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Budgeting for Fiscal Stability over the Business Cycle: A Countercyclical Fiscal Policy and the Multiyear Perspective on Budgeting

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This essay is a theoretical exploration of a new budgetary system to cope with fiscal uncertainty and instability.¹ It examines policies requiring positive year-end balances and infers that annual budget cycles lead to a mismatch between the budget cycle and the continuity of public service provision. The author considers a multiyear perspective on budgeting as a potential solution, with countercyclical fiscal reserves to help ensure stability during fluctuating economic conditions. By adopting budget stabilization funds and keeping sufficient reserves, states can better maintain trend-level public services during recessions. Panel data analysis provides empirical evidence that such funds helped stabilize state general expenditures during downturns. The adoption of countercyclical fiscal policy and budget stabilization funds is a step toward a longer-term perspective on budgeting, thus promoting fiscal stability over the economic cycle.

During the 1980 recession, Naomi Caiden wisely warned, “The task of public budgeting has become infinitely more complex, complicated and worrisome. Current budget theory and practice lag behind operational requirements” (1981, 7). Since then, although experiments have been made in practice, theoretical explorations are still lacking. The 2001 recession once again exposed the inadequacies of the current budget system. Stories and news reports of state deficits became almost daily news.² This article attempts to fill in the theoretical gap by contrasting annual and multiyear budgeting policies and practices.

The annual budget format, as a product and achievement of the budgetary reform movement (1890s–1910s), has served state and local governments well. Annual budgeting has been effective at controlling spending and managing financial operations. Its inadequacies have also been evident during the past century. Annual budgeting is not a sufficient device for financial planning, often leading to incurable cyclical deficits, which deprive governments of a means to maintain fiscal stability over the economic cycle. It is now time to launch another round of public budget-

ing reform: extending the perspective of budgeting from a single year to a longer time frame in order to reinforce the planning function. One option that has been suggested is to adopt the multiyear budget format. However, multiyear budgeting relies heavily on accurate estimates of revenues and expenditures. Yet technical errors in forecasting are almost unavoidable, making the multiyear budgeting format an unhandy tool.

The theory of subnational countercyclical fiscal policy paves the way for the extended perspective, hence the wider application, of the multiyear budget. The theory suggests that state and local governments can accumulate fiscal reserves during boom years so that surplus funds are available in lean years to better maintain fiscal stability. This article proposes that well-structured countercyclical fiscal policies and tools be adopted as the core of the multiyear budgeting perspective.

This article focuses on budgeting at the state level. It is organized as follows: The first section examines the annual budget format and analyzes its inadequacies; the second section introduces multiyear budgeting and shows why it is not a viable tool for state and (especially) local governments; the third section introduces the theory of subnational countercyclical fiscal policy and offers empirical analyses of its ability to stabilize state government spending over the business cycle; the conclusion offers policy recommendations.

Annual Budgeting: Heritage of the Budgetary Reform Movement

At the turn of the 19th and the 20th centuries, parallel to the movement for administrative reform, the movement for budgetary reform was initiated in municipalities.³ The latter achieved great success and was soon carried over to state governments. The concept of the *budget* was widely and strongly advocated in the budgetary reform movement to serve three purposes (Willoughby 1918b, 1–5). Politically, the budget was a governance tool used to promote democracy and

curb corruption;⁴ managerially, it was intended to coordinate the legislative and executive branches;⁵ and technically, it aimed to improve administrative efficiency.⁶ In terms of budgetary politics, the annual format or annual reassessment of appropriations with a biennial budget is the means through which the legislature keeps a strong hold on the budget. For good or for bad, budgetary processes will always remain political. Budgetary politics has thrived on the annual format.

Thus, budgets have three major orientations or functions—control, management, and planning (Schick 1966). The control function ensures that public resources (tax dollars) are used to accomplish only—and exactly—the established (budgeted) targets. In the context of the budgetary reform, “the proper function of the budget is . . . the presentation and adoption of a plan in fiscal affairs which will insure the most judicial use of the resources of the state for the purposes most desired by the citizens of the state” (Lowrie 1915). The management function promotes technical and operational efficiency and effectiveness. The planning function facilitates decision making on the objectives and policies (i.e., the acquisition, use, and disposition of the resources) (Schick 1966). This theory of the three functions of the budget remains true even now, though the priority of the three may have shifted in different periods. For example, throughout the budgetary reform movement, effective control of expenditures to curb corruption was the priority, whereas during the government performance review era (mid-1990s), the focus was on the use of management to improve performance (efficiency).

A core tenet of this standard budgetary theory is the concept and practice of maintaining a balanced annual budget (i.e., authorized expenditures must not exceed authorized revenues) (Wildavsky 1978, 502).⁷ The *annual* nature of the budget is made most explicit by Willoughby: “An estimate is made of expenditures . . . required in the due conduct of governmental affairs during a period (*almost universally fixed at one year*)” (1918a, 3; emphasis added). In the context of budgetary reforms, “it shall be the duty of the Mayor . . . in each year to submit to the Council the annual budget of current expenses of the city” (National Municipal League 1899). Furthermore, “the expenditures of the city should be brought into direct relation to its possible or actual revenues and be based on estimates and recommendations emanating from the spending departments” (Willoughby 1918b, 6).

This balanced budget requirement is not strange to us. All 50 states, by their constitution or statute, must balance their budgets.⁸ Since our nation was founded, citizens (taxpayers) have recognized the need to curb government spending within allowable limits and avoid corruption in the expenditure of revenues. The

budgetary reforms undertaken 100 years ago were part of a campaign to rid municipal governments of rampant corruption. The program succeeded in restoring budgetary discipline to governmental finances.

The most important task for financial managers under standard budgeting theory is to achieve structural balance—balancing annual expenditures against annual revenues. Even for states that adopted biennial budgets, the focus stays on the annual balance either by readjusting the biennial plan near the end of the first year or by allocating appropriations into the annual time frame, though the span of planning stretches out one more year (PACH 1950, 25).⁹ The three functions play out around this core of annual balance.

An annual budget cycle has obvious advantages. Spending checks and reviews are conducted on a regular basis (at short intervals) so that the budget as a control system accounts effectively for tax money. Oversight is comprehensive, with internal and external auditing mechanisms set up for the whole government entity, as well as its departments and component units. At the very foundation is the appropriations system, which guarantees financial certainty: Not a single dollar can be spent without an appropriation; once appropriated, the specified dollar amounts can only be spent for the specified purposes.¹⁰ Thus, every aspect of the financing of government is ascertained before the start of operations. It is in this sense that the budget becomes a plan for the whole government entity in the coming fiscal year. Until now, this annual perspective has served state and local governments for a century with numerous successes.

Inadequacies of the Annual Perspective

The term *balance* can be misleading. Conceptually, a pure balance with no surplus or deficit at the end of a fiscal year is not possible because neither revenues nor expenditures activities stop at the end of the fiscal year—that point of time is set for accounting purposes. Government operations (public service provision) constitute an ongoing process. A real balance can exist only in the account book, not in reality.¹¹ On the other hand, balanced budget requirements in state finance laws (including state laws for local governments) prohibit deficits at the end of fiscal years. Thus, by definition, balanced budget requirements do not allow year-end deficits but require that governments end their fiscal years with surpluses.¹² The “balance,” therefore, means *positive* balance (i.e., surplus).

Such year-end general fund surpluses must exist also for a practical reason. The continuous nature of public service provision requires working capital to pay for spending before tax dollars are collected. In this sense, working capital is a lubricant for the government

machinery: Without it, the government has to borrow for imminent expenses; the interest thereof adds to the cost.¹³ Working capital is kept in the general fund and, as such, adds to general fund balance; a zero or a very small surplus in the general fund may indicate the absence of or insufficient working capital.¹⁴

Maintaining structural balance with a general fund surplus on an annual basis is easier said than done, for both political and economic reasons. The political reason is related to the budgetary process, which is “intrinsicly and irreducibly political” (Rubin 2000; Wildavsky 1964). As the literature on public expenditures and budgetary processes has revealed, taxpayers in general have a tendency to demand more public services than their tax payments can support. When current demands are adequately satisfied but the government still possesses extra resources, requests for tax refunds often dominate (Proposition 13 is one example). Elected officials and legislators, following the preferences of voters, also prefer current spending curbs or tax refunds to win elections. Therefore, surpluses are often subject to spending pressure from key players in the budgetary process and are not easy to accumulate or sustain.

The economic reason is related to the business cycle. Imagine there exists a gradually increasing trend line along which both governmental revenues and expenditures move. In normal years, revenues are enough to cover expenditures, with marginal surpluses. During years of national recession or regional downturn, revenues fall short of budgetary estimates and cannot cover the trend-line expenditures necessary to maintain public services as needed. However, public service programs are not supposed to stop when revenues shrink, and the general public is not happy about reduced services at times of critical need. As a result, governments often have to exhaust surpluses to sustain service levels. When surpluses are not sufficient, account books cannot be balanced and deficits result.

Recurring annual deficits have been common among state governments. Table 1 lists the number and percentage of states that ended fiscal years 1979 through 1999 with general fund deficits. Although the percentage is generally higher during and immediately after recessions (1980, 1982, and 1991), some states ended each year of this period with a deficit, even during the record-long economic prosperity of the late 1990s. Two reasons for this phenomenon may be the political and economic ones discussed earlier, which are both rooted in the annual budget format.¹⁵ Therefore, we can conclude that the annual perspective on budgeting, though successful at the control and management functions, falls short on planning. With only one year’s span, the annual budgeting cycle cannot guarantee a balanced budget and makes it more difficult for state and local governments to ensure balanced budgets in the long run or maintain stable spending for necessary service levels during lean years.

Classification of Deficits

Deficits fall into three categories—structural, managerial, and cyclical. Though the distinction among them may not seem important to the ordinary observer, a clear separation of the three facilitates a better understanding of the deficit problem and alternatives for resolution.

Structural Deficits These occur in cases in which the size or amount of the revenue portfolio does not match that of expenditures, so that revenues are not adequate to cover the cost of promised public services. This is linked to the political reason mentioned previously: The service level should be kept within affordable means. The solution for such deficits is either to raise the tax rate (or in the long term, to enlarge the tax base) or lower the service level. Neither is easy, given the nature of budgetary politics.

Table 1 States with General Fund Deficits, 1979–99

Fiscal Year	1979	1980	1981	1982	1983	1984	1985
Number	2	4	9	17	17	14	11
Percentage	4	8	18	35	35	29	22
Fiscal Year	1986	1987	1988	1989	1990	1991	1992
Number	10	9	12	14	18	20	21
Percentage	20	18	24	29	37	41	43
Fiscal Year	1993	1994	1995	1996	1997	1998	1999
Number	13	12	15	15	10	8	11
Percentage	27	24	31	31	20	16	22

Source: Compiled from the *Comprehensive Annual Financial Reports* (CAFR) of the states. For years before each state published the CAFR, the *Annual Financial Report* is the source. Due to differences in the basis of accounting between the two sources, the number of states with deficits in the early, middle, and late periods of the sample years is not comparable.

Notes: A *deficit* is defined as a negative, unreserved, undesignated balance of the general fund. Arkansas, which always reported zero unreserved, undesignated balance, is excluded; therefore, the denominator for the percentage is 49 instead of 50.

Managerial Deficits Even when budgeted annual revenues and expenditures match in size, deficits can still occur as a result of poor financial management—that is, ignoring the control and management functions of the budget. Inadequate control may lead to overspending or spending on unbudgeted targets; mismanagement may cause problems in technical and operational efficiency and effectiveness. The solution for such deficits lies in hiring and empowering qualified, experienced financial managers and tightening day-to-day control and management by enforcing the budget.¹⁶

Cyclical Deficits By nature, these deficits are not a result of structural mismatch or poor fiscal management; they occur even when the budget has been planned annually for structural balance (to avoid structural deficits) and well implemented on a year-to-year basis (to eliminate managerial deficits). They occur because the planned annual revenues are not generated at the expected rate because of a recession—even though demand for some services may increase—with the effect that revenues fall far short of needed expenditures. Mere success at achieving annual structural balance is far from enough to eliminate cyclical deficits. The solution for such deficits requires more than conventional budgeting concepts and practices that focus on annual cycles. Cyclical deficits indicate a failure of the annual perspective of the current budgetary system.

Annual Budgeting—No Cure for Cyclical Deficits

In a generic approach to the deficit problem, states may institute statutory or constitutional balanced budget requirements based on the annual perspective, which can be classified into three categories, each state being bound by one, two, or all three of them. First, the governor must submit a balanced budget to the legislature; second, the legislature must pass a balanced budget; and third, the governor must sign a balanced budget into law.¹⁷ Designed for the annual budget, balanced budget requirements may help directly avoid structural deficits and indirectly harness managerial deficits. Because recessions are unpredictable in timing and strong in magnitude, however, balanced budget

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To be more precise, cyclical deficits occur not because the budget cannot be balanced annually in recession years with drastic fiscal measures such as service reductions, hiring freezes (even layoffs), and tax increases but because these measures, though technically feasible, are “distasteful to taxpayers, uncomfortable with financial managers, and politically risky for elected officials” (Forsythe 1993). Although state governments often have to adopt such measures, as they did in coping with the 2001 recession, cyclical deficits are merely reduced to an acceptable (technically manageable and politically tolerable) level but not eliminated. Furthermore, such drastic measures are procyclical. During recessions, underfunding of public services (when demand is higher than in normal years), tax hikes, and hiring freezes all run counter to citizen preferences and market forces, undermining the effects of expansionary monetary and fiscal policies at the national level.

Tracing the causes of cyclical deficits, economists have found that government revenues and expenditures are two separate lines of activities with distinct features (White 1983). Public expenditures are service driven—they tend to increase when the economy is down and people need extra help from the government. Tax revenues, on the other hand, can be more elastic relative to economic growth, depending on the specific portfolio of the tax structure (Misirolek and Perdue 1987)—states levying all three of the principal types of taxes (personal income, corporate income, and general sales) have a more stable revenue stream, whereas those without a personal income tax suffer from high revenue volatility. Another study reveals that even the same tax structure has inherently different long-run growth

potential and short-run cyclical variability over the business cycle (Sobel and Holcombe 1996). Therefore, the current focus of governmental budgeting on balancing the annual or biennial budget cannot solve the cyclical deficit problem without resorting to procyclical fiscal measures. In

Naomi Caiden’s words, “traditional landmarks fade amidst uncertainty and instability” (1981, 18).

Table 2 Changes in State Balanced Budget Requirements, 1979–99 (Number of States Adopting the Requirement)

	1979	1984	1989	1994	1999
Governor must submit a balanced budget	23	43	44	43	44
Legislature must pass a balanced budget	21	39	38	39	39
Governor must sign a balanced budget	29	29	31	29	37
State may carry deficit over into next fiscal year	11	21	9	11	9

Source: Tabulated from the National Governors Association, *Book of the States*, various years.

A Multiyear Perspective on Budgeting

What is needed to address the cyclical deficit problem is to plan over a longer time span—to aim at maintaining structural balance through the peaks and troughs of the business cycle. This is a fundamental change in the concept of public budgeting. Budget theorists such as Naomi Caiden have long identified as a problem the mismatch between the annual or biennial budget cycle and the continuous nature of many service activities: “[B]ecause annual budgeting uses a static framework to control a continuous and dynamic flow of activities, it may become a source of uncertainty” (1981, 15). Practitioners have firsthand experience with the problem of cyclical imbalance. A former New York state budget director succinctly said that surpluses and deficits, as natural phenomena over the business cycle, cannot be avoided through traditional budgeting (Forsythe 1993). Alice Rivlin, former director of the Office of Management and Budget and the Congressional Budget Office, also sees the necessity of “a longer planning horizon” (1987, 7–8).¹⁸

Against this background, the multiyear budget format began to draw more attention and support from academics (Boex, Martinez-Vazquez, and McNac 2000; Fisher 1997; Forrester 1991; Joyce 2000; Rivlin 1987), as well as professional organizations (Guajardo 2000). Britain began conducting multiyear public expenditure surveys in 1961 (Hecló and Wildavsky 1974, 209). In the 1990s, it was a trend among countries of the Organisation for Economic Co-operation and Development to replace their annual budget processes with a multiyear approach (OECD 1998). More recently, the Government Finance Officers Association reported a success story of transition from the annual to the biennial format by local governments in the United States (Jackson 2002).¹⁹ The Government Performance Project (1998–2002) advocated the multiyear budgeting perspective in assessing the management capacity of state and local governments.

A multiyear budget, simply put, is a financial plan that budgets revenues and expenditures for more than one year.²⁰ So far, a consensus has not been achieved on a uniform or standard definition of multiyear budgeting or on the span, layout, or other technical details, such as adjustment or price volatility. That will emerge only after many more years of practice by many more governments at different levels. Until the technical details are finalized, we may best depict multiyear budgeting as a perspective that aims to rectify the inadequacies of the annual perspective by assuming a longer span of financial planning (as long as five to 10 years) with a focus on achieving balance over the business cycle.

Multiyear budgeting presents some potential benefits. First, the assumption of a longer-term perspective

requires governments to prioritize and express their policy goals explicitly and consistently. Second, current policies have to fit the multiyear fiscal strategy (Boex, Martinez-Vazquez, and McNac 2000, 92). Most significantly, with a longer planning span, a multiyear perspective helps mitigate (if not eliminate) cyclical deficits. No doubt, multiyear budgeting also faces hurdles. The question of how to satisfy budgetary politics, staged annually by legislators, is one that must be answered in order for multiyear budgeting to win legislative support.

The technical foundation of multiyear budgeting is an accurate estimation of future revenues and expenditures (Boex, Martinez-Vazquez, and McNac 2000; Guajardo 2000); however, accurate estimates do not come easily. As a “technically complex and administratively costly tool” (Boex, Martinez-Vazquez, and McNac 2000), forecasts are developed by well-trained, experienced professionals using advanced computing equipment, working with data accumulated over time from many societal components. It is a highly resource- and expertise-intensive enterprise, and the rate of accuracy often is not encouraging. Table 3 provides examples of error rates for state and local governments’ revised estimations for the next fiscal year.²¹ The error rates illustrate the variance between the estimates and actual revenues and expenditures.

Estimation errors come in two types. One is intended protective error—“fiscal conservatism” in the form of underestimation of revenue and overestimation of expenditures by financial managers and executive officials to guard against political pork barreling (Rodgers and Joyce 1996). In table 3, fiscal conservatism is displayed in the positive error rate of the 50-state average of the general fund, as well as total operating fund revenues (actual exceeding estimation) and the negative average error rate on the expenditure side of both funds (actual smaller than estimation). The other type is a technical error in estimation resulting from uncertainty in economic operation and the complexity of forecasting. Although the former may be reduced (if financial managers and executive officials want to keep fiscal conservatism to the minimum), the latter is difficult to avoid.²² Therefore, multiyear budgeting alone cannot furnish the peace of mind that fiscal planners crave. A built-in mechanism is necessary to facilitate fiscal stability in the long term.

Countercyclical Fiscal Policy and Tools

Countercyclical fiscal policy nicely bridges the gap between the need for a long-term perspective on budgeting and the unavoidable (technical) errors in forecasting. Suffering from recurring national and regional financial bumps, states have, in fact, been seeking a longer-term perspective on budgeting, and some of them have approached it, intentionally or unintentionally. Historically, state and local governments have

Table 3 Error Rates of Revenue and Expenditure Estimates, 50 States

Item		1996	1997	1998	1999	Four-year Average
General fund revenue (percent)	Average	4.20	3.83	4.75	3.07	3.59
	Low	-8.10	-7.62	-12.61	-12.39	-11.03
	High	65.63	67.68	64.95	65.67	65.70
Total operating fund revenue (percent)	Average	1.75	3.35	3.94	1.64	2.79
	Low	-11.43	-15.73	-12.77	-12.91	-10.20
	High	29.46	77.64	80.24	41.73	47.23
General fund Expenditure (percent)	Average	-2.03	-1.27	-2.09	-1.33	-1.67
	Low	-23.02	-28.38	-28.61	-29.14	-27.25
	High	14.50	26.30	15.35	13.42	16.62
Total operating fund expenditure (percent)	Average	-4.12	-2.63	-3.56	-4.33	-3.60
	Low	-41.89	-43.27	-43.90	-40.80	-42.23
	High	26.40	29.31	32.70	15.58	24.22

Source: Government Performance Project, State Financial Management Survey, 1998 and 2000.

Note: Error rate=(actual-estimate)/estimate. Positive revenue ratios indicate that actual revenue was larger than estimated (underestimation of revenue), and negative ratios mean that actual revenue was smaller than estimated. Negative expenditure ratios indicate that actual expenditures were smaller than estimated (overestimation of expenditure), and positive ratios mean that the actual expenditures exceeded estimates. Smaller absolute values indicate better accuracy (smaller error) rates.

accumulated surpluses in boom years and then used them in recession years.²³ Variation in the stringency of the balanced budget requirement is another example. On one hand, states require their governors and legislatures to submit, pass, and sign balanced budgets; on the other hand, some states choose to loosen the stringency of the implementation side of the requirements to allow deficits to carry over from the current year into the next budget cycle (table 2, last row). This measure is probably out of practical consideration for ensuring the continuity of public service provision in downturn years, but it reflects the adoption of a more flexible attitude among the states toward cyclical deficits and a change from rigid to more flexible requirements in balancing the annual budget. Interestingly, the number of states allowing deficit carryover increased with each recession and decreased after each economic recovery.²⁴ The rise and fall of this number may indicate, among many other things, that the states have not found a satisfactory solution to the problem but rather have been merely “muddling through.”

Legislators in states that adopt a more volatile tax structure acutely realize the limitations of the annual budgeting process before those in other states. One example is in the finance law of the state of Washington:²⁵ “The current budgetary system of Washington lacks stability. It encourages crisis budgeting and results in cutbacks during lean years and overspending during surplus years.”²⁶

The theory of subnational countercyclical fiscal policy (Gramlich 1987) paved the way for a longer-term perspective on budgeting.²⁷ This theory opposes the use of procyclical fiscal measures because they have a “perverse” consequence: Balancing the budget

annually in such a manner amplifies the fluctuation of the business cycle. The theory advocates the fiscal policy for stability: State governments can smooth the fluctuation of economic cycles by curbing spending during booms in order to accumulate more reserves for expenditure during cyclical downturns.²⁸ Balancing the budget through the business cycle instead of the fiscal year serves as the theoretical basis of the longer-term budgeting perspective.

Two major countercyclical fiscal devices are the general fund surplus (GFS) and budget stabilization fund (BSF). The GFS used to dominate the scene; however, the expenditure limitation and tax revolt movement since the late 1970s, typically represented by Proposition 13, changed the scene. Tax revolts, which are one example of the political pressure on public spending, drastically reduced general fund surpluses. States then increasingly turned to the BSF as a legal haven for countercyclical reserves:²⁹ Enabling legislation for a BSF usually dictates that BSF balances cannot be used except in times of budgetary shortfall with special appropriations.

Effects of Fiscal Reserves

Empirical analysis can provide evidence on whether fiscal reserves helped states during years of revenue downfalls. First, trend expenditures of all 50 states can be obtained using simple regression from their actual general expenditures from fiscal years 1979 through 1999. Then, subtracting actual expenditures from the trends and dividing the differences by the trends yields gaps between the actual and trend lines. The expenditure gaps are positive when actual expenditures were higher than the trend and negative when the actual expenditures were lower than the trend.

Table 4 Regression Results

Dependent Variable: General Expenditure Gap	Below Trend	
	Coefficient	z-stat
Independent variables		
BSF as percent of actual general fund expenditures ($t-1$)	0.654	7.23
Dummy: Presence of BSF ($t-1$)	-0.016	-3.29
GFS as a percentage of actual general fund expenditures ($t-1$)	-0.031	-1.42
Dummy: GFS on MAB of accounting ($t-1$)	-0.002	-0.58
General fund expenditures as a percentage of general expenditures ($t-1$)	-0.058	-1.96
Socioeconomic factors		
Population change in current year over last year	0.009	0.14
Increase rate of real per capita personal income	-0.146	-1.80
Own-source welfare spending as a percentage of general expenditures	0.419	4.77
State unemployment rate as a percentage of national rate	0.003	0.25
Balanced budget requirement dummies		
Governor must submit a balanced budget	-0.000	-0.02
Legislature must pass a balanced budget	0.006	0.87
Governor must sign a balanced budget	-0.011	-1.98
May carry over deficits	0.002	0.35
State economic structure		
Durable goods manufacturing	0.327	1.98
Nondurable goods manufacturing	-0.343	-1.54
Mining	0.061	0.39
Agriculture, forestry, and fishing	0.109	0.44
Construction	0.511	1.78
Finance, insurance, and real estate	-0.113	-0.72
Electronics and equipment	-0.284	-1.32
Government	-0.125	-0.47
State party politics		
Dummy: Party confrontation between governor and legislative majority	0.011	3.61
Dummy: House majority is Democrat	-0.007	-1.41
Dummy: Senate majority is Democrat	0.011	2.20
House dominance by one party	0.003	2.44
Senate dominance by one party	0.000	0.18
Number of observations	1,026	
Censored observations	479	
Uncensored observations	547	
Wald X^2 (94)	523	
Likelihood ratio test of independent equation X^2	2.01	

Note: Results for stage one and fixed effects are not reported.

Regressing real gross state product from 1976 through 1999 against expenditure gaps offers a convenient examination of the cyclical properties of the gaps (see table in appendix), which are positively correlated with the economy (national and regional). When the economy is strong, state expenditures tend to exceed the trend line, presumably because revenues are larger than the amount that has been budgeted. When the economy is down, actual spending tends to fall below the trend because revenues fall short of expectations and accumulated surpluses are not adequate to fill in the gap. The shortfall in both

revenues and surplus funds sets the stage for cyclical deficits to occur.

The empirical test is conducted using the expenditure gaps as the dependent variable and the Heckman sample selection model (Heckman 1979) as the empirical methodology to separate periods of economic downturn from upswings; thus, we examine the effects of BSFs on state general expenditures during recession years. We expect the BSF to present a positive coefficient—that is, the presence of the BSF pushes up state expenditures during a downturn. Control variables include socioeconomic factors, balanced budget requirements, state economic structure, and state party politics (for a list of all explanatory variables and their definitions, see the appendix); these variables are believed to exert strong influences on state spending.

The test produces evidence that the BSF, with an expected positive sign, was an effective countercyclical fiscal device in the three national recessions and several regional downturns that occurred in the period from 1979 to 1999. During economic downturns in the 21-year sample period, when the actual general expenditures of the states fell below their trend lines, each percentage-point increase in the BSF balance as a percentage of general fund expenditures in the previous fiscal year narrowed the negative expenditure gap in the next fiscal year by 0.65 percentage point, all else being equal. The result is highly significant.³⁰

The widening adoption of BSF among the states reflects an ongoing effort by the states—perhaps unintentional—to identify a better budgeting mechanism that extends beyond the annual or biennial cycle. This effort started over half a century ago when the state of New York first adopted the BSF in 1946, followed by Florida in the 1950s. By 1999, finding that the BSF was probably a useful means of achieving long-term structural balance, 39 states had established BSFs. By adopting the countercyclical fiscal policy, these states completed the first step in the conceptual shift from the annual to the longer-term budgeting perspective.

Conclusion: Moving Toward Budgeting for Fiscal Stability

The annual budget format as an achievement of the budgetary reform movement has served state and local governments well for a century by tightening control over spending and strengthening day-to-day financial management. But its one-year span renders it an inadequate tool for financial planning, resulting in cyclical deficits that are insurmountable with the mechanisms available in the traditional budgetary system. As a consequence, state and local governments often have to adopt procyclical fiscal measures in recession years, a fact illustrated during the 2001 recession by hiring freezes, reductions in services, and higher taxes.

The multiyear budget format looks appealing as a way to restore the tripod of the modern budgetary system, but this format is dependent on accurate estimates of revenues and expenditures in the coming years. On one hand, economic forecasts are very resource-intensive (in terms of expertise, time, and equipment), but on the other hand, the inherent uncertainty of economic activity and the complexity of forecasting make technical errors unavoidable (and other technical details are yet to be worked out), creating a barrier to wider adoption of multiyear budgets. This is a conundrum facing contemporary public budgeting.

The theory of subnational countercyclical fiscal policy offers a possible solution. By adopting such a fiscal policy and using effective policy tools, state and local governments can mitigate the adverse effects of forecasting errors, narrow expenditure gaps in recession years, and maintain fiscal stability over the business cycle. At the state level, the policy tool of choice used to be general fund surpluses; since the late 1970s, the budget stabilization fund has enjoyed increasing appeal.³¹

Enabling legislation is a prerequisite for creating budget stabilization funds at the state level. The BSF legislation does much more than create a countercyclical reserve; it institutionalizes countercyclical fiscal policy, lifting the policy to a level above and beyond the whimsical power of single political actor. The policy becomes a permanent feature of the government system. This, in the language of institutionalism, is capacity building. With a well-structured, institutionalized BSF, a state can accumulate high levels of fiscal reserves, which turns the potential countercyclical capacity into *actual* fiscal capacity—and with a higher level of fiscal reserves, a state can better manage public expenditures to deliver services during recessions. This link transforms management capacity into performance (Ingraham, Joyce, and Donahue 2003).

Empirical analysis provides reliable evidence that from fiscal years 1979 through 1999, BSFs increased state expenditures in downturn years by releasing fiscal reserves to fill the gap between current revenues and trend-line public expenditures. States that established a BSF before the 1980, 1982, and 1991 recessions fared better than those that did not; states that established a BSF earlier better weathered recessions better than those that adopted the fund late. Adoption of a countercyclical fiscal policy and establishment of a BSF improved the states' potential and actual management capacity and enhanced the fiscal performance of the state governments during those three recessions.

In practice, these states have switched from the old annual budgeting perspective to a longer-term perspective by instituting a tool to balance funds throughout the business cycle. This is a significant step toward “a new budgetary system more in keeping with the new context of public finance” (Caiden 1981, 18). How did these states weather the 2001 recession? We expect that they performed better than states that did not adopt this fiscal policy and policy tool. Once reliable data are available, detailed analysis will follow.

The policy recommendations are clear. Until all of the technical issues are clearly resolved, multiyear budgeting may best be described as an approach or

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perspective that can improve and enhance—not replace—the annual budget (Boex, Martinez-Vazquez, and McNac 2000; GPP, 1998–2002).³² Crucial features of the approach include but are not limited to (1) shifting the focus from a “technical task” to strategic planning that links long-term goals with the financial planning process (Esser

2000, viii); (2) emphasizing multiyear estimation of revenues and expenditures to reinforce the budget as a financial plan that embeds the government's strategic plan; and (3) adopting a well-structured countercyclical fiscal policy and support device. A longer-term perspective requires much more than merely a countercyclical fiscal policy and policy tool, but the latter is no doubt an important step toward—and an essential component of—the former.

Multiyear budgeting without countercyclical fiscal policy is an unreliable journey. Multiyear budgeting coupled with countercyclical fiscal policy and an appropriate policy tool stresses financial planning and provides a firewall against unexpected events. With such a policy and policy tools, state and local governments can respond positively to expansionary monetary and fiscal policies at the national level. This couplet is budgeting for fiscal stability over the business cycle by state and local governments. It is my belief and hope that equipped as such, state and local governments will be able to better withstand the economic fluctuations of the future.

Appendix: Methodology

Definitions

The *budget stabilization fund* (BSF) is defined as a cross-fiscal year/budget cycle mechanism specifically designed as a countercyclical fiscal device for the government entity, with detailed legal language regarding funding source, purpose, approval for use, and replenishment after fund use. The *general fund*

surplus (GFS) is the unreserved, undesignated general fund balance at the end of the fiscal year, as defined by the Governmental Accounting Standards Board and published in each state's *Comprehensive Annual Financial Reports*. This is the definition adopted by the National Association of State Budget Officers in its *Fiscal Survey of the States*. Both the BSF and the GFS are taken directly from state *Comprehensive Annual Financial Reports* or *Annual Financial Reports* for years before the former report was compiled.

Explanatory Variables

1. *BSF balance as a percentage of actual general fund expenditures on budgetary basis (BSF)*: To fully account for the BSF effect, a dummy variable was designated for the year in which a state established the fund by law. The year of the first balance in the fund and subsequent years after are recorded as 1, and years before the first balance are recorded as 0. This variable identifies two kinds of effects: First, when a state does not have a BSF, the BSF is necessarily 0, and the BSF dummy variable is able to pick up its effects. Second, even after a state sets up the fund and starts putting money into it, low levels of funding and exhaustive use may reduce the fund to a zero balance. This is different from the zero balance of states that do not have a BSF.

2. *GFS as a percentage of actual general fund expenditures on budgetary basis (GSF)*: This variable tests whether the GFS has stabilizing effects alongside the BSF and how large the effects are. A dummy variable for modified accrual basis of accounting (MAB) corrects for any possible distortion by mixing data from the *Comprehensive Annual Financial Reports* and budgetary basis *Annual Financial Reports*. The general fund ratio spots the varying ratios of general fund expenditures against general expenditures across states and fiscal years.

3. *Economic structure (ES)*: The varying composition of state economies contributes to changing levels of state tax revenue within the business cycle, thereby accounting for some fluctuations in state expenditures during recession years. Eight economic sectors were chosen to control for the varying composition of state economy. Six of the eight sectors are procyclical: manufacturing of durable goods; manufacturing of nondurable goods; mining industries; construction; electronics; and agriculture, forestry, and fishing. The government sector is countercyclical because in recession years, more people rely on welfare. The finance, insurance, and real estate sector is insensitive to business cycles.

4. *Socioeconomic factors (SE)*: Four variables were used as controls: (1) rate of population change, that is, the difference between current-year and previous-year population over the previous-year population; (2) own-source welfare spending as a percentage of state general expenditures; (3) rate of increase in real per capita personal income; and (4)

state average monthly unemployment rate as a percentage of the national average monthly unemployment rate. Population change and personal income reflect the demand for public services when the economy is strong; welfare spending and unemployment rate reflect the demand for social services when the economy is on the downside. In both cases, higher demand for services increases state expenditures.

5. *Balanced budget requirements (BBR)*: Four variables were included: (1) governor must submit a balanced budget; (2) legislature must pass a balanced budget; (3) governor must sign a balanced budget; and (4) state may carry over deficits into the next fiscal year. Time-series data of these variables show that state policies on balanced budgets did change over the sample period of this study, implying that controlling for these policies is important.

6. *Party politics (PP)*: Five variables were included: (1) political party confrontation between governor and the majority in the state legislature; (2) Democratic majority in the House; (3) Democratic majority in the Senate; (4) dominance of the House by one party; and (5) dominance of the Senate by one party. The first three are dummy variables. The last two are ratios: The number of seats held by one party is divided by the number held by the other party. Only ratios larger than 1 were used. (For the unichamber, nonpartisan election of Nebraska—49 nonpartisan seats—one was designated as a neutral case with no dominance of either party.) Political variables are an essential factor in studies of finance; exclusion of them could lead to omitted-variable bias.

Panel Data, Fixed-Effects Model

$$\text{Exp Gap}_{it} = \lambda_1 \text{BSF}_{it-1} + \lambda_2 \text{GFS}_{it-1} + \alpha_i + \gamma_t + \beta_1 \text{SE}_{it} + \beta_2 \text{BBR}_{it} + \beta_3 \text{ES}_{it} + \beta_4 \text{PP}_{it} + \varepsilon_{it}$$

$I = 49$ (no Alaska), $T = 21$ (1979–1999)

Cyclical Properties of General Expenditure Gaps, 1979–99

Model	Prais-Winsten Two-Step ^a			
	Without		With	
Year-Fixed Effects	Coefficient	t-stat	Coefficient	t-stat
Constant	0.050	1.33	0.066	3.15
Current GSP	0.102	-2.11	-0.120	-1.99
GSP t-1	0.137	2.83	-0.012	-0.19
GSP t-2	0.171	3.56	0.141	2.43
GSP t-3	0.182	4.09	0.232	4.11
Observations	882		882	
R^2	0.048		0.222	
Adjusted R^2	-0.012		0.156	
DW stat. (original)	0.622		0.790	
DW stat. (transformed)	1.780		1.731	

Regression: $\text{Exp Gap}_{it} = \alpha_i (+ \nu_t) + \beta_0 \Delta \text{GSP}_{i,t} + \beta_1 \Delta \text{GSP}_{i,t-1} + \beta_2 \Delta \text{GSP}_{i,t-2} + \beta_3 \Delta \text{GSP}_{i,t-3} + \varepsilon_{it}$

a. This model is used to correct for first-order serial correlation (AR1).

The lag for BSF and GFS captures the effects of reserves saved in previous years on current expenditures. The Heckman sample selection model was used to calculate the likelihood of a state's spending falling below the trend line and then to test the effects during those years. Variables used to select the sample include—apart from the socioeconomic factors, balanced budget requirements, and state politics—regional economic growth, last year's sector contribution to state gross product (GSP), and state tax structure. It is assumed that if the region had positive growth last year, a state in the region may well have above-trend expenditures in the current year. Along the same line of reasoning, last year's contribution to state gross product from the eight sectors may help explain whether the current-year expenditure is above or below the trend. The three dummy variables for tax structure—personal income, corporate income, and general sales taxes—control for state revenue.

Acknowledgments

This article was completed when the author was working in the Department of Public Administration at Rutgers University–Newark. The author is grateful to that department and colleagues there for their generous research support. The author also expresses sincere thanks to the three anonymous *PAR* reviewers for their invaluable comments on an earlier draft of this manuscript.

Notes

1. The exploration is developed along Naomi Caiden's 1981 proposal for fiscal stability. In Caiden's words, "budgeting processes . . . thrive on stability. . . . The traditional means of coping with uncertainty appear inadequate. . . . Current budget theory and practice lag behind operational requirements" (1981, 6–7).
2. The Business Cycle Dating Committee of the National Bureau of Economic Research determined on July 17, 2003, that the trough of the 2001 recession had occurred in November 2001. Previously, the committee had announced that the peak of the last economic expansion had occurred in March 2001 (see www.nber.org). Though the 2001 recession is "over" at the time of this writing, its adverse effects remain apparent in state finances; detailed reports can easily be found in major newspapers and research sources.
3. The two movements progressed separately. "It was not until the rise of the modern movement for budgetary reform that the connection between the two was seen" (Willoughby 1918b, 13). In this sense, budgetary reform can be viewed as part of administrative reform.
4. "[The budget] at once serves to make known past operations, present conditions, and future proposals, *definitely locates responsibility and furnishes*

the means for control" (Willoughby 1918b, 1–2; emphasis added).

5. "When discretionary powers and authority are increased [to the executive branch], a corresponding increase should be made for controlling and supervising [by the legislative branch] the manner in which these augmented powers are exercised" (Willoughby 1918b).
6. "Government officers should . . . be held to the same standards of efficiency and honesty as . . . in the business world, . . . [where] it is recognized that no undertaking of magnitude . . . can be efficiently administered which does not have a system of accounts and reports" (Willoughby 1918b).
7. According to Wildavsky, the budgeting process repeats itself each year, with the budgeted amount increasing marginally from the previous year on a cash basis.
8. Some studies exclude Vermont from this category; in fact, Vermont has a legal obligation, though the statutory wording is a bit different, to balance the budget.
9. The conferees to the Public Administration Clearing House (PACH) at Princeton Budget Theory Symposium, held in July 1949, pointed out that "the trend has been toward [an] annual state budget . . . [but] there is no magic about a [one-]year period. Stabilization of tax expectance [for businesses] is more important." Furthermore, "longer projections and more frequent reviews by the legislative body are both desirable . . . [though] the longer the projection, the greater is the inertia built up against change in the budget estimates" (PACH 1950, 25).
10. However, to make the budget more operable, managerial discretion is permitted to move and use funds between items, funds, and even accounts. The extent of discretion varies from entity to entity.
11. Arkansas's *Comprehensive Annual Financial Report* reports zero for its unreserved, undesignated balance of the general fund, which is really the result of post-year-end adjustments that reserve or designate surpluses for different purposes. The general fund total balance is not zero.
12. *Surplus* is defined as the unreserved, undesignated balance of the general fund at the end of the fiscal year that is available for appropriation in the next fiscal year. See the list of terms in the *Fiscal Survey of the States*, compiled and published by the National Association of State Budget Officers twice a year.
13. The recurring "spring borrowing" of the state of New York is one example.
14. Some states, such as Florida, keep a separate working capital fund for cash flow; even so, it is reported in the annual financial report under the general fund.

15. Another reason for this phenomenon is management tradition. Specifically, 14 of the 50 states had no deficit years in the sample period. These are mainly southern states (Alabama, Arkansas, Florida, Mississippi, Oklahoma, Tennessee, and West Virginia) and midwestern and western states (Hawaii, Kansas, Montana, North Dakota, and Utah). Exceptions are New Jersey (mid-Atlantic) and Ohio (Great Lakes). Another 14 states had only one to three deficit years. But 11 had 10 or more deficit years, and the rest had between four and nine deficit years.
16. This is an understatement. Managerial deficit is a complex issue that entails separate treatment from many different angles. Partial solutions are also multifarious. The large body of literature on budget reform, bureaucratic behavior, performance budgeting, and measurement sheds light on possible solutions.
17. See the *Book of the States* series, published by the National Governors Association; the Significant Features of Fiscal *Federalism* series, published by the Advisory Commission on Intergovernmental Relations; and NASBO (1992).
18. Here, Alice Rivlin is addressing mainly budget and fiscal policy at the federal level. Her suggestion, this author believes, is applicable to the state and local levels as well. She further points out that although economists still cannot accurately forecast two years in advance, that does not erode the case for multiyear budgets (Rivlin 1987, 7–8).
19. Jackson (2002) reports that a small city recently abandoned the traditional annual budget to embrace a biennial format. In doing so, the city has “improved its strategic planning capabilities and enhanced its overall financial condition.”
20. The Government Finance Officers Association defines the multiyear format as “an operating budget . . . that spans two or more years” (Guajardo 2000)—a very general classification. Boex, Martinez-Vazquez, and McNac (2000, 92) define it as a “multiyear period” without specification. This author argues that a two-year span is obviously not adequate to address the problem of cyclical deficits posed in this article.
21. The state governments surveyed by the Government Performance Project conduct several estimates each year. The last estimate, calculated before the budget is submitted to the legislature, is the final revised estimate and should be the one believed to be most accurate. In the *Comprehensive Annual Financial Reports*, these estimates are reported on the balance sheet of the general fund and compared with actual revenues and expenditures. Error rates reported in table 3 are calculated based on these estimates.
22. In Wildavsky’s words, “given economic volatility and theoretical poverty, the ability to outguess the future is extremely limited” (1978, 504).
23. The Advisory Commission on Intergovernmental Relations, 1979, Report A-70, lists 1957–77 quarterly data.
24. Specifically, in 1979, only 11 states allowed deficit carryovers; after the 1980 and 1982 recessions, the number rose to 21. After the 1988 peak, the number fell to a mere nine but rose to 11 again after the 1991 recession, then fell to nine again after the continuous prosperity of the 1990s. See table 2, last row.
25. Washington is one of the states with a more volatile tax structure. Not levying a personal income tax, the state’s finances rely on sales taxes and several business taxes.
26. See the Revised Code of Washington, Title 43, Ch 43.135.045. This article was adopted in 1981 as part of the enabling legislation for the state’s budget stabilization fund, the Emergency Reserve Fund.
27. Although Gramlich’s theory focuses more on economic stability, it is surely related to longer-term budgeting.
28. Here, I am referring to the weak version of this policy for stability. The strong version includes raising taxes during boom years and lowering them during recessions.
29. Data collected from state *Comprehensive Annual Financial Reports* show that many GFS balances shifted to BSF balances over the 21-year sample period, though the sum of GFS and BSF balances remained at similar levels during the early and late years of the period.
30. The results do not show that the GFS exerted this countercyclical effect in the sample period, as did the BSF (the GFS coefficient is not statistically significant anyway). This is not surprising because much of the GFS in states that had a BSF had already been transferred to the BSF. The negative sign of the BSF dummy reveals the negative effect of zero BSF balances on expenditures.
31. Among metropolitan and large counties as surveyed by the Government Performance Project, however, the general fund surplus remains the primary countercyclical tool.
32. Wildavsky (1978) provides a detailed analysis of the virtues and defects of the traditional budget format.

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