

Risky Business: Term Limits, Budgets and Fiscal Uncertainty

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Abstract

Do term limits impede the ability of legislators to effectively set fiscal policy? To address this question, this study examines state bond ratings from 1996 to 2006. Bond ratings serve as a valuable indicator of a state's fiscal performance, gauging the risk and uncertainty that investors face when buying these bonds. In addition to providing an external, systematic indicator of state fiscal performance, bond ratings can also be seen as a policy end in itself. High bond ratings make it easier for states to borrow and raise revenue, while lowering interest rates. Results from analyses of "term-limitedness" and legislator experience suggests that term limits do negatively impact a state's fiscal performance and lead to lower bond ratings.

As the Michigan Legislature's budget deadline neared in the summer and fall of 2007 without a hint of an impending deal that would cope with either the immediate budget deficit or a long term "structural deficit," many politicians (predictably) began pointing fingers. Though the usual suspects, including party leaders and the governor, had their fair share of critics, a somewhat surprising scapegoat for the budget impasse emerged: legislative term limits. Governor Jennifer Granholm contended that term limits had, "created a problem with trust" and House Speaker, Andy Dillon, conceded that his own inexperience had contributed to the impasse (Hornbeck and Cain 2007). Similar arguments were also heard from outside government. The Chamber of Commerce supported a proposal to extend term limits to twelve years for state House members, arguing that the current limit of six years had lead to a "brain drain" in the state legislature ("Time up for Term Limits?" 2007).

Though Michigan lawmakers were ultimately able to pass a budget in 2007 (after four hours of a partial government shutdown), the uncertainty surrounding the drawn-out budget process may have damaged the state's economic climate (Hornbeck and Snell 2007). Further, it is not clear whether the budget that was agreed upon addressed longer-term fiscal problems. Indeed, Michigan continues to face budgetary problems, with lawmakers missing the budget deadline two of the last three years (Martin 2010). Thus, many political observers remain skeptical about the term-limited legislature's ability to create sound fiscal policy. Still, it is not clear whether these concerns are empirically supported.

So, do term limits actually impede the ability of legislators to effectively set fiscal policy? This is a difficult question to answer because it requires a normative evaluation of the quality of fiscal policy that is produced by legislatures (e.g. Kousser and Straayer 2007). To address this inherently normative question, I examine the relationship between term limits and

bond ratings in the American states. Bond ratings serve as an effective indicator of a state's fiscal performance, gauging the risk and uncertainty that investors face when buying these bonds. In addition to providing an external, systematic indicator of state fiscal performance, bond ratings can also be seen as a policy end in itself. High bond ratings make it easier for states to borrow and raise revenue, while lowering interest rates. Existing research shows that bond ratings are responsive to both economic and political factors (e.g. Lowry and Alt 2001; Depken and LaFountain 2006; Krueger and Walker 2008). Results from this analysis suggest that term limits do negatively impact a state's fiscal performance and lead to lower bond ratings.

Term Limits & Policy Making

Legislative term limits may seem somewhat far-removed from the policy making process that ultimately produces state budgets and other fiscal policies, but recent scholar literature has demonstrated a variety of ways in which they can influence legislative behavior and public policy outcomes (e.g. Kurtz et al. 2007; Mooney 2009). First, it is clear that term limits increase turnover in state legislatures (Carey et al. 2006; Moncrief et al. 2004). This increased turnover creates less experienced and less knowledgeable legislators (Moncrief et al. 2008; Berman 2007). As veteran legislators are forced out of office, policy expertise is lost, as well as institutional memory and familiarity with legislative procedures. Kousser (2006) argues that this lack of experience and knowledge limits the ability of term-limited legislatures to produce broad and complex policy. Further, the decline in expertise in legislatures with term limits is associated with a decline in legislative budgeting power (Kousser 2005). Term-limited legislatures tend to make significantly fewer adjustments to governors' budget proposals than other legislatures.

The higher turnover and less experience associated with term-limited legislatures also affect the political climate in which policy is made. Sarbaugh-Thompson et al. (2006) find that term limits in Michigan have reduced cross-party relationships, with more legislators relying on party leaders and regional networks for cues rather than on policy leaders and other informal legislative leaders. With less time to build relationships, term-limited legislators rely on narrow, often partisan, networks. This may limit the ability of legislatures to build consensus on complex issues and for bipartisan negotiation. This more partisan climate is evident when looking at the percentage of bills introduced by a party that pass both chambers (legislative batting average). Kousser (2005) finds that the advantage of majority parties relative to minority parties increases significantly in legislatures with term limits. With a rise in partisanship and a narrowing of networks in term-limited legislatures, it is not surprising that the political climate in these legislatures has become less civil and more conflictual. A series of case studies conducted as part of the Joint Project on Term Limits (JPTL) finds that legislators are less willing to compromise, are less collegial and hold lower regard for the legislature as an institution (Berman 2007). Not only do these legislators have little time to build relationships, their time horizon is such that they have little incentive to act in ways that benefit the institutional interests of the legislature.

Just as term limits have decreased experience, knowledge and relationship while increasing partisanship and conflict among rank and file legislators, they have also had similar effects on legislative leaders. Party leaders, like all legislators in term-limited states, have relatively little experience in the legislature, but they have even less in terms of their leadership tenure (Little and Farmer 2007). This lack of leadership experience may hinder the legislative process both in quantity and quality of legislation (Miquel and Snyder 2006). In addition,

increased turnover in leadership creates increased intra-party competition for these positions. This competition manifests itself with a heightened emphasis on fundraising and ideological stances rather than on legislative skill and relationship-building. In addition, leaders may be hindered by their lame duck status, making it difficult to credibly maintain an incentive system to support the party leadership (Bowser et al. 2003). Similar impacts are felt in committees (Cain and Wright 2007). The upshot for this literature is that the ability of legislative leaders to build lasting coalitions and legislate effectively is undermined by term limits. Thus, it is not surprising to find evidence of decentralized power in term-limited legislatures (Apollonio and La Raja 2006).

Though much of the research on legislative term limits focuses on impacts on legislative behavior, these effects should ultimately influence policy outcomes. For general policy outputs, term-limited legislatures produce shorter and less complex legislation (Kousser 2006). This effect may stem, in part, from incentives of term-limited legislators to pass symbolic measures aimed to benefit themselves politically in the short term rather than addressing serious policy problems with long term solutions (Kousser and Straayer 2007). Further, once fully implemented, term limits make legislatures less innovative and subsequently less able to address complex policy problems (Kousser 2005).

Fiscal policy should be affected by term limits in a similar manner, but several studies find additional effects, particularly on levels of spending. Erler (2007) finds that a decentralized budget process leads to increased spending. Other scholars have identified alternative mechanisms for increased spending in term-limited legislatures. The shortened time horizons of term-limited legislators may remove incentives to moderate spending in the short term (Herron and Shotts 2006). Limited time in office may also reduce the ability of the legislature to engage

in oversight of the executive branch. Without sufficient monitoring, term-limited legislatures are ill-equipped to check executive agencies and effectively evaluate spending requests. Though supporters of term limits saw these reforms as a way to reduce wasteful spending, it seems that they have had the opposite effect. Indeed, empirical evidence suggests that legislatures with term limits have ceded budgetary power to the executive branch (Kousser 2005; Kousser and Straayer 2007).

Taken together, the literature on legislative term limits supports the argument that term limits can negatively affect a state's fiscal policy. The increased turnover creates a less knowledgeable and less experienced legislature which may reduce the quality of fiscal policy. The decrease in cross-party relationships, narrower policy networks and increased partisanship make compromise and consensus building difficult. In turn, the heightened conflict and loss of collegiality make coping with complex policy problems more difficult, especially when paired with less knowledgeable policy makers. These effects may be magnified as legislative leaders lose clout. The effect of increased spending, whether caused by decentralization of power or other mechanisms, also places constraints on the ability of legislatures to set long-term fiscal policies.

State Bond Ratings & Term Limits

As discussed earlier, a significant obstacle in testing whether term limits have a negative impact on a state's fiscal policies is systematically evaluating policy outcomes. I address this problem by examining state bond ratings. Bond ratings gauge the risk of investing in government debt. These ratings allow investors to evaluate the probability that the issuer will be able to make full payments according to schedule and will continue to do so in the future. As such, credit rating

agencies analyze information on the fiscal health of the government, including outstanding debt, revenue streams, spending levels and fiscal policies. In short, bond ratings provide information about risk and uncertainty that result from the interaction between economic and political factors (e.g. Ingram et al. 1983; Lowry and Alt 2001; Depken and LaFountain 2006; Krueger and Walker 2008). In addition to providing a systematic indicator of risk resulting from state fiscal policies, bond ratings can also be viewed as a policy end in itself. States with lower bond ratings must offer higher interest rates when they issue debt, placing greater strain on the taxpayers. Higher bond ratings make borrowing and raising revenue easier.

Though much of the research on state bond ratings focuses on economic factors such as unemployment, revenue and debt (e.g. Liu and Thakor 1984; Uyar and Escarraz 1995), recent political economy studies have highlighted significant political factors. Krueger and Walker (2008) demonstrate how political uncertainty, such as divided government, can lead to lower bond ratings. In situations of political uncertainty, the risk to investors may be greater as the future of government fiscal policy, and thus the risk of default, is unclear. Divided governments are also slower to adjust to economic shocks, which could negatively affect bond ratings (Alt and Lowry 1994). In addition, there may be differences between Democratic and Republican governments in their preferred fiscal policy that also affects bond ratings (Alt and Lowry 1994; Lowry et al. 1998; Lowry and Alt 2001). Depken and LaFountain (2006) show that public corruption reduces state bond ratings.

In all, this research is quite congruent with the argument that term limits have a negative impact on fiscal policy and, subsequently, on bond ratings. Factors that increase political uncertainty like turnover and decentralization should decrease bond ratings. Factors that

increase levels of spending and limit the ability of government to respond to economic problems, like inexperience and a lack of broad policy networks, should also decrease bond ratings.

Data & Analyses

To analyze the effect of legislative term limits on state bond ratings I extend the Depken and LaFountain's (2006) model, estimating bond ratings as a function of term limits, political factors and economic factors. I collected data on 49 states from 1996 to 2006 (see Table 1).¹ As previous research has discussed, there are three financial services agencies that rate state government bonds: Standard and Poor's (S&P), Moody's and Fitch. Though each scale ranges from a high of AAA (Aaa) to a low of C, they differ in the number of intervals (19 to 35). From these ordinal ratings, I use two approaches for the analyses. First, I convert the S&P's 25 ordinal ratings to a corresponding cardinal range from 1 to 25. This approach allows for a simple interpretation of the results. I use the S&P rating in this approach because it rates the highest number of states in most years.² The second approach follows Depken and LaFountain (2006), using the mean cardinal percentage of all three ratings, with a possible range of 0 to 1.³

The primary explanatory variable of interest here measures legislative term limits. The most common approach has been a dichotomous indicator of whether the state has any term limits in effect, but this measure ignores the variation in the length of term limits across the states as well as whether the restrictions apply to lifetime service or just consecutive terms (Mooney 2009). To account for this variation, I use Sarbaugh-Thompson's measure of Term-Limitedness (2010). This variable (shown in Table 2) measures the change in turnover rates in a term-limited

¹ Nebraska is excluded due to its nonpartisan legislature.

² Not all states were rated by all three services in every year.

³ Each rating was converted from an ordinal rating to a cardinal rating and then normalized by the total possible ratings available for that service. The available normalized ratings were then averaged by state for each year.

legislature from the decade prior to term limits to the decade afterward. It is then adjusted to account for the potential of legislators to move back and forth between chambers. States without legislative term limits have a Term-Limitedness score of 0 while the most term-limited state (Arkansas) has a score of 1.99.

Another challenge in estimating the effects of legislative term limits is the problem of endogeneity (Mooney 2009). Supporters of term limits expected that they would restrain wasteful government spending and foster more conservative fiscal policy since legislators would have fewer distributional incentives absent the possibility of continued reelection (Erler 2007). Thus, the adoption of term limits in the first place may be related to a state fiscal policy and its bond ratings. To account for this, I estimate employ instrumental-variables regression analysis. Initiative use and the average citizen ideology and partisan control of government from 1990 to 1994 are used as instrumental variables predicting Term-Limitedness.⁴ The second stage predicts state bond ratings.

In addition to Term-Limitedness, the model also includes several other political factors. Divided government should decrease bond ratings (Krueger and Walker 2008). Likewise, Democratic control of government should also depress bond ratings (Lowry and Alt 2001; Alt and Lowry 1994). Public corruption, as measured by the per capita number of federal convictions for public corruption, is also expected to negatively affect bond ratings (Depken and LaFountain 2006).

⁴ All the states impacted by term limits in the analyses adopted these reforms during this time period. Initiative use is measured as the natural log of the number of ballot measures during this time period. Citizen ideology is measured as the mean of the Multilevel Regression and Poststratification estimates of annual ideological identification produced by Pacheco (2009). Partisan control of government is measured using a Ranney Index (Ranney 1976).

Following Depken and LaFountain (2006), I also include the following economic variables: state tax burden, debt to revenue ratio, income per capita and unemployment rate. States should have relatively higher bond ratings with low tax burdens, debt to revenue ratios and unemployment rates. Higher income per capita should boost bond ratings.

Estimation & Results

Since bond ratings are censored (at 1 and 25 for the S&P rating, at 0 and 1 for the average percentage rating) and Term-Limitedness is often considered endogenous, I use instrumental-variables tobit to estimate the models. The models include fixed effects for years and standard errors are clustered on the state. The results from the second stage tobit analysis are presented in Table 3.

The results reveal a sizable and statistically significant effect of term limits on bond ratings. The first model shows that a unit increase in Term-Limitedness, on average, decreases S&P ratings by over one and a half points. The second model produces similar results. Increasing Term-limitedness by one leads to a loss of 6.7 percentage points for the average bond rating. These impacts are sizable given the fairly narrow range of observed bond ratings: S&P ratings range from 18 to 25, while the average rating ranges from 0.72 to 1. Figures 1a and 1b show the magnitude of these effects for each of the states impacted by legislative terms limits in the analysis. Michigan, a state with relatively short limits, few recycling opportunities and a lifetime ban, the effect of term limits is to reduce their S&P bond rating by nearly two and half points. States without term limits have an average S&P rating of 23.3, or AA. Adopting Michigan-style term limits would reduce this rating to 20.84, or A. The bond ratings of less term-limited states, such as South Dakota and Maine, show a much smaller decrease. These

patterns are consistent for the Average Bond Rating Percentage model. Extrapolating the average ratings to the Moody's and Fitch ratings, Michigan is three points and two points lower than states without term limits (Aa3 to A3 and AA+ to AA-), respectively.

The rest of the results are, in general, consistent with previous research on state bond ratings. Divided government decreases bond ratings. As Krueger and Walker (2008) note, this may be due to the fact that divided government can be taken as a sign of an uncertain political future or that divided governments have tendencies to overspend. Consistent with Depken and LaFountain (2006), public corruption also has a negative impact on bond ratings. Finally, three of the four economic variables reach at least marginal levels of significance. Not surprisingly, states with higher debt-to-revenue ratios have lower bond ratings, reflecting investors' concerns about a state's ability to repay debt when revenues are relatively low compared to debts. Further, when states have healthy economic climates, i.e. low unemployment and high per capita income, bond ratings are significantly higher.

Legislative Experience & Bond Ratings

Though the results of the previous analyses are robust across other indicators of term limits, like Sarbaugh-Thompson's unadjusted Term-Limitedness (2010) and a binary term limits variable, I also examined the relationship between legislative experience and bond ratings. Many of arguments regarding the impact of term limits hinge upon the increased turnover and decreased experience of legislators, especially those relating to legislator knowledge. Thus, I compiled the average experience of legislators from 1996 to 2003 using the "State Legislative Returns, 1967-2003" database (Carsey et al. 2008) and used this measure as an alternative independent variable. Since both states with and without term limits can have low experience levels, I do not treat it as

an endogenous variable and estimate a single equation tobit model. The results are presented in Table 4.

Interestingly, the impact of average legislator experience is dependent on the chamber in question. In the upper chambers, more experienced legislators increase bond ratings as the term limits literature suggests, but experience in lower chambers does not have a significant impact (and the coefficient is actually negative). On average, the mean experience of term-limited upper chambers is six years, compared to nine and a half years for non-term-limited upper chambers. This difference results in a 0.6 point decrease in the S&P rating. For the average bond rating percentage, this relative lack of experience results in a decrease of 2.2 percentage points. The magnitudes of these impacts are still significant, but far less than the previous models. This suggests that the impact of term limits extends beyond legislator experience and may also be driven by increased partisanship, decreased civility and narrower networks that are not captured by the experience variable. This is also evident in Figures 2a and 2b, plotting the predicted values from the models against the average experience in upper chambers. Though, on average, states with less experienced upper chambers have lower bond ratings, other factors are also clearly influential. Still, as Michigan lawmakers might have predicted, the states falls towards the low end of both bond ratings and experience.

Discussion

Altogether, the analyses presented here are supportive of Michigan's blame attribution in the summer of 2007. As an indicator of the soundness of investing in a state, bond ratings are also a good indicator of the quality of fiscal policy. Though other political and economic factors certainly affect a state's bond rating, term limits also have a significant detrimental effect. This

finding is important, not only for its implications for how term limits affect fiscal policy broadly, but also for its more immediate impact. As bond ratings decline, states face higher borrowing costs and place more pressure on taxpayers. The analyses show a strong impact of “term-limitedness”, but when only focusing on experience the effect is less pronounced. This suggests that the impact of term limits on fiscal policy is not only driven by legislator inexperience and lack of knowledge, but also may be affected by the increased partisanship, decentralization of power, shortened time horizons and narrower networks.

Clearly, further work is necessary to more fully understand how term limits affect bond ratings and fiscal policy in general. Future work will incorporate fiscal institutions (e.g. Lowry and Alt 2001), such as NOCAs and late budget provisions. In addition, other indicators of fiscal policy should be examined in order to provide a more direct link between term limits and policy outcomes.

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Table 1. Descriptive Statistics

Variable	Mean	Std. Dev.	Min.	Max.
Standard & Poor's	23.252	1.280	18	25
Average Bond Rating Percentage	0.925	0.053	0.72	1
Term-Limitedness	0.119	0.377	0	1.99
Divided Government	0.579	0.494	0	1
Democratic Control	0.165	0.372	0	1
Public Corruption	18.005	22.826	0	136
Debt-to-Revenue Ratio	0.503	0.276	0.674	1.682
State Tax Burden	0.094	0.011	0.057	0.12
Income Per Capita (k)	25.639	3.937	17.702	41.173
Unemployment	4.719	1.138	2.3	8.1
Initiative Use (logged)	1.220	1.492	0	4.382
Ranney Party Control Index (1989-1994)	0.562	0.154	0.232	0.838
Citizen Ideology	0.211	0.028	0.158	0.283
Average Experience (lower chamber)	7.113	2.546	2.167	14.367
Average Experience (upper chamber)	9.032	2.818	2.133	16.239

Table 2. States Impacted by Legislative Term Limits, 1996-2006

State	Lower Chamber Limit (years)	Upper Chamber Limit (years)	Lifetime Ban?	Term-Limitedness (adjusted for recycling)
South Dakota	8	8		0.090
Maine	8	8		0.210
Arizona	8	8		0.270
Colorado	8	8		0.330
Montana	8	8		0.470
Ohio	8	8		0.520
Missouri	8	8	✓	0.750
California	6	8	✓	1.370
Michigan	6	8	✓	1.550
Arkansas	6	8	✓	1.990

Source: Sarbaugh-Thompson, Marjorie. 2010. "Measuring "Term Limitedness" in U.S. Multi-State Research." *State Politics and Policy Quarterly* 10 (2):199-217.

Table 3. State Bond Ratings, 1996-2006

Variable	(1)		(2)	
	<u>Standard & Poor's</u>		<u>Average Bond Rating Percentage</u>	
	Coefficient	P-Value	Coefficient	P-Value
Term-Limitedness	-1.592	0.036	-0.067	0.035
Divided Government	-0.547	0.060	-0.019	0.088
Democratic Control	-0.407	0.173	-0.017	0.159
Public Corruption	-0.012	0.044	-0.001	0.021
Debt-to-Revenue Ratio	-1.944	0.001	-0.081	0.000
State Tax Burden	12.277	0.410	0.407	0.426
Income Per Capita (k)	0.078	0.095	0.003	0.113
Unemployment	-0.207	0.085	-0.009	0.060
Constant	22.928	0.000	0.937	0.000
N	488		497	
χ^2	56.11		50.32	

Notes: Coefficients are a result of the second stage tobit analysis; Fixed effects for years are included in the model, but are not presented here; P-values are for one-tailed tests when appropriate

Figure 1a. Impacts of Term Limits on Standard & Poor's Ratings

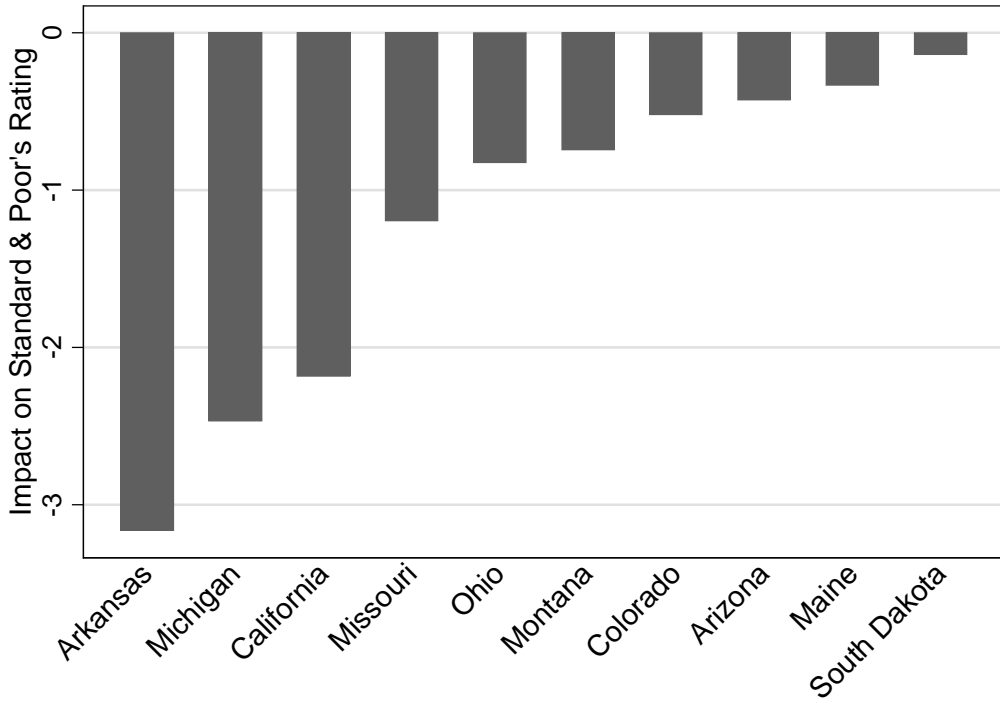


Figure 1b. Impacts of Term Limits on Average Bond Rating Percentage

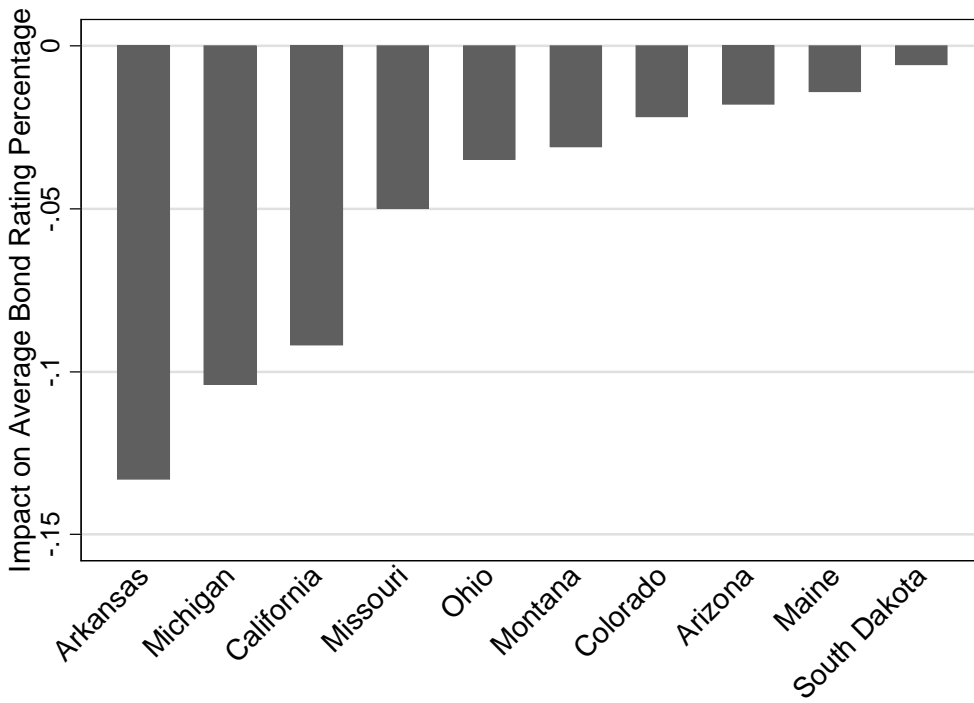


Table 4. State Bond Ratings, 1996-2003

Variable	(1)		(2)	
	<u>Standard & Poor's</u> Coefficient	P-Value	<u>Average Bond Rating Percentage</u> Coefficient	P-Value
Average Experience (lower chamber)	-0.130	0.176	-0.005	0.165
Average Experience (upper chamber)	0.170	0.027	0.006	0.029
Divided Government	-0.402	0.109	-0.009	0.232
Democratic Control	0.215	0.675	0.012	0.550
Public Corruption	-0.013	0.025	-0.001	0.006
Debt-to-Revenue Ratio	-1.236	0.013	-0.058	0.003
State Tax Burden	-6.905	0.313	-0.317	0.242
Income Per Capita (k)	0.065	0.105	0.003	0.077
Unemployment	-0.417	0.001	-0.018	0.000
Constant	25.040	0.000	1.009	0.000
N	343		352	
LR	86.091		97.214	

Note: Fixed effects for years are included in the model, but are not presented here; P-values are for one-tailed tests when appropriate

Figure 2a. Experience & Predicted Standard & Poor's Ratings

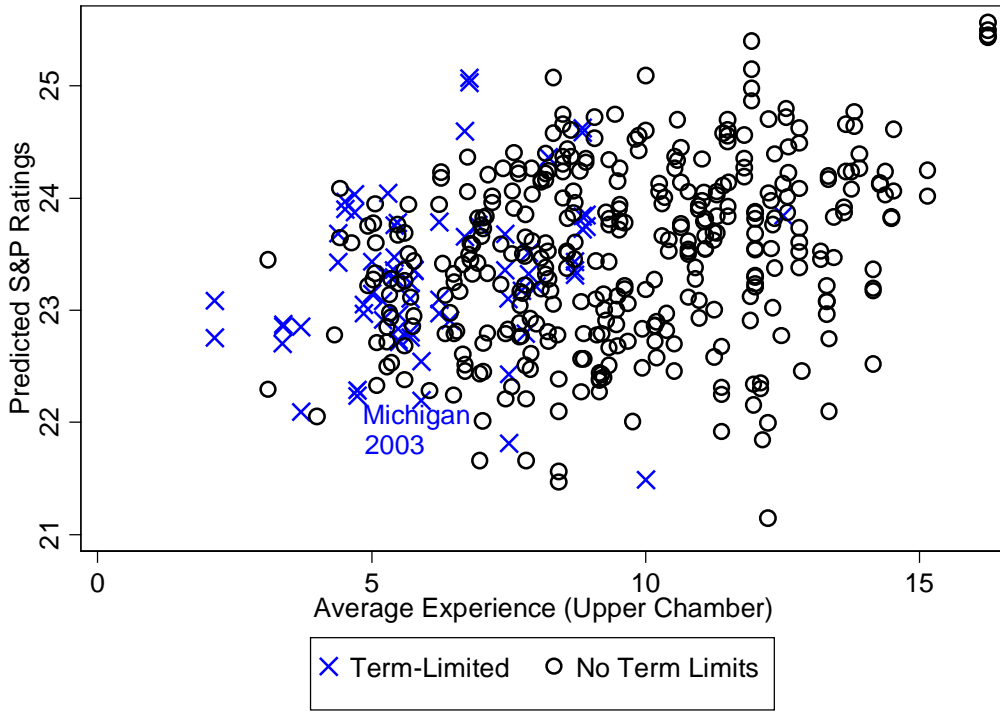


Figure 2b. Experience & Predicted Average Bond Rating Percentages

