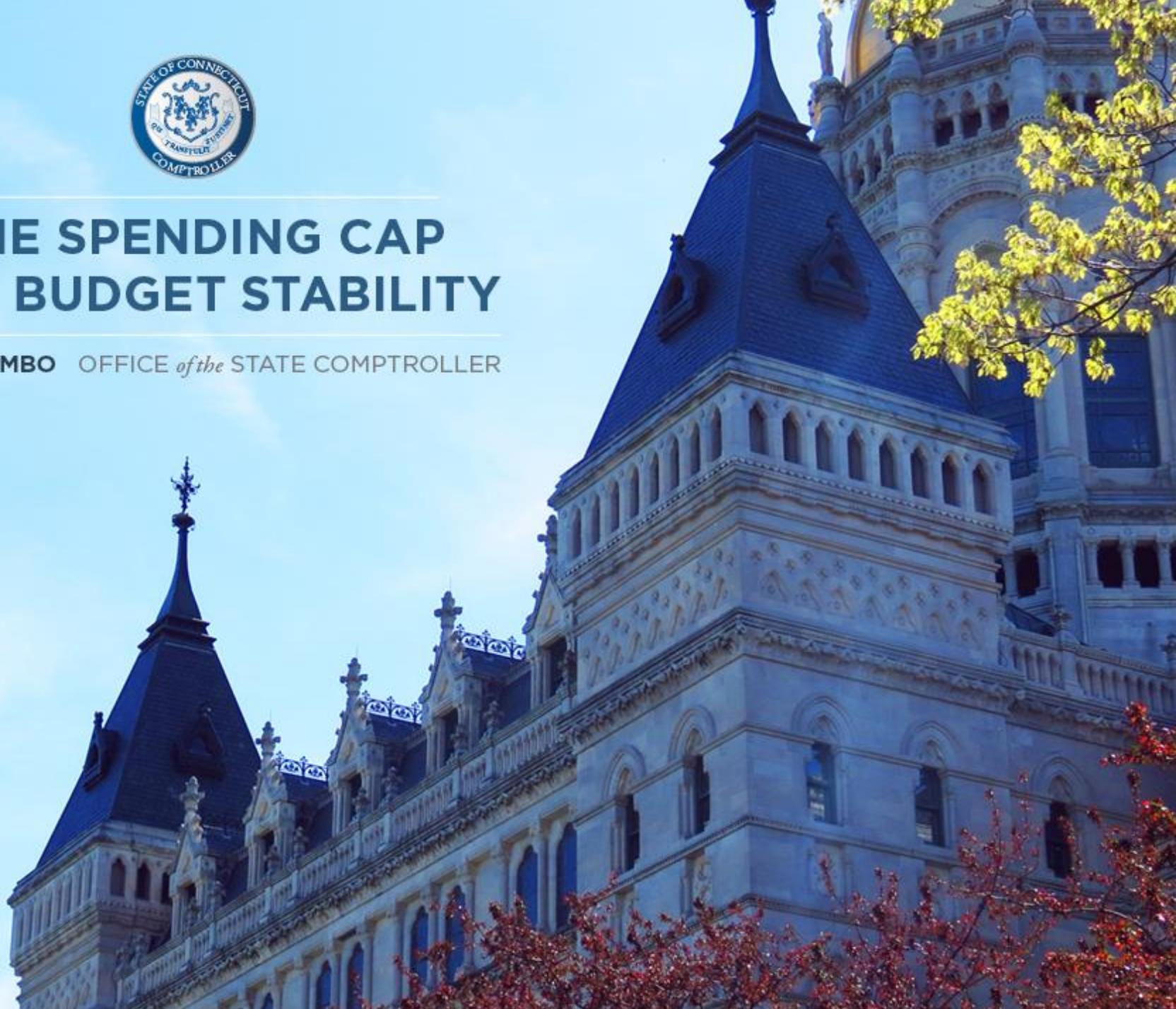




THE SPENDING CAP AND BUDGET STABILITY

KEVIN LEMBO OFFICE *of the* STATE COMPTROLLER



GOAL:

- **Encourage more stability in state expenditures by reducing the volatility of annual changes in spending cap limits**

BENEFITS:

- **Build a culture of compliance by requiring less drastic annual changes in appropriations**
- **Build greater budget reserves by appropriating less during economic expansions**
- **Alleviate need for future crisis-driven tax increases, service cuts or layoffs during economic recessions by using budget reserves to maintain needed government services**



INTERDEPENDENCE OF THE BRF DEPOSIT RULES AND THE SPENDING CAP

- **Historically, state expenditure growth has been driven by the availability or scarcity of revenue**
- **BRF deposit rules divert windfall revenues from volatile revenue sources to BRF, reducing available revenue to support expenditure growth during economic expansion**
- **BRF deposit rules are necessary but not sufficient**
 - Only target most volatile revenue sources
 - Spending cap can play a complimentary role by limiting expenditure growth driven by windfall revenue from other revenue streams



LESSONS LEARNED IN DEVELOPING THE BRF DEPOSIT RULES

- **Goal was to lower volatility of GF revenue by diverting revenue above norms to the BRF**
- **Number of years included in measure to determine historic norms matters**
- **5 years too short**
 - Overstates historic norms at the end of economic expansions and understates historic norms during economic recovery
- **10 years is just right**
 - Generally includes both years of economic expansion and decline
 - Not so long that it fails to adjust to new economic realities
- **Defining measures under the spending cap requires similar considerations**

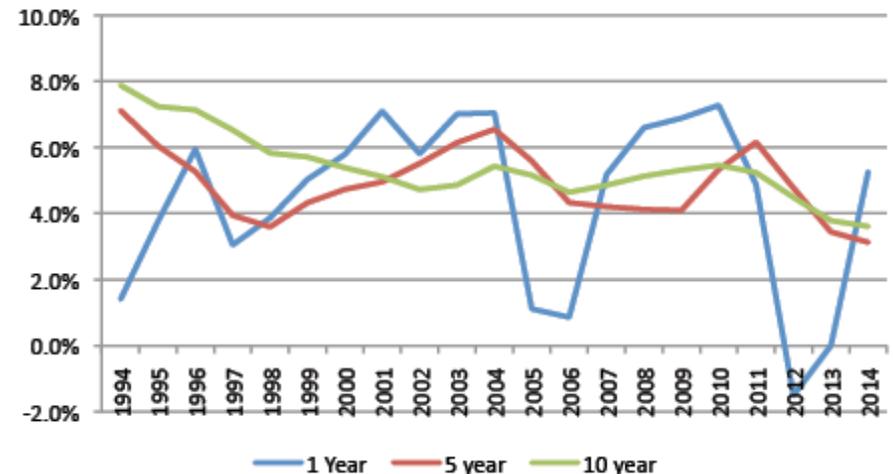


- Personal income growth can vary significantly year to year.
- Using an average of several prior years reduces the annual volatility of the measure.
- Increasing the number of years included in the average reduces volatility and better smooths the ups and downs of the typical business cycle by generally including some years of *strong economic expansion* and years of recession and recovery.

PERSONAL INCOME VOLATILITY AS MEASURED BY STANDARD DEVIATION FY 1994-2014

1 Year	2.6%
5 Year	1.1%
10 Year	0.9%

Personal Income Annual Growth Rate 10 year, 5 year, 1 year



- **Changing the inflation measure to better reflect the inflationary cost increases faced by state government may help to further reduce the volatility of the spending cap.**
- **One option for an alternative inflation measure is the Government Consumption Expenditures and Gross Investment measure - implicit price deflator - tracked by the Federal Bureau of Economic Analysis (herein referred to as the price deflator).**

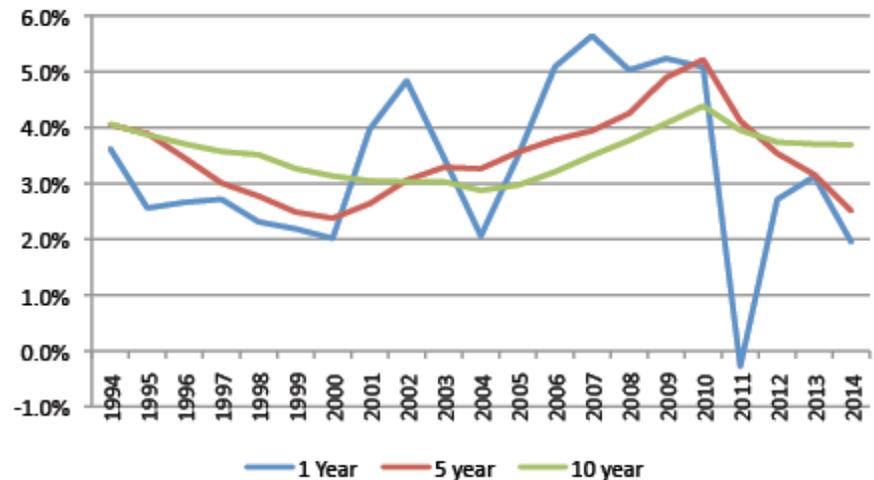


- The price deflator can vary significantly year to year.
- Using an average of several prior years reduces the annual volatility of the measure.
- Increasing the number of years included in the average reduces volatility and better smooths the ups and downs of the typical business cycle by generally including some years of strong economic expansion and years of recession and recovery.

PRICE DEFLATOR VOLATILITY AS MEASURED BY STANDARD DEVIATION FY 1994-2014

1 Year	0.9%
5 Year	0.7%
10 Year	0.4%

Price Deflator Annual Growth Rate
10 year, 5 year, 1 year



Using both a 10-year average of personal income and a 10-year average of the price deflator for the inflation measure produces best results – smoothing the peaks and valleys of the existing cap calculation.

The extent of the reduction in volatility is dependent upon the economic scenario it is applied to, sometimes the effect is significant and in other cases minor.

SPENDING CAP VOLATILITY 1994-2014	
Original Calculation	1.1%
Calculation with 10 year CAGR of PI and 10-year CAGR of the price deflator	0.9%

SPENDING CAP VOLATILITY 2000-2014	
Original Calculation	1.1%
Calculation with 10 year CAGR of PI and 10-year CAGR of the price deflator	0.6%

Cannot predict future economic performance but extending the number of years used to calculate measures under the spending cap will reduce the annual volatility. It's a question of how much.



- **Define personal income and inflation in a way that reduces erratic annual fluctuations in allowable spending growth.**
- **Less volatile limits = Greater compliance by future governors and legislatures.**
- **Combined with new Budget Reserve Fund rules (effective 2020) = more stable state expenditures; increased budget reserves; fewer service cuts; fewer tax increases during economic downturns and faster economic recovery.**

