Institutions and State Spending

An Overview

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U.S. fiscal policy at the federal, state, and local level is on an unsustainable path.[1] Although reformers look for ways to reduce spending on particular budget items, tomorrow's legislatures may easily reverse these cuts. In contrast, a change in the rules that govern the political process—the "institutions" that shape a budget—can have a lasting effect on spending for years to come.[2] Codified in statutes and in constitutions, these institutions include the rules of budgeting, electioneering, and legislating. They influence the decisions of legislators, governors, presidents, bureaucrats, voters, and even lobbyists. Institutional reform can be a more effective and sustainable path to fiscal probity than a one-time budget cut. In this article, we summarize the empirical investigations of more than a dozen state-level institutions. The lesson for both state and federal policymakers is that a number of institutional reforms are more likely to put spending on a more sustainable path.

The Laboratory

Justice Louis Brandeis famously referred to the federal system as a "laboratory" in which each state is free to implement novel social and economic experiments

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1. For past state spending, see Mitchell 2010a. For future state spending, see Miron 2011. For future federal spending, see U.S. Congressional Budget Office 2011.

2. The Nobel Laureate Douglass North is often considered the father of modern institutional economics. In his terms, institutions "are the humanly devised constraints that shape human interaction" (1990, 3).

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(*New State Ice Co. v. Liebmann,* 285 U.S. 262 [1932]). For the social scientist interested in understanding how institutions affect policy outcomes, the metaphor is apt. Each of the fifty states has its own set of institutions, some of which have changed over the past several decades. At the same time, many other factors that might influence outcomes do not vary across the states. In other words, cross-state studies effectively control for factors such as macroeconomic conditions, culture, and the broad legal/constitutional setting in which each state operates. Moreover, researchers can employ various econometric techniques to control for the influence of factors that *do* differ across states, such as climate and demographic makeup. In sum, the state setting provides a rich laboratory in which to test the effect of different institutions on spending.

Many researchers have performed such tests. Here we review this literature, summarizing the effect of sixteen institutions on state spending.[3] We concentrate on peer-reviewed studies that rely on large data sets and well-accepted econometric techniques. Each of these studies carefully accounts for other factors that have been shown to affect spending, such as demographic makeup, climate, and the economy.

We begin with some of the most-studied institutions (strict balanced-budget requirements), move on to those that have received comparatively less attention (for example, item-reduction vetoes), and conclude with a pair of institutions whose study has yielded conflicting conclusions (direct democracy and term limits). Where possible, we present the findings in terms of the institutions' effect on spending per capita and convert all dollar amounts to 2008 dollars to permit side-by-side comparison. We hope that this overview will provide useful insights to state policymakers who may be interested in reform. We also hope that it will be helpful to federal policymakers because many of these institutions may be transferred to the federal level.

Figure 1 highlights the results of the studies that present their findings in terms of spending per capita. To put some of these figures in perspective, state and local expenditures per capita in 2008 averaged approximately $5,708.[4] Thus, the studies we review suggest that these institutions can decrease spending per capita from 1 to 22 percent. Justice Brandeis's "experiment" clearly has yielded economically significant results.

Sixteen Institutions and Their Effects on State Spending

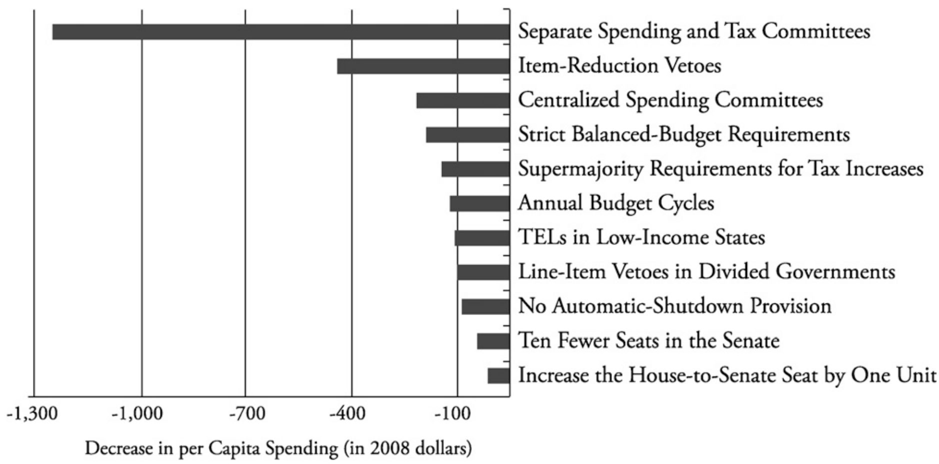
1. Strict Balanced-Budget Requirements

With the exception of Vermont, every state has a balanced-budget requirement, but the stringency of these requirements varies widely. For example, in some states the governor must submit a balanced budget, but the legislature need not pass one. In other states, estimates of the enacted budget need to show balance, but

3. Though we focus on the effect of institutions on spending, a larger literature focuses on the effect of institutions on a wide variety of policy outcomes. For a review of this larger literature, see Besley and Case 2003.

4. Our calculation, using figures from U.S. Census Bureau 2010a and 2010b.

Figure 1
The Marginal Impact of Institutions on per Capita Spending



Note: We have converted all figures into 2008 dollars.

Sources: Crain and Muris 1995 (separate committees, centralized spending committees); Gilligan and Matsusaka 1995 (Senate seats); Besley and Case 2003 (line-item vetoes in divided government); Crain 2003 (item-reduction vetoes, supermajority requirements for tax increases, annual budget cycles, TELs in low-income states); Primo 2007 (strict balanced-budget requirements, shutdown provision); Chen and Malhotra 2007 (House-to-Senate ratio).

there are no consequences if these estimates prove wrong at the end of the fiscal year and the actual budget is not in balance. In some states, the legislature may carry over a deficit from one year to the next, but in others they may not. Finally, in some states an independently elected Supreme Court is the ultimate enforcer of the requirement, whereas in others the legislature appoints the members of the Supreme Court. Even though balanced-budget requirements are designed to ensure only that spending be less than revenue, these requirements may reduce *both* spending and revenue. James Buchanan and Richard Wagner (1977) explain why both might be reduced by observing that the ability to buy items for current taxpayers while leaving future taxpayers to pick up the tab systematically biases policy in favor of greater spending.

Indeed, several studies have found that states with stricter balanced-budget requirements tend to tax and spend less than other states. Henning Bohn and Robert Inman (1996) for example, find that spending per capita is approximately $189 less in states with strict balanced-budget requirements relative to those with only weak requirements.[5] David Primo (2007) arrives at a remarkably similar result, finding that strict balanced-budget requirements reduce spending per capita by approximately

5. This estimate, like all others reported in this paper, has been converted to 2008 dollars for ease of comparison. When we report a range of estimates, we have taken the average and then converted that average into 2008 dollars.

$184 per capita.[6] If this amount is the effect of moving from a weak to a strict balanced-budget requirement, it is possible that if the federal government were to adopt a balanced-budget requirement, the impact would be even greater.

Strict balanced-budget requirements have other salubrious effects. Bohn and Inman (1996) also find that states with strict requirements tend to have larger rainy-day funds and larger surpluses and that states with these requirements tend to balance their books through spending reductions rather than with revenue increases. Shanna Rose (2006) finds that states without strict balanced-budget requirements are more likely to suffer from a "political business cycle" whereby policymakers increase spending shortly before an election, only to cut back after the election.

A strict balanced-budget requirement may have some unintended consequences. Noel Johnson, Matthew Mitchell, and Steven Yamarik (2011) conclude that although such rules limit the likelihood of partisan fiscal outcomes, they increase the likelihood of partisan regulatory outcomes. When Democratic-controlled states were unable to carry a deficit forward to the next fiscal cycle, they were more likely to raise the minimum wage, less likely to adopt a right-to-work statute, and more likely to regulate personal freedoms.

2. State Rainy-Day Funds

Some commentators worry that a balanced-budget requirement exacerbates the ups and downs of the business cycle (see, for example, Ornstein 2011). Because state budgets tend to be tightest at the bottom of an economic downturn, this argument goes, strict balanced-budget requirements force states to cut back on spending at the worst time. One institutional answer to this critique is a "budget-stabilization fund," better known as a "rainy-day fund." States contribute to this fund during good years and draw on it when the budget is strained owing to a downturn or some other event, such as a natural disaster. Forty-seven states currently maintain such funds, but, as for many institutions, their design varies from state to state (Rueben and Rosenberg 2009).

Studies of rainy-day funds suggest that they can smooth out the spending cycle, but the details matter. Gary Wagner and Erick Elder's (2005) study is the most comprehensive recent examination of rainy-day funds. They find that states whose rainy-day funds have strict rules governing deposits and withdrawals tend to experience less volatility of spending per capita ($14 less, as measured by the cyclical variability of spending per capita over time).

3. Supermajority Requirements for Tax Increases

Fifteen states require supermajority votes of the state legislature in order to raise taxes (Waisanen 2010). Depending on the state, these rules require two-thirds,

6. Crain 2003 also corroborates this finding.

three-quarters, or three-fifths of the legislature to consent to a tax increase. In some states, the supermajority requirement applies to all taxes, and in others it applies to a subset of taxes. Several researchers have found that these rules reduce spending. Mark Crain and James Miller (1990), for example, find that states with supermajority requirements for tax increases tend to increase spending at a slower pace. A subsequent study by Brian Knight (2000) finds that the effective tax rate in states with these requirements is between 8 and 23 percentage points lower than in states without such a requirement. The latest and most comprehensive studies suggest that these requirements are associated with significantly lower spending per capita. Mark Crain (2003), for example, finds that states with these rules spend on average $151 less per capita. Timothy Besley and Anne Case (2003) similarly find that these rules reduce spending per capita by $103.

4. Tax and Expenditure Limits

In the past several decades, several states have experimented with formal rules that are specifically designed to arrest government's rate of growth. These so-called tax and expenditure limits (TELs) are codified either in the statutes or in the constitutions of twenty-eight states (Waisanen 2010). The rules bind state spending or taxation or both by formulas that relate to factors such as state residents' personal income, population growth, the inflation rate, or some combination thereof.

Early studies of these rules, such as the one by Burton Abrams and William Dougan (1986), concluded that they generally fail to restrain the government's fiscal growth. Newer studies, though, use larger, more detailed data sets and tend to find that these institutions are effective in certain circumstances.[7] As with balanced-budget requirements and rainy-day funds, however, the details matter.

Some studies, noting that TEL formulas are often based on residents' incomes, examine whether TELs have different effects in high-income states than in low-income states. Crain (2003), for example, finds that TELs in low-income states seem to reduce spending by about $114 per capita, whereas TELs in high-income states seem to increase spending by about $534 per capita.[8]

Other studies have focused on how the details of TEL laws vary from state to state. These studies, too, tend to conclude that TELs can effectively restrain spending, but only in certain circumstances. Mitchell (2010b), for example, finds that TELs are more effective when their formula is based on the sum of inflation plus population growth, when they bind spending rather than revenue, when they require a supermajority rather than a simple majority vote to be overridden, when they immediately

7. One recent study, however, finds TELs to be "largely ineffective" (Kousser, McCubbins, and Moule 2008).

8. Crain defines low-income and high-income states as those whose incomes are one standard deviation below or above the mean. Others report similar findings (Shadbegian 1996; Mitchell 2010b).

refund revenue collected in excess of the limit, and when they prohibit unfunded mandates on local governments.

5. Line-Item Vetoes

Like the president of the United States, every governor in the union possesses a veto power. Forty-four governors also possess, in addition to the simple veto, a line-item veto, which allows them to strike specific sections from a bill (Vock 2007). At the federal level, both houses of Congress approved and President Bill Clinton signed a statutory line-item veto in 1996. Two years later, however, the Supreme Court struck down the law in *Clinton v. City of New York* (524 U.S. 417 [1998]). At this point, a federal line-item veto would require a constitutional amendment or a carefully worded statute that would ensure the legislative branch retains the final say on the matter.[9]

Early state-level studies of the line-item veto (for example, Abrams and Dougan 1986) found that it had no effect on overall spending. Following Douglas Holtz-Eakin (1988), researchers have narrowed their focus on the effect of the line-item veto in times and places where different parties control the governor's mansion and the legislature. In contrast with the earlier studies, this line of research finds that the line-item veto can have a large and statistically significant effect on spending per capita. Besley and Case (2003), for example, find that in a state with a divided government, the line-item veto reduces spending per capita by about $100.

6. Item-Reduction Vetoes

In most cases, when a governor possesses a line-item veto, he must defund completely any budget items he wishes to strike. In twelve states, however, the governor need not eliminate the funding entirely (Vock 2007). Instead, he may write in a lower amount. In such cases, the governor is said to possess an "item-reduction veto." Such a veto theoretically changes the negotiating power between the governor and the legislature by effectively denying the legislature the ability to make the governor a take-it-or-leave-it offer. Crain (2003) estimates that this kind of veto power has a substantial effect on spending, lowering expenditures per capita by $471.

7. Baseline Budgeting

States tend to use one of two different "baselines" when they consider a new budget. In the first approach, they may take the dollars spent in the previous year as the baseline;

9. A bipartisan group of more than forty senators has introduced such a bill, the Reduce Unnecessary Spending Act of 2011 (S. 102, 112th Cong., 1st sess.).

in the second, they may take the level of services that those dollars bought as the baseline. If they take the second approach, then price increases in services are automatically incorporated into the budgetary baseline. These automatic price adjustments theoretically should bias spending upward. Indeed, Mark Crain and Nicole Crain (1998) find that spending grows about half a percentage point faster in states that use services rendered rather than dollars spent as the baseline.

8. No Automatic-Shutdown Provision

In twenty-two states, the government automatically shuts down if policymakers have not reached an agreement on the budget by the beginning of the fiscal year (National Conference of State Legislatures 2008). A similar rule applies to the federal budget.[10] Primo explains the theoretical effect of an automatic-shutdown provision: "The legislature has the bargaining advantage because the governor, when considering a spending proposal, compares it to the outcome that would be obtained if he vetoed the spending proposal." In these circumstances, "the legislature will be able to achieve its ideal budget, so long as the governor prefers it to no spending" (2007, 102). In other words, the threat of a shutdown essentially permits the legislature to make a take-it-or-leave-it offer, which suffices to make the governor concede to the legislature's spending demands. Empirical analysis seems to corroborate this theory. According to Primo (2007), states without an automatic-shutdown provision spend approximately $80 less per capita.

9. Separate Spending and Taxing Committees

Some states allow one legislative committee to have jurisdiction over both spending and taxing legislation. Others divide the two powers between separate committees. States that keep these functions separate seem intuitively likely to spend less than those that combine them. The idea is essentially Madisonian: if one committee has jurisdiction over taxing but not spending, its members—unable to steer spending projects toward their constituents—will have an incentive to block the interests of other committees with spending authority.[11]

It appears that the most recent study of separate spending and taxing committees is by Mark Crain and Timothy Muris (1995). According to their data (which is from the 1980s), five states combine spending and revenue authority in one committee, and the other states keep these two functions separate. They find that states with

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10. At the federal level, shutdowns can also occur for other reasons. For example, the near shutdown in August 2011 was the result of the nation's statutory debt ceiling.

11. As the principal framer of the Constitution and its chief advocate through *The Federalist*, James Madison argued for checks and balances on the grounds that "ambition must be made to counteract ambition" ([1788] 1961, 322).

combined spending and revenue authority tend to spend $1,241 more per capita than states with separate authorities. As indicated by figure 1, this amount is by far the largest effect per capita produced by the institutions we survey here. The study is also one of the oldest considered here, and the subject may well need a fresh look with updated data.

10. Centralized Spending Committees

Researchers have also examined the effect of centralizing spending authority in one committee rather than dividing it among several separate spending committees. In this case, the theoretical predictions differ: when a number of different committees have a hand in determining spending priorities, spending is subject to a "tragedy of the commons." As Crain and Muris explain, "[N]o one committee has the incentive to restrain its spending commitments because the total level of spending is no longer the responsibility of any one committee. To the contrary, the resulting competition among committees to spend results in more spending than would otherwise occur, increasing reliance on deficit financing" (1995, 314).

John Cogan (1994) examines this question at the federal level and finds that during periods in which the U.S. Congress had decentralized spending authority, spending grew much faster than in other periods.[12] At the state level, Crain and Muris (1995) find that in the 1980s twenty-four states had centralized spending authority in one committee, and the other states spread it out among several committees. Their results corroborate the federal-level study by Cogan. They indicate that on a per capita basis, states with centralized spending authority spend about $199 less than those with decentralized spending authority.

11. Annual Budgeting

Some state budget cycles last one year; others last two. Given the large number of complex projects that governments currently fund, biennial budgeting would seem to afford legislators the time to scrutinize the budget carefully in order to weigh properly the costs and benefits of different programs. Indeed, Crain notes: "Since 1977 a number of proposals have been introduced in the U.S. House and Senate to lengthen the federal budget cycle from an annual to a biennial process. The perception behind these proposals is that a federal biennial budget would help curtail the growth of federal expenditures" (2003, 102).

But the theoretical relationship is not so clear. According to Paula Kearns (1994), a biennial budget might, on the one hand, shift the balance of power from the legislature to the governor. Because governors cannot export the costs of

12. Spending authority in the U.S. Congress was decentralized from 1886 to 1921 and again from 1932 until the present. See also Brady and Morgan 1987.

spending to other districts as legislators can, she reasons that this inability might result in less spending. She also notes that, on the other hand, biennial budgeting introduces a measure of durability that may make lobbying for government largesse more appealing for special-interest groups, thereby increasing spending.

Kearns's empirical investigation supports the second hypothesis: a biennial budget cycle seems to increase spending. Crain (2003) corroborates this result, finding that states with annual budgets tend to spend about $119 less per capita than states with biennial budget cycles.

12. Small Senates

Several researchers have examined whether the size of a legislative chamber affects spending. The expectation has tended to be that larger chambers will spend more because each member has an incentive to spend in his or her own district and to spread the cost of that spending among all districts. Thus, if the number of cost-sharing districts increases, the incentive to spend grows stronger.[13]

Using data at both the city level and the national level, John Bradbury and Frank Stephenson (2003) find that larger unicameral legislatures do tend to spend more. In bicameral legislatures, however, the more seats/more spending relationship holds only in the upper house. For example, Thomas Gilligan and John Matsusaka (1995) find that the number of state House seats has little or no effect on spending, but the number of Senate seats does. State Senates range from twenty-one to sixty-seven members, and a one-seat increase in membership is on average associated with about $17 more in spending per capita.

13. Large House-to-Senate Ratios

Why does the size of the House not affect spending? Jowei Chen and Neil Malhotra offer one reason, observing that "lower chamber districts, at least in the U.S., are unique because they are geographically imbedded within Senate districts." Thus, "dividing each Senate district into more House districts has the effect of shrinking each House member's constituency, *ceteris paribus.* Having a smaller constituency dilutes House members' payoffs from exploiting common pool resources to fund large pork barrel projects" (2007, 670, 658). So adding more House seats may not have an effect per se, but increasing the ratio of House-to-Senate seats *should* lead to less spending. They corroborate this theoretical prediction with empirical analysis, estimating that decreasing the Senate size by one seat can lower per capita spending by almost $6, and increasing the House-to-Senate seat ratio by one unit decreases per capita spending by about $45.

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13. Kenneth Shepsle and Barry Weingast (1981) formalized the idea.

14. "Citizen" Legislatures

In some states, legislating is a full-time job. Legislators work year round, have large professional staffs, and are paid salaries that make outside work unnecessary. In other states, however, the legislative session is short, staffs are small, and legislators are paid too little to make legislating their only means of employment. The theoretical effect of a "professional" versus "citizen" legislature is unclear. A citizen legislator, who spends most of his time away from the legislature, might be more susceptible to the persuasions of interest groups than a professional who gets his information from paid staffers. However, because citizen legislators have other jobs, they might not need the legislative job security that comes with appeasing interest groups.

Stephanie Owings-Edwards and Rainald Borck (2000) examine this question with an "index of professionalization" that includes factors such as legislative compensation, staff expenditure, and the length of legislative sessions. They find that a one-standard-deviation increase in professionalization increases spending by about 10.2 percent.

15. Direct Democracy

In the late nineteenth century, states began to experiment with direct democracy by permitting their citizens to vote directly on legislation in statewide ballots.[14] Today, twenty-seven states permit this sort of direct democracy in one form or another.[15]

Early studies of direct democracy at the state level concluded that it either had little effect on spending (for example, Farnham 1990) or that it boosted spending (Zax 1989). More recent studies that use larger data sets tend to find the opposite effect. For example, Matsusaka (1995) finds that an initiative with a 5 percent signature threshold (the most common threshold) is associated with $136 less spending per capita. Dale Bails and Margie Tieslau (2000) arrive at a similar result, concluding that the initiative tends to decrease spending per capita by approximately $158.

More recently, however, Besley and Case (2003) estimate a series of regression equations and find that in most of them the initiative has little effect on spending.[16] Matsusaka (2004) suggests one way to reconcile all of these findings. He argues that the effect of direct democracy switched at some point in the past several decades and that direct democracy was associated with more spending in the early part of the twentieth century and with less spending in recent decades. This difference may be the result of changing public attitudes toward spending.

14. An issue placed on the ballot by petition is an initiative. When the legislature places it on the ballot, it is a referendum. For an overview of the terminology, see Matsusaka 2008.

15. For this information and other data on direct democracy, see Initiative and Referendum Institute n.d.

16. In one specification, it does seem to be associated with lower income taxation per capita.

16. Term Limits

Does limiting the time a politician can spend in office affect spending? Some proponents of term limits have argued that such limits break up the political culture of spending (e.g., Payne 1991). Not everyone agrees. Some researchers argue that term limits remove an important check on politicians by freeing them from the necessity of seeking voter approval in their final terms.[17]

Empirical investigations of term limits have not clarified matters. Consistent with the view that term limits lead to more spending, Besley and Case (1995) find that Democratic governors tend to spend more in their second terms when they cannot run again. Using a larger data set, Besley and Case (2003) recently reexamined the question and observed an odd pattern. Like the effect of direct democracy, the effect of gubernatorial term limits seems to have changed over time. Besley and Case conclude that gubernatorial term limits led to more spending in the 1950s, 1960s, and early 1970s, but to less spending from the mid-1970s on. They unfortunately conclude, "[W]e can offer no simple explanation for this pattern" (55).

The effects of *legislative* term limits are no clearer. In a 2000 study, Bails and Tieslau find that legislative term limits reduce spending per capita by approximately \$173. But a more recent study by Abbie Erler (2007) finds that states with more restrictive legislative term limits actually spend approximately \$212 more per capita than others. In sum, the evidence on term limits is decidedly mixed.

Conclusion

Absent policy change, governments at all levels—and those who have come to depend on them—face a bleak future. According to projections, both federal and state spending growth is unsustainable, threatening to push the ratios of debt to gross domestic product (GDP) well past 90 percent in a matter of decades.[18] The 90 percent mark is important because that is when, according to Carmen Reinhart and Kenneth Rogoff (2010), debt begins to hamper economic growth.[19]

A handful of policies seems to be driving the problem: Medicaid, pensions, and other postemployee benefits loom large. But these policies—like all policies—are themselves the products of the institutions that helped to create them and of the rules that influence political outcomes. These institutions and their effect on spending have

17. For an excellent survey of the issue and the various arguments for and against, see Tabarrok 1994.

18. Federal gross debt surpassed 90 percent of GDP in 2010 (U.S. Office of Management and Budget 2011). Absent policy change, debt held by the public is expected to exceed 90 percent of GDP within a decade (U.S. Congressional Budget Office 2011). And according to Jeffrey Miron (2011), seventeen states will have accumulated net debt levels in excess of 90 percent of GDP by 2030.

19. Their figures are based on gross debt, not debt held by the public, so the federal government is already past the point at which the debt ratio tends to hamper growth. As the operator of the world's reserve currency, the United State s may be able to withstand higher debt levels than other countries, but even this "exorbitant privilege" will not be enough to permit the nation to have a 200 percent debt-to-GDP ratio.

been studied extensively. We have surveyed this research and highlighted more than a dozen institutions that have been shown to limit spending, limit the growth of spending, or limit the volatility of spending.

After all estimates are converted into 2008 dollars per capita, it is clear that separate taxing and spending committees and item-reduction vetoes have the largest effect on spending per capita (see figure 1). These institutions also happen to be among the least studied, so further analysis may be warranted. Among the most studied institutions are strict balanced-budget requirements, supermajority requirements for tax increases, and tax and expenditure limits.

In many cases, subsequent study of institutions has yielded more nuanced results. For example, some of the institutions we discussed are effective only in certain circumstances or when they are designed in a certain way. This finding suggests that we may still have much to learn about the institutions that have received comparatively less attention (such as item-reduction vetoes). Nevertheless, policymakers interested in arresting the unsustainable growth of government already have a number of tools at their disposal.

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