Testimony Of

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"Fixing a Broken Process: Lessons from States"

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Chairman Enzi, Ranking Member Sanders, and distinguished members of the Senate Budget Committee, thank you for inviting me to discuss state budget processes and some lessons that states have learned that may guide some of your deliberations. My name is John Hicks, and I am the Executive Director of the National Association of State Budget Officers (NASBO). For more than 70 years, NASBO has been the professional membership organization for state budget and finance officers. As chief financial advisors to our nation's governors, NASBO members are influential decision makers in state government. They guide their states in analysis of budget options and formation of sound public policy.

As this Committee considers a review of the federal budget process, there are lessons that states have learned and fundamental differences between the states and the federal government that can be instructive for your review.

I have been asked to address several areas, including fundamental differences between state and federal budget processes, state biennial budget processes, how states set budget totals, how states reach budget agreement in a divided government, how states budget for emergencies, and state budget process trends with performance information.

State governments differ significantly from the federal government as to their nature and mission. The U.S. federal government must contend with nationwide responsibilities, notably the national economy and national defense. States, especially through their constitutions, have primary responsibility for elementary and secondary education, criminal justice, transportation, and public higher education, and carry out many elements of direct service provision to their citizens.

Fundamental Budgetary Differences between the States and the Federal Government

The primary budget process and environment differences between the states and the federal government include:

Balanced Budget Requirements

States have balanced budget requirements that may apply to recommendation by the governor, legislative adoption, governors' approval of appropriations bill, and completing the year without a deficit. Most state balanced budget requirements are governed by constitutional provisions. States adhere to balanced budget requirements closely. This represents one of the most fundamental budget process difference between states and the federal government. Most states, like the federal government, have a unified budget that incorporates all appropriated funds. State balanced budget requirements are usually applicable to all funds, not just the state general fund, the fund from which most state tax revenues are collected and spent.

Revenue Estimates as a Spending Limit

The revenue estimating process is both the primary means of framing the balanced budget requirement and the initial basis for setting states' topline resource figures - the appropriation totals or caps for state budgets. Over half of the states engage in an executive-legislative consensus revenue forecasting process that reduces the policy and political tension around this key budgeting element. In other states, state law directs a single actor to set the revenue estimate that binds both the governor and the legislature. A minority of states have a separate and competing revenue estimating process between the executive and the legislative branches. State budget processes include resource estimates for federal funds and other

state special funds. For the last completed fiscal year, fiscal 2018, federal funds made up 31 percent of all state spending.

Line-Item Veto

Governors in 45 states have a line-item budget veto power. This budget power provides another role for the executive in state budgetary processes that does not exist at the federal level. Thirty-eight states require a legislative supermajority to override a governor's line-item veto. Because of the supermajority override requirement, the governor plays a role in the final legislative stages of getting to budget agreement.

Capital Budgets

All states have some form of a capital budget that is separate from their operating budget. State legislatures usually adopt the operating and capital budgets concurrently. Balanced budget requirements recognize that a portion of state capital projects funded through the issuance of bonds is accounted for through the appropriation of debt service payments within the operating budget. Appropriations within the federal budget process do not distinguish between operating and capital spending. Many federal budget process reform reviews have considered the efficacy of having a federal capital budget.

Debt Limits

Forty-three states have some form of specified limit on state debt or the amount of debt service payments, many through a constitutional limit. The limit constrains the cumulative amount of borrowing a state can undertake. The use of state debt is primarily considered when making appropriations in the capital budgeting process.

Biennial Budgeting

Twenty states have a biennial budget process where appropriations are made for either two individual fiscal years, in 17 states, or for a 24-month fiscal period, in three states. A more extensive discussion of biennial budgets is addressed later in this written testimony.

Appropriation vs. Authorization

States typically do not incorporate sum-specific or target funding amounts in their program authorizing legislation, which is a common practice with the federal government. Like the federal government, the primary legal basis for funding state programs is their existence in state law. The appropriations process, not the authorizing statute, governs the amount of funding approved, not the authorizing statute. States do have the ability to temporarily modify requirements from authorizing legislation and a few can amend permanently statutory law within appropriations bills.

Joint Legislative Committee Budgetary Starting Points

There are more than ten states where the legislative process, like the federal congressional budget resolution process, establishes a budgetary starting point in addition to the governor's recommendation, that is then considered by each of the two legislative chambers. This often includes the topline budget totals and specific appropriation recommendations.

Mandatory or Fixed Spending

States do not have "mandatory spending" in the manner that it is treated in the federal budget process, where some spending is not subject to legislative appropriations. Almost all state spending is subject to appropriations. Even fixed obligations like debt service payments for voter-approved general obligation debt are included within the appropriations bills. Constitutional provisions hold primacy over other state government obligations though constitutional provisions do not prescribe funding amounts; they are left to the appropriations process to be determined. Constitutional and statutorily authorized programs, in combination with federal program participation, comprise the basis for what appropriations fund. To that extent, much of the state budget is determined by past legislative decisions. Even then, the specific appropriation amounts are still the subject of deliberation throughout the steps of the budget process. Outside entities, like the bond rating agencies, have developed categories to equate certain state government spending (debt service, pension contributions, the Medicaid program) as "fixed costs", a method to communicate to the bond market their view of the ability of a state to pay back debt and a type of measure of a state's fiscal flexibility. Governors and legislatures recognize the practical realities of limits on their discretion in making budget decisions. Even then, some of the more difficult budget actions taken during the Great Recession, where nominal state tax revenues declined by an average of 11 percent over two years, revealed that the highest priority categories of states spending were not immune from spending cuts. Those occurred even with the use of reserves, the federal fiscal assistance, and some state revenue raising actions.

Tax Policy Changes and the Budget Process

In most cases, tax policy changes in states are done contemporaneously with the appropriations process, as both the spending and revenue sides of the balance sheet must be aligned to meet balanced budget requirements. Voter-approved constitutional changes, ballot initiatives and referenda often precede the budget process and alter a future stream of revenue to which a subsequent budget process must adapt.

Mid-year Appropriations Changes

States have established various authorities to ensure a fiscal year does not end in a deficit, particularly the authority to reduce appropriations. The authority for the governor to execute the enacted budget often includes the power to reduce appropriations under specific circumstances, the equivalent of authorized impoundment. The legislature imposes restrictions on the governor's use of this authority but addresses the practical need for timely action by the executive, especially for states where the legislature can not exercise their appropriation power upon adjournment. There are states where a joint legislative committee, or a joint legislative-executive committee has final approval of appropriation change actions.

Having reviewed the fundamental differences between state and federal budgeting practices, this testimony will now more deeply explore several state budgeting areas and potential lessons that can be gleaned from experiences in the states.

Reserve Funds

All 50 states now have statutory or constitutional reserve funds. Reserve funds are a tool that states rely on during revenue shortfalls and to address emergency situations, including natural disasters. States build up their reserve balances during better budgetary times and utilize reserves as one source of solving unexpected fiscal downturns.

Biennial Budgeting in States

There have been many instances where federal budget process reform proposals have advocated changing to biennial budgets. The following discussion reflects the attributes that biennial budget states associate with their biennial budget process. There are equally compelling attributes about state annual budget processes. My remarks will be limited to discussing the state biennial budget process.

Twenty states use some form of biennial budgeting. That number has been steady for over a decade. In 1933, only five state legislatures convened on an annual basis, while the rest did so once every two years. Biennial budgets were a necessity in most states. By the early 1960s, 19 state legislatures met annually. By 1974, that number rose to 42 states. Today, 46 state legislatures meet yearly. Only Montana, Nevada, North Dakota and Texas have legislatures that meet every other year. With that change, the number of states that switched from biennial budgets to annual budgets occurred in line with the change to annual legislative convenings. Currently, 16 states have annual legislative sessions while having a biennial budget process. The last five states that have moved to annual legislative session have chosen to retain their biennial budget process.

Of the twenty states that have a biennial budget process, 17 adopt appropriations for two individual fiscal years and three states enact 24-month appropriations. There are some hybrid nuances among them: adopting a capital or bond funded project budget in alternating years, or budgeting for the major state agencies and programs in one legislative session and smaller agency budgets in the other.

The benefits ascribed to a biennial budget process include:

- embedding a longer term planning horizon into public-policy making decisions by providing the ability to plan for the phase-in and ramp-up of new spending and tax policy initiatives or changes which fits more practically with a longer time horizon. Many states use multi-year forecasts for new initiatives or changes that extend beyond the immediate budget period, providing decision-makers with the fiscal impacts of new and expanded programs and revenue changes. The second year of a biennium serves as a better basis for the long-term fiscal effects, supporting structural budget balance and providing the information needed to understand a fuller fiscal implication for their decision-making;
- providing greater budget certainty and predictability which benefits agencies, programs and service provision and their beneficiaries;
- an ability for the legislative body to use the off-budget year to focus on non-budget legislation and oversight responsibilities, which holds greater emphasis for part-time legislatures and those states with shorter legislative session;
- performance evaluation cycles between biennial budgets can be assisted by a biennial budget process by allowing more time for performance review and support a greater emphasis on program outcomes than on budget control;
- a greater degree of flexibility is possible with a biennial budget to align resources and spending with two fiscal years at issue which provides a wider berth for decision-makers compared to budgeting for a single year;
- provides certainty of funding for capital projects that require multiple years to carry out;
- legislative and executive budget staff also have the opportunity to deepen their program and policy knowledge when they are freed from a near-perpetual budget-making cycle;
- one governor recently stated, "…biennial budgeting is needed to remove the incremental cost increases that creep into base budgets simply due to the fact that the budget is created annually.

> Biennial budgeting will also provide additional funding stability to those entities dependent on state resources and will help smooth the highs and lows that can occur with annual budgeting."

Many biennial budget states still take some level of appropriation actions in the off-year session to contend with fast-moving issues, unexpected or exigent circumstances. The level of adjustments varies widely and is often related to the disposition of surplus funds due to higher actual revenues than estimated. Some legislatures, like in Wyoming and Kentucky, have set up supermajority voting rules for the introduction or passage of appropriation or revenue changes in the off-year session. The level of error in revenue forecasting has been found by some studies to be higher in the second year of a biennium. Alternately, recent experience in the last twelve years has revealed that revenue shortfalls have occurred at a greater rate in annual budget states.

Setting Budget Totals

States set their total fiscal year appropriations based on their revenue estimates, as adjusted by the amount of new tax or revenue measures. In addition, a number of states have constitutional spending limits. Commonly the revenue estimates are prepared centrally and estimates of federal funds and special revenue sources are prepared by the responsible state agencies and adjusted and approved in the governor's budget recommendation and by legislatively approved appropriations bills. A few states have a legal limitation or a practice of not appropriating 100 percent of their revenue estimates. This cautious approach is another element of setting a state budget total. About half of the states update their revenue estimates during the legislative session and after the governor has proposed the budget.

Adherence to revenue estimates by both the governor and the legislature is done to comply with legal requirements or has been adopted as a norm in a state's budget process. Adjustments are made based only with the adoption of tax policy and other revenue changes.

Reaching Agreement on the Budget

All states except Nebraska have a two-chamber legislature. Both chambers consider and decide on appropriation amounts that are ultimately harmonized through a conference or joint committee or accept amendments to one chamber's version. Only a few states require a supermajority to pass appropriations bills. Differences between the two legislative chambers' budget versions are common whether their party majorities are the same or different. In the last 30 years, the number of states with a divided party legislature has dropped from a high of 16 in 1992 to an average of five states over the last decade. Unified majorities have become more the trend among state legislatures. In the current year, 2019, only one state, Minnesota, has a majority from different parties in the house and the senate.

How state legislatures come to a timely budget agreement between the two chambers and with the governor is a more qualitative than quantitative question. Difficult fiscal and economic environments can contribute to not reaching timely budget agreement. Despite the number of divided governments, the number of partial government shutdowns has been very low. Many states with late budgets have avoided shutdowns by either default mechanisms in state law that continue the operation of government or a temporary budget is put in place. In 2017, ten state legislatures entered the beginning of fiscal year 2018 with no adopted budget, the highest number in many years. Four of them had partial shutdowns, the longest lasting four months. Only three of the ten states had a divided legislature. But in the following year, there were just two states that began fiscal year 2019 without an adopted budget, and only one where there was a political issue as the primary reason. Circumstances most common with either late budgets or no budget include non-budget related disagreements between leadership and marginal small dollar issues. Tight fiscal times with tough budget decisions are often a function of low growing or

declining tax revenues. Getting to agreement in a divided party legislature has required meaningful negotiations among legislators and the governor, with all compromising to ensure a budget was adopted before a fiscal year begins. It is common to see agreements result from closed-door negotiations, several iterations of proposals vetted with party caucuses, the ramifications of no budget passage, and sometimes small dollar adjustments.

Budgeting for Emergencies and Natural Disasters

The majority of states have separate funds or accounts that contain appropriated amounts set aside to respond to natural disasters and emergencies. Other states provide non-sum-specific appropriation authority to expend funds for disaster and emergency response and relief. About half of the states also have authority to transfer funds from other accounts if necessary. These funds range in size and are reserved for a limited set of purposes. States may also pass supplemental appropriations. These sources and authorities are also combined with federal funds in response to a federally declared disaster.

Trends in States Using Performance in the Budget Process

In NASBO's most recent *Budget Process in the States* publication, 39 states reported that performance measures are used to inform executive budget recommendations, while 22 states reported that they are used to inform legislative actions on appropriations. It also found that legislatures are more likely to use performance information if they have input over performance measure selection. The use of performance information in state government budget processes has been gradually increasing. Its use in the operations of government programs will continue to be more prominent than in the resource allocation process. An effective performance budgeting system that leads to reliable, actionable data requires the buy-in of both the executive and legislative branches, and state agency staff. This buy-in necessitates a perception that the performance data collected and reported will be used in making budget decisions.

Summation

Beginning a fiscal year or a fiscal biennium with an enacted budget that is on-time is a state budgeting norm. The certainty that provides to the programs and services for both citizens and businesses is expected and fosters long-term fiscal stability. In addition to balanced budget requirements, states have constructed a set of budgetary rules and practices that are commonly used to guide the composition and execution of budgets: adherence to a revenue estimate that caps the amount of spending, compliance with debt and spending limits, concurrent actions on tax changes and spending, subjecting all spending to appropriations within a unified budget, adopting both an operating budget and a capital budget, setting up reserve funds with definitive rules on their usage, aligning the authorization of programs with their appropriations, and reaching agreement among the two legislative chambers and the governor, whether in a divided or unified government.