

**Fiscal Policy in the American States**

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**Abstract and Keywords**

This chapter reviews the recent scholarly literature on fiscal policy in the American states, focusing on several important topics: (1) size and growth of the public sector in the states; (2) how states determine expenditure and revenue priorities; (3) the politics of state budget deficits and surpluses; (4) the effects of fiscal policy on various political, economic, and social outcomes. The pace of scholarly research by political scientists on state fiscal policy has slowed considerably during the first decade of the 2000s, resulting in a leveling off of scientific progress in understanding state fiscal policy. There is a lot we still do not know about the size of the public sector, state spending and revenue policy, state deficits and surpluses, and the effects of state fiscal policy. We conclude with a discussion of unanswered research questions as a means of building an agenda for future research on state fiscal policy.

Keywords: fiscal policy, growth, public sector, budget, deficit, surplus, outcomes, revenue policy, effects of policy

One of the sharpest divisions in contemporary politics is based on disputes over spending and taxation issues. In the United States, citizens differ considerably in their views toward the proper size of the public sector, the relative mix of spending and taxation, and who will receive the benefits (and be responsible for the costs) of government programs. Americans differ over what spending priorities should be and which classes of individuals should receive the relative benefits of government spending and bear the relative burdens of taxation. The suggestion that politics is about "who gets what, when, and how" (Lasswell 1936) or "the authoritative allocation of values" (Easton 1953) rings true.

Of course, such disputes are not limited to the U.S. federal level. On the contrary, similar divisions about spending and taxation preferences arise in the American states (cf. Beck and Dye, 1982; Beck, Rainey, and Traut, 1990; Garand and Blais, 2004; Sears and Citrin, 1982;). Within some constraints arising from the nature of the U.S. federal system and from state constitutional and statutory provisions, each state government is responsible for deciding the size of its public sector, its levels of spending and taxation, and the size of its budget deficits and surpluses. Given the schisms within state electorates relating to the proper role of government and the appropriate levels of government spending and taxation, it is no surprise that issues relating to government spending and tax policy are often highly contentious.

Public policies relating to the budget, taxation, and spending fall within the realm of *fiscal policy*, which is commonly defined as *the use of government spending, taxation, and budget deficits and surpluses to influence economic performance in a political system*. At the U.S. federal level, the national government has wide latitude to adopt spending and tax policies as a means of achieving macroeconomic outcomes—i.e., manipulating aggregate demand, lowering unemployment, and fostering steady economic growth. There is little doubt that national fiscal policy has an effect on economic performance, though there is some variation in (and debate about) how fiscal policy instruments are translated into specific economic outcomes. Of course, not all federal fiscal policies are intended solely to achieve the public good of favorable macroeconomic outcomes; rather, the federal government often uses the federal budget to reward individuals or geographic units through "pork-barrel" (localized spending) projects, to achieve other specific policy goals, or to redistribute wealth from one income group to another.

State governments also use fiscal policy, though the effects of state fiscal policy on state economic performance are less clear. The role of state governments in generating macroeconomic outcomes is in some dispute; indeed, some scholars suggest that state economies are driven largely by how the economy performs at the national level, with state governments having little sway over state economic conditions (Brace, 1991, 1993; Hendrick and Garand, 1991a). Other scholars find that state governments have fiscal policy tools at their disposal that can affect economic performance (Brace, 1993; Jones, 1990). In addition to the possible direct economic effects of state fiscal policy, state governments can also use their budgetary authority to distribute resources to specific subgroups or geographic areas, achieve other specific policy goals, or redistribute wealth from one income group to another. In essence, fiscal policy in the American states plays a multifaceted role in shaping economic, policy, redistributive, and political goals and outcomes.

In this article we explore the scholarly literature on American state fiscal policy. We begin by discussing what is known about the overall size of the public sector in the American states. We focus here on competing explanations of state government size and the empirical support for these explanations. Second, we consider separately the literatures on state spending policy and state revenue policy. In particular, we note that the theoretical frameworks that explain demand for spending and willingness to pay are quite distinct from each other, and this has implications for our understanding of variation in state spending and revenue levels. Third, we consider explicitly the scholarly literature on budgetary deficits and surpluses in the American states. In discussions of national fiscal policy, deficits and surpluses play a prominent role, yet it is unclear if deficits and surpluses in the American states play a similar role. Finally, we explore the effects of state fiscal policy as an independent variable. What are the economic, political, policy, and social effects of state fiscal policy?

One of the themes of this article is that there remains a substantial research agenda left in studying state fiscal policy. During the second half of the

twentieth century, state-level data on expenditures, taxation, government size, intergovernmental grants, and economic performance became readily available, and during the 1970s, 1980s, and 1990s there was a veritable explosion of research on state fiscal policy. The pace of scholarly research by political scientists on state fiscal policy has slowed considerably during the first decade of the 2000s, and the result is that scientific progress in understanding state fiscal policy has leveled off. It would be only a slight exaggeration to suggest that the study of state fiscal policy has become somewhat of a "forgotten" area of study. There is a great deal that we still do not know about the size of the public sector, state spending and revenue policy, state deficits and surpluses, and the effects of state fiscal policy. In this article we point out many of these unanswered questions as a means of building a research agenda for future research on state fiscal policy.

## The Size of the Public Sector in the American States

One of the critical questions about the role of state governments in shaping policy outcomes—including macroeconomic outcomes—is the overall size of the public sector. The size of government is one indicator of the level of policy activism by state governments, since a small public sector is unlikely to have the resources to play as active a role in achieving policy objectives. Moreover, the size of the public sector is a key indicator of state fiscal policy and the use of the state budget to achieve a wide range of policy goals.

### Measuring the Size of the Public Sector

Before we can consider competing explanations of the size of the public sector, it is important to discuss how government size is measured in the extant literature. Most studies of public sector size use an indicator of state spending, usually divided by a variable that indicates the size of the state population (i.e., per capita spending) or the size of the total state economy, such as total personal income or Gross State Product (GSP). It is important to standardize raw spending by population or the size of the state economy, since a state such as California (with a large population and a large state economy) will naturally spend more than Wyoming (with a small population and a small state economy). There are other studies that measure the size of the public sector in the American states in terms of government employment (Weiher and Lorrence, 1991), though such measures are somewhat less relevant to studies of state fiscal policy.

The conventional measure of state government size is calculated by taking total state expenditures and dividing by the size of the total state economy. If one explores the trend in government size over time, one gets a good idea of how much the state political system is drawing from the private economy to fund government programs. However, scholars have noted that the inflation rates are different for the public and private sectors (Berry and Lowery, 1984a, 1984b; Lowery and Berry, 1983). Garand (1989) finds that the inflation rate for the private sector—as measured using the Gross National Product (GNP) price deflator—averages 4.6 percent per year from 1945 to 1985, and this compares to an inflation rate for state and local government purchases sector of 6.0 percent. Extending the time frame from 1945 to 1998, Garand and Baudoin (2003) find that the mean inflation rate for GNP is 4.0 percent, while the mean inflation rate for the state and local government purchases sector is 5.0 percent. Clearly, the inflation rate is higher in the state and local government sector than in the private sector. What explains the difference in the state and local government purchases and GNP price deflators has not been considered in the scholarly literature, though Lowery and Berry (1983) explore the determinants of the gap in inflation rates for the public and private sectors at the national level; understanding the inflation gap for the public and private sectors in the American states is certainly an important question, which warrants the attention of state politics scholars.

Why does this matter? First, if the price of state government goods and services rises at a faster rate than the overall economy, the purchasing power of state government will decline over time relative to that of the private sector. This means that to keep real government spending at a constant share of the real economy, it must increase at a faster rate than the private economy. This suggests that there will be constant pressure for state policy makers to increase the size of government over time in order to provide the same level of state government services. Second, increases in the size of the public sector over time does not necessarily mean that government is doing more; rather, increases in the size of the public sector can reflect both a government growth component (i.e., government is doing more) and an inflation component (i.e., the price of government rises at a faster rate than the price of the private sector). Indeed, Garand (1988b, 1991) develops a technique for decomposing increases in the size of state government into these two components, and he finds that from 1945 to 1984 almost 47 percent of government growth was due to differences in the inflation rates for the state government and private sectors. Finally, following the work by Berry and Lowery (1984b) at the national level, Garand (1989) explores the degree to which using nominal or real measures of government size has an effect on parameter estimates from models of state government size. He finds that there are moderate differences in the effects of key independent variables on government size, depending on whether a nominal or real measure of government size is used. These findings suggest that the measurement of government size has nontrivial implications for the inferences that scholars generate from their work on state government size.

### Explaining State Government Size

Most studies show that the size of the public sector in the American states has increased in the post-WWII period (Garand 1988a, 1988b; Garand and Baudoin, 2003; Kapeluck, 2001). For instance, Kapeluck finds that the mean size of government has grown fairly steadily from 1945 to 1976, after which the rate of growth continued but at a slightly lower rate and reached a high of over 14 percent of total state personal income throughout the 1990s. Scholars have not continued to follow these trends into the 2000s, so more work is needed on patterns of government size over the past decade.

What explains variation across states and over time in the size of the public sector in the American states? Scholars have divided competing explanations of government size and government growth into two main categories (Berry and Lowery, 1987; Garand, 1988a, 1989; Kapeluck, 2001; Lowery and Berry, 1983). *Responsive government explanations* suggest that the size of the public sector reflects citizen demands for government goods and services in a state political system; simply, government growth or contraction is a function of citizen demands for more or less government. On the other hand, *excessive government explanations* suggest that the public sector itself is a player in determining the size of government; in this

view, government grows in response to pressures from government actors for an expanded public sector.

**Responsive government explanations:** What are the responsive government explanations that are applicable to the size of government in the American states? First, Wagner's Law (Wagner, 1877) suggests that government grows as societies become more industrialized and (hence) urbanized, personal incomes grow, and the externalities associated with industrialization and urbanization create the need for government action. Despite its theoretical plausibility, at the state level there is relatively little support for Wagner's Law; indeed, Garand (1988a, 1993) finds little evidence to support Wagner's Law, though more recently Kapeluck (2001) finds that government size is larger in highly urbanized states.

Second, some responsive government explanations point to the importance of political parties in shaping the size of the public sector. The *party control explanation* suggests that government size is a function of control of state government by the Democratic (or more liberal) or Republican (or more conservative) parties. When state government institutions, such as the governorship and state legislature, are controlled by the more liberal party, one would expect that the size of the public sector will increase, with all else equal; on the other hand, when state government is controlled by the more conservative party, the size of government will either shrink, remain the same, or grow at a slower rate, with all else equal. Although this explanation seems very plausible, in the American states there is only mixed evidence for a systematic relationship between party control and state government size. Garand (1988a) finds that there is a relationship between party control of state government and growth in the public sector in only two states; on the other hand, Kapeluck (2001) uses pooled data from the American states for the time period from 1946 to 1997 and finds that Democratic control of state government has a significant positive effect on government size.

Another explanation relating to the role of political parties in shaping government size is the *interparty competition explanation*, which suggests that the public sector grows in response to higher levels of party competition in a given state. The reasoning is that the two political parties compete with one another for the affection of voters during periods of high competition, and the result is higher spending as the competing parties try to outbid each other for voter support. Thus far there is little empirical evidence to support this hypothesis as a general explanation of state government size (Kapeluck, 2001; Rogers and Rogers, 2000). It is unclear, however, how this explanation would fare in the current climate of enhanced political polarization at the state level (Garand 2010).

Third, some scholars point to the effects of *political culture* as an explanation of variation in state government size. Some states are comprised of citizenries that are ideologically high demanders of government provision of goods and services, while other states have citizenries that demand less government. Most of the studies that consider the effects of political culture focus on the political ideology of state electorates; simply, states with relatively liberal electorates are expected to have larger state governments than states with relatively conservative electorates. Kapeluck (2001) finds some weak support for the political culture explanation, though more work is needed that takes advantage of improved measures of state ideology. Moreover, with increases in mass political polarization at the state level in the past 20 years, it is possible that the effects of state ideology on government size may be stronger; however, the effect of state mass polarization on the relationship between state ideology and government size has not been fully explored.

Fourth, the *political needs explanation* suggests that variation in state population characteristics helps to shape demand for the size of the state public sector. In particular, states with populations comprised of high demanders of government goods and services are likely to have larger public sectors than other states. High-demand groups include the young (those under 18), the elderly (those over 65), members of racial and ethnic minority groups (e.g., blacks, Latinos), the unemployed, public-sector employees, and members of labor unions. The results from previous research are somewhat mixed. For instance, Kapeluck (2001) finds that the under-18 population and state unemployment rate are associated with increased size of the public sector, but the black and over-65 populations are not.

Finally, there has been a considerable amount of scholarly work on the role of government institutions in shaping the size of the public sector in the American states. In particular, scholars have studied the effects of *fiscal constraints* that arise from efforts by state electorates to place institutional limits on state spending, state revenue, or the overall size of the state governmental sector. Krol (2007) summarizes the literature on fiscal constraints, which includes institutions such as the line-item veto (Alm and Evers, 1991; Nice, 1988), tax and/or expenditure limitations (Bails 1990; Cox and Lowery, 1990; New, 2010), and borrowing constraints (Kiewiet and Szakaly, 1996). Other institutional arrangements can have an effect on the size of the public sector as well. For instance, Gilligan and Matsusaka (2001) show convincingly that the number of seats in the upper chamber of state legislatures during the first half of the twentieth century is strongly and positively related to state expenditures and revenues. On the other hand, Kapeluck (2001) finds that the size of the upper house has a null effect and the size of the lower house a negative effect on state government size during the post-WWII era.

**Excessive government explanations:** There are numerous mechanisms through which processes associated with excessive government explanations work to increase the size of the public sector. First, perhaps the most widely cited excessive government explanation is the *fiscal illusion theory*, which suggests that governmental actors (1) seek increases in the size of the public sector for their own self-interest; and (2) manipulate demand for government goods and services by concealing the costs of government programs so that citizens demand more government than they would normally be willing to support with higher taxes. There are a number of illusory revenue mechanisms cited in the literature, such as withholding provisions and deficit spending, all of which are seen as preventing taxpayers from accurately estimating their tax burden. However, the fiscal illusion theory draws only mixed empirical support. Garand (1988a) finds evidence to support the fiscal illusion theory in only a small number of states. In his pooled analysis of data from the post-WWII period, Kapeluck (2001) finds that income taxes (which have withholding provisions) are unrelated to the size of the public sector, but state deficits have a strong positive effect on government size.

Second, the direct role of government employees in shaping the size of government has drawn considerable scholarly attention. The *bureau information monopoly theory*, most closely associated with Niskanen (1971), suggests that government bureaucrats use their advantage over information about the workings of their agencies to influence legislators charged with policymaking. Faced with these information asymmetries, legislators are poorly positioned to question agency requests for larger budgets. In the literature on state government growth, there have been no direct tests of this provocative theory. Unfortunately, there has been little research done to test Niskanen's theory at the state level, in no small part due to the difficulty in

collecting the data necessary to test the theory in the American states. Alternatively, the *bureau voting theory* suggests that government employees use their voting strength in the electorate to shape the size of the public sector. This theory assumes that government employees are self-interested actors who have stronger preferences for an expanded governmental sector than other voters, are more likely to turn out to vote, and are more likely to vote for candidates who support an expanded public sector. Hence liberal candidates are advantaged by the electoral participation of a group of citizens who support greater government spending and who vote in sufficient numbers that they are likely to be overrepresented in the typical electorate (Garand, Parkhurst, and Seoud, 1991a, 1991b). Applied to the American states, the bureau voting theory has found strong empirical support in aggregate data (Garand, 1988a; Kapeluck, 2001), though there has been relatively little empirical evidence for the micro-level foundations of the theory (but see Garand and Blais, 2004; Garand et al., 1991b).

Third, the *intergovernmental grant explanation*, often described as the *flypaper effect*, emphasizes the role of the federal system in shaping the size of state government. The core idea here is that as intergovernmental grants flow to the states, policy makers in the states are faced with a choice. They can use federal funds as a substitute for state funds, essentially keeping the total size of the state public sector constant over time and adjusting the revenue burden on state citizens downward in response to the influx of federal funds. Alternatively, state policy makers can view intergovernmental funds as a source of additional revenue that can be added to the current level of state revenue; hence federal funds "stick" with the recipient state government and generate an overall increase in the size of the state public sector. The real question here is the degree to which a dollar of federal grants results in less than a dollar of increased state spending (i.e., a replacement effect) or more than a dollar of increased spending (i.e., the flypaper effect). The empirical results from studies of state government size have been mixed, with some scholars producing evidence that is more consistent with the replacement effect (Borcherding, 1977; Garand, 1988a, 1993), while others find evidence to support the flypaper effect (Kapeluck, 2001).

## State Spending Policy

The size of the public sector in each of the American states is a function of both spending and revenue levels. Because most states require or encourage a balanced budget, state spending is linked explicitly to the levels of revenue available to support such spending. However, the process that drives spending levels is somewhat different to that which drives revenue levels. Specifically, models of state government spending are largely driven by policy choices, with state officials deciding explicitly how much will be spent in total and for various categories of spending. State policy makers must account for public demands that are often relatively insensitive to the costs of the public sector, as well as the incentives built into the structure of democratic political systems that typically lead political elites to support spending levels that are high relative to the revenues required to cover the costs of that spending. In other words, the mass public often demands more government spending than it is willing to pay for, and political elites facilitate higher levels of spending because it is in their interests to do so.

On the other hand, the generation of revenue is hard work. For one thing, support for taxes necessary to fund state spending is usually far below support for spending, prompting some scholars to refer to a "something for nothing" mentality (Sears and Citrin, 1982). Indeed, scholars find that support for government spending usually exceeds support for taxes by a considerable amount (Garand and Blais, 2004; Welch, 1985), and state policy makers find it much more difficult to generate coalitions in favor of increased revenue than coalitions in favor of increased spending. Moreover, state revenue generation is dictated in part by policy choices, since state policy makers establish the types of taxes to be used, as well as setting tax rates. However, state revenue is also dictated in part by factors that are beyond the direct control of state policy makers, such as state economic performance. Ultimately, this means that state expenditure is typically more predictable than state revenue, and the uncertainty surrounding revenue generation can wreak havoc with state budgets, particularly during economic downturns.

In the United States, state government spending constitutes a substantial share of total government spending. In 2008, federal expenditures were \$2655.4 billion, which represents 20.7 percent of Gross Domestic Product (GDP); on the other hand, state direct expenditure (i.e., without intergovernmental grants) was \$1256.8 billion, or 8.7 percent of GDP, while local direct expenditure was 1577.3 billion, or 10.1 percent of GDP (U.S. Census Bureau 2010). Hence total state direct expenditure represents 21.6 percent of total federal, state, and local expenditure, compared to 51.3 percent for federal government expenditure and 27.1 percent of local direct government expenditure. However, the pattern of state spending differs from federal spending in many ways. First, state governments have different spending priorities than federal government. The U.S. federal government spends a substantial proportion of expenditure on national defense, but state governments do not need to spend on national defense at all. Moreover, the federal government focuses its spending on redistributive areas like welfare and entitlements such as Social Security and Medicaid, while state governments focus their spending on developmental areas like education, infrastructure, and public safety (Peterson 1995). Furthermore, state governments are better positioned to engage in explicit expenditure tradeoffs as a tool to shift spending priorities between different spending areas, since most states have constitutional or statutory restrictions on deficit spending (Alt and Lowry, 1994; Garand and Hendrick 1991; Nicholson-Crotty, Theobald, and Wood 2006; Poterba and Rueben 2001).

Second, the determinants of cross-state variations of state spending are quite different from over-time variations of federal spending. The unique social, economic, political, and demographical conditions of the American states result in spending policies that are quite distinct from one another (Abrams and Dougan, 1986; Alt and Lowry 1994, 2000; Bohn and Inman, 1996; Cnudde and McCrone, 1969; Cox and McCubbins, 1991; Dawson and Robinson 1963; Merrifield 2000; Peterson, 1995; Tompkins 1975). Unlike the case for the federal government, residents of states have higher levels of mobility to choose a state of residence that satisfies their preferences of public goods the best to move to (Allard and Danziger, 2000; Bailey, 2005; DeHoog, Lower, and Lyons, 1990; Hawkins, 1992; Lowery and Lyons, 1989; Lyons and Lowery, 1989; Lyons, Lowery, and deHoog, 1992; Percy and Hawkins, 1992; Peterson and Rom, 1990; Schram, Nitz, and Krueger, 1998; Tiebout, 1956). Given the market-like conditions created by the U.S. federal system, it is likely that public preferences exert a stronger influence on state spending policy. State expenditure policy can also be influenced by federal government spending such as federal aid (Bae and Feiock, 2004; Abrams and Dougan, 1986; Chubb, 1985; Osman 1966; Pogue and Sgontz 1968) or by spending in neighboring states (Baicker, 2005).

## Areas of spending and expenditure tradeoffs

Unlike the federal government, state governments do not expend resources on national defense. Instead, state governments focus their spending in areas such as education, public welfare, highways, health and hospitals, police and fire protection, and governmental administration, among others. In 2008, the first four of these spending categories—education, public welfare, highways, health and hospitals—comprised 78.5 percent of state general expenditure. During the same year, in which state government spending comprised 8.7 percent of GDP, on average the American states spent 3.8 percent of GDP on education, 2.9 percent of GDP on welfare programs, 0.8 percent of GDP on health and hospitals, and 0.7 percent on highways. On average, American states spent 36.4 percent of total spending on education, 27.4 percent on welfare, 7.5 percent on health and hospitals, and 7.1 percent on highways (U.S. Census Bureau, 2010).

*Developmental vs. redistributive spending areas:* Peterson (1995) finds that although both federal and state spending increased in the second half of the twentieth century, the patterns of change are different. According to Peterson, state governments focus their spending on developmental areas such as education, transportation, safety, natural resources, and utilities. Spending in developmental areas is not only greater than in redistributive areas, but developmental spending also grows at a faster rate. From 1962 to 1990, state spending in developmental areas increased from 3.55 percent of GNP to 5.08 percent in 1990. Instead, spending in redistributive areas like welfare, pension and medical insurance, health and hospitals, and housing only took up 1.44 percent of GNP in 1962 and 2.52 percent in 1990. In contrast, the federal government spends more money in redistributive areas, and federal spending in those areas grows much faster. Whether these patterns remain in force today should certainly be explored by state politics scholars.

*Expenditure tradeoffs:* When resources are limited, policy makers are often required to support increases in one expenditure category by taking resources from other expenditure categories. The result is what scholars have referred to as *tradeoffs* in spending across expenditure categories. Garand and Hendrick (1991: 917) define tradeoffs as “a systematic pattern of direct shifts in spending priorities from one spending category to another,” while Berry and Lowery (1990: 671) describe tradeoffs as circumstances in which “the choice of an expenditure level for one category must affect the amount of money allocated to the other category, such that spending in one comes at the expense of the other.”

At the federal level, the concept of expenditure tradeoffs was first used by scholars to describe the interrelationship of “guns vs. butter”—that is, the tradeoff between defense and domestic spending (Domke, Eichenberg, and Kelleher, 1983; Mintz, 1989; Mintz and Huang, 1990; Russet, 1982). There has been some consideration of spending tradeoffs at the American state level (Garand and Hendrick, 1991; Nicholson-Crotty, Theobold, and Wood, 2006), though the scholarly literature is less well developed. In one sense, the possibilities of tradeoff effects would seem to be greater at the state level than at the federal level. The reason for this is that most states have constitutional or statutory provisions that mandate a balanced budget, and the result is an environment of scarce resources that facilitates tradeoff behavior. On the other hand, at the federal level there is no balanced budget requirement, and the federal government can respond to resource scarcity by borrowing money and running deficits; hence in theory expenditure tradeoffs should be less likely to occur at the federal level than in the American states.

What do we know about tradeoffs at the state level? Garand and Hendrick (1991) capture expenditure tradeoffs among education, welfare, highways, and health spending categories by modeling changes in spending in each category as a function of changes in spending in other categories, as well as a series of control variables. If the coefficients of spending in other categories are negative, Garand and Hendrick suggest that there is a systematic pattern of tradeoffs. Their results provide evidence that priority changes in one spending category often come at the expense of priority changes for at least another spending area, and tradeoffs are also observed to take place in every state. However, the magnitude of tradeoff effects varies across the states and expenditure categories, and systematic tradeoffs do not occur with equal probability across states or all spending areas. Hendrick and Garand (1991b) explore the degree to which tradeoff effects are determined by political-strategic, organizational, and economic characteristics of the American states, and their findings point to the effects of these variables in shaping the relationships among spending priorities for the various expenditure categories. Finally, Nicholson-Crotty et al. (2006) adopt Berry and Lowery’s (1990) admonition against the practice of regressing spending priorities in one area against spending priorities for other areas, and they adopt an approach in which tradeoffs between two expenditure categories are captured explicitly in the dependent variable.

## Determinants of state spending priorities

States vary distinctly from one another in their spending policies. Not only is there considerable variation in the amount that states spend, their relative spending priorities are quite different as well. The study of the “nationalization” of state spending priorities—i.e., the degree to which the variance in state spending priorities has decreased over time—was once an important research question for American politics scholars (cf., Hofferbert, 1966; Hofferbert and Sharkansky, 1971; Kemp, 1978; Tucker, 1984), but this question has not been explored in some time. For instance, Peterson (1995) uses coefficients of variation for different spending areas to measure the extent to which the fifty states differ from one another in their spending priorities and whether state spending policies have become more divergent or uniform over time. He finds that states vary substantially in their spending policies, and the variation has not declined from 1962 to 1990. The question of how much state spending priorities are nationalized in recent years is worthy of scholarly attention, as is the question of what explains patterns of nationalization or divergence in spending priorities over time.

As noted, state government size is determined by responsive government explanations and excessive government explanations, and these can be applied to explain variations in federal and state spending over time. Determinants of cross-state variation in spending priorities can be different to the determinants of federal spending priorities over time for several reasons. First, unlike the federal government, which is only one unit, states differ from one another in terms of their various institutional settings, demographic attributes, and political and economic conditions, all of which can influence policy choices and processes in one way or another. Second, American citizens have a high level of mobility with which they can change their state of residence, based on their preferences for public goods; hence there are market-based incentives that motivate both citizens and governments such that public opinion of residents in each of the states can have a strong influence over state spending priorities. Finally, state spending can be influenced by the behavior of other governments. For instance, grants-in-aid from the federal government or the spending priorities of neighboring states can influence state spending priorities in individual states.

*Unique state characteristics:* States differ from one another in their institutional, political, economic, and social settings, and these settings can influence state spending priorities and processes. In terms of institutional variables, for instance, all states except for Vermont have *balanced-budget provisions* to some degree, which prevent state governments from carrying over deficits from one year to the next. Balanced-budget provisions restrain states' flexibility to increase spending by increasing state deficits (Alt and Lowry 1994; Bohn and Inman, 1996; Garand and Hendrick 1991; Poterba, 1994). By the same token, *divided government* makes expenditure and revenue decisions much more difficult (Alt and Lowry, 2000). Other institutional settings, such as *spending or revenue limits* and *restrictions on general obligation debt*, also restrain state spending (Poterba, 1994; Bails and Tieslau, 2000; Reuben, 1996; but see Cox and Lowry 1990).

State economic conditions influence spending priorities as well. States differ in the magnitude of their tax and revenue pools from which the resources to support state spending are drawn. Hence when the *tax capacity* or the level of *taxable income* of a state increases, there is often public or elite demand for greater public consumption, which leads to a higher level of state spending (Abrams and Dougan, 1986). Economic growth increases the revenue pool but decreases the need for greater spending, while economic contraction and high unemployment can result in decreased or stagnant revenue levels but increased demand for public expenditure.

Social and demographic attributes of the state also determine state spending levels and priorities. Simply, demand for government goods and services (and, hence, higher spending) is likely to be higher in states with certain population configurations. For instance, higher *poverty rates* may increase overall welfare spending, though high poverty rates may tend to depress welfare spending per recipient because states with higher poverty rates may try to "keep more poor people from migrating in by lowering redistributive expenditure" (Peterson, 1995: 93). States with higher *population density* tend to spend more on transportation and other developmental areas because denser populations are associated with higher social interdependence levels and induce high demands for spending in those areas (Peterson, 1995). States with higher percentages of *central city population* tend to spend more in both welfare and developmental areas (Peterson, 1995). The proportion of residents in the state population from disadvantaged racial and ethnic groups also directly influences the level of welfare expenditures (Tompkins, 1975).

Finally, state spending priorities are a function of political variables. States with Democratic governors and Democratic-majority legislatures are expected to allocate higher levels of resources to welfare and education (Garand, 1985). There is also speculation in the literature that high levels of interparty competition has a positive effect on state welfare spending; simply, when interparty competition is high, the two political parties are seen as competing for the votes of low-income voters, who are usually characterized by lower turnout rates. This hypothesis is usually attributed to Key (1949), though the evidence on this point is mixed (Dawson and Robinson, 1963; Dye, 1966; Hofferbert, 1966). However, what is most likely is that interparty competition acts as a mediating variable that translates other variables (such as party control of state government) into higher (or lower) welfare spending levels. For instance, Barrilleaux, Holbrook, and Langer (2002) find that Democratic control of the state legislature is positively related to state welfare spending only in states characterized by high levels of interparty competition.

*Mass preferences toward state fiscal policy:* State residents are mobile and can select the state or local community that best satisfies their preference for public goods (Tiebout, 1956). If residents are fully aware of the revenue and expenditure patterns of various states, they are able to react to the differences and move to the states that can best satisfy their spending and taxation preferences. For instance, parents with children in school can choose to move to states or communities that spend more on education, while elderly people can choose to move to states or communities that spend more on senior care. Given this, the preferences of state residents can exert an influence on state policy making (Erikson, Wright, and McIver, 1993; Tiebout, 1956).

One problem in this literature is that there is very little data available on the state spending and taxation preferences of state citizens. The work of Sears and Citrin (1982) is a classic exception, insofar as the authors focus on the attitudes toward spending and taxation among Californian citizens in the wake of the tax revolt associated with Proposition 13 in the late 1970s. There are occasional studies of spending and taxation preferences among citizens in individual states (e.g., Beck and Dye, 1982; Garand and Blais, 2004), but there are no data sources that capture systematically the attitudes of the mass public towards state spending and taxation across states and over a long period of time. Hence, scholars rely on general measures of state mass ideology (Berry, Ringquist, Fording and Hanson, 1998; Berry, Fording, Ringquist, Hanson, and Klarner, 2010; Erikson, Wright, and McIver, 1993). What this means is that there is relatively little research done on public preferences toward state fiscal policy, and this is a major shortcoming in the scholarly literature.

## State Revenue Policy

The U.S. federal government has a wide array of options available when adopting revenue policies. However, state governments are constrained by constitutions, demographics, in-state actors, and even the federal government itself. Revenue policies at the state and local levels are extremely important; funds collected finance state agencies and social programs, as well as the numerous public-sector jobs at the state level required to administer those agencies and programs. During difficult economic times, most states are required either to reduce spending to match projected revenue or to increase revenue through new taxation. One need only look to the financial difficulties faced by state governments—especially for large states such as California, New York, and Illinois—during the period from 2008 to 2010 to understand the potentially devastating effect of revenue shortfalls on the public goods and services provided by state governments.

## Determinants of Taxation

Attempts to explain the taxation policies of the American states have a long history in this literature (Bingham, Hawkins, and Hebert 1978). In an effort to test empirically some of the more common theories, Berry and Berry (1992) use pooled cross-sectional time-series data and events history analysis to test five explanations of state adoption of income taxes, gasoline taxes, or any taxes. They find particularly strong support for the role of politics in state tax adoption. Specifically, they find that state governments are more likely to institute taxes when there is a long time period before the next election cycle. State legislators may well believe that an increase in taxes is the fiscally appropriate thing to do, but taxes are unlikely to be popular

with their electoral constituencies. Adopting new taxes would make the most sense during the time period in which elected officials do not face an imminent threat of electoral defeat as a result of having taken a stance in favor of tax adoption. Legislators are likely to reason that political behavior is also heavily shaped by more recent events, and if an election cycle is far in the future there is a strong likelihood that the voters will forget an increase in taxes that occurred months or even years ago in favor of more recent political actions.

Berry and Berry also find that political opportunities to increase taxes can arise during fiscal crises. When fiscal crises occur, policy makers must increase tax revenue if they want to maintain present levels of state services, given state constitutional or statutory mandates to balance the state budget. In addition, Berry and Berry speculate that states are more likely to adopt new tax policies when neighboring states have adopted new tax policies as well. The adoption of new taxes by other states may help to shield state legislators from the political costs of such policies. Berry and Berry (1992) find that their empirical evidence is consistent across tax instruments and different periods of analysis throughout the twentieth century and are able to justify the fiscal health explanation, the election cycle explanation, and the regional diffusion explanation as being valid explanations of state tax innovation.

Berry and Berry (1992) also consider the effects of economic development on state tax adoption. The economic development theory suggests that an increase in the private resource base—i.e., as reflected in increases in population, businesses in a state, or income—should also result in an increased probability of state tax adoption. However, they find little support for this theory. The authors also test for the effect of party control of state government on state tax adoption, but they find little evidence of a partisan control effect.

Berry and Berry (1994) extend their analysis of state tax adoption to cover increases in state tax rates, and their findings are hauntingly similar to those for state tax adoption. Simply, tax rate increases are more likely to occur during fiscal crises, when neighboring states have adopted tax rate increases, and early in elected officials' terms of office.

## The Role of the Public

There has been some scholarly attention paid to the effect of public opinion on taxation policies. When examining the relationship between the mass public and state tax policy, it is important first to ascertain whether or not the public is able to link state government taxes to state government performance. Bowler and Donovan (1995) use survey data collected in five years—1983, 1985, 1987, 1989, and 1991—in which opinions about state tax rates and perception of government performance are measured. The authors find that citizens' hostility toward taxes is strongly related to the actual tax level, suggesting that the mass public has at least some knowledge about objective tax levels and is able to translate that knowledge into assessments of the tax system. Further, Bowler and Donovan find that the public is able to accurately attribute unpopular taxation policies to the state-elected officials who enacted the policies, although little is said about the role of the media and this connection. These findings may point towards an important relationship between public opinion and revenue policies. It would appear that the American mass public has a clear and consistent interpretation regarding state tax provisions. Voters would also seem able to hold elected officials responsible for unpopular taxes, especially when state taxes are already relatively high (Bowler and Donovan, 1995).

The findings by Bowler and Donovan are consistent with those of Attiyeh and Engle (1979) and Lowery and Sigelman (1981). These findings may be attributed to the fact that at the local level individuals have first-hand experience with the outcome of tax dollars being collected and then spent (Hawthorne and Jackson, 1987). However, there is still some debate regarding the public's level of economic knowledge.

## State Tax Sources

Unlike the federal government, state governments do not have the constitutional authority to impose tariffs or other taxes on trade goods, and as a result the individual state governments have a relatively small number of options available when they consider raising revenue. The federal government does make contributions to the states through various intergovernmental grant and joint federal-state programs, but the amount available has varied considerably over time (Alt and Lowry, 1994). On the other hand, the U.S. federal system can also impose costs on the states. State governments are often required by the federal government to provide funds for unfunded mandates, which usually involve laws or regulations by the federal government that impose costs on state governments (Posner, 1998). States can generate their own revenues and benefit from intergovernmental grants from the federal government, but they also must bear the costs of federal legislation.

According to Campbell (2009), over the past 90 years the sources of state revenue have changed. In the 1920s, most state revenues came from property taxes. During this time period state governments were able to support their programs with this tax, but this began to change significantly in the 1930s. The Great Depression reduced the amount of property tax that the states had been receiving, and federal funds to the states also decreased. In response, most states began to adopt income and sales taxes and left most property taxes to the local governments, which were having an increasingly difficult time funding their own services (Campbell, 2008). Changes in the federal tax code also paved the way for state and local tax codes. In 1939, only 4 million households paid the federal income tax, but by 1945 that figure had jumped to 45 million households (Campbell, 2008). Income taxes had become part of American life.

Political pressure in the 1950s once again forced a change in state and local fiscal policy. Many in power had felt that the upper-class bore too much of the tax burden, and laws were rewritten so that the middle-class were made to pay a larger percentage of tax on their property and income. In an effort to keep programs fully funded and pay the balance of underfunded federal programs, state and local governments slowly raised income and property taxes. In some states, property taxes increased at a higher rate than home values. Citizens became increasingly frustrated with this state of affairs, and eventually this frustration was manifested at the polls. In California, rapidly increasing property values (and, more importantly, assessments of those property values) resulted in large increases in property taxes, and in 1978 voters passed Proposition 13, a ballot initiative that limited property tax increases. Similar measures were passed in other states, and a strong anti-tax sentiment extended to the national level (Martin, 2008). In response to a decrease in revenues, states began to turn to sales taxes. This consumption tax is easier to predict than a property tax, which may fluctuate rapidly based on the will of those in power at the state level. Sales taxes may also vary, but the consumer does not need to worry about

paying sales tax on items that have already been purchased.

Where do state governments obtain their revenue? Across all states in 2008, 51.6 percent of revenue comes from taxation, while another 29.5 percent comes to states in the form of intergovernmental grants. Among the various tax categories, the largest two revenue sources are individual income taxes (representing 35.6 percent of all taxes collected) and general sales taxes (30.8 percent), followed by selective sales taxes (15.0 percent), corporate income taxes (6.5 percent), and license taxes (6.3 percent). However, the distribution of state revenue sources varies significantly across states. For instance, in 2008 six states did not report any revenue from the individual income tax, and another five states did not have revenue from the general sales tax (U.S. Census, 2010). Other states are highly reliant on these taxes for the lion's share of their revenue, so it is clear that states vary in their approaches to raising revenue. One unexplored issue in the literature on state revenue policy is what explains variation in states' reliance on different mixes of taxes in generating revenues. In other words, why do some states rely on sales taxes, while others rely on income taxes or other taxes?

## Deficits and Surpluses in the American States

The use of deficits and surpluses at the national level to achieve macroeconomic goals has long been the subject of considerable debate. The federal government is legally permitted to generate deficits and, except for 1999 and 2000, has done so each year since 1960. The American states, however, are much more constrained in their legal authority to run deficits. As of 2010, 49 or 50 states—Vermont is the sole exception—have some kind of constitutional or statutory requirement designed to result in a balanced budget or budgetary surplus. According to the National Council of State Legislatures (2010): (1) in 44 states, the governor is required either by constitutional provision or by statute (or both) to submit a balanced budget to the legislature; (2) in 41 states, the legislature is required by constitutional provision or statute (or both) to pass a balanced budget; and (3) in 38 states, a budget deficit cannot be carried over from one fiscal year to the next. Clearly, the American states face an array of legal constraints relating to deficits and surpluses, and in most states budget deficits are prohibited by law.

That does not mean that there is no pressure on state governments to spend more than they take in. To the contrary, state governments face many of the same pressures that lead the federal government to spend in the red during the vast majority of fiscal years. For instance, state governments have an interest in facilitating favorable macroeconomic outcomes, and Keynesian economic theory places a great deal of emphasis on the role of deficits in stimulating the federal economy. If states are unable to generate deficit spending, the argument goes, an important macroeconomic policy tool has been taken from states' proverbial macroeconomic tool kits. Moreover, state governments face greater demand for spending from their constituents than demand for increased taxes. How states deal with the multitude of pressures for deficit spending varies considerably across the states, and this is the topic of this section.

### Patterns of Deficits and Surpluses in the American States

Given the constitutional and legal incentives for balanced budgets in the states, it is no surprise that most states balance their budgets most of the time. In their study of budget deficits and surpluses in the American states from 1961 to 1997, Garand and Kapeluck (2004) find that in 82 percent of cases states had budget surpluses or balanced budgets. Moreover, there is a strong trend over time towards balanced budgets or budget surpluses. According to Garand and Kapeluck, in the first few years of the 1960s fewer than 50 percent of states balanced their budgets; after 1982, at least 90 percent of states balanced their budgets, and in some years (1985, 1986, and 1997) all states had a balanced budget or a budget surplus. There is, however, quite a bit of variation in the size of state deficits and surpluses; Garand and Kapeluck find that the mean budget surplus has increased over time, reaching almost 16 percent of state expenditures in 1997; however, the standard deviation of the gap between revenues and surpluses has also increased over time, meaning that states vary considerably in their deficit and surplus behavior.

What explains patterns of deficits and surpluses in the American states? First, economic variables have a strong effect on the size of state deficits and surpluses. On one hand, strong state economic performance is positively associated with revenue increases, so there is less pressure for states to have deficits or smaller surpluses when economic growth is high and unemployment is low. When the economy is weak, revenues are likely to decline, and this increases pressure for deficit spending or smaller surpluses. On the other hand, weak economic performance in a given state also creates pressure for state government officials to take action to improve state economic performance, and this means greater pressure for states to stimulate the economy through increased government spending. Garand and Kapeluck (2004) find considerable support for the role of economics in shaping state deficits and surpluses; they find that state economic growth has a positive effect on budget surpluses, while unemployment and inflation depress state surplus levels.

Second, constituency demand for government spending should have a strong negative effect on the magnitude of state budget surpluses. Some segments of state populations are typically high demanders of public goods and services due to need borne out of economic disadvantage, economic self-interest, or ideological considerations. Garand and Kapeluck find that states are more prone to budget deficits (or smaller surpluses) as a function of the size of the African-American, young (under 18), and elderly (over 65) populations. Moreover, states that are characterized by high levels of ideological liberalism among the mass public are also more likely to run smaller surpluses or increase debt (Clingermayer and Wood, 1995; Garand and Kapeluck, 2004).

Third, the role of partisan politics in shaping budget deficits and surpluses has had a prominent place in the scholarly literature on state deficits and surpluses. Scholars have focused considerable attention on the effects of party control of the legislature or governorship, particularly in terms of (1) whether the Democrats or Republicans hold unified control of state government; or (2) whether there is divided government between the two major parties. Regarding control of state government by the two major political parties, scholars have hypothesized that Democratic control is related to budget deficits or smaller surpluses, though the evidence underlying this hypothesis is weak (Alt and Lowry 1994; Garand and Kapeluck, 2004; see also Seitz, 2000). Even more intriguing is the suggestion that divided government increases the probability that state governments will experience budget deficits. The argument is that divided government creates gridlock between the two political parties that slows state responses to fiscal crises.

Garand and Kapeluck (2004) do not find that budget deficits are significantly different under unified Democratic, unified Republican, or divided governments, though Poterba (1994) and Alt and Lowry (1994) find that unified governments are better able than divided governments to respond to fiscal crises and avoid deficits.

Finally, the role of institutions in shaping state deficits and surpluses has been a major feature of the scholarly literature on state fiscal policy. Perhaps the most notable institutional characteristic is state constitutional and statutory provisions that are intended to proscribe (or, at least, discourage) state deficits. The states vary in the stringency of these provisions, so while deficits are not permitted in some states, in other states deficits are permitted under certain circumstances. One institution that has drawn a great deal of attention is state carryover provisions, which prohibit states from carrying deficits over from one fiscal year to the next. Scholars have found that carryover provisions have a strong positive effect on budget surpluses, indicating that deficits are significantly less likely in those states with these provisions (Alt and Lowry, 1994; Garand and Kapeluck, 2004; Poterba, 1994). In addition, election proximity can have a significant effect on state deficits and surpluses. During election years there is considerable pressure on elected officials to increase spending, and this makes surpluses much more difficult to achieve (Garand and Kapeluck, 2004). Moreover, Cummins (2008) contends that term limits reduce the size of state surpluses by reducing the level of policy experience held by elected officials, which is subsequently translated into weaker capacity of state government to avoid deficits. His findings are consistent with expectations insofar as term limits have a significant negative effect on the size of state surpluses.

## The Role of the Federal Government

Funding provided by the federal government can also play a large role in state fiscal policy. During the time period from 1968 to 1987, 20–25 percent of all state spending was funded by the federal government (Alt and Lowry, 1994), and more recently that figure has approached 30 percent (U.S. Census Bureau, 2010). Clearly, these figures reveal the level to which state governments depend on federal funds when making budgetary decisions. Alt and Lowry (1994) also point out that state legislatures must often attempt to anticipate changes in federal aid due to changes in the national business cycle. An economic downturn in the steel belt can lead to a decrease in federal revenue, which can in turn lead to a decrease in funds available to the states—even those states that are geographically far removed from the economically suffering area.

State governments are often forced to fund federally mandated programs that are not fully funded by the federal government thereby (Chubb, 1985). These unfunded (or underfunded) mandates can be seen as reducing the autonomy of state governments and can play a crucial role in states' fiscal policymaking. Individual states may not approve of a mandated program but are forced to fund it, and during difficult economic times this can have the effect of forcing states to make a choice among diverting funds from other programs, raising additional revenue or, when possible, running deficits. National monetary policy can also affect interest rates on state bonds, and this in turn can have an impact on the amount states can borrow.

## Deficit Constraints

As noted, with the exception of Vermont all states have a balanced budget rule in one form or another. Wagner (1999) differentiates the types of deficit constraints states can have into five categories: (1) the governor is required to submit a balanced budget; (2) the state legislature is required to adopt a balanced budget; (3) the state may carry forward a budget deficit to be corrected in the next fiscal year; (4) the state may not carry forward a budget deficit into the next budget cycle (which is 2 years for the 20 states operating on a biennial cycle); and (5) the state may not carry forward a budget deficit into the next fiscal year. Wagner's categories illustrate the widely different levels of constraint with which state legislatures and governors may have to deal. A lower level of restrictions may give more autonomy to state policy makers, but a hidden cost is that those who govern must make more intricate economic decisions that are not only based on local economics but also on national economic conditions.

However, state Supreme Courts have a long history of circumventing balanced budget laws by ruling that revenue bonds are not included in the calculation of constitutional debt limits (Gelfand, 1979; Quirk and Wein, 1971). In addition, Gramlich (1991) discusses how most states with balanced budget rules are permitted to run deficits so long as they are able to pay off the difference with cash in reserve. This creates an incentive for states to run a surplus whenever possible. Political institutions in general will often assist the state legislature in finding legal ways around any balanced budget requirements (Bunch, 1991). A state's credit history may also act as a constraint. In cases in which a state is willing and able to run a deficit, it must find investors who are willing to take the financial risk of investment. If individuals do not trust a state to pay back the full value of a bond, investment will not occur; regardless of the state's desires, deficit spending cannot occur. Moreover, states with poor credit histories or low bond ratings may face increased deficits or smaller surpluses based on the increased cost of borrowing that they face.

The level of constraint placed upon states has been shown to have an effect on a legislature's economic decisions (Alt and Lowry, 1994; Bohn and Inman, 1996; Levinson, 1998). States that are constitutionally required to have a balanced budget are more likely than other states to anticipate negative economic shocks, and as a result are more likely to save money to pay off any shortfall (Bohn and Inman, 1996). In turn, these anticipations can drive state macroeconomic outcomes. Saving money for an economic downturn may be beneficial, but as a result, any surplus funds (that may be used to prevent an economic downturn) cannot be immediately reinvested in the state economy.

## State Fiscal Policy as an Independent Variable

State fiscal policy is the most important policy made by state governments. Good fiscal policy not only promotes macroeconomic stability and growth, it is also a powerful tool to reduce poverty and inequality. In this section, we discuss possible economic, political, policy, and social effects of state fiscal policy.

### Economic Effects

*Macroeconomic performance:* In his *The General Theory of Employment, Interest and Money*, Keynes (1936) contends that governments can use fiscal

policy to effectively manage the economy. In particular, governments can stimulate the economy and fight against unemployment rate by increasing deficit spending during recessions, and government can suppress inflation by cutting government outlays or increasing taxes during boom times. The theory, as heatedly debated as it could be, has been tested in empirical studies and has also been adopted in practice by many governments. Scholars have demonstrated in one way or another that fiscal policy can change economic outcomes in a short run, though arguably the market is primarily responsible for the long-run business cycle (Brace, 1989; Hendrick and Garand, 1991a; Hibbs, 1977; Jones, 1990; Keynes, 1936; Poterba and Rueben, 2001; Tufte, 1975, 1978). Although state governments typically lack the authority to create deficits, they can certainly use taxation and spending policy to manipulate economic growth, unemployment, and inflation rates by cooling down or stimulating the state economy.

To what extent can states adopt fiscal policies that affect state economic performance? There is actually a considerable amount of debate over this question. One primary bone of contention is the degree to which the performance of state economies is dependent on the performance of the national economy. Do state economies march in lockstep with the national economy, or is there sufficient variation in state economic performance to suggest that state governments can have an independent effect on their economies? Hendrick and Garand (1991a) show that more than half of the variation in economic performance is explained by the unique economic performance of state economies, though the state effect has taken a decidedly downward shift during the early 1960s, but has stabilized through 1985. On the other hand, Brace (1989, 1991) shows that the national influence on state economies has been on the decline; he finds that state variables did not have significant effects on state economic performance prior to 1980, but during the period from 1980 to 1985 finds that several state-level variables had strong effects on state per capita income. Moreover, Jones (1990) explores explicitly the effects of state policies on state economic performance, and he demonstrates that expenditures on education, highways, and policy and fire services promote business development and employment, while welfare expenditures depress business development and employment.

*Stock and bonds market:* State fiscal policy not only influences macroeconomic performance, but it also influences consumers' perception of economy and further yields of state bonds. Poterba and Rueben (2001) find that unexpected deficits are correlated with higher state bond yields, though the relationship is mediated by state fiscal institutions.

## Political Effects

*Economic voting:* Since state fiscal policy affects macroeconomic performance and voters base their voting decisions (at least in part) on economic performance, state fiscal policy indirectly influences voting behavior. Economic voting theory argues that voters base their voting choices on retrospective (or sometimes prospective) evaluations of their own economic situations or the national economy (Campbell, 1992; Downs, 1957; Fair, 1978; Garand and Ulrich, 2008; Hetherington 1996; Holbrook and Garand, 1996; Kramer, 1983; Lewis-Beck and Stegmaier, 2000; Mackuen, Erikson, and Stimson, 1992; Markus, 1988; Nadeau and Lewis-Beck, 2001; Tufte, 1978). Given that "pocketbook" voters (i.e., voters who base their voting choices on their own economic situation) and "sociotropic" voters (i.e., voters who base their voting choices on national economic performance) both exist, one could speculate that voters could base their vote choices on state economic performance. Actually, Cohen and King (2004) have found that voters are able to differentiate unemployment rates on the state and national level, and they reward governors if state unemployment rate is lower than the national unemployment rate and hold governors accountable if it is higher. Garand and Ulrich (2008) demonstrate that individuals' sociotropic evaluations of the national economy are shaped, at least in part, by state economic performance. Economic performance also influences popularity of governments and politicians (Cohen and King, 2004; Conover and Feldman, 1986; Garand and Ulrich, 2008; Mackuen, 1983; Nadeau et al., 1999).

One aspect of the political effects of state fiscal policy involves the electoral implications of tax increases. Scholars and political observers speculate that governors who support increases in state taxes will have a day of reckoning at the polls, and the implication is that there should be electoral retribution directed against state politicians who advocate tax increases. Kone and Winters (1993) explore the effects of increases in state income taxes, sales taxes, and any taxes on electoral support for gubernatorial candidates of the incumbent party from 1957 to 1985. They find that increases in state sales taxes have a negative effect on the electoral prospects of incumbent-party gubernatorial candidates, though the effect is asymmetrical—i.e., tax decreases do not have a positive effect commensurate with the negative effect of tax increases. Tax increases for other taxes have a weak or null effect on gubernatorial election outcomes.

## Social Effects

*Income inequality and poverty:* The two components of state fiscal policy—taxation and spending—both have the potential to play a redistributive function in the American states. Progressive income taxes take a higher share of resources from those with higher incomes, and this provides a pool of resources that can (theoretically) be reallocated to the have-nots through a variety of redistributive programs. At the national level, Piketty and Saez (2003) find that steep, progressive income taxes and estate taxes prevent the wealthy from becoming wealthier. Peterson (1995) finds that greater spending on redistribution programs (such as welfare, pensions, and medical insurance) reduces the gap between the rich and poor. Scholars also find that Democratic presidents and policy liberalism both tend to suppress income inequality because they are both associated with more redistributive spending or pro-redistributive policies (Bartels, 2008; Kelly, 2005). Yet there has not been much research done to explore the degree to which state fiscal policy directly leads to lower levels of poverty and income inequality (cf., Xu and Garand, 2010). This shortcoming should be rectified in future research.

*Welfare magnets:* States differ in their welfare spending levels, and this variation can have important implications for the residential choices of those living in poverty. For example, in July 2006 the maximum monthly TANF case welfare benefits for a family of four was \$1025 in Alaska and \$194 in Mississippi (U.S. House Committee on Ways and Means, 2008). The large variation of welfare benefits potentially leads to a welfare magnetic effect. States with more generous welfare benefits would keep current poor people from leaving the state and attract additional poor people or immigrants to move into the state (Bailey, 2005; Borjas, 1999; Frey, Liaw, Xie, and Carlson, 1996; Levine and Zimmerman, 1999; Peterson, 1995; Peterson and Rom, 1990). Therefore states with generous welfare provisions like California and New Jersey attracted many immigrants in the past several decades. This is also why states with a higher poverty rate tend to spend less on welfare, because they do not want to attract more poor people.

In sum, if Keynes (1936) and his intellectual progeny are correct, state fiscal policy potentially can be used to manage macroeconomic performance. Deficit spending can stimulate the economy and reduce unemployment rate during recessions, while higher taxation and reductions in government expenditures can cool down the economy and reduce inflation in boom times. Not only can state fiscal policy be used to create the public good of strong state economic performance, it can also be used by politicians to manipulate economic performance for personal ends, such as for re-election. By influencing macroeconomic performance, fiscal policy also indirectly influences voting choices. It has been demonstrated that political business cycles exists in the United States, though further research is necessary to ascertain the degree to which political business cycles exist at the state level. Finally, the social effects of state fiscal policy are potentially nontrivial. Spending in redistributive areas can reduce poverty and inequality, but at the same time, it is possible that it creates a welfare magnetic effect. Compared to national-level studies, more studies need to be done on how state fiscal policy influences economics, politics, and society at the state level.

## An Agenda for Future Research

As noted at the outset of this chapter, the unfinished research agenda on state fiscal policy is very extensive. During the past four decades of the twentieth century, scholars devoted considerable attention to the study of state fiscal policy. In contrast, over the past decade there has been a relative dearth of empirical studies of state fiscal policy, and this has left many unanswered questions relating to the topic. It is important for state politics scholars to redirect some of their energies to a resurgence of the study of state fiscal policy.

We suggest that there are some broad themes that may prove fruitful in rebuilding the state of scientific knowledge about state fiscal policy. First, given the relative inattention paid to state fiscal policy over the past decade, it is important for scholars to replicate, extend, and update research conducted in the latter half of the twentieth century. Many of the findings relating to the study of government size, spending, and tax policy, and deficits and surpluses are based on research conducted during the 1980s and 1990s, and extending these studies to cover data from more recent years is crucial. For instance, much of what we know about the determinants of government size is based on research findings from the 1980s and early 1990s, yet there have been considerable changes in the roles and responsibilities of state governments since that time. Moreover, the excellent works on state tax adoption (Berry and Berry, 1992, 1994) and the electoral implications of state tax changes (Kone and Winters, 1993) were conducted during the early 1990s, and it is important for scholars to extend this research stream to cover more recent data and political circumstances.

Second, although state fiscal policy has not drawn much scholarly attention over the past decade, the study of fiscal policy at the national and cross-national levels has continued unabated. State politics scholars have always taken advantage of theoretical perspectives, methodological approaches, and the research findings generated in national-level research, and it is important for state politics scholars interested in fiscal policy to continue to adapt research conducted at the national level to the state level. To take one example, Cameron (1978) has suggested that the growth of the public sectors in Western democracies is a function of globalization and economic interdependence among countries. Is this theoretical argument applicable to the American states? Are states that are heavily dependent on international trade more likely to increase the size of their public sectors than states that are less dependent? This is the kind of research question that has been generated in comparative cross-national research, but could be explored in research on the American states.

Third, it is important for state politics scholars to combine both macro- and micro-approaches in studying state fiscal policy. Most of the research in this research program has been conducted using aggregate data (e.g., state government size, spending and tax levels, budget deficits and surpluses). This is important and useful, but relatively little is known about the micro-level foundations of state fiscal policy. For one thing, most of the research on the fiscal policy preferences of Americans has been focused on the national level; with a few exceptions, little is known about Americans' knowledge of state economic conditions, their perceptions of the effectiveness of state fiscal policies, and the preferences and attitudes of Americans relating to state fiscal policy (Garand and Blais, 2004; Sears and Citrin, 1982). Moreover, there has been little micro-level research conducted on state political elites who are involved in the making of fiscal policy; for instance, what motivates state legislators and governors as they develop state fiscal policies? We suggest that an increase in the attention paid to the micro-level has the potential to generate important insights about state fiscal policy.

In specific terms, what are some of the unanswered research questions confronting state politics scholars studying state fiscal policy? Regarding state government size, first, it is important for scholars to explore the degree to which and why the inflation rates are different for the public and private sectors. There has been some research done at the federal level (Berry and Lowery, 1984a, 1984b), but this question has not been addressed at the state level. Second, the effects of party control of state government, mass political ideology, and interparty competition on government size has been studied in previous research, but not during the more recent time period characterized by such intense polarization at the mass level (Garand, 2010). What is the effect of political variables during the current period of high mass and elite polarization? Third, political scientists know woefully little about mass preferences relating to the size of the public sector. There has been a bit of resurgence in the study of state public opinion as new data and techniques have become available (cf., Cohen, 2006) and state politics scholars would find a fruitful research program in studying Americans' preferences toward the size of their state governments. Fourth, more research needs to be done on the effects of politically relevant groups on the size of state public sectors; for example, what is the role of public-sector unions in shaping increases in the size of state governments? Finally, most of the American states have faced a recent major fiscal crisis. It is important for scholars to categorize and study the determinants of how states respond to severe fiscal crises, particularly in terms of how they maintain or reduce the size of their public sectors in response to revenue shortfalls.

Regarding spending, revenues, and deficits and surpluses, there are several unanswered research questions. First, the research on expenditure tradeoffs needs to be updated. In particular, scholars should assess the degree to which there are expenditure tradeoffs among the various spending categories at the state level. But more importantly, scholars should focus attention on how and why tradeoff patterns vary across states and over time. What conditions facilitate and obstruct expenditure tradeoffs? Second, scholars have studied the degree to which state expenditure and revenue patterns have become nationalized, but this is an area of research that needs renewed attention, particularly in light of shifts over time in the relationship between the federal and state governments. Third, how do states respond to the expenditure and tax policies of their neighboring states? What, specifically, are the processes that result in the neighbor effect? Fourth, many states have constitutional or statutory requirements requiring a

balanced budget or are unable to carry debt over to the next fiscal year. Bowler and Donovan (2004) look at these constraints and the ways in which local and state governments use existing laws to circumvent requirements. They find that during difficult economic times states with tax and expenditure limitations often seek to change their institutional structures in order to get around fiscal restrictions. To what extent do state governments change institutions during periods of fiscal crisis? Finally, we suggest the need for scholars to study public opinion relating to state taxes, expenditures, and deficits. For instance, scholars should consider the joint preferences that individuals have towards government spending and revenues (cf., Garand and Blais, 2004). Do individuals link their support for state spending with their willingness to pay (Green, 1992)? Do individuals shift their support for spending as a function of the need to generate additional revenue to support increased spending?

Finally, it is important for scholars to explore the effects of state fiscal policy on the workings of state political systems. First, state politics scholars have paid insufficient attention to the question of the effects of state spending, taxes, and deficits and surpluses on state economic performance. When states make investments in education or highways infrastructure, is there an economic development payoff at some point in the future? There are some hints of such effects in the work of Brace (1989, 1991), Hendrick and Garand (1991a), and Jones (1990), but political scientists should move beyond these efforts by updating the research program on the linkage between state fiscal policy and state economic performance. For instance, in those few cases where states generate deficits, does this have the effect of stimulating state economic performance, as suggested by Keynes? Second, what is the effect of state spending, taxation, and deficits and surpluses on individuals' trust in and support for state government? If state governments are doing good things with state expenditure, one would expect state citizens to develop positive evaluations of state government and state officials. On the other hand, do high taxes diminish individuals' support for state governments?

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