro system requires 10 new buses each year just to keep pace with traffic congestion. Between 1990 and 2010, Maryland's population grew by 1.1 million people which resulted in governments adding 3,700 additional police officers. (Boyd and

Dadayan 2008, 17; Associated Press October 6, 2008, A4; Maryland Department of Public Safety and Correctional Services 2010, 12);

  - Baseline operations may be under funded. When tax and expenditure limits go into effect, growth based on any economic indicators do not take into account additional spending needed to fund operations sufficiently. For example, Maryland officials reported that the state did not have enough environmental inspectors to enforce existing laws (Associated Press September 24, 2008, A4). Deferred maintenance backlogs were reported totaling $100 million in Vermont, $237 million in Utah, and $35.9 million for Maryland's Department of Natural Resources (Maryland Department of Budget and Management Facilities Maintenance 2008, 5; Griffin 2009, 1);

- Unfunded liabilities exist in states for the costs of retirement and retiree health costs (a.k.a. Other Post Employment Benefits or OPEB). Many states continue to provide defined benefit pension plans, often invested in a large ratio of equities. Achieving 100% funded status on an actuarial basis is made more challenging when the economy falters and stocks lose value. In 2010, it was estimated that states had a one trillion gap between actual assets and actuarially required funding levels (The Pew Center on the States 2010, 1). Compounding the problem, many states use high assumptions of annual returns (*e.g.*, 8% per year). When stock values fall, states not only lose asset value but then have to make up for missed benchmarks with higher contributions in future years (Walsh 2010, 3). The Governmental Accounting Standards Board requires that states report unfunded OPEB liabilities. A 2009 analysis by Standard & Poor's found that state OPEB liabilities exceed $400 billion (Standard & Poor's 2009, 2);

- Federal mandates are enacted periodically which require states to add spending to implement programs to achieve federal purposes. In 2008, Maryland reported, for example, that it would need to spend $9 million in capital and $30 million to $37 million in operating over five years in order to comply with federal REAL-ID requirements (Maryland Department of Transportation 2008, 10);
- New facilities open each year as states construct new or replacement buildings as part of prisons, schools, higher education institutions, etc. At the 2010 session, Maryland reported that facilities proposed in its six-year Capital Improvement Plan would require 307 positions and $33.6 million when fully operational (Maryland Department of Budget and Management Maryland Capital Budget 2010, xii, xiii);
- Major Information Technology expenses are incurred as states increasingly provide services on the Internet and replace obsolete legacy systems which are no longer supported. Large outlays are required for development of replacement systems. In 2010, Maryland's Major IT spending plan included 26 projects totaling $369 million (Maryland Department of Budget and Management Maryland Operating Budget 2010, 866-893). Additional costs are incurred for software, annual licenses, and routine server and other hardware replacement;
- Unanticipated needs arise for unexpected purposes. Natural disasters, court ordered education spending, and homeland security are all areas that can quickly become spending priorities. Eight years after 9/11, Maryland reported that it was spending $90 million for homeland security needs ranging from interoperable communications, training, biosurveillance, transportation security, planning, and other related purposes

(Maryland Office of the Governor spreadsheet "2009_p210_GOHS_Homeland Security Spending Report" 2010, 1-9).

Hypothesis Testing

Hypothesis 1 – Degree of Formalization of Tax and Expenditure Limitations – States with institutionally formalized tax and expenditure limitations will have accumulated larger combined cash balances (defined as reserve fund balance and general fund balance) during periods of slack which will have been available to mitigate the impact of the 2001 recession.

The underlying basis for hypothesis 1 is that more formal, structured tax and expenditure limitations would have the effect of limiting spending growth and result in higher cash balances between combined general fund balances and reserve fund balances. However, as was demonstrated in Chapter IV which examined the states of Delaware, Maryland, and Virginia, fund balance is influenced by a number of variables. Thus, in order to test hypothesis 1, it becomes necessary to briefly compare revenue and spending actions, as well as reserve fund policies, among the three states.

Figure 5.5 shows total available cash for each of the three states (defined as the combination of general fund cash and balance in the Rainy Day Fund) for the period from fiscal year 1997 through fiscal year 2001. This is the period at the peak of the business cycle, prior to the recession of 2001. In Delaware, balances grew to more than 18% of the ongoing general fund operating budget by fiscal year 1999 but declined to below 8% by fiscal year 2001. Maryland also accrued increasingly larger cash balances of nearly 18% through fiscal year 2000 before falling to just under 16% in fiscal year 2001. Finally, Virginia exhibited a trend similar to Delaware in that its cash balances grew through fiscal year 1999, to just over 8%, before declining in fiscal year 2000 and fiscal year 2001.

Figure 5.5
Delaware, Maryland, and Virginia: Total Available Cash
As a Percent of Ongoing General Fund Expenditures (Note 1)
Fiscal Year 1997 – Fiscal Year 2001

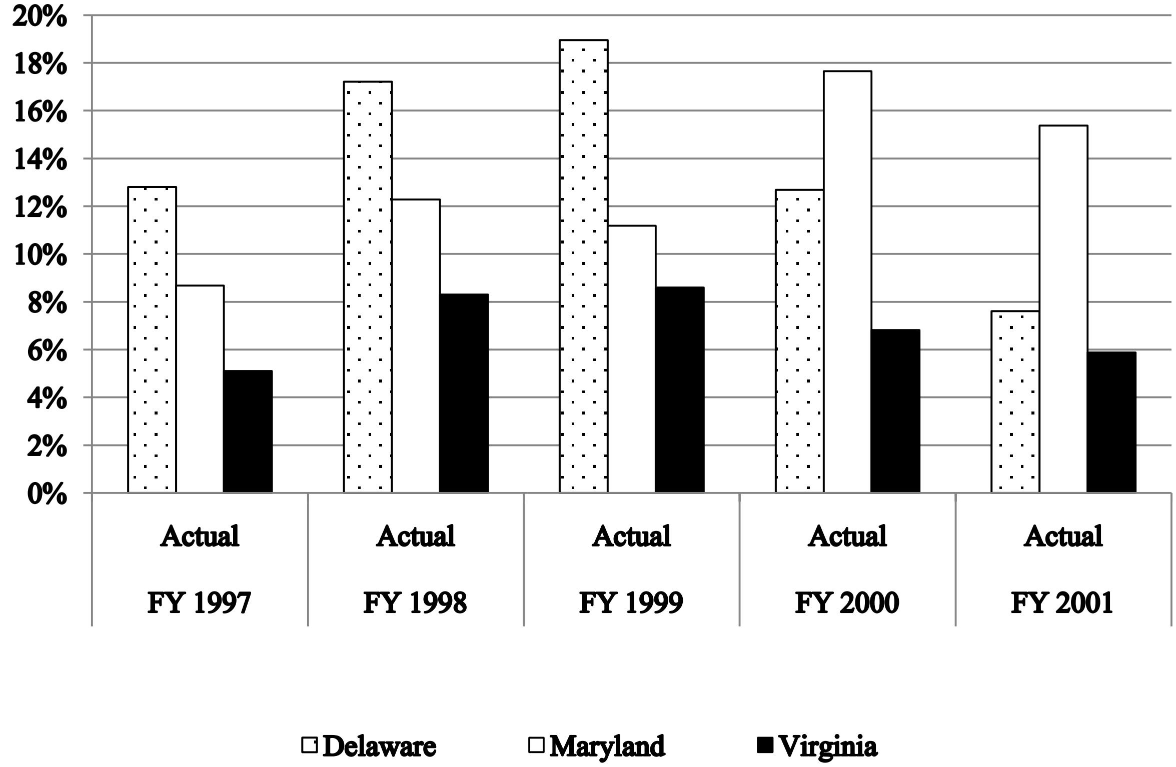


Figure Notes
Note 1: Sources: Todd Haggerty email to author, August 20, 2009 with attached file "DE, MD, VA general fund data (FY 1996 to FY 2005).xls"; Maryland Department of Fiscal Services Sine Die Report 1997, 8; Maryland Department of Legislative Services 90 Day Report 1998, A-15; Maryland Department of Legislative Services 90 Day Report 1999, A-23; Maryland Department of Legislative Services 90 Day Report 2000, A-23; Maryland Department of Legislative Services 90 Day Report 2001, A-30; Maryland Department of Legislative Services 90 Day Report 2002, A-38; Maryland Department of Legislative Services 90 Day Report 2003, A-38; Maryland Department of Legislative Services 90 Day Report 2004, A-43; Maryland Department of Legislative Services 90 Day Report 2005, A-34; Maryland Department of Legislative Services spreadsheet "Frank_reserve fund_FY 2010.xls"; Michael Morton email to author, September 29, 2009"; Todd Haggerty email to author, August 20, 2009, with attached file "DE, MD, VA general fund data (FY 1996 to FY 2005).xls"; Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1994 - 1997); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1998 - 2001); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 2002 - F.Y. 2005); Becky Covey email to author, July 10, 2009, with attached file "RDF History for Senator Whipple1.xls"; Todd Haggerty email to author, August 20, 2009, with attached file "DE, MD, VA general fund data (FY 1996 to FY 2005).xls"; Bill Echelberger email to author, August 10, 2009 with attached file "Growth by Year to Chapter 781 (2009 Session) FY 06 Base.xls.

Turning first to the revenue side of the ledger, **Figure 5.6** illustrates the annual change in general fund revenue in the 3 states for the same fiscal year 1997 through fiscal year 2001 period. Delaware experienced strong revenue growth above 6% annually during 1997 through 1999. Virginia also saw strong revenue growth above 8% between 1997 and 2000. Finally, Maryland saw more moderate growth of around 6% for each year, with the exception of fiscal year 2000 which saw growth of around 8%.

Figure 5.6
Delaware, Maryland, and Virginia: General Fund Revenue Trends
Annual Percent Change (Note 1)
Fiscal Year 1997 – Fiscal Year 2001

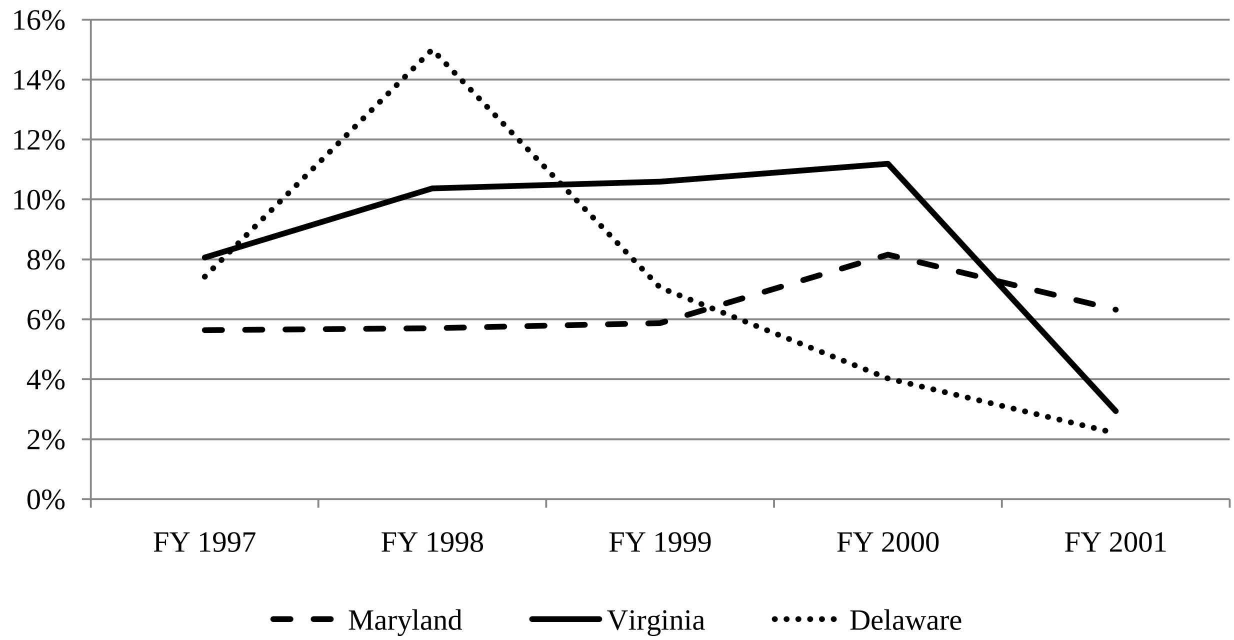


Figure Notes
Note 1: Sources: Maryland Board of Revenue Estimates 1998, 20; Maryland Board of Revenue Estimates 2001, 25; Maryland Board of Revenue Estimates 2004, 27; David Gregor email to author, November 17, 2009 with attached files providing Delaware's closing Financial Reports for fiscal year 1997 through fiscal year 2004 "FY97 Final Accounting Report0001.pdf", "FY98 Final Accounting Report0001.pdf", "FY99 Final Accounting Report0001.pdf", "FY00 Final Accounting Report0001.pdf", "FY01 Final Accounting Report0001.pdf", "FY02 Final Accounting Report0001.pdf", "FY03 Final Accounting Report0001.pdf", "FY04 Final Accounting Report0001.pdf"; Virginia Secretary of Finance 2004.

Part of the decrease in revenue is explained by the cumulative loss of revenue due to tax actions enacted during this period. **Figure 5.7** shows the estimated cumulative loss of general fund revenue by fiscal year 2001 for each state, as a percent of actual revenue attainment. As noted in Chapter IV, each state enacted a series of tax reductions, affecting the personal income tax, corporate, sales, and other taxes. Delaware experienced the largest loss at just over an estimated 10% of its fiscal year 2001 general fund revenue.

Figure 5.7
Delaware, Maryland, and Virginia: Foregone General Fund Revenue
Estimated Cumulative Loss as a Percent of General Fund Revenue (Note 1)
Fiscal Year 1997 – Fiscal Year 2001

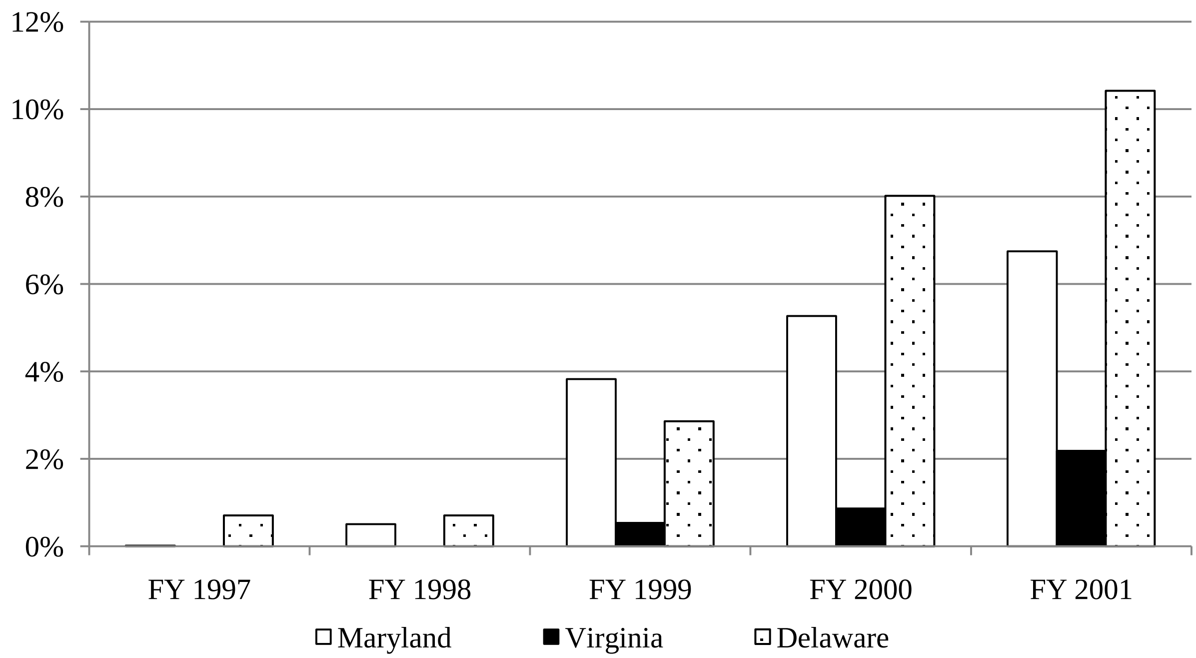


Figure Notes
Note 1: Sources: Maryland Department of Legislative Services Effects of the Legislative Program 1997, 55; Maryland Department of Legislative Services Effects of the Legislative Program 1998, 51-52, 55; Maryland Department of Legislative Services Effects of the Legislative Program 2000, 50; Maryland Department of Legislative Services Effects of the Legislative Program 2001, 56; Maryland Department of Legislative Services HB 599 Fiscal Note 1998, 8; Maryland Department of Legislative Services HB 190 Fiscal Note 1999, 1; Maryland Department of Legislative Services HB 423 Fiscal Note 1999, 1; Maryland Department of Legislative Services SB 344 Fiscal Note 1999, 9; Maryland Department of Legislative Services SB 56 Fiscal Note 2000, 1; Maryland Department of Legislative Services SB 309 Fiscal Note 2000, 4; Mackey 1996, 25-27, 30; Zelio 1997, 26, 28, 34; Zelio, Mackey, and Rafool 1999, 18, 21, 25-26; Rafool 2000, 18, 23-24, 38-39; Rafool 2001, 28-29, 42-43; Rafool 2002, 22, 32; Rafool. 2003, 17, 21, 30; Rafool 2004, 17, 21-22, 37-38.

A phased-in 10% cut in the income tax in Maryland, among other tax cuts, resulted in the loss of nearly 7% in revenue. Virginia experienced a much smaller revenue loss of about 2% of revenues.

Cash balance in reserves is influenced by each state's specific rainy day fund policies. As noted, Maryland began sweeping unappropriated general fund surpluses above $10 million into its rainy day fund beginning in fiscal year 1998; however, balances above 5% could be appropriated for any purpose in the budget bill by the Governor each year. So, while Maryland's rainy day fund balance grew to nearly 10% of ongoing spending by fiscal year 2001, the balance would have been closer to 14% had almost $400 million not been spent by the Governor in fiscal year 1999 to fiscal year 2001.

Delaware's reserve fund represents a flat 5% revenue set aside each year. Calculated as a percent of spending, it remained at roughly 6% of spending each year. Delaware has never used its reserve balances. Virginia, which had just created its fund in 1992, saw its balance grow from under 2% of spending to nearly 6% based on constitutional and statutory provisions that specify the criteria for annual deposits as well as when withdrawals can be made.

On the expenditure side, cash balances were influenced by growth in ongoing operating spending and decisions to apply a portion of surpluses for one-time PAYGO capital. **Figure 5.8** shows an upward trend in ongoing general fund spending in each of the three states. As indicated in **Table 5.2**, ongoing general fund spending in Maryland grew at the lowest rate of 6.2% on average between fiscal year 1997 and fiscal year 2001. Delaware's ongoing spending grew at 6.9%, and Virginia grew at an average of 10.8%. The primary reason for the large growth in Virginia was the enactment of legislation to subsidize the local car tax, which appears as a grant in the operating budget.

Figure 5.8
Delaware, Maryland, and Virginia: Ongoing General Fund Spending
Annual Percent Change (Note 1)
Fiscal Year 1997 – Fiscal Year 2001

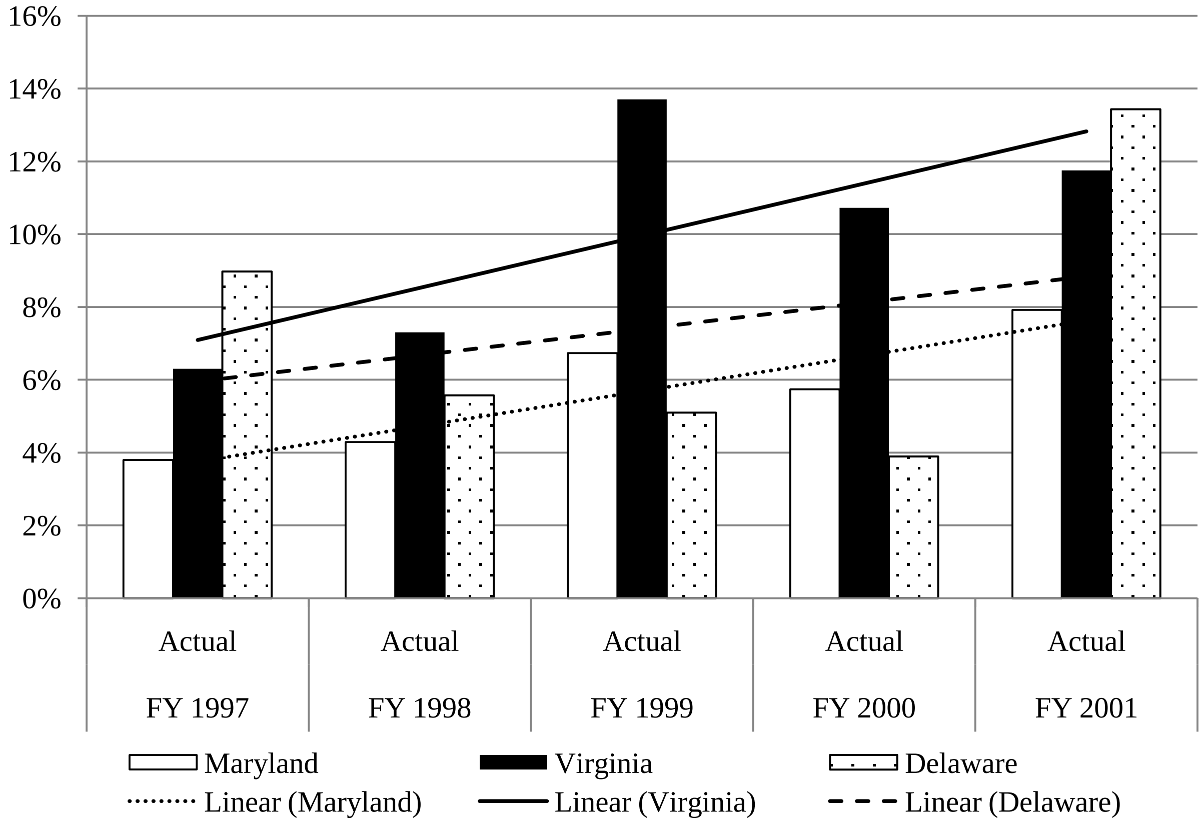


Figure Notes
Note 1: Sources: Maryland Department of Fiscal Services Sine Die Report 1997, 8; Maryland Department of Legislative Services 90 Day Report 1998, A-15; Maryland Department of Legislative Services 90 Day Report 1999, A-23; Maryland Department of Legislative Services 90 Day Report 2000, A-23; Maryland Department of Legislative Services 90 Day Report 2001, A-30; Maryland Department of Legislative Services 90 Day Report 2002, A-38; Maryland Department of Legislative Services 90 Day Report 2003, A-38; Maryland Department of Legislative Services 90 Day Report 2004, A-43; Maryland Department of Legislative Services 90 Day Report 2005, A-34; Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1994 - 1997); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1998 - 2001); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 2002 - F.Y. 2005); Bill Echelberger email to author, August 10, 2009 with attached file "Growth by Year to Chapter 781 (2009 Session) FY 06 Base.xls".

Table 5.2
Delaware, Maryland, and Virginia: Ongoing General Fund Spending
Average Annual Percent Change (Note 1)

State	FY 1997-2001 Ongoing General Fund Operating Budget Average Rate of Expenditure Growth
Maryland	6.2%
Virginia	10.8%
Delaware	6.9%

Table Notes
Note 1: Calculation of average spending per year calculated by the author.

In addition to ongoing general fund spending, each state directed surplus general fund revenue toward one-time PAYGO capital spending. As seen in **Figure 5.9**, Delaware directed significant amounts of spending toward one-time PAYGO, increasing from just under 4% of combined operating and PAYGO spending to about 16% in fiscal year 2000. Maryland increased PAYGO spending from just under 1% to over 6% of its combined general fund expenditures by fiscal year 2001. Virginia also increased its PAYGO spending, but to a lesser extent, increasing to about 2% annually during this period.

Each state's combined cash balance trends yields the following observations:

Delaware: While Delaware experienced strong general fund revenue growth in fiscal year 1997 through fiscal year1999, revenue tailed off significantly in fiscal year 2000 and fiscal year 2001 to below 4% each year. In part, this was due to cumulative revenue losses from enacted tax legislation which eroded the tax base equal to approximately 10% of revenues by fiscal year 2001. Spending growth on average was nearly 7% a year, but significant amounts of surplus revenues were directed to one-time PAYGO. Throughout the period, about 6% of the operating budget was maintained in reserve. So while Delaware's combined cash balances peaked at 19% of the general fund budget in fiscal year 1999, the balance fell to below 8% by fiscal year 2001 as foregone revenue, ongoing spending growth, and PAYGO spending outpaced revenue growth.

Figure 5.9
Delaware, Maryland, and Virginia: PAYGO General Fund Spending As a Percent of Combined Ongoing and PAYGO General Fund Budgets (Note 1.)
Fiscal Year 1997 – Fiscal Year 2001

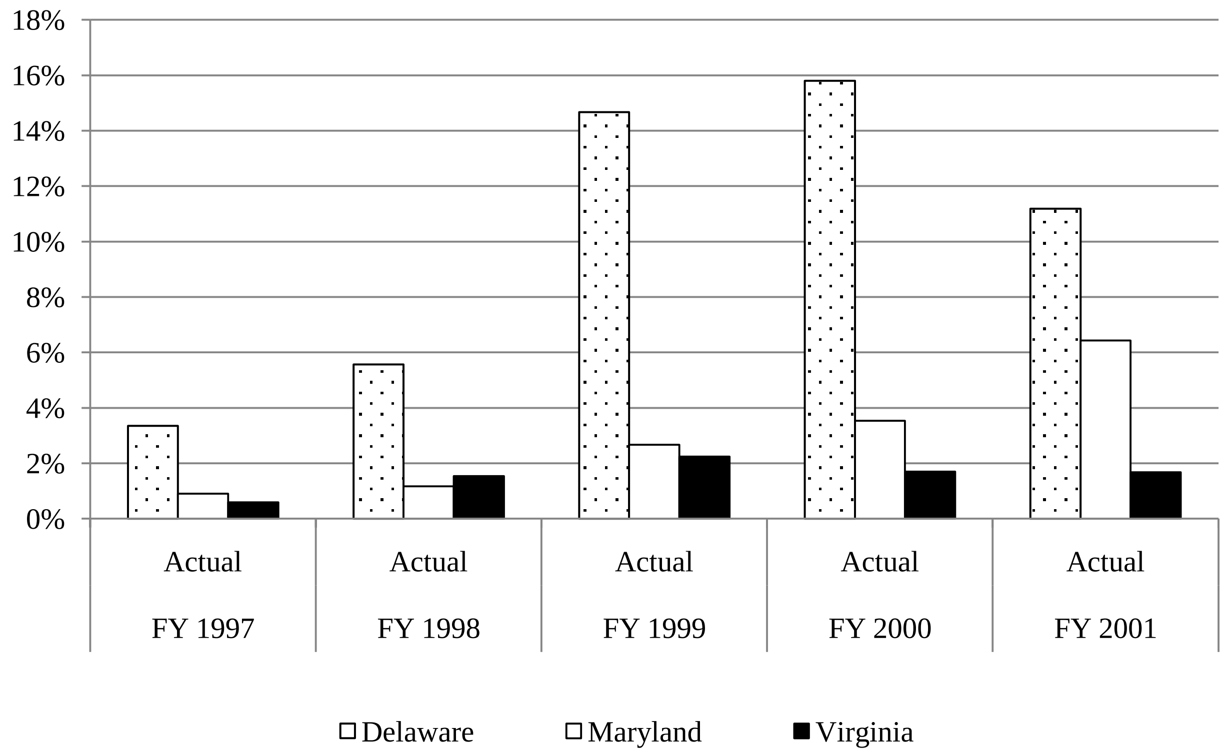


Figure Notes
Note 1: Sources: Maryland Department of Legislative Services 90 Day Report 1998, A-15; Maryland Department of Legislative Services 90 Day Report 1999, A-23; Maryland Department of Legislative Services 90 Day Report 2000, A-23; Maryland Department of Legislative Services 90 Day Report 2001, A-30; Maryland Department of Legislative Services 90 Day Report 2002, A-38; Delaware.gov Capital Budget Authorizations by Funding Source; Bill Echelberger email to author, August 10, 2009 with attached file "Growth by Year to Chapter 781 (2009 Session) FY 06 Base.xls".

Maryland: Moderate annual revenue growth of approximately 6% was seen in Maryland each year, except for fiscal year 2000 when growth eclipsed 8%. A phased income tax reduction was chiefly responsible for erosion of the tax base which grew to an estimated 7% of fiscal year 2001 revenues. Maryland increased ongoing spending in the range of 6% per year and like Delaware also applied surplus cash to PAYGO purposes (over 6% of spending by fiscal year 2001). Maryland's automatic sweeper was responsible for depositing surplus cash into reserves, which reached almost 10% of the operating budget by fiscal year 2001. Therefore, Maryland maintained a combined cash balance above 15% of spending.

Virginia: Finally, Virginia also saw very strong revenue growth during this period. In each year, revenues grew between 8% and 10% except for fiscal year 2001 which fell to 6% growth. While Virginia also enacted legislation to implement tax credits and other tax relief, it amounted to a small percentage of overall revenues by fiscal year 2001. Spending growth, which averaged nearly 11% per year, was driven by the car tax subsidy. Small amounts of spending were also applied to PAYGO but not nearly at the levels seen in the other two states. Virginia's reserve fund balance grew during the period, due to automatic deposit mechanisms, but otherwise revenues were spent as combined cash balances exceeded 8% in fiscal year 1998 and fiscal year 1999 before falling to the 6% range by fiscal year 2001.

This study concludes that Hypothesis 1 – that states with institutionally formalized tax and expenditure limitations will have accumulated larger combined cash balances – is partially supported. Delaware, which has a formal constitutional limit on spending, accrued the largest cash balances between 1997 and 1999 but saw those balances erode due to other factors such as foregone revenue and increased PAYGO spending. Maryland, which has a non-binding limit, accrued large combined cash balances based on more moderate tax relief, ongoing spending growth, and PAYGO spending. Virginia had the lowest cash balances as revenues were largely spent on ongoing budget growth.

Hypothesis 2 – Effectiveness of Binding versus Non-binding Tax and Expenditure Limitations – States with binding constitutional or statutory tax and expenditure limitations will have experienced less fiscal stress in the fiscal year 2002 through fiscal year 2004 post-recessionary period than states with non-binding tax and expenditure limitations.

Hypothesis 3 – Effectiveness of Non-Binding versus No Tax and Expenditure Limitations – States with non-binding tax and expenditure limitations will have experienced less fiscal stress in the fiscal year 2002 through fiscal year 2004 post-recessionary period than states with no tax and expenditure limitations in place.

Hypotheses 2 and 3 can be effectively considered together since the fiscal stress experienced by the three states can be analyzed relatively. Recall that fiscal stress is defined as a combination of the budget balancing actions adopted by the states to support actual general fund spending, as well as reductions from a long-term spending trend. Examples of the latter include the use of general fund balance, non-general fund transfers, new tax and fee revenue, and transfers from reserve funds. The former is composed of a straight line assumption of 5% annual growth above the fiscal year 2001 level, plus federal aid that was received in fiscal year 2003 and fiscal year 2004 that was used to supplant general fund spending.

Figure 5.10 shows the trend in fiscal stress for fiscal year 2002 through fiscal year 2004. Delaware experienced the lowest fiscal stress of the three states over the three-year post-recessionary period. Non-general fund transfers supported 5% of the fiscal year 2002 budget. Fiscal stress equaled 5% of general fund spending in fiscal year 2002, largely comprised of cuts from the estimated growth trend. By fiscal year 2004, spending was also supported by new taxes and fees and federal aid. However, it is important to note that in the fiscal year 2002 through fiscal year 2004 period, Delaware continued to have positive general fund revenue growth which helped to reduce the level of fiscal stress experienced.

Figure 5.10
Delaware, Maryland, and Virginia: Fiscal Stress
As a Percent of Ongoing General Fund Spending in
Fiscal Year 2002 – Fiscal Year 2004 (Note 1)

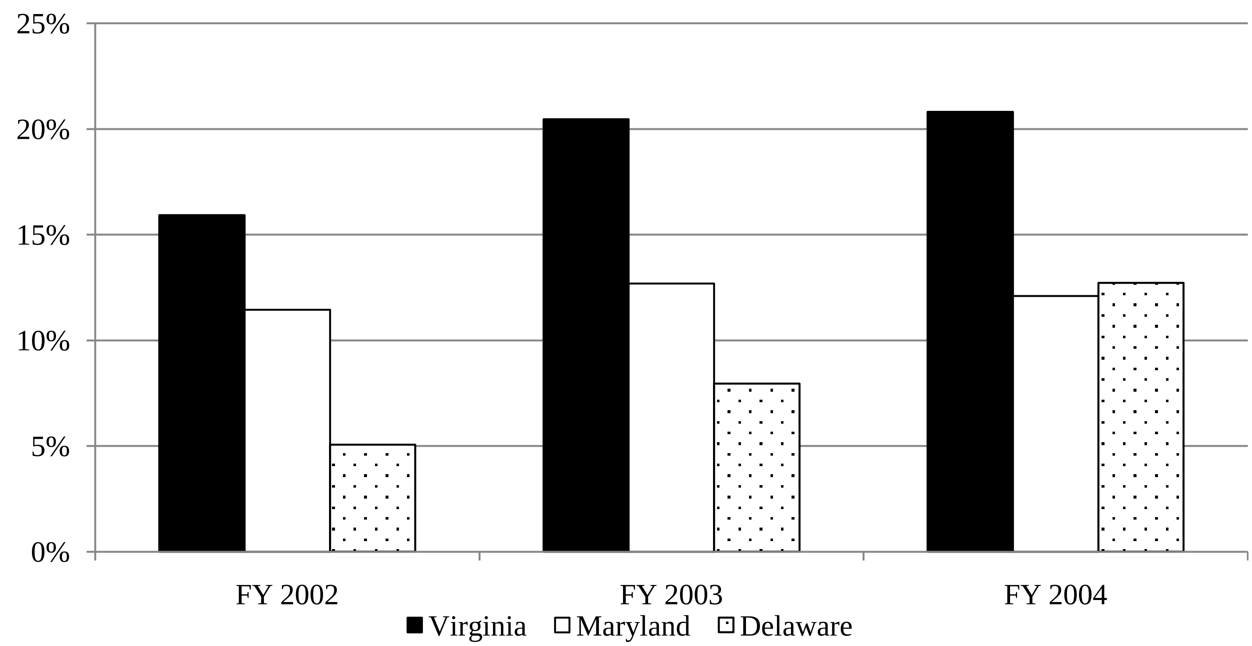


Figure Notes
Note 1: Sources: Zelio, Mackey, and Rafool 1999, 21; Rafool 2000, 23; Rafool 2001, 24; Rafool 2002, 22; Rafool 2003, 17, 21, 30; Rafool 2004, 17, 21-22, 37-38; Federal Fund Information for States 2004, 5; Todd Haggerty email to author, August 20, 2009 with attached file "DE, MD, VA general fund data (FY 1996 to FY 2005).xls"; Maryland Department of Legislative Services spreadsheet "Frank_reserve fund_FY 2010.xls"; Maryland Department of Legislative Services spreadsheet "FY 2002-2006 Transfers.xls"; .Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1994 - 1997); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 1998 - 2001); Delaware.gov Department of Finance State General Fund Expenditures by Category (F.Y. 2002 - F.Y. 2005); Bill Echelberger email to author, August 10, 2009 with attached file "Growth by Year to Chapter 781 (2009 Session) FY 06 Base.xls"; Senate Finance Committee staff provided a copy of a table entitled "Actual GF Revenue and Transfer History" which included non-general fund transfers in the Appropriations Act; Becky Covey email to author, July 10, 2009 with attached file "RDF History for Senator Whipple1.xls".

Fiscal stress in Maryland approximated an 11% level in all three fiscal years following the recession. Non-general fund transfers, general fund balance, and use of rainy day funds above the 5% level contributed over one billion toward the fiscal year 2002 budget, in addition to new tax and fee revenues. These sources were also used in fiscal year 2003 and fiscal year 2004, in addition to federal aid and cuts made from the estimated 5% growth trend. Even though between 1997 and 2001, Maryland had roughly comparable growth in general fund spending to Delaware, fiscal stress was higher largely because general fund revenues declined in fiscal year 2002 and fiscal year 2003.

Finally, in Virginia fiscal stress equaled 16% in fiscal year 2002 largely due to estimated reductions from the 5% growth trend, but also due to the use of over $1 billion in general fund balance, rainy day funds, and non-general fund transfers. Budget balancing actions to support over 20% of the budget were adopted in fiscal year 2003 and fiscal year 2004 mostly due to the estimated reductions from the growth trend. Spending was also supported by new taxes and fees, large use of non-general fund transfers, and federal aid which supplanted general fund spending. Stress was also exacerbated in Virginia because general fund revenue fell by about 4% in fiscal year 2002.

In analyzing the hypotheses it is important to also examine the responses from the nine interview participants. Interviewees were asked 3 sets of questions related to the effects of tax and expenditure limitations. This included the extent to which limitations (if present) constrained state spending in the boom times of the late 1990s; whether fewer budget balancing actions had been required after the recession as a result of having limitations in place; and what type of limit, if any, was the optimal tool for fiscal management.

Prior to the recession, the three participants from Delaware affirmed the benefits of their state's 98% limit. They indicated that the state maintained a 2% balance, more revenue was used for one-time purposes, and there were fewer supplemental budgets.

Maryland participants also thought that the spending affordability process did help to constrain spending growth in the late 1990s. In several years, the Governor introduced budgets that exceeded the limit, but the legislature always reduced spending in line with the recommended limit. One interviewee thought the Rainy Day Fund balances would be an indicator of successful spending restraint.

In Virginia, participants indicated that growth may have been higher but the state always had a balanced budget and could not spend beyond its revenues. One interviewee thought that limits would have handcuffed its pro-business and other investments. The Rainy Day Fund diverted some revenue, and surplus cash was used for one-time purposes.

In looking at the extent of post-recessionary budget balancing actions, the Delaware interviewees unanimously thought that their limit had better positioned the state to adopt fewer budget balancing actions, which always have to be put into place to some extent after a recession. One participant thought that the shortfall after the recession would have been much higher had growth not been limited.

Maryland participants thought that the constraint imposed by spending affordability did not mitigate the budget balancing actions that were required. One interviewee thought that growth would have had to have been limited to 1% below personal income with the surplus put into reserve, in order to make an appreciable difference after the recession.

Virginia interviewees thought that all major revenues fall, which necessitates budget balancing actions regardless of whether or not a tax and expenditure limit is in place.

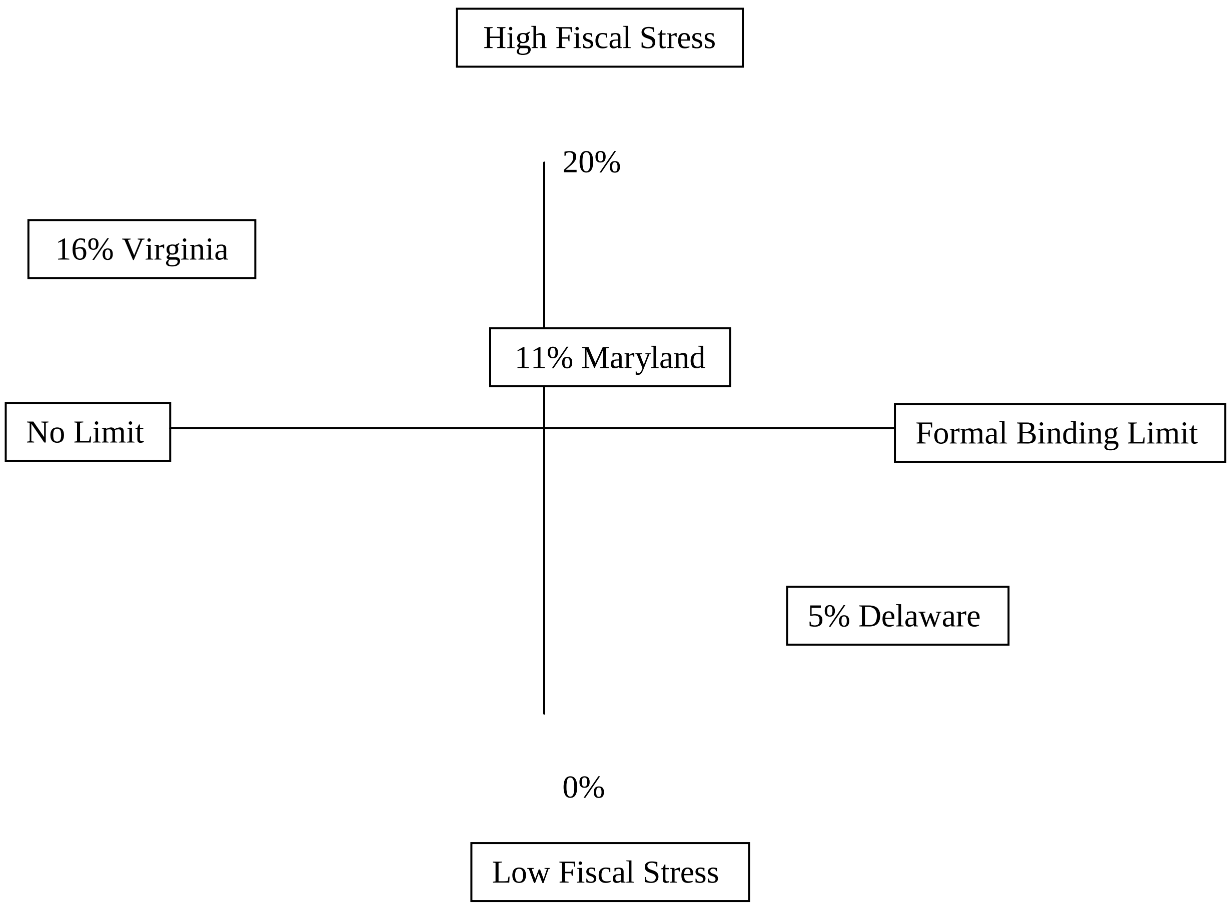
When queried about the optimal type of tax and expenditure limit (formal legal, non-binding, or no limit), all of the Delaware interviews cited their constitutional limit as the optimal approach. They all thought it limited spending in good times, is easy to calculate, and provides flexibility to use the remaining 2% in emergencies. There was no consensus on a non-binding limit with some viewing it as an ineffective approach and some believing that such an approach could work in Delaware given its conservative fiscal outlook. None of the interviewees favored having no limit in place.

Two participants in Maryland thought its non-binding approach was preferred. The third interviewee opted for no limit. None favored a formal legal approach because of concerns over flexibility to address unexpected spending needs, particularly during economic downturns. It was stated that officials are elected to make decisions. There was also concern that strict limits will spur creative ways to circumvent them. One participant noted that good people can make a bad fiscal system work and wrong minded people can subvert the best fiscal system in the world.

In Virginia, all three interviewees thought that the policy of no spending limit was the preferred option. They thought that formal legal limits were too restrictive and would impede the flexibility to meet unforeseen spending needs. There was no perceived difference between no limit and a non-binding limit. From the standpoint of accountability it was expressed that elected officials have a responsibility to assess public policy needs and make decisions on how much revenue to raise and how much to spend.

In the context of tax and expenditure limitations, **Figure 5.11** shows how the three states compare against each other in fiscal year 2002. Virginia, which has no limit, experienced the highest fiscal stress. Maryland with a non-binding limit experienced the second highest fiscal stress. Delaware, with a 98% constitutional limit on spending as a percent of revenue, had the lowest level of fiscal stress just after the recession.

Figure 5.11
Delaware, Maryland, and Virginia: Fiscal Stress in Fiscal Year 2002
Relative to Tax and Expenditure Limitation Usage



This study concludes that Hypothesis 2 – that States with binding constitutional or statutory tax and expenditure limitations will have experienced less fiscal stress in the fiscal year 2002 through fiscal year 2004 post-recessionary period than states with non-binding

tax and expenditure limitations – is not supported. Delaware experienced less fiscal stress than did Maryland in fiscal year 2002 immediately after the recession of 2001.

However, both states had seen roughly comparable rates of ongoing general fund growth between 1997 and 2001. The additional stress that Maryland experienced was due to general fund revenue declines in 2002 and 2003 whereas in Delaware positive revenue growth continued after the recession.

This study concludes that Hypothesis 3 – Effectiveness of Non-Binding versus No Tax and Expenditure Limitations – States with non-binding tax and expenditure limitations will have experienced less fiscal stress in the fiscal year 2002 through fiscal year 2004 post-recessionary period than states with no tax and expenditure limitations in place – is supported.

Both Maryland and Virginia saw revenues fall in fiscal year 2002. Maryland, which uses a non-binding spending limit, constrained ongoing general fund spending in the late 1990s relative to personal income. Virginia's ongoing spending grew an average of 10.8% annually between 1997 and 2001. Thus, while Maryland did experience fiscal stress at 11% of its ongoing general fund budget following the 2001 recession, the state fared better than Virginia which has no limit.

Hypothesis 4 – Rainy Day Fund Requirements – States that limit reserve funds to be used only during times of economic crisis, will have maintained larger reserve fund balances for use following the 2001 recession, than states that permit reserves to be used for broader purposes.

In order to test hypothesis 4, it is necessary to analyze each state's rainy day fund balance as a percent of ongoing general fund spending, as well as withdrawal requirements. This study assumed that states with tax and expenditure limitations would have limited growth below states with non-binding or no limits and, consequently, would have been more likely to deposit surpluses in their respective rainy day funds.

Figure 5.12 provides the rainy day fund balances in each state as a percent of general fund spending. Maryland built up the largest balances prior to the recession, accruing nearly 10% in reserve by fiscal year 2001. As noted, Maryland has a sweeper provision at closeout which allocates unappropriated general fund surpluses in excess of 10% to reserves. Delaware maintained a level of reserve balance equal to 6% of ongoing general fund spending throughout the period. Its policy is to cap reserves at 5% of general fund revenues, with excess balances transferred to the general fund. Virginia's rainy day fund balances increased from 2% of spending in fiscal year 1997 to 6% by fiscal year 2001. Virginia also has specific deposit provisions which sweep a portion of surplus revenues into the account at closeout.

With respect to withdrawal requirements, Virginia has the most restrictive limitations. Monies can only be accessed once a fiscal year has begun and when general fund revenue falls more than 2% below the actual sales and income tax collections for the prior year. Even after these conditions have been met, transfers may not exceed the lesser of 1/2 of the shortfall or 1/2 of the balance. So, not surprisingly during good times, none of the balance was used, and in conjunction with deposit requirements the balance increased each year through 2001. Virginia did not reach its 10% cap on the amount of funding allowed in its reserve fund.

Figure 5.12
Delaware, Maryland, and Virginia: Rainy Day Fund Balances
As a Percent of Ongoing General Fund Spending (Note 1)
Fiscal Year 1997 – Fiscal Year 2001

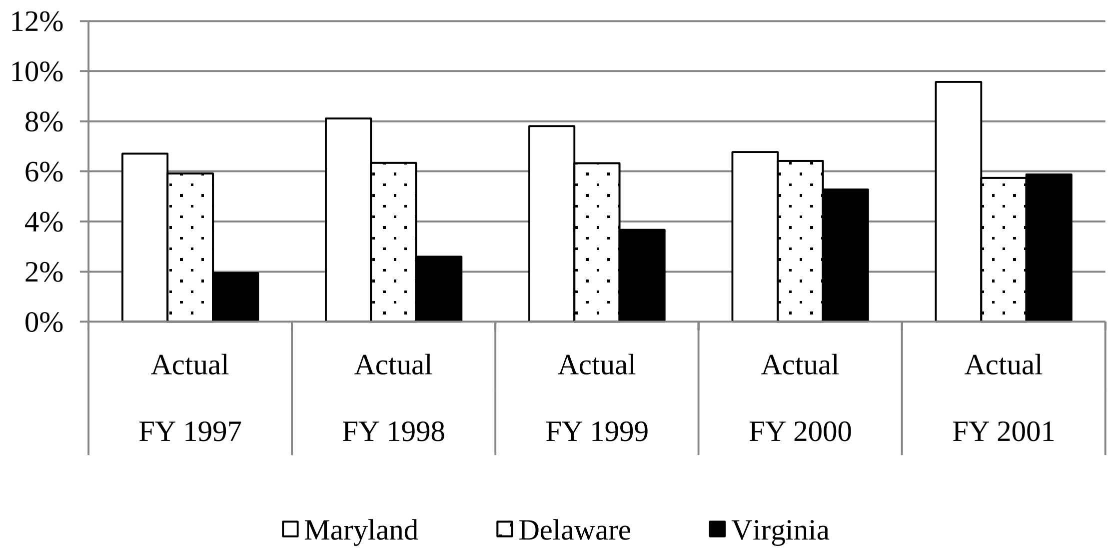


Figure Notes
Note 1: Source: Maryland Department of Legislative Services spreadsheet "Frank_reserve fund_FY 2010.xls"; Michael Morton email to author, September 29, 2009; Becky Covey email to author, July 10, 2009 with attached file "RDF History for Senator Whipple1.xls."

Delaware's rainy day fund may be used either to address unexpected deficits or to replace any revenue reduction enacted in legislation. During the 1997 to 2001 period, Delaware maintained the maximum 5% of general fund revenues in reserve and did not use any balance.

Prior to 1991, Maryland's reserve fund balance could only be accessed if unemployment remained above 6.5% for a certain six-month period prior to the next legislative session and if the rate exceeded the unemployment level for the same period in the prior year. This constraint proved to be unworkable when balances were needed at the 1991 session, so the law was changed to allow the Governor to appropriate any amounts needed in the budget bill. So while Figure 5.12 showed that Maryland maintained healthy balances in reserve, the Governor withdrew nearly $400 million in fiscal year 1999, fiscal year 2000, and fiscal year 2001.

Figure 5.13 demonstrates that Maryland's reserve balance would have approached 14% of ongoing general fund spending had the Governor not been permitted to access the balance for any purpose. Notwithstanding this, the state managed to maintain reserves in excess of 6% each year, and had nearly 10% set aside by fiscal year 2001 just prior to the recession.

Figure 5.13
Maryland's Actual Rainy Day Fund Balance vs. Balances Had Funds Not Been Used Prior to the 2001 Recession As a Percent of Ongoing General Fund Spending (Note 1)
Fiscal Year 1997 – Fiscal Year 2001

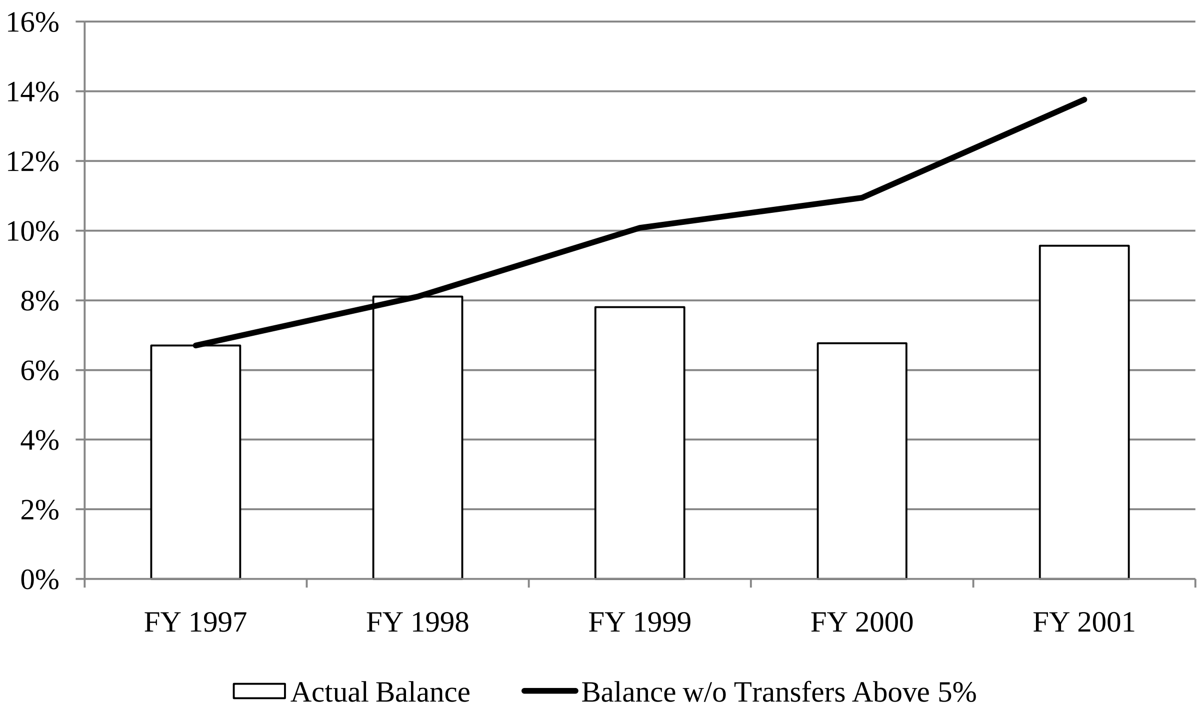


Figure Notes
Note 1: Source: Maryland Department of Legislative Services spreadsheet "Frank_reserve fund_FY 2010.xls".

In assessing Hypothesis 4, there are several factors to consider. Although Virginia has the most restrictive withdrawal requirements, it established its fund in 1992 and did not have large surpluses coming out of the recession of the early 1990s to build larger fund balances.

Virginia's rainy day fund balance is also capped at 10% of certain revenues for the preceding three fiscal years and would thus be constrained from establishing larger balances. Delaware also caps its rainy day fund balance, at 5% of revenues, constraining it from accruing larger balances.

Maryland had the least restrictive withdrawal requirements, later changed in 2006 to require the Governor to submit separate legislation to access fund balance below 5% of general fund revenues; however, even this limit would not have prevented the use of balance above 5% as occurred in the late 1990s.

This study concludes that Hypothesis 4 – that states that limit reserve funds to be used only during times of economic crisis, will have maintained larger reserve fund balances for use following the 2001 recession, than states that permit reserves to be used for broader purposes – is not supported. The state with the least restrictive rainy day fund withdrawal requirements had the largest balances as a percent of ongoing general fund spending, while the state with the most restrictive withdrawal requirements had the smallest balances. Cap requirements and the age of the accounts were factors which influenced the level of balance. There does not appear to be any relationship to the presence or absence of tax and expenditure limitations and the size of reserve fund balances.

Summary

Three cases studies of the states of Delaware, Maryland, and Virginia were analyzed in this chapter. Miles and Huberman suggest a case oriented, variable oriented, or mixed methods approach to analyzing cases. A mixed methods approach was used to examine fiscal policy variables across the states in the economic boom years of the late 1990s, as well as the fiscal stress outcomes following the 2001 recession.

The study examined four hypotheses to assess whether states with formal tax and expenditure limitations accumulated larger cash and reserve fund balances and limited spending growth during the late 1990s, relative to states with non-binding, or no limitations. It was also proposed that states with restrictive criteria for use of rainy day fund balances would additionally accrue larger fund balances.

The accumulation of cash balances was the expected outcome in a state with the most restrictive spending limit, and large cash balances were initially accumulated in Delaware. However, revenue growth decreased in part due to tax actions which eroded the revenue base. Cash balances were higher in Maryland and Delaware, which have tax and expenditure limits in place, than in Virginia which has no limit.

In assessing the success of tax and expenditure limits in constraining growth in good economic times, a measure of fiscal stress was used which was based on the level of reductions assumed from an average trend in spending growth as well as the extent to which temporizing actions were adopted. This included use of cash and reserve fund balances, transfers from non-general funds, federal stimulus aid, and revenue increases.

Delaware, which has a formal tax and expenditure limitation, had the least amount of fiscal stress following the 2001 recession, but this was largely due to better revenue performance after the recession than was seen in Maryland. Maryland, which has a non-binding limit, experienced moderate fiscal stress. The tax and expenditure limits in both states played a role in limiting ongoing general fund operating budget spending to comparable average rates of growth in the late 1990s. Virginia, which has no limit, was in the worst fiscal position of the three states after the recession.

States with the most restrictive withdrawal criteria for rainy day funds did not have the largest fund balances, as expected. This was due in part to cap limitations on the maximum level of balance and the age of the funds.

Elements of accountability were also examined. Political party dominance does not appear to have been a major influence on fiscal policy actions in the three states in the late 1990s. From the perspective of transparency, Delaware's limit is the easiest to calculate and report. Although Maryland reports the calculation at each step of the process, it is difficult to calculate and has included more exemptions over time.

It was also demonstrated that tax and expenditure limitations can be easily circumvented or may contain provisions which allow additional general fund spending. Legislation can be enacted to require greater spending in future years, which is outside of calculations which usually affect one budget year or cycle. Delaware's limit includes prior year fund balances and projected general fund revenues, which allows greater spending than if just revenues were considered.

Limits that only apply to general funds do not constrain spending for programs supported by non-general funds. Those that do apply to all state sourced revenue can be manipulated to allow general fund spending to grow excessively, which was the case in Maryland. Limits also cannot prevent revenue erosion from the repeal of taxes or the adoption of tax credits. Moreover, states can enact legislation which dedicates or redistributes revenue as a means of avoiding spending limits.

Finally, problems with tax and expenditure limits arise if spending is held to specific formula based growth. States must address current services needs, federal mandates, and unfunded liabilities among others.

CHAPTER VI – Summary, Conclusions, and Recommendations for Additional Study

Introduction

This chapter summarizes the study and its conclusions, discusses implications, and offers recommendations for potential future study.

Tax and expenditure limitations have existed since the 19th century, but took on national prominence with the adoption of Proposition 13 in California in the late 1970s. Limits have been chiefly adopted following bad economic conditions when governments are prone to adopt counter cyclical policies such as revenue increases, when the public can least afford them. In many instances they were adopted through external means in states that feature the initiative or referendum process, though some limits were adopted by states in order to avoid more stringent measures.

Similar to other reforms, such as balanced budget requirements and term limits, tax and expenditure limits have had mixed results affecting state government finances. Studies have found examples of states with such limits that have grown less quickly than states without limits or which have limited government's share of spending as a percent of personal income, but the results have not been conclusive.

The value of tax and expenditure limits as a tool to help make government smaller is not a practical goal. What is small enough? Should spending be limited by factors such as inflation and population growth? What if current services are insufficiently funded or if officials want to address major unfunded needs? A more practical approach to assessing the value of tax and expenditure limitations lies in their ability to limit the growth of ongoing general fund spending during good times, so as to limit the extent of counter cyclical actions during bad times.

Finally, the literature on accountability raises aspects of trust in government officials to adopt actions that best address the needs of citizens. As seen in the Friedrich-Finer debate, tax and expenditure limitations can be viewed as an externally imposed mechanism to limit revenue and spending actions instead of granting the flexibility to elected officials to use their judgment.

Summary of the Study Findings

This purpose of this study was to look at how effectively tax and expenditure limitations have been in restraining growth during periods of economic expansion, in order to limit fiscal stress during a period of economic downturn. Three states, Delaware, Maryland, and Virginia, having comparable fiscal management policies and revenue structures were chosen as case studies. Interviews were conducted with three participants from each state, including legislators, executive branch budget directors, and legislative branch staff budget directors. Quantitative data on revenue and spending trends and general and reserve fund balance were collected and analyzed.

The literature on tax and expenditure limitations found mixed results on their performance. Comparisons were made between states with and without limits, or among all states using different spending growth parameters such as growth relative to personal income. Some studies found that tax and expenditure limitations did constrain growth, while others found no difference.

Other themes related to financial management were also examined, chiefly relating to policies for depositing and withdrawing funds in rainy day fund accounts. There is no consensus in the literature over whether rainy day funds are intended to provide a short-term source of cash following a downturn or whether they ought to contain sufficient balances to carry a state through a recession. Credit rating agency guidance suggests that 5% in reserve is a desired level of balance.

Tax and expenditure limitations also serve as a tool of accountability, by limiting the discretion of elected officials to raise revenue or to increase spending excessively.

Conclusions

This study examined four hypotheses through an integrated analysis of qualitative interview narratives and quantitative budgetary data. In relation to Hypothesis 1, the study found that the level of cash balance held by a state is influenced by many factors. This includes revenue performance, legislation which enhances or erodes the revenue base, the extent to which surplus funds are credited to rainy day funds, how much ongoing general fund spending is permitted to grow during good economic times, and the degree to which surplus funds are applied to one-time purposes such as PAYGO capital. Thus, there was not necessarily a strong correlation between states having tax and expenditure limitations and the size of available cash balances.

The cumulative effect of revenue policy decisions during periods of economic growth was very influential on a state's cash position, as evidenced in the case studies of Delaware and Maryland. Income tax rate reductions, tax credits, sales tax exemptions, and other revenue actions were adopted each year between fiscal year 1997 and fiscal year 2001. While the data provides only a rough approximation of foregone revenue, it suggests that tax decisions in Delaware leading up to the recession reduced general fund revenue by approximately 10% of actual collections. In Maryland a 10% income tax reduction was the largest action enacted in the late 1990s, resulting in the loss of 7% of revenue just prior to the recession.

Hypotheses 2 and 3 were considered together inasmuch as they compare the degree of fiscal stress in a state with a binding tax and expenditure limitation (*i.e.,* Delaware) to a state with a non-binding limit (*i.e.*, Maryland), then comparing the state with the non-binding limit to a state with no limit in effect (*i.e.*, Virginia). The degree of fiscal stress in the first fiscal year following the 2001 recession was found to be the highest in Virginia, second highest in Maryland, and lowest in Delaware. However, fiscal stress was influenced by revenue performance after 2001, which was better in Delaware than in Maryland. Both Delaware and Maryland managed to limit ongoing general fund spending to comparable average rates of growth in the late 1990s.

Thus, the study concluded that the adoption of binding tax and expenditure limitations was no more successful in limiting ongoing general fund budget growth and limiting fiscal stress than the use of a non-binding limit in Maryland. Both states applied increasingly larger proportions of their budgets to one-time PAYGO capital as a result of limits to their operating budgets.

Virginia, which has no limit, experienced the highest average annual growth in its ongoing general fund operating budget. This was due largely to a decision to enact a car tax subsidy for local governments which gave relief to taxpayers but added a large ongoing spending component to the state's budget.

It was interesting to note that nearly all of the nine interview participants believed that the type of tax and expenditure limitation in place in their state, or in the case of Virginia no limit, was the optimal budgetary limit.

The study did not support Hypothesis 4 where it was expected that states with the most restrictive withdrawal requirements for rainy day funds would see the largest cash balances. Maryland had the largest cash balances, equal to about 10% of spending, but would have had balances closer to 14% had it not been for the ease with which the Governor could spend balances through the operating budget bill. The size of balances was also influenced by caps – Delaware's fund is limited to 5% of revenues and so its cash balance could not have been larger.

Virginia has the most restrictive withdrawal policies, which can only take effect during a fiscal year once a downturn of a certain size has been experienced. Moreover, the balance can only be used to solve the lesser of ½ of the shortfall or ½ of the balance. While Virginia's fund is also capped at 10% of revenue, the cap did not come into play because the account was too new to have built up sufficient levels.

It was also learned that two of the three states, (note that the general obligation bonds for all three states are rated "AAA" by all three credit rating agencies), were hesitant to use any rainy day fund balance below 5% lest they be put on credit watch or have their bond rating downgraded. Following the 2001 recession, Virginia withdrew fund balances and was not put on credit watch or downgraded by any of the rating agencies. All three states were selected for this study because of their strong and cautious fiscal management policies.

From the interviews, participants from all three states indicated that rainy day fund balances had not been used prior to the 2001 recession, which was true for the amounts below 5% of revenues – the apparent yardstick adopted by the credit rating agencies. Many of the participants also expressed an interest in increasing future rainy day fund balance requirements following the experience of adopting budget balancing actions after the recession.

Accountability

Interview participants opined that elected officials require flexibility to address needs, determine spending growth, and balance how much taxpayers should pay. It was suggested that voters ought to judge results based on services received and amounts paid, and if unhappy, vote for someone else.

Tax and expenditure limitations have varying degrees of transparency. The limit in Delaware is easy to calculate but only covers general fund spending. Maryland has a more complex limit to calculate which excludes a lot of spending but does include all state-sourced revenue. From the perspective of accountability, an ideal system would be one that balances flexibility while monitoring the direction of the economy.

Recommendations for Action and Additional Research

Based on this study there are several areas of significance to the field of public administration, and to public sector budgeting in particular. This section discusses four broad areas along with recommended actions that state government officials may consider implementing as tools of fiscal management or which may be the topic of additional research. This includes:

- tax and expenditure limitations as a tool of counter cyclical fiscal policy;
- general fund cash balance requirements;
- rainy day fund balance requirements and related policies; and
- surplus cash management policies.

Tax and Expenditure Limitations as a Tool of Counter Cyclical Fiscal Policy

While Maryland and Delaware use different types of tax and expenditure limitations, both types were successful in constraining ongoing general fund operating budget growth in good economic times. Both states adopted other positive fiscal management policies such as maintaining funds in reserve and directing surplus funds to one-time PAYGO capital purposes.

The disadvantage of tax and expenditure limitations is that they reduce the flexibility of elected officials to address spending needs specific to the circumstances within each state. State governments face pressure to adequately fund current services, expand services, address unfunded liabilities, meet federal mandates, expand information technology automation, etc.

Tax and expenditure limitations are imperfect and can be circumvented formally or through other means. These include multi-year spending authorizations, using more non-general funds, changing revenue distributions or adopting tax breaks, or by other loopholes in their design. It appears that revenue policy decisions had as much of an impact on each government's cash position as spending decisions.

Recommendation for Action: Virginia, and other states with no tax and expenditure limit in place, may benefit by considering adoption of a system or set of policies to compare proposed operating budget spending relative to some measure(s) of economic activity. Maryland's non-binding limit is complex and difficult to calculate, and permits general fund growth to exceed the overall recommended budget limit. Consideration could be given to a simpler calculation methodology, and to apply the limit to each revenue source in order to reduce manipulation. Delaware may consider excluding prior year fund balances in the calculation of its 98% limit, in order to limit the effects of large one-time fund balances during good times.

Recommendation for Further Study: Additional research may be considered to assess the effectiveness of tax and expenditure limitations in other states at constraining ongoing general fund spending growth. Such analysis could also examine the fiscal management policies of states that operate with and without limits to ascertain use of funds for one-time purposes.

General Fund Cash Balance Requirements

A requirement to maintain a minimum 2% general fund balance exists in Delaware but not in Maryland or Virginia. The value of a cash balance requirement is twofold. First and foremost, it provides the first line of defense against revenue under performance, behind rainy day fund balances. Delaware's 2% methodology is easy to calculate, can be overridden in emergencies, and adds certainty to the amount of balance remaining at the conclusion of budget action.

Recommendation for Action: Neither Maryland or Virginia has rules governing the size of general fund balance. These and other states may benefit by adopting similar guidance on the level of general fund balance.

Recommendation for Further Study: Additional research could examine the existence and functioning of general fund balance requirements in place in other state.

Rainy Day Fund Balance Requirements and Related Policies

Hou, Joyce, and Zahradnik discuss provisions to improve rainy day fund policies in order to accrue larger fund balances to be available during poor economic conditions. These included no caps on maximum balances, formal deposit mechanisms, no supermajority requirements for withdrawal, longer time to replenish balances once used, no limits on the amounts that can be withdrawn, and the dedication of fund balances to only address budget shortfalls in lieu of broader purposes.

Virginia's rainy day fund has formal deposit requirements up to a 10% cap, with restrictive withdrawal requirements to use balances only for current year shortfalls. Delaware maintains a fund capped at 5% of revenues. The fund has never been used due to the state's conservative fiscal policies. Maryland's fund has formal deposit requirements, no cap, and liberal withdrawal requirements.

Based on the multi-year nature of the fiscal stress experienced by the three states, it is not realistic to expect rainy day fund balances to fully cover revenue shortfalls. While the credit rating agencies support a 5% reserve balance, Joyce suggested that each state should determine the optimal amount based on revenue volatility. Political acceptability is also a variable that has to be considered in balancing the goals of saving surplus revenues vs. addressing unmet spending needs.

Recommendation for Action: Based on the literature and the stated interest by several of the interview participants, maximum balance caps on the rainy day funds in Delaware and Virginia should be removed so that larger balances can be realized. While Virginia has very restrictive withdrawal requirements, there is value in limiting use of the balance to the lesser of ½ of the balance or ½ of the shortfall since this theoretically spurs the state to adopt other ongoing revenue and spending actions to achieve balance. However, any benefit would be lost if other one-time actions are pursued.

Other states could consider limiting the amount of reserve fund balance that can be used during a year in order to encourage ongoing budget balancing actions. At one time, Maryland had overly restrictive withdrawal policies, but those were modified to permit funding for any purpose. Consideration could be given to limiting withdrawals for the sole purpose of addressing budgetary shortfalls. Delaware may also wish to examine its withdrawal policies since in practice the state has foregone any use of this budget balancing tool.

Recommendation for Further Study: Additional research could focus on the optimal size of rainy day fund balances by the states and credit rating agencies, and whether concern over bond ratings influenced decisions to forego use of balances during recessionary periods.

Surplus Cash Management Policies

Shunk and Woodward had suggested that states adopt tax and expenditure limitations to constrain growth to changes in inflation and population, then use rules to allocate 1/3 of the savings to PAYGO capital, 1/3 to reserve, and 1/3 as tax rebates. Regardless of the form of tax and expenditure limit, there is some value in considering budget growth within a larger economic context.

Many of those interviewed for this study expressed the view that the role of elected officials is to make revenue and spending decisions for their state. Voters then decide their satisfaction with state fiscal policies through periodic elections. As this study showed, however, there are many elements to consider with respect to the management of surpluses. This includes how much to allow ongoing general fund spending to grow each year; how much to spend on one-time purposes; overall revenue policies to address the need for tax relief, tax credits to provide incentives for specific purposes, or to divert revenue to limit the temptation to spend more; and policies to divert surplus revenues to reserves or toward large unfunded liabilities.

Recommendation for Action: States need to pay particular attention to revenue policies during good economic times, as the cumulative effects of multiple years of tax actions can have detrimental effects on financial management. Because of the difficulty in raising taxes, states would be better served by limiting tax relief to one-time actions such as rebates. States ought to determine methodologies for allocating surplus funds at closeout to unmet spending needs, PAYGO and other one-time purposes, and diversion to reserves and unfunded liabilities.

Recommendation for Further Study: Further research could examine state government policies for allocating unanticipated revenue surpluses. State finances suffer when large unexpected balances accrue and policy makers allow ongoing spending to grow beyond sustainable levels. There may be states that have adopted policies that divert portions of surplus revenues at closeout to a mix of tax rebates, PAYGO or other one-time purposes, ongoing spending growth, unfunded liabilities, and reserves.

Additional Significance of Findings

Finally, this study highlights other areas of significance related to the formats of public sector operating budgets, the value of the research methodology, and the importance to this researcher as a scholar and practitioner.

- ***Budget Formats:*** As was noted in Chapter I, governments use different formats for preparing and reporting public sector spending. This ranges from line-items to performance budgets. As this study highlights, regardless of the format used governments should consider isolating specific budget elements at a macro level so that taxpayers can better ascertain fiscal management decisions. This could include reporting ongoing general fund spending compared against ongoing general fund revenue; general fund spending for one-time PAYGO capital; and the allocations and balances of reserve funds;
- ***M*ethodology**: While case studies provide in-depth analysis, their findings are not often generalizable. This study sought to improve the external validity of the findings by combining qualitative interviews with quantitative fiscal data, which was integrated to help confirm or refute the opinions of the interview participants. This mixed methods approach helped to identify lessons in fiscal management that any government may be able to use; and
- ***Value to the Researcher:*** As a scholar, this researcher benefitted through exposure to academic research on the topics of tax and expenditure limitations and approaches to cyclical instability. The findings of this study may provide additional avenues for academic research for future scholars. As a practitioner, the findings of this research offer lessons that can be discussed with elected officials when making fiscal management decisions. This can include the policies related to general fund and reserve fund

balances, the advantages and disadvantages of tax and expenditure limitations, and revenue and spending options during good economic times.

Summary

Tax and expenditure limitations are not a panacea. State fiscal management, particularly as it relates to efforts to deal with surpluses in good times and maintaining balanced budgets in bad times, is not a paint-by-numbers kit. As this study has shown, there are strong interrelationships between revenue actions, spending growth, and general and reserve fund balances during good times.

Tax and expenditure limitations do have value in constraining ongoing operating budget spending during boom times. However, if they are constructed too rigidly, they can impact a government's ability to properly fund services and address unmet needs. Moreover, any limit, no matter how it is constructed, can be circumvented. Ultimately, it is up to elected officials to balance the need for services against the burden of paying for them, and then for voters to express their satisfaction or dissatisfaction at the polls.

Larger issues of cash management were also raised. With respect to reserve funds, states have differing approaches as to deposit requirements, the size, and accessibility of rainy day funds. Larger balances in reserve serve a counter cyclical purpose but cannot be amassed at the levels needed to carry a state through a recession. Ideally, states should not maintain limits on maximum balances, should determine balance goals based on revenue volatility and political acceptability, should adopt automatic deposit requirements, and limit use of balances to addressing budgetary shortfalls.

Surplus cash management and revenue policies also have an important role in fiscal management. Conservative revenue forecasting in the public sector often leads to large unexpected fund balances and ensuing pressures to spend them by advocates for government services. Pressure is also exerted for tax relief or targeted measures such as tax credits to encourage certain policy goals. This study found that states adopted revenue actions over multiple years that cumulatively eroded the general fund revenue base to varying degrees. Revenue policies should be more carefully monitored in good times.

Actions to reduce pressures to ramp up ongoing spending and erode revenues can be mitigated by the adoption of policies to maintain minimum levels of general fund balance and reserves, to direct spending to PAYGO capital and other one-time purposes, to apply funds to large unfunded liabilities such as retirement systems and retiree health care needs, and to provide limited one-time tax relief such as rebates to taxpayers.

Ultimately, elected officials need both the flexibility to manage government finances and guidance from responsible policy sources such as state fiscal agencies to responsibly address spending needs. Both require knowledge of national, regional, state, and local economic conditions; a clear understanding of state policy dynamics; and the political will to continue the development of a process of fiscal management with both a retrospective of past fiscal policy experience and a prospective view of what new elements of fiscal strategy may be necessary to achieve the fiscal policy outcomes envisioned by these policy tools.

APPENDICES

Appendix A – Interview Cover Letter

Month 1, Year

Dear Participant:

One of the requirements for the Doctor of Public Administration program at the University of Baltimore is the completion of a dissertation analyzing a public policy issue germane to the field. My objective is to conduct a comparative time-series case study which will examine the fiscal management practices of Delaware, Maryland, and Virginia in the late 1990s and the fiscal years subsequent to the recession of 2001.

Data to be collected will be comprised of end of year balance information for the general fund and reserve funds, tax cuts enacted in the late 1990s, and the actions taken following the recession to ensure a balanced budget. This includes but is not limited to tax and fee increases, spending reductions, use of reserve fund or general fund balances, transfers from other dedicated funds, accounting changes, and other actions. Part of this research will also include interviews of public officials from each state. I intend to interview one legislator from a budget committee, the legislative fiscal staff Director, and the Director of the executive budget office. The purpose of the interviews is to assess each participant's perspective on the fiscal management policies during the peak of the business cycle to determine how well each state was prepared for the loss of revenue resulting from the economic downturn.

The interviews are anonymous and no information or statement will be attributed to a specific participant. Your participation is voluntary. There is no penalty should you refuse to participate, or choose to discontinue participation at any time. Each interview is expected to last no more than one hour per participant, and will be recorded as a means of ensuring accuracy. You will be given the opportunity to read and confirm the accuracy of the notes taken from the interview as well as to review the findings in general. Notes and recordings from the interview are confidential and will not be made available to anyone other than the interviewer and interviewee. Any recordings will be destroyed upon the completion of the project.

In closing, thank you again for your willingness to assist in this research. It is hoped that the findings from this study will help to further the understanding of state fiscal management policies, and you will be given a copy upon its completion. Should you have any questions at any time about this research I can be reached either by email at david.juppe@mlis.state.md.us or by calling my cell phone at 410.991.8149.

Sincerely,

David B. Juppe, MPA

Appendix B – Interview Questions

Background

1. What is your name and state (Delaware, Maryland, Virginia)?

2. What is your role (Legislator/former Legislator, Executive Branch Budget Director, Legislative Branch Budget Director?

3. In what years have you served in this capacity?

4. What is your political party affiliation (R, D, I, Non-Partisan)?

Pre-Recession Activity

Prefactory: The late 1990s was a period of economic expansion. I am specifically focusing on the range of years between 1997 and 2001, prior to the recession.

5. During the good times of the late 1990s, what types of actions did your state take with respect to taxes, creating or increasing a reserve fund balance, or increasing spending for either new initiatives or program expansion?

6. Were there discussions that spending growth should be limited?

   a. What efforts, if any, were taken to limit growth?
   b. What was your role?
   c. Did the presence or absence of spending limits in your state play any role in limiting spending growth?
   d. Were there any other budgetary processes or institutional controls that may have acted to limit spending growth during this period?

Post-Recession Activity

Prefactory: The 2001 recession began in March, but for most states its effect was realized during fiscal year 2002 and during preparation of the fiscal year 2003 budget. Many states continued to deal with funding problems in fiscal year 2004. For the following questions, I am focusing on the range of years between 2001 and 2004, after to the recession.

7. Following the 2001 recession, what types of actions did your state take to address the downturn in the economy? For example, did your state:

   a. Raise taxes or fees?
   b. Use the balance in the rainy day fund below its required minimum?
   c. Adopt other one-time actions such as sale of assets?
   d. Transfer balances from dedicated funds?

e. Cut spending?
    i. What areas of the budget were cut?
    ii. How difficult was it to decide where to cut and how much to cut?

f. Adopt accounting gimmicks, such as delaying payment of bills to a future fiscal year, for example?

8. Based on the experiences of the last recession, what actions do you think your state might undertake during the next period of economic expansion?

<u>Reserve Funds</u>

9. Prior to the 2001 recession were rainy day fund balances accessed, transferred, or spent for purposes other than deficit reduction?

    a. What were the funds used for?
    b. Who initiated their use?
    c. Was there any controversy about their use?

10. If reserve funds were not used, but instead retained as fund balance, what pressures kept those funds from being used?

<u>Effects of Institutional Limits</u>

11. From the standpoint of fiscal management, do you think that it is better to have a constitutional or statutory limit on revenue or spending, a non-binding limit on revenues or spending, or no limit?

12. Do you think the presence or absence of tax and expenditure limitations had any effect in restraining state general fund spending from 1997 until 2001?

13. Do you think that the presence or absence of tax and expenditure limitations had any effect in mitigating the extent to which actions were taken to balance the budgets following the 2001 recession?

Appendix C – Data Collection: Documents

Data to be collected from Maryland, Virginia, and Delaware includes:

Rainy Day Fund

1. Year established
2. Balance requirements
    a. Level (*e.g.*, 5%)
        i. Is upper limit capped?
    b. Rules for appropriating funds to the fund
3. Withdrawal requirements
    a. Super majority vote?
    b. Criteria for withdrawal
        i. Formula
            (1) Unemployment
            (2) Revenue performance
            (3) Other
        ii. Any purpose

4. Repayment provisions
5. Balances fiscal year 1997 to fiscal year 2004
    a. Appropriations
    b. Withdrawals
        i. Was fund used in 2001-2004 post-recession period?
    c. End-of-year balance
    d. Percent of General Fund expenditures

General Fund Balance

6. End-of-year balance 1997-2004
    a. General fund revenues
    b. General fund spending
7. Balanced budget requirements
8. Revenue and Spending Actions
    a. Annual general fund tax reductions
    b. Annual general fund spending reductions
    c. Annual Transfers
        i. Rainy day funds
        ii. Other dedicated special funds
        iii. General fund balance
        iv. Other revenue actions
        v. Accounting adjustments
        vi. Tax and expenditure limit waived in any year (except Virginia)

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