

No. 80
September 2010

MERCATUS ON POLICY

SPENDING RESTRAINT IN FLORIDA

By Matthew Mitchell
and Tate Watkins

MERCATUS CENTER
George Mason University

FOLLOWING THE ECONOMIC collapse of 2008, almost every state in the Union faced a significant budget shortfall. Florida was no exception. Yawning budget gaps plagued the state budget in 2009 and 2010.¹ Though the recession was the proximate cause of the gaps, decades of overspending spawned Florida's fiscal woes. Furthermore, the predicament was avoidable. If Florida had held spending constant for the last 20 years while adjusting for inflation and population growth, it would have avoided its 2009 budget gap. Moreover, the state can avoid future budgetary problems by restraining the growth of spending, permitting Floridians greater economic freedom, and adopting stronger balanced-budget requirements.

BUDGET GAPS

IN 2009, FLORIDA faced a \$5.7 billion budget shortfall, equal to 22 percent of its General Fund.² As soon as the state closed that gap, however, another emerged in 2010. In order to close the gaps, Florida enacted a number of emergency measures, including fee increases, tax hikes, and spending reductions. For instance, the state increased new car registration fees by 35 percent, raised its cigarette tax by \$1 per pack, increased its tax on real property transfers, and decreased spending on transportation and corrections.³ Each of these decisions created hardship for Floridians as they encountered unanticipated costs and reduced services.

The recession was the proximate cause of Florida's budget gaps and its citizens' pain. When the economy contracted in late 2008 and 2009, state revenue fell precipitously. At the same time, demand for the state's welfare services increased, generating the nation's 11th-largest budget gap in 2009. But the recession was not the only cause for this gap. Though all states experienced the recession, not all states encountered large gaps. Recent research indicates that the following policies in particular contributed to large budget gaps:

- Growth in per capita spending during the decades preceding the recession.⁴
- Low levels of economic freedom, characterized by onerous regulation or burdensome government activity.
- Weak balanced budget requirements.⁵

All three of these policies contributed to Florida's gap.

Spending Growth

In 1987, Florida spent \$2,666 per citizen.⁶ In 2007—the year before the recession—the state spent \$3,772 per citizen.⁷ Thus, even after adjusting for inflation, the state increased per capita spending 41 percent over 20 years. This might not have been a problem if the state's economy had grown as quickly, but it didn't. Over the same period, inflation-adjusted per capita personal income increased only 32 percent. Growth in state government spending therefore outpaced growth in state income by nearly 30 percent. Because the state relies on the private sector for its revenue, such a spending path is unsustainable. If, however, Florida had maintained its inflation-adjusted per capita spending level of 1987, it would have avoided its 2009 budget gap.

Economic Freedom

People are said to enjoy economic freedom when their persons and property are protected by the rule of law and when they are permitted personal choice, voluntary exchange with others, and freedom to compete in markets.⁸ Political scientists William Ruger and Jason Sorens have developed a measure of each state's level of economic freedom.⁹ Taking into account factors such as state spending, regulation, and tax policies, Sorens and Ruger rank Florida the 22nd-most economically free state in the Union.

As with limited spending growth, econometric tests show that Sorens and Ruger's measure of economic freedom is associated with smaller budget gaps.¹⁰ If Florida exhibited the same level of economic freedom as the freest states (such as South Dakota, New Hampshire and Colorado), its 2009 budget gap would have been 37 to 47 percent smaller.¹¹

Strict Balanced-Budget Requirements

A number of researchers have investigated the stringency of state balanced-budget requirements.¹² These requirements can be more or less strict depending on whether they apply to proposed or enacted spending, whether they permit deficits to be carried over to the next year, and whether an independently elected high court evaluates the legislature's compliance with these requirements. While Florida meets the first two criteria, its Supreme Court members are politically appointed, resulting

in less-strict state balanced-budget requirements.¹³ Research shows that states with balanced-budget requirements such as Florida's tend to have budget gaps that are 35 to 45 percent larger than states with stronger balanced-budget requirements.¹⁴

THE PROBLEM OF OVERSPENDING

FLORIDA CAN CLOSE its budget gap in the short run by raising taxes or cutting expenses. However, the state cannot solve its long-term budgetary problems merely by raising taxes.

First, taxes are economically costly. In a review of the literature, economist Timothy Bartik found that, according to the median estimate, a 10 percent increase in state taxation is associated with a 3 percent reduction in business activity such as employment, firm births, and investment.¹⁵ Thus, a state that raises taxes to close its deficit substitutes one problem for another.

Moreover, a number of studies suggest that tax increases lead to further spending increases.¹⁶ This is because government spending tends to adjust to whatever resources are available. Thus, if a state addresses its budget gap by raising revenues, it often increases total expenditures in the years that follow. And because expenditure increases eventually result in larger budget gaps, attempts to rectify revenue shortfalls with tax increases may be self-defeating.¹⁷

Lastly, as noted above, Florida spending has outpaced private-sector growth for several decades. Even if the state were to continually raise taxes enough to keep pace with spending growth, this is not a sustainable solution. Prudent fiscal reform must address the persistent problem of overspending.

MECHANISMS TO LIMIT SPENDING

AS FLORIDA POLICY makers search for mechanisms to rein in spending, they have several options. Studies have shown that a number of institutions can limit state spending.¹⁸ One option is a supermajority vote requirement for all tax increases. Florida currently requires a supermajority vote in the legislature to raise its corporate income tax. If the state applied this requirement to all tax increases (as ten states currently do), it would provide a powerful restraint on future spending increases.¹⁹

An executive line-item reduction veto is another option. This type of veto—present in 12 states—permits the governor to write in a lower spending amount for particular items in the budget.²⁰ In contrast with the more-conventional veto power in which the governor must veto an entire item if he objects to its cost, the line-item reduction veto has been shown to be a significant tool in limiting spending.

Strict balanced-budget requirements (as described above) are another option. Recent research has shown that these too can be a significant break on spending.

Certain tax and expenditure limitations can also limit state spending. In the next section, we explore one such limit in detail.

TAX AND EXPENDITURE LIMITATIONS

A TAX AND expenditure limitation (TEL) is a formal rule that limits state spending or revenue growth by formula. Thirty states (including Florida) operate under such rules, but the structures of their TELs vary considerably.²¹ Many, such as Florida's, are based on growth in state income. Florida's rule limits state revenue growth to the average growth rate of state personal income over the previous five years.²²

Florida illustrates the problem of an income-based limit: When state income is rapidly expanding—as during a housing boom—the limit is not limiting. It simply grows with the rate of income. In contrast, one of the most restrictive TELs limits spending growth to the sum of inflation and population growth.²³ In other words, it holds real per capita spending constant over time.

Figure 1 displays Florida's budget path under such a TEL. The dark blue line depicts Florida's actual spending path. The dashed light-blue line shows the upper limit to Florida's spending if it had been restrained in 1987 to grow no faster than the sum of inflation and population growth. The solid light-blue line is an estimate of what Florida would have spent under such a limit, assuming that spending would have fallen during years in which actual spending fell.

In 2009, Florida spent approximately \$66 billion. If the state had maintained its real 1987 per capita spending level, however, its 2009 budget would have been \$46 billion. The difference would have easily been enough to avoid Florida's \$6

billion budget gap.²⁴ Additionally, if many other states had adopted a similar TEL they would have avoided their budget woes as well.²⁵

CONCLUSION

LIKE NEARLY EVERY state in the Union, Florida faced unprecedentedly large budget gaps in both 2009 and 2010. In response, the state cut budgets, raised taxes, and hiked fees. Though these responses closed the budget gaps (for now), they caused much hardship and failed to address the fundamental problem of excessive government spending.

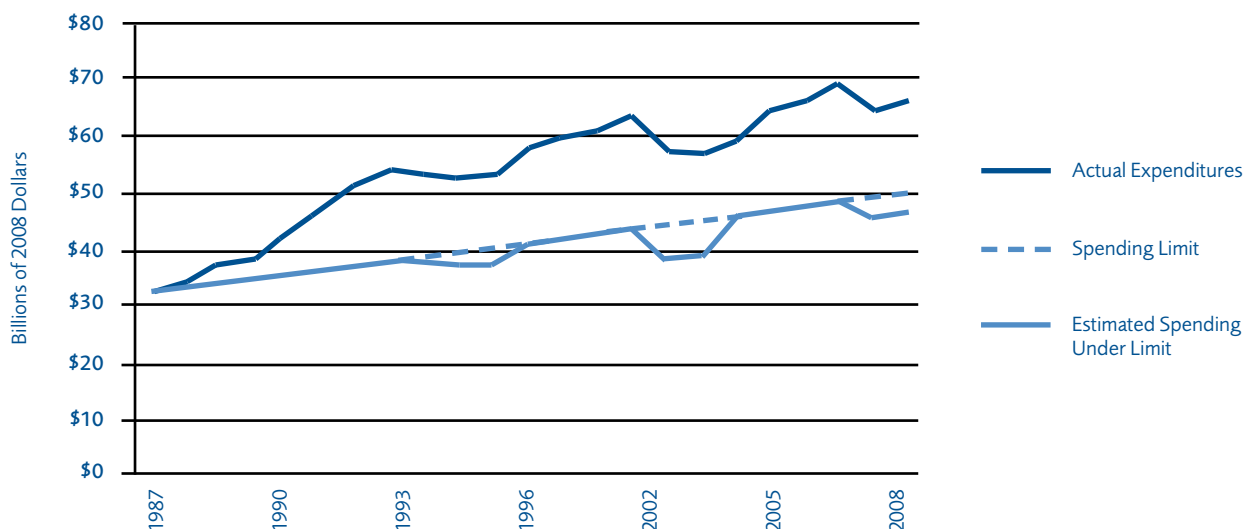
Future budget gaps could be mitigated or avoided altogether if the state were to adopt a more-stringent balanced-budget requirement, permit its citizens greater economic freedom, and/or take serious steps to limit the growth in state spending.

There are a number of reforms that would help Florida limit spending: a line-item reduction veto, a supermajority requirement for all tax increases, a strict balanced-budget requirement, or a formal tax and expenditure limitation. In this paper, we analyzed the impact of an expenditure limit that would permit state spending to grow no faster than the sum of inflation and population growth. If the state had adopted and adhered to such a measure in 1987, it would have avoided its entire 2009 budget gap.

ENDNOTES

1. All budget years are fiscal years.
2. Elizabeth McNichol, Phil Oliff, and Nicholas Johnson, "Recession Continues to Batter State Budgets; State Responses Could Slow Recovery,"

FIGURE 1: FLORIDA'S ACTUAL AND ALTERNATIVE SPENDING



Source: National Association of State Budget Officers, State Expenditure Reports, 1987 through 2009; Census Bureau, Current Population Report; Bureau of Labor Statistics, Consumer Price Index, 2010; author's calculations.

- Center on Budget and Policy Priorities, July 15, 2010, <http://www.cbpp.org/cms/?fa=view&id=711>.
3. "State Measures to Balance FY 2010 Budgets," National Conference of State Legislatures, September 10, 2010, <http://www.ncsl.org/?tabid=19650>. See also *The Fiscal Survey of States, Spring 2010* National Governors Association and National Association of State Budget Officers, (Washington, DC: 2010) 6, <http://www.nasbo.org/LinkClick.aspx?fileticket=gxz234BlUbo=%3d&tabid=65>.
 4. States whose governments had spent a large share of state income for decades experienced smaller budget gaps, suggesting that increases in spending, not the spending level, are what cause large budget gaps.
 5. Matthew Mitchell, "State Budget Gaps and State Budget Growth: Between a Rock and a Hard Place" (working paper, Mercatus Center at George Mason University, Arlington, VA: July 2010).
 6. Authors' calculations, based on National Association of State Budget Officers, *State Expenditure Report 1989* (Washington, DC: NASBO, 1989); Census Bureau Statistics; and Bureau of Labor Statistics. Figures are in 2008 dollars.
 7. Authors' calculations, based on National Association of State Budget Officers, *State Expenditure Report 2008* (Washington, DC: NASBO, 2009); Census Bureau Statistics; and Bureau of Labor Statistics. Figures are in 2008 dollars.
 8. Robert Lawson, "Economic Freedom," in *The Concise Encyclopedia of Economics*, 2nd edition, ed. David Henderson (Indianapolis: Liberty Fund, Inc., 2007).
 9. William Ruger and Jason Sorens, *Freedom in the 50 States: An Index of Personal and Economic Freedom*, Mercatus Policy Series (Arlington, Virginia: Mercatus Center at George Mason University, 2009).
 10. Mitchell, "State Budget Gaps and State Budget Growth."
 11. Authors' calculations, based on *ibid*.
 12. Henning Bohn and Robert Inman, "Balanced Budget Rules and Public Deficits: Evidence from the U.S. States," *Carnegie Rochester Conference Series on Public Policy* 45: 13–76. See also David Primo, *Rules and Restraint: Government Spending and the Design of Institutions* (Chicago: University of Chicago Press, 2007).
 13. Ronald Snell, "State Balanced Budget Requirements: Provisions and Practice," National Conference of State Legislatures, 1996 (updated 2004), <http://www.ncsl.org/?TabId=12651>. Also see "Florida State's Court System," Florida Supreme Court, http://www.floridasupreme-court.org/pub_info/system2.shtml
 14. Mitchell, "State Budget Gaps and State Budget Growth."
 15. Timothy Bartik, "Taxes and Local Economic Development: What Do We Know and What Can We Know?" *Proceedings of the Eighty-Seventh Annual Conference on Taxation* (1994): 102–206.
 16. See James Payne, "The Tax-Spend Debate: Time Series Evidence from State Budgets," *Public Choice* 95, no. 3 (1998): 307–320. For documentation of the phenomenon at the state level, see Joakim Westerlund, Saeid Mahdavi, and Fathali Firoozi, "The Tax-Spending Nexus: Evidence from a Panel of US State-Local Governments" (working paper, University of Gothenburg, 2009). The case for the hypothesis at the federal level—where government can more easily rely on debt finance—is not as strong. See Andrew Young, "Tax-Spend or Fiscal Illusion?" *Cato Journal* 29, no. 3 (Fall 2009).
 17. Mitchell, "State Budget Gaps and State Budget Growth."
 18. The discussion of spending reduction institutions is based on Matthew Mitchell, "State Spending Restraint: An Analysis of the Path Not Taken" (working paper, Mercatus Center at George Mason University, Arlington, VA: August 2010).
 19. Bert Waisanen, *State Tax and Expenditure Limits—2010* (Washington, DC: National Conference of State Legislatures, 2010).
 20. Daniel Vock, "Govs Enjoy Quirky Veto Power," *Stateline.org*, April 24, 2007.
 21. Waisanen, *State Tax and Expenditure Limits*.
 22. *Ibid*.
 23. Alaska, Colorado, Nevada, Utah, and Washington have such a TEL. Colorado has currently suspended its TEL, however, and Utah exempts large portions of its budget from the limit. Waisanen, *State Tax and Expenditure Limits*.
 24. It is not likely that revenue would have actually followed its same course. If the state had spent less on, say, Medicaid, then the federal government would have sent fewer matching dollars to the state. On the other hand, less spending might mean less crowding-out of private activity, expanding the tax base and, with it, revenues. Whatever the net effect, we assume that revenue would have remained constant as a simple analytical illustration of the impact of spending restraint, holding all other factors constant.
 25. Mitchell, "State Budget Gaps and State Budget Growth."

The Mercatus Center at George Mason University is a research, education, and outreach organization that works with scholars, policy experts, and government officials to connect academic learning and real-world practice.

The mission of Mercatus is to promote sound interdisciplinary research and application in the humane sciences that integrates theory and practice to produce solutions that advance in a sustainable way a free, prosperous, and civil society.

Matthew Mitchell is a research fellow with the State and Local Policy Project. His research focuses on spending and budget issues, particularly the ways in which government policy is developed and how it impacts various measures of well being. Mr. Mitchell received his PhD in economics from George Mason University and a BA in political science and BS in economics from Arizona State University.

Tate Watkins is a research associate with the Technology Policy Program and the State and Local Policy Project. He received MA and BA degrees from Clemson University.