

CHAPTER 13

Public Budgeting and Finance

■ SETTING THE STAGE

From October 1995 to January 1996, Americans watched with a mixture of anger and disgust as President Bill Clinton and the Republican-controlled Congress faced off over the budget. The seeds of the budget crisis were sown a year earlier when, spearheaded by Newt Gingrich (R-GA), the Republican Party gained control of the House of Representatives in the 1994 midterm elections. This marked the first time that Republicans had control of the lower chamber since 1952. When President Clinton submitted his budget to Congress that year, the Republicans declared it dead on arrival.

By the time September came around, the White House and Congress were locked in mortal combat over passage of the federal budget, which is due by law on October 1. As the hours and minutes moved closer to the deadline, President Clinton and the Republicans in Congress only hardened their positions. Clinton called the Republican plan to prevent a shutdown of the federal government “blackmail,” and Gingrich threatened to risk the first default on the national debt to get a budget reflecting Republican spending priorities.¹

As the days passed and still no budget deal was in sight, each side blamed the other for the stalemate. The Republicans released a plan that would require a balanced budget in seven years. President Clinton called this plan “a cynical assault on American values.” He said the Republican plan attempted to wring savings out of Medicare and Medicaid. The Republicans countered that Clinton was making a “last desperate defense of big government, bloated budgets, and deficit spending.”²

As a result of the budget impasse, “nonessential” parts of the federal government were shut down in November. National monuments, museums, and visitor centers at national parks were closed. During the shutdown, 800,000 federal workers, or 40 percent of the government’s workforce, were temporarily laid off without pay.

To a large extent, it was federal employees who bore the brunt of the budget battle between the president and congressional Republicans. Congress and the president set aside their squabbling long enough to pass temporary spending measures, but these were merely stopgap efforts lasting only a few days at a time. On the major issues, Republican insistence on a seven-year plan to balance the budget and Clinton’s resolve to preserve his spending priorities, there was little compromise. The government was partially shut down again in December, around Christmas time. In early January, after the longest federal government shutdown in history, Clinton gave in to the Republican demand for a seven-year balanced budget plan, and the Republicans conceded to Clinton’s spending plan and increased taxes.



Newt Gingrich, Speaker of the U.S. House of Representatives, challenged President Bill Clinton over the 1995 federal budget.

SOURCE: Richard Ellis/AFP/Getty Images

■ CHAPTER PLAN

Except in dramatic instances, such as the struggle between Congress and the White House just described, budgets are seldom the center of public attention. Yet the example underscores the importance of budgets and budgeting to both public administrators and ordinary citizens. In this chapter, we define budgeting and describe the different purposes of public budgeting. Next we explain the evolution of the budget process and discuss four major types of budget reforms: line-item budgeting, performance budgeting, the planning-programming budgeting system, and zero-based budgeting. The next section provides an overview of major revenue systems, followed by a discussion of the rational and incremental models of budgeting. The chapter concludes with a discussion of capital budgeting and debt management.

What Is Public Budgeting?

Public budgeting is the process by which scarce resources are allocated among competing activities and interests in society. These activities range from educating children and fighting crime to finding a cure for cancer. However, since human desires are unlimited while society's resources are not, setting priorities becomes an inevitable part of the process. Therefore in budgeting, there are winners and losers. The "winners" are the groups or individuals whose values and preferences prevail as reflected in larger program and project budgets; the "losers" receive smaller budgets for their programs and projects.

The Purposes of Public Budgeting

Public budgeting serves four distinct but related purposes. First, budgets reflect the policy preferences of elected policymakers at all levels of government. As one budget scholar noted, budgeting "lies at the heart of the political process."³ Whether a municipality prefers education spending more than public safety spending, for example, can be determined by looking at the municipal budget. Similarly, a national consensus for increased defense spending versus domestic spending is reflected in the federal budget. To a large extent, the political values of American society influence governmental decisions on raising and spending money for public services and programs. Consequently, the size of government and its spending levels are often controversial political issues. In addition, there is a broad consensus that taxing and spending decisions should be made only with the approval of the public, and voters demand full accountability of how funds are spent by public officials.

Budgeting's second purpose is to serve as a means by which a government exercises control over the operations of its programs. It is a tool for increasing the efficiency and effectiveness of the delivery of public services. Budgeting sets goals and objectives, measures the progress toward achieving those goals, identifies weaknesses and poor performance, and controls and integrates the numerous activities that are carried out by the various units of government.⁴

Budgeting's third purpose, enhancing economic growth, is primarily a function of the federal government, although increasingly state and local governments make considerable investments to promote economic development. The federal government has had a significant role to play in the national economy since passage of the Employment Act of 1946. Federal policies are chiefly directed toward achieving full employment, maintaining low levels of inflation, and stimulating economic growth. In pursuing those objectives, the federal government uses a combination of fiscal policy and monetary policy. The budget is the chief mechanism to enact and implement fiscal policy, which uses taxes and spending to influence the economy. Monetary policy, which uses control of the money supply and interest rate, is the domain of the Federal Reserve Banking system. State and local governments attempt to use fiscal policy to encourage job growth and increase personal income, sales receipts, and property values.

Budgeting's fourth purpose is to serve as a mechanism for government accountability. Initially, public budgets, particularly at the local level, were designed to ensure fiscal accountability on the part of elected officials. Contemporary public budgeting still asks the question: Does government spend the taxpayers' money in a manner that meets the public's approval and in an honest fashion? However, an important function of budgets today is assessing program effectiveness as well as assuring accountability and expenditure control.

The Budget as a Plan of Action

The budget is a plan of action that links specific tasks with the resources necessary to accomplish those tasks over a definite time period; typically one year, which is known as a **fiscal year**.⁵ At its most basic, the budget is simply a document that reports and keeps track of government spending and

income. However, contemporary budgets are often much more. Budgets as action plans typically evolve through four stages that comprise a cycle, which is discussed below.

Fiscal Year An accounting period covering twelve months; the fiscal year is designated by the calendar year in which it ends.

Budgets may consist of one or several documents. At the federal level, the budget consists of several massive documents. At the local level, it is typical for city councils to approve the budgets submitted by their mayor as a single document. States' budgets vary between one and several documents, with the largest ones consisting of hundreds of documents. Most budgets that are submitted to legislatures contain the executive's budget message, which summarizes the government's priorities for the upcoming year and highlights revenue trends and economic conditions. The executive budget document contains the budget summary and sections on program and department details in addition to the budget message. These sections often include a narrative describing the functions of each program or department and a list of the **objects of expenditure**.

Objects of expenditure The numeric codes used by governments to classify expenditures by categories, such as personnel, supplies, and equipment.

The Budget Cycle

Budgeting occurs in cycles that can extend over a period of several years. The four phases of the **budget cycle** are

1. Preparation of the budget and its submission by the executive to the legislature.
2. Review of the budget by the legislature and approval.
3. Policy execution by the executive branch.
4. Audit by a specialized agency, typically separate from the executive branch.

Budget cycle A process consisting of (1) preparation, (2) legislative review, (3) execution, and (4) audit and overlapping several years.

Although U.S. governments vary in size, many governments retain the key elements of the above model, since they operate on the principle of the separation of powers between the executive branch and the legislative branch.⁶ The budget cycle in a democratic government is thus an important mechanism for

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TABLE 13.1 Line-Item Budget

Item	2003 Budget
Personal Services	
Salaries & Wages—Reg.	\$100,000
Salaries & Wages—Temp.	\$50,000
Retirement	\$15,000
Insurance	\$7,500
Other personal services	\$10,000
Subtotal	\$182,500
Operating Expenses	
Office Supplies	\$5,000
Photocopying & Printing	\$2,000
General Supplies	\$500
Subtotal	\$7,500
Capital Expenditures	
Computers	\$20,000
Total	\$210,000

Performance Budgeting

The first Hoover Commission in 1949, recognizing the importance of Key's observation, recommended that the executive budget become more of a management tool for the federal government. The commission's report to President Harry Truman expressed the view that the budget should be "based upon functions, activities, and projects."⁸ With **performance budgeting**, the emphasis shifts from inputs to government programs and functions, as well as to the tasks performed. Performance budgeting was implemented first in the armed services and was later extended to other federal departments and agencies.

Performance budgeting A type of budgeting that combines output and cost data from programs to show if they are being efficiently operated.

Performance budgets emphasize management by focusing on the efficient accomplishment of agency objectives, and they concentrate on the outputs of governmental activities (i.e., spending and personnel) instead of inputs (see [Table 13.2](#)). For example, in a municipal Streets and Highways Department budget, categories would consist of items such as number of street miles repaired, number of street miles replaced, and number of street signs replaced. The agency collects performance measures on those activities, which are then compared to the costs of performing those activities to determine efficiency in usage of financial resources. An example of this is determining the average cost of repairing one mile of highway. Public officials can use this information to make better management decisions by comparing actual costs to planned costs and performance. Deviations from planned levels suggest problem areas that need to be corrected.

TABLE 13.2 Performance Budget

Planing New Trees

Number of new trees to plant: 200

Cost per new tree to plant: \$50

Total annual cost: \$10,000

Removing Dead Trees

Number of dead trees to remove: 50

Cost per dead tree to remove: \$100

Total annual cost: \$5,000

Total \$15,000

Parks: Tree Maintenance

Summary: The parks department is responsible for maintaining the trees in the city's 10 public parks. Tree maintenance consists of planting new trees and removing dead trees. This year's appropriation request for tree maintenance is \$15,000. Specific performance measure statistics follow:

Parks Department: Tree Maintenance Performance Measures

Thus, the important contribution of performance budgeting, from the perspective of government managers, is to improve agency efficiency by linking performance data with cost data. The resulting performance ratios can then be compared across agencies and within agencies over time to assess efficiency of operations.

Planning-Programming Budgeting Systems

Secretary of Defense Robert S. McNamara introduced the **planning-programming budgeting system (PPBS)** to the federal government in 1961. In 1965, President Lyndon B. Johnson required every federal agency to use PPBS. The system has three basic steps. First, the goals and objectives of the unit are identified and prioritized; the same is done for the programs designed to achieve those goals. Second, a systems analysis capacity is developed that will relate the costs of achieving the goals as measured in outputs. Third, an information and reporting function is created to provide feedback to the system for planning and programming purposes.⁹

Planning-programming budgeting system (PPBS) A type of budgeting that stresses the use of analytical techniques to improve policy-making; the budget format that comes closest to the rational budget decision-making model.

PPBS takes organizational missions or goals and breaks them down into specific objectives and subobjectives, and then groups similar activities into programs that relate to achieving those objectives and subobjectives (see [Table 13.3](#)). For example, the Department of Defense used a classification system called the program structure that grouped nearly one thousand of these activities, known as program elements, together into nine major programs or missions as follows:

1. Strategic Retaliatory Forces
2. Continental Air and Missile Defense Forces
3. General Purpose Forces
4. Airlift and Sealift Forces
5. Reserve and National Guard Forces
6. Research and Development
7. General Support
8. Military Assistance
9. Civil Defense

The program structure grouped similar activities together from different branches of the armed services in order to facilitate analysis across agency lines.

TABLE 13.3 Planning-Programming Budget**ProtectiOn of Persons and Property**

Chief objective: To maintain high levels of personal and property security and to assure a safe and pleasant environment for people who live and work in the city.

Service Area—Police Protection:

To increase public and private safety through street patrol, criminal investigation, and preventive measures.
\$1,500,000

Service Area—Fire Protection:

To increase public and private safety through fire fighting and fire prevention. \$1,000,000

Total \$2,500,000

Another key element of PPBS was its multiyear perspective. Secretary McNamara instituted five-year Defense Plans that projected costs and personnel needs based on the program structure. PPBS required agency analysts to do five-year budget projections and to show the future impact of current programs to aid in multiyear planning.

Despite the considerable effort to implement PPBS at the federal level, it was discontinued shortly after Richard Nixon assumed the presidency in 1969. Few people in Congress and the agencies mourned its demise. In general, there was a lack of understanding and commitment to this type of budgeting on the part of the departmental leadership. It required more specialized and technical skills than many agencies possessed. Furthermore, in certain types of programs (e.g., social services, national defense, public safety) there was considerable difficulty in establishing useful program measures. Although many state and local governments had jumped on the PPBS bandwagon after it was introduced in the federal government in the 1960s, few of these systems were still in place by the end of the decade. Although PPBS never really caught on, it did produce some lasting changes as more state and local governments began to make greater use of program information and quantitative analysis in the budgetary process.

Zero-Base Budgeting

Jimmy Carter first used **zero-base budgeting (ZBB)** as governor of Georgia in 1973; after Carter was elected president in 1976, he applied the technique to the federal government. The main innovation was its systematic consideration of alternative levels of services with their associated costs. ZBB, as practiced by the Carter administration, consisted of three components. First, *decision units* were identified within the agency, which would generate the *decision packages*, or budget requests, including alternative means of accomplishing a goal. Second, three different funding levels were identified for each decision package: (1) the minimum level that provided services below current levels; (2) the current level that maintained services without either an increase or decrease in standards; (3) the improvement level that provided services beyond existing standards. Third, managers ranked the decision packages according to their importance.

Zero-based budgeting A type of budgeting in which a program's continued existence is not assumed, and all expenditures, not just new ones, must be justified every year; the goal is to eliminate unnecessary programs.

Some federal government administrators observed that ZBB focused more attention on agency objectives, generated alternative spending and service levels, and encouraged the use of more quantitative data in budget requests, but overall, the federal government's experience with ZBB was largely negative.¹⁰ Most public officials criticized the huge demands on their time and the mountains of paperwork that was required. For some programs, the identification of a minimal service level was a fruitless exercise because, as in the case of entitlement programs such as Medicare, annual expenditures are set by statute. Thus, changes in budget amounts can be achieved only by altering the enabling legislation. Furthermore, it was difficult to define goals and objectives both for the activities being budgeted and for the organization as a whole.¹¹

ZBB was abandoned by Carter's successor, Ronald Reagan. And ZBB failed to make significant inroads among state and local governments despite considerable interest at first. Few state and local governments

actually attempted anything as ambitious as the federal government did, although ZBB in modified form still survives in twenty states.¹²

Revenue Systems

Government expenditures are made to improve the lives of citizens. Before they can spend, however, governments must first raise money. They do this through various revenue sources, including taxes, fees, intergovernmental transfers, and borrowing. Most of government's general revenues are derived from taxes. Individual and corporate income taxes are the chief source of

federal revenues. The most important tax at the state level is the general sales tax, which accounts for the majority of total revenues. The property tax is the most important tax for local governments, particularly school districts. Fees, or user charges, are becoming increasingly important, particularly at the local level, although in contrast to taxes, fees or charges are typically levied on the users of particular services (e.g., fees for driver's licenses, municipal recreation centers, and hunting licenses). As governments try to avoid raising taxes they increasingly turn to fees for services to replace the lost tax revenues.

Intergovernmental transfers are the funds that the federal government provides to state and local governments, and that state governments provide to their local governments, to help pay for public services. These transfers, or grants-in-aid, reached their peak in terms of dollar amounts in the late 1970s and have declined considerably since then but are still a major source of revenues for state and local governments.

Governments often incur debt to help finance their operations. State and local governments mainly use long-term borrowing to finance capital projects that extend over a period of several years (e.g., dams, highways, bridges, and buildings). They use short-term borrowing to cover deficits in their operating budgets for short periods of time. In contrast, the federal government borrows to finance both its day-to-day operating expenses and capital projects.

Taxes

Several important criteria that must be considered when evaluating taxes are equity, yield, elasticity, ease of administration, and political accountability. Equity refers to the tax's fairness, that is, whether the tax burden is distributed according to the taxpayer's ability to pay. A **progressive tax** is one in which the tax burden increases as a person's income increases (i.e., a wealthy person pays more taxes than a middle-income person does). A **regressive tax** is one in which the tax burden decreases as a person's income increases (i.e., a wealthy person pays proportionately less in taxes than a middle-income person does). A **proportional tax** is one in which the burden stays the same regardless of income level.

Progressive tax A tax in which the ratio of tax to income increases as a taxpayer's income rises.

Regressive tax A tax in which the ratio of tax to income declines as a taxpayer's income rises.

Taxes can also be evaluated on the basis of their yield, or their efficiency in generating revenue. Efficiency is measured by subtracting the costs of administering the tax from the total revenues it produces. Taxes that are relatively inexpensive to administer have high yields, while taxes that are expensive to administer have low yields. The property tax is considered a low-yield tax, while income taxes are considered high-yield. Tax elasticity is related to yield. An elastic tax is very responsive to economic conditions. For example, when per capita income rises, an elastic tax's revenues will also rise. An inelastic tax is less responsive to economic conditions. The federal income tax is an elastic tax, while the property tax is inelastic.

Proportional tax A tax in which the ratio of tax to income stays the same as a taxpayer's income rises.

Ease of administration refers to a number of factors related to tax collection and enforcement. A tax that is easy to understand, in which compliance is not difficult, and where evasion is difficult would rank high on this criterion. Finally, the government should be held accountable by the public for the taxes it employs and how they are administered. Changes in taxes should be voted on directly by the people or by their representatives in the legislature. (See [Table 13.4](#) for the major taxes used in the United States evaluated according to the above criteria.)

Individual and Corporate Income Tax The federal government and forty-three state governments employ some form of individual income tax, which accounts for 31 percent of total government revenues. The individual income tax offers several important advantages as a source of revenues. First, income is generally a good indicator of a person's ability to pay. Thus, using income as a tax base results in a fairer tax. As we mentioned above, the income tax is a progressive tax, which means that a higher-income person's tax burden is greater than someone with a lower income. This system is not perfect, however, since in some cases a person may have a relatively low current income but still possess considerable personal wealth (for example, owning an expensive house). But for the most part, income is closely associated with economic well-being. Second, tax liabilities take into account the personal circumstances of the individual taxpayer. For instance, two taxpayers

may have the same income, but the one with the larger family will actually have a smaller tax burden under a progressive income tax system.

Third, its ability to combine all sources of income, including wages, interest, rent, profit, and royalties, results in a broader base, which avoids the necessity of imposing unacceptably high tax rates in order to obtain a desired level of revenues. Fourth, the income tax ranks high on ease of administration due to the system of employer withholding, in which taxes are deducted from employees' paychecks and sent to the government. Fifth, at the federal level, the income tax is an important tool of economic policy. During periods of economic downturn, income tax rates can be lowered to stimulate aggregate demand and jump-start the economy. When the economy is experiencing high inflation, on the other hand, raising tax rates can slow economic growth and reduce inflationary pressures.

TABLE 13.4 Major Tax Systems Ranked According to Criteria

Criteria	Major Tax Systems
1. Equity	
High (progressive)	Personal and Corporate Income Taxes
Low (regressive)	Property Tax, Sales Tax
2. Yield	
High	Personal and Corporate Income Taxes
Moderate	Property Tax, Sales Tax
3. Elasticity	
Good	Personal and Corporate Income Taxes
Fair	Property Tax, Sales Tax
4. Ease of Administration	
Good	Personal and Corporate Income Taxes, Sales Tax
Poor	Property Tax
5. Accountability	
Good	Sales Tax
Fair	Personal and Corporate Income Tax
Poor	Property Tax

Some negative aspects of the income tax are: (1) it does not include nonwage income sources, such as in-kind services, which increase a person's net wealth; (2) tax revenues are extremely sensitive to changes in economic conditions—a recession results in a significant decline in revenues, which can lead to cutting public budgets; (3) the existence of numerous tax loopholes, often the result of special interest legislation, narrows the tax base and necessitates higher tax rates; and (4) part of the burden of administering the tax is shifted to the employers who must withhold taxes for the government and the individual taxpayers who are required to prepare an annual income statement to determine their total tax payment, which is due on April 15 every year. In addition, unindexed income tax systems are problematic due to bracket creep. This refers to a situation in which tax increases can occur without legislative action to raise tax rates. As a result of inflation, while a person's earnings rise, so do price levels, so that real income remains unchanged. When this occurs, the person is bumped into a higher tax bracket (i.e., tax rate) even though in real terms his or her income stays the same. While the federal government indexes income taxes, many states have not adopted indexing.

Corporate income taxes apply to the profits of corporations minus some deductions. Proponents of the corporate income tax argue that corporations receive special benefits from society and should therefore help pay the costs of government. Further, they assert, if corporate income goes untaxed this creates opportunities for tax avoidance, since taxpayers could reduce their income tax liability by allowing their income to accumulate within the corporation in the absence of a corporate earnings tax.¹³ Opponents, however, believe that taxing corporation income results in a form of double taxation: first corporate income is taxed, and then individual income in the form of stock dividends.

Property Tax The property tax is a form of tax on wealth. The tax is levied on the value of an asset (land and buildings) rather than on current earnings like an income tax. Local governments rely heavily on this revenue source: 32 percent of total local revenues come from the property tax, and it is the chief source of revenues for school districts.¹⁴ The property tax is generally considered regressive, and in many places, it has sparked significant opposition. General dissatisfaction with the property tax helped to launch **Proposition 13** in California and similar tax revolt movements elsewhere (this is discussed more fully below). Various localities were forced to diversify their tax base and to rely more heavily on other sources of revenue, including state aid. School districts are also relying to a greater extent on state aid and less on the property tax. The property tax is predominantly a local tax; it currently accounts for only 2 percent of the tax revenues for state governments.

Proposition 13 The California law passed in 1978 that restricted the property tax rate to 1 percent of market value, touching off a national tax revolt movement.

Since the property tax is not based on a person's ability to pay, individuals on low or fixed incomes often find it difficult to pay their tax bills, especially if, unlike their income, the value of their property keeps increasing. In order to make the property tax less regressive, many states have passed **circuit breaker** laws to provide property tax assistance in the case of low-income or senior citizen homeowners. Typically, a circuit breaker law imposes a limit on the amount of taxes owed, which is usually based on a percentage of income. If the tax paid by a homeowner exceeds this limit, the state refunds the taxpayer the amount of the difference. Circuit breakers help make the property tax less regressive because allowance is made for personal income in determining the tax burden.

Circuit breaker A mechanism that reduces the regressivity of the property tax by exempting low-income elderly and other groups from some portion of their property taxes.

Sales Tax The sales tax is the single largest source of state revenues. Forty-five states impose some type of a tax on sales receipts on purchased goods, and far less commonly on services. In addition, many states authorize local governments to impose their own sales taxes. As a result, sales taxes have become the second largest revenue producer for local governments after the property tax. Sales taxes are levied as a percentage (ranging between 3 and 7 percent) of the purchase price of goods, and are of two types: general (applied to a broad class of products) and selective (applied to particular products). An example of a general sales tax is the tax on general retail sales that many state revenue systems rely heavily on for a large proportion of their own-source revenues (i.e., from sources within the state). The tax on gasoline is an example of a selective sales tax. In addition, a **sumptuary tax** is a selective tax that is levied on certain items, such as alcohol and tobacco, to discourage their use.

Sumptuary tax A selective sales tax imposed on certain items such as alcohol and tobacco, in part, to regulate undesirable consumption.

The general sales tax is regressive because low-income persons spend a greater proportion of their disposable income on consumer goods than do high-income persons. Consequently, poor persons must bear a larger burden of the tax. To make the sales tax more equitable, most states exclude certain “necessities” from the base. All but one state (New Mexico), for example, exclude prescription drugs from the tax, while twenty-seven states exclude food purchases, and thirty-one states exclude utilities.¹⁵

Despite its regressivity, the sales tax retains its popularity among state and local governments because it (1) generates a large percentage (31 percent) of the states’ own-source revenues; (2) is easy to administer, since the tax is collected by merchants at the retail level; (3) substitutes for user fees in some cases (for example, the gasoline tax is an indirect tax for road use); and (4) is easy to hide, since the tax is included in the final price of the good. Further, sales taxes tend to be less unpopular among taxpayers than property taxes and income taxes, since their perceived impact on the pocketbook is less than that of the other two taxes.

State governments could increase the fairness of their sales tax systems and increase the amount of revenues they collect by broadening the sales tax base to include personal and professional services. Equity would be increased because high-income individuals tend to be heavy users of such services. Currently half the states tax services such as auto repair, hair cutting and styling, dry cleaning, printing, and rentals. However, professionals such as doctors and lawyers are still untaxed. Attempts to tax professional services have proven unsuccessful, no doubt because of the opposition of powerful professional groups such as the American Bar Association and the American Medical Association.

Another area of controversy is the taxation of mail-order sales and Internet sales. In the case of mail-order sales, the states have been hindered in their efforts to tax this lucrative market because of Supreme Court interpretations of the interstate commerce clause that restrict the states' ability to tax interstate business transactions. Similarly, the Internet Tax Freedom Act of 1998, which has subsequently been extended, prohibited states from taxing the multibillion-dollar e-commerce market. This act imposes a moratorium on taxing sales that occur over the Internet. Many businesses support the moratorium, but state and local governments are generally opposed to it, because they forego several billion dollars a year in uncollected sales taxes on hundreds of billions of dollars in Internet sales. (See [Vignette 13.1](#).)

VIGNETTE 13.1 **Electronic Commerce and State Sales Taxes**

User Fees

Governments sometimes charge for certain services and privileges, similar to a private sector firm, with the price covering either all or part of the cost of providing the service or privilege. These charges are called **user fees**, and they have become an increasingly important method of government financing, particularly at the local level. User fees, however, are appropriate in only a limited number of cases. They can be used when only part of a community directly benefits from a service, rather than the service directly benefiting the whole community. For example, only people who participate in recreational fishing should pay the fees for a license allowing them to fish in a state's lakes and streams. Another instance when fees can be applied is when it is feasible to exclude some people from using the service. Thus toll booths and gates are a means of restricting the use of certain roads to only those who pay the toll.

User fee A charge for a service (e.g., drivers license, hunting license, parks fees) that is levied by government.

User fees are viewed by public finance specialists as a fair method of obtaining revenues because frequent users, who benefit more, pay more for the service than do infrequent users. In addition, a user charge provides a reliable indicator of the actual level of demand for a particular service in a community, which leads to an efficient allocation of resources. A government can gauge how much to charge for an ice-skating rink or public pool by setting a price and seeing what happens with public demand. If it charges too much, demand will drop; if it charges too little, demand will exceed capacity.

The Internet has pluses and minuses for governments. On the one hand, the Internet can help governments keep in better touch with their constituents, and it is a source of quick information that helps officials do their jobs better. On the other hand, the increasing volume of commerce over the Internet represents a massive drain on state government revenues that adds up to billions of dollars a year.

Since the beginning of the World Wide Web, the Internet has been a rapidly growing source of retail sales. Merchandise sales on the Internet account for over \$100 billion in revenues for retailers. Millions of Americans use the Internet to make online purchases every month. Most of these purchases are not taxed.

In 1998, Congress passed the Internet Tax Freedom Act, which imposed a three-year moratorium on state and local governments' ability to tax commerce on the Internet. The act was extended by Congress in 2001, and in 2004 President George W. Bush signed the Internet Tax Nondiscrimination Act, which again extended the moratorium on federal, state, and local taxes on e-commerce.

The online industry argues that taxing e-commerce hampers the Internet as an engine for economic growth. State and local government officials, however, contend that they are losing tax revenues that could be used to finance important government services, such as public safety and education. In addition, the absence of taxes on the Internet raises issues of fairness. Some consumers are at a disadvantage. A person with the means to buy a computer and Internet access can avoid taxes on a purchase that another person without those means must pay if buying the same good or service from a store.

Businesses that have not gone online also face a disadvantage. For example, a local store selling CDs is required to collect sales tax from customers who make purchases. But CD-sellers over the Internet have a competitive advantage in not having to collect the state sales tax. Therefore they can sell their products at a discount. However, online stores are required to collect sales taxes from consumers in states where the businesses have a physical presence, such as a store, business office, or warehouse. Therefore, retail stores such as Wal-Mart, Target, and Circuit City back efforts by state governments to formulate similar tax rules for all online retailers, which the chains see as a means to level the playing field.

There appears to be increasing consensus among business and government that some type of tax on economic transactions that occur over the Internet is inevitable. However, it is not known how these taxes will be collected. A major complication is that cyber businesses are not restricted by physical location. A business might be headquartered in California, have its server that processes its transactions in Iowa, and ship its products out of a warehouse in New Jersey. Its customers might be all over the world. The old ways of establishing tax liability no longer apply.

SOURCES: Bob Graham, "Should the Internet Be Taxed? Communities Hurt If Web Isn't Taxed," *Roll Call*, February 28, 1999; Matt Grayson, "Erosion of State Tax Bases," *Spectrum* (Fall 1998): 1-4; Michael Moynihan, "Taxing Web Wallets," *New York Times*, June 21, 1999, A15; Matt Richtel and Bob Tedeschi, "Online Sales Lose Steam," *New York Times*, June 17, 2007; Bob Tedeschi, "E-commerce Report: The Battle over Collecting Taxes for Online Sales Turns Acrimonious," *New York Times*, February 17, 2003.

User fees are not feasible when (1) nonpayers cannot be excluded from enjoying the benefits of a service; (2) the service intentionally benefits a low-income population and charges would discourage use; (3) the charges are too expensive to administer; and (4) the service maintains public order or safety (for example, police and fire).



The fees paid at highway toll booths are an example of a common type of user fee.

SOURCE: Peter Titmuss/ Alamy

Lotteries and Gambling

The most common form of legalized gambling activity in the United States is the lottery, a venerable tradition in America. The earliest lotteries were established in the 1600s and were common throughout the country until the late nineteenth century, when scandals led to their being banned by the states and the national government. Today thirty-seven states operate lotteries as revenue generators.

Lotteries offer several advantages to states. First, they are good revenue producers, bringing in between 3 and 4 percent of total state revenues. Second, lotteries are popular among residents, and because they are voluntary, they do not require periodic tax hikes. Third, they help to relieve the pressure on states to constantly increase taxes for costly services. Many states, for example, earmark lottery proceeds for education and other important functions.

These benefits, however, are offset by several disadvantages. One, lotteries are expensive to administer and consequently result in low revenue yields. The costs of administration include paying for advertising, security, high vendor commissions, and prizes that must be kept large enough to attract ticket buyers. Two, lottery proceeds can fluctuate from year to year, which makes it difficult for state governments to budget accurately, particularly in areas where lottery proceeds are earmarked. Three, buying lottery tickets accounts for a higher proportion of a low-income person's earnings, so the lottery is a regressive way for states to obtain revenues.¹⁶

Growing in importance as a means to generate revenues for the states is legalized casino gambling. At one time allowed only in Las Vegas and Atlantic City, casinos have spread to twenty-one states. Viewed by many states as a source of jobs, tourists, and taxes, casinos are nevertheless a mixed blessing for state governments and their citizens. Indeed, opponents of legalized casinos cite a number of moral and social ills that they argue counterbalance any short-term financial rewards. According to opponents, these social problems have economic costs as well, which has led some states to use a certain percentage of gambling revenues for programs to help people deal with gambling addiction and other related problems.

Further, lottery or casino gambling funds that are earmarked for specific public purposes, such as schools, may not be producing the revenue boon anticipated by their proponents. State legislatures, for example, that have earmarked lottery revenues for education have, in some cases, reduced funds for other education programs by equivalent amounts.¹⁷ And in Florida, lottery earnings replace and do not supplement general-fund revenues to education.¹⁸

Tax Revolt Movement

With the passage of Proposition 13 in California in 1978, a grassroots tax revolt movement spread throughout the country. Taxpayer opposition to high taxes and big government fueled the movement. By the time the tax revolt movement began to lose momentum in the 1980s, eighteen states had passed statutory or constitutional limitations on state and local governments' ability to tax and spend, and more than half the states had reduced personal or corporate income taxes or the sales tax. Taxing and spending limitations are typically tied to growth in some economic indicator, such as per capita income or total value of all the private real estate property in a community. Although the movement had significantly weakened by the 1990s, its effects are still being felt by politicians, who are reluctant to raise taxes unless there is a compelling reason to do so.

Tax and expenditure limitations, according to some research, have not produced the intended impact of significantly reducing state spending.¹⁹ In large part, states have avoided reductions in service levels by increasing their reliance on user fees and other revenue sources to replace the lost taxes, as in California's case, or by shifting the tax burden to other groups.

Models of Budgeting

Models and theories help us to understand complex processes such as public budgeting by simplifying the process. Models identify the most important factors and highlight the major relationships between these factors. In this section, we discuss the rational and incrementalist models as applied to budgeting.

Rational Budgeting

In the **rational budgeting** model, budgetary decision-making proceeds according to a logical sequence of steps, as shown in [Figure 13.1](#). The model assumes that the search for budget alternatives occurs within a context of complete and perfect information. Further, the decisionmaker can know all the relevant costs and anticipated benefits of each alternative. Finally, all of the factors that might affect an outcome are identified and quantified, so that analysis can occur within a cost-benefit framework. In short, the rational model makes nearly superhuman demands on decisionmakers. It also assumes that public budgeting occurs in an environment entirely free of politics; in other words, it assumes an environment in which management values always prevail. Despite these unrealistic assumptions, the rational decision-making model has influenced such budgeting reforms as PPBS and ZBB.

Rational budgeting An approach to budgeting that involves (1) selection of objectives, (2) identifying alternatives along with their costs, (3) comparison of alternatives on the basis of achieving the objectives, (4) choosing the best alternative.

Incremental Budgeting

The **incremental budgeting** model was dominant during the period of national economic expansion and virtually uninterrupted government growth from the late 1940s until the late 1970s.²⁰ The basic premise underlying this model is summed up in the following:

Budgeting is incremental, not comprehensive. The beginning of wisdom about an agency budget is that it is almost never actively reviewed as a whole every year in the sense of reconsidering the value of all existing programs as compared to all possible alternatives. Instead, it is based on last year's budget with special attention given to a narrow range of increases over decreases.²¹

Incremental budgeting A model of budgetary decisionmaking that asserts the process is inherently political, that no single group dominates, budgetary changes are marginal and the result of mutual accommodation among diverse interests.

Since decisionmakers do not face an unlimited menu of choices every year, incremental budgeting helps to expedite and order what might otherwise be an impossible task. Incremental budgeting takes the budget base as a given, thus leaving the agency to concentrate on (1) defending the base from cuts, (2) increasing the base by spending more on existing programs, and (3) expanding the base by adding new programs. Finally, the budgetary process is characterized by negotiation, which results in mutual accommodation, with nearly everyone eventually getting something and no single interest dominating all the others all the time.

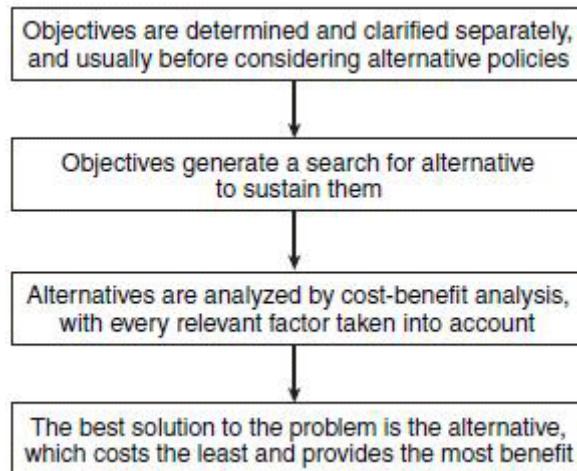


Figure 13.1 Rational Budgeting Model

SOURCE: The Rational Decision Making Model (Source: Robert T. Golembiewski and Jack Rabin, "PPBS: Theory, Structure, and Limitations," in *Public Budgeting and Finance*, 4th ed., eds. Robert T. Golembiewski and Jack Rabin (New

York: Marcel Dekker, 1997).)

Incremental budgeting has been attacked on both descriptive and normative grounds. One study, for example, examined Atomic Energy Commission appropriations and found significant variations in program budgets, although only incremental changes were noted for the total agency budget.²² The study concludes that incrementalism misses significant policy changes by concentrating on the total budget while ignoring the key decisions made at the lower levels. On normative grounds, incrementalists have been criticized for being overly cautious, inherently conservative, and biased against innovative alternatives.²³ This is one of the reasons for the appeal of reforms like ZBB; they attempt to counter the incremental mindset by challenging the notion that there is an untouchable base that does not need to be justified annually.

Capital Budgeting and Debt

At the state and local levels, it is common for governments to divide their budgets into two separate parts, one for operating expenditures (day-to-day expenses of government), and one for capital investments (projects that are expected to have a long useful life). A dam that is built to last for several generations is a capital expenditure, as are airports, police stations, schools, and waste-water treatment plants. On the other hand, wages for personnel, office supply purchases, and purchases of periodicals are operating expenditures. Typically, to be classified as a capital item, a project must be above a certain expenditure threshold and should not need to be replaced for several years. But governments vary in which items are categorized as capital projects. For example, a small municipality might consider the purchase of a police car to be a capital expenditure, whereas a similar vehicle might be classified as an operating expenditure in New York City, with the durability of the car being the key factor. In the small town, the police car can be expected to give several years of good use; in New York City, its expected useful life is probably considerably shorter.

Another important distinction between capital and operating expenses is the method of financing. Borrowing is typically used to finance items on the capital budget, while taxes and user fees are mostly used to finance operating expenditures. A local government that borrows to build a new library is similar to a person who takes out a loan to purchase a new house. In both cases, the buyer incurs a debt that must be repaid over time. In the case of the local government, however, bonds are sold to investors who lend the money to build the facility; in return, the government undertakes the legal obligation to pay the investors the capital and interest out of the municipality's revenues every year.

Types of Debt

There are two types of government bonds: **general obligation bonds** and **nonguaranteed bonds**. The full revenue producing capacity of the borrowing government, including taxes and other revenues, backs general obligation (GO) bonds. In issuing these bonds, the government pledges to pay back the amount borrowed as well as interest by using every revenue-producing means at its disposal. Failure to make debt payments will cause a government to go into default. By contrast, nonguaranteed (NG) bonds do not have this means of financing, but are backed instead by the revenue-producing potential of the facility built by the proceeds of the debt. User charges are typically used to repay the loans. A municipal golf course, for instance, might be financed by revenue bonds that are paid off through the collection of fees from the users. In this way NG bonds have the advantage of making the people who benefit the most from a service also pay for it.

General obligation bonds Long-term debt that is guaranteed by the issuing government's entire revenue generating capacity.

Nonguaranteed bonds Long-term debt in which the principal and interest are paid off using the revenues generated by the facility built with the funds from the bond.

Government securities are given preferential treatment by tax laws. Investors in state and local government bonds do not have to pay federal and state income taxes on the interest on these bonds. This tax advantage is particularly attractive to high-income taxpayers. As a result of the special status of government bonds, state and local governments can sell these bonds at lower interest rates than private debt, which results in a considerable savings for these governments. However, during the early 1980s, many state and local governments abused this tax break, which led to an important change in the federal tax code in 1986. Congress, concerned about the loss of federal revenues, imposed tight restrictions on state and local governments' use of private purpose bonds. As a result, the volume of private purpose bonds issued by state and local governments has declined considerably.



Municipal recreational facilities, such as the swimming pool shown here, are commonly financed using revenue debt.

SOURCE: Bob Daemmrich/ The Image Works

In most state and local governments that have separate capital and operating budgets, there is an effort to develop **capital investment plans** that project capital needs and costs several years into the future, with five years being the typical planning time period. These capital investment plans also serve as an important element in a government's asset management strategy. In many large cities, particularly older ones, deteriorating infrastructure is a major concern. Roads and bridges in an advanced state of disrepair are just two examples of decaying public works that make older cities less attractive places to live and work in. A key component of a

state and local government's asset management plan is an inventory of existing infrastructure that assesses the current condition of facilities and has linkages with the capital budgeting process.

Capital investment plan A long-range plan used by governments to guide their capital investment policies; focuses on the expected infrastructure needs of a jurisdiction and includes costs estimates for projects in the plan.

Federal Capital Budgeting

Unlike every state government and many local governments, the federal government does not separate capital investments from operating expenditures in its budget. In contrast to the accepted financial practice at the state and local government levels, the federal government borrows funds to pay for its current activities. Also in contrast to the state governments, the federal government is not legally required to have a balanced budget. Thus, the federal budget has frequently run a deficit in recent years, as shown in [Table 13.5](#). The accumulation of annual deficits increases the national debt, which is also shown in the table. Furthermore, much of the federal government's expenditures on capital items is concentrated in the area of defense and cannot be considered an investment in the same way that a dam or fire station would be. Defense systems become obsolete when they no longer fulfill their purpose of providing adequate protection from potential enemies. Thus the principle of useful life that applies to state and local government capital projects is not relevant in the case of defense expenditures.

TABLE 13.5 Federal Deficits and Debt, Selected Years, 1970–2005

Year	Deficit (in billions of dollars)	As Percent age of GDP	Debt (in billions of dollars)	As Percent age of GDP
1970	−3	−2.1	283	28.1
1975	−53	−3.4	395	25.4
1980	−74	−2.7	710	26.1
1985	−212	−4.9	1,500	36.5
1990	−221	−3.1	2,411	42.4
1995	−163	−2.8	3,603	49.2
2000	+ 236	−2.4	3,409	35.1
2005	− 318	−2.6	4,592	37.4

Source: The Congressional Budget Office, The Economic and Budget Outlook, Fiscal Years 1998–2007, <http://www.cbo.gov>.

The federal government also invests in capital projects that are designed to stimulate the economy. Every year, billion of dollars in federal grants flow to state and local governments, disguised as capital spending, but for the true purpose of providing economic assistance to those communities. A community might need a new highway less than the jobs and economic spillover that it produces.

In recent years, there have been a number of calls for capital budgeting at the federal level. Supporters of federal capital budgeting believe that it would make the federal government more efficient.²⁴ Capital budgeting can provide a more accurate picture of a government's financial health. From an accounting standpoint, purchase of a physical asset does not represent a "loss," since one asset (money) is exchanged for another (capital item). Only depreciation (the gradual wearing out) of the asset should be viewed as a loss and therefore counted toward the deficit. If only depreciation were included and not the total purchase amount, then the federal government's expenditures would actually be lower. However, the task of preparing a federal capital budget would be more complicated. At the federal level, there is no clear-cut distinction between investment and noninvestment spending. Thus, federal spending on education and job training could be considered capital spending in the sense that they are investments in human capital that help to lower future welfare and criminal justice costs. For instance, in the 1993 budget, the Clinton administration argued that welfare expenditures were human capital investments. But if we take such a broad view of capital spending, what would not be included in the capital budget?

■ Chapter Summary

Public budgeting is a process for determining who gets what in our society. Consequently, it lies at the heart of our political process. Public budgeting serves four distinct purposes: (1) It reflects the policy preferences of our representatives and other decisionmakers; (2) it is the means by which governments exercise control over the operations of public organizations; (3) it is a tool for managing economic growth, particularly at the national level; and (4) it acts as a mechanism for ensuring the accountability of our elected officials. The budget cycle consists of four phases which occur over a period of several years: preparation and submission; legislative review; executive branch execution; and audit. Efforts to improve the budgetary process have led to such historically significant reforms as executive budgeting, line-item budgeting, performance budgeting, the planning-programming budgeting system, and zero-based budgeting. Early budget procedures such as executive budgeting and line-item budgeting focused on centralization and control. Later budgeting systems aimed at bringing more data and systematic analysis into budgeting. However, not all of these reforms have proved successful; PPBS and ZBB were largely abandoned by the national government because of their considerable resource demands.

In order to improve citizens' lives, governments must obtain revenues and make expenditures. The chief sources of revenues in the United States are taxes, but user fees are becoming increasingly important at all governmental levels, while lotteries and legalized gambling are also becoming more significant. The chief types of taxes are property taxes, income taxes, and sales taxes. The important criteria that must be considered when evaluating taxes include equity, yield, elasticity, ease of administration, and political accountability.

Models of budgetary decision-making help us to understand the complexity of the budgetary process. They also serve as guides for reformers in their efforts to improve the budgetary process. The rational model makes certain assumptions regarding budgetary decision-making that are difficult to fulfill in real-life situations. Nonetheless, it is implicitly the model for budget systems such as PPBS and ZBB. The incremental model provides a more accurate description of budgeting but has been attacked on grounds that it is too status-quo oriented. Capital budgeting is important because it draws our attention to the fact that much of government expenditures are investments and that citizens will be receiving benefits from public assets for many years in the future. Capital budgets are financed primarily by debt at the local and state levels, while federal capital expenditures come out of the general budget.

■ Chapter Discussion Questions

In reviewing the four purposes of public budgeting, it quickly becomes apparent that the potential exists for two or more purposes to come into conflict in any particular situation. What should an administrator do when encountering such a situation?

How does the budget cycle serve the objective of ensuring the public accountability of governmental actions?

What are some examples of efforts to increase the managerial effectiveness of budgeting? How might these attempts fare when they come up against the political aspects of public budgeting?

Progressive taxes such as the personal income tax are considered by policy analysts to be fairer than other types of taxes. However, polls consistently show that Americans dislike the income tax as much as the property tax and more than the sales tax (both regressive taxes). What aspects of the income tax might lead to this seeming disagreement between the experts and taxpayers?

Why are most states legally required to balance their budgets every year but the federal government is not? What are some negatives associated with deficit spending? What are the positive aspects of deficit spending?

BRIEF CASE

SCHWARZENEGGER'S BUDGET CRISIS

One of the first things that Arnold Schwarzenegger said publicly after he was elected California's governor in 2003 was: "I'm not going to cut dog food for blind people. It won't happen. I'm not going to take prosthetics from people that have disabilities and all that stuff."²⁵ Why did the former actor utter such things to the news media? California's worst budget crisis in years was the immediate cause for Schwarzenegger's remarks. Upon winning the governorship in a special recall election in November 2003, he inherited a budget gap of \$38.2 billion for the fiscal years 2002–2003 and 2003–2004.²⁶

California's budget crisis did not happen overnight. As a result of the late 1990s economic boom, California enjoyed several years of budget increases. In fact, Governor Gray Davis, the man Schwarzenegger replaced, presided over both record surpluses and record deficits during his term in office. While the state experienced the prosperity of the dot-com boom, California state revenues grew by 44 percent from 1997 to 2001. The state used this newfound money to fund new initiatives, particularly in education. California implemented a class size reduction program and, in general, spent dramatically more for public schools during this time. In addition, the state expanded healthcare coverage for uninsured children, made more college scholarships available, and gave raises to government employees. The governor and the legislature also cut the vehicle license fee by 67.5 percent.²⁷ However, when the economy turned south, the state's government revenue situation began to quickly deteriorate.

The causes for the rapid decline in California's budget fortunes are largely structural. On the one hand, the state relies heavily on the personal income tax, which falls and rises with the business cycle.²⁸ On the other hand, the programs the state spent heavily on during flush times locked it into future spending. "The state put into place wages and programs that committed the state to a certain level of spending that did not correspond to the reality of the situation," according to UCLA economist Christopher Thornberg.²⁹

The governor, legislators, and voters must share equal blame. A poll issued in the summer of 2003, before the recall election, showed the voters' partial responsibility in the state's fiscal woes. Huge majorities of Californians were opposed to spending cuts in public schools (82 percent), health and human services (71 percent), higher education (69 percent), and transportation (61 percent). At the same time, the state's taxpayers opposed increasing taxes to pay for these programs. The poll indicated that the only solution that appealed to a majority of Californians was borrowing. Nevertheless, the poll's director noted that the people are "resentful about the choices they are being asked to make."³⁰

The simple, unavoidable fact is that sacrifice is necessary, despite all the politicians' reluctance to admit this. A state budget expert says, "there are three ways out of the crisis: cutting spending, raising taxes or deferring some cuts through borrowing," all three will be necessary to solve the state's budget problems.³¹ In recognition of this, Schwarzenegger declared a financial emergency shortly after he took office. He traveled around the state, holding campaign-like rallies, to garner support for the drastic measures necessary to bring the state's deficit under control. He criticized the state legislature, in particular the Democratic majority, accusing them of spending the state into a deep hole: "You are all supposed to keep within a budget to make ends meet. But for lawmakers there is a double standard. They go out and spend money they don't have."³² He cut the car tax upon entering office, making good on a campaign pledge, which promptly increased the budget gap by an additional \$4 billion. He then had to cut \$150 million from mostly public health and welfare programs in order to make payments to local governments so that they could keep necessary facilities open and avoid laying off public safety employees.

Brief Case Questions

1. *If you were California's governor, would you borrow money to pay for current spending? Why or why not?*
2. *State polls show that Californians support spending on popular programs while wanting to keep taxes from growing. What can explain this apparent disconnection from reality?*

3. *How might the governor make a successful case for increasing taxes? In your answer, think of a package that might be palatable to the state legislature and the voters.*

Key Terms

budget cycle ([page 302](#))
capital investment plan ([page 320](#))
circuit breaker ([page 312](#))
executive budgeting ([page 304](#))
fiscal Year ([page 302](#))
general obligation bonds ([page 319](#))
incremental budgeting ([page 317](#))
line-item budget ([page 304](#))
nonguaranteed bonds ([page 319](#))
object of expenditure ([page 302](#))
performance budgeting ([page 305](#))
planning-programming budgeting system (PPBS) ([page 306](#))
progressive tax ([page 309](#))
proportional tax ([page 309](#))
Proposition 13 ([page 311](#))
rational budgeting ([page 317](#))
regressive tax ([page 309](#))
sumptuary tax ([page 312](#))
user fee ([page 314](#))
zero-based budgeting ([page 308](#))

On the Web

http://www.rms.net/gloss_govt.htm

Glossary of U.S. budget terms.

<http://www.whitehouse.gov/omb/budget/>

The *entire* federal budget document can be found on this site.

<http://www.cbpp.org/>

The Center on Budget and Policy Priorities, a nonpartisan think tank conducting research and analysis on a range of government policies and programs, with an emphasis on those affecting low- and middle-income people.

<http://www.gpoaccess.gov/usbudget/index.html>

Government Printing Office's Budget Access website, an online portal for all federal budget documents.

<http://www.kowaldesign.com/budget/>

The Budget Explorer is an interactive site that introduces the user to important issues of the federal budget.

<http://www.publicdebt.treas.gov/opd/odpennym.htm>

The federal debt to the penny, maintained by the U.S. Treasury.

<http://www.budgetsim.org/nbs/>

The national budget simulator gives you an idea of the trade-offs that policymakers need to make in creating federal budgets and dealing with deficits.