Special Report / Viewpoint

Problems and Prospects For State and Local Governments

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Once again, states and localities are facing severe budgetary pressures and are being forced to take actions to get their fiscal houses in order. Indeed, as measured in the National Income and Product Accounts (NIPA), the sector ran a deficit of about $50 billion in its aggregate operating budget in 2002, compared with surpluses of about $40 billion in the late 1990s. In this report, we discuss the major factors contributing to this deterioration, drawing in part on the results of a high-employment budget measure we developed for the state and local sector in the early 1990s and have recently updated. We also compare the current situation with the budget crises of the early 1980s and early 1990s.

I. Recent State and Local Developments

Media reports of deteriorating state and local finances began to break in early 2001, and the stories have continued, taking on a more urgent tone over time. Business cycle and financial market developments have cramped the revenues of many governments, and most states and many localities are facing serious financial difficulties. These difficulties have been compounded by a series of tax reductions in the second half of the 1990s, along with rapid increases in Medicaid outlays in recent years and the relatively slow adjustment of overall spending to the new fiscal realities.

The most comprehensive data for the state and local sector are from the NIPA, which are aggregated across all governmental units and published on a quarterly basis by the Bureau of Economic Analysis.1 According to the NIPA, state and local governments were running sizable and growing surpluses in their aggregate operating budgets (excluding social insurance funds) in the second half of the 1990s. The surpluses emerged in 1994 and topped out at roughly $40 billion, on average, in 1998 and 1999 (Chart 1, next page, upper panel). They subsequently shrank to $18 billion in 2000 and were followed by deep deficits in 2001 and 2002. When measured as a percentage of GDP, the deficit in 2002 was the largest on record (Chart 1, middle panel).

The marked deterioration in state and local budgets over the past couple of years has partly reflected a dramatic shortfall in revenues, which have been damped by weak incomes, a falling stock market, and legislated tax reductions.

The National Conference of State Legislatures (NCSL) and the National Association of State Budget Officers (NASBO) also provide timely information on the sector’s fiscal condition, but their focus is on the states’ general fund budgets, which are the states’ primary operating budgets.2 States’ general fund

(Text continued on p. 429.)

1 The main underlying source data for the NIPA are the Surveys of Government Finances, which are available with varying lags. When the NIPA underwent their last annual revision (in July 2002), the most recent information on state revenues was for fiscal 2001 (which ended in June 2001 for most states), on state spending was for fiscal 2000, and on local government revenues and spending was for fiscal 1999. The NIPA estimates for subsequent quarters are based on monthly employment and construction data, information on income tax collections from the Census’s Quarterly Summary of State and Local Government Tax Revenue, and extrapolations of historical patterns when no suitable high-frequency indicators are available.

2 In the NIPA, the surplus/deficit for the state and local sector is the difference between the sector’s current receipts and current expenditures. In the NCSL/NASBO framework, a government is considered to be in surplus as long as the sum of its current receipts plus accumulated unspent receipts from prior years covers its current expenditures, and to experience a shortfall if this is not the case. A state with a deficit of $20 million as measured by the NIPA conventions could use $30 million of prior unspent receipts to bring the bottom line in the general fund up to $10 million.
Chart 1
State and Local Government Accounts
(NIPA basis)

Current Account
Billions of dollars

Note: Excludes social insurance funds.

Current Account
Percent of GDP

Note: Excludes social insurance funds.

Real Own-Source Revenue
Four-quarter change
Percent

Note: Includes all personal, corporate, and indirect business taxes and nontaxes, adjusted by price index for personal consumption expenditures.
II. Factors Contributing to the Current Fiscal Crisis

While analysts have posited a variety of explanations for the current fiscal crisis in the state and local sector, systematic evidence on the relative importance of these proposed causes is sparse. This section attempts to provide a quantitative assessment of the contributions of some key factors by examining changes in the NIPA surplus/deficit in recent years. Two of the factors we consider — macroeconomic conditions and capital gains realizations — are primarily external to the sector and are frequently cited as contributing both to the burgeoning surpluses in the late 1990s and the subsequent plunge into deficit. Our basic strategy is to use a high-employment budget framework to isolate the effects of the business cycle on state and local budgets, which we supplement with an adjustment for the movements in capital gains taxes in recent years. With these estimates in hand, we can separate the deterioration in the NIPA budget into three major components: a macroeconomic component; a capital gains component; and a residual, which we label “policy and other” and interpret as a rough indicator of the sector’s underlying budgetary stance.

The Analytical Strategy

A. Cyclical Influences

To calculate the effect of the economic slowdown on state and local budgets, we use the high-employment budget (HEB) methodology developed for the federal sector by De Leeuw, et al. (1980) and subsequently applied to the state and local sector by Kusko and Rubin (1993). This methodology, which is described more fully in Appendix 1 (p. 438), calculates the HEB surplus/deficit by adjusting tax receipts and outlays to the levels they would attain if the economy were operating at its potential level. The Congressional Budget Office (CBO) defines potential GDP as the highest level of economic output that can persist for a substantial period without raising inflation; the estimates of potential GDP used in this paper are taken from CBO (January 2003).

High-employment tax receipts are calculated by adjusting tax bases to their high-employment level. In particular, for each of the sector’s major tax bases (NIPA taxable personal income for income taxes, corporate profits for corporate taxes, and personal consumption expenditures for sales taxes), we regressed the tax base divided by GDP on a constant term and the GDP gap, defined as the percentage difference between actual and potential GDP. The coefficients on the GDP gap were significant in each of the three regressions. Using these coefficients, one can calculate high-employment tax bases and subsequently high-employment tax receipts. To calculate high-employment outlays, we adjusted transfer payments according to estimates of the cyclical properties of welfare and Medicaid caseloads; in practice, these adjustments to transfers are minor.

Chart 2 (next page, upper panel) shows our annual estimates for the state and local high-employment budget as a percent of potential GDP; the gap between the high-employment measure and the actual surplus/deficit is closely related to the gap between potential and actual GDP (middle panel) and represents the cyclical component of the budget. When actual GDP is at its potential level — as was the case in the late 1980s and mid-1990s — the cyclical component of the budget is equal to zero, and the actual and high-employment surpluses are the

(Text continued from p. 427.)
Chart 2
The Macroeconomy and Capital Gains Realizations

State and Local Surplus or Deficit

Source: Excludes social insurance funds.

Actual GDP and Potential GDP

Source: Estimates of potential GDP are from the Congressional Budget Office (January 2003).

Capital Gains Realizations

Source: Congressional Budget Office (January 2003).
same. When actual GDP exceeds potential — as it did in the late 1990s — the cyclical component of the budget is positive, and the high-employment surplus is smaller than the actual one; the reverse is true during recessions and early expansion periods. Note that the cyclical sensitivity of the sector’s budget is much smaller than at the federal level: Our measure suggests that, in today’s economy, a 1 percent increase in GDP relative to potential would raise the state and local surplus less than $10 billion.

B. Capital Gains Realizations

One concern that has been raised about the usefulness of a high-employment budget measure in the current situation is that its cyclical adjustment does not capture movements in capital gains realizations, which are instead reflected in the high-employment surplus. In the past, capital gains taxes generally were not a major factor in state and local budgets, in part because the movements in realizations were not that great. In addition, although some large states — most notably, California and New York — have relatively high tax rates on capital gains, other states tax capital gains much more lightly, or not at all (Florida and Texas). Also, most local governments do not have individual income tax systems and hence do not tax capital gains. However, with the dramatic developments in financial markets in recent years, it is worth examining the effect of changes in capital gains taxes on state budgets over this period.

Financial market developments made a measurable contribution to the emergence of substantial budget surpluses in the late 1990s and to the subsequent retreat to deficit.

We have no direct information on capital gains taxes for the states as a whole, but we put together estimates using data from CBO (January 2003) on capital gains realizations by individuals. To convert these realizations to a payments, or receipts, basis, we applied the following rule, which is based on the timing of estimated payments: In any given year, individuals are assumed to pay three-quarters of the lesser of current-year or previous-year liability due to capital gains realizations, with the remainder of the current-year liability paid in the following year.

To further convert realizations on a payments basis into tax receipts attributable to capital gains, we multiply these realizations by an aggregate state capital gains tax rate, as estimated for the NBER’s TAXSIM model. The NBER estimates are available only through 1999; we assume that the capital gains tax rate remained at its 1999 value through 2002.

Our calculations suggest that financial market developments made a measurable contribution to the emergence of substantial budget surpluses in the late 1990s and to the subsequent retreat to deficit. For the sector as a whole, we estimate that capital gains taxes grew steadily over the second half of the 1990s and by 2000 were roughly $15 billion higher than they were at the start of the stock market boom; that windfall has since been reversed. While macroeconomic conditions probably were more important for the sector as a whole, swings in capital gains receipts may have been an overriding factor in some states. State budgets have also been affected — again, to varying degrees — by other stock-market-related changes in tax liability, such as the income from the exercise of stock options, withdrawals from capital-gains-augmented IRAs and 401(k) plans, and bonuses in the financial services industries. The effects of these factors, which are difficult to quantify, may be as large as or larger than the direct capital gains effects.

C. Policy and Other

Once the effects of the business cycle and capital gains have been stripped out, the remaining surplus/deficit provides a rough gauge of the underlying trends in the sector’s budgets. It is important to realize, however, that while movements in this budget measure may reflect legislative actions, such as tax cuts or changes in provisions of spending programs, they may also be caused by such factors as an increase in health care costs, additional homeland security needs, or new federal mandates that are beyond the direct control of these governments. In any event, this budget measure tends to move toward greater surplus in the early phase of an economic expansion as governments act to rebuild their fiscal positions and then to fall back once the sector’s budgets are restored to health. The upward trend in this measure was very pronounced in the early 1980s.

4 As CBO notes in its report on the standardized and cyclically adjusted budgets (March 2003), movements in capital gains tax receipts are not treated as cyclical because the linkage between those receipts and the business cycle is usually tenuous. However, in addition to its usual cyclically adjusted budget measure, CBO regularly publishes another adjusted budget measure that also excludes the effects of swings in collections of capital gains taxes and some other temporary factors.

5 The CBO report provides actual data on realizations through calendar year 2000 and estimates or projections of realizations thereafter. These data are shown as a percent of GDP in the lower panel of Chart 2.

6 This rule reflects two features of estimated tax payments. First, regarding the three-quarters assumption, individuals make three estimated payments on the current year’s tax liability in that year (April, June, September) and one in January of the following year. Second, regarding the lesser of current-year or previous-year liability, taxpayers generally are penalized for underpayment only if estimated payments fall short of tax liability in both the previous and current years. Note that this rule reflects the timing of the estimated payments and may not capture the timing of capital gains receipts in the form of final payments.

7 More specifically, we use the NBER’s national average of marginal state income tax rates on long-term capital gains. According to Feenberg (2000), this rate is calculated as follows. First, using the actual distribution of income, the sum of state income tax liabilities owed by all taxpayers in a given year is calculated. Then, capital gains are increased by 1 percent for each taxpayer and the tax is recalculated. Finally, the national average capital gains tax rate equals the ratio of the additional tax to the additional income. Thus, the tax rate can be interpreted as a weighted average rate, where the weights depend on capital gains liability.
Explaining the Current Budget Crisis

Chart 3 shows the results of applying our analytical framework to the current budget crisis. The line traces out the actual NIPA surplus/deficit on an annual basis, while the bars show the relative contributions of the three factors discussed above. The light green portions of the bars, which are based on the high-employment budget calculations, indicate that the contribution of the macroeconomy to the surplus increased steadily over the second half of the 1990s as the economy moved well above its potential level. This contribution peaked at $20 billion in 2000 and subsequently fell to zero in 2001 as the economy returned to its potential level; following the recession that began in 2001, the macroeconomic contribution turned negative (-$9 billion) in 2002. Similarly, the run-up in capital gains tax payments (shown in dark green) worked to increase the surplus by growing amounts through 2000; following the stock market decline that began in 2000, the positive impetus lessened in 2001 and disappeared in 2002 as capital gains returned to their 1996 trend.8

The “policy and other” bars illustrate the sharp deterioration in the sector’s structural budget position in recent years.9 This pattern owes in part to the relatively rapid increases in state and local consumption spending between 1998 and 2001, and the return of double-digit growth in Medicaid outlays after a quiescent period in the mid- to late 1990s.

8 To be precise, the capital gains effect on this chart is the difference between our estimates of actual capital gains taxes and a series that holds these taxes constant as a share of GDP after 1996.

9 Movements in the structural budget measure can also be used to gauge how much budgetary thrust (or restraint) states and localities are imparting to overall economic activity. As shown by “policy and other” bars, the structural budget moved from a small surplus in 1999 to a deficit of about $20 billion in 2000; this swing provided a thrust to real GDP growth of roughly 0.25 percentage point. Between 2000 and 2001, the structural budget fell further into deficit, again adding 0.25 percentage point to real GDP growth. In 2002, the structural budget stabilized and the sector’s budgetary stance shifted to neutral as the tax cuts came to an end and spending decelerated.
Chart 5
Cumulative Changes in State and Local Surplus/Deficit
(Calendar years, NIPA basis)

1998 to 2002

1998 to 2000

2000 to 2002
1990s (Chart 4, p. 433, upper and middle panels). In addition, the states enacted a series of tax reductions between 1995 and 2001 that, according to the NCSL, reduced state collections a cumulative $36 billion — 8 percent — below baseline levels (Chart 4, lower panel). In 2002, the states enacted some tax increases, but much of the additional revenue did not show up until this year. The bottom line of this analysis is that neither the cyclical weakness in the economy, when measured relative to its potential level, nor the direct effects of capital gains realizations, when measured relative to their longer-run trend, account for very much of the deficit in 2002. The implication is that the current deficit is largely structural and thus unlikely to be eliminated in the absence of significant budgetary actions by these governments.

The bottom line is that neither the cyclical weakness in the economy, when measured relative to its potential level, nor the direct effects of capital gains realizations, when measured relative to their longer-run trend, account for very much of the deficit in 2002.

Although the macroeconomy and capital gains are not major contributors to the 2002 deficit when measured in levels, these factors do account for about one-third of the swing in the budget between 1998, the year the surplus peaked, and 2002 (Chart 5, upper panel). It is important to note, however, that during part of this period (1998 to 2000) the macroeconomic and capital gains components of the surplus were still growing and thus offset some of the worsening in the sector’s underlying budget stance (Chart 5, middle panel). Between 2000 and 2002, with the macroeconomic contribution swinging from positive to negative and the capital gains windfall evaporating, these factors accounted for the bulk (roughly two-thirds) of the change in the surplus/deficit (Chart 5, lower panel). In fact, all else being equal, had the macroeconomic and capital gains factors been as favorable in 2002 as they were in 2000, the sector would have recorded a deficit of less than $10 billion in 2002, compared with the actual deficit of approximately $50 billion.

Comparison With Prior Fiscal Crises

The present fiscal crisis stands out in comparison with the two previous ones, mainly because of the sharpness of the fiscal deterioration in the face of a relatively shallow contraction in economic activity. The upper panel of Chart 6 (next page) replicates the parsing out of the 1998-2002 experience from Chart 5, while the middle and lower panels present a similar accounting for 1989-91 and 1978-82, respectively; these periods span the years between the highs in the surplus and the bottoming out of the deficit. As the chart illustrates, when measured by the change in the NIPA surplus/deficit as a percent of GDP, the current crisis is roughly twice as severe as that of the early 1990s and comparable with that of the early 1980s. However, whereas the budgetary difficulties during the earlier episodes stemmed primarily from weakness in macroeconomic conditions — especially during the early 1980s — the current difficulties owe importantly to a pronounced deterioration in the sector’s underlying budget situation.

III. Assessing the Adjustments to Date and in Prospect

The outsized budget gaps reported by the states, combined with balanced budget requirements, have forced governments to institute adjustments to spending and taxes. Governments have tightened their belts, as evidenced by the sharp deceleration in purchases of goods and services since 2001. In addition, many states enacted revenue increases in 2002 and 2003. Even so, the spending and tax adjustments to date have not been as sizable as much of the rhetoric would suggest, as these governments have used other measures to help satisfy their mandated requirements.

Balanced Budget Amendments And Fiscal Remedies

Analysts who are concerned about state budget adjustments often cite balanced budget requirements as providing an impetus for rapid adjustment (Appendix 2, p. 439). However, although 49 states have at least one formal statutory or constitutional balanced budget requirement, these are not always binding in practice. For example, some requirements are prospective, or based on projected budgets, and hence do not prohibit actual, or end-of-year, shortfalls. Moreover, these requirements apply mainly to state general fund budgets. And even in states with binding requirements, those facing declining tax bases may undertake remedies other than spending cuts and legislated increases in taxes and fees.

• Reserves and other funds. According to the NCSL, at the end of fiscal 2002, the states as a group still had around $20 billion in combined general and rainy day fund balances. While some states exhausted these funds in fiscal 2002, others did not and used them in fiscal 2003. In addition, many governments tapped reserves in other types of funds.

• Debt financing. Sales of municipal bonds for new capital, which are used to finance infrastructure, were very strong in 2002 and the early part of 2003, as were sales of tax-exempt refunding bonds and short-term

(Text continued on p. 437.)
Chart 6

Cumulative Changes in State and Local Surplus/Deficit in Prior Fiscal Crises
(Calendar years, NIPA basis)

1998 to 2002

1989 to 1991

1978 to 1982

Percent of GDP
debt. Some states have sold bonds backed by the future stream of tobacco settlement payments.

- **Accounting shifts.** Some states have taken such actions as moving employee pay dates from the last day of one fiscal year to the first day of the next fiscal year or accelerating tax collections.

### Gauging the Adjustment

The state and local sector recorded a NIPA deficit of $50 billion in 2002 (equal to 0.5 percent of GDP), and the deficit remained large in early 2003 as slow economic growth continued to offset the effects of enacted adjustments to spending and revenues. The size and speed of any further adjustments will depend on the strength of overall economic activity going forward. If, for example, the economic expansion were to remain relatively slow over the remainder of 2003 and in 2004, macroeconomic forces would make only a small contribution to reducing the deficits in state and local budgets. As a result, governments would be forced to undertake sizable further adjustments to spending and revenues to eliminate the structural imbalance in their budgets. Of course, stronger economic activity, all else being equal, implies that smaller adjustments would be required to meet specified budgetary objectives.

The historical experience on the pace of adjustment varies greatly. Notably, in the early 1980s, states and localities were running substantial budgetary surpluses by late 1983 — only a year after the official recession trough — as economic activity rebounded sharply and governments kept a tight rein on their budgets. The adjustment in the early 1990s, however, was much more protracted: Although the deficit bottomed out around the time of the recession trough in early 1991, the budget remained in deficit through 1993 as the sector’s budget-repair efforts were thwarted by soaring outlays for Medicaid and the slow start to the economic expansion of the 1990s.

### References


National Conference of State Legislatures, *State Tax Actions*, various years.


Appendix 1: High-Employment Budget (HEB) Methodology

Receipts

This analysis first estimates the cyclical sensitivity of three major tax bases: taxable personal income for income taxes, corporate profits for corporate income taxes, and personal consumption expenditures for sales taxes. The following equation relates these tax bases as a share of the economy to the GDP gap, a time trend, and a constant.

(1) \[ \frac{\text{Base}_t}{\text{GDP}_t} = \alpha + \beta \cdot \text{Time}_t + \gamma \cdot \text{Gap}_t + \epsilon_t \]

where \( \text{Gap}_t = \frac{\text{GDP}_t - \text{PGDP}_t}{\text{PGDP}_t} \) and \( \text{PDGP} \) refers to potential GDP. For estimation purposes, first differences of equation 1 are taken:

(2) \[ \Delta \left( \frac{\text{Base}_t}{\text{GDP}_t} \right) = \beta^* + \gamma \Delta \text{Gap}_t + \Delta \epsilon_t \]

As shown in Table 1 below, the GDP gap is statistically significant for each tax base. Personal income and consumption expenditures rise as a share of the economy during recessions (when GDP falls below potential), while the income share of corporate profits falls.

When the economy is operating at potential (\( \text{Base} = \text{Pbase} \) and \( \text{GDP} = \text{PGDP} \)), the GDP gap is zero and equation (1) can be rewritten as follows:

(3) \[ \frac{\text{Pbase}_t}{\text{PGDP}_t} = \alpha + \beta^* \cdot \text{Time}_t + \epsilon_t = \left( \frac{\text{Base}_t}{\text{GDP}_t} \right)_t - \gamma^* \text{Gap}_t \]

Multiplying through by potential (PGDP) yields high-employment bases:

(4) \[ \frac{\text{Pbase}_t}{\text{PGDP}_t} = \left( \frac{\text{PGDP}_t}{\text{GDP}_t} \right) \cdot \frac{\text{Base}_t}{\text{PGDP}_t} - \gamma^* \text{Gap}_t \cdot \text{PGDP}_t \]

The first term in this expression scales the tax base according to whether the economy is above (\( \frac{\text{PGDP}_t}{\text{GDP}_t} < 1 \)) or below (\( \frac{\text{PGDP}_t}{\text{GDP}_t} > 1 \)) its potential level, while the second term adjusts the potential tax bases to account for cyclical shifts in income shares. Using this estimate of HEB tax bases, HEB receipts can then be calculated by multiplying the high employment tax base by the relevant effective tax rate.

Outlays

Blank (1997) estimates the dynamic response of welfare caseloads to the unemployment rate (UR) as follows:

(5) \[ \Delta \text{Caseload}_t = \sum_k \beta_k (\text{NAIRU}_k - \text{UR}_k) \]

where the NAIRU is the non-accelerating inflation rate of unemployment. Using the estimated parameters (\( \beta_k \)) over the preceding 12 quarters, and accounting for the fact that the federal government finances more than half of the Medicaid program, we adjust transfer payments (mainly Medicaid and welfare payments) to their high-employment level by setting the unemployment rate equal to the NAIRU.

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<th>Corporate Profits / GDP</th>
<th>Consumption / GDP</th>
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Appendix 2: State Balanced Budget Rules

While all states except Vermont have some form of a balanced budget requirement, the manner in which state governments must correct shortfalls in operating budgets depends on the requirements’ details, which vary substantially across states. These rules are either stated explicitly in the state’s constitution or are part of the laws of the state, and some states have multiple provisions that require a balanced budget. Balanced budget requirements can be placed into the following five categories, according to the state’s most stringent provision:

1. Governor must submit a balanced budget — that is, one that contains no projected shortfall (1 state);
2. Legislature must pass a balanced budget (5 states);
3. State must correct any shortfall in next fiscal year (7 states);
4. No carryover of shortfall into next biennial budget cycle (7 states); and
5. No carryover of shortfall into next fiscal year (29 states).

To comply with the first three types of balanced budget rules, which are prospective, some states overestimate revenues and underestimate expenditures in their budget projections (Briffault, 1996).\(^a\) While only 13 states have these prospective requirements, this group includes some of the largest states: California, Illinois, Michigan, New York, and Pennsylvania. Only the final two types of balanced budget rules are retrospective, explicitly prohibiting end-of-year shortfalls, and the fourth type binds only every other year.

Econometric studies confirm that retrospective requirements are more binding than prospective requirements. Bohn and Inman (1996) find that states with retrospective requirements tend to run larger surpluses and save these funds in anticipation of future deficits. In a study focusing on the short-term effects, Poterba (1994) finds that states with retrospective requirements also correct unexpected budget shortfalls more rapidly than do those states with prospective balanced-budget requirements.

The manner through which balanced budget requirements are enforced also varies across states. Bohn and Inman (1996) report that requirements with more stringent enforcement mechanisms are more binding than those with weaker enforcement mechanisms. Among states with retrospective balanced budget requirements, those with an elected, rather than appointed, supreme court and those with a constitutional, rather than statutory, basis for balanced budget requirements tend to run larger surpluses.

In addition to balanced budget requirements, other factors contribute to fiscal discipline. Credit markets place constraints on state borrowing, and rating agencies provide incentives for healthy state finances. Moreover, some analysts feel that the most important factor contributing to budget outcomes is tradition: Elected officials and most voters tend to share the view that states should not chronically run budget deficits.

\(^a\) The third type of requirement, which is in place in California, seems at first glance to be binding because it stipulates that shortfalls must be corrected in the next fiscal year. However, under this type of requirement, states can repeatedly roll over shortfalls into the next fiscal year so long as the projected budget shows a correction of the shortfall in the next fiscal year.