Constitutional Limits to State and Local Spending

address by

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Good afternoon and Happy New Year.

Wisconsin is now considering several proposals to establish a constitutional limit on state and local government spending with the usual political controversy between those who pay most of the taxes and those who especially benefit as producers of state and local government services. My remarks today bring several personal perspectives to this issue but by one without a detailed understanding of the politics and fiscal conditions specific to Wisconsin.

The Case for a Tax and Spending Limit

In the absence of a constitutional limit on state and local government spending, the primary processes that limit this spending are *exit* and *voice* -- the net effects of government spending and taxes on the migration of people and businesses and on the popular vote for the candidates of the incumbent party. The primary case for a tax and spending limit amendment is that these two processes do not appear to be sufficient to serve the interests of a majority of the resident population. This conjecture can be tested by estimating the marginal effects of increased spending and taxes on such conditions as migration and votes. A broadly popular fiscal program should lead to net migration into the area served by the government and an increased vote for candidates of the incumbent party; a fiscal program that does not serve the interests of the majority should have the opposite effects. The evidence from both migration and voting studies suggests that government budgets are higher than would be approved by a majority of the resident population. As it happens, I have done empirical studies of both of these processes, summarized in my article on "The Case for a New Fiscal Constitution," [1] but my results are much like those from other studies.

Migration

My study of interstate migration is based on the migration among the 48 contiguous states in the years 1980 through 1988. Net migration into a state during the 1980s appears to have been a positive function of the percent metropolitan, population density, and migration patterns during the 1970s, and a negative function of the unemployment rate and state and local tax revenues per capita at the beginning of the decade. Population density, in turn, appears to be a negative proxy for the relative importance of agriculture and mineral production in a state. One of the surprising results of this test is that migration patterns during the 1980s do not appear to be a significant function of personal income per capita at the beginning of the decade. For the argument here, the most important result is that a 10 percent higher level of state and local tax revenues per capita in 1980 appears to have reduced the net migration into a state from 1980 through 1988 by 0.6 to 0.9 percent of the 1980 population. I encourage one or more of you to do a similar study of interstate migration patterns in the 1990s to estimate the effect of the level of taxes in Wisconsin on net migration into the state.

Voting

My study of the fiscal effects on voting is specific to the federal government, because exit is not a significant discipline on the budget of a large national government. (Barbara Streisand once promised that she would move to Canada if Bush were elected, but she broke her promise, alas, when no one else seemed to care.) So we are entirely dependent on voice to discipline federal fiscal policy. My study of the effects of federal fiscal policy on voting is based on the popular vote for the presidential candidate of the incumbent party in the 24 presidential elections from 1896 through 1988. The general results of these tests, roughly consistent with that from other studies, are that incumbency and economic growth favor the candidate of the incumbent party and that war and higher taxes favor the opposition candidate. (As an aside, George W. Bush would probably have received nearly 58 percent of the major party popular vote if not for the war in Iraq.) Presidential candidates of the incumbent party have often survived an increase in taxes only because voters have a strong preference for continuity and credit the incumbent party for general economic growth. For the argument here, the most important result is that a 10 percent increase in real federal tax revenues per capita since the prior election year appears to have reduced the popular vote for the presidential candidate of the incumbent party by about 1.2 percentage points. I plan to update this study sometime this spring to include the four additional presidential elections since 1988 in the sample. I encourage one or more of you to do a similar study of the popular vote for the governor of Wisconsin to provide a better basis for estimating the effect of voting in limiting the fiscal policy of this state.

Some Interpretive Comments

Why are exit and voice not more effective in limiting government spending? One reason is that the decision to move or to vote for a specific candidate is based on a *package* of conditions, of which taxes are only one condition. If the other conditions are favorable, few people will change their behavior unless the increase in taxes is extraordinarily high. Another reason is that the political demands for government spending reflect the interests of both the consumers and producers of government services. Those of you who have been engaged in politics at any level will testify to the powerful effect of teachers' unions, road builders, defense contractors, etc. on government spending, even though these groups, as consumers, may not have an unusual demand for the government services they supply. The market demands for private goods and services, in contrast, are almost entirely determined by the preferences of consumers (except for the trivial demand-increasing effect of advertising). In any case, the empirical evidence at both the state and federal government levels indicate that taxes and spending are generally higher than would be approved as a *separate* issue by a majority of the resident population. Moreover, my own estimate from another study[2] is that the cost to the economy of the last dollar of total government tax revenue is now about $2.75 -- much higher than the plausible marginal benefit. Taxes and government spending in the United States are clearly too high by any standard of the general welfare.

The Design of a Tax and Spending Limit

May I acknowledge that I also bring some personal experience and maybe a bias about the design of a state tax and spending limit. I was a member of the committee, along with a then young red-head lawyer named Anthony Kennedy, that drafted the Proposition 1 amendment for California. I was the chairman of the committee that drafted the Headlee amendment for Michigan, and the general structure of the Headlee amendment was later approved as the Hancock amendment for Missouri. And I am a founding member of the National Tax Limitation Committee that has promoted such limits at both the state and federal level.

Some form of general tax and spending limit has now been approved in 27 states, beginning with New Jersey in 1976. This sample is now sufficient to estimate the effects of specific provisions of these limits on state and local government spending per capita. And Michael New has made these estimates in a policy analysis for the Cato Institute published in 2001.[3] He finds that the most effective limits have the following four provisions:

- A constitutional amendment approved by a referendum or initiative has been more restrictive and with fewer loopholes than a statutory limit approved by the legislature.
- A limit on the growth of state and local spending to inflation and population growth reduces annual state and local spending per capita by about $115 per

year.

- A provision that requires an immediate refund of surplus revenues to taxpayers reduces annual state and local spending per capita by about $40 per year.
- A provision that the state be required to reimburse local governments for newly mandated activities or expenditures is essential to protect local taxpayers.

The provision that has proved to be the most controversial is whether to limit spending growth to the growth of personal income or to inflation plus population growth. The first type of limit gives the stakeholders in government spending an incentive to support policies that increase per capita income, whereas the second type of limit only compensates for the increased cost of a larger state population. That is the reason why I supported a limit based on personal income in the several amendments to which I contributed. Amendments with this type of limit have also been less vulnerable to a subsequent override. On the other hand, a limit on spending growth to inflation plus population growth reduces the tax and government-spending share of personal income over time and leads to larger tax refunds (unless overridden by a subsequent vote, as has been the case in both Colorado and Washington.) These different effects have now made me somewhat ambivalent about the choice between these two types of spending limits.

One other general concern is to smooth the level of government spending relative to temporary changes in the level of tax revenues. This is best achieved, I suggest, by making the level of allowed spending a function of the level of tax revenues in the second prior fiscal year. For Wisconsin and most other states, this would have constrained the rapid growth of state and local government spending through 2000 and allowed somewhat higher spending in the next two years.

Conclusion

In a world in which human capital is now the most important contributor to economic well-being, Wisconsin has not realized its potential. Although Wisconsin has many good public schools and a superior university system, per capita income in Wisconsin, to my surprise, is now somewhat below the national average. A constitutional limit on taxes and government spending in Wisconsin may be essential to realize the economic potential of this state. The decision whether to approve such a limit, of course, will be your choice, not mine. May I suggest, however, that you would best make that decision "behind the veil of ignorance" about whether you are or are more likely to be an average consumer or a producer of government services. Only that perspective will assure that your decision on taxes and government spending will serve the general welfare of the people of Wisconsin.

Studies that are referenced in the text:

1. Niskanen, William, The Case for a New Fiscal Constitution, in *Policy Analysis and Public Choice*, Northhampton, Massachusetts: Edward Elgar, 1998.

2. Niskanen, William, The Economic Burden of Taxation, in Mark A. Wynne, Harvey Rosenblum, and Robert L. Formaini (eds) *The Legacy of Milton and Rose Friedman's Free to Choose*, Dallas, Texas: Federal Reserve Bank of Texas, 2004.

3. New, Michael J., Limiting Government through Direct Democracy: The Case of State Tax and Expenditure Limitations, Washington, D.C.: Cato Institute Policy Analysis no. 420, December 13, 2001.