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Authors

Katherine G. Willoughby is professor of public administration and urban studies at Georgia State University. Her primary focus of research is on state government budgetary and fiscal management. She is the coauthor (with Kurt Thurmaier) of Policy and Politics in State Budgeting. Her recent research in this area examines the decision-making activities of government budget analysts in three American cities. She is also a grading team leader in the area of MONEY for the Government Performance Project. The project assesses the management capacity of the American states. Results from the most recent survey are available at www.gpponline.org. Email: kwilloughby@gsu.edu

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Katherine G. Willoughby
Georgia State University

Betting on the Future with a Cloudy Crystal Ball? Revenue Forecasting, Financial Theory, and Budgets— An Expanded Treatment

Fred Thompson and Bruce L. Gates

Thompson and Gates present a financial management toolkit to support state government navigation through fiscal storms. This toolkit suggests analytical methods, rules, and institutions that can help states reduce revenue volatility of tax structures. The "good result" sought is structural balance: the ability of a state to generate revenues adequate enough to support spending policies. Toolkit components assessed by these researchers include growth analysis, portfolio analysis, hedging, and consumption smoothing. They also incorporate a financial theory orientation.

In this commentary, I consider outcomes of the 2005 Government Performance Project (GPP),

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as well as research about individual states, to tease out the usefulness and challenges of components of the toolkit.¹ With these data, I first offer to *PAR* readers a broader overview of why Thompson and Gates's focus on structural imbalance and efforts to smooth revenue volatility in the states is a salient and important topic. I then use data from the GPP to discuss the opportunities and challenges that the authors are likely to encounter when trying to introduce portfolio analysis, pooling, and other aspects of their proposal into the budget process. I conclude that the authors have performed a service by nicely framing a salient and enduring issue facing state governments and by offering ways to address this issue. Still, political realities of

the budget process in most states are likely to make key aspects of their financial theory-based proposal problematic in practice.

State Economic Context and Tax Reaction

The period from 2000 to the present provides an especially unique one for the study of structural balance in the states and attests to the need to look for possible solutions to state revenue volatility. In recent years, several factors have contributed to dramatic shifts in state revenues and, in turn, expenditures. These include the recession brought on partially by September 11th, and Washington's subsequent focus on homeland security and the war in Iraq. Also responsible are the accountability requirements of No Child Left Behind legislation, as well as unusually frequent and virulent natural disasters both in the United States and abroad. State challenges have been accentuated because many states cut taxes and increased spending amid the very strong economic growth of the 1990s.

An examination of the net effects of enacted revenue actions in the states during that decade is telling. From 1997 through 2000, when revenues were fairly plentiful, states consistently cut their most predominant revenue sources: sales and income taxes. States realized a net decrease in revenues of billions of dollars in every one of these years, and a total decline in revenues of approximately \$26.7 billion in nominal terms. This exacerbated state budget imbalances in the subsequent recessionary period. Thus, from 2002 to the present, state tax bases and rates had to be increased to generate revenue growth. Net increases in revenues were realized annually in every one of these years, except 2007, for a total in nominal dollars of \$23.9 billion. By 2007, fiscal stress began to subside a bit. Net revenues resulting from changes declined by \$2.1 billion in 2007.²

Engaging Governors to Focus on Structural Balance

This pattern of state taxing behavior suggests the need for more effective financial management tools. The toolkit offered by Thompson and Gates focuses on structural balance and can serve to educate and perhaps temper expectations of state budgeting stakeholders. Stakeholders include those intricately involved in the development, passage, execution, and audit of state budgets, as well as citizens. Typically, governors—as state chief executives—drive the budget and policy agenda in any given year. Even though this role may be muted in "strong legislative" states, governors set the stage for citizens' expectations regarding impending accomplishments and the costs of state government operations in the next fiscal year. They can, for example, sensitize citizens to structural balance problems. Moreover, state governors would currently seem more amenable than in the past to consideration of toolkits like the one offered by Thompson and Gates.

In their 2007 state of the state addresses, a majority of governors referred directly to structural balance problems, and 71 percent mentioned budget balance, surplus or deficit, and/or rainy day funds (Willoughby 2007, 150). For example, Maryland's governor referred to his state's "huge looming structural deficit." Connecticut's governor weighed state investments against recommended tax increases. She explained to citizens: "I have had to make cuts I did not want to make and I have had to raise taxes I did not want to raise, in large part because we have a constitutional cap on spending. But, I respect that cap and I believe it acts to restrain runaway spending and taxes." Mississippi's governor distinguished one-time money from ongoing revenues, noting that the problems associated with using one-time money to fund ongoing expenditures "would put us back in

the same budget hole we were in when I was elected. We've dug out of the hole; and we have to stay out of it" (Willoughby 2007, 152).

Thus, proposed strategies for governors to use to address structural imbalances they face are increasingly salient, and Thompson and Gates have offered their own toolkit for consideration. Informed by these tools, governors might educate citizens about the problems states face and why they are addressing them in specific ways. These efforts at education might help reorient public expectations about what government can and cannot accomplish, in what ways, and with what revenues.

Realistic Application of Toolkit Components

But how likely are governors and other elected state officials to follow Thompson and Gates's advice? The greatest challenge for their proposals is realistic application of their toolkit to current state budget and financial management processes. For example, revenue estimates must be packaged into a final state revenue forecast that legislators use to deliberate and pass the budget each fiscal year. Analytical tools support one form of rationality, but such analyses must be coupled with the formal and informal aspects of the budget process. This means gaining agreement on the revenue forecast itself.

Of the dozen states indicating a strong, as opposed to weak, long-term budgeting perspective in the GPP study, ten utilize a consensus method of forecasting state revenues. Consensus methods include the participation of members from the executive and legislative branches, as well as other external stakeholders. These groups develop revenue and (sometimes) expenditure estimates, as well as the final revenue forecast. Interest-

ingly, states combining multiple methods of analysis (including simple trend analysis) with consensus forecasting produce the most accurate revenue forecasts, if one compares general fund revenue estimates to actual revenues. Mathematical accuracy of forecasting notwithstanding, agreement among stakeholders on the forecasted amount is thus the primary constraint on the next year's spending plan.

Consensus-based or otherwise, broadening the amount, type, and quality of information used to make decisions about the revenue future can certainly be useful. Consequently, Thompson and Gates's effort to provide a better understanding of the random versus systematic components of revenue volatility may aid state budget stakeholders to focus on possible methods to reduce such volatility. However, "the essential prerequisite of economic rationality is that multiple ends have been specified and valued" (Thurmaier and Willoughby 2001, 103). Also, within a technical-political framework, there are a number of feasible options to solve whatever budget problems are identified. Thus, agreement on which option to choose is paramount to taking action. Even then, adoption by governments of toolkit components is one step, agreement as to application in the budget process is a second step, and then consistent championing and use of the component over time is a third step. And all of this is complicated by the politics of state budgeting, the fluidity of the process, and the timeliness of the budgeting cycle.

The example of portfolio analysis applied to Oregon that Thompson and Gates provide is interesting and illustrates this dilemma. Oregon's tax structure is not diversified. Over three-quarters of the state's total tax revenues are from individual and corporate income taxes. Common practices in the state include late budgets and continuation budg-

ets. Citizens of Oregon also have both initiatives and referenda that constrain state government fiscal decision making, diminish revenue and expenditure flexibility, and erode the possibility for structural balance.³

The authors illustrate how tax portfolio diversification in this state can reduce revenue volatility "without substantially reducing revenue growth." They further note, however, that to generate a tax portfolio that is both equitable and efficient would not reduce revenue volatility. They add that "portfolio analysis tells us that we need a lot of tax types to eliminate all unsystematic variance in revenue growth. We may not have enough tax types to work with." Yet Oregonians have been offered the chance for tax diversification and additional revenues through a sales tax at least nine times, and every time citizens have voted "no" and "often by large margins" (Simonsen 2006, 122). Agreement on the ends and the discipline to work toward these ends must be possible in order for portfolio analysis to work.

Wisconsin also exhibits weak structural balance and illustrates how politics has compromised fiscal discipline in the government. These dynamics would make application of the toolkit components offered by Thompson and Gates very difficult, if not impossible. Unlike Oregon, Wisconsin has a fairly diverse tax structure. The state depends on several major tax sources, which comprise nearly 90 percent of its revenue (viz., the individual income tax and the general and selective sales taxes), as well as other minor tax sources. Also strengthening possibilities for structural balance is Wisconsin's requirement that new tax policy and/or amendments be coupled with the budget bill. As Conant writes, "The budgetary process brings together decision making about both revenues and expenditures and, at least in theory, provides a clear-cut mechanism for

elected officials to ensure that expected revenues equal anticipated expenditures" (2006, 239). Also improving the chances for structural balance, Conant identifies a macro-budgeting process in the state in which budget decisions are enclosed within a specified framework. The framework "may include a definition of how much the state will spend, how the revenues to support that spending will be raised, what the priorities will be, and what share of state expenditures each program, agency, or function will be assigned" (Conant 2006, 241-242). If used, this process presents overt tradeoffs among budget priorities within defined parameters that should promote structural balance.

Nonetheless, weak structural balance is chronic in Wisconsin. This is partly because political leaders "have made an extraordinary financial commitment to local governments and to K-12 schools," and because they have acquiesced to other citizen demands for funding (Conant 2006, 248). GPP findings identify constant struggling by this state to meet these demands. They also show use of a compendium of revenue and expenditure strategies to manage chronic budget imbalance, an inability or unwillingness by legislators to fund Wisconsin's rainy day fund, and typically negative general fund balances each year. Conant emphasizes that "the structural dimension of the FY 2001-2003 and 2003-2005 budget problems was largely the result of gubernatorial and legislative policy decisions made during the 1990s, add[ing] more than \$2 billion worth of expenditure increases to the base budget and cut[ting] taxes by almost \$2.6 billion" (2006, 252). He adds that the state's creation of a rainy day fund that itself was not funded is "rather surprising in a state known for both its progressive approaches to governance and marvelous institutional capacity" (2006, 252-253).

My larger point is this: while restructuring and reforming individual taxes is a commonplace occurrence in the states, large-scale, comprehensive tax reform is done much less often. As such, the portfolio analysis component of the toolkit offered in this article is interesting and thought-provoking from a theoretical and analytical standpoint. Yet the realpolitik of state budgeting processes makes it problematic in practice.

Finding Traction with Pooling

At the same time, Thompson and Gates's proposal for pooling state rainy day funds to advance budget balancing is intriguing and might find traction in some states over time. States in the habit of keeping rainy day funds replenished might be lured by the possibility offered of increased revenues. But states completely depleted rainy day funds during the period from 2002 to 2004. Moreover, many continue to struggle to keep these funds at legally prescribed levels, if they fund them at all.

To be sure, the strictures placed on depositing and accessing funds in a rainy day pool could foster greater fiscal discipline in the states and help abate revenue volatility. Yet a healthy number of states would first have to join the pool. Moreover, an analogy may hold between developing nations and some states when it comes to this proposal. In developing countries highly dependent upon donor funds to support programs, services, and infrastructure, structural balance is often not officials' first priority. Also, they frequently complain that they do not have sufficient flexibility to spend donated funds in other than prescribed ways and within certain periods of time. Consequently, even some of the most needy nations have declined funds that do not afford the flexibility they need. Might not U.S. states exhibiting

chronically weak structural balance—that is, states needing the support of such a pool the most—react similarly? Pooling rainy day funds and providing comprehensive oversight of these funds inevitably reduce individual state flexibility to manage them as they might wish. Still, if enough states were to join, make prescribed deposits to the pool, and subsequently realize increased revenues from pooling, the interest of nonmember states may be piqued.

Changing Expectations

Thompson and Gates are correct when they say that modern financial theory is "about understanding and making prudent choices in the face of financial uncertainty." But anyone applying financial theory to address revenue volatility in state governments must recognize the political messiness of dealing with such uncertainty. Citizen expectations are often contradictory. This is most overtly exhibited when they press state governments for tax reductions and/or eliminations, while simultaneously demanding program and service delivery increases. Political leaders react as expected: they push tax cuts and spending increases during periods of revenue growth. As I noted earlier, these choices then exacerbate fiscal stress in periods of recession when new revenues must be found and spending must be cut.

Amid these contradictions, prior research finds no one technical path to structural balance within the states. Of the eight states that scored well on structural balance in the GPP, tax structures ranged from highly diverse to almost sole sourced. Nor did any one tax structure emerge as the means to structural balance. Rather, it was a state's use of its management tools and rules (formal *and* informal), as well as the politics of budgeting, that either supported or compromised structural balance.

Concluding Thoughts

The greatest strength of the toolkit offered by Thompson and Gates is its focus on structural balance, in particular revenue volatility abatement. Also useful is the variety of the tools they offer. Attuning political leaders and citizens to name the sources of structural imbalance, and define and weigh alternative solutions to it, is a first step toward fiscal responsibility. On the other hand, their toolkit's greatest weakness is realistic and consistent applicability within complex, fluid, and political budget systems. The authors do seem to recognize such hurdles. For instance, they suggest hedging against revenue volatility as a possible toolkit component, yet they also point out that it is unlikely that "governments will embrace the use of futures and options contracts to hedge against systematic revenue volatility any time soon, both for political and technical reasons."

The formidable task of governors, legislators and citizens in the 21st century is to incorporate any set of rational technical prescriptions into a political process. How might this occur? A citizenry that desires strong leadership and a willingness to consider possibly painful strategies for solving public problems would help. Elected officials interested and prepared to discuss chronic budget problems are a must. Governors' state-of-the-state addresses this year seem to indicate that at least some elected officials are moving in this direction. Thompson and Gates's work can help advance this educative process. Bringing technical rationality as an input into the political discussion is not an insignificant contribution. Turning technical rationality into decision rules for making political choices, however, is likely to be a "mug's game."

Notes

1. The GPP is a 50-state survey of government management capacity that is supported by the Pew

Charitable Trusts and the Pew Center on the States. Information and data presented from the GPP are from survey results in the February 2005 issue of *Governing* and online at www.gpponline.org. A complete explanation of the survey, the research methodology, grades, and scores—overall and by state—are available at this website.

2. Data for this section consider enacted revenue actions by state and type of revenue, net increase or decrease in millions of dollars as presented in Table 7 of *The Fiscal Survey of the States*, fall surveys in the years 1996 to 2006, and in Table 8 of the *Fiscal Survey of the States*, spring survey 2007, published by the National Association of State Budget Officers and accessed at www.nasbo.org on August 1, 2007.
3. The GPP measure of structural balance took into account a compendium of variables, including, but not limited to, the existence, funding, and use of budget stabilization and/or rainy day funds or other countercyclical devices, use of earmarked and one-time or windfall funds, revenue and expenditure change strategies, and general fund-ending balances and total balances as a percent of expenditures across years. Eight of the 50 states scored as having strong structural balance as measured by GPP; these states were able to weather through the period of fiscal stress under study. Relative to other states, these governments made modest revenue and expenditure adjustments, and exhibited discipline by linking ongoing revenues with ongoing expenditures and one-time or windfall funds with one-time expenditures. These states were not as likely to divert earmarked revenue into general funds, were more likely to have funded and be able to use countercyclical devices like rainy day funds to reach balance, and to exhibit stable and/or growing year-end general fund balances and total balances as a percent of expenditures.

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