

Budget Rules and Financial Management Quality: An Empirical Analysis of the U.S. States

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## *Introduction*

Public management is an important component of government performance. Recent research shows a strong link between public management, policy priorities and outcomes (Cogburn and Schneider 2003; Donahue et al 2000; Lynn et al 2000). Governments with higher management capacities make better resource allocation decisions than those with lower management capacities (Cogburn and Schneider 2003). Financial management, a subset of public management, encompasses the legal and organizational frameworks that govern the entire budget process from inception through execution. Financial management decisions can promote efficiency or waste, allow the delivery of essential services or leave streets riddled with potholes, and guard against risk or leave a state vulnerable. Since the states are taking on more and more service delivery responsibilities, the quality of their management is highly pertinent to the quality of life of their residents (Barrett and Greene 2005).

Despite its importance, financial management theory is fragmented and offers little practical advice on how governments can improve their management capacity (Khan and Hildreth 2004). This paper addresses this gap by investigating whether policies on the length of the budget period, running annual deficits, and tax and expenditure limitations (TEs) influence the quality of financial management in U.S. states. A generalized ordered logit model is used to investigate the relationship between the three budget rules and financial management quality. Grades from the Pew Center's Government Performance Project are used to measure financial management capacities of the U.S. states.

## *Literature Review*

A wide array of activities composes financial management including budgeting, cash management, debt management, revenue administration, accounting and reporting (Miller 1990). The broad goals of financial management are fiscal discipline, strategic allocation of resources and efficient service delivery (World Bank 2005). Of all the components of public management- human resource management, capital management, and information technology management- what makes financial management so important? Simply said it is because there is never enough money (Miller et al 2004). How well financial resources are managed determines the quality of other aspects of public management.

Financial management theory is criticized for a lack of coherence (Bartle and Ma 2004; Khan and Hildreth 2004). Current research trends in financial management are the development of a theoretical model for decision-making, understanding the process of interpretation that occurs over technical regulations, and understanding the importance of legal and institutional frameworks in financial managers behavior (Bartle and Ma 2004; Collins and Khan 2004; Miller et al 2004; Kee 2004; Hackbart and Ramsey 2004). The impact of legal and institutional frameworks on management decisions is most relevant to this analysis. Even within this research area, little empirical research exists relevant to the U.S. states. In contrast, a rich literature exists on the impact of budget rules on fiscal outcomes (Alesina and Perotti 1999; Feld and Kirchgassner 1999; Campos and Pradhan 1999; Poterba 1994). Fiscal outcomes are typically measured in expenditure and debt levels. The difference between fiscal outcomes and financial management quality is superficial. At the state level, financial managers must make decisions in particular legal and statutory environments. The final outcomes of these decisions are debt, expenditure, and revenue levels. In Poterba's examination of the influence of balanced budget

amendments on state deficits, the mechanism through which the amendment affects deficits is how policymakers manage given the balanced budget restrictions (Poterba 1994). The intervening variable in most analyses of budget institutions and fiscal outcomes is financial management. Do certain restrictions seem to encourage high or low quality financial management decisions? While fiscal outcomes tend to focus on single indicators (e.g. state debt ratios); financial management is a composite of fiscal outcomes and also assesses how well state administrators make trade-offs between limited resources and multiple priorities. The difficulty in the past was how to measure financial management quality directly.

The Government Performance Project Index of State Grades offers a relatively standardized measure of financial management quality. GPP grades have been used as measures of government managerial capacity in research on public management and social capital (Donahue et al 2000; Cogburn and Schneider 2003; Knack 2002; Tavits 2006). States are assessed on four main management areas: financial, human resource, infrastructure, and information systems. Within the analysis of financial management there are five criteria on which states are graded: long term perspective in budget decision, transparency and inclusiveness of the budget process, financial management of ongoing revenues and expenditures, efficiency of procurement activities and internal controls, and the state's ability to assess the management and effectiveness of its financial operations. Included in each of these categories are five subcriteria, issues such as the management of state pension funds, debt load, timeliness of budget passage and financial reports, and the accuracy of revenue forecasts.

Three budget institutions are examined in relation to financial management: the periodicity of the budget, the anti-deficit rule and state and local tax and expenditure limitations. As seen in table 1, annual budgets, the anti-deficit rule and strict TELs on localities are present in

over half of states. Strict TELs at the state level are less common. As with most budget rules, they do not change often, certainly not over the course of six years.

Table 1: Budget Rules in U.S. States

Year	Annual Budget Process	Anti-Deficit Rule	State TELs	Local TELs
1999	30	37	8	31
2001	30	37	8	31
2005	30	38	9	31

Source: NCSL 2007a; NCSL 2007b; NCSL 2004

The budget period is the length of time in which the budget document is binding (Kearns 1994). In an annual budget period a budget applies for one year and in a biennial period, the budget applies for two years. Currently thirty states have an annual budget and twenty use a form of biennial budgeting (NCSL 2007a). The choice of annual and biennial budgeting represents a trade-off between flexibility and stability (Kerns 1994). Annual budgets are more flexible and able to respond to changes in the economic and political environments. However, they also have higher administrative and preparation costs. Biennial budgets provide stability and certainty in program funding but suffer from potentially less accurate revenue and expenditure forecasts.

Several aspects of budget period length have implications for financial management. Annual budgets allow for better control of intergovernmental transfers, improved oversight of agency spending, less discretionary spending power for the executive branch and increased revenue forecast accuracy (Kerns 1994). Biennial budgets allow for longer term planning. Empirical analysis reveals a positive relationship between biennial budget periods and spending and a negative relationship between annual budget periods and spending (Kerns 1994). Therefore, states with annual budgets are expected to have greater fiscal discipline. A positive relationship between annual budget period and financial management quality is hypothesized.

This implies that a state with an annual budget period will have a better financial management grade than a state with a biennial budget period.

Several rules govern the ability of states to run a deficit. An important one is the anti-deficit rule. While most states are required to pass a balanced budget, unexpected deficits may arise throughout the year. The anti-deficit rule forces states to correct a deficit before the end of the fiscal year (Poterba 1994). Currently thirty-eight states have an anti-deficit rule in place (NCSL 2004). Depending on legal restrictions, states may use short-term or long-term borrowing, general fund balances, rainy day funds, or accounting gimmickry (e.g. changing actuarial assumptions) to deal with unexpected deficits (Poterba 1994). In a study of the short-term responses to fiscal shocks, states with anti-deficit rule were found to change their spending levels to a greater extent than states without the rule (Poterba 1994).

The behavior response caused by the anti-deficit rule has implications for financial management quality. A fundamental rule of financial management is not to spend more money than is taken in. Not adjusting spending patterns to address fiscal shortfalls leads to a rapid accumulation of public debt (Alesina and Perotti 1999). By dealing with annual deficits, states adjust spending patterns and also prevent the buildup of large deficits each year. This allows states to build-up rainy day funds, contribute an actuarially sound amount to public pensions and avoid structural imbalance. The expected relationship between financial management quality and the anti-deficit rule is positive. States with anti-deficit rules are expected to have higher grades on financial management than states without the rule.

As of 2007, thirty states have some type of tax and expenditure limitation (TEL) at the state level (NCSL 2007b). At the local level, all states except for Connecticut, Maine, New Hampshire, and Vermont have some form of TEL (Mullins and Wallin 2004). Local TELs refer

to those imposed state wide on all local governments. While some local TELs are voted into effect by specific municipalities, these are not included in the analysis. Previous research indicates that only highly restrictive TELs will impact state and local finances, therefore this paper will only consider 'strict' TELs (Bae and Gais 2007; Joyce and Mullins 1991). A restrictive local TEL is defined as a property tax revenue limit, general revenue limit and/or general expenditure limit (Joyce and Mullins 1991) and a restrictive state TEL is defined as a TEL tied to changes in population and/or inflation rates and codified in the state constitution (Bae and Gais 2007). Since population and inflation tend to grow slowly or even negatively, this limits states to close to zero growth in either revenue or expenditures depending on the type of restriction. In addition, once a state constitution is amended to include a TEL, reversing it is difficult. The restrictiveness of TELs provides an important indication as to the flexibility state budgeters and legislators have in dealing with fiscal shortfalls or increased service needs.

The mechanisms by which TELs may affect financial management are numerous. Shifts in service provision from local to state government, changes in the utilization of revenue sources from broad-based taxes to fees and charges, an increase in the number of local governments and shifts in functional allocations have all been found to be consequences of TELs (Mullins and Joyce 1991; Joyce and Mullins 1996; Hoene 1994; Bowler and Donovan 2004; Bae and Gais 2007). Both local and state level TELs are found to have implications on tax and expenditure levels and service responsibilities for state governments; however, their impacts differ. Local limitations tend to decrease the ability of local governments to raise broad based taxes and shift their reliance to user charges and state assistance (Mullins and Joyce 1996; Hoene 2004; Skidmore 1999). The subsequent drop in local revenue abilities also appears to be offset by states taking on formerly local service delivery responsibilities (Mullins and Joyce 1996; Mullins

and Joyce 1991). In addition, states tend to increase taxes in response to local limitations (Mullins and Joyce 1991). Overall a centralization of revenue systems occurs with the imposition of local TELs (Skidmore 1999; Mullins and Joyce 1996). In some states, such as California, the allocation of property revenues was transferred completely from local governments to the state government (Hoene 2004).

At the state level, TELs decrease state's ability to increase revenues and constrain spending (Skidmore 1999). However, state policymakers have proven adept at skirting state level TELs (Bowler and Donovan 2004; Galles and Sexton 1998). Shifts in revenue sources and the creation of special districts and municipalities increase the flexibility of government to maintain services without increasing constrained revenue sources (Bowler and Donovan 2004). State level TELs have also been found to severely limit state response to fiscal shortfalls (Poterba 1994). At the same time state level TELs, have also been found to increase levels of indebtedness (Donovan and Bowler 1998).

Some states face both state and local TELs. These states tend to experience both an increase in responsibilities shifted from local to state government, but with much smaller increases in state taxation compared to states with only local limitations (Mullins and Joyce 1991). States with both local and state TELs also show an increase in state aid to local governments and a sharp decline in local taxes (Joyce and Mullins 1991). Therefore states may face restrictions in their abilities to raise revenues and increasing responsibilities in terms of local assistance at the same time. The breakdown of state and local TELs supports this argument. While only 9 states have strict state level TELs, 31 states have strict local TELs. Five of the states with strict state level TELs also have strict local level TELs (NCSL 2007b). By contrast, local level TELs are typically present alone and do not have the detrimental effect on state

finances that state level TELs do. In fact, the centralization of local finances may increase the quality of state financial management since states have increased revenue-raising options, better ability to control debt levels, and more control over local decision-making. The net effect of state-level TELs on financial management quality is uncertain; but appears to lean towards a negative relationship. States with state level TELs are expected to have lower financial management grades than states without them and states with local TELs are expected to have higher grades than states without local TELs. States with both types of limitations are expected to have lower financial management grades.

#### *Other Determinants of Financial Management Quality*

State characteristics such as wealth, demographics, and political environment affect financial management capabilities. In testing the impact of budget rules on financial management performance, state wealth, financial resources, and political divisiveness are controlled for.

The overall income level of a state's residents can affect both the demand for services and government accountability (Knack 2002). States with higher income residents may face stronger demands for accountability and efficiency from their residents or higher income residents may opt out of public services and ignore state management of all but the most basic services. States with lower resident incomes may face more demands for social services. Besides the demand side effects of income levels, wealth also impacts the tax base available to states for revenue collection. The exact direction of the relationship between financial management quality and state resident wealth is unclear.

The amount of financial resources available to a state relates to population size, natural resource wealth, and willingness to tax residents. The availability of resources can be both a boon and a burden to state financial management. In states with large natural resource reserves,

revenue forecasts fluctuate wildly (e.g. Alaska) and an abundance of revenue may retard development of quality management systems. States with larger populations may have more demands on resources making it difficult to manage debt or spending levels (Knack 2002). Governing may be simply more difficult with larger populations (Barrett and Greene 2005); California's recent \$10 billion shortfall is an example of this. Therefore despite the intuitive expectation that management would be better with more resources available, the direction of the relationship is not so clear.

Political divisiveness appears to have a negative effect on government management abilities (Poterba 1996; Alt and Lowry 1994). When the party of the governor and the majority parties of the legislature are not the same, legislative gridlock is more likely to occur. In this situation it may be more difficult for a state to respond to fiscal crises and make difficult decisions regarding on-going problems.

The proposed model of financial management quality includes the three budget rules, state income level, size, financial resources and political divisiveness. Based on existing literature, it is hypothesized that budget rules will impact financial management quality in the following ways:

*H<sub>1</sub>: Annual budgets lead to higher financial management grades.*

*H<sub>2</sub>: Anti-deficit rules lead to higher financial management grades.*

*H<sub>3</sub>: State TELs will not have a significant impact on financial management grades but local TELs will be associated with higher grades.*

*H<sub>4</sub>: States with both state and local level TELs will be associated with lower grades.*

## *Data and Methods*

The hypotheses are examined using data from the Government Performance Project from 1999, 2001, and 2005 as the dependent variables. The GPP was administered and data collected for all fifty states in these years. The process involves states completing a survey on management practices, academic teams analyzing this data and using other published reports, and journalists conducting interviews with key individuals in each state government (Barrett and Greene 2005). Based on this information, grades are assigned based on criteria representing good management practices. The Grades range from A+ to F. In order to make interpretation simpler, each letter category is collapsed into a single numeric value. A+, A, and A- are coded 4; B+, B and B- are coded 3; C+, C, and C- are coded 2 and D+, D and D- are coded 1. No state received a score below D-. As shown in table 2, the average grade fell from a B in 1999 and 2001 to a B- in 2005. Strictly speaking the grade a state receives in 1999 is not comparable to the grade it received in 2001 or 2005. Grading criteria are changed slightly each year as is the process and individuals involved in assigning grades (Barrett and Greene 2005). To control for the potential variation year to year, dummy variables are included for each year.

Table 2: Average Grade, per capita income and annual expenditure

Year	Average Grade	Average Per Capita Income	Average Expenditure
1999	B	26,607	19,967,302,000
2001	B	29,250	23,705,205,000
2005	B-	33,413	29,409,249,000

Sources: Governing 1999, 2001, and 2005; U.S. Census Bureau 1999, 2001, 2005

The anti-deficit rule, annual budget period, and tax and expenditure limitations are in the model as dummy variables. States with anti-deficit rules are coded 1 and those without are coded 0. California adopted an anti-deficit rule in 2004 and is the only state to change value in the

dataset. States are coded 1 if they use an annual budget and 0 if they use some form of biennial budgeting. As Table 1 shows, no state changed its budget period between 1999 and 2005. The TELs are separated into local and state level and are coded 1 if the TEL is present and 0 if they are not. As mentioned, only states with strict TELs are included.

Per capita income (log) is included as a control variable for the relative income level of state residents. This variable also controls for the level of dependence in the population. The lower the per capita income, the more likely state residents are to require social services. Data on per capita income for 1999, 2001, and 2005 is from the U.S. Census bureau.

State annual expenditures (log) are included in the model as a measure of state financial resources. Originally total population (log), population between 5 and 17 (log), population over 65 (log) and total annual revenues were included in the model to control for state size, financial resources, and dependent populations. However, there was a very high correlation (greater than .94) between all of these variables and total annual expenditures. Therefore these variables were not included in the model. Annual expenditures controls for population size and dependence levels because the larger the state and the greater its responsibilities, the more it spends. Data on total annual expenditures for 1999, 2001, and 2005 is from the U.S. Census bureau. To control for political divisiveness, a dummy variable is included coded 1 if either the majority of members in the state house and senate or the governor are of a different party than the others. This data was taken from the *Governing Magazine's* issue on GPP grades in 1999, 2001, and 2005.

Ordered logit<sup>1</sup> is used to analyze the dataset. The dependent variable is ordinal; the grade measures the underlying quality of financial management. A is ranked higher than B, B higher than C, and C higher than D.

Table 3. Determinants of Improved State Financial Management Performance

Dependent variable:	Financial Management Grade
Anti-deficit rule	.065 (.474)
Annual process	.059 (.356)
Local TEL	.987* (.393)
State TEL	.568 (.760)
State TEL & Local TEL	-2.38* (.982)
Divided gov't	-.712* (.336)
Expenditures (log)	-.054 (.190)
Per capita income (log)	.111 (1.45)
Year 2001	-.123 (.425)
Year 2005	-.564 (.511)
Observations	150
Pseudo R-squared	0.065

Standard errors in parentheses; \* significant at 5%

### Findings

The results reported in table 3

support the general hypothesis that budget rules impact financial management

performance. The first two variables

measuring the anti-deficit rule and annual budget do not have a significant impact on

the quality of financial management.

However, two of the three variables

measuring TELs have an impact. State

level TELs do not have a significant impact

on financial management grades.

As hypothesized local TELs have a

significant impact (.05 significance level)

on financial management grades in a

positive direction, States with local level

TELs have .987 higher log odds of having a

higher grade than states without local TELs among states with the same policies on anti-deficit

<sup>1</sup> The proportionality of odds assumption is not violated at the 1% significance level ( $\chi^2(20) = 34.3$ ;  $\text{prob} > \chi^2 = .0242$ ). A comparison between generalized ordered logit and logit shows similar coefficients in both size and direction with the exception of the state TEL variable. With the proportionality of odds assumption relaxed the state TEL variable is significant between 'A' and the other grade categories.

rules, budget period, and state level TELs as well as similar per capita income and expenditure levels. If states had local TELs, no state TELs and the rest of the variables held at their mean, 17.9 % of states would be expected to receive an A, 61.5% a B, 19.1% a C, and 1.5% a D.

The term measuring the impact of having both state and local level TELs on financial management grades is also significant in a negative direction as hypothesized. States with both state and local level TELs log odds of being in a higher-grade category are 2.38 lower than the log odds for states without both of these policies holding the other variables constant. If all fifty states had local and state level TELs and characteristics similar to holding the rest of the variables at their means, 2% would receive an A, 24% would receive a B, 60% would receive a C, and 14% would receive a D.

Divided government also significantly negatively impacts on the financial management grade. This is consistent with existing research on the role of political divisiveness in management capacity. States with either a governor or the majority of the house or senate of a different political party than the others have log odds .711 higher of receiving a lower grade in financial management than states with single party control of the executive and legislative branches holding budget rules, state per capita income, and expenditures constant. States with divided governments and the rest of the variables at their means are expected to have the following distribution: 10.6% with an A, 57.1% with a B, 29.6% with a C, and 2.7% with a D.

Based on these results:

H<sub>1</sub> and H<sub>2</sub>: The empirical results do not support a relationship - in either direction - between financial management quality and policies on budget period and anti-deficit rules.

H<sub>3</sub>: Local TELs are associated with higher financial management grades, supporting the hypothesis that centralization increases state financial management capacity. The relationship

between state TELs and financial management is less clear. As hypothesized state TELs do not impact state financial management grades.

H<sub>4</sub>: As hypothesized states with both state and local TELs have lower financial management grades. As with the state TEL category, this is a relatively small number of states (5). However, the literature supports the empirical result that states limited at both the state and local level will be less able to respond to fiscal shocks and on-going management issues.

### *Summary and Conclusion*

This analysis of U.S. states provides evidence that budget rules influence decisions made by financial managers and ultimately affect their ability to deal with key financial management issues. The effects of TELs reverberate beyond their targeted area of influence into other areas of financial management. Legislators may find it more difficult to pass the budget on time since there is less revenue to parcel out to high priority issues or state's may ignore the need balance revenues and expenditures and face structural imbalances. Another potential response is a raiding of rainy day funds, leaving the state vulnerable in the face of an economic downturn. The results support current research on TELs and their impact throughout state and local government. In states with both local and state level TELs the impact is greatest. Financial managers in these states face restrictions on revenue raising ability coupled with greater expenditure responsibilities; as such they are less able to deal with fiscal shocks and day to day problems. While states with local TELs may benefit from the centralization of revenue collection and service delivery, the effect on local governments is to leave them less able to match local services to local needs and preferences (Mullins and Joyce 1996). Therefore, while financial management is an important measure of government performance it is not the only indicator.

The policy implications of this analysis are to consider the effects of TELs at both the state and the local levels. While restricting tax raising and spending may seem a good idea in the short-term, citizens are unlikely to expect or support cuts in services. Voters and policymakers in these states should consider removing at least one level of restriction. Also, policymakers in states considering both types of limitations may want to take a step back and consider the ramifications of such a policy on their ability to make financial decisions.

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