The Politics of Balancing the Budget

Balancing the budget by cuts and layoffs is absolutely the worst thing to do. Cuts and layoffs only compound the problem, create renewed deficits. And if the next budget is balanced with further cuts and layoffs, the Miami-Dade County would be on its way to becoming a banana republic!


The debt and the deficit is just getting out of control, and the administration is still pumping through billions upon trillions of new spending. That does not grow the economy.


The most important constraint on budgeting is the requirement for balance: Revenues must equal or exceed expenditures over a given period of time. Balancing is a key part of budgetary decision-making, but it is not always successful. Rebalancing the budget normally requires revenue increases and spending decreases. The possibility of increasing taxes evokes ideological and class differences about whom to tax and how heavily; similarly, decisions about which expenditures to cut and by how much incur intense debate that divides the young from the old, Democrats from Republicans, and the poor from the rich. The issues are so contentious that they are often not resolved. A 2011 congressional
committee (nicknamed the supercommittee) set up to devise a plan to rebalance the federal budget failed dramatically, even though the alternative was widely unacceptable automatic across-the-board spending cuts.

Especially at the national level, and to a lesser extent, at the state level, governments sometimes incur deficits to moderate negative trends in the economy, maintain spending for unemployment benefits and welfare during a recession, or deal with emergencies, such as those caused by earthquakes or hurricanes. When deficits are caused by emergencies or by declines in the economy, the borrowing required to cover them is temporary and is not particularly harmful. Budgets have to be flexible and responsive to the environment, and some borrowing may be necessary to that end. Governments at all levels may experience deficits for a less worthy reason: The decision makers are unwilling to make difficult choices. Elected officials may choose to reduce taxes or keep them low, to gain popularity, without cutting spending proportionately. Sometimes deficits occur because revenues are growing more slowly than expenditures and decision makers are unwilling to risk loss of voter support by increasing taxes or fees or cutting services. In recent years, some elected officials have been so bent on reducing taxes that they create deficits. When elected officials do not make the necessary tough decisions, they often propose new budget processes and more rigid budgetary constraints instead, with the idea that these decision rules will save them from themselves or from their colleagues, insulate them from popular demands, and obscure their responsibility for painful outcomes.

Although the decisions that have to be made to reduce or eliminate deficits may be politically unpopular, the solution of ignoring hard decisions and running deficits is not popular either. Both the public and the financial community oppose deficits. After the federal budget was balanced in the late 1990s, public concern with deficits naturally fell off, but it reawakened with the resurgence of massive deficits in the George W. Bush administration. As the economy sank in the Great Recession, the Obama administration added bank and business rescues and financial aid to the states, further ballooning the deficits. Worry about the deficit, however, fell behind concern with fixing the economy and creating jobs. Public officials found themselves in a bind. Fixing the economy, say those on the right, requires reducing taxation, especially on businesses and the wealthy, potentially adding to the deficit; fixing the economy, say those on the left, requires more public spending, potentially worsening the deficit.

Because none of the choices seem good, when governments run chronic deficits, those responsible for them often deny them or minimize their size and importance. The definition of balance may be loose, applying only to some portions of the budget or only to the proposed and not the approved budget. Or
deficits may be obscured by delaying expenditures or selling assets for one-time revenue. Budgets may look balanced but not really be balanced. For example, at the national level, the deficit is usually presented including the Social Security surplus, which is misleading, because Social Security is off-budget and its surplus cannot be used to defray the deficit. The quality of the budget numbers suffers under these circumstances. Between bad numbers and fuzzy definitions of what constitutes a deficit, it can be extremely difficult to figure out the real size of a deficit.

By the time those in charge of the budget decide to act, the deficit may be very large and proportionately difficult to cut back. Whose programs should be cut back and by how much? Where can cuts legally be made? How can resistance from interest groups be minimized? Whose taxes should be raised and by how much? Can expenditures be shifted to other levels of government, or can grants to state or local governments be reduced to cut the size of the deficit? Can states take revenue from local governments to balance their own budgets? How can the appropriate actions be taken while maintaining accountability and acceptability to the public? How can politicians make such unpopular choices and still maintain their support base? The politics of budget balance revolves around how and why budgets become unbalanced as well as how to rebalance them and who gets hurt in the process. In exploring this decision stream, it may help to return first to the characteristics of public budgeting outlined in Chapter 1 as they apply to budget balance:

- Public budgets are constrained by the requirement for balance. Governments do have a “bottom line.” The bottom line in businesses is profit; in government, it is balance.
- The politics of balance involves multiple actors with conflicting policy goals.
- Budgets are open to the environment. Automatic spending, including entitlements, is especially vulnerable to changes in the economy, and some program structures may be simultaneously affected by a drop in revenues and an increase in demand. Recessions trigger deficits unless sufficient savings have been put aside in contingency accounts and the recession is either mild or short-lived.
- Deficit politics has to resolve the separation of taxpayer and budget decision maker, by negotiating publicly acceptable solutions. This is so difficult to do that decision makers may minimize the size or importance of deficits or obscure responsibility for politically difficult decisions. Acceptability may trump accountability.
Balance as a Constraint

A broad definition of budget balance is that revenues equal or exceed expenditures for some stated period of time. Governments in the United States try to balance their budgets, and most of the time, most of them succeed. This is true even in the absence of clear legislative or constitutional requirements for budgetary balance. This frequently positive outcome occurs because balance is a norm that budgeters accept; it is intrinsic to budgeting. A budget would not have much meaning if there were no balance constraint. Moreover, those who evaluate the creditworthiness of governments, and hence control the cost of public sector borrowing (higher risk = higher cost for borrowing), downgrade governments that cannot balance their budgets, warning potential investors that there is a risk they will not be repaid on time or at the agreed upon rate. Markets thus enforce the discipline of balance.

Having said that budgets generally balance, however, doesn’t tell you as much as you might think, because in practice balance is variously defined (see the minicase “Is the Wisconsin Budget Balanced?” on p. 188 for an example). At the state and local level, budgets may be technically balanced by using revenue or fund balances left from a prior year, even if in the current budget year expenditures exceed revenues. Similarly, budgets are normally considered in balance at state and local levels when contingency funds, so called rainy-day funds, are drawn down. Internal borrowing, from pension funds or from funds with their own earmarked revenues, may also be used to balance the budget. At the national level, fund balances in trust funds may be applied against deficits in other funds in the calculation of aggregate deficits, even when those funds are earmarked and cannot be spent to cover deficits elsewhere. At the national level, deficits are calculated based on actual revenues compared with actual outlays, which makes delaying outlays particularly tempting. Some states delay paying vendors in years when budget deficits threaten. In some states, it is possible to balance the budget with borrowed money. However it is defined, the balance constraint is real, and many states during the Great Recession had to cut spending midyear in order to come up with balance by year end.

Most of the time, balance is determined one year at a time, but sometimes balance occurs over several years. Trust funds in particular are structured to balance over time. If all outstanding obligations were to be deducted from this year’s revenue, a budget might not be balanced, but if those same obligations were matched against several years’ anticipated revenues, that same budget might be balanced. The federal Highway Trust Fund illustrates this somewhat looser definition of balance over time (see the minicase on p. 189).
Minicase: Is the Wisconsin Budget Balanced?

In January 2012, Gov. Scott Walker in Wisconsin claimed the state’s budget was balanced, while the secretary of the Department of Administration claimed the budget was not balanced. This was not a disagreement between members of opposite political parties: Both men are Republicans on the same team. Walker could argue the budget was balanced, because he relied on cash accounting, which depends only on the cash on hand at a given time. The amount of cash is influenced by borrowing, by delayed spending for goods and services already purchased, and one-time revenues that do nothing to cure structural imbalances between revenue and expenditures. (A structural deficit means that revenues are not growing as fast as expenditures, over time.) By contrast, Mike Huebsch, the Department of Administration secretary, was using generally accepted accounting principles (GAAP) used by all other Wisconsin governments. In this approach, bills and revenue are assigned to the period in which they were incurred, regardless of when the money goes out the door. The governor claimed a $68 million surplus, while the Annual Financial Report in December listed a deficit of $3 billion.

Governor Walker wanted to take credit for a balanced budget or at least avoid blame for deficits during a bitter recall election, but Huebsch wanted to reduce the number of people eligible for medical assistance coverage under the new federal Affordable Health Care Act, which he could do if the state could demonstrate that it was running in the red. Defining balance turns out to be a political choice rather than a technical or legal one. The easiest way to obscure a deficit is to choose an accounting system that allows maximum flexibility for when expenditures are counted.


Another way that the constraint of balance can be loosened or tightened is to change the point at which the budget must be balanced: when the executive proposes it, when the legislature passes it, when the governor signs it, or at the end of the year. According to a 2010 study, forty-four states required the governor to propose a balanced budget, forty-one required the legislature to pass a balanced budget, but only thirty-eight required the state to finish the year with a balanced budget, prohibiting any deficit to be carried over into the following fiscal year. These numbers were based on the perceptions of finance officers, how they see the process, rather than on the text of the law or constitution.
depends in some cases on informal understandings or interpretations and sometimes on court cases. Prohibitions on borrowing to balance the budget are sometimes interpreted to be a balanced budget requirement, but strictly speaking they are not, because they don’t address delayed payments for goods and services already received, sale of assets to balance the budget, or carrying a deficit forward from one year to the next.

Minicase: Balance in the Federal Highway Trust Fund

The national level Highway Trust Fund is an account based on gas taxes primarily for building and repairing the nation’s highways. When projects are finished, the states bill the federal government for reimbursement from the Highway Trust Fund. Revenues have to be greater than obligations, not just greater than outlays, because the states are running up bills that they have not yet submitted for reimbursement. By next year, there should be more money in the fund to pay off the bills that are being incurred now but that will not be presented until next year or the year after. So how can anyone tell if the trust fund is really balanced at any time? How can Congress or the president ensure that the states do not spend more money than the fund can expect to receive? And if there is a surplus, how does anyone know how much it is?

When money is committed by the states, it shows up in the trust fund as obligated but not yet spent. So the total in the fund remains high, although much of the money is already committed and cannot be spent on anything else. The result of not subtracting this committed money from the trust fund total is to make the balance in the fund look greater than it really is. This can help to make the federal budget as a whole look balanced, if the “surplus” in the Highway Trust Fund is counted as part of the consolidated balance of the federal government. But the result is misleading.

Attributing future expenses to the present year’s budget is equally misleading, as matching several years’ expenditures against a single year’s revenue would normally result in deficits for that fund. To avoid this problem, Congress, through the Byrd Amendment to the Federal-Aid Highway Act of 1956, restricted the growth of future commitments to a level not to exceed the current year’s unexpended balance plus projected income for the following two fiscal years.1

The result does provide some protection against overspending, but it does not yield an exact figure for budgetary balance or an exact estimate of the surplus. To calculate a surplus in this situation, one has to subtract the actual obligations from the present unobligated revenues plus estimated

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unobligated future revenues. The number is spongy, in part because until bills are actually presented for projects approved or under way, the exact cost is not known, and in part because the calculation depends on estimates of revenues for the present and the next two years.


The constraint against borrowing to balance the budget does not guarantee a balanced budget or good financial management. For example, Louisiana in 1988 got around the prohibition. State officials confronted a deficit that had been rolled over from year to year. They had been covering that deficit through internal borrowing and delayed payments to vendors. It would have been better management and more accountable to borrow long term to pay off the short-term obligations and spread out the deficit repayment over a period of years, but the state was forbidden to borrow to balance the budget. So the state created a special district to issue the debt. The special district had the same boundaries as the state. It levied a 1 percent sales tax to pay off the bonds.²

Though states sometimes evade the rules they operate under, because they feel the constraints are too tight or result in poor management, the general direction has been toward more restrictive rules mandating balance. In 2004, for example, California voters passed a referendum requiring the legislature to pass a balanced budget, mandating that the state resolve midyear shortfalls before the end of the year and prohibiting the state from borrowing to cover end-of-year shortfalls.

Washington state strengthened its requirements in 2012, though the balance requirements before the change were not particularly weak. If a cash deficit occurred during the year, the governor was required to implement across-the-board cuts. In 2012, the state added a kind of “look forward” requirement, so that the legislature had to assure balance not just for the current biennium but also for the next one, four years at a time. There were complicated exceptions to the rule, including the results of collective bargaining; the rule was legislatively based, not constitutionally based, and so could be changed in the future; further, it was not to take effect for several years. The definition of future balance was based on generous projections of revenue. Even considering these softening features,
However, a legislative requirement to pass a budget that would be in balance for the next four years added a new and potentially powerful constraint to budgeting in Washington state.3

Indiana, which is forbidden to borrow to balance the budget, is in the process of adding a constitutional amendment to require a balanced budget, which is considered by some to be a stronger and more inclusive constraint. The governor called for such an amendment in his state of the union speech, even though the state budget has routinely been balanced. The legislature passed the proposal in 2015, but before it can be placed before the public, it must also pass the next independently elected legislature.

Tightening the balance rules may be one way to try to restore balance and/or maintain it in the future, but it can also be a way of keeping down expenditures and controlling the size and intrusiveness of government. The additional constraints can vary from a moderate change in the budget process that makes the linkage between revenue and expenditure decisions tighter and more authoritative, to a change in statute making the requirements for balance more inclusive and more difficult to get around, to a change in the constitution narrowly specifying the conditions under which deficits may be run or forbidding deficits or borrowing to pay them off. At the national level, deficit hawks have repeatedly put forth proposals for a balanced budget amendment to the constitution.

There is no evidence that more severe constraints work better than milder ones or even informal ones. On the contrary, there is some suggestion that more severe constraints encourage unintended consequences, such as asset sales—which are often a bad deal for the public—and delayed payments to vendors. The more draconian the requirements, the more likely they are to generate responses that meet the letter rather than the spirit of the rules.4 Illinois, for example, has a constitutional requirement for a balanced budget, but has routinely evaded the spirit of the requirement through interfund sweeps, through pushing off bills into future years, and by diverting money owed to the pension funds. In some years, the state has borrowed money to pay into the pension system.

**Multiple Actors, Ideologies, and Deficits**

Who gets involved in the politics of balance, and how do those actors come down on the variety of policy issues involved in budget balancing?

The public plays an indirect role by putting pressure on elected officials to balance the budget. Citizens argue that their personal budgets have to balance, and hence governmental budgets should also balance. At the same time, citizens often want something for nothing, demanding lower taxes without cuts
in their services or benefits. When elected officials comply with the demand for lower taxes and more services, they create deficits; when the elected officials try to reduce or eliminate deficits, the need to give the impression of not raising taxes or cutting services leads to evasion, distortion, and erosion of transparency.

Interest groups and agency heads may contribute to deficits by making it difficult to raise specific taxes or cut particular programs. When cuts are being proposed, interest groups and agency heads may work to protect programs that benefit them. However, neither individual interest groups nor bureau chiefs typically have distinct policies toward deficits (as opposed to policies toward maintaining the programs that benefit them). The appropriate size of government and level of taxation are issues that affect the rich and the poor differently, and thus class-based coalitions often take sides in debates on budgetary balance. An alliance of labor unions may oppose a consortium of business groups.

Elected officials in both the executive and legislative branches, responding to party platforms, constituency demands, and the ebb and flow of intergovernmental revenue, are key actors in this decision stream. Courts also play a role in budget balance, by judging the legality of efforts to balance the budget and by adjudicating bankruptcies.

These actors take sides on the appropriate size of government; the role of the budget in the economy; the appropriate role of each level of government; and the outcomes—that is, whose taxes will be increased and/or whose programs will be cut, by how much, and with what effect.

The Appropriate Size of Government

Budgets can be balanced by allowing revenues to increase; by freezing revenues at current levels and cutting expenditures to match; or by reducing revenues and cutting expenditures deeply to create balance at a new, lower level of spending. Allowing revenues to increase to reduce deficits is a fiscally conservative but socially more liberal position, without major implications for current program spending. Liberals hope to increase taxes on the rich to pay for programs for the poor. Achieving budget balance by deeply cutting programs is a more politically conservative position. Some conservatives press for cuts in taxes as a way to force cuts in expenditures, using the requirement of balance as a vehicle to reduce the scope of government. They hope to reduce the tax burden on the rich and simultaneously reduce services to the poor and dismantle regulations that hamper businesses and reduce profitability.
The Role of the Budget in the Economy

Should the budget be a tool of control over the economy to dampen economic swings, to control inflation and unemployment levels? Political liberals have accepted the need for deficits during recessions because of the need to increase unemployment benefits and maintain welfare spending at the same time that government receipts decline as a result of falling incomes. Liberals are more comfortable with using government spending as a way to jump-start a stalled economy. Some conservatives oppose deficit spending as a technique to help stimulate the economy when it is weak. They prefer that the budget not be responsive to economic cycles at all and argue that expenditures should be cut back when revenues fall during recessions. Other political conservatives will tolerate deficits during recessions if the deficit is caused by tax reductions to businesses and the wealthy. They argue that this policy will increase the supply of capital and thus stimulate the economy and create jobs. Not only conservatives and liberals line up on this issue but also interest groups that represent business and labor.

The Role of Each Level of Government

Where should the burden of providing services and benefits be placed? If balancing the budget becomes a valued goal at the federal level, there may be a strong temptation to balance it at the expense of other levels of government, cutting back grants and passing on program responsibilities. The states may do the same with local governments. Cities and towns may try to give service responsibility back to the state government or to townships, counties, special districts, or the private sector. Each level of government has an interest in passing on expenditures to other levels and preventing expenditures from being passed to itself.

The Choice of Outcomes

Which functions should continue to be performed? Whose benefits and programs should be maintained or cut? The politics of balance may lightly veil a bitter politics of outcomes, with protection or termination of particular programs or benefits as the goal. Interest groups, service recipients, and agency heads may take sides on this issue to protect their programs.

These four issues summarize what many of the actors in this portion of the budgetary decision-making process are trying to achieve. Liberals are trying to maintain the scope of government, while conservatives are trying to shrink it. Working people and their representatives want the budget to be used to keep the level of employment high, while businesspeople and their representatives
prefer that the budget be used to keep taxes low. Each level of government wants to balance its budget, possibly by shifting the costs of programs and the burden of taxation elsewhere. Interest groups, legislators, beneficiaries of programs, and agency heads try to protect their programs from cuts that are proposed to balance the budget.

The Environment, Unpredictability, and Deficits

Deficits occur in part because budgets are open to the environment. Deficits can occur no matter how hard public officials work to balance the budget. The courts may declare that patients cannot be committed to a mental hospital without treatment or that overcrowding of prisons is cruel and unusual punishment, so governments have to increase treatment in mental hospitals and build more prisons and hire more guards. Hurricanes, floods, blizzards, or exceptionally cold or hot weather can increase spending. Riots; explosions; killings by terrorists, ideologues, or police; and political demonstrations can all require extra staff hours, more equipment—such as cameras—improved training, or better public relations. War, with its overriding urgency, can increase expenditures without reference to current revenues.

Unexpected losses of revenue can result from courts’ declaring some tax unconstitutional, which may require the restoration of the revenue to the taxpayers. The passage of tax limits can freeze or reduce revenues for state and local governments. Borrowing may become more expensive just when a government is planning to issue a bond. The costs of medical insurance or gasoline can surge unexpectedly or relentlessly. A sudden downturn in the economy can shrink revenues below expectations. At the local level, a business may close unexpectedly or move to another state, causing a decline in property tax revenue and leaving people without jobs and income, reducing sales tax revenues. Cycles of boom and bust in residential property can increase and then decrease revenues from property taxes.

The intergovernmental revenue system introduces considerable uncertainty for state and local governments. With competitive grants, the potential recipients do not know whether they will receive the money. Sometimes intergovernmental aid is set up as an entitlement, so that all cities that have an unemployment rate over a given threshold are eligible for particular kinds of aid. Those paying for the program cannot estimate its cost; those who might receive the aid do not have any way of knowing in advance whether they will be eligible. When state governments give aid to local governments in the form of entitlements, the problem is exaggerated because the state governments have to balance their own budgets. To
meet unexpected increases in costs, they have to set aside contingency funds, which may be inadequate to the purpose. At times states incur obligations to their local governments that they do not have the money to fund. Local governments that included revenues from the state in their budgets have to guess how much they will receive of what they were entitled to.

A related problem with intergovernmental revenues is that when the donor-level government is in financial trouble, it may hold back the money it is supposed to give to the recipient for weeks or months, earning interest on the holdback to help with its own financial problems. Or the donor can delay payments into the next year, forcing those who planned to use the money to borrow in anticipation of receiving it later.

Some expenditures depend on the demand; the supply of the service is not determined by how much money is budgeted. The problem of demand-driven costs is particularly acute at the federal level, because so much of federal spending is now composed of open-ended entitlements. That means that if there is an increase in the number of people eligible for a given program, the money must be found to pay them, regardless of what is happening on the revenue side. Entitlements decouple revenue and expenditure decisions and hence make budgets more vulnerable to deficits.

Long and severe recessions contribute most directly to budgetary imbalance, because they simultaneously increase expenditures for unemployment relief and welfare and reduce revenues because so many people are out of work or earning less. It is politically very difficult to raise taxes when many people are unemployed and perhaps equally difficult to reduce the benefits of people who are desperate for them because they have lost their jobs. Moreover, reducing public spending to balance the budget may worsen the recession, because people have even less money to spend to keep the economy going.

The environment may also contribute to deficits when the economy of a whole region is gradually declining and with it the amount of taxable wealth. The costs of delivering programs and projects does not decrease proportionally to the tax base, because service costs may be related to lane miles of road or linear feet of water pipe, neither of which shrink with population or with loss of businesses, and because remaining population may be poorer and more in need of public services than those who leave. The result may be a long-term disequilibrium between the cost of government and the availability of revenues. Either governments must continue to raise tax rates, taking a greater and greater share of people's income, against which the public will eventually rebel, or they must continue to cut back programs and projects, potentially exaggerating the decline. In the face of such continuing negative choices, officials may run deficits.
In short, many deficits stem from changes in the environment. These changes may require more flexibility than the budget can deliver. Forbidding deficits—which is one response to them—seems futile in the face of the openness of the budget to the environment. The budget can be made less open to the environment and it can be made more flexible so that it can adapt without deficits. But the most common response seems to be to run the deficits and then worry about how to eliminate them in a timely and fair manner.

Increasing Stress Between Payer and Decider

The difficulties created by the separation of payer and decider may become acute when governments run deficits. The public wants balance, but it simultaneously wants to maintain services and programs that it likes, and it does not want to increase its tax burden. Decision makers are faced with a series of politically unacceptable choices. Citizens may argue for taxing someone else and cutting someone else’s programs, but for the decision maker there may not be many legal options that satisfy those conditions.

The unpopularity of deficits, when combined with the unpleasant options available to reduce them, creates a tendency to hide or minimize deficits. The budget may lose much of its ability to provide public accountability. Balance may be redefined, the system of accounting may be changed to a cash basis to hide deficits, long-term capital borrowing may be used to cover operating deficits, expenditures may be pushed off into the next year, or funds may be borrowed between accounts inappropriately and possibly without record (with or without an intent to repay). Revenues may be overestimated or expenditures underestimated to make the budget, as passed, look more balanced than it is. The longer this hiding goes on, the more convoluted and uninformative the budget becomes.

How, then, can a deficit situation ever be fixed? A number of pressures work to reveal the extent of the problem and restore balance. For example, if there has been a lot of internal borrowing, agency heads and program beneficiaries whose funds are being borrowed may become desperate enough to complain. Second, internal borrowing may become so tangled that auditors can no longer certify the honesty and integrity of the financial records, a warning sign of trouble that may bring the situation to public attention. Third, newly elected politicians have an incentive to reveal deficits and attribute them to their predecessors. Fourth, if the amounts involved grow large enough, they necessitate public borrowing, which means turning to the financial markets for funds. Banks and other investors require evidence of sound financial practice and require higher interest rates to compensate for higher perceived risks. If the situation is sufficiently serious, the
market may close completely. The more desperate a government is to borrow, the more it needs to restore its fiscal integrity to be able to do so. After a deficit is acknowledged, the difficult task of restoring balance remains. When many programs are entitlements that benefit nearly everyone and other programs have intense interest group support, it is difficult to know where and how to cut expenses while maintaining acceptability to the public.

State governments, with their requirements for annual balance, have so little time to deal with emerging deficits that borrowing to balance the present budget and paying back over a period of years may seem to be the only viable solution. That can mean borrowing internally by not funding pensions fully—in essence borrowing against the future, with the idea that the situation will improve later and funds can be restored. In that case, the problems being created are not likely to come home to roost while current elected officials are in office. States may borrow against anticipated revenue sources, such as tobacco settlement money they are due in the future but need now. Sale of assets, such as highways or privatization and issuance of long-term leases, may provide temporary infusions of cash. (See the minicase of Chicago’s parking meter lease below for an example of what can go wrong in such deals and also the minicase of Iowa’s privatization of Medicaid on p. 198.)

These one-time revenues cannot address a long-term structural imbalance between revenues and expenditures, but they tend to dampen the sense of urgency, lower the estimates of deficits in the short term, and hence reduce the embarrassment of running deficits and the need to make politically unpopular cuts in services or programs. In extreme cases, states have borrowed long term to cover an accumulation of short-term operating deficits. That makes the cuts more manageable and the levels of service disruption less noticeable.

**Minicase: Chicago’s Parking Meters**

Sale or lease of assets brings in one-time revenues, but sometimes these deals go awry. The case of Chicago’s parking meters is a good illustration of what not to do and how not to do it. In 2008, Mayor Daley leased thirty-six thousand parking meters to a private consortium for $1.2 billion for seventy-five years, giving up that revenue stream. The city’s inspector general argued it was worth much more than the city got. As soon as the consortium had control of the meters, it jerked up parking costs, as much as fourfold, to the highest in the nation. Under the terms of the lease, the city owed the

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Minicase: Iowa’s Privatization of Medicaid

Not all privatization deals are fiscally unfortunate, but estimating savings can be tricky. Advocates of privatization can be tempted to exaggerate the potential savings, and companies can be tempted to lowball to get the contract and later increase the costs. Opponents assume that reductions in cost mean reduction in the quality of services provided.

When the Iowa governor privatized the management of its Medicaid program, turning the program completely into managed care, the state department of human services estimated a savings of $51 million in the first six months, an estimate that legislators used when passing the budget. When legislators asked for the documentation to support the estimate, the department could not offer any. The most benign interpretation is that having come up with the estimate, they then discarded any documentation; a less kind interpretation is that the figure came from unidentified experts offering a wide range of possible outcomes. Since the governor was pushing the privatization proposal, staff may have chosen from that range a figure that would justify the governor’s decision.

The uncertainty reportedly was not conveyed to the legislators. The savings predicted may not materialize. Privatization may look like a good way to balance the budget, but it can present major managerial and ethical problems. The first sign of trouble occurred when an administrative law judge recently recommended that one of the four contracts with private sector providers be thrown out, “noting that the company failed to disclose details of its ‘integrity agreement’ with the federal government after the 2014 convictions of three former executives involving the misuse of Medicaid money. In addition, WellCare had paid $138 million to resolve claims that it over-billed Medicare and Medicaid, and the firm had also hired two former Iowa legislators, who improperly communicated with the Branstad administration during the bidding process.”1 (See Figure 6.4 on p. 213.)
When cuts are necessary, one response is to make them where they are least noticeable to prevent citizen complaints. Such cuts break the visible link between taxes paid and services produced; it appears as if cuts can be made without reducing services. The model of invisible cuts encourages elected officials to keep on cutting, as there never seems to be any harm or public outcry.

Another approach is to cut across the board, to give the impression of fairness. To the extent that this strategy is employed, it prevents cutting more deeply the programs that have more waste or those whose services can be more easily dispensed with or provided by the market. It may work if the cuts are temporary but be inefficient if the problem is long term and structural. It can also be a difficult strategy to implement, as interest groups that perceive their programs are about to be cut will fight to protect them, regardless of what is happening to other programs.

A third approach is to cut the programs that have the weakest interest group support, including programs that have no powerful interest group support, such as personnel or foreign aid. A related strategy is to cut the programs of political opponents—either the ones that serve opponents’ constituents or the ones into which opponents have in the past hired most of their political supporters.

Some programs are mandated by a higher level of government or may be required to be performed at a given level by the constitution or a charter provision or by the courts. In such cases, spending is cut back not where the priorities are lowest, but wherever it is legal to cut. At the state and local levels, public works programs may be most severely cut, because they have projects that are not yet committed, delaying them will save some money in the short run, and such cuts are usually permissible under law.


The four characteristics of public budgeting—constraints, variety of actors and goals, openness to the environment, and the separation of payer and decider—provide some common themes for the politics of deficits at different levels of government. Nevertheless, there are some important differences among the federal, state, and local levels that influence how each level deals with deficits when they occur.

One difference is that state and local governments are generally required to balance their budgets, if not in the current year or biennium, then in the following one. The federal government is not so constrained. When changes in the environment push up the costs of entitlement programs at the federal level, the increased costs show up as increased deficits; at the state level, the costs have to come out of a contingency fund or reduced spending for other budgeted expenses. Because state and local governments generally have to balance their budgets every year or at least in a short period of time, there may be more pressure to delay payments, push up revenue collection, or shift more program costs to local governments. States and localities sometimes build up budgetary surpluses to guard against deficits. Another product of the state and local requirement for balance is that efforts to hide deficits may be more intense.

A second difference between the levels of government is that the role of deficit spending in regulating the economy is most salient at the federal level. State governments are only marginally involved in efforts to control the economy, and local governments are generally too minor a part of the economy to control it no matter how they spend their money. State and local prohibitions on running deficits make it impossible for them to spend more during a recession, even if such spending could stimulate economic growth. A third difference has to do with overall size. At the federal level, the tremendous size of budget deficits and their chronic nature create a noisy and stubborn problem with potentially major impact on the national economy. Deficits are rarer and more tractable at state and local levels, in part because the requirements for annual or biennial balance make it more difficult (though not impossible) for large deficits to accumulate from year to year.

**The Politics of Deficits: The Federal Level**

Deficits were a fact of life at the federal level for many years, but they became particularly large in the late 1980s and early 1990s (see Figures 6.1 and 6.2). They were brought under control by 1998, only to grow again, to record levels, after 2001. In recent years the deficit has been coming down again. As of August 2015, the Congressional Budget Office estimated the federal deficit for fiscal year 2015 at $426 billion, compared to $1.3 trillion in 2011.
From the beginning of the republic to the 1930s, deficits were associated primarily with wars, and debts were paid off after the wars were over. During the Great Depression of the 1930s, politicians responded to falling revenues and the urgent need for aid for the poor by allowing deficit spending. The Depression forged a new role for the federal government to help minimize swings in the economy and the attendant social and economic distress. After the Great Depression, an economic theory, Keynesianism, emerged that argued that deficits for this purpose were not necessarily harmful and that spending during recession actually helped stimulate the economy. Deficits incurred to offset recessions and stimulate the economy are supposed to be temporary, but since the middle of the 1970s, deficits have occurred nearly continuously.

Since the 1970s, politicians who promised to eliminate deficits have often failed to do so, creating the impression that deficits were out of control. Whatever acceptance there was of moderate-sized and occasional deficits began to evaporate when the deficits became huge. In 1974 the federal government had a deficit of $6.1 billion, which was four-tenths of 1 percent of the gross national product (GNP). By 1992 the deficit had reached $290 billion—$340 billion not counting the Social Security surplus.5
The Clinton administration focused on eliminating the deficit, and by 1998, the budget was more or less in balance. All that changed very quickly in the Bush presidency, for a combination of reasons. The September 11, 2001, attack on the World Trade Center and the Pentagon resulted in sharply higher costs for antiterrorist activities. The intelligence budget was $26.7 billion in 1998; it took a leap upward in 2001. By 2007, the total was $63.5 billion and reached $78.6 billion by 2011. Government documents leaked by Edward Snowden indicate that intelligence spending in 2013 for defense and nondefense agencies was approximately $75 billion. For 2016, the budget request was for $71.8 billion. These numbers have come down only slightly in the past few years. The costs for intelligence gathering are dwarfed by the costs of wars undertaken at least partly in response to the terrorist attacks. Depending on how inclusive the researchers have been in defining what is included in the cost of the wars, estimates vary from the Defense Department’s $1.2 trillion over ten years from 2001 to 2011 to Neta Crawford’s estimate of $4.4 trillion through 2014. The larger estimate is for a longer period and includes obligations as well as actual outlays, including the costs of treating the injuries of veterans. Throughout the Bush administration the wars were

![Federal Surplus or Deficit as a Percentage of GDP, 1940–2015](image)

**Source:** OMB, *Historical Tables*, FY 2017, Table 1–2.

*Note:* The Congressional Budget Office estimates are somewhat lower than OMB’s for deficits in dollars and also somewhat lower for estimates of the deficit as a proportion of GDP.
funded by emergency supplemental appropriations, which did not require offset-ting revenues or spending cuts, so war costs added directly to the deficits. In the Obama administration, the costs of the wars have been tucked into the Overseas Contingency fund, which is “off budget,” does not follow any of the rules for on-budget items, and hence is not offset by revenue. As a result, war spending still adds directly to the deficit.

In addition to war and antiterrorism activities, a recession began mid-2001. Making the revenue problem more serious, the Bush administration granted two major tax reductions in 2001 and 2003. By the end of 2007, a second recession had begun; the Bush administration responded by reducing taxes again, which cost an estimated $170 billion, beginning to bail out the auto industry with loans, and working to rescue the banks. The program, called the Troubled Asset Relief Program (TARP), was signed by President Bush in October 2008.

The Obama administration took office in the midst of this recession. This one, unlike 2001, was long and deep, with widespread unemployment. His administration was marked by the continuation and expansion of the two wars, continuation of the Bush tax cuts, and the bailout of General Motors, Chrysler, and the banks. The recession, triggered by the bursting of the real estate bubble, left many banks and financial institutions in severe financial trouble; loan activity was frozen, which made the economic downturn more severe. President Obama was not happy about continuing the TARP program, but found it necessary:

... if there's one thing that has unified Democrats and Republicans, and everybody in between, it's that we all hated the bank bailout. I hated it. You hated it. It was about as popular as a root canal.

But when I ran for President, I promised I wouldn't just do what was popular—I would do what was necessary. And if we had allowed the meltdown of the financial system, unemployment might be double what it is today. More businesses would certainly have closed. More homes would have surely been lost.

So I supported the last administration’s efforts to create the financial rescue program. And when we took that program over, we made it more transparent and more accountable. And as a result, the markets are now stabilized, and we’ve recovered most of the money we spent on the banks.9

The Congressional Budget Office estimated as of 2015, the costs of TARP to the public would be only about $28 billion of the $440 billion program spending, the rest of the spending had been recovered.10
The Republicans demanded an extension of the Bush tax cuts of 2001 and 2003, which benefited primarily the wealthy, as the price of support for Obama's request for an extension of the federal unemployment payments. To this, Obama added a cut in payroll taxes to working people as a stimulus to the economy and antirecession aid to the states, to prevent massive layoffs of teachers, police, and firefighters. The federal government also helped the states pay for Medicaid during the deepest parts of the recession. The financial assistance to the states included some funds for so-called shovel-ready projects to employ construction workers quickly.

There is no way around these numbers. In 2000, receipts from both on-budget and off-budget accounts represented 20.6 percent of GDP, while expenditures were 18.2 percent. By 2011, receipts had dropped to 15.4 percent of GDP, while expenditures had increased to 24.1 percent. The resulting deficits were not merely big; they were enormous. (See Figure 6.3 for a sense of the impact of reducing revenues and increasing expenditures.) After 2011, with spending curbs and across-the-board cuts, the winding down of the wars, and recovery of much of the TARP bailout funds, along with recovery from the recession, the deficit has roughly halved from its peak.

**FIGURE 6.3 Total Federal Spending and Receipts, as a Percentage of GDP, 1930–2016**

![Figure 6.3](https://www.whitehouse.gov/omb/budget/Historicals)

The Politics of Balancing the Budget

The trends from 2001 to 2011 reflect political stalemates in which neither party could completely enforce its will on the other. While the Republicans fought for tax breaks for business and the wealthy, the Democrats fought for middle- and working-class tax relief; while the Democrats sought extension of benefits for the unemployed and jobs for public sector employees at the local level, Republicans sought to cut spending and opposed any kind of tax increase. Even though the bank and automobile bailouts were begun in a Republican administration, the expansion of government into the economy angered some on the right. To them, government ownership of shares of business looked like socialism; to the left it looked like a rescue of the economy but only for the upper classes, while the poor were being kicked out of their homes when they could not pay their mortgages. The only political agreement that seemed possible was support for further tax reductions and increased spending for the financial sector.

Republicans used the size of the deficit as a wedge to argue for cuts in spending. They refused to support an increase in the debt limit, which would have allowed the government to pay its bills, until an agreement was reached to cut back spending. Their proposals excluded tax increases, forced cuts in programs for the poor, and ended further effort to bail out the economy. They successfully insisted on the level of cuts and forged an agreement to establish a supercommittee to designate which programs' budgets would be reduced and by how much. The committee, composed of both Democrats and Republicans, failed to reach agreement, leaving the cuts to be made across the board, including defense.

Not long after the agreement was reached, Republicans backed off from it, demanding deeper cuts in other programs and exemptions from cuts to Department of Defense spending. The original agreement involved cuts of $1.2 trillion over ten years, but with the failure of the supercommittee to agree on tax increases or spending cuts, the fallback position was invoked, across-the-board cuts of more than $1 trillion, including defense, but exempting the neediest. Confronted with half a trillion dollars in cuts to defense, Democrats wanted to soften the cuts with some tax increases; Republicans refused to consider them. Instead, House Republicans proposed to reduce defense cuts by cutting food stamps, Medicaid, and other social programs. “The Congressional Budget Office estimated that the bill would push 1.8 million people off food stamps and could cost 280,000 children their school lunch subsidies and 300,000 children their health insurance coverage through the federal and state Children’s Health Insurance Program. Elimination of the social services block grant to state and local governments would hit child abuse prevention programs, Meals on Wheels and child care.”11 This proposal seemed less aimed at reducing the deficit than shifting cuts from defense to social services.
Some Republicans wanted a guarantee that a balanced budget amendment to the Constitution would pass Congress before they would support an increase in the debt ceiling. They did not get that guarantee, but the balanced budget amendment did reach the floor of both the Senate and the House of Representatives. The House failed to get the necessary two-thirds majority to pass a constitutional amendment in November of 2011. Both a Democratic and Republican version of the balanced budget amendment failed in the Senate in December of 2011. While these proposals failed, they illustrate the renewed effort to come up with a budget process that would tie the hands of Congress, which would somehow force balance and discipline or would force the cuts in spending that some preferred. Sen. Orin Hatch from Utah, who sponsored the Republican version, argued, “Congress will not kick its overspending addiction alone, but only if required to do so by the Constitution itself.” The wording of one of the proposals was suggestive, in that it required a supermajority vote to raise taxes or allow spending to exceed 18 percent of GDP. Spending hadn't been that low as a percentage of the economy since 1966. The balanced budget amendment thus may have been more about achieving a smaller government and keeping taxes low than about balancing the budget.

As discussed earlier, the solution to the controversy over whether the across-the-board cuts would include the Defense Department was shifting war costs into the Overseas Contingency Operations account, which was “off budget” and hence did not come under the requirement for across-the-board cuts. Some of the regular Defense Department expenditures were also shifted into the fund making the DoD base budget look smaller.

The Politics of Deficits: States

When they are facing deficits, the states, like the federal government, have to decide whether and how much to raise revenues or cut expenditures, with similar implications for the scope of government. Just as at the federal level, there are problems of defining what constitutes a deficit and of measuring the size and importance of deficits. Just as the federal government has to decide how much of a financial burden it can shift to the states or the private sector, states have to decide how much expense to absorb from or pass on to local governments and how much service burden they can unload on them. But the requirement of annual (or biennial) balance in the states creates some differences from the national government.

States are especially stressed by recessions that increase the cost of entitlements while simultaneously decreasing revenues. If only the states could put off
rebalancing until the recession was over and the economy had recovered, they might avoid deep cuts, but state laws do not permit deficits to run for several years. It takes time and political risk to raise revenues; the short time line for states to achieve annual or biennial balance means they have to make deep cuts, sometimes even multiple times in a single year, to balance their budgets. In an effort to minimize the need for such gap closings, the states have often relied on more-or-less legal, if not always fiscally conservative, methods to tide themselves over until the economy improves. When confronted with high deficits, many states do some cutting but also some temporizing. They frequently use budget gimmicks of various sorts to prevent deeper cuts in programs and staffing, hoping that if they put the tough decisions off into the future, the economy will recover and balance will be easier to achieve later. Many states borrow; they draw down whatever reserves they may have in rainy-day funds; they delay or suspend payments to local governments and to vendors. Some states move paydays, delay tax refunds, speed up fee collections, or sell buildings and lease them back. Several states have engaged in a kind of arbitrage, borrowing money in the government market where interest is relatively low, giving the proceeds to the pension funds that invest in the private sector at higher rates of return. The pension funds are expected to pay back the loans and make some money in the process, lowering the amount the state has to contribute to the pensions.

States wrestling with balanced budget requirements sometimes use budget gimmicks to not only react to deficits but to obscure or minimize them. If the deficit is small or defined away, they will not have to raise taxes or cut services, both of which are politically unpopular. For example, Rep. David Obey, D-Wis., reported a number of years ago, “I come from a state with a balanced budget requirement. In the six years that I served in the legislature, Wisconsin’s indebtedness doubled, because they engaged in all kinds of phony-baloney devices, off-budget accounting, dummy building corporations, all the rest, that simply defined out of the budget all kinds of spending that was really governmental.”14

Another gimmick to make a budget look balanced is to accelerate tax collections, which produces a one-time windfall for the state. For example, if a state changes from a quarterly to a monthly collection schedule, it can collect fifteen months’ revenues in twelve months. On a quarterly basis, it could collect taxes the first of the year for the preceding three months; the second payment would be at month three for the preceding three months; the third payment would be at month six for the preceding three months; and the final payment for the year would be at month nine for the preceding three months. But if the state goes to monthly collections at that point, it can collect the taxes for months ten, eleven, and twelve, for which it would normally have to wait until the next fiscal year.15
A similar gimmick is to put off some expenditures into the next fiscal year. That increases the next year’s expenditures, but by then the recession may have ended so that increased revenues will cover the extra expenditures. A way to push expenditures into the following year is to change the basis of accounting from modified accrual to cash. Under cash accounting, expenditures that are incurred this year but not paid until next year are officially counted as next year’s expenditures. Under accrual accounting, they would be counted as part of this year’s expenditures.

In Illinois, the governor changed the accounting system from modified accrual to cash in 1978, making the budget look more balanced that year. In addition, the cash budget changed the definition of a deficit. A cash budget measures deficits by looking at the available cash balance at the end of the year rather than matching revenues and expenditures during the year. The available cash balance is eminently suited for manipulation: Any cash on hand goes into the available balance, even if it is a loan. The available balance is also affected by speedups in revenue collections, delays in paying vendors, and manipulating the timing of drawdowns of federal funds. “When an administration commits itself to a specific end of year available balance, it can manipulate the revenue processing system to bring about an available balance consistent with its prediction.” Perhaps most important, the cash balance is always positive and hence makes it look as if the state is running a surplus, even when it is running a deficit.

Budget gimmicks reduce the amount of spending cuts or the size of tax increases that might otherwise be necessary, helping elected officials avoid hard political choices that make enemies. These techniques are not necessarily bad; it makes sense to avoid deep cuts and expensive restructuring to eliminate a deficit that will disappear on its own as the economy recovers. They can be harmful if they go on too long and allow huge buildups of unpaid obligations; moreover, they obscure the true financial picture, reducing accountability.

One of the more constructive responses that many states have adopted is to create and expand rainy-day funds, to be used when the economy falters and revenues decline below expectations. In the ideal case, money is put into these funds during years when revenues are growing and drawn down during recessions when revenue falls. Funds that are depleted during recessions have to be replenished over the next few years. Such funds, if they are big enough, can help prevent the need for midyear cuts. Some states are more successful than others at building and using rainy-day funds. The funds are often too small to function as intended or have to be repaid before the economy and revenues recover.

When midyear cuts are necessary, it is often the governor who has to make the cuts; in some states governors can do this on their own initiative, in others, proposed cuts must be approved by the legislators. While legislators have not
been eager to do the rebalancing themselves, they have not always been eager to give the governor unlimited power to change the priorities in the budget midway. Fifteen states give the governor unlimited authority to cut the budget during the year.\textsuperscript{18} It is more common for legislators to give the governor limited authority to cut back the budget, either across the board—that is, without changing legislative priorities—or up to a given percentage without legislative approval.\textsuperscript{19} Governors are thus expected to help balance the budget during the year and are often granted considerable discretion in doing so. But if more action is required that might seriously change legislative spending priorities, the governor generally has to come back to the legislature for approval.

Although there are sometimes controversies over whose programs will be cut, the states do not have enormous flexibility in what will be cut back. When budget cuts are necessary, the discretionary portion of state budgets is cut first, such as highways, education, police, prisons, courts, and shared revenue or grants to the local governments. Other spending may be mandated by law.

Even within the so-called discretionary budget, there may be limited discretion. For example, Proposition 4 in 1979 in California limited appropriations growth to the percentage increase in the cost of living and the percentage increase in the state or local government's population. In reaction, citizens passed Proposition 98 in 1988, which requires a minimum of 40 percent of California's general fund to be spent on education. Similarly, Colorado's TABOR amendment caused serious budget cuts year after year, including in K–12 education funding. In response, citizens passed a referendum ensuring funding for those schools. The result was that higher education was nearly the only expenditure left that could be cut. State universities' budgets were sharply reduced. It is partly this lack of options that makes it so tempting for states to pass along costs to the local governments or take local revenues to pay state bills.

Passing the Buck to Local Governments

Because local governments are subordinate to the states and have to take orders from state governments, the states can decide to pass the burden of paying for programs and projects onto their local governments. That is, the state can command the local governments to perform a particular service at a higher level or in a different manner than before, without giving the local governments the money to pay for the new requirements. The states can also claim local revenues. A third possibility is for the states to balance their budgets by cutting financial aid to local governments, even if that aid was a replacement for revenues the state took away from them.
Each of these three strategies has the possibility of aggravating the financial condition of the local governments. Because the states are ultimately responsible for the fiscal health of the local governments, they have an interest in not squeezing them too hard, but at the same time, the states have to balance their budgets each year or biennium and have few choices about what to cut. Therefore, state officials may adopt any or all three of these strategies, if they have no rainy-day fund, if they have an inadequate one, or if they decide not to use the one they have. Some states give in to the temptation to balance their budget on the backs of the local governments.

**State Unfunded Mandates.** States may help balance their budgets by passing along expenditures to the local governments that the state would normally pay for. These burdens can make it more difficult for local governments to balance their budgets. In 1996, the citizens of Oregon passed a constitutional amendment prohibiting the state from imposing unfunded mandates on the local governments. What made this measure urgent was that the local governments were confronting rigid statewide limits on their ability to raise taxes. The provision required public reaffirmation of the amendment in four years: It was enthusiastically renewed.

In 1996 twenty-eight states had some type of mandate restraint program established by constitutional provision, statute, or both. Of the twenty-eight states, seventeen provided for the reimbursement of all mandates; nine provided reimbursement of selected mandates. The extent of reimbursement could be full, partial, or a combination. By 2007, thirty-five states had either a constitutional or statutory provision to require reimbursement of some sort for state mandates.\(^20\)

States have generally found it difficult to abide by limitations on their ability to pass costs along to their local jurisdictions, but such laws or constitutional provisions do seem to help local governments fight back, despite the disproportionate power of the state compared to the localities. For example, in Washington state, the local governments won a number of lawsuits brought against the state to recover costs the state had mandated.\(^21\) However, laws barring unfunded mandates overestimate local government’s ability to resist state imposition of costs, since the statutory provisions may be overlooked in practice. Even a constitutional amendment may be circumvented. When a state is in financial trouble, it often finds a way to avoid paying for mandates.

In California, a constitutional amendment required the state to fund mandates on the local governments, but when the state didn’t have the money, it merely postponed the payments. In 2004, Proposition 1-A required the state to either pay for mandates or suspend or terminate them, but money owed from before 2004
could be paid out over time. The response of the state has been to annually suspend the mandates, making compliance optional for the year, and making state payment unnecessary. Since the mandated activities are in some cases required by the federal government, are still in the statute books, may be reinvoked in any future budget, and may be built into curricula and processes already, schools and local governments cannot easily suspend many of these activities. As a result, they simply lose the reimbursements for the activities that they were formerly mandated to perform. As of the 2012 budget, the state still owed over $1 billion in backlogged mandate compensation, no provision for any payment on the backlog was included in the budget, and over fifty mandates had been suspended, many for over a decade.22

Once a mandate has been suspended, the state is not only freed from the obligation to compensate the local governments for compliance, it is also freed from paying for the costs of the mandate before the suspension. Hence the state department of finance annually scrutinizes the list of mandates and suspends as many as possible. In addition to the suspension of mandates and reimbursements, the state manages to avoid the requirement for reimbursement entirely for mandates for which the local governments can raise fees, such as in solid waste and recycling.23

State Tax Grabs. States can also help balance their budgets at the expense of the local governments by taking over local government tax revenue. The state may take over a local source of revenue or require the local governments to remit money to the state. When California ran into fiscal difficulties, it took more than $40 billion from local government revenues over twelve years. Initially the state took property taxes that were going to the local governments and gave them instead to the schools and community colleges, thereby reducing its own expenditures on education. Then after September 11th, 2001, when the state’s financial position worsened, the state reneged on replacing revenues lost through a reduction in the car tax. The state then delayed payments on mandated expenditures, leaving the local governments to find whatever money they could to fulfill the state requirements. Collectively, these losses aggravated financial problems at the local level, in some cases causing or at least contributing to staffing reductions in police and fire departments.

The local governments in response proposed a constitutional amendment to restrict the state’s revenue grabs. Eventually a compromise was worked out in which the state promised to stop taking the local governments’ revenues but retained some leeway in case of severe fiscal exigency. The amendment “prohibits the Legislature from taking car taxes, local property tax money and sales-tax
money from local governments unless the governor first declares a fiscal emergency and two-thirds of legislators agree. Even then, the money must be paid back in full within three years.”

In addition, the measure requires the state to pay back the costs of mandates for which it had not paid the local governments for several years, and it allows the local governments to decide not to comply with future unfunded mandates if they cannot afford to pay for them or disagree on their importance. The amendment protecting local government revenues had wide bipartisan support and passed easily in November 2004.

Despite the 2004 amendment, in 2009, the state legislature took about $5 billion from local government funds. In response, in 2010, an alliance of local government groups put an initiative on the ballot to prevent the state from taking local government revenues for public safety and transportation. The measure passed 60.7 percent to 39.3 percent. These included gas taxes as well as locally imposed hotel taxes, parcel, utility, and sales taxes, earmarked for public safety and transportation.

**Cutting State Aid to Local Governments.** The temptation to cut reimbursements and shared revenue can be overwhelming when a state runs into fiscal difficulty or if the state’s policy makers want to reduce taxes or keep them low and need to find a place to cut to balance the budget.

Many states cut their local aid during the Great Recession; some failed to fully restore that funding after the recession, even when there were budget surpluses and even when cities, such as Detroit, were in severe fiscal stress. For example, after accounting for inflation, thirty states were still funding locally provided public education in 2014 through 2015 at levels lower than before the recession hit.

In Wisconsin, between the 2005 through 2007 budget and the proposed 2013 through 2015 budget, state spending on direct aid payments to counties and municipalities dropped by 17 percent in inflation-adjusted dollars. In 2015, years after the end of the last recession, state aid was still lower than it had been in 2002.

Ohio reduced its local government funding by $1.5 billion between 2010 and 2015. The estate tax, which funded local governments, was eliminated; the state eliminated local taxes and failed to replace them with promised state revenues; property tax relief was curtailed; and the local government fund was cut back. Between 2003 and 2011, Minnesota’s aid to local governments dropped 24 percent in nominal terms—inflation correction indicates about a 50 percent reduction. (See Figure 6.4 on p. 213.)
FIGURE 6.4 Minnesota’s History of Funding Local Governments, in Constant Dollars per Capita, 1972–2014


Note: Figure 6.4 shows what happened to state aid to local governments in Minnesota from 1972 to 2014.
A report on Minnesota critiqued the administration of its state aid program, saying,

Most of the state’s financial woes since 2002 have not been resolved by increasing state taxes or by cutting state government expenditures, but by shifting the problem on to local governments through cuts in state aid. From 2002 to 2008 per pupil state aid to Minnesota school districts has declined by 13.4 percent, while per capita state aid to Minnesota cities and counties has declined by 36.7 percent and 31.3 percent respectively after adjusting for inflation in government purchases.30

This reduction in state aid to local governments in Minnesota occurred while the state was shifting significant service mandates to the local governments. Governor Dayton, a Democrat who took office in 2011, has partly restored the local government funding, but as of 2015, funding was still noticeably below the level in 2002.31 In 2015, Republicans in the legislature were working to reduce funding to particular cities.

For Michigan, from 2002 to 2013, state revenue sharing dollars dropped from over 900 million annually to around 250 million. The Michigan Municipal League estimated the cumulative total revenue losses at over $6 billion. The revenue sharing losses were usually accompanied by reduction or elimination of local revenue sources, for which the state was supposed to compensate the local governments but had failed to do so.32 Detroit, which filed for bankruptcy, lost over $732 million between 2002 and 2013 from the state reductions.33

New York State has had a program of state aid to local governments intended to reduce local property taxes called AIM (Aid and Incentives for Municipalities). Funding for local governments in the AIM program outside New York City grew from $578.6 million in 2004 to $1078.2 million in 2010. Funding dropped to $714.7 million by 2012 and stayed there through 2015.34

Maryland increased its aid to local governments from 2002 to 2008, which was a period between recessions. From 2008 to 2014, it decreased aid, with local health departments and cities and counties the biggest losers. See Table 6.1 on p. 215 for the details.

In Maryland, the steep drops during the great recession have not been completely reversed since the recession ended. Aid to counties and municipalities dropped from a high of $904.6 million in 2008 to a low of $380.6 million in 2011. There was some increase after that, but funding is still well below the levels of a decade earlier. Aid to counties and municipalities dropped 5 percent in 2008, 18.6 percent in 2009, and a whopping 46 percent in 2010. The year 2011 saw a further drop of 4.2 percent. Aid increased 38.4 percent from 2010 to 2015, but that increase has not been enough to compensate for earlier losses: From 2008 to
In the recession beginning in late 2007 and during its aftermath while the state economies were still weak, state aid to local governments, including to public schools, was often deeply cut; the resulting stress on the local governments was offset by federal aid for two years, but by the end of 2011, that assistance had ended. On the local level, financial problems typically develop more slowly than at the state level, because local governments are less dependent than the states on income taxes (which drop quickly during a recession) and more dependent on property taxes, which tend to be more stable. But the recession that began in December 2007 was caused by the bursting of a housing bubble, which means that real estate prices fell, reducing local government revenue from property taxes. With sales taxes also depressed by the recession, local governments experienced sharper revenue declines than normal in a recession.

Sometimes reductions in aid came simultaneously with a shift of responsibilities to the local governments. For example, North Carolina diverted portions of the education lottery—earmarked for local schools—to the state’s general fund. The

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**TABLE 6.1 Average Annual Increase/Decrease in State Aid to Local Governments: 2002–2008 Versus 2008–2014, Maryland**

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<thead>
<tr>
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<tbody>
<tr>
<td>Public Schools</td>
<td>10.3%</td>
<td>2.1%</td>
</tr>
<tr>
<td>Libraries</td>
<td>5.9%</td>
<td>−0.7%</td>
</tr>
<tr>
<td>Community Colleges</td>
<td>4.8%</td>
<td>1.7%</td>
</tr>
<tr>
<td>Local Health Departments</td>
<td>2.6%</td>
<td>−8.2%</td>
</tr>
<tr>
<td>Counties/Municipalities</td>
<td>4.1%</td>
<td>−8.7%</td>
</tr>
<tr>
<td>Retirement Payments</td>
<td>9.5%</td>
<td>7.2%</td>
</tr>
<tr>
<td>Total State Aid</td>
<td>8.8%</td>
<td>1.3%</td>
</tr>
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legislature cut out funding for new school buses in 2013, forcing costs onto local governments; afterward, the state increased the number of miles a school bus could drive before it had to be replaced by the state from 200,000 to 250,000. The state has to replace fewer buses, but with more, older buses on the road, repair costs inevitably increase. The state pays a given amount for maintenance, but if a school district runs over that ceiling for maintenance costs, it has to pick up the excess.

California, mandated by the courts to reduce prison overcrowding, devolved responsibility for low level offenders to the county jails in 2011, providing funding for the newly decentralized function. Local governments were naturally anxious that the state continue to provide the resources for this new responsibility, especially in light of the state history of revenue grabs. AB 109 provided a permanent source of funding—a vehicle license fee and a portion of the sales tax. In 2012, Proposition 30 was passed by the voters, to make constitutional the dedicated sources of revenue the 2011 legislation provided. Nevertheless, it is not clear that the dedicated revenue sources—1.0625 percent of the sales tax and $12 of the $25 vehicle license fee—will be sufficient to cover program costs. If recession reduces state sales tax revenues, money for the program may become inadequate.

Some states, in an effort to help their local governments weather the financial storm, have granted local governments new or expanded taxing powers. For example, in Massachusetts, in the 2010 budget, the legislature allowed the local governments to raise a tax of .75 percent on restaurant meals. But in other states, no new taxes were permitted, and increases in existing taxes were prohibited or curtailed, making the problems more rather than less severe.

When the local governments were simultaneously confronted with reduced property tax revenues, reductions in state aid, and the end of federal assistance, they had few options. They could cut staffing and services, raise taxes, or get the state to ease up on unfunded mandates, allowing the local governments more flexibility in how to carry out their responsibilities less expensively. Raising taxes was politically difficult and sometimes legally impossible, and getting more money from the state seemed like a nonstarter. Being responsible for the health and safety of their respective residents, there was only so far they could cut staffing and programs and still carry out their responsibilities. As a consequence, across the country, the local governments argued for more flexibility, to become more efficient at delivering services.

A number of states are reviewing and some have revised state mandates on local governments. For example, Texas passed a comprehensive mandate relief measure that allows school districts to furlough teachers, reduces contract termination notification and minimum salary requirements, and expands the Texas Education Agency’s authority to grant waivers for the 22:1 student-teacher classroom ratio.
Ohio also passed an education mandate relief bill, with a somewhat different slant:

The legislation . . . lifts the unfunded mandate requiring schools to offer all-day kindergarten and places the authority to charge tuition for all-day kindergarten back in the hands of most districts. Other provisions include the elimination of the requirement that school districts set aside a specified amount per pupil into a textbook and materials fund, and ending a policy requiring school districts to establish family and civic engagement teams.37

In New York State, an extensive effort was made to review mandates and include recommendations from local officials. Legislation passed in 2011 was estimated to save about $125 million a year, but many of the serious recommendations from the special commission, called the redesign team, were not adopted by the legislature. The proposals that passed included reduction in paperwork requirements and permission for local governments to piggyback on federally approved vendor lists and contracts. Local governments were permitted to use their own labor on small contracts, and statutory salary requirements for police chiefs were eliminated. Some of the micromanagement by the state was eased, requirements for reporting reduced in frequency, and small school districts were permitted to share a superintendent. While these adjustments are clearly in the right direction for local governments, they are not earthshaking. Among rejected proposals were a constitutional amendment to prevent the passage of additional unfunded mandates and a provision that would have allowed local governments to ask for a waiver from mandates.38 In 2012 Governor Cuomo's mandate relief council turned down fifty-one out of sixty-five requests for relief; the following year the council received only four requests and acted on only one of them. Created in 2011 to hear local government grievances, by the end of 2014, it closed up shop.

When states are unable or unwilling to prevent or alleviate the fiscal stress of their local governments, they find themselves responsible for their local governments' financial problems. Some states have laws allowing them to impose a kind of receivership on local governments, in which the state government chooses a financial manager who may exert extraordinary decision-making power over the local government's finances. In Michigan, a new law was passed in 2012, called the Local Financial Stability and Choice Act. By 2015, six struggling cities were in state receivership; in addition, Detroit had had a state appointed financial manager, who endorsed bankruptcy for the city. In Pennsylvania, the state took control over the finances of twenty-seven cities, including the cities of Harrisburg,
Scranton, and Reading. A separate oversight board was created to deal with Philadelphia’s financial problems.39

Some states permit their local governments to declare bankruptcy under federal law. Under Chapter 9 of the federal bankruptcy law, local governments can gain some protection from their creditors while they reorganize and work to improve their finances. Twelve states grant local governments unlimited authority to declare bankruptcy; fifteen states impose conditions on declaring bankruptcy or offer municipal bankruptcy to some jurisdictions. In these states, the local government in fiscal trouble may have to get permission from the state to declare bankruptcy under federal law—permission which may not be granted. Twenty-two states have no law enabling local governments to use the federal bankruptcy provisions, while one state (Georgia) has a prohibition.40

Under federal bankruptcy law:

To establish insolvency, a judge must determine that the municipality cannot use its reserves, reduce expenditures, raise taxes, borrow, or postpone debt payments to pay its obligations to creditors. In a Chapter 9 case, a bankruptcy court is prohibited from interfering with the municipality’s property, revenues, or political or governmental powers. Consequently, the court may not require the municipality to sell property, raise taxes, or remove officials from office. However, a municipality’s unreasonable failure to exercise its taxing powers could violate its duty to act in good faith—disqualifying the municipality from bankruptcy protection.41

With the consent of two-thirds of the creditors, when a local government declares bankruptcy, a court may impose a plan that will have the impact of changing prior agreements and contracts. Creditors may get some proportion of what is owed to them, retirees may have their pensions or health care coverage reduced, or wages and benefits for current employees may be cut.

When a state takes over the finances of a local government through the appointment of an emergency financial manager rather than allowing bankruptcy, the local elected officials may lose autonomy. A city may be forced to sell property to pay bills, to raise fees, or to meet some obligations while retreating on others. Given the differences between what an emergency financial manager can do and what a bankruptcy judge can do, the decision between state control and bankruptcy is likely to be controversial.

States had been limited in how much fiscal stress they could impose on local governments to ease their own financial burdens, because they are ultimately responsible for the fiscal condition of the local governments in their boundaries. But recently an escape hatch seems to have opened—bankruptcy. Municipal
bankruptcies historically have been rare in the United States, but there has been an increase in the last few years. The list includes Vallejo, Stockton, and San Bernardino in California; Jefferson County, Alabama; and Detroit, Michigan.

Detroit’s bankruptcy in 2013 has been the largest to date. The case of Detroit involved some poor decisions by the city, cuts in state aid, a takeover by the state, and finally adjudication by a federal bankruptcy judge. (See the minicase “Detroit Bankruptcy” below.)

Minicase: Detroit Bankruptcy

The underlying cause of Detroit’s financial problems was a long-term erosion of its tax base, especially the failure of the auto industry in which both General Motors and Chrysler eventually declared bankruptcy. With the erosion of its industrial base came a loss of jobs and population. Then a deep recession worsened the city’s revenues. Michigan’s policy of cutting back on aid to local governments made the revenue problem worse. The end of federal antirecession assistance also played into the financial difficulties of the city. Inadequate revenue forced layoffs that reduced contributions to the pension funds at the same time that the recession reduced the value of existing pension holdings, increasing the amount of money the city owed to the pensions.

A city in financial trouble sometimes adopts complicated, risky, and possibly illegal strategies. Banks, investment houses, and financial advisers eager to make some money sell such schemes to anxious city officials. When these strategies go sour, the city is left with unsupportable levels of debt. Such problematic arrangements featured in Detroit’s story.

In 2005, Detroit workers successfully sued to force the city to contribute what it owed to their pension fund. With no money to pay for the court settlement, the mayor wanted to borrow money to put into the pensions. However, the city had already reached its state-mandated debt limit, making ordinary borrowing impossible.

Financial advisers and bankers helped the city work out a plan to get around this limit. The city created two service corporations—spinoff organizations from the city with independent borrowing power—whose sole function was to borrow money on the city’s behalf. To encourage and protect potential investors, the city agreed to a variable interest rate on much of the borrowed sum. If interest rates rose, the city would have to pay a higher rate of interest on much of the $1.4 billion it was borrowing. Encouraged by the banks and financial advisers, the city then swapped the variable rate loans for

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fixed rate loans at 6 percent, as a guarantee against a rising rate. But then, instead of rising, the interest rates fell, leaving the city with an expensive fixed rate of interest instead of the less expensive variable one. The banks with whom the city was dealing required a very high penalty fee to cancel the contract. In 2009, when the city’s credit rating was downgraded, violating the terms of the swap agreement, the city restructured the agreement to reduce the risk to the banks of the city’s default, depositing its revenue from casinos directly into an escrow fund from which the banks could draw money if the city defaulted. Later, when the city defaulted on its payments, the banks took the city’s casino revenues.

In March 2013, Governor Snyder appointed Kevyn Orr from the law firm Jones Day to be the city’s emergency financial manager. Jones Day represented both the city and the state in the bankruptcy proceedings. Orr had broad authority to change the city’s budget, renegotiate or void union contracts, sell city assets, privatize services, and deal with creditors on the city’s behalf. Under Michigan law, a city can declare bankruptcy only if that course is recommended by the state-appointed emergency financial manager.

Orr rejected the possibility of getting out of some of the city’s obligations on the ground that those obligations had been illegal. He argued that the chance of success in court was only 50–50, and the city didn’t have time for a lengthy court proceeding. As an expert in bankruptcy law, he undoubtedly knew that interest swaps and other derivatives get favorable treatment in federal bankruptcy proceedings.

Orr began negotiations with the city’s creditors. Offering only pennies on the dollar to obligations that he determined were not secured, not surprisingly, he was unable to get all the parties to agree voluntarily to his proposals. Failing to get such agreement, he petitioned for bankruptcy for the city. He wanted to change the pension system to a defined contribution rather than a defined benefit plan, which puts much more risk on the employee instead of the employer, he advocated deep cuts in employee health care, he proposed deep pension cuts as a way of forcing labor concessions and recommended only modest reductions in the amounts owed to the banks holding the interest swaps. While he was managing the city’s finances, he skipped the city’s contributions to the pension funds, while maintaining payments on outstanding bonds and the interest rate swaps and continuing to pay “certain important” vendors. Orr had exaggerated both the extent of the pension’s underfunding—as a result of borrowing, the pension was reasonably well funded—and had also exaggerated the relative importance of the pension and health insurance obligations compared to other obligations of the city.

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The bankruptcy judge ruled that Detroit was eligible for bankruptcy and that pensions could be reduced despite the state constitutional prohibition on reducing pensions. However, he rejected Orr’s proposal for how much the banks should be given to terminate the interest rate swaps and consequently how much of the city’s casino revenue could be recovered and used to reduce future borrowing and help restore city services. Orr’s first proposal to the bankruptcy court was to pay 80 percent of what was owed to the banks holding the interest rate swaps; when that was rejected, he proposed 60 percent. When the judge rejected this proposal as well, Orr and the banks agreed to a 30 percent settlement. The final deal approved by the bankruptcy judge also cut the pensions considerably less than Orr’s original proposal.

The governor generally kept a low profile while this was going on, but with his backing, the state did eventually contribute some money to prevent creditors from forcing the sale of art in the city’s museum and to reduce the impact of cuts on retiree pensions. Despite this late-stage support, the *Washington Post* argued that Governor Snyder had “pushed Detroit into bankruptcy.” The *New York Times* similarly noted that “Gov. Rick Snyder of Michigan on Friday defended his decision to force Detroit into bankruptcy as a necessary step to halt its decades-long decline and resolve its spiraling debt crisis.”

The Jones Day lawyers who represented both the state and Detroit in bankruptcy proceedings believed that bankruptcy was the only way to solve Detroit’s problems and that the emergency financial manager could not possibly come to voluntary agreements with all the creditors and thus avoid bankruptcy. They expressed that opinion in emails before one of their own, Kevyn Orr, was appointed as the emergency financial manager. They felt that the purpose of the emergency financial manager was to check off the boxes and make it look as if all possible alternatives had been exhausted, thus making Detroit eligible for bankruptcy. It thus appears that the governor, the law firm representing the city and the state, and the emergency financial manager all felt that Detroit had to declare bankruptcy. One likely reason was so that the pensions could be cut, bypassing constitutional guarantees for pensions.

It is possible that there was no realistic alternative for Detroit besides bankruptcy, even if every possible alternative had been tried and failed, but forcing the city into bankruptcy seemed predetermined, other rescue options were not seriously discussed. Some states prefer to avoid bankruptcy for their cities, because they can exert more control over the outcomes with an emergency manager and because bankruptcy in one jurisdiction has a contamination effect of hurting others in the state, but if there is a constitutional
The Politics of Public Budgeting

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A key element in the Detroit fiscal meltdown was the complex financial arrangements the city made with the banks to pay for the pension underfunding. Complex financial dealings that looked too good to be true were also part of Jefferson County, Alabama's bankruptcy case. (See the minicase on Jefferson county on p. 223 for details what happened in Jefferson County.) The state's role was critical in both Alabama and Michigan. Not only did both states have to decide whether the state was willing to bail out its ailing local governments, providing new revenue sources or substituting its own credit rating for that of the failing local government, enabling it to borrow, but both states had to decide whether to allow or prevent their local governments from declaring bankruptcy. Also, in both Jefferson County and Detroit, the courts played an important role. In Detroit, a court ruled that the city had to pay what it owed into its pensions, and later the bankruptcy judge ruled that worker pensions could be cut despite a constitutional guarantee; in Jefferson County, a court ruled that the county had to fix a leaking sewer system, and a judge ruled that new revenue sources were


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illegal. While theoretically the outcomes might be the same regardless of whether a court-appointed official or a state-appointed one took over the local government’s finances, bankruptcy normally means negotiating with all the major creditors, so that they all take some losses, while a state-appointed official might control the local government, cut spending, or reduce labor contracts, in order to make sure that the banks and bondholders are paid in full. The result may be higher taxes and lower service levels for poorer residents and better outcomes for the richer investors. In the legislature, those who represent richer districts may resent demands to bail out poorer ones and resist any deals that require such payments. In a bankruptcy proceeding, state-elected officials lose control over the choice of outcomes.

As one might imagine, bond insurers, the ones who have to make the bondholders whole if a jurisdiction declares bankruptcy, have argued against bankruptcy proceedings. One bond insurer, the only one active in 2012, suggested it might not insure bonds in a state that does not have a procedure for examining and possibly preventing local governments from declaring bankruptcy and abandoning their debts, leaving the insurer with the bill.42

Minicase: Why Did Jefferson County, Alabama, Declare Bankruptcy?

In December of 1996, responding to a lawsuit arguing that its leaking sewer system was violating the federal Clean Water Act, the county issued debt to repair the sewer system. The project cost more than initially projected, and the financing was more expensive than it should have been, causing a huge run-up in fees that homeowners paid for sewerage. In 2002 and 2003, J. P. Morgan refinanced the bonds, converting what had been primarily fixed-rate bonds into variable-rate issues and linking the sale with interest rate swaps. The deal was supposed to save the county money, because interest rates on the bonds would be based on auctions that would occur at short intervals. Any increase in interest rates due to the auctions was supposed to be offset by the interest rate swaps, an investment by the county with the bank that was supposed to return more money if interest rates rose.

The deal was corrupt from the start. The bank had paid out millions in bribes to county officials and their friends, some unrelated to the deal, to get the business, and then charged the county much higher fees, which were not revealed, to cover the extra costs. But the really serious trouble started in 2008, when the auction market froze. In accordance with common practice, Jefferson

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County had sold the sewer bonds with insurance to protect the buyers, but the bond insurers, as a result of the housing crisis, lost their top ratings. Many institutional investors were permitted to invest only in bonds insured by top-rated companies, forcing them to dump the bonds insured by the companies with lowered ratings. With so few buying, many of the bond auctions failed. Investors dumped Jefferson County’s sewer bonds on banks that had agreed to serve as buyers of last resort, triggering contractual requirements for the county to pay off its debt in four years rather than the expected thirty or forty years.

With no auction prices to fix the interest rates, the county was forced to pay a default interest rate, which was much higher than the auction rates had been. When municipal auction rate notes are issued, they typically include a default rate of interest, which in this case was capped at 12 percent. The investment linked to the bonds—the interest rate swaps that depended on interest rates at the time—did not generate more revenue for the county as they were supposed to, because interest rates fell sharply. During the recession, banks were not lending and hence not paying high interest rates to attract capital for them to lend out. The county had to pay very high interest rates on its bonds and got very low returns on its linked investments, all the while paying high transaction fees. In September of 2008, Jefferson County defaulted; it failed to make a payment of principle of $46 million on the bonds.

Default on the bonds made it impossible for the county to refinance to take advantage of lower interest rates; no one would lend money to a county that could not pay back its debt in a timely fashion. To make matters worse, in 2009, a new tax was declared illegal by the court. The state tried again with a different tax, which was declared illegal in 2011. Each of these events threw the county into a desperate situation with regard to revenue.

The county tried to negotiate with its creditors and worked out a deal that would reduce its obligations to the banks but required state cooperation to replenish the revenue of the county and to create an independent sewer authority to issue bonds on the county’s behalf, with a state-backed guarantee. The state refused to go along, forcing the county into bankruptcy.

The Politics of Balancing the Budget

While large bankruptcies draw the eye, they remain relatively rare. Most cities try to maintain year-end balances to tide them over when recession hits, but they are often unable to predict downturns in the economy and must reduce expenditures during the year to balance the budget.

At the local level, as at the state level, considerable effort may be spent to hide or minimize deficits, especially ones that are not the result of immediate environmental calamities. Cities use many of the same tactics that states do, including borrowing between funds (sometimes invisibly and without intent to repay), changing the basis of accounting so that some expenditures are counted in the next year’s budget, delaying paying bills, and borrowing from pension funds by not making the required employer contribution. Cities may also hide deficits by borrowing outside the city for operating expenditures, pretending they are borrowing for capital expenditures. They sometimes shift expenditures from a fund that is poorer into another that is richer.

Depending on the definition of deficit used, cities can sometimes make the budget look balanced by drawing down reserves, which may be technically legal but obscures the fact that the city is running an operating deficit. Or the budget can be balanced with revenues from the sale of property, from grants, or from other one-time income. Overestimating revenues also makes the budget look more balanced than it is.

When deficits occur unintentionally during the year, the normal response is to gather unspent money and defer spending it until the crisis is over or until the council has had a chance to act on priorities. The result may be heavier cuts in some areas than in others; the intent is not to choose program areas but to find money that is as yet unspent. Capital projects are often delayed if the money is not yet spent or irrevocably committed.

When a deficit is imminent in the following year’s budget or when a deficit is carried over from one year to the next, the manager or mayor makes recommendations for how the deficit gap is to be closed, and the council must approve or reject the recommendations. In this situation, program priorities must be decided, revenue increase and expenditure decrease weighed, and the scope of services reevaluated. Formally, the council often has the legal power to make the decisions, but in reality, the distribution of power between the mayor, manager, or administrator, on the one hand, and the council on the other, is highly variable.

The issue of scope of services is unlikely to arise in response to a midyear revenue decline, but it can arise as local governments wrestle with what appears to be an impending imbalance in the next year’s operating budget. For example, in the 1970s, when cities were dealing with fiscal stress, if they were responsible for a range of functions, they often tried to shift some of them to other levels of
government. Services such as courts, city universities, and museums were shifted to other levels of government or to the private sector. Some cities gave their planning functions to the county. In some states, cities were able to shift some or all of their share of welfare to the state as well as some of the cost of policing.43 A number of counties have given responsibility for the courts to the state.

The minicase “The Politics of Deficits—An Urban Example” illustrates how budgets can become structurally unbalanced; that is, revenue grows more slowly than expenditures over time. The case also illustrates how difficult it can be to cut spending when every program seems to have a political protector or be exempt from cuts. In this minicase a change in structure was required, with a strengthened linkage between revenues and expenditures and sufficient central authority to cut back spending proposals. The case occurred in the 1970s when the option of increasing federal aid was still open; had it occurred more recently, it would probably have a different ending.

Minicase: The Politics of Deficits—An Urban Example

The city of Southside (a fictional name given to protect the anonymity of those involved) ran deficits that were hidden in the budget from 1972 to 1976.1 During the later part of this period, there was no recession to blame. The initial causes of the deficit included hiring at the same time a young and inexperienced city manager and an inexperienced budget officer. But the city’s problems went well beyond hiring a few inexperienced people. It was suffering from long-term erosion of its economic base, as heavy industry in the region declined, leaving behind many unemployed and a reduced demand for housing. The result was frozen or slow-growing revenues from both sales and property taxes. Department heads and elected officials seemed unwilling or unable to cut back expenditures proportionately. Elected officials at one point actually reduced property tax rates despite increasing costs. The young city manager did not have enough power to force department heads to cut expenditures, so he tried to reduce labor costs instead, incensing the city’s employee unions and actually increasing labor costs.

The young manager initially hid the deficits and then tried to publicize them as a way to force the council to make the requisite cuts. He used his budget message to warn council members about emerging deficits, but council members later argued that they did not understand that the budget had to balance fund by fund. They said they were looking at the bottom line, which showed a cash balance. Cash balances are nearly always positive at the end of the year and are misleading indicators of the existence of a deficit.
The deficits were hidden in part by inappropriate, secret internal borrowing, especially from the cash flow of the water fund. The director of the water department worried that he could no longer do his job properly. He pleaded his case emotionally at a budget hearing. Auditors refused to certify the condition of the water fund because its records were not complete—the first public acknowledgment of serious financial trouble.

The second key event in forcing the deficits into public view occurred as the council and manager struggled to deal with the long-term decline of the city's economic base. They helped promote a new regional shopping center on the edge of the city. To carry out their end of the bargain required annexations, property acquisitions, and capital outlays for water, roads, traffic signals, and a new police substation. The city had to borrow by issuing a bond. The bond issue meant that Moody's, one of the major bond evaluators, would have to examine and vouch for the city's creditworthiness, or potential bond buyers would not risk their money. The evaluation of the city's creditworthiness was a disaster; the staff had to struggle to retain any rating at all. The problem was now public. The city had to take action to avoid complete humiliation and maintain the marketability of its bonds.

The manager tried to cut back spending by the departments but was hampered by the independence of the department heads. The police and fire chiefs were hired and fired by a police and fire board appointed by the mayor. Thus they were not directly responsible to the city manager and felt free to ignore his budget advice. The fire department was spending more than its budgeted allocation; police department expenditures had grown rapidly in response to urban riots a number of years earlier, and the manager was unable to cut them back. He requested cuts by other department heads, and they also refused. The manager was further stymied when he tried unsuccessfully to cut council members' pet capital projects. In frustration, the manager tried to cut some of the union contracts and restructure the unions so they would be easier to deal with, but ended up with some expensive, arbitrated settlements that further unbalanced his budget. The manager was then fired and replaced with a more senior manager.

The new manager froze departmental budgets and increased revenue by increasing federal aid, an option still open in the late 1970s. Perhaps more important, he changed the budget process. The manager had control over the street department head, who was responsible to him, and fired him. The manager forbade department heads to communicate directly to the council unless they went through him, to prevent end runs in which department heads got protection for expenditures from the council before they appeared in the budget request. The new manager insisted on the right to hire the
police and fire chiefs and was successful, so that they reported to him. The fire department was broken out of the general fund and set up with its own earmarked taxes, reducing the drain on other funds. The new manager had more authority to enforce balance.

The case of Southside indicates that cities sometimes do run deficits, but because such deficits are illegal, their size may be obscured. When that happens, the deficit can grow to a substantial portion of all spending and make remedies politically difficult. Because decision makers believed that the public would not tolerate an increase in the property tax, the option of reducing spending was explored, but the young manager failed to make significant cuts. When the city finally resolved to handle its deficit problems, it chose budget process reform as a solution, giving the manager more power to balance the budget. The deficits seemed to result as much from failure of structure as from economic circumstances, so a reform of structure was a logical response.


**Summary and Conclusions**

Budget balancing is more than a technical activity that readjusts spending and revenue decisions. It is linked to issues about the scope of government, because balance depends on decisions to raise taxes and maintain scope or cut spending and reduce services or shift them to other locations. Balance is also linked to spending priorities: When expenditures are cut back, some programs will be protected and others cut back disproportionately, or all programs will be cut across the board. Balance is linked to federalism, because one level of government may seek to balance its budget at the expense of others. The relationship between states and their local governments is complicated by the fact that the states are responsible for the financial condition of their local governments; states can only shift so much of the burden to local governments before they are confronted with the need to solve the financial problems of the local governments. Some states have gotten out of this box by allowing their local governments to declare bankruptcy under federal bankruptcy law. Finally, the politics of balance is linked to the politics of process, as governments shift budget-making power in attempts to increase discipline, control expenditures, and systematically and authoritatively link revenues and expenditures.
Many of the issues involved in budget balance bring out ideological differences between Democrats and Republicans, liberals and conservatives, and business and labor. The politics of balance is closely linked to the politics of budget implementation. A budget can become unbalanced during the year because of environmental changes or because gimmicks used to make the budget look balanced cause problems during the budget year. Budgeters may overestimate revenues and underestimate expenditures, so that the budget as submitted looks balanced, but it will become unbalanced during the year. At the state and local levels, the budget may have to be changed during the year to rebalance it. Requirements for balance also encourage interfund transfers during the year, to make the budget look more balanced than it is. The importance of changes that occur during the budget year is discussed in the next chapter.

Useful Websites

**Governing Data** (www.governing.com/data) and its companion **Governing by the Numbers** (www.governing.com/blogs/by-the-numbers) provide useful and often graphical explanations of quantitative data in the news, such as employment numbers, the locations of municipal bankruptcies, and public sector layoffs.

The Brookings Institution (www.brookings.edu) often posts studies of interest to budgeters. One in particular provides some in-depth backup for this chapter: **Structurally Imbalanced: Cyclical and Structural Deficits in California and the Intermountain West**, by Matthew Murray with Sue Clark-Johnson, Mark Muro, and Jennifer Ve (www.brookings.edu/~/media/research/files/papers/2011/1/05%20state%20budgets/0105_state_budgets.pdf).

Three resources concerning rainy-day funds are particularly helpful: a brief primer on state rainy-day funds (www.taxpolicycenter.org/briefing-book/state-local/fiscal/rainy-day.cfm), one with more detail on how rainy-day funds are structured (www.itep.org/pdf/pb25rdf.pdf), and recent experience and suggestions for reforms of rainy-day funds (www.cbpp.org/cms/index.cfm?fa=view&id=3387).

There have been a number of commissions and policy recommendations for how to rebalance the federal budget. The president’s National Commission on Fiscal Responsibility and Reform issued a report in 2010, called **The Moment of Truth** (www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf). The report has been referred to as the Simpson-Bowles report after its cochairs, Erskine Bowles and Sen. Alan Simpson. Minutes and videos of the commission’s meetings were posted online (www.fiscalcommission.gov/meetings).

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A second set of recommendations was worked out by the Bipartisan Policy Center, released at about the same time as the Simpson-Bowles report. This report, titled *Restoring America’s Future: Reviving the Economy, Cutting Spending and Debt, Creating a Simple, Progrowth Tax System*, was cochaired by Dr. Alice Rivlin and Sen. Pete Dominici, R-NMex., [http://bipartisanpolicy.org/library/restoring-americas-future/](http://bipartisanpolicy.org/library/restoring-americas-future/).