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Fiscal Contrast: An Analysis of State and Federal Fiscal Processes

States and the federal government both employ sovereign fiscal powers to tax, spend, and borrow, although their fiscal approaches differ starkly. Understanding the vital state-federal fiscal relationship can help decision-makers learn from both and improve fiscal processes.

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Fiscal Contrast: An Analysis of State and Federal Fiscal Processes

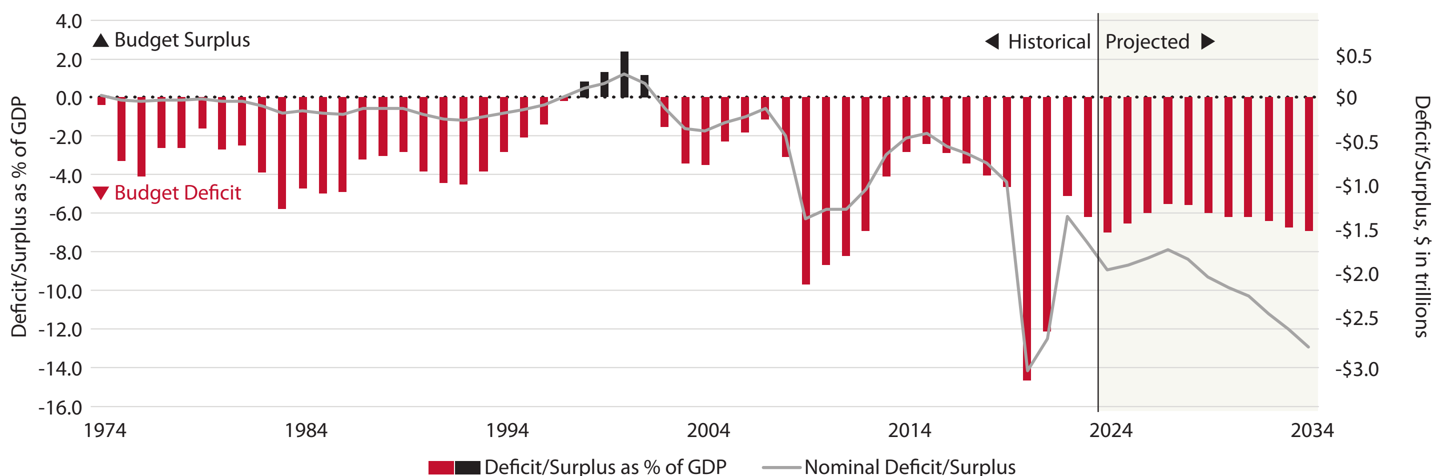
States and the federal government share a vital fiscal relationship. Both levels of government fund and administer their own programs. The federal government also funds programs that states administer. However, distinct differences mark this fiscal partnership. States typically balance their budgets over a one- or two-year budget window, follow standard annual or biennial appropriation processes, and engage in proactive contingency planning, including setting aside reserves and conducting stress testing. In contrast, the federal government typically runs an annual deficit while employing a ten-year budget window, spends most of its budget outside standard annual appropriation processes, and uses debt as the primary contingency management tool. By understanding these key differences, state and federal decision-makers can learn from each other and improve fiscal processes.

Key Findings

- **Fiscal federalism –** Under the U.S. Constitution, states and the federal government both employ sovereign fiscal powers to spend, tax, and borrow.
- **Growth in federal government's fiscal role –** Over the past century, the federal government's fiscal role increased dramatically as it interpreted its delegated powers much more broadly. Federal spending as a percentage of the economy totaled about 3% in 1929 at the start of the Great Depression. In 2023, federal government spending measured about 24% of gross domestic product (GDP).
- **Division of functions –** State and local governments deliver most government goods and services to citizens, while the federal government directly provides some services like national defense. The federal government redistributes resources through programs like Social Security and also plays a lead role in promoting economic stabilization policies. States also engage in these polices although to a much lesser degree and can sometimes slow economic recovery due to balanced budget requirements.
- **Sharing of funds –** States and local governments receive intragovernmental transfers from the federal government. As of FY 2023, federal money funded about 35% of total state expenditures, up from 31% prior to the COVID-19 pandemic. States also allocate significant state funds to local governments.
- **State practices –** Typical state budget practices include balancing the budget over a one- or two-year budget window, regular budget adoption through standard appropriation processes, and proactive planning, including building up budget reserves and conducting stress testing.
- **Federal practices –** Typical federal budget practices include regular annual deficit spending while using a ten-year budget window, most spending outside of a regular annual appropriation process, and debt as the primary contingency management tool.

By understanding these budgeting process differences, as well as the differentiation in fiscal roles played by federal and state governments, decision-makers can better address disconnects and strengthen the federal-state fiscal relationship.

Federal Government Deficit and Surplus Amounts and as a Percentage of GDP, Federal Fiscal Year 1974–2034(p)



Source: Congressional Budget Office

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Introduction

State and federal budget and financial management processes differ in fundamental ways. While commonalities exist, this paper serves as a primer on these key differences to (a) strengthen the federal-state relationship by increasing the federal government's understanding of state budget management, (b) convey lessons from state budgeting processes, and (c) enhance the public's understanding of the unique fiscal roles and processes of states and the federal government.

> *"The States will retain, under the proposed Constitution, a very extensive portion of active sovereignty."*
>
> – The Federalist Papers No. 45 (James Madison)

Federal-State Partnership. The federal government relies on states and territories to administer many programs it funds. States, meanwhile, count on federal funds to fully or partially support numerous programs benefiting their residents. To optimize this fiscal relationship, both government levels must understand how the other budgets and spends money. States' recent experience managing the federal funding influx for pandemic-related aid, infrastructure, and other purposes highlighted this critical need.

Learning from the States. While its nature and mission differs significantly, the federal government could likely draw lessons from how states develop budgets and manage finances. Understanding the principles and procedures states follow to regularly balance budgets, routinely pass appropriation bills, and plan for contingencies can yield useful lessons for the federal government to consider as it carries out its unique role.

Citizen Education. Citizens often become confused as they work to understand government fiscal affairs in the United States. Part of this confusion stems from the complexities of particular spending, taxing, and borrowing decisions. Confusion also comes from navigating the fiscal roles played by different levels of government. Educating citizens on these differing fiscal roles and responsibilities can foster greater civic understanding and support efforts to engage the public in budgeting decisions.

> *"Money is, with propriety, considered as the vital principle of the body politic; as that which sustains its life and motion, and enables it to perform its most essential functions."*
>
> – The Federalist Papers No. 30 (Alexander Hamilton)

This paper provides a high-level overview of U.S. state and federal fiscal processes addressing the following topics:

1. **Fiscal Federalism** – Fiscal federalism refers to the states and federal government dividing sovereign fiscal powers. Key takeaways include:
   - Under the U.S. Constitution, states and the federal government both employ sovereign fiscal powers to spend, tax, and borrow.
   - All government levels impose their own taxes and fees to generate revenue.
   - States and local governments receive intragovernmental transfers from the federal government. States also allocate significant state revenue to their local governments.
2. **State Budgeting Practices** – Typical state budget practices include:
   - Budget balance over a one- or two-year budget window.
   - Regular budget adoption through standard appropriation processes.
   - Proactive planning for contingencies, including through reserves and budget stress testing.
3. **Federal Budgeting Practices** – Typical federal budget practices include:
   - Regular annual deficit spending while employing a ten-year budget window.
   - Most spending outside of a regular annual appropriation process.
   - Debt as the primary contingency management tool.

I. States and Federal Government Both Exercise Sovereign Fiscal Powers

The U.S. Constitution divides sovereign powers between states and the federal government (termed "federalism"). Sovereign power means autonomous power exercised independently, without requiring permission to exercise that power. Both states and the federal government independently exercise sovereign fiscal powers, including to tax, spend, and borrow.

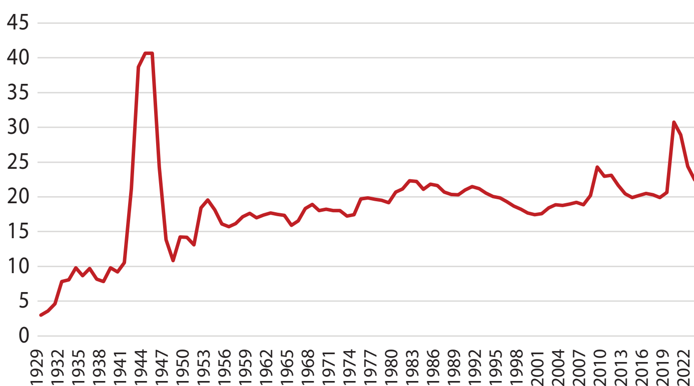
Brief History of U.S. Fiscal Federalism

The U.S. Constitution's novel arrangement of dividing sovereign powers between states and the federal government springs from the preceding Articles of Confederation's unsuccessful power-sharing arrangement. Prior to the U.S. Constitution, the initial national government lacked full sovereign power, which states in effect retained. For example, the central U.S. government under the Articles of Confederation relied on states to collect and send money to fund national operations such as the military. When one or more states refused to do so, the national government's ability to implement agreed-upon budget items suffered.[1]

Fairly quickly, the fledgling country's leaders realized the Articles of Confederation's weaknesses impaired a strong and unified nation. After its 1787 creation and subsequent ratification by the people of the states via ratifying conventions, the U.S. Constitution took effect in 1789.[2] It delegated to the federal government certain powers previously held by the states.

In fiscal affairs, the U.S. Constitution's Article 1 Section 8 specifically grants Congress enumerated powers. These include authority to impose taxes, provide for the common defense and welfare, coin money, and borrow money on credit, among various other powers. That is, states agreed to grant the federal government certain sovereign fiscal powers, which the federal government can now directly employ without seeking state permission or funding. Under the original U.S. Constitution, state legislatures elected U.S. senators, with the intent to preserve the states' voice in federal affairs. With adoption of the 17th Amendment, the people now directly elect U.S. senators for their state.[3]

Figure 1: Federal Spending as a % of GDP, 1929-2023



Source: Federal Reserve Economic Data (FRED) from U.S. Office of Management and Budget

> *"Key state reserved powers include the ability to independently tax, spend, and borrow for state purposes. States jealously guard these sovereign fiscal powers."*

Over the past century, the federal government's fiscal role increased dramatically as it interpreted its delegated powers much more broadly. The federal government's spending as a percentage of the economy, measured by gross domestic product (GDP), totaled about 3% in 1929 as the Great Depression began, rose to 8-10% during the Great Depression, and further increased over time to about 24% as of 2023 (Figure 1).[4]

In 1913, Congress used its delegated powers to create the Federal Reserve, which independently controls the money supply (monetary policy). Congress by statute directs the Federal Reserve to fulfill a dual mandate of maintaining maximum sustainable employment and price stability. Although monetary policy fulfills a critical economic role, this paper focuses on state and federal fiscal policy.

Even with the U.S. Constitution's grant of sovereign fiscal powers to the federal government and a much-expanded federal fiscal role, states retain their own fundamental powers never delegated to the federal government.[5] Key state reserved powers include the ability to independently tax, spend, and borrow for state purposes. States jealously guard these sovereign fiscal powers.

Constitutional Frameworks Guide Fiscal Affairs

The U.S. Constitution, however, constrains these powers. Both the federal government and states remain subject to limits set in the U.S. Constitution, such as the 14th Amendment's equal protection and due process clauses and the First Amendment's free speech, religion, and assembly clauses, among others.

Moreover, each state's constitution also governs its fiscal affairs. Although they vary, state constitutional fiscal provisions generally lay out basic parameters for balanced budgets, taxing, spending, and borrowing.

The federal-state relationship differs constitutionally from the state-local relationship. Unlike the autonomous sovereign powers the federal government and states independently exercise in the U.S. system of federalism, local governments such as cities, counties, school districts, and other local entities are political subdivisions of states. Local governments exercise state power as granted in state constitutions, by state statutes or case law, or carried out in accepted state practices. Depending on the state, some local governments exercise extremely broad discretion (such as home rule cities), while others face more direct state control over day-to-day affairs.

Division of Functions Between Different Government Levels

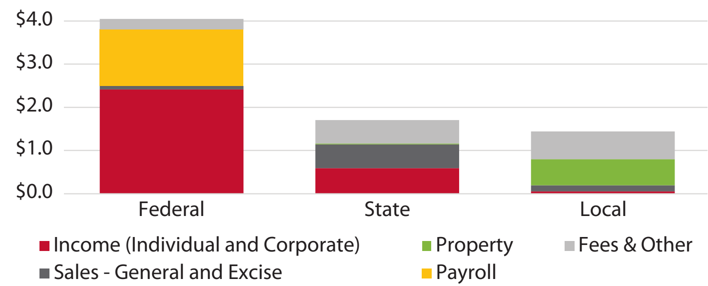
In the United States, the three levels of government play different fiscal roles, including to provide goods and services, redistribute resources, and stabilize the economy. Citizens hold different views on desirable government service levels, the appropriate level of government to perform these functions, and efficacy of the public sector in fulfilling these roles.

1. **Provide Goods & Services** – States and their local governments directly deliver most government goods and services to citizens. For example, even though the federal government spends much more money overall, GDP data measuring the economic value of actual production by state and local governments indicates their production of government goods and services is 70% higher than that of the federal government.[6] Although directly providing a smaller service delivery share, the federal government does deliver various nationally-scoped goods and services, such as national defense.

2. **Redistribute Resources** – Even though it plays a smaller direct service delivery role compared to state and local governments, the federal government collects more revenue and spends more than states and local governments. This occurs because the federal government redistributes resources through its taxing and spending policies. Social Security provides an example. Revenues collected from payroll taxes fund payments to retirees, people who are disabled, and their survivors. While states may also adopt some redistributive policies, the federal government primarily carries out this fiscal function. That said, states play an important administrative role in carrying out many redistributive programs funded by the federal government.

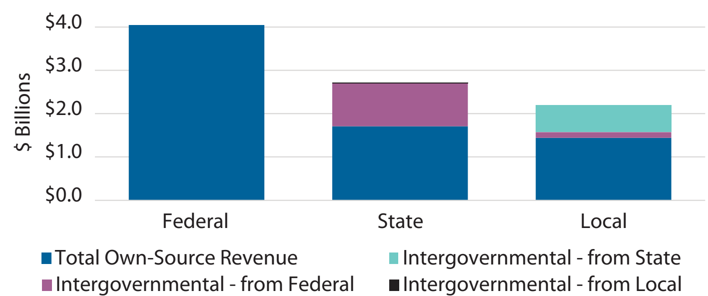
3. **Stabilize the Economy** – The federal government aims to promote economic stability and growth, especially during cyclical downturns. The federal government performs this stabilization function in part through fiscal policy, such as by cutting taxes and increasing spending (and related borrowing) during recessions. For example, in recent recessions the federal government temporarily cut taxes via economic stimulus rebates, a short-term payroll tax reduction, and business tax incentives such as accelerated depreciation. Similarly, in response to the COVID-19 pandemic, Congress increased spending on health care services, forgivable loans to businesses, enhanced unemployment insurance payments, and aid to states and local governments.[7] States may also use fiscal policy to stabilize the economy, but generally at a much lower level due to balanced budget requirements. In fact, state budget-balancing fiscal policy can create a counterstabilizing impact, since states may cut spending or, to a lesser extent, increase taxes when facing a downturn.

Figure 2: U.S. Total Own-source Revenue by Level of Government, 2021



Source: U.S. Census Bureau and Congressional Budget Office

Figure 3: Own-Source and Intergovernmental Revenue Totals by Level of Government, 2021



Source: U.S. Census Bureau and Congressional Budget Office

Own-source Budget Revenues

In 2021 (the most recent year for nationwide federal, state, and local revenue reporting), government revenue in the United States totaled about $7.2 trillion. Of this total, the federal government collected $4.05 trillion (56%), states about $1.71 trillion (24%), and local governments about $1.44 trillion (20%). Note this total reflects own-source revenues collected at each level of government, not total budgeted revenues incorporating funding allocated between government levels. As Figure 2 shows, each government level relies on a different revenue source mix.

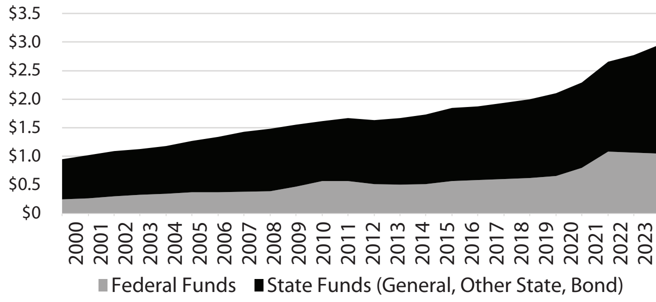
Intergovernmental Budget Revenues

As discussed previously, the federal government directly delivers some goods and services. However, for many programs, the federal government centralizes revenues and then distributes resources to states and local governments to implement federal programs. In addition, the federal government sometimes provides discretionary nonrecurring state and local aid, particularly during economic downturns as it aims to stabilize the economy. As of 2021, during the COVID-19 pandemic, federal grants to states and local governments totaled about $1.1 trillion (Figure 3).

Federal Funding in State Budgets

In recent decades, federal funds increased both in nominal dollars (Figure 4) and as a share of total state expenditures (Figure 5). As of FY 2000, the federal government funded about 26% of total state expenditures. By FY 2019, prior to the COVID-19 pandemic, federal money funded 31% of total state expenditures.

Figure 4: Federal and State Funding of Nominal Total State Expenditures, FY 2000–2023



Source: National Association of State Budget Officers

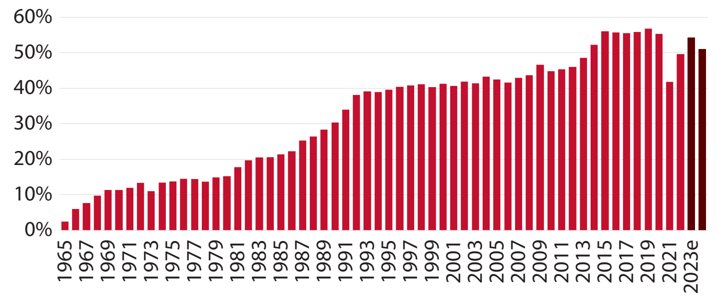
Figure 5: Federal Funds as a Percentage of State Total Budgets, FY 2000–2023

Source: National Association of State Budget Officers

Federal funds to states typically spike amid recessions as the federal government carries out its stabilization function, thereby increasing the federal share of total state expenditures. For example, in FY 2010 at the peak of the Great Recession's impacts on state budgets, federal funds made up about 35 percent of total state spending. Similarly, increased federal aid during the COVID-19 pandemic increased the federally-funded share of states' total budgets to nearly 41 percent in FY 2021. As of FY 2023, federal funds made up an estimated 35 percent of total state expenditures. In fact, federal funds for states exceeded state General Fund spending in FY 2021 and FY 2022. The federal share of state expenditures appears likely to continue declining as pandemic-era funding winds down.

In short, federal funds helped to stabilize state budgets during recent economic downturns.

Figure 6: Medicaid as a Share of All Federal Grants to States and Local Governments, Federal Fiscal Year (FFY) 1965–2024e



Source: U.S. Office of Management and Budget

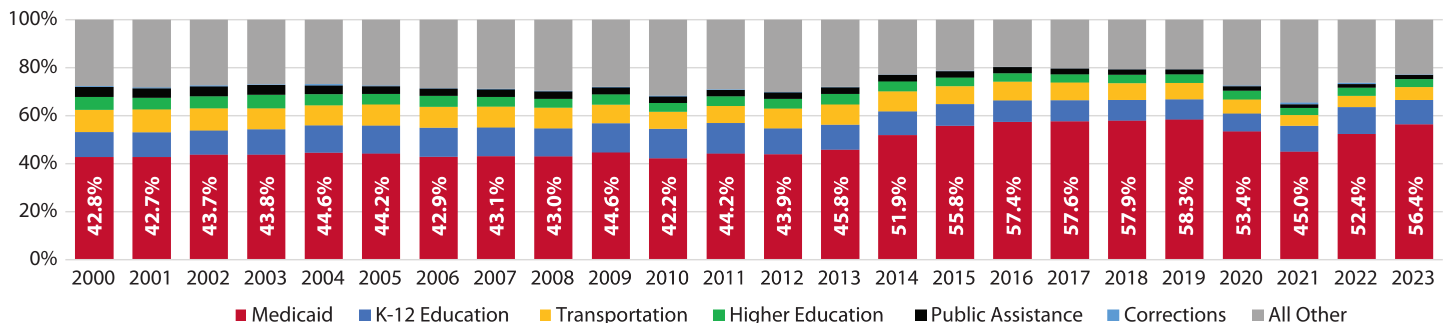
Medicaid: A Majority of Federal Grants

At both the federal and state levels, health care represents a critical ongoing cost driver. Medicaid is by far the largest ongoing federal grant program for states, making up a majority of all ongoing federal funds allocated to states and local governments from 2014 through 2020 (Figure 6). In federal fiscal years 2021 and 2022, non-Medicaid grants spiked, largely in response to the COVID-19 pandemic. Medicaid is again on track to represent a majority of federal grant outlays to states and localities in FY 2023 and 2024.

NASBO data collected from states (using state rather than federal fiscal years) also confirms this trend.[8] As Figure 7 shows, in the years leading up to Medicaid expansion implementation under the federal *Affordable Care Act* (FY 2000 to FY 2012), Medicaid made up between a 42% to 45% share of total annual state spending from federal funds. By FY 2014, Medicaid's share of total federal funds to states rose to nearly 52% and reached a pre-pandemic peak of over 58% in FY 2019. Due to a sizable uptick in one-time federal aid during the pandemic (which mostly shows up in the "All Other" category), Medicaid's share fell to about 45% of federal funds to states in FY 2021, but rose to over 56% in FFY 2023.

Most federal funds for local governments flow through state budgets for their designated purpose, rather than going directly to local governments. States allocate both federal funds and state own-source revenues to local governments, such as for education or local transportation projects. Some local governments also remit small amounts to states, usually as part of a program cost-sharing arrangement.

Figure 7: Composition of Federal Funds in State Budgets by Program Area, FY 2000–2023



Source: National Association of State Budget Officers

II. State Budgeting Practices

The U.S. Constitution, state constitutions, statutes, formal administrative law, and informal practices guide state budgeting processes, establishing parameters for revenues, spending, and borrowing. States share the same overarching approach, even though each state adopts a unique process. This section highlights standard state budget practices, including:

(a) budget balance,
(b) standard appropriation process budgeting, and
(c) proactive contingency planning.[9]

U.S. territories and the District of Columbia follow the same processes as states to ensure budget balance, and local governments generally follow similar practices. However, details such as major revenue sources and fiscal year timing can vary.

States Consistently Balance Budgets Over a One- or Two-Year Budget Window

Budget Balance

Extensive state fiscal processes revolve around the basic concept of maintaining budget balance, legally required by state constitutions and/or statutes in 49 states.[10] State balanced budget requirements may apply to a governor's budget recommendation, legislative budget adoption, a governor's appropriation bill approval, and ending the fiscal year without a deficit.

Researchers regard some states' balanced budget provisions as more stringent than others.[11] For example, a requirement that a state ultimately execute a balanced budget – that is, not carry over a deficit at the end of a fiscal year – may be perceived as stricter than a requirement for the governor to propose or legislature to initially enact a balanced budget.

States balance their budgets over a one- or two-year budget window. Thirty states budget annually and twenty states budget biennially (every two years). The twenty biennial budget states adopt budgets for either two individual fiscal years (17 states) or for a single 24-month fiscal period (3 states). Forty-six states begin their fiscal year on July 1. The remaining four states follow different fiscal year timing (Figure 8).[12]

States closely adhere to balanced budget requirements. Like the federal government, most states employ a unified budget incorporating all appropriated funds. State balanced budget requirements may apply to all funds (or accounts) or apply to the state's General Fund (the main account used to deposit, hold, and spend most state tax revenues). Additionally, balanced budget requirements may apply only to the operating budget and exclude the capital budget, or apply to both.

Figure 8: State Budget and Fiscal Year Cycle

Annual Biennial Hybrid

Note: With four exceptions, state fiscal years begin on July 1. The other four states are Texas (September 1), New York (April 1), Michigan and Alabama (October 1).
Source: National Association of State Budget Officers

Revenue Estimates Function as a Spending Limit

Due to balanced budget requirements, revenue forecasts for existing funding sources frame the initial budget process by limiting state budget spending. If states want to spend more than existing revenue systems provide, they must adjust tax and fee provisions and then spend within that new limit. If states determine existing revenue streams supply more funds than needed, they may reduce taxes and fees to constrain spending.

Revenue forecasting processes and participants vary across the states. Twenty-eight states use a consensus revenue estimate prepared jointly and agreed to by both the executive and legislative branches. Ten states utilize only an executive branch forecast, while twelve states employ separate executive and legislative branch forecasts in the budget process.[13]

Separate from revenue estimates themselves functioning as a spending limit due to balanced budget requirements, 26 states also employ specific tax or spending limits in their constitution or statutes that may further constrain spending levels.[14]

At least annually and generally multiple times a year, states forecast General Fund revenues, as well as other state revenues restricted for particular purposes in special accounts outside the General Fund. States also forecast federal fund receipts and other budget drivers that influence federal revenue, such as Medicaid enrollment and utilization.

Mid-year Spending Adjustments to Maintain Balance

When economic or fiscal conditions change and forecasts suggest a developing deficit, states activate various spending reduction processes to address the shortfall. To ensure budget balance, state law both authorizes and directs governors

Figure 9: Historical Summary, Idaho Bond Payment Budget, FY 2022 - 2024

Bond Payments

Historical Summary

OPERATING BUDGET	FY 2022 Total App	FY 2022 Actual	FY 2023 Approp	FY 2024 Request	*FY 2024 Gov Rec*
BY FUND CATEGORY					
General	179,684,000	179,608,600	0	0	*0*
Dedicated	15,433,000	15,019,400	15,283,000	0	*0*
Total:	**195,117,000**	**194,628,000**	**15,283,000**	**0**	***0***
Percent Change:	0.0%	(0.3%)	(92.1%)	(100.0%)	*(100.0%)*
BY OBJECT OF EXPENDITURE					
Operating Expenditures	186,091,200	105,242,000	8,112,200	0	*0*
Capital Outlay	9,025,800	89,386,000	7,170,800	0	*0*
Total:	**195,117,000**	**194,628,000**	**15,283,000**	**0**	***0***

Source: Idaho Division of Financial Management and Idaho Legislative Budget Book

to reduce previously-authorized spending under specific circumstances, such as when revenue collections begin to fall below the adopted target. In 46 states, the executive branch holds authority to reduce or withhold appropriations under certain conditions.[15] Governors may also take other steps to restrict spending to address a budget gap, such as limiting new contracts or personnel costs by imposing a hiring freeze, layoffs, or furloughs. States may also use one-time budget management tools such as deferring payments or relying on other funding sources to resolve an emerging budget gap.

Legislatures may restrict executive authority, such as by requiring across-the-board cuts, legislative notification or approval, or other means. State legislatures may also convene in regular or special sessions to employ other budget responses, such as drawing from rainy day funds or adjusting revenues. However, executive authority for mid-year spending adjustments addresses the practical need for timely budget-balancing action when on-the-ground conditions change.

Debt and Capital Budgets

With few exceptions, states do not bond for standard operating expenses. Bonded debt typically finances capital spending, such as for transportation infrastructure or buildings, rather than paying for regular operations. All states employ some form of a capital budget, enacted on an annual or biennial basis, often concurrent with operating budget adoption. As of FY 2022, bonds financed about 30% of state capital spending nationally, with the remainder coming from state pay-go cash funding (nearly 45%) and federal sources (25%).[16]

Balanced budget requirements influence state debt levels since annual debt service payments generally constitute spending allocations subject to state balanced budget requirements. Most states also have limits, often enshrined in their constitutions, directly constraining state borrowing to remain below specific levels. In 40 states, policies limit authorized debt balance levels and in 29 states, separate policies limit debt service payments.[17]

The U.S. Census Bureau reports combined state and local government debt totaled about $3.3 trillion as of FY 2021 (roughly $10,000 per U.S. resident). Of this, state debt totaled about $1.2 trillion (about $3,600 per capita), while local government debt totaled about $2.1 trillion (about $6,400 per capita). For contextual comparison, state assets in the form of cash and securities (exclusive of insurance trust systems and bond funds) totaled about $1.8 trillion nationwide, while local government balances came in at $1.4 trillion. That is, in FY 2021 state cash and security balances exceeded the entire amount of state bonded indebtedness, and local governments' balances well over half of local government bonded debt.[18] While some of these cash and security assets may be reserved for future use, this comparison highlights a generally cautious approach to debt.

As an example further illustrating a reserved approach to bonded debt, Figure 9 shows the State of Idaho's budget line item for debt payments zeroed out in FY 2024, as the state retired its non-transportation bonded debt. While Idaho may again incur bonded debt, retiring debt for a time demonstrates fiscal control and illustrates state use of debt as needed for capital projects rather than regular operating expenses.

Structural Budget Balance

States annually or biennially balance their budgets by covering each budget period's expenses with funding sources available over that period. The term "structural balance" refers to funding ongoing (recurring) expenses with ongoing revenues over the business cycle, rather than continuously relying on one-time (or non-recurring) funding sources to cover ongoing expenditures. Annual or biennial balance may differ from structural balance

Figure 10: Arizona Executive Budget Presentation of General Fund Structural Balance

	FY 2022		FY 2023		FY 2024		FY 2025		FY 2026	
	Prelim Actual	YOY % Chg.	Executive Budget	YOY % Chg.	Executive Budget	YOY % Chg.	Executive Budget	YOY % Chg.	Executive Budget	YOY % Chg.
GENERAL FUND CASH FLOW										
Beginning Balance	$894,636,000		$4,709,445,955		$2,933,878,911		$273,010,209		$96,390,651	
Adjusted Base Revenues	$16,684,285,855		$16,007,358,056		$15,155,998,887		$15,748,471,720		$16,574,788,028	
Revenue Changes					(40,470,200)		(40,470,200)		(40,470,200)	
One-time Revenues	$20,000,000		(2,270,989,600)		(394,795,220)		(50,000,000)		(50,000,000)	
Total Sources of Funds	**$17,598,921,855**		**$18,445,814,411**		**$17,654,612,378**		**$ 1 5,931,011,729**		**$16,580,708,480**	
Total Uses of Funds	**$12,889,475,900**	**11.6%**	**$15,511,935,500**	**20.3%**	**$17,131,602,169**	**10.4%**	**$15,834,621,078**	**-7.6%**	**$15,699,019,857**	**-0.9%**
BSF Deposit -			0		250,000,000		0		0	
Ending Balance	**$4,709,445,955**		**$2 ,933,878,911**		**$273,010,209**		**$96,390,651**		**$881,688,623**	
GENERAL FUND STRUCTURAL BALANCE										
Ongoing Revenues	**$16,684,285,855**		**$16,007,358,056**	**-4.1%**	**$15,065,528,687**	**-5.9%**	**$15,658,001,520**	**3.9%**	**$16,484,317,828**	**5.3%**
Ongoing Spending	**12,041,346,700**		**14,158,683,200**	**17.6%**	**15,000,372,359**	**5.9%**	**15,376,152,078**	**2.5%**	**15,676,725,257**	**2.0%**
Structural Balance	**$ 4 ,642,939,155**		**$ 1 ,848,674,856**		**$ 6 5,156,328**		**$ 2 81,849,442**		**$ 8 07,592,571**	

Source: Arizona Governor's Office of Strategic Planning and Budgeting

due to reliance on one-time revenue sources. Examples of one-time revenue sources include rainy day funds, unspent carryover funds, non-recurring federal funds (such as federal pandemic aid), a single settlement payment, or a temporary revenue spike (such as a revenue acceleration driven by federal tax changes).

Numerous states separately report one-time revenue and/or one-time expenditures in their budget documents to maintain focus on structural balance.[19] For example, Arizona's executive budget breaks out ongoing and one-time revenues and compares ongoing revenue to ongoing spending to calculate the state's structural balance over each budget cycle (Figure 10).

To be clear, states do anticipate using one-time funding sources to support ongoing programs (such as education, Medicaid, public safety, or general government) during economic downturns as a business cycle management tool. Supporting critical programs when revenues decline is precisely the purpose of a rainy day fund, which is a one-time funding source. Said differently, even though states do not generally deficit spend from an annual (or biennial) perspective, they may do so from a structural balance perspective. This does not necessarily create long-term budget challenges if done temporarily, such as from reserves accumulated during good economic times or one-time federal aid. Problematic structural imbalances can arise when ongoing spending permanently exceeds ongoing revenues, even in good economic times.

Structural imbalance may also occur when budgets do not fully incorporate future costs, due to pushing ongoing costs or tax cuts outside the state's one-year or two-year budget window. This may occur via delayed bill effective dates, phased implementation, or incurring long-term liabilities with costs not fully reflected in the current budget.

As a tool to help avoid a structural imbalance for this reason, 30 states produce and publish budget forecasts beyond the annual or biennial budget window (sometimes called the "out years").[20] Most commonly these out-year forecasts cover 1-4 years beyond the budget window. States do not typically consider these out-year forecasts binding like the standard annual (or biennial) forecasts and recognize they are far more uncertain. Rather, states use them as a tool to identify and plan responses to potential imbalances in the out-years.

State budget policymakers possess broad powers to adjust budgets over time. First, states control their spending levels. Over a sufficiently long period, all cost types are variable. States can and do regularly adjust spending to balance their budgets when budget gaps or deficits occur. States also control their revenue structures, and can increase or decrease revenues as appropriate by adjusting the tax (or fee) base and rates. As part of these powers, states also exercise considerable control over fiscal inflow and outflow timing. As discussed later, states also use budget reserves as an important budget management tool, including formal rainy day funds and other budget reserves.

Standard Appropriation Process Budgeting

States regularly adopt budgets through annual or biennial budget processes. With some exceptions, state funding does not occur automatically. Rather, state legislatures must affirmatively take action to authorize spending. This differs from the federal government's "autopilot" entitlement spending, with continuous funding set in statute, which federal budget practitioners refer to as "mandatory" spending.

Case Study - Structural Budget Balance and Employee Benefits

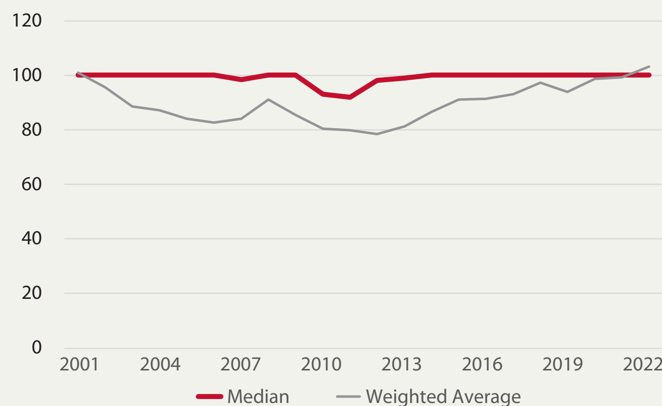
State and local government pension and other post-employment benefit (OPEB) funding received extensive attention in the aftermath of the Great Recession's significant investment return declines. Not fully funding employer pension or OPEB actuarial contributions impairs long-term structural budget balance. Although these costs could theoretically remain consistent with current ongoing funding levels if investment returns recover very strongly and quickly following economic downturns, costs will likely be higher. If not funded, these higher ongoing costs mean future budgets start with an initial budget gap before policymakers make any other decisions.

Figure 11 shows state and local government pension annual funding levels from FY 2001 to 2022 by state, and Figure 12 shows the funding distribution detail for all systems. As illustrated, many states fully funded (and some even over-funded) actuarially determined contributions over this two-decade period. In some states, however, funding levels fell below actuarially-determined contribution levels. To the extent investment returns or other funding sources do not cover this gap, this could create a structural budget imbalance. As Figure 12 shows, many state and local governments used pandemic era state revenue windfalls to further stabilize pensions.

In recent decades, many states adjusted retirement benefits to function more like the private sector. As a result of this shift, states now face increasing wage cost pressures with a young, mobile workforce responding to wages generally lower than the private sector and benefits comparatively less generous than before, particularly for new employees.

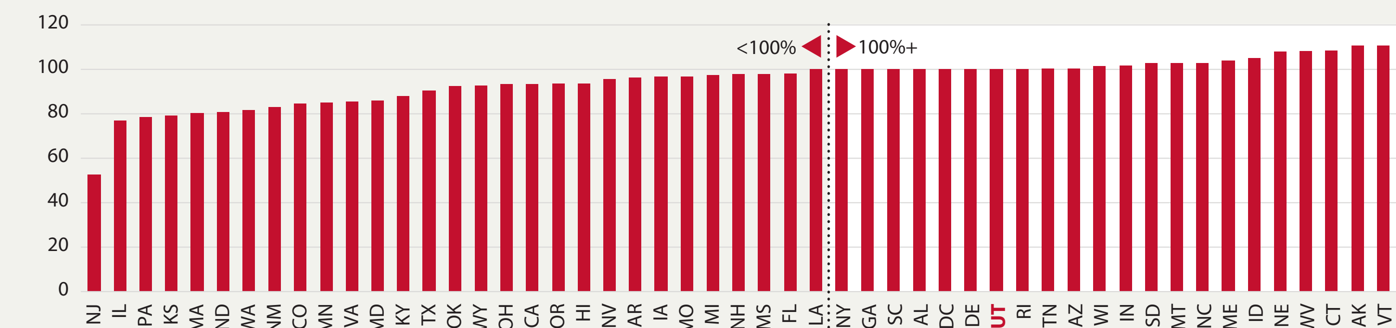
This highlights that actuarial pension reform estimates alone do not include the impacts of these tangible future costs on structural budget balance. Ultimately, examining structural balance requires looking holistically at the budget in detail. Well-intended actions to improve structural balance in one area may simply drive challenges and budget imbalances elsewhere.

Figure 12: Pension Plan Distribution of Employer Contributions as a Percentage of Actuarially Determined Contribution (ADC), FY 2001–2022



Note: Actuarially determined contributions previously called actuarially required contributions.
Source: National Association of State Retirement Administrators

Figure 11: Pension Plan Distribution of Weighted Average Employer Contributions as a Percentage of Actuarially Determined Contribution (ADC) by State, FY 2001 to 2022



Note: Actuarially determined contributions previously called actuarially required contributions.
Source: National Association of State Retirement Administrators

Spending Requirements

States generally do not have "mandatory" spending. With few exceptions, state spending remains subject to appropriation through the regular annual or biennial legislative process. Even obligations like debt service payments on general obligation debt follow this process.

Constitutionally- and statutorily-authorized programs, along with federal program participation (such as Medicaid), provide a budget starting point. Previous funding levels influence much of the state budget for the next cycle, as states generally use some form of incremental budgeting – an approach to budgeting that focuses decisionmakers' attention primarily on incremental

changes to the current budgeted or "base" expenditures. That said, specific appropriation amounts remain subject to deliberation through the annual or biennial budget process, and the process for allocating new funding in particular is often quite competitive. Even for programs in the budget "base" viewed as more "fixed," such as Medicaid, states can and do make policy changes that influence the overall program cost.

While state officials recognize practical and political realities limit their budget-making discretion, states have demonstrated a strong track record of adjusting spending to balance budgets. For example, during the Great Recession when nominal state tax revenues declined by 11% over two years on average, states cut even high-priority spending categories. Similarly, during the COVID-19 pandemic's early months, when economists forecasted significant revenue declines, many states adopted budget cuts or cancelled planned spending increases. Specifically, 19 states reported mid-year budget cuts due to projected revenue shortfalls in FY 2020. For FY 2021, 18 states enacted budgets with net General Fund spending decreases, and 10 states reported mid-year cuts after budget enactment for FY 2021.[21] These spending adjustments occurred even with the use of budget reserves, federal fiscal assistance, and some state revenue-raising actions.

Constitutional provisions hold primacy over other state government obligations. However, most constitutional provisions generally do not prescribe specific funding amounts. State constitutions typically leave these to the standard appropriations process. Similarly, states do not typically incorporate funding amounts in their program-authorizing legislation, unlike the federal government's process. The competitive appropriations process, not the authorizing statute, typically governs approved funding amounts.

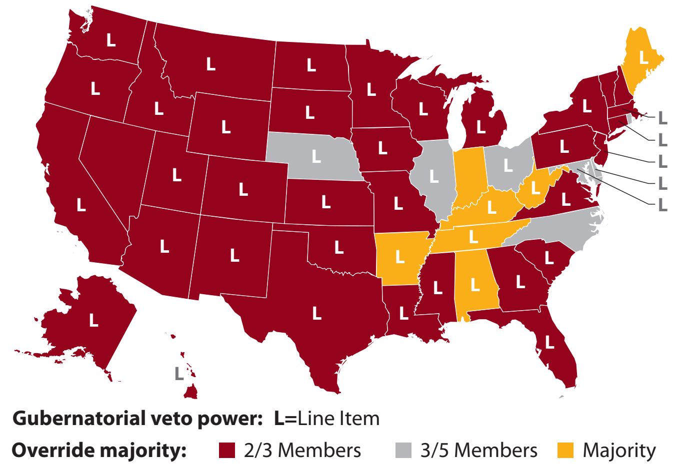
Line-Item Veto

State constitutions in 44 states grant governors line-item budget veto authority. This executive budget power does not exist at the federal level. Thirty-eight states require a legislative supermajority to override a governor's line-item veto (Figure 13). Because of this supermajority override requirement, the governor generally plays a role in the final legislative stages of getting to budget agreement.

Tax Policy Changes and the Budget Process

In most cases, policymakers change state tax policy contemporaneously with the appropriations process to meet balanced budget requirements. Unlike the federal budget, voter-approved constitutional changes, ballot initiatives, and referenda may alter revenue and spending streams. Subsequent budgetary decision-making must adapt to (or sometimes may alter) these voter-approved changes to maintain budget balance.

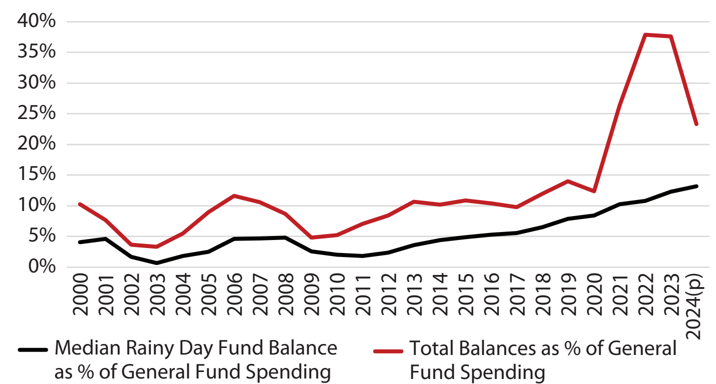
Figure 13: State Line Item Veto Authority



Gubernatorial veto power: L=Line Item
Override majority: 2/3 Members 3/5 Members Majority

Source: National Association of State Budget Officers, *Budget Processes in the States* (2021)

Figure 14: State Formal Rainy Day Fund and Total Balances as a Percentage of General Fund Spending, FY 2000 to 2024



Note: 2024 reflects preliminary estimates based on enacted budgets
Source: National Association of State Budget Officers

States Proactively Plan for Budget Contingencies

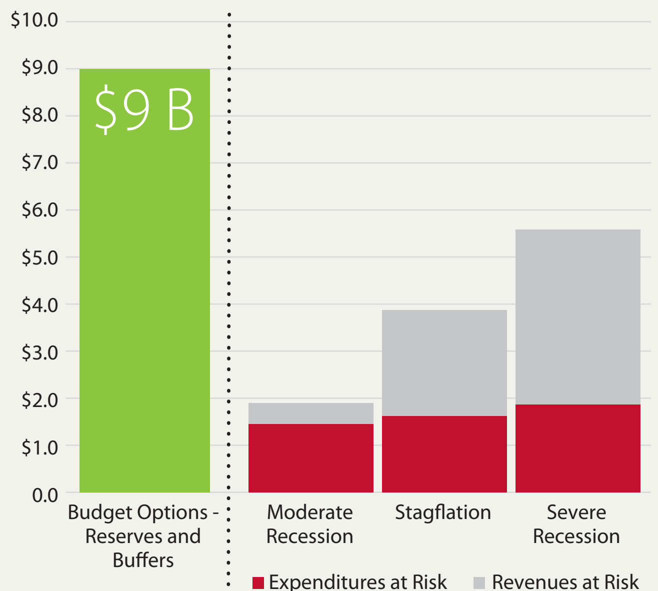
States proactively plan for budget contingencies. Examples include setting aside formal rainy day funds and other budget reserves, budget stress testing, and revenue estimating approaches. In addition to state efforts, the federal government often provides some state aid during downturns.

Budget Reserve Funds

All 50 states have statutory or constitutional budget reserve funds or requirements. States rely on this business cycle management tool during revenue shortfalls and to address emergency situations, including natural disasters. States build up their reserve balances during good budgetary times and later utilize these reserves as a one-time funding source to resolve unexpected fiscal downturns.

Forty-three states also use separate accounts holding funds for natural disaster and other emergency responses.[22] Other states provide the governor authority to expend funds for

Figure 15: Utah Budget Stress Test Estimates of Five Year Value at Risk, 2022 Stress Test



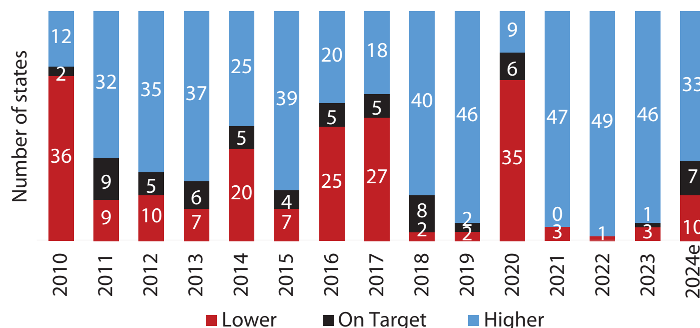
Source: Utah Governor's Office of Planning and Budget and Office of the Legislative Fiscal Analyst

disaster and emergency response and relief. About half of the states also have authority to transfer funds from other accounts for an emergency, if necessary. These saved emergency funds range in size. State legislatures may also pass supplemental appropriations during emergencies. States combine these and other state funding sources and spending authority with federal funds in response to a federally-declared disaster.

State budget reserves consist of resources beyond formal rainy day funds. For example, as of FY 2024, the state median for formal state rainy day funds available to supplement General Fund spending during a downturn stood at an estimated 12.3% of General Fund spending. Since states allocated a significant portion of General Fund expenditures in FY 2023 for one-time purposes, rainy day fund balances notably represent an even larger percentage of *ongoing* General Fund spending. Total balances (a measure defined by NASBO as formal rainy day funds combined with general fund ending balances) nearly double that level, at 23.3% of FY 2023 General Fund spending (Figure 14). Further, other potential reserves such as unspent restricted account balances, excluded from NASBO's "total balances" measure, push these reserves even higher.

Notably, record-setting FY 2021 and 2022 state revenue surpluses drove the unprecedented steep rise in states' total balance levels in many states. The use of the non-rainy day fund component of total balances is less restricted compared to rainy day funds and sometimes designated for spending in a subsequent budget period. That all said, these robust balance levels currently provide states a wide array of options and liquidity to manage a downturn.

Figure 16: State General Fund Revenue Collections Compared to Original Budget Projections, FY 2010 to 2024



Note: Preliminary estimate for 2024, subject to future revision.
Source: National Association of State Budget Officers

Particularly during the pandemic era, the federal government's stabilization function supported states' ability to maintain and increase rainy day fund balances. Federal aid both addressed state needs that may have otherwise required drawing down rainy day funds, as well as propped up economic activity, contributing to sizable increases in nominal state revenues – a portion of which states added to rainy day funds.

Budget Stress Testing

In addition to maintaining budget reserves, an increasing number of states stress test their state budget to gauge preparedness for adverse economic events. The Pew Charitable Trusts report 14 states did so as of 2021.[23] Although complexity and formality vary by state, a comprehensive budget stress test examines revenue and spending value at risk over a specified budget time frame. States then compare this combined value at risk to formal rainy day funds and other budget reserves, and other budget actions that states could deploy to address a downturn. Figure 15 summarizes the State of Utah's recent budget stress testing results.

Cautious Revenue Estimates as a Budget Buffer

States generally exercise caution in developing their revenue forecasts and rarely use estimates assuming the most optimistic economic scenario. Notably, revenues for most states typically exceed (not just meet) the forecast target most years (Figure 16). For most states, revenues typically come in below forecast only when economic downturns occur – the Great Recession in FY 2010, the unofficial business investment recession in FY 2016 and 2017,[24] and the pandemic recession in FY 2020. Note that even during these recent economic slowdowns, a third to half of states experienced revenue collections at or above forecasts.

Additionally, in building their budgets, some states routinely plan to spend an amount below the revenue forecast. For example, states such as Delaware and Mississippi have legal tax and expenditure limitations that restrict General Fund appropriations to 98% of forecasted General Fund revenue.

III. Federal Government Budgeting

The U.S. Constitution, federal statutes, formal administrative law, and informal practice guide federal budgeting processes. This section highlights standard federal budget practices, including:

(a) Regular annual deficit spending while employing a ten-year budget window,

(b) A large share of spending that occurs outside of a regular annual appropriation process, and

(c) Debt as the primary contingency management tool.

Annual Deficit Spending While Employing a Ten-Year Budget Window

Standard Deficit Spending

The federal government does not regularly balance its budget, even in good economic times. Rather, its standard practice is to deficit spend (that is, annual spending exceeds revenues). The federal government balanced its budget in only four of the last 50 years. These few years of balance occurred consecutively over a four-year span covering fiscal years 1998-2001, following passage of the *Balanced Budget Act* in 1997 and during a time of rapid economic growth. Federal deficits occurred in each of the other 46 years.

For FY 2024, the Congressional Budget Office (CBO) reports federal revenues of $4.9 trillion and spending of $6.9 trillion. Spending 40% more than revenues results in a deficit of $2.0 trillion. CBO projects a large increase of the federal deficit over the next ten years to $2.8 trillion, a gap of about 6.9% of U.S. GDP (Figure 18). The federal government's structural budget deficit tends to spike during major economic downturns. But unlike states, the budget very seldom balances annually (never in the past two decades), much less returns to full structural balance as the economy strengthens.[25]

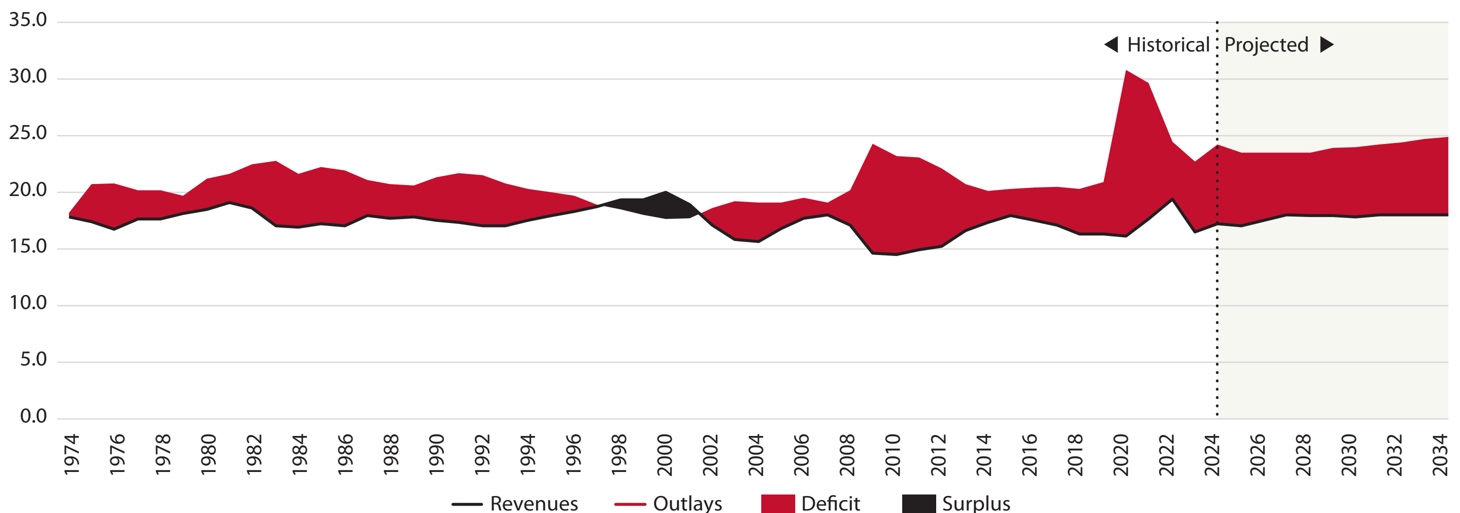
Annual Federal Fiscal Year and Ten-Year Budget Window

The federal fiscal year starts October 1 and runs through September 30 (different than most states with a July 1 to June 30 fiscal year). The federal government accounts for fiscal impacts of budget decisions over a ten-year budget window, although each fiscal year's budget operates annually.

This fiscal year difference from most states can create state budget challenges, such as when the federal government extended its income tax filing deadline from April to July in 2020, or when it extended its 2023 deadline until October for some California, Alabama, and Georgia resident returns.[26] Given balanced budget requirements, states that simplify resident tax filing by aligning state and federal income tax due dates may face a budget challenge if they conform to federal changes, as the deadline shift then crosses into a different state fiscal year.

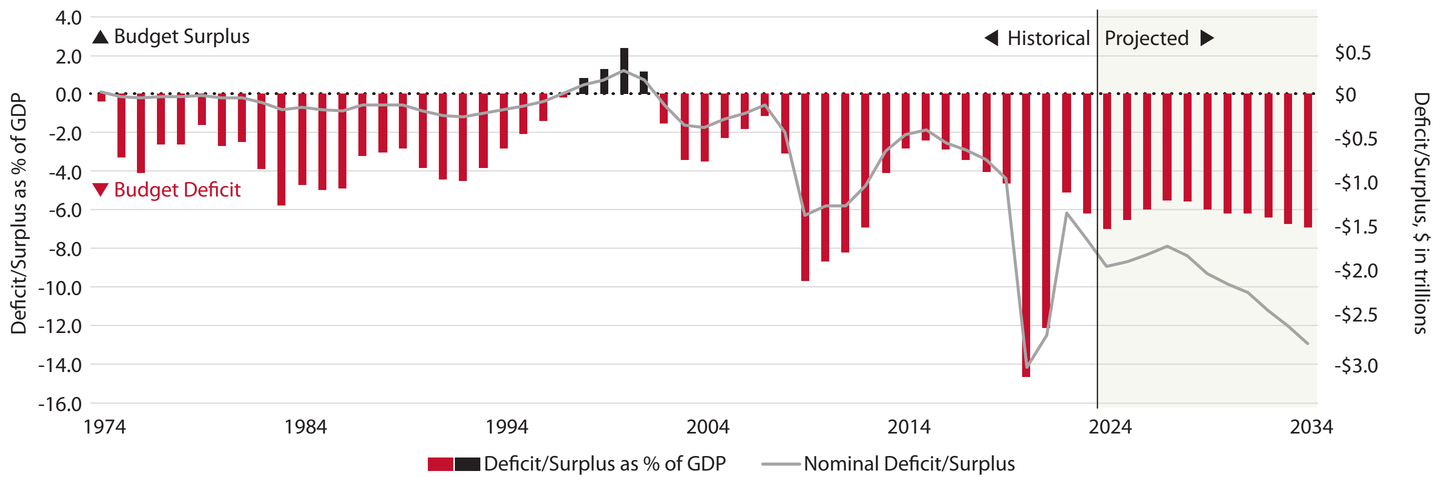
Congress established the long-term budget window of ten years with the good intention to minimize fiscal estimate gaming. Despite its well-intended purpose, in practice this approach appears quite unsuccessful in meeting its objective – and arguably may worsen the very problem it sought to avoid. Consistent manipulation of tax and spending bill effective dates creates various temporary tax and spending provisions that officially drop in and out of place within the ten-year budget window. Congress often extends these temporary provisions after their original expiration date. Due to this dynamic, official deficit projections may understate actual federal structural budget imbalances. For example, most of the individual income tax changes in the *Tax Cut and Jobs Act* enacted in 2017 will expire at the end of 2025, creating tax system uncertainty

Figure 17: Federal Revenues and Spending as a Percentage of GDP, Federal Fiscal Year 1974 to 2034(p)



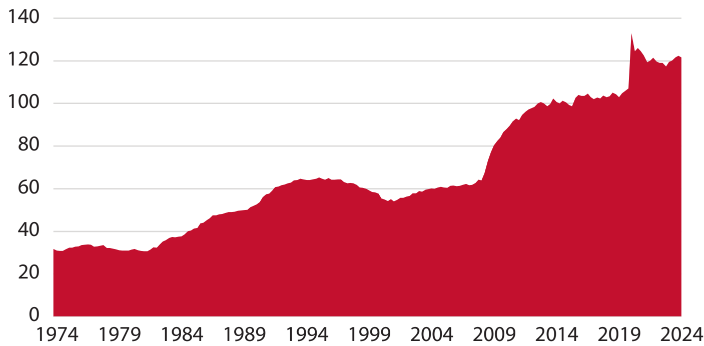
Source: Congressional Budget Office

Figure 18: Federal Government Deficit and Surplus Amounts and as a Percentage of GDP, Federal Fiscal Year 1974–2034(p)



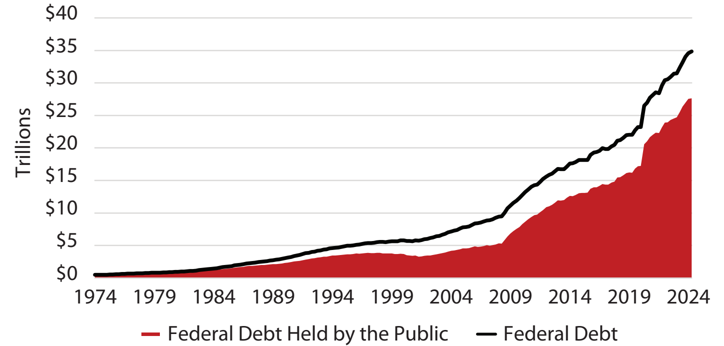
Source: Congressional Budget Office

Figure 19: Federal Total Debt as Percent of GDP, Federal Fiscal Year 1974-2024



Source: U.S. Treasury

Figure 20: Federal Total Debt and Debt Held by the Public, Federal Fiscal Year 1974-2024



Source: U.S. Treasury

for families and businesses. This expiration date also creates budget uncertainty after that date for the federal budget and for state budgets, whose individual income tax systems often conform to federal tax provisions.

Federal Debt

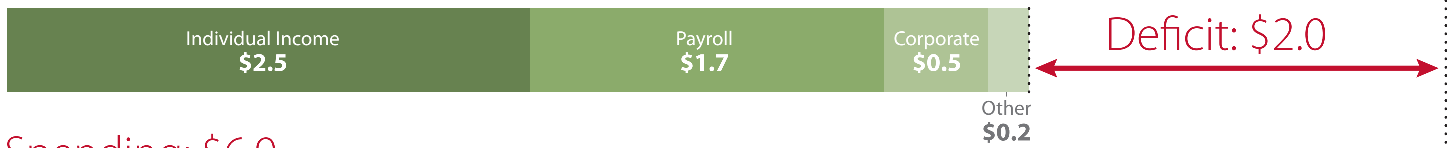
The federal government finances its annual operating deficit by issuing U.S. Treasury securities to borrow money. This contrasts with states and local governments, which generally issue debt to finance capital spending only. The federal government does not budget separately for capital expenditures in the manner that states do.

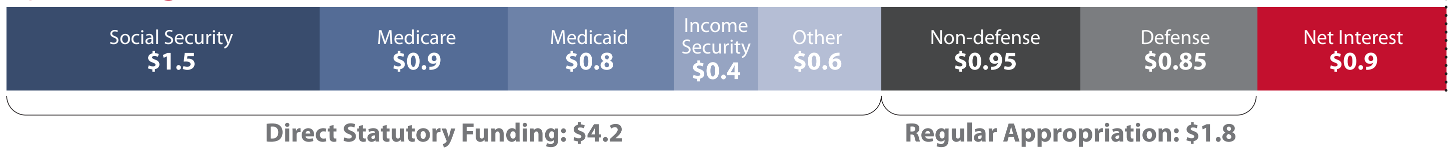
As of September 2024, the accumulated national debt totaled about $35.3 trillion (about 120% of U.S. GDP and roughly $100,000 per capita). Federal agencies hold a portion of this debt ($7.2 trillion), while the public holds the remainder ($28.1 trillion). Although foreign holdings make up roughly $8.0 trillion of the debt held by the public, banks, insurance companies, pension funds, mutual funds, the Federal Reserve, states and local governments, and individual investors hold the majority of the national debt.

Federal Debt Limit

The federal government's debt authorization ceiling does not automatically align with its spending processes. Negotiations around raising or suspending the federal debt limit periodically occur when a debt ceiling increase authorization becomes necessary for the federal government to meet its funding authorizations. To date, these negotiations have always avoided a catastrophic federal default when Congress increases or suspends the debt limit – such as with the enactment of the *Fiscal Responsibility Act of 2023* in June 2023. However, given the federal fiscal trajectory and continuing periodic debt limit negotiations that require the U.S. Treasury to use extraordinary measures to avoid default, two of the three major credit rating agencies (S&P Global and Fitch) now rate U.S. bonds a notch below their highest credit rating. The third (Moody's) placed U.S. Treasury bonds on negative watch for a potential rating downgrade.

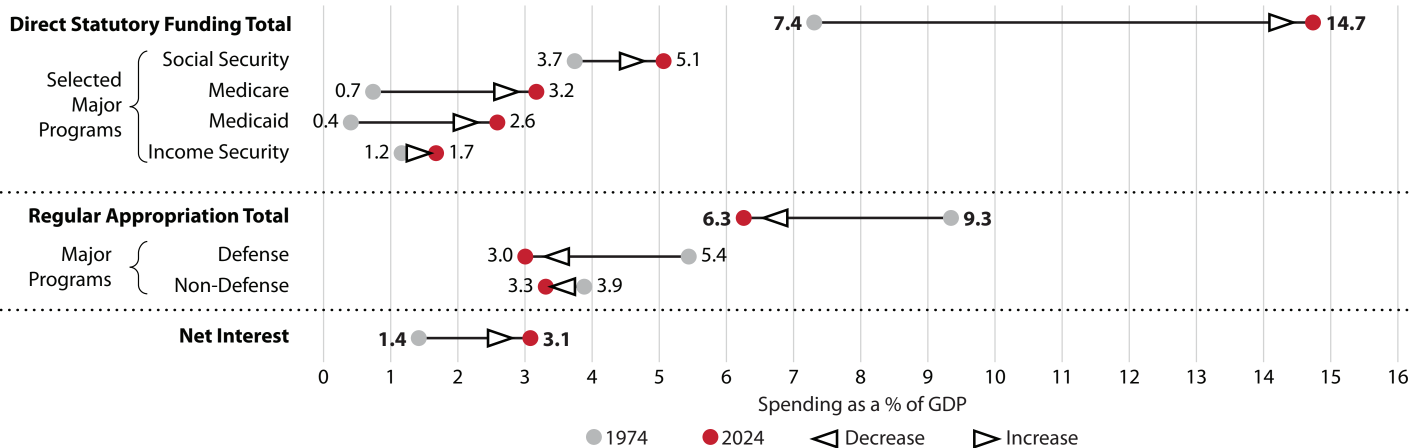
Figure 21: The Federal Budget in Fiscal Year 2024
($ in trillions)





Source: Congressional Budget Office

Figure 22: Federal Direct Statutory Funding and Regular Appropriation Spending as % of GDP, Federal Fiscal Year 1974 to 2024



Source: Congressional Budget Office

Most Federal Spending Occurs Outside of Regular Appropriation Process

Unlike states where most funding follows a traditional annual or biennial appropriation process, most federal funding occurs outside of a regular annual process. The federal budget is commonly divided into three components – direct statutory funding (termed "mandatory"), regular appropriation funding (termed "discretionary"), and net interest on the national debt. The largest spending category is direct statutory funding, followed by regular appropriation funding, and then net interest.

Direct Statutory Funding

About two-thirds of federal spending occurrs outside annual appropriation processes. Although termed "mandatory" spending, Congress actually has broad constitutional authority to change the laws authorizing this spending, akin to the earlier discussion on how states may make policy changes that impact their "base" spending.

Importantly, unlike a standard appropriation process that requires action to authorize funding, with direct statutory funding programs, continuing the existing funding scheme requires no action. Altering these spending provisions does require action, which faces political hurdles.

Statutory entitlement funding makes up the vast majority of this spending and includes major federally-administered programs like Social Security and Medicare, as well as joint federal-state funded programs like Medicaid. Other programs include food assistance (SNAP), various tax credits (including child tax credit and earned income tax credit), veterans' programs, and supplemental security income. The greatest federal government spending growth comes in Social Security, Medicare, and Medicaid. The underlying major federal budget cost drivers come from an aging U.S. population and increasing health care costs.

Regular Appropriation Funding

Roughly a quarter ($1.8 trillion) of the federal budget follows a regular annual appropriations process. Federal budget practitioners term this "discretionary" funding. The federal government divides this regular appropriation funding between defense ($0.8 trillion) and non-defense spending ($0.9 trillion).

Defense spending supports various military functions, while non-defense spending includes funding for health, transportation, education, and various other programs.

Net Interest

The remaining roughly 13% of the federal budget (about $0.9 trillion) pays for interest on the national debt. As of 2024, interest payments now exceed the national defense budget. With increasing debt this share will rise over time to a projected 4.1% of GDP by FY 2034 (up from 3.1% in FY 2024).

Debt as a Contingency-management Plan

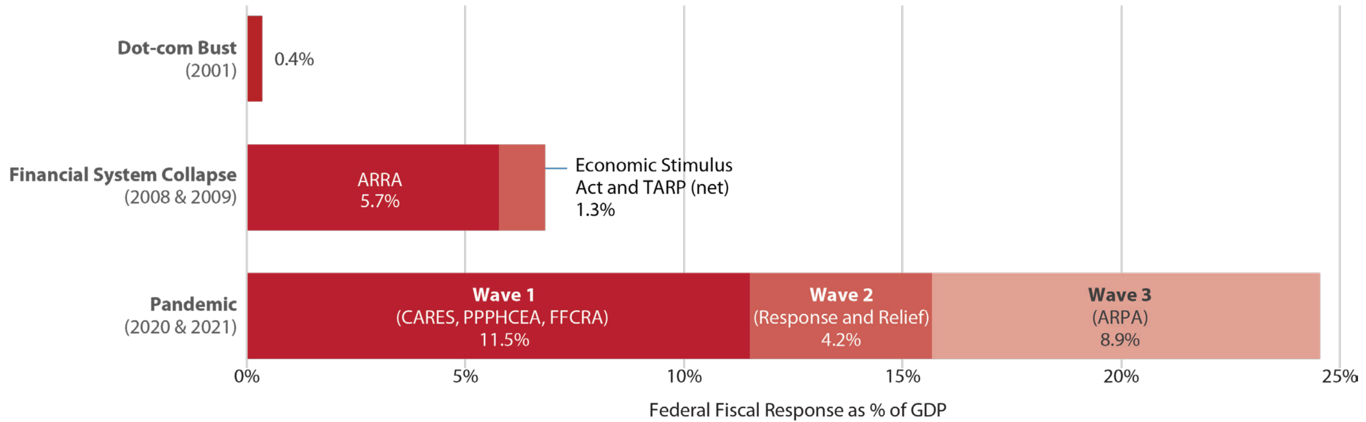
Unlike states that tend to build reserves during good economic times for use during economic downturns, the federal government's practice is to increase its deficit spending. To fulfill its economic stabilization function, the federal government generally collects less in taxes and spends more during recessions, running a short-term cyclical deficit.

This short-term cyclical deficit differs from the structural budget deficits run annually at the federal level, even during good economic times. These structural deficits are not inherent in the structure and roles of U.S. fiscal federalism, but rather a product of ongoing tax and spending policy decisions by federal policymakers.

States and local governments have historically benefitted from this increased deficit spending. They received a portion of federal stabilization funding, particularly following the financial system's collapse during the Great Recession, and again during the COVID-19 pandemic (see state aid spikes in Figure 5). Figure 23 shows the overall federal fiscal response during the three most recent official U.S. recessions, including not only funds to states but also funds allocated for many other purposes. As shown, the federal fiscal responses varied dramatically, with the pandemic fiscal response over $5 trillion, equal to nearly 25% of U.S. GDP. While spent over several years, the federal pandemic fiscal response (which included sizeable health-related spending) dwarfs previous responses.

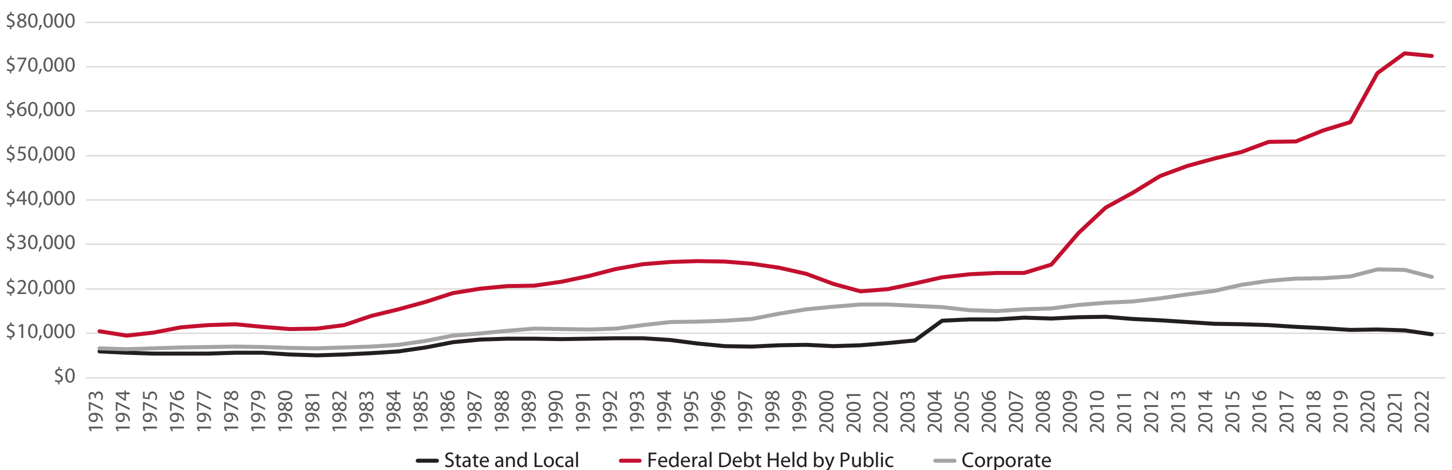
Because states and local governments often cut budgets during downturns to balance the budget, their budget-balancing actions may create a drag on economic recovery coming out of downturns. In contrast, economists consider

Figure 23: Overall Federal Fiscal Response as Percentage of GDP in Recent Recessions



Source: Gardner Institute from Congressional Budget Office and U.S. Bureau of Economic Analysis data

Figure 24: Real Per-Capita U.S. Federal, State and Local, and Corporate Bonded Debt, 1973-2022



Source: Federal Reserve Economic Data (FRED)

certain federal programs "automatic stabilizers" that help mitigate an economic downturn. This expansionary fiscal policy automatically occurs through spending increases (Medicaid and SNAP) or tax collections that automatically drop as taxable incomes drop. This process later reverses as the economy recovers (spending drops as fewer people qualify for Medicaid and SNAP) and revenue collections increase as incomes grow).

The combined effect of annual structural operating deficits and heightened cyclical deficits during recession spikes results in ever-increasing federal debt, while state and local debt has historically remained fairly constant in recent decades. Figure 24 contrasts outstanding debt of the federal government with that of states and local governments (termed "municipal" debt). The graph also includes corporate debt for reference. Clearly, states and local governments take a different approach to debt than the federal government.

Conclusion

In summary, the U.S. employs a federal system of government that divides sovereign fiscal powers and responsibilities between states and the federal government. Both states and the federal government independently exercise sovereign fiscal powers as they tax, spend, and borrow. As political subdivisions of states, local government powers spring from state powers.

Typical state budget practices include budget balance over a one- or two-year budget window, regular budget adoption through standard appropriation processes, and proactive planning for contingencies. Typical federal budget practices include regular annual deficit spending while employing a ten-year budget window, most spending outside of a regular annual appropriation process, and the use of debt as the primary contingency management tool.

Understanding these differences in budgeting practices, as well as the differentiation in fiscal roles played by the federal and state governments, can shed light on common disconnects between the two levels of government and inform efforts to address such disconnects, and in turn strengthen the federal-state fiscal relationship.

For further reading on federal and state budget processes, how they differ and how they interact:

- *State Budget Processes & Spending Federal Funds* (NASBO, 2022), https://higherlogicdownload.s3.amazonaws.com/NASBO/9d2d2db1-c943-4f1b-b750-0fca152d64c2/UploadedImages/Issue%20Briefs%20/State_Budget_Processes___Spending_Federal_Funds.pdf
- *Budget Processes in the States* (NASBO, 2021), https://www.nasbo.org/reports-data/budget-processes-in-the-states
- *The Unprecedented Federal Fiscal Policy Response to the COVID-19 Pandemic and Its Impact on State Budgets* (Phil Dean, 2022), https://gardner.utah.edu/wp-content/uploads/Fiscal-Stimulus-May2022.pdf
- *U.S. and Utah Debt Policy: A Study in Contrasts* (Michael Christensen and Max Becker, 2022), https://gardner.utah.edu/wp-content/uploads/BondingReport-Nov2022.pdf

Endnotes

1. https://constitutioncenter.org/blog/10-reasons-why-americas-first-constitution-failed
2. https://www.archives.gov/founding-docs/constitution/how-did-it-happen#:~:text=The%20founders%20set%20the%20terms,states%20enacted%20the%20new%20government.
3. https://www.senate.gov/about/origins-foundations/senate-and-constitution/seventeenth-amendment.htm#:~:text=Article%20I%2C%20section%203%20of,of%20Representatives%2C%20but%20none%20succeeded.
4. https://fred.stlouisfed.org/series/FYONGDA188S
5. https://constitution.congress.gov/browse/amendment-10/
6 https://apps.bea.gov/iTable/?reqid=19&step=2&isuri=1&categories=survey#eyJhcHBpZCI6MTksInN0ZXBzIjpbMSwyLDNdLCJkYXRhIjpbWyJjYXRlZ29yaWVzIiwiU3VydmV5Il0sWyJOSVBBX1RhYmxlX0xpc3QiLCI1Il1dfQ==
7. In addition to federal fiscal policy, the independent, but congressionally-authorized, Federal Reserve uses monetary policy to incentivize more economic activity during downturns.
8. Exact percentages may differ slightly due to timing differences between state and federal fiscal years, federal grant allocations, and actual state spending and reporting mechanisms.
9. This section draws heavily from NASBO's insights provided to Congress in "Testimony of John Hicks, Executive Director, National Association of State Budget Officers (NASBO) Before the Budget Committee United States Senate, *"Fixing a Broken Process: Lessons from States"* June 19, 2019"
10. Vermont is the only state without some form of a constitutional budget balance requirement, and reports that in practice it has never run a year-end deficit
11. NASBO, *Budget Processes in the States* (2021), Table 9.
12. Ibid., Table 1. ; New York begins on April 1, Texas on September 1, and Alabama and Michigan on October 1
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