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Managing Fiscal Volatility by Redefining ‘Tax Cuts’ and ‘Tax Hikes’

by David Gamage and Jeremy Bearer-Friend

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This report analyzes how states should cope with fiscal volatility at the level of institutional-design policy. We propose that states reconsider how they define terms like “tax cuts” and “tax hikes.” By adopting a new baseline for defining those terms, states can increase the likelihood of using tax rate adjustments to cope with fiscal volatility rather than more harmful spending fluctuations.

By switching from tax-rates baselines to revenue-targets (or spending-needs) baselines, states could increase their use of tax rate adjustments.

This argument is an extension of our previous *State Tax Notes* report, which analyzed ordinary political solutions to the fiscal volatility problem created by economic cycles interacting with balanced-budget constraints.¹ In contrast with the trend of primarily fluctuating government expenditures, our previous report used risk allocation theory to argue that states should instead rely more on adjusting the rates of their broad-based taxes. The report concluded that states should raise their tax rates during economic downturns and lower their tax rates during periods of economic growth. Based on the premise that spending fluctuations are

more harmful than tax rate fluctuations, this new report offers institutional-design-level solutions for managing fiscal volatility. By switching from tax-rates baselines to revenue-targets (or spending-needs) baselines, states could increase their use of tax rate adjustments and decrease their reliance on spending fluctuations, thereby minimizing the harms of fiscal volatility.

The report is organized as follows. First, we introduce the broad conceptual challenges in defining “tax cuts” and “tax hikes” and the role of baselines in defining those terms. We then outline alternative baselines that might be used in place of tax rates and briefly discuss how states might implement those alternative baselines. Next, the report explains why the choice of baselines matters, reviewing literature from positive political theory and from behavioral public finance. The report concludes by briefly summarizing the unique opportunity provided by the current round of state budget crises.

I. The Challenge of Defining ‘Tax Hike’ and ‘Tax Cut’

The labels “tax cut” and “tax hike” are among the most potent phrases in the American political lexicon. Even before the ascendancy of the modern conservative movement, politicians were extremely averse to being seen as raising taxes. Today, any Republican viewed as supporting tax hikes risks a primary challenge sponsored by groups like the Club for Growth. Similarly, many Democrats strive to deflect the charge of “tax-and-spend liberal.”

Yet despite the political salience of these labels, we lack a precise theoretical definition for what constitutes a tax cut or a tax hike. Most crucially for our purposes, these labels make sense only in reference to a baseline. Without some concept of what the default tax and spending policies would be in the absence of legislated changes, we cannot determine whether any proposed legislative action constitutes a tax cut or a tax increase.

Unlike at the federal level, the states’ balanced-budget constraints make it impossible for state governments to hold their tax and spending policies constant during changes in the economy. Because of

¹David Gamage and Jeremy Bearer-Friend, “Minimizing the Harm of State Fiscal Volatility,” *State Tax Notes*, Sept. 6, 2010, p. 633, *Doc 2010-16820*, or *2010 STT 172-6*.

balanced-budget requirements and shifting economic conditions, states are unable to use all of the tax and spending policies from a previous year as a baseline for future years. As such, state income and sales tax systems use only the previous year's tax rates as their baseline — the tax rates on the books. In the absence of legislative action, tax rates are held steady throughout economic cycles while revenue fluctuates. While most government expenditures need to be reauthorized annually through acts of the legislature, tax rates remain in effect once passed and are automatically reauthorized until changed by some future act of legislation.² When legislatures raise tax rates, those changes are coded as “tax hikes,” even when overall revenue is declining due to slowing economic conditions.

Without some concept of what the default tax and spending policies would be in the absence of legislated changes, we cannot determine whether any proposed legislative action constitutes a tax cut or a tax hike.

Although this institutional-design-level policy choice has not been critiqued (or even noted), there are alternative baselines that could be chosen in place of tax rates. For instance, the local property tax systems of several states hold revenue targets constant as their baseline. As the property values that form the bases for those taxes fluctuate, the default response is to adjust their tax rates so as to keep the amount of revenue generated constant. The localities are considered to propose tax hikes or tax cuts only when they call for changes to the revenue targets; the annual tax rate adjustments are not labeled as tax hikes or tax cuts unless they result from a legislated raising or lowering of the revenue targets.

Moreover, tax rates and revenue targets are not the only aspects of fiscal policy that can be used as a baseline. Consider that many federal grants to states are sized based on metrics for how much the states need the spending. Grants of that sort supporting poverty assistance programs will thus automatically grow larger during downturns and smaller during upturns as their funding metrics show the state populations needing either more or less poverty assistance. We could potentially create a baseline for state tax rates based on metrics for spending needs, causing the rates to be administratively adjusted to

meet the cyclical funding requirements of programs that cost more during busts than during booms.

The choice of baselines at the institutional-design level affects the outcomes of the ordinary political process. The literature on voter psychology tells us that preferences for tax and spending policies exhibit a status-quo bias (that voters display an “endowment effect” in regard to fiscal policy and “loss aversion” regarding fiscal policy changes). Further, positive political theory predicts that it is generally harder to change a default policy than to prevent such a change (because of the prevalence of veto points within our system of checks and balances). Consequently, whatever aspect of fiscal policy is chosen as a baseline should tend to fluctuate less as the economy changes.

Hence, the trend of allocating most of fiscal volatility to government spending results at least partially from states using tax rates as their primary baselines. By replacing those baselines with revenue targets (or with spending metrics), we could make tax rate adjustments more common and expenditure fluctuations rarer. State politicians would be less likely to cut spending during downturns if the alternative did not require voting for “tax hikes.” And if upturns no longer automatically brought massive revenue growth, politicians would be more reluctant to increase spending.

Most voters and political actors care more about their steady-state policy preferences than about how volatility is allocated around the steady state. Conservatives are unlikely to accept tax increases during downturns and liberals are unlikely to approve of tax cuts during upturns, unless they have guarantees that those policy changes would be reversed after the end of the current economic phase. Moreover, because the governing coalition in control during a downturn might have lost power by the next upturn, governing coalitions have even greater reason to care more about the effect of economic changes on steady-state policies than about optimal responses to volatility. A governing coalition could not credibly call a tax increase made during a downturn a response to volatility that will be undone during the next upturn, because the later governing coalition might not play along. Hence, to improve how states cope with fiscal volatility, we need a means for separating the policy question of choosing what to adjust as a response to fiscal volatility from the policy question of setting the steady-state levels of taxes and spending.

We tend to think of the terms “tax cut” and “tax hike” as having set meanings. Although there are circumstances in which politicians argue about whether a policy change should be labeled as a “tax cut” or a “tax hike,” there is generally widespread agreement that most expansions in state tax rates should be called “tax hikes” while most decreases in

²Tax laws function like entitlement spending in that they remain in effect until explicitly altered. Discretionary general account spending must be rebudgeted annually.

these rates should be called “tax cuts.”³ Yet the very notion of legislated changes — as embodied in terms like “tax cuts” and “tax hikes,” or even “spending cuts” and “spending increases” — requires a notion of a default policy outcome that would have been enacted in the absence of the legislated change.⁴ We can only measure changes from the policy status quo by referencing a baseline for what constitutes the status quo. Because balanced-budget constraints make it impossible to hold all state budgetary policies constant as the economy changes, there can be no ontological definitions for labels like “tax cuts” and “tax hikes.”⁵

³The exceptions to this maxim only serve to support the general rule. For instance, Democrats and Republicans dispute whether allowing the Bush tax cuts to expire should be viewed as increasing taxes. The frame here is contestable because the parties can argue about whether the relevant baseline includes extension of the temporary tax cuts. But were the Democrats to propose raising tax rates further — beyond the pre-Bush levels — there would be no doubt that this would be considered a “tax increase.” Whether overall revenue is increasing or declining because of economic circumstances is not now viewed as a relevant consideration in whether a policy change is called a “tax cut” or a “tax hike.”

⁴One might argue that general account spending does not have baselines in the same sense as does tax legislation because as general account spending must be reauthorized each year. But that argument is not fully persuasive because most general account spending is reauthorized without full review, and changes in the previous year’s levels of spending are usually viewed as “spending cuts” or “spending increases.” Zero-base budgeting is seldom implemented in practice.

⁵The difference between state general account spending and federal discretionary spending is that the federal government can incur deficits. Hence, at the federal level, revenue volatility (the default response to economic cycles under a tax-rates baseline) causes the deficit to automatically grow and shrink unless the legislature proactively adjusts tax or spending policies. In contrast, at the state level, there is no actual default fiscal policy. The tax-rates baseline means that any legislated change to tax rates is coded as a “tax cut” or “tax hike,” but any legislated change to spending will similarly be coded as a “spending cut” or a “spending increase.” See *supra* note 1. Revenue volatility forces states to adjust either their tax or spending policies as their economies fluctuate, but the states must actively decide which specific policies to adjust.

This report focuses on the definition of tax cuts and tax hikes because these terms are more salient within the current political environment — as reflected by the increasing rarity of “tax hikes.” The motivating idea is that, since voters appear to increasingly be making decisions based on whether politicians are seen as voting for “tax cuts” or “tax hikes,” we should strive to make the content of these terms reflect what voters actually care about. Or, alternatively, we should strive to eliminate any negative consequences of the increased salience of these terms that does not result from the reasons voters care about the terms.

Voters presumably care about these terms based on their preferences about steady-state policy, not based on preferences for how fiscal volatility should be allocated. Hence, we should define these terms so that the terms convey the

(Footnote continued in next column.)

One dictionary defines a tax cut as “a reduction in the amount of taxes taken by the government.”⁶ But the amount of revenue the government receives from taxes is constantly changing. Sometimes these changes occur due to legislative fiddling with tax rate structures or with the rules for calculating tax bases. At other times, the government increases or decreases its revenue intake due to evolving economic conditions or to changing responses to tax provisions.⁷ Nearly any government program that affects the economy can alter the amount of revenue collected through taxes. But if we labeled any change in government policy that might alter the amount of revenue generated through taxation as a “tax cut” or “tax hike,” those terms would become meaningless.

As such, we can determine the appropriate baselines for terms such as “tax cuts” and “tax hikes” only by making decisions about what aspects of our budgetary policy we would like to hold constant as a default. This institutional-design-level choice of baselines determines which types of policy outcomes become presumptive responses to fiscal volatility and which become presumptive changes to steady-state policies.

This report argues that states should adjust their tax baselines — the default tax policies that are enacted in the absence of explicit legislative change — in order to make tax rate adjustments more common and expenditure fluctuations rarer. But before proceeding, it is important to clarify the difference between adopting a new tax baseline and adopting a tax expenditure limit.

Tax expenditure limits have been adopted by numerous states in order to prevent legislatures from raising taxes or to limit the circumstances under which legislatures can raise taxes. An example of a tax expenditure limit is a supermajority voting rule for legislatures to raise taxes. Whereas tax expenditure limitations are designed to bias the evolution of steady-state policies (usually against raising taxes and spending), the choice of baselines

information voters seek about legislated changes to steady-state fiscal policy (the size of government decision), without negatively affecting how states respond to cyclical economic fluctuations (the fiscal volatility decision).

⁶See <http://www.investordictionary.com/definition/Tax+cut.aspx>. This is the only dictionary we have been able to find which defines the phrase tax cut.

⁷For instance, the California State Department of Finance and the state’s Legislative Analyst’s Office analyze the effects of several economic variables on the amount of tax revenue collected by the state, including trends in consumer and business spending, housing, employment, profits, and income distributions. See Jon David Vasche and Brad Williams, “Revenue Volatility in California,” *State Tax Notes*, Apr. 4, 2005, p. 35, *Doc 2005-4744*, or *2005 STT 63-2*.

is only meant to influence which aspects of steady policies fluctuate in response to fiscal volatility. Adopting a new baseline should not prevent legislatures from adjusting steady-state policies as they desire. Instead, adopting a new baseline only alters the mechanism through which legislatures change steady-state policies.

II. Alternatives to the Tax-Rates Baseline

Consider the following spectrum of possible baselines for which aspects of a tax system could be held constant throughout economic cycles:

On the left-hand side of the spectrum, tax rates are held constant in the absence of legislated changes. Consequently, decreased revenue becomes the default response to economic downturns, and increased revenue becomes the default response to upturns. Any deviation from those default responses requires legislative action and will typically be labeled as a “tax hike” or a “tax cut.” The left side of the spectrum depicts the general rule governing most state- and federal-level tax systems, with the exception of the property tax systems in some states.

In the middle of the spectrum — corresponding with the property tax systems of 22 states — the amount of revenue raised is held constant as the economy moves through cycles, with tax rates automatically adjusted so as to maintain the revenue targets.

Moving to the right side of the spectrum, tax rates are adjusted to maintain the spending needs of government programs. For instance, some federal grants to states are based on participation levels for the grant-funded spending programs, which tend to increase during economic downturns and decrease during upturns. This is particularly true for programs that provide poverty assistance or that fulfill a social insurance function. A baseline tied to spending needs would automatically adjust the tax rates in order to maintain the same funding per program participant, or per other metric for spending needs.

The next section will proceed by first discussing how some states have moved from tax-rates baselines to revenue-target baselines for their local property taxes. The section will then discuss how alternative baselines might be implemented for statewide taxes such as state sales and income tax systems.

A. ‘Truth-in-Taxation’ Property Tax Systems

Because no government has ever implemented a baseline other than tax rates for a sales or income tax, the best way to explain how an alternative baseline might work for those taxes is to start by looking at the property tax systems of the 22 states that have effectively adopted revenue-target baselines. Those states vary greatly in how they have implemented their alternative baselines, and local property taxes are sufficiently dissimilar from state-

wide taxes that we should not put too much stock in these examples. Nevertheless, those revenue-target property tax systems are the best real-world examples of the use of a baseline other than tax rates.

The use of revenue-target baselines for property taxes began in the 1960s as part of a “Truth-in-Taxation” movement. The advocates of those alternative property-tax baselines were concerned that local governments had been “automatically” receiving extra revenue as their local property values increased without the governments ever needing to explicitly raise taxes. The advocates of these measures were the same conservative groups that promoted tax expenditure limits in other states. Those groups viewed themselves as calling for a softer form of tax expenditure limit. Yet the logic behind their measures and the means in which they were implemented had the effect of changing the state property tax systems from using tax-rate baselines to using revenue-target baselines.

According to Robert Bland and Phanit Laosirirat:

Truth in taxation, also known as full disclosure, was developed by the U.S. Advisory Commission on Intergovernmental Relations (ACIR) in 1962 as a method to reduce revenue windfalls in the wake of an en masse reappraisal of property. It seeks to make local lawmakers more accountable for tax increases by focusing taxpayers’ attention on the rate setting process and not only on their property’s reappraised value. This is usually achieved by first informing citizens of the constant yield rate (CYR), the tax rate that will produce the same amount of revenue as last year when applied to this year’s tax base. Then citizens must be notified of a public hearing where they can question local lawmakers on why a tax rate greater than the CYR should be adopted. Unlike other tax limitation measures that impose statewide restrictions on rates or levies, truth in taxation preserves local governments’ discretion to set rates that meet local expenditure preferences while giving taxpayers an opportunity to scrutinize proposed [tax] increases.⁸

In other words, the purpose of the truth-in-taxation measures is to change the default policy response created by rising property values from holding tax rates constant while revenue goes up, to holding revenue constant while tax rates go down. Tax increases are redefined as increases to “constant yield rates” — the rates that, when applied to the new and more valuable tax base, would generate the same revenue as in the previous year. Effectively,

⁸Robert Bland and Phanit Laosirirat, “Tax Limitations to Reduce Municipal Property Taxes: Truth in Taxation in Texas,” *19 J. of Urban Affairs* 45 (1997).

tax increases are defined as increases in local government revenue, rather than as increases in the actual tax rates applied to property values.

For an example of how those measures are given statutory authority, consider the following language in the Texas State Constitution:

Subject to any exceptions prescribed in general law, the total amount of property taxes imposed by a political subdivision in any year may not exceed the total amount of property taxes imposed by that subdivision in the preceding year unless the governing body of the subdivision gives notice of its intent to consider an increase in taxes and holds a public hearing on the proposed increase before it increases those total taxes.⁹

Again, an increase in taxes is defined in reference to the “total amount of property taxes” rather than in reference to the rates previously applied to the property tax base. Here the institutional mechanism for raising taxes requires the local government to give notice of its intent to “increase taxes” and to hold a public hearing. That requirement is activated when the local government seeks to increase its property tax revenue from that received in the previous year, not when the local government seeks to change its tax rates.

The 22 states that have adopted these revenue-target baselines for their property taxes differ in whether and how they index the baseline.¹⁰ Indexing is needed because what it means for revenue to remain “constant” is not entirely straightforward. Some states hold their baselines constant in real dollar terms. Other states index their baselines for inflation, thus holding revenue constant in nominal dollars. Still other states index their baselines for GDP growth and thus hold revenue constant as a percent of GDP. Some states even index their baselines to grow at a constant annual rate. How to index a baseline is an important question of institutional design, but there are no theoretically correct answers to this question. The decision of how to index the baseline is an important design element, but a full discussion of this issue is beyond the scope of this paper.

Like the indexing decision, the enforcement mechanisms for those baselines differ amongst the states.¹¹ Some states require only that any “tax hikes,” as defined by the revenue-targets baseline,

be publicized in local newspapers. Other states allow taxpayers to sue in district courts if they believe the local government administrators have not calculated and published any “tax hikes” as defined by the new baselines in the manner the statute demands. Some states even require local governments to obtain voter approval for any increase in the revenue targets, through ballot measures, or allow petitions for citizen initiatives to roll back any such increases. Regardless, all these measures have the effect of altering the baseline for defining what constitutes a tax cut or a tax increase. All of the measures switch the default policy response to increases in property tax values (the response that occurs if the local governments do not take the required steps for passing a “tax increase”) to one in which revenue remains constant while tax rates are lowered.

Unfortunately, the local property tax context is too dissimilar from the statewide sales and income tax context for those measures to provide a concrete guide for implementing a revenue-target baseline at the state level. There are at least three major differences between the local property tax context and the statewide tax contexts that limit the value of these examples. First, the value of local property tax bases is determined through property appraisals conducted by government agents. Second, property values have tended to increase over time, whereas sales and income tax bases oscillate as the economy goes through cycles. Third, local-government tax lawmaking relies on different institutions and procedures than does state-level tax lawmaking.

Let us first look at the issue of property appraisals. Whereas the tax bases of sales and income taxes fluctuate with economic cycles — as consumers purchase more or fewer goods and as incomes go up and down — property tax bases change in value partially because of the actions of government property appraisers. As Cornia and Walters explain:

In contrast to state sales and income taxes, “nothing in property tax practice and administration inherently identifies and adjusts for changes in market value [changes in the tax base]. To appraise or reappraise a property, assessors must act overtly and estimate the sales price of each property as of the legal lien date. The need to proactively establish the economic value of the base makes the property tax different from other taxes where the value of the base is established through observable economic transactions (e.g., sales price of goods or annual income).”¹²

⁹Chapter 26, Property Tax Code, Article VIII, section 21. See also, “Texas Property Tax: Truth-in-Taxation, A Guide For Setting Tax Rates,” Report of the Office of Carol Strayhorn, Texas State Comptroller (2005; on file with author).

¹⁰See Advisory Commission On Intergovernmental Relations, “Significant Features Of Fiscal Federalism,” at 151-167 (1995, 1977).

¹¹*Id.*

¹²Gary Cornia and Lawrence Walters, “Full Disclosure: Unanticipated Improvements in Property Tax Uniformity,” *Pub. Budgeting & Fin.* 106, 110 (2005).

Because property tax bases change in value partially as a result of the action of government agents, it might be easier to reframe what is considered a tax cut or a tax increase for property taxes than it would be for sales or income taxes. Hence, the mere fact that voters appear to accept the operation of revenue-target baselines for local property taxes does not in and of itself imply that voters would similarly accept those baselines for statewide sales and income taxes.

That voters appear to accept the operation of revenue-target baselines for local property taxes does not imply that voters would similarly accept those baselines for statewide sales and income taxes.

The second relevant difference between local property taxes and statewide sales and income taxes is that property values generally increase over time while sales and income tax bases fluctuate far more wildly. As such, adopting a revenue-target baseline for property taxes can be sold as preventing “automatic tax hikes” because of increasing property values.¹³ Although the recent financial crisis has seen a widespread decline in housing values, that development is still too new (and historically unique) to have brought on any significant calls for reform.¹⁴

As a final difference, tax lawmaking at the local level relies on a very different set of institutions and procedures than does tax lawmaking at the state level. Even a cursory discussion of those differences is beyond the scope of this report. Still, any attempt to draw inferences from local governments’ experiences with these truth-in-taxation systems should include a warning on the differences between tax lawmaking at these two levels of governance.

¹³The advocates of the truth-in-taxation property tax measures viewed themselves as promoting a softer version of a tax expenditure limit with the purpose of reining in the growth of local governments. This report argues for revenue-target baselines for statewide sales and income taxes in order to transfer some of the effects of fiscal volatility from the public sector to the private sector, not to limit the growth of government. Consequently, the political actors supporting revenue-target baselines for local property taxes would not necessarily support these baselines for statewide sales and income taxes.

¹⁴At the time of this writing, the truth-in-taxation property tax systems remain intact, and (to the authors’ knowledge) there have not yet been any significant political moves to abolish them.

B. Implementing an Alternative Baseline for State-Level Taxes

The local property tax context is sufficiently different from the context surrounding statewide taxes that truth-in-taxation property tax measures cannot provide clear guidance for implementing an alternative tax baseline at the state level. Still, the success of those local property tax measures is at least encouraging for this report’s project. At a minimum, those measures indicate that analysts and policy-makers appear to believe that baselines matter for at least some forms of taxation and that it is at least sometimes possible to alter those baselines.

Just as truth-in-taxation local property tax systems have been implemented differently across the various states that have adopted them, there are numerous possibilities for implementing revenue-target baselines for state-level taxes. Perhaps the most straightforward method of implementation would be to have an administrative agency adjust predesignated tax rates as the economy goes through cycles. That could work similar to how the federal government (and some states) administratively adjust their income tax brackets for inflation. As with these inflation adjustment systems, the legislatures could always adjust the brackets or rates afterwards in order to generate any outcome desired. But in the absence of specific legislative action, the administrative body would adjust tax rates to keep revenue constant as the economy changes.

Of course, the authorizing statutes would have to specify what it means to hold revenue constant. As in the local property tax context, the revenue-target baselines could be indexed for inflation, for GDP growth, or to a wide variety of other possible indexing possibilities, including not indexing at all. The authorizing statutes would also have to specify which taxes the administrative agency is to adjust as the economy fluctuates. The agency might adjust all statewide taxes equally so as to keep total general account revenue constant. Or the agency could adjust a specific subset of statewide taxes. Any subset of state taxes could be adjusted by enough to keep total state revenue constant.¹⁵ For example, a new statewide property tax could be created with a

¹⁵Note that if a progressive-rate income tax is to be adjusted (as opposed to a flat-rate income tax), the authorizing statute must specify which rates are to be adjusted as the economy fluctuates. As with indexing and other design variables, any answer to that question must be somewhat arbitrary. There is no theoretically correct method for adjusting the rates of a progressive income tax. One possible approach would be to attempt to adjust the rates so as to make the tax adjustments neutral with respect to distribution. But this is not the only possibility, and a normative argument can be made in favor of adjusting the rates so that high-income

(Footnote continued on next page.)

steady-state rate of zero that would oscillate between imposing an additional tax liability during downturns or a credit against existing taxes during upturns. During periods of growth, that tax could be gradually reduced (or made into a gradually larger credit) to counteract the additional revenue generated by other state taxes, with the opposite occurring during downturns.

One obvious concern about having administrative officials adjust tax rates in this fashion is that that might require delegating too much authority to the administrative officials. Yet state administrative officials (or legislative staffs in some states) already enjoy most of the discretionary powers that a delegation of that sort would entail.

With tax rates set as the baseline for statewide taxes, states require estimates for the revenue those taxes will generate. Those estimates are crucially important due to state balanced-budget requirements, as the estimates determine what levels of spending are permissible. If the administrative or legislative staffs charged with making revenue estimates report that less revenue is available, legislatures must cut spending or raise taxes.

If states adopted revenue targets as their baselines for state taxes in place of tax rates, they would need estimates for the tax rates needed to generate the revenue targets.

If states adopted revenue targets as their baselines for state taxes in place of tax rates, they would instead need estimates for the tax rates needed to generate the revenue targets. That form of estimating would replace the current need to estimate revenue based on legislatively set tax rates. Hence, the distinctive feature of this report's proposal is not that it relies on estimates, or that forecasting officials have substantial control over fiscal policy, but rather that revenue targets replace tax rates as the independent variable in the estimating equation. We now label this forecasting as the revenue estimating process because we use tax rates as our baseline. With revenue targets as the baseline, the process would be labeled as tax rate estimating. Under either system, calculations made by administrative officials significantly affect fiscal policy outcomes.

Still, projecting revenue from the starting point of tax rates might be thought of as more straightforward than projecting tax rates from the starting point of revenue targets. State income taxes are collected an-

nually, and even sales tax rates must be announced significantly in advance of when they take effect. At some point, the tax rates must be fixed for the year. To the extent that the economy changes after setting the tax rates, or to the extent that a set of projections proves inaccurate, a state might not collect the amount of revenue requested. Revenue targets are merely targets, after all. In the short term, states may not actually raise the amount of money demanded. Yet that problem is easily resolved within the context of a multiyear time frame. If a state experiences a revenue shortfall in a year, the default tax rates for the next year can be adjusted to make up for the shortfall. Instead of looking only to the current year's revenue targets when setting tax rates, the forecasting agency could factor any shortfall or surplus from the previous year into the amount of revenue requested. The agency would then estimate the tax rates needed to raise the combined revenue target. Those tax rates would become the default policy outcome for the year. If state or local policymakers want to raise or lower the level of taxes to be collected, they would simply adjust the revenue targets causing the forecasting agency to recalculate the tax rates based on the new amount of revenue requested. Over a longer time frame, it remains the case that states must either project revenue from the baseline of tax rates or else project tax rates from the baseline of revenue targets. Both systems require significant delegation to administrative agencies or other forecasting staffs.

The decisions involved in implementing a baseline of spending metrics are similar to those involved in implementing a revenue-targets baseline. It is useful here to distinguish between a partial spending-metrics baseline and a complete spending-metrics baseline. A partial spending-metrics baseline works in essentially the same fashion as a revenue-targets baseline, except that the revenue targets are further adjusted based on metrics for program needs. For instance, the administrative agency might start with a baseline of holding revenue constant (perhaps indexed for inflation or GDP growth) but then adjust the baseline to meet the funding needs of countercyclical entitlement programs such as Medicaid. As additional beneficiaries qualify for Medicaid in a downturn, the agency would adjust the baseline to automatically allocate revenue to fund the additional beneficiaries. After adjusting the baseline as appropriate, the agency would then set tax rates to keep discretionary revenue constant after adjusting for any changes in the funding needs of entitlement spending programs.

In contrast to the partial spending-metrics approach, a complete spending-metrics system would set tax rates to fund legislative spending authorizations instead of the revenue targets being calculated independently of spending. Under this approach, balanced-budget constraints would have no independent force. Legislatures would deliberate directly only

taxpayers bear more of the tax burden during downturns and less during upturns. See Gamage and Bearer-Friend, *supra* note 1.

on spending, with taxes being calculated based on the revenue needed to fund the authorized spending.

Although the complete spending-needs system is a plausible means of adopting an alternative baseline, it is discussed here mostly to highlight its differences from a partial spending-metrics system and a revenue-targets system. Under both of those latter systems, balanced-budget constraints continue to exert independent force. Legislatures cannot simply increase spending and then rely on the rate-setting agency to fund that spending. Instead, if legislatures want to increase spending under either of these systems, they must explicitly raise taxes through the means of increasing the revenue target. These systems are meant to change the mechanism through which legislatures raise and lower taxes — from adjusting tax rates to adjusting the revenue targets. But neither revenue-target baselines nor partial spending-metric baselines in any way relieve legislatures of the need to set the level of taxation and to conform spending to revenue generated by the chosen tax levels.

Both spending-metrics baselines and revenue-target baselines are intended only to change how states respond to fiscal volatility, not to alter the evolution of steady-state policies. Nevertheless, adopting either baseline would have the side effect of altering the default policy response to changes in long-term economic growth rates. With tax rates as a baseline, the default policy response to improving long-term growth trends is increased revenue, and the default response to worsening growth trends is reduced revenue. Under the alternative baselines, revenue would remain constant while tax rates would increase or decrease, respectively.

The arguments for why tax rates should absorb the majority of fiscal volatility, provided in the previous installment of this report, do not apply to changing long-term growth trends. But neither is there any particular reason to think that the default response to changing long-term growth trends should be changes to future revenue as opposed to future tax rates. Which default response we prefer depends on the metric we wish to use to evaluate the future size of government. Yet both metrics are incomplete. To rationally determine preferences for the future size of government in the face of changing growth trends, we would need information about both the burden taxes impose on the economy (related to tax rates) and the cost of funding the public spending we desire (related to revenue). By definition, an unexpected change in long-term growth trends means that we cannot have accurate information about both future tax rates and future revenue, because the changing growth trend alters the relationship between tax rates levied and revenue generated.

Because neither existing tax-rates baselines nor the alternative baselines discussed in this report of-

fer any clear advantages for responding to changing long-term growth trends, we should choose whichever baseline best responds to short-term fiscal volatility. Not only are the alternative baselines preferable for dealing with economic fluctuations that are clearly the result of short-term volatility, but forecasting officials have also tended to dramatically overestimate the degree to which trends are caused by changes in long-term growth, as opposed to being caused by short-run volatility. Therefore, there is additional reason to err on the side of adopting the baseline that best responds to fiscal volatility.

An alternative baseline tied to revenue targets or spending metrics could be implemented in numerous distinct ways. This section has only attempted to briefly discuss some of the design decisions involved in adopting an alternative baseline. A more thorough discussion will have to wait for future papers.

III. Why the Choice of Baselines Matters

Although it is almost tautological to say that we could not use terms like “tax cuts” or “tax hikes” without a baseline for defining those terms, that notion alone is not enough to conclude that the choice of baselines actually matters. For instance, we might imagine legislatures determining their preferred levels of taxation and spending each year without reference to policy of the previous year. If legislatures determined their tax and spending policies anew each year from scratch — without being influenced by any notions of a policy status quo — the choice of baselines would not influence policy outcomes. Instead of debating about policy changes, such as tax cuts and tax hikes, the political debate would be dominated by the discussion of desired outcomes.

However, “a core feature of humans is that we are highly attuned to changes in our circumstances, not merely the absolute levels.”¹⁶ Any examination of campaign advertisements or political newspaper stories will quickly reveal that political actors at least operate as though labels matter. Rarely do politicians try to convince voters about the proper size of taxation or spending as a percent of GDP. Instead, politicians accuse their opponents of wanting to “raise your taxes,” and the media dutifully reports the number of times a politician has voted for “tax cuts” or “tax hikes.” It is not by accident that the No New Taxes Pledge commits its signers to “oppose any and all efforts to increase . . . tax rates,” rather than committing them to attempt to bring the overall level of taxation to some targeted size.¹⁷

¹⁶Matthew Rabin, “A Perspective on Psychology and Economics,” 46 *European Economic Review* 657, 666 (2002).

¹⁷William Gale and Brennan Kelly, Brookings Institution and Tax Policy Center, “The ‘No New Taxes’ Pledge,” at 4 (2004).

Alternatively, a skeptic might think that voters care only about their individual tax rates and will consider any changes to those tax rates to be “tax cuts” or “tax hikes.” Yet voters repeatedly express strong opinions about tax policy changes that do not affect them directly — as evidenced by the political salience of the debate over the estate tax (or “death tax”) even though that tax affects only a small portion of the voting populace. Moreover, from the perspective of policy outcomes, what matters is which tax changes voters blame on individual politicians and legislators. Voters may dislike their tax rates going up, and they may view that as a “tax hike.” But when tax rates go up without any sitting legislator voting in favor of the tax rate hike, voter anger may remain unfocused and may thus have minimal political impact.

Consider the debate at the federal level about whether the opponents of making the Bush tax cuts permanent are sponsoring tax increases or simply opposing new tax cuts.¹⁸ The answer to that question depends on whether our baseline is current law with the Bush tax cuts extended or current law without the tax cuts extended. Notably, the appropriate label is controversial, with both sides viewing the choice of labels as significant. Also notable is that while many Democrats feel comfortable advocating for the Bush tax cuts to expire, far fewer Democrats are openly calling for taxes to be raised above the pre-Bush levels.

A similar dynamic became a major point of controversy during the 2004 presidential election.¹⁹ Democrats and Republicans proposed different frames for understanding John Kerry’s tax plan. The Kerry campaign claimed they wanted to repeal some of the tax cuts previously enacted by the Bush administration while the Bush campaign claimed that Kerry wanted to raise taxes. Both campaigns were referring to the same substantive policy proposals, but their choice of labels differed, with both parties appearing to believe that their preferred label was politically advantageous for their side. Again, it is worth noting that Kerry called only for repealing previously enacted tax cuts. If labels and baselines were irrelevant, the Kerry campaign would not have had to distinguish between repealing the Bush tax cuts and simply raising taxes.

This discussion of the Bush tax cuts shows that political actors care about the baselines used to measure tax policy and that these baselines are at least sometimes contestable. As Daniel Shaviro argues, “labels can matter even if they are arbitrary

¹⁸See Karen Burke and Grayson McCouch, “Turning Slogans Into Tax Policy,” 27 *Virginia Tax Review* 747, 759-761 (2008).

¹⁹Daniel Shaviro, *Taxes, Spending, and the U.S. Government’s March Towards Bankruptcy* (2006).

and potentially misleading. Thus, politicians fight about labeling a particular provision as a tax increase or a spending cut, even if substantively the classification makes no difference.”²⁰

For another example, although President Reagan’s 1981 tax package slashed the marginal tax rates and introduced new tax incentives for businesses and real estate, many astute commentators have argued that the legislation’s “most significant enduring feature was the elimination of rate bracket creep through inflation adjustments.”²¹ According to Michael Graetz, “these inflation adjustments eliminated the sizeable automatic income tax increases that had been produced even at relatively low levels of inflation. The lasting revenue impact of this change is dramatic — far greater than is generally known.”²²

By indexing the tax code for inflation, the 1981 tax act changed the baseline for determining tax cuts and tax hikes. Before 1981, the default outcome in the absence of legislative action brought additional revenue as inflation moved taxpayers to higher brackets. After 1981, those “automatic tax increases” were abolished and Congress was no longer able to obtain the same yearly revenue increases without explicitly voting to raise taxes.²³ That adoption of a new tax baseline through inflation indexing is thought to have dramatically altered the dynamics of the federal tax policy debate.²⁴

As these examples demonstrate, it has long been understood that baselines and labels matter in politics and that political entrepreneurs are sometimes able to change the previously dominant labels. The advocates of inflation indexing argued for decades

²⁰*Id.* at 221.

²¹Michael J. Graetz, “Tax Policy At The Beginning Of The Clinton Administration,” 10 *Yale J. on Reg.* 561, 563 (1993).

²²*Id.*

²³Before indexing, inflation caused taxpayers’ income to be taxed at increasingly higher rates over time as greater portions of their income moved into higher tax brackets. That effect was so pronounced in the late 1970s that the “change from 1976 to 1981 represented an increase of 23% in the real level of the income tax burden.” Edward McCaffery, “Cognitive Theory and Tax,” 41 *UCLA L. Rev.* 1861, 1896-1897 (1994). By any holistic measure, the level of taxation increased during that period. Yet those changes were not generally viewed as government-sponsored tax increases. “Indeed, the two major Carter era tax bills, the 1977 Tax Reduction and Simplification Act and the 1978 Revenue Act, were each billed, projected, and expected to be tax reductions.” *Id.* at 1897. With nominal tax rates functioning as the tax baseline, the Carter administration was credited with passing tax cuts even though the real level of taxation was increasing. The absence of indexing allowed the government’s revenue intake to rise without Congress or the Carter administration taking significant political heat for passing tax increases.

²⁴Aaron Wildavsky, *The New Politics of the Budgetary Process* at 240-297 (2nd edition, HarperCollins 1992).

that the pre-1981 baseline for the federal income tax was wrongheaded. By 1981 they had finally convinced enough important political actors to have their preferred baselines partially enacted into the federal legislative process.²⁵

Looking outside the tax context for a final example, that payouts from the federal Social Security program are indexed to growth in wages is thought to partially account for the rapid increase in the size of the program as a percent of GDP. When the Bush administration called for Social Security payouts to be indexed to inflation instead, there was uproar over this attempt at “benefit cuts.” In the words of Shaviro:

The choice of a baseline is inevitably arbitrary, or at least subject to differing interpretations. By having the rules they do, however, Social Security and Medicare effectively end any such dispute and dictate the choice of a relatively generous baseline. The Bush Administration learned this the hard way during the 2005 Social Security debate, when it found few takers for its argument that eliminating wage indexing, and henceforth pegging benefits just to the inflation rate, was not really a benefit cut as it would merely prevent them from rising.²⁶

If Congress ignored baselines and redetermined the appropriate size of Social Security benefits each year from scratch, or if voters paid attention only to changes to the actual size of their Social Security payments, the Bush administration’s proposal would have been meaningless. The widespread controversy that surrounded the proposal thus strongly suggests that political analysts believe that the choice of baselines can affect policy outcomes. Again from Shaviro, structural fiscal language — like baselines — functions as “formal rules of the game that participants can manipulate but not openly flout. It tilts and constrains real policy choices, and induces political actors to befuddle themselves even as they labor to befuddle constituencies whose support they need.”²⁷

As the above examples indicate, baselines in the tax and spending contexts are already the subject of considerable debate.²⁸ This report’s unique contribution to the literature on tax baselines is to point out

another arbitrary feature of the baselines we now use for most state and federal level taxes. Currently, the default legislative outcome is for tax rates to remain constant as the economy cycles, even as revenue rises during upturns and fall during downturns. There is essentially no literature discussing this choice of baseline. Yet there are many reasons for thinking that this baseline is partially responsible for states preferring spending fluctuations to tax adjustments as a means of coping with fiscal volatility.

The remainder of this section will briefly discuss two theoretical literatures that provide explanations for why the choice of baselines affects the outcomes reached by the ordinary political process.

A. Positive Political Theory

The first explanation for why the choice of baselines matters comes from positive political theory.²⁹ Our democratic political system — both at the state and federal levels — is characterized by numerous veto points. New legislation cannot come into effect unless passed by both legislative chambers (in the majority of states with bicameral legislatures), with either the governor not vetoing the legislation or else with a supermajority of the legislature overriding the governor’s veto. Moreover, in most state legislatures, there are many additional actors such as committee chairs who can frequently block the adoption of new legislation.

A naïve view of democracy might assume that median voters’ preferences are always enacted into law. Yet each individual legislator and the governor are all elected by a distinct subset of a state’s voters. Predictably, political actors disagree with one another about which policies should be enacted. Legislative proposals thus typically require the support of more than a mere 51 percent majority to become law. A proposal will not become law unless it is either supported by every political actor with the ability to block new legislation or else has sufficient support from other political actors to override attempts to block the proposal.

“Coping with Demographic Uncertainty” (2007), available at <http://wagner.nyu.edu/performance/socialsecurity/demographiuncertainty.pdf>.

²⁹See, e.g., Alberto Alesina, “The Political Economy of the Budget Surplus in the U.S.,” 14 *J. of Econ. Perspectives* 3, 3-19 (2000), at 11 (“The academic literature has pointed out that the fragmentation of a political system is an obstacle to the implementation of the appropriate fiscal decisions, particularly when various shocks require a swift fiscal response. In the most general sense, political fragmentation is a situation in which many political groups have a voice in fiscal decisions, and many have veto power. The point is not that fragmentation necessarily creates budget deficits, but that fragmentation creates obstacles to policy changes, because it becomes more difficult to reach agreements about corrective fiscal measures.”).

²⁵The advocates of inflation indexing were only partially successful in that many important elements of the federal income tax remain unindexed — most notably the alternative minimum tax.

²⁶See Shaviro, *supra* note 19.

²⁷*Id.* at 49.

²⁸For other innovative proposals involving tax and spending baselines, see Leonard Burman, Robert Shiller, Gregory Leiserson, and Jeffery Rohaly, “The Rising Tide Tax System, Indexing the Tax System for Changes in Inequality” (unpublished manuscript on file with the authors); Jason Furman,

(Footnote continued in next column.)

Exacerbating this effect of veto points are agenda-setting powers. Legislatures do not have the time or the resources to fully deliberate over every possible legislative change. Even a new proposal supported by the majority and by all veto players might not become law if time runs out on the legislative calendar.

Looking specifically to tax baselines, all of those effects are magnified in the many states that have adopted tax expenditure limits making it more difficult to raise taxes.³⁰ For instance, in states requiring supermajority votes to raise taxes, the difference between tax changes that need to be voted on and tax changes that come as a result of economic growth are particularly pronounced.

Under a tax-rates baseline, the default policy outcome is for revenue to decline during downturns and to increase during upturns. If the majority wants to depart from that default outcome, it has to get its proposed change through all of the relevant veto points. Hence, even if only a minority of a legislature is strongly opposed to tax increases during downturns, that minority may still be able to have its way, particularly if there is a supermajority requirement for raising taxes or the minority has the support of an important veto player.

In contrast, under a revenue-targets baseline, the default outcome is for tax rates to rise during downturns and fall during upturns. Again, if the majority does not like that default outcome, any proposed change must pass through all the relevant veto points.

Ultimately, a sufficiently strong majority in favor of overturning a default outcome will succeed in enacting its preferences into law. Nevertheless, baselines matter because there is often a range of policy changes that would have the support of the majority of voters but is not supported by political actors wielding veto powers. When one is looking at tax policy specifically, the choice of baselines determines which veto players' preferences are enacted into law. Whichever veto players' preferences are closest to the default option created by the baseline should determine the eventual policy outcome.

Hence, baselines matter because any veto player who prefers the default policy outcome to a proposed change can defeat the proposed change. The majority must refashion its policy proposal so that all veto coalitions prefer the proposal to the default option or else the proposal will not be successful. If we switch the default option from holding tax rates constant to holding revenue constant, a revenue-targets base-

line should thus make tax fluctuations more common and expenditure fluctuations rarer.

B. Behavioral Public Finance

The second literature providing an explanation for why baselines matter is behavioral public finance (also known as political psychology). Hundreds of experiments and field studies have demonstrated that individuals exhibit what is known as either loss aversion, the endowment effect, or the status-quo bias. Those three labels refer to related phenomena — that individuals dislike losses more than they like gains, or that individual preferences are biased toward whatever they view as the status quo.

Many theorists have argued that this phenomenon applies to fiscal policy changes, so that “tax cuts are not nearly as ‘good,’ from the standpoint of the endowment effect and status quo bias, as tax increases are ‘bad.’ So a high-tax baseline for defining changes can increase people’s tax tolerance.”³¹ Most notably, Ed McCaffery and Jon Baron have confirmed that the fiscal policy preferences of experimental subjects are biased in the direction of whatever outcome they perceive to be the status quo.³² Hence, voters are far more likely to punish a politician for raising taxes than for failing to lower taxes.

Of course, just because a change of baselines alters the default legislative outcome does not necessarily mean that it also alters voters’ conceptions of what constitutes the status quo. Even under a revenue-targets baseline, voters might still notice when their tax rates go up.

Just because a change of baselines alters the default legislative outcome does not necessarily mean that it also alters voters’ conceptions of what constitutes the status quo.

Yet voters do not blame all policy changes they dislike on elected politicians. When the Federal Reserve Board increases interest rates, even voters who dislike high interest rates seldom blame Congress for allowing it to happen, despite the fact that Congress could override the Federal Reserve’s authorizing statute at any time. Similarly, under a revenue-targets baseline, even voters who notice their tax rates going up during downturns might come to view those changes as a natural response to evolving economic conditions (or blame the changes on the administrative board enacting the new rates)

³⁰See Ellen Moule and Nicholas Weller, “The Spread of Tax Revolt, the Diffusion of State Tax and Expenditure Limits” (unpublished manuscript on file with author); James Poterba, “State Responses to Fiscal Crises: The Effects of Budgetary Institutions and Politics,” 102 *J. of Political Economy* 799 (1994).

³¹See Shaviro, *supra* note 19.

³²Edward McCaffery and Jonathan Baron, “The Political Psychology of Redistribution,” 52 *UCLA L. Rev.* 1745 (2005).

rather than as tax increases sponsored by the state legislature. Once taxpayers become accustomed to seeing tax rates fluctuate annually, even in the absence of any new tax legislation, they should eventually begin to understand the new baseline. In any case, it is difficult to hold politicians accountable for changes they do not propose. Even voters who want to blame politicians for allowing tax rates to go up may not know which politicians to blame.

Under a revenue-targets baseline, tax rates rise during downturns without any politician specifically needing to vote for a tax increase. There is reason to think voters will be less averse to those automatic tax rate increases than to tax rate increases that are specifically voted on by the legislature — tax rate increases that are clearly “tax hikes” as that term is understood. Hence, adopting a revenue-targets baseline should again make tax fluctuations more common and expenditure fluctuations rarer.

These theoretical explanations for why baselines matter are empirically supported by studies of the “flypaper effect.”³³ The flypaper effect refers to the hypothesis that additional money “sticks where it lands,” so that, for instance, federal government grants to state governments result in more state spending increases than do equivalently sized federal payouts to the state’s citizens. A particularly relevant paper in this literature — by Helen Ladd — looked at the changes to state tax systems that occurred due to the 1986 federal tax reform.³⁴ When the federal government broadened its income tax base, this automatically broadened the income tax bases for those states that tied their income tax base calculations to the federal rules. According to Ladd, the extra dollars states received as a result of the federal tax reform were far more likely to be used to fund increased state spending than would be predicted by a model without framing effects.³⁵

The empirical evidence thus corresponds with the theoretical analysis — baselines matter.³⁶ Although legislatures do not simply follow default policy outcomes, the choice of a default policy outcome exerts

a powerful pull on fiscal policy. By switching from tax rates baselines to revenue-targets (or spending-needs) baselines, states could increase their use of tax rate adjustments and decrease their reliance on spending fluctuations.

IV. Conclusion

As this report goes to press, the states are facing yet another round of budget crises as a result of the ongoing recession.³⁷ Predictably, states have begun slashing funding for a variety of spending programs.³⁸

State budget problems tend to lag declining economic conditions, and the states have a history of using rainy day funds and budgetary gimmicks to muddle through the early parts of a downturn.³⁹ Hence, we do not yet have the data needed to fully analyze state responses to the most recent recession. Still, if history is a guide, state budget conditions will continue to deteriorate even as the overall economy improves. Because the current recession appears dramatically more severe than recent analogs, there is reason to fear the worst.⁴⁰

Evidence suggests that fiscal volatility will become an increasingly pressing problem over the coming decades.⁴¹ This report has proposed one potential solution to the fiscal volatility problem. Undoubtedly, future papers will explore alternative approaches.⁴²

Nevertheless, this round of state budget crises presents an opportunity that should not be ignored. As states reevaluate their fiscal structures, they should be called on to consider long-term approaches for managing fiscal volatility. An effective discussion of these issues should include a discussion of budgetary baselines, and we hope this report will begin a dialogue about the roles that budgetary baselines play in forging a better framework for managing fiscal volatility. As the saying goes, “a crisis is a terrible thing to waste.”⁴³ ☆

³³James R. Hines Jr. and Richard H. Thaler, “Anomalies: The Flypaper Effect,” 9 *J. of Econ. Perspectives* 217 (1995) (summarizing the literature on the flypaper effect).

³⁴Helen F. Ladd, “State Responses to the TRA86 Revenue Windfalls: A New Test of the Flypaper Effect,” 12 *J. of Policy Analysis and Management* 82 (1993).

³⁵*Id.*

³⁶More generally, a sizeable empirical literature has concluded that fiscal institutions matter. James Poterba, “Do Budget Rules Work?” NBER Working Paper 5550 (Apr. 1996) (“Several distinct strands of empirical evidence, from the U.S. federal experience with anti-deficit rules, from U.S. state experience with balanced budget rules, and from international comparisons of budget outcomes in nations with different fiscal institutions, suggest that fiscal institutions *do matter*.”).

³⁷Iris J. Lav and Elizabeth McNichol, Center on Budget and Policy Priorities, “New Fiscal Year Brings No Relief From Unprecedented State Budget Problems,” available at <http://www.cbpp.org/cms/?fa=view&id=711>.

³⁸*Id.*

³⁹Robert Zahradnik, Iris J. Lav, and Elizabeth McNichol, Center on Budget and Policy Priorities, “Framing the Choices,” at 1 (2005), at 5-6.

⁴⁰See Lav and McNichol, *supra* note 37.

⁴¹See Gamage and Bearer-Friend, *supra* note 1.

⁴²For a discussion of alternative solutions for the state of California, see David Gamage, “Coping Through California’s Budget Crises in Light of Proposition 13 and California’s Fiscal Constitution,” in *Proposition 13 at 30*, at 59-65 (Jack Citrin and Isaac Martin, eds.; 2009).

⁴³Fred Shapiro, Freakonomics Blog, “Quotes Uncovered: Who Said No Crisis Should Go To Waste?” Aug. 13, 2009, available at <http://freakonomics.blogs.nytimes.com/2009/08/13/quotes-uncovered-who-said-no-crisis-should-go-to-waste/>.