

# THE ROLE OF FISCAL AND POLITICAL INSTITUTIONS IN LIMITING THE SIZE OF STATE GOVERNMENT

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In many states, tax and expenditure limits constrain government spending. All but one state have adopted balanced-budget rules. Some governors have the power to veto individual budget items (the so-called line-item veto). This article reviews the evidence linking fiscal and political institutions to state taxation, spending, and debt.

It appears that properly designed fiscal and political institutions are effective in containing the growth of state government. Constitutional tax and expenditure limits have been more successful than spending constraints established legislatively. Balanced-budget rules that prohibit deficit carryover to the following fiscal year are superior to rules that allow deficit carryover.

Researchers have identified two other relationships. First, there is evidence that fiscal rules reduce state borrowing costs. Second, the citizen initiative process has played a role in controlling spending: states with a citizen initiative process spend less.

## State Spending and Fiscal Controls

In the United States, state government spending has grown rapidly, nearly doubling since 1995. Population and prices have grown as well, but at a much slower rate. The result has been a significant expansion in real per capita state government expenditures. Although the finances of state governments have improved considerably in the last

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few years, overspending in the 1990s was a major contributor to the fiscal problems that plagued state governments in 2001–03.

Conventional views of government do not offer a justification for fiscal controls. For example, Downs (1957) argues that elected officials provide public services consistent with the preferences of the median voter. From this perspective, politicians act to maximize the net benefits of the median voter and there is no need to limit government. Similarly, Tiebout (1956) contends that businesses and individuals affect the size of government by voting with their feet, leaving jurisdictions with levels of spending they consider too high. In this view, competition between states brings about the right level of spending.

Alternatively, the special-interest view of government (Stigler 1971, Peltzman 1976, Becker 1983) and the Leviathan view (Niskanen 1975, Brennan and Buchanan 1979) predict that the influence of lobbying groups and the behavior of self-interested bureaucrats result in levels of government spending that exceed what the average voter desires. In contrast to conventional views of government, special-interest and Leviathan views place far more emphasis on the role public institutions and rules play in facilitating (and limiting) the growth of government.

Certainly state governments have a role to play in the provision of public goods and services, such as police, courts, and infrastructure. They also play a role in transfer programs. However, there is increasing concern over the growth in state spending. Economists and others worry that excessive spending results in higher taxes that, in turn, stifle economic activity (Barro and Sala-i-Martin 1995 and Engin and Skinner 1996). In the political arena, this concern has been manifested in the various attempts to establish fiscal and political institutions citizens can use to control the growth of state government.

## Fiscal Institutions

### *Tax and Expenditure Limitations*

Tax and expenditure limitations (TELs) are rules that attempt to constrain the growth of a state's revenues or expenditures. Most TELs limit the increase in expenditures to the growth of state personal income or the growth in state population plus inflation. Poulson (2005) reports that 30 states have some form of a TEL limitation. The majority (18) are constitutional, while the remaining (12) are statutory. Statutory TELs tend to be weaker and easier for the legislature to modify or avoid.

The early studies by Abrams and Dougan (1986), Cox and Lowery (1990), and Bails (1990) found TELs to be ineffective in controlling the growth of state government expenditures. However, those studies examined a cross section of states at one point in time. With such limited data, it is difficult to control for all the factors that influence spending.

More recent studies look at states over time. With far more observations, they are able to control for observable and unobservable (using fixed-effects estimators) factors that influence spending. These studies do, in fact, find that TELs reduce state government spending. In examining the effect of TELs, it is important to isolate a political response to a change in voters' attitudes (which may lead to the imposition of a TEL) from the direct effect of a TEL itself. Using an instrumental variables approach, Reuben (1996) finds that the presence of a TEL reduces state spending by about 1.8 percent (partially offset by an increase in local spending). Bails and Tieslau (2000) confirm Reuben's results. Their estimates indicate real state and local expenditures per capita to be \$41 less, on average, in states with TELs.

Poterba (1994) examines the influence of state TELs on the budget adjustment process following an economic downturn. Looking at the 1991–92 recession, Poterba finds that budgets in states with TELs tend to adjust faster. When revenues fall, TEL states are less likely to increase taxes to balance their books. For a \$1.00 budget deficit increase, TEL states increase taxes by \$0.47 while non-TEL states increase taxes by \$1.03. Poterba finds no difference in spending reduction behavior between TEL and non-TEL states; TEL states are more likely to run a deficit than to increase taxes in response to a negative budget shock. Poterba's work suggests that the most effective TELs are constitutional, written by voters, and those that limit spending rather than revenues.

Poterba and Rueben (1999) examine the impact of TELs on general obligation state debt yields. While state general economic conditions and the level of outstanding debt influence the yield, fiscal institutions have an independent influence. Poterba and Rueben examine data from 40 states with significant borrowing during the 1973–97 period. They find that where fiscal institutions are in place to limit expenditures, borrowing costs are an average of four basis points lower. In contrast, limitations that constrain revenue growth result in borrowing costs that are 17.5 basis points higher, on average. Clearly, financial markets react to statutory and constitutional fiscal constraints. With revenue limitations, lenders may fear that state governments would not be able to raise funds needed to service outstanding debt. Expenditure limitations have the opposite effect. They control

the growth of general spending, making it easier to service outstanding debt.

To summarize, recent research indicates that TELs can slow the growth of government. TELs linked to expenditure growth also reduce borrowing costs on public debt.

### *Line-Item Veto*

Governors exert considerable influence over state budgets. Thirty-three governors have line-item veto power. With this power, a governor can eliminate specific items (lines) in the budget without rejecting the entire budget. The line-item *reduction* veto provides the governor with even greater budget policy flexibility. If a governor thinks a program has some merit but considers it overfunded, he or she can reduce the level of funding without canceling the entire program. Eleven governors have item-reduction veto power. When legislators appropriate funds for programs that benefit special interests in their district, these appropriations may differ significantly from what the typical statewide voter would want. The line-item veto gives the governor the legal power to align program allocations with statewide priorities.

Much like the literature on TELs, the early studies on the line-item veto found little impact on spending (Rowley, Shughart, and Tollison 1986; Nice 1988; Alm and Evers 1991). These studies had similar methodological problems. The focus was on cross-sectional analysis; researchers were unable to control for other factors that influence spending.

In contrast, looking at state data over time, Holtz-Eakin (1988) identifies two circumstances under which the line-item veto reduces expenditures. First, spending is lower in line-item veto states where the political parties of the governor and legislature differ. Second, the line-item veto is more effective in states where the majority party does not have sufficient seats in the legislature to overturn a veto. Crain and Miller (1990) find that states with the more flexible item-reduction veto spend less regardless of the political affiliations of the governor and legislature.

Dearden and Husted (1993) present evidence that governors in states with a line-item veto find themselves signing budgets closer to the ones they initially proposed. If the governor's budget proposal more closely reflects the views of the typical voter in a state, this is a desirable outcome. Like Crain and Miller, Dearden and Husted find a stronger impact on spending under the item-reduction veto than the straight line-item veto. Dearden and Husted confirm the Holtz-Eakin

finding that governors are more likely to use the line-item veto when it is sustainable.

The evidence suggests that the line-item veto can control spending. Further, the item-reduction veto strengthens the governor's ability to limit spending without necessarily eliminating a program.

### *Balanced-Budget Rules*

All U.S. states except Vermont have some form of a balanced-budget rule (BBR). In some states, the only constraint is that the governor must propose a balanced budget. In other states, the legislature is required to pass a balanced budget. Neither of these requirements binds officials if a budget deficit may be carried over into the next year (or biennium). Binding BBRs require same-year budget adjustments to correct for unanticipated revenue shortfalls.

BBRs are applied to the general fund in 48 states (Snell 2004); 33 states apply the rule to capital spending; and 30 states apply the constraint to trust funds. Thus, for most states the BBR applies to a significant portion of the budget, but not all of it. This gap may allow officials in some states to shift dollars between different state funds, reducing the tightness of the budget constraint. It is also possible for politicians to use gimmicks such as postponing payments or counting anticipated revenues to avoid necessary adjustments. However, these options are limited and are not large enough to solve a significant and persistent deficit.

Several researchers have examined the effect of BBRs on state spending, finding evidence that strict BBRs limit expenditures (Potterba 1994, Bohn and Inman 1996, Bails and Tieslau 2000). However, in these studies, the characterization of state balanced budget rules as strict or lenient relied on inconsistent self-reporting by state officials, leaving all findings on BBRs in question (Krol and Svorny 2007).

### *Debt Limits*

Forty states have constitutional limits on the amount of general obligation debt that may be issued. The exact limit varies substantially from state to state. General obligation debt is backed by the full taxing power of the state. In most states, debt limits do not apply to non-general obligation debt or off-budget items. Non-general obligation debt and off-budget items are generally repaid by earmarked funds raised by the specific public authority that issues the debt.

Politicians may try to work around debt limits by issuing non-general obligation debt to expand programs. Both Von Hagen (1991)

and Bunch (1991) find evidence to support this claim. Although Von Hagen does not find that debt limits reduce total debt per capita, both researchers find that states with general fund debt limits have a higher ratio of non-guaranteed debt to guaranteed debt. Bunch finds that states with debt limits have more public authorities. For example, states with debt limits are more likely to have a public building authority that can issue non-guaranteed debt.

A variety of mechanisms are used to control debt. Kiewiet and Szakaly (1996) suggest five categories to measure the severity of the debt restriction: (1) borrowing is prohibited, (2) voters must approve borrowing by referendum, (3) borrowing must be approved by a legislative supermajority, (4) debt is limited to some proportion of the revenue base, and (5) no limit at all. They find that states that prohibit borrowing or require a voter referendum have significantly less debt. State revenue-based limits have no significant impact, while limits that require a legislative supermajority result in significantly more debt. Evidently, the power of legislative logrolling offsets the higher vote threshold needed for passage.

Debt limits appear to influence state borrowing costs. There is evidence that states that borrow excessively face higher interest rates. The net effect is that participants in financial markets impose market discipline on the management of state finances.

Goldstein and Woglom (1992) and Bayoumi, Goldstein, and Woglom (1995) test the market discipline idea using state data from the 1980s. After controlling for a wide range of factors that influence state borrowing costs, they find states with borrowing limits are able to borrow at interest rates that are 50 basis points lower. These results suggest lenders in financial market view states with debt limits as less risky, lowering the interest rate risk premium.

### *Budget Stabilization Funds*

Over the last 25 years, budget stabilization funds (or rainy day funds) have become a common fiscal feature of state governments. The idea behind these funds is straightforward. Governments set aside a portion of surplus funds in boom years in order to avoid spending cuts or tax increases during recession years when revenues are low. Currently, 44 states have budget stabilization funds.

The structure of budget stabilization funds varies from state to state. Twelve funds have strict deposit rules that require annual appropriations into the fund or have a formula (based on personal income growth or unemployment) that determines the amount deposited each year. Of the remaining 32 funds, eight impose no

requirements on the legislature to deposit funds. In this case, there is little difference between the stabilization fund and the state's general fund. The remaining funds have rules that require deposits when revenue growth is positive or whenever there is a general fund surplus.

Fund withdrawal rules also vary by state. Five states have a formula that links the withdrawal of funds to the economic performance of the state. Five funds require a supermajority vote in the legislature to withdraw funds. Seventeen states allow the use of stabilization funds to cover shortfalls due to revenue forecasting errors. For the remaining 17 states, funds can be spent at any time. Once again, in this last case, there is little difference between stabilization funds and general funds (Wagner and Sobel 2006).

In order for stabilization funds to ease fiscal adjustment during a recession, they must be large. The National Conference of State Legislatures has suggested funds should be about 5 percent of general fund expenditures. However, most studies suggest the 5 percent rule is too small. Philip Joyce (2001) correctly argues that the optimal size depends upon state revenue volatility. However, Joyce finds little relationship between revenue volatility and the size of state stabilization funds. He concludes that, for many states (especially the most volatile), stabilization funds are too small.

Sobel and Holcombe (1996) approach this issue from a different perspective. They try to determine whether the presence of a stabilization fund reduces what they label "fiscal stress." They define fiscal stress for a downturn as the sum of (1) legislated tax increases, plus (2) the decline in expenditures from long-run trend as a percentage of the pre-recession budget. After controlling for other factors that could influence fiscal stress, Sobel and Holcombe find that the simple presence of a stabilization fund had no significant impact on reducing fiscal stress during the 1990–91 recession. They do find that states that require deposits be made into the fund experience less fiscal stress, suggesting the size of the fund may be important. They also try to calculate the stabilization fund size needed to avoid fiscal stress. Based on their calculations, they conclude that most fund balances are too small.

These studies suggest that adopting a stabilization fund is not enough. To have a significant impact on fiscal policy during economic downturns, the balances in these funds need to be substantial.

The presence of state stabilization funds raises the question of whether these funds increase total state saving (stabilization fund balance plus general fund balance). Given the fungible nature of the dollars in stabilization and general funds, deposits in the stabilization

fund may replace surplus funds in the general fund. In other words, the two funds may serve as substitutes for each other.

Knight and Levinson (1999) and Wagner (2003) investigate this issue. Both examine the impact of a stabilization fund on total state saving per capita. In both papers, total saving is defined as the sum of the general fund balance and the stabilization fund balance divided by population. Knight and Levinson find total saving increases roughly dollar for dollar suggesting little substitution between the two accounts. Wagner argues that Knight and Levinson incorrectly detrend some of the data. After correcting for the trend properties of the data, Wagner finds a high degree of substitutability between the two funds. He finds general fund balances decline by about 50 cents for each dollar deposited in the stabilization fund. This result suggests a more modest increase in total state saving as a result of establishing stabilization funds, weakening their ability to reduce fiscal stress during a recession.

The conventional view of the rise of stabilization funds in the 1980s was that they were a response to the fiscal stress brought on by the severe recession in the early 1980s. However, Wagner and Sobel (2006) have an alternative, cynical, explanation. They point to the growing number of tax and expenditure limitations that reduced politicians' control over how surplus funds were to be used. Because dollars in the stabilization fund are not subject to the expenditure limitation, these funds may allow politicians to circumvent the efforts of voters to limit the growth of government.

Wagner and Sobel find that bad economic times did, in fact, increase the likelihood that a state would adopt a stabilization fund. However, consistent with their hypothesis, the existence of a TEL was the most important factor contributing to the adoption of a statutory stabilization fund.

Using several decades of data, beginning in the 1970s, Wagner (2004) examines the impact of stabilization funds on state borrowing costs. Controlling for economic factors that influence the yield on general obligation state debt, he finds the introduction of a stabilization fund lowers general obligation debt yields by almost 10 basis points. More importantly, states with stabilization funds that have strict deposit and withdrawal rules experienced a much larger, 33 basis point, reduction.

In summary, on the positive side, state stabilization funds have a limited ability to reduce fiscal stress. Stabilization funds with strict deposit and withdrawal rules lower borrowing costs. But the motives behind these funds may be less than noble as, to some extent, they

crowd out general fund surpluses, shifting money out of the reach of tax and expenditure limits.

## Political Institutions

### *Citizen Initiatives*

The initiative process gives citizens the right to propose and approve laws without the consent of a state's elected officials. While citizen initiatives are not, strictly speaking, a fiscal institution, they have the potential to influence the size of government and policy.

Twenty-four states and approximately half of all cities have an initiative process (Matsusaka, 2004). Initiatives can be directed at introducing or changing both statutes and constitutional amendments.

Matsusaka (2004) argues initiatives can have a direct and indirect impact on policy. Where the initiative process overrides poor or unpopular decisions of elected officials, the impact is direct. Indirectly, the citizen initiative process represents a threat that can cause elected officials to choose policies that are generally more consistent with the will of the people. However, initiatives can be a double-edged sword in regards to limiting the growth of government. Initiatives can be approved that expand the size and role of government. For example, Colorado's Amendment 23, which passed in 2000, requires K–12 education spending to increase by enrollment growth and inflation plus one percentage point each year.

Matsusaka (1995, 2004) examines the impact of the initiative process on spending at the state and local levels in the United States. He finds state and local spending is 4 percent lower in initiative states than in noninitiative states for the 1970 to 2000 period. He provides evidence that suggests a shift in spending away from the state to local governments in initiative states. In addition, there is evidence that taxes are shifted away from broad-based taxes to user fees.

Evidence from Switzerland is consistent with these results. Feld and Matsusaka (2003) look at the effect of mandatory spending referendums and initiatives on spending in Swiss cantons. Swiss citizens vote on new spending programs whenever they exceed a predetermined spending threshold. They find spending is as much as 19 percent less as a result.

Additional evidence provided by Feld and Kirchgassner (2000) suggests that initiatives can improve the efficiency by which public goods and services are provided. In Switzerland, the cost of public services, such as garbage collection, is 20 percent lower because of

the initiative process. This may be due to the fact that initiatives are a strong counterweight to the influence of public unions.

There is also evidence that supports the notion that the constraints imposed on politicians by the citizen initiative process produce a more efficient level of government spending. As a result, private sector productivity and output is higher. Blomberg, Hess, and Wewerapana (2004) find this to be the case for U.S. states. Feld and Sevioz (1997) find this to be true in Switzerland as well.

To sum what we know, governments in initiative jurisdictions produce services cheaper, spend less overall, and substitute user fees for broad-based taxes. With constraints on government spending, the private sector is more productive.

### *Term Limits*

Oklahoma was the first state to approve legislative term limits, in 1990 (Basham 2001). Since that time, an additional 17 states have approved legislative term limits. Without term limits, lack of political competition makes incumbent reelection nearly a certainty.

Peltzman (1992) argues when there are no term limits, constraining the level of taxes and spending can improve a politician's reputation, and increase his or her chance for reelection. Term limits can change the incentive structure facing a politician. A term-limited politician can be expected to exert less effort toward reputation building because the payoff is less. As a result, taxes and spending may be higher if a politician faces a binding term limit.

It remains an empirical question as to whether the presence of term limits (legislative and gubernatorial) have had the desired effect of slowing the growth of government spending and taxes. A second question is whether the impact of term limits is the same for legislators and governors.

Owings and Borck (2000) examine the impact of professional legislatures on spending. They differentiate between professional and citizen legislatures. Professional legislators receive high pay, have large staffs, and have little or no outside income. Citizen legislators receive low pay, have little staff, and have significant outside income. These two organizational forms differ in two important respects. Owings and Borck find that professional legislatures, with more resources, produce more legislation. As a result, government spending increases. They find that citizen legislatures have higher turnover, reducing logrolling opportunities (logrolling or vote trading rises with tenure), which should reduce the number of pork-barrel projects in the budget.

Owings and Borck examine the impact of what they call “professionalism” on real per capita spending at the state level. Their index of professionalism takes into account legislators’ compensation, expenditures on staff, and the length of the legislative session. They find increases in legislative professionalism result in significantly higher spending. A one standard deviation increase in the professionalism index increases spending between 7 and 10 percent annually. This is consistent with the view that there is more pork-barrel logrolling and a greater chance of being captured by special interest groups in professional legislatures.

In a more recent paper, Erler (forthcoming) examines the impact of term-limited legislators on spending and taxes. Looking at the 48 lower states (she drops Nebraska because of the unicameral structure of the legislature) using annual data for the period 1977 to 2001, she finds spending per capita to be significantly higher than average by \$53 under term-limited legislatures.<sup>1</sup>

Erler’s results differ from Owings and Borck’s for two reasons. First, rather than using an index of legislator professionalism, she constructs a dummy variable that takes on a value of one starting in the legislative session before legislators are term-limited out of office. This is the legislative session when spending would likely increase because of weaker reputation effects and the resulting more decentralized structure of legislatures under term limits. Second, the data sets are different. Owings and Borck use data from the years 1964, 1974, 1984, and 1994. Since most term limits were passed between 1990 and 1994, their data set does not capture the impact of term limits very well. Erler’s data are not subject to this problem. As a result, Erler’s results are more credible.

Besley and Case (1995) investigate the impact of gubernatorial term limits on state taxes and spending. The reputation model predicts that politicians will limit spending and taxes in the first term, to increase their chances of reelection for a second term. However, once reelected and subject to a term limit, the incentive may be to let their reputation deteriorate, reducing the incentive to control spending and taxes. Of course, this incentive may be partially or fully offset by political party goals, the desire to seek another elected office, or because governors lack complete control over the budget.

Besley and Case find that governors working under a term limit tend to tax and spend more. For example, income taxes are \$9 higher

<sup>1</sup> Erler also finds average tax rates lower in states with term limits. She argues it is harder to form majorities necessary to pass tax increases under term limits.

per capita under term-limited governors. Spending is \$15 higher per capita. Controlling for political party, only Democratic governors appear to raise taxes and spending in their second term. The increased variability of spending and taxes brought on by term limits increases uncertainty, making private investment and consumption decisions more difficult to plan. The inefficiency introduced from this fiscal cycle can slow economic growth.

Johnson and Crain (2004) find the same pattern in taxes and spending at the national level (they look at data from 48 countries). Both taxes and spending are higher when an executive is subject to term limits. The evidence indicates term limits can result in higher levels of government spending. In addition, governors, especially Democrats, tend to tax more while legislators tax less when faced with term limits.

## Lessons Learned

The evidence discussed in this article indicates that properly designed fiscal and political institutions can slow the growth of state governments. Empirical evidence points to the following options for those interested in limiting state government spending:

1. *Tax and Expenditure Limits.* Recent evidence indicates TELs can slow the growth of government. TELs linked to expenditures also reduce borrowing costs on public debt.
2. *Balanced-Budget Rules.* Aim for rules with no carryover provisions and that apply to the entire budget (rather than just the general fund).
3. *Gubernatorial Budget Veto Power.* Item-reduction veto powers are more effective than simple line-item powers in limiting government.
4. *Citizen Initiatives.* The availability of citizen initiatives appears to shift power from legislators to voters, offsetting forces that would otherwise cause state government spending to expand.

There is also evidence suggesting the types of economic and political institutions that may not meet the budget reduction goals of reformers:

1. *Budget Stabilization Funds (Rainy Day Funds).* These types of funds can reduce fiscal stress and borrowing costs but may be tools to get money out of general funds where it is subject to TELs.
2. *Term Limits.* Evidence on legislative and gubernatorial term

limits suggests they result in higher levels of government spending. The evidence on the impact on taxation points toward lower taxes with legislative term limits and higher taxes with gubernatorial term limits.

There are many forces causing governments to grow. Public unions, in particular, favor weak limits on government spending. Fiscal and political institutions appear to be tools that voters and policy-makers can turn to if they want to constrain taxes and spending.

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