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ECONOMIC PERSPECTIVES

STATE BUDGET INSTITUTIONS

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Over the past six decades, state and local government spending has increased at more than twice the rate of private sector growth.[1] Left unchecked, this growth puts state and local governments on a costly path that is unsustainable.[2] Either spending growth must slow, taxes must rise, or both. Spending growth can contribute to significant fiscal stress,[3] requiring difficult adjustments when large budget gaps arise. Unfortunately, short-term thinking often dominates the adjustment process so that legislators frequently make choices—such as underfunding pension obligations—that improve the short-term fiscal outlook at the expense of worsening the long-term outlook.

By altering the institutions, or rules, that govern the fiscal decision-making process, policymakers can encourage the sort of long-term thinking that is too often absent from the budgeting process. Reforming the institutions that shape legislators' spending and taxing decisions is a better way to put states on a more sustainable fiscal path.

INSTITUTIONS THAT CONSTRAIN BUDGETS

A study by Mercatus Center economists identified 15 institutions that are significantly associated with less spending.[4] These institutions shape fiscal outcomes in three areas: the budget process, the legislative process, or the political process.

INSTITUTIONS THAT SHAPE THE BUDGET PROCESS

Many state constitutions include budget rules that have an explicit goal of improving fiscal health. Specific goals of budget rules involve restraining government spending, eliminating deficits, or cutting wasteful programs in some way.

- *A balanced budget requirement*. This is one rule that many states have implemented to reduce or eliminate deficits. They vary in stringency, but in general they require a state to balance its budget so that expenditures do not exceed revenues over a given time.

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A well-designed budget rule should seek to reduce budget gaps or constrain spending growth and cannot easily be manipulated. To achieve this, there are four main principles that policymakers can use to guide the design of rules that shape the budget process:[5]

- *Broad scope*. Applying a budget rule to all spending categories forces legislators to place all spending on the table if cuts are needed. It also reduces the incentive for future lawmakers to place their favorite items beyond the scope of these rules.

- *Few escape clauses*. Legislators should not have opportunities to sidestep the rule. It is essential that escape clauses cannot be used as an easy way out of difficult spending decisions. If an escape clause is to be used, the threshold for activating it should be high, such as requiring the approval of 90 percent of voters.

- *Minimal accounting discretion*. Too much discretion leads policymakers to create new spending categories, such as "off-budget" entities not subject to the rules.

- *Enforcement*. A budget rule is only effective if it has teeth. Internal enforcement is often susceptible to manipulation while external enforcement through the courts can act as a powerful motivator for legislators to follow budget rules. In either scenario, the enforcer should be credible and have limited discretion. Constitutional rules are typically the most binding rules because they provide a check against legislative discretion.

When approaching each state's unique fiscal situation, state policymakers can use the principles of well-designed budget rules as a general guide for informing policy reform. The following seven institutions are specific examples of budget rules proven to be associated with less spending and a better fiscal outlook.

- *Vetoes*. Line-item vetoes allow governors to strike specific sections of bills, whereas item-reduction vetoes allow governors to write in a lower spending amount for these sections rather than zeroing out an entire budget item. Research suggests[6] that in states where different parties control the executive branch and

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the legislature, line-item vetoes are associated with less spending per capita[7]—about $100 per year. This translates into a reduction of about $460 million for the median state. Even more significantly, item-reduction vetoes have been shown to lower per capita expenditures by about $470 per year,[8] a reduction of about $2 billion for the median state.

- *Strict balanced budget requirements*. The mere existence of a balanced budget requirement does not guarantee a balanced budget. Most states have these requirements, but some are ineffective. More stringent rules require end-of-the-year balanced budgets and don't permit deficits to be carried over into the next year. Rules enforced externally through state constitutions and by independently elected judges have been shown to lead to effective budget balancing.[9] States with more stringent requirements spend about $180 less per capita per year[10] or about $830 million for the median state. Other benefits include an increased likelihood of having larger rainy day funds and surpluses, making it easier for states to weather economic downturns.

- *Annual budget cycles*. Having a budget cycle that lasts one year as opposed to two years has been shown to be associated with less spending. It has been theorized that biennial cycles are more susceptible to influence by special interest groups pushing for more spending. Moreover, under a biennial cycle, agencies have a longer leash and may be able to use that greater discretion to increase their budgets, whereas annual budget cycles allow legislators to exercise greater oversight. Empirical evidence demonstrates that states with annual budgets tend to spend about $120 less per capita per year than states with biennial cycles.[11]

- *Supermajority requirements for tax increases.* Tax increases may be an enticing way to quickly balance a budget, but their costs are often overlooked, and studies suggest they tend to lead to future spending increases.[12] Some states require that for any tax increase to pass it must gain supermajority approval by the state legislature—usually three-fifths, two-thirds, or three-fourths of the legislature's consent. Although raising taxes can already be politically challenging, imposing a supermajority can act as an additional constraint on tax hikes. The latest research shows that supermajority requirements for tax increases are associated with about $100 less spending per capita per year.[13] States with these requirements also have lower effective tax rates[14] and tend to see a lower spending growth rate than other states.[15]

- *Tax and expenditure limits (TELs)*. Many states create TELs to limit budget growth. The limit is determined by a preset formula. The effectiveness of TELs varies greatly depending on their design.

  Effective TEL formulas limit spending to the sum of inflation plus population growth. This type of formula is associated with statistically significantly less spending. TELs tend to be more effective when they require a supermajority vote to be overridden, are constitutionally codified, and automatically refund surpluses. These rules are also more effective when they limit spending rather than revenue and when they prohibit unfunded mandates on local government. Having one or more of these characteristics tends to lead to less spending.[16]

Ineffective TELs are unfortunately the most common variety. TELs that tie state spending growth to growth in private income are associated with *more* spending in high-income states.

- *No automatic shutdown provision*. Some state governments cease operations in the event of a budget impasse because of the presence of an automatic shutdown provision. Research demonstrates that the absence of such a provision is better for a state's fiscal health.

  States without an automatic shutdown provision spend about $80 less per capita per year or about $370 million for the median state.[17]

  In the presence of automatic shutdown provisions, legislators or governors who prefer to increase spending have bargaining power when presenting their budgets. This type of rule can lead to more spending because policymakers usually prefer to accept a budget that is not ideal to no spending at all.

- *Baseline budgeting*. When considering a new budget, states can create a baseline using either the dollars spent in the previous year or using the level of services that those dollars bought. Research shows that spending grows more slowly in states that use dollars spent as the baseline, rather than services rendered.[18]

INSTITUTIONS THAT SHAPE THE LEGISLATIVE PROCESS

The following six institutions shape the legislative process and have been found to be associated with more constrained budgets.

- *Separate spending and taxing committees*. In some states, legislative rules consolidate spending and taxing authority into one committee whose members both allocate funds and set tax policy. This committee design makes it easier for members to direct spending toward their preferred projects, which in turn causes them to favor higher tax rates. In other states, a tax committee has sole responsibility for setting tax rates while a separate committee allocates spending. Evidence suggests that states with separate spending and taxing committees spend much less than other states.[19] States in which one legislative committee has both spending and taxing powers spend between $300 and $450 more per person per year.

- *State rainy day funds*. Policymakers can create rainy day funds in which they deposit extra revenue so that they have reserves to draw from when budget shortfalls arise. Well-designed rainy day funds are governed by strict rules that compel legislators to ensure a predetermined level of funding. Policymakers should exercise caution when designing these funds to make sure there is not too much legislative discretion regarding the input and withdrawal of funds. Research shows that states with well-structured rainy day funds experience less spending volatility[20] and less fiscal stress.[21]

- *Centralized spending committees*. When states disperse spending authority into several legislative committees it can also be detrimental to budgetary restraint.[22] Multiple spending committees create a fiscal commons,[23] a situation in which many can draw from a common resource while responsibility for the total level of spending rests with no single group. This leaves little incentive for each group to keep spending in check. In contrast, states that centralize spending authority spend about $200 less per capita each year.[24]

- *Small senates*. The larger the senate, the greater the incentive members face to spend because the cost is spread across more districts. There is evidence that senates with 10 fewer seats relative to other states spend about $170 less per capita per year.[25]

- *Large house-to-senate seat ratio*. For bicameral legislatures, a larger ratio of house to senate seats is associated with less spending. All else being equal, when senate districts are divided into more house districts, each house member's constituency is smaller. States with a one-unit larger house-to-senate ratio spend about $45 less per capita compared with other states.[26]

- *"Part-time" legislatures*. Legislatures made up of members who don't make legislating their only means of employment tend to spend less than states that have full-time legislators. States in which members work year-round and are considered professional legislators demonstrate a propensity to spend more.[27]

INSTITUTIONS THAT SHAPE THE POLITICAL PROCESS

The following two institutions have been thought to constrain budgets by improving incentives in the political process. In both instances, however, the empirical evidence is more complicated.

- *Direct democracy*. When citizens are allowed to vote directly on legislation in statewide ballots, policies are thought to better reflect public attitudes toward spending. Researchers have found that direct democracy was associated with[28] more spending in the early 20th century, but with less spending more recently.

- *Term limits*. While early research found that legislative term limits were associated with less spending,[29] more recent research[30] finds that legislative term limits are associated with *more* spending (particularly pork-barrel spending). On the other hand, gubernatorial term limits have been associated with less spending since the 1970s,[31] while the same limits were associated with more spending prior to the 1970s. The expectation that term limits would make policymakers more accountable for fiscal outcomes is a reasonable hypothesis, but the empirical evidence is mixed.

LINKS

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2. http://mercatus.org/publication/state-spending-restraint
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