State Tax and Expenditure Limits--2007

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Overview

The first years of the 21st century have brought renewed interest in the structure and effectiveness of tax and expenditure limitations (TELs). These fiscal mechanisms are designed to provide certain strictures to restrain the growth of governmental budgets either on the tax side or the spending side or on both. This paper reviews the use of state TELs and explores the policy issues associated with fiscal limits.

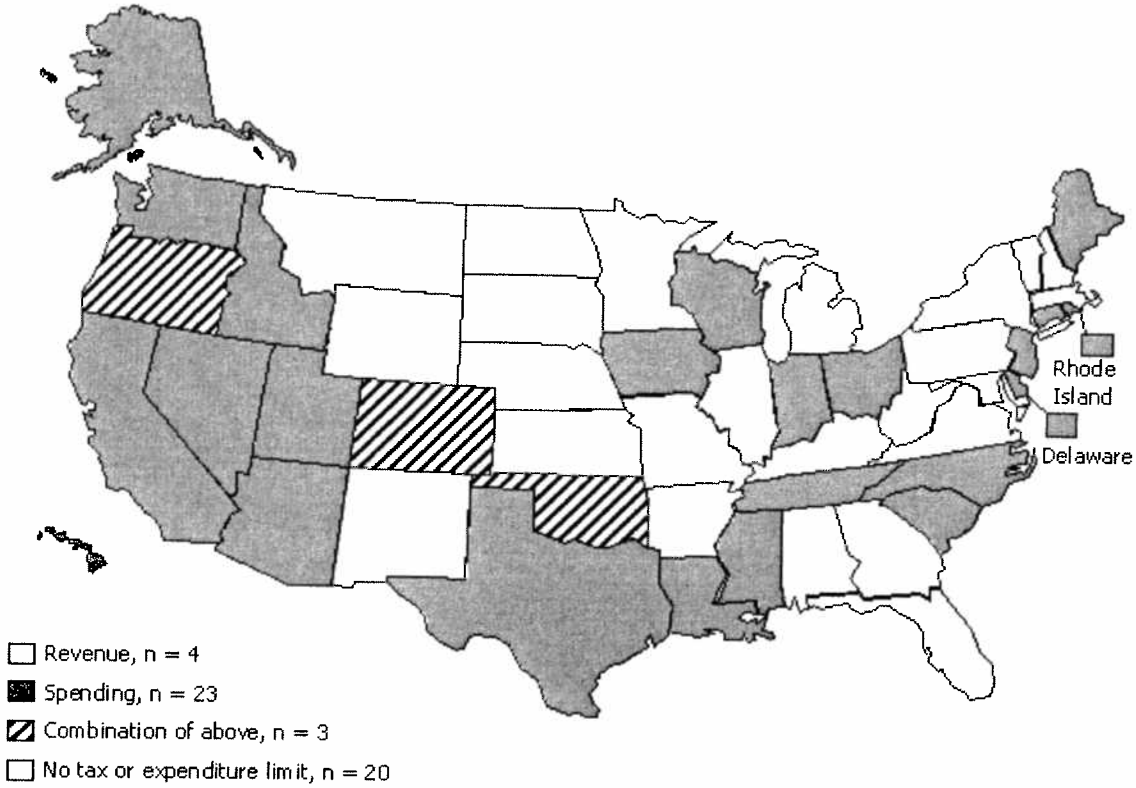
As of January 2007, 30 states operate under a tax or expenditure limitation. Ohio is the most recent state to impose one. In their 2006 session, legislators crafted a statutory spending limit based on population plus inflation growth or 3.5 percent, whichever is greater. This is the second enactment of a TEL in several years. Maine enacted a spending limit in 2005. Several states, like Maine and now Ohio, have statutory spending or tax limit mechanisms, while others, such as Colorado, have TELs embedded in their state constitutions. Colorado is commonly viewed as having the most restrictive set of fiscal limits, and will be further explored in this report.

Twenty-three states having spending limits, four have tax limits, and three have both. About half are constitutional provisions and the other half are statutory. Many of the existing TELs were enacted in two periods of time--the late 1970s and early 1990s. These periods coincided with economic fluctuations in the United States and began shortly after the property tax revolt in California that resulted in passage of Proposition 13. This paper will review the states' experience with TELs.

Types of Limits

In general, no two TELs are exactly alike in their design and characteristics. While the general goal of limits is the same--to restrain government tax revenues or spending outlays--they vary considerably in design, scope and restrictiveness. In the first NCSL report on TELs, four categories of traditional TELs were identified: expenditure limits, revenue limits, appropriations limited by the revenue estimate, and hybrids or combinations (note 1). In addition, within these categories, some TELs also may include certain exceptions and exemptions. Also, some states have other provisions that require voter approval or supermajority legislative votes.

Figure 1. **State Tax and Expenditure Limits, 2007**



Source: National Conference of State Legislatures, 2007.

Traditional Limits

Traditional limits refer to revenue, expenditure or appropriation limits. The features and restrictiveness of these limits vary considerably. S[illegible] variations make it difficult to categorize state TELs, but generally, they fall into one of the categories described below:

Revenue limits. Revenue limits tie allowable yearly increases in revenue to personal income or some other type of index such as inflation or population. The limit provides for the refund of excess revenues to taxpayers.

Expenditure limits. This is the most common type of state TEL. Expenditure limits, like revenue limits, are typically tied to personal income or a growth index. The impact of expenditure limits depends upon the limit parameters. In many states, the limit is tied to a growth index related to the expansion of the economy. Somewhat more restrictive are expenditure limits with refund provisions if revenues exceed the authorized spending level.

Appropriations limited to a percentage of revenue estimates. This variation of a spending limit simply ties appropriations to the revenue forecast, typically ranging from 95 percent to 99 percent of expected revenues. It does not establish an absolute limit or tie growth to a measurable index. Delaware, Iowa, Mississippi, Oklahoma and Rhode Island have this type of appropriation limit in place.

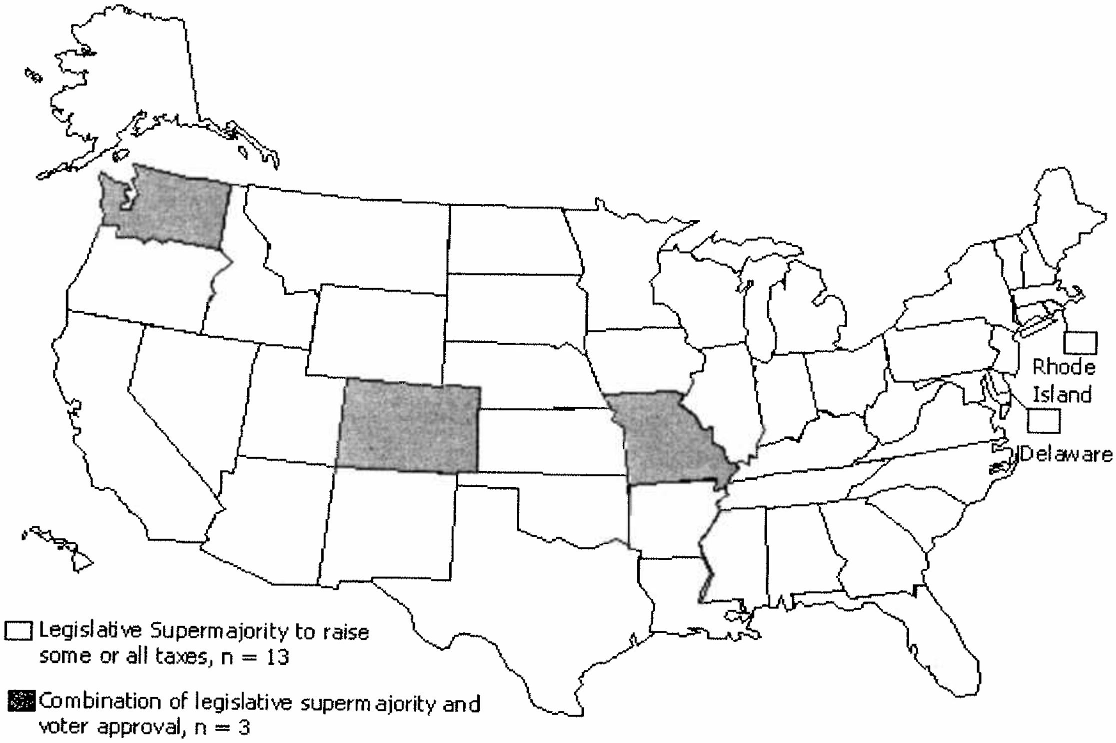
Hybrids. States also have combined components of various limits. For example, Oregon has a state spending limit tied to personal income growth, and a provision requiring refunds if revenues are more than 2 percent above the revenue forecast. This law limits spending and, in a sense, limits revenues by tying them to the forecasted amount. Colorado is another hybrid state.

Other Tax and Expenditure Limitations

A number of states operate under voter approval or supermajority requirements that are not tax or expenditure limitations in the traditional sense; however, they can limit state revenue and expenditure options. Therefore, they are discussed here as a type of limitation. Often these measures are more restrictive than traditional limits.

Voter approval requirements. This is the most restrictive type of limit since all tax increases or tax increases over a specified amount must receive voter approval. Only three states have adopted voter approval requirements. Currently Colorado requires voter approval for a[illegible] increases, and Missouri and Washington require voter approval for tax increases over a certain amount.

Figure 2. **Legislative Supermajority and Voter Approval to Raise Taxes, 2007**



Source: National Conference of State Legislatures, 2007.

Supermajority requirements. Sixteen states now require supermajority votes to pass tax increases. Supermajority requirements dictate either a three-fifths, two-thirds or three-fourths majority vote in both chambers to pass tax increases or impose new taxes. The effectiveness of supermajority requirements depends upon the political makeup of the legislature. In states with one predominant party, the majority party may have enough votes to increase taxes or block tax proposals.

F...nulas for Fiscal Restraint

Generally, two camps have developed regarding the formulas used in fiscal limits: the more strict restraints of population growth plus inflation and the more flexible economic responsiveness of percent of personal income. Why are certain economic indicators contained in these formulas viewed as having such impacts? Population growth is generally a steady, if not slow or stagnant, demographic indicator in a state. Generally it is not volatile, and it takes significant population inflows through interstate migration and international immigration to register a big increase year over year. Such events typically only occur in certain pockets of the country and from time to time. The consumer price index (CPI) inflation measure also has grown slowly in recent years. While the CPI trend is related to the low inflation environment experienced in the United States, it is by no means a guarantee of future levels. Also, it is widely accepted in economic circles that as the official government estimate of inflation, the CPI has the capacity to understate actual inflation. This occurs because of important adjustments that are made to the data over time. In general, the personal income growth measure tends to track economic ups and downs, with incomes decreasing during recessions and increasing during expansionary periods. As a result, use of this indicator is intended to keep budget growth restrained to the level of general economic growth in a state.

Interest Groups Are Generally in Two Camps

Supporters of TELs argue for their expansion into more states as a means of downsizing state government and containing spending and taxes. The CATO Institute is among groups that are strong advocates for TELs. CATO supports TELs that limit government spending to the inflation rate plus population growth index and mandate immediate rebates of government surpluses (note 2). The Americans for Prosperity Foundation (APF) believes that TELs should be enacted in the states, and that states with them experience fewer tax increases. APF argues that TELs are most effective when they include the population and inflation formula, are put into state constitutions, and include voter approval for tax increases (note 3).

On the other hand, groups such as The Bell Policy Center have reservations about the impact of TELs on a government's ability to fund public services adequately. The Bell Center concludes in its 10-year review of the Taxpayers' Bill of Rights (TABOR) in Colorado that TELs in ...state have indeed limited government, that education and health programs have borne a disproportionate share of cuts, that TABOR prevents state budgets from recovering after recessions, and it has diminished the role of elected officials (note 4). The Center for Budget and Policy Priorities argues that while restrictive TELs sound reasonable, they are "actually a recipe for sharply reduced public services and an impaired ability to respond effectively to public needs, federal mandates, and changing circumstances" (note 5) It also argues that public services have declined since the passage of TABOR and particularly since the latest recession (note 6).

Studies on the Impact and Effectiveness of TELs

A number of academic studies have been completed over the past few years to examine how well TELs work and what other implications may have had for state fiscal policy. For example, the Center for Tax Policy examined TELs, noting that limiting the growth of ernment through fiscal caps is much more prevalent than property tax limits. It outlined the structures of TEL mechanisms as follows:

- Method of codification (statutory or constitutional)
- Method of approving the limit (e.g., citizen vote, legislative referendum, legislative action)
- Formula of limit
- To what the limit applies
- Treatment of any surplus
- Waiver provisions
- Requirements for passing tax increases (legislative or popular vote) (note 7)

The Center then qualified the level of fiscal restrictiveness of each state's TEL based on these criteria, with the key factors being the constitutional requirement, the population and inflation economic factor, voter approval requirements for spending and tax increases, and legislative supermajorities for considering tax increases (note 8). Colorado was ranked the most restrictive TEL state and Rhode Island the least.

A 1999 California study on the topic of TELs found that they may have an impact on borrowing costs, specifically the bond yields that affect debt servicing costs. Co-authors James Poterba and Kim Rueben found that states with strict spending limits faced lower borrowing costs during the previous two decades, while alternatively, states with strict tax limits faced higher than average borrowing costs. The authors concluded that higher bond costs may reflect the difficulties limits can add to raising revenue to meet debt payments (note 9).

Another study considered the question of TELs' impact on government growth and size. It found that since most TELs did not "outlaw growth in government" that they did not have a strong effect on the size of government. However, the study did find government size limitation effects in TELs states with low income growth, and increased government growth in states with high income growth. In other words, TELs were responsive to income growth, perhaps because the majority of states use personal income in their TELs mechanisms (10).

In 2004, as Wisconsin considered a TABOR-like fiscal limit mechanism, a University of Wisconsin study simulated what the state's budget trends would have been had TABOR been in effect since 1986 (note 11). It concluded that such a TEL would have restricted government spending, and estimated that state spending would have been $8.4 billion lower from 1986 to 2003. This would have required "a dramatic reduction in state government and school district spending."

Pros and Cons

There are numerous arguments in favor of state tax and expenditure limitations. For example, limits are said to:

- Make government more accountable;
- Force more discipline over budget and tax practices;
- Make government more efficient;
- Make governments think of creative ways to generate revenues--for example, advertising on state-owned facilities;
- Control the growth of government;
- Enable citizens to vote on tax increases and determine their desired level of government service;
- Force government to evaluate programs and prioritize services;
- Raise questions about the advisability of some functions provided by state government;
- Help citizens feel empowered and result in more taxpayer satisfaction;
- Help diffuse the power of special interests;

There are arguments against state tax and expenditure limitations as well. For example, limits are said to:

- Shift fiscal decision making away from elected representatives;
- Cause disproportional cuts for non-mandated or general revenue fund programs;
- Fail to account for disproportionate growth of intensive government service populations like the elderly and school-age children;
- Make it harder for states to raise new revenue so that scarce resources may be shifted between programs;
- Cause a "ratchet-down" effect where the limit causes the spending base to decrease so that maximum allowable growth will not

bring it up to the original level;

- Result in excess revenues that are difficult to refund in an equitable or cost-effective manner;
- Result in declining government service levels over time;
- Fail to provide enough revenues to meet continuing levels of spending in hard economic times;
- Shift the state tax base away from the income tax to the more popular (but regressive) sales tax if voter approval is required;
- Shift the tax base away from broad taxes (property, sales and income) to narrowly defined sources such as lotteries and user fees.

TELs in the News: Colorado's TABOR

Perhaps the most well known TEL is Colorado's Taxpayers' Bill of Rights. TABOR is a set of constitutional provisions Colorado voters adopted in 1992 that limits revenue growth for state and local governments and requires that any tax increase by state or local government (counties, cities, towns, school districts and special districts) be approved by the voters of the affected government.

TABOR is principally a revenue limit. It limits annual revenue the state government can retain from all sources except federal funds to the previous year's *allowed* collections (not necessarily actual collections) plus a percentage adjustment equal to the percentage growth in population plus the inflation rate. Any revenues received in excess of this limit must be refunded to the voters. When revenues fall, the following year's limit on collections is still based on the allowed collections of the previous year. The result is that in years following a recession, allowed revenues will grow only from the worst revenue collection year of the recession to the extent allowed by the rate of population growth and inflation. (This "ratchet" provision was eliminated in 2005, discussed later.) Although citizens may vote to allow the state to keep the excess, TABOR limits the times when such votes may occur.

TABOR also affected a 1991 limit on spending growth that the General Assembly had passed. It made the limit impossible to amend except by a vote of the people. This provision, known as Arveschoug-Bird, limits the growth of general fund expenditures to 6 percent more than the previous year or 5 percent of personal income, whichever amount is lower. In practice the 6 percent limit has generated the lower amount.

Colorado's early experience with TABOR included very rapid demographic and economic growth because of substantial migration (30 percent population growth from 1990 to 2000) and the rapid expansion of the electronics and telecommunications industries in the state. Taxpayers saw substantial "TABOR refund checks" as revenues above the limit were returned to them. The General Assembly subsequently reduced personal income and sales tax rates to reduce surplus (returnable) revenues. However, TABOR itself was not responsible for economic growth in the state (note 12).

Contraction in electronics and telecommunications industries occurred rapidly in 2000 and 2001, shrinking the state economy and tax collections (note 13). The interaction of an additional constitutional provision with the TABOR revenue limit exacerbated the state's budget problems. Voters in 2000 approved Amendment 23, which requires the General Assembly to increase base per-pupil funding for K-12 education by inflation plus 1 percentage point annually through 2010, and by inflation thereafter. K-12 funding now accounts for 42 percent of the Colorado general fund budget.

Without any voter-approved adjustments to the limit, the TABOR cap ensures that state revenue growth will remain below the rate of economic growth in the state. At the same time, Amendment 23 requires an increasing share of allowable revenue growth be directed to K-12 education.

TABOR prevented the creation of a traditional state rainy day fund through implication as well as its requirement that revenues in excess of a limit be returned to the voters. Reserves of 3 percent of the general fund are allowed, but any use must be repaid in the following fiscal year. Thus the reserve fund is more like a cash-flow reserve than a rainy-day fund.

Changes to TABOR in 2005

Following the pressure points exposed by the impact of a severe recession in the early 2000s, there was bipartisan agreement that some easing of the existing limits would be helpful in allowing the state budget to recover and move forward. For example, former Republican Joint Budget Committee Chairman Brad Young states that TABOR shrinks state government relative to the economy every year, regardless of federally mandated spending and other budget demands, and results in direct democracy, rather than representative governance (note 14). Certainly there are other viewpoints about TABOR, but the challenges associated with post-recessionary fiscal policy under TABOR were shared by members of both parties in the state.

O 'ember 1, 2005, voters in Colorado approved a legislative referendum related to TABOR's allowable revenue base. The approval of Referendum C allows the state to retain all revenues it will collect for the next five years. In 2011, a new revenue base will be selected, and growth from that base will be limited to the increase in population plus inflation. This change effectively removes the so-called "ratchet effect" which had frozen the revenue base at its 2002 recessionary low. By approving the referendum, voters decided to forego projected mandatory tax refunds that would have been required had allowable revenue collections been left at the former base level. The revenue impact over five years is $3.743 billion.

Other State TELs Actions

ado voters are not the only ones considering TELs modifications. On November 8, 2005 voters in California defeated a proposal known as Proposition 76, which would have revised the state's spending growth limit from one based on income growth and population to one based on the average of revenue growth over the preceding three years.

Also in 2005, Maine enacted a spending limit. Under Maine's legislation, a statutory spending limit tied to average personal income growth limits state appropriations.

Ohio legislators approved a spending cap in 2006. Initially the Ohio TEL proposal had qualified to be on the November ballot as a constitutional change. However, a gubernatorial candidate who had earlier been a chief proponent of an initiative changed his approach and supported a statutory spending limit that was ultimately approved by the state legislature. The ballot question was then removed prior to the election. The new spending cap statute limits state spending growth to the percentage growth in population plus inflation or 3.5%, whichever is greater. It also imposed a 2/3 supermajority requirement or governor-declared emergency to exceed the new appropriations limit.

During the November 2006 elections, voters in Maine, Nebraska and Oregon rejected new tax and spending limit initiatives by wide margins. In Nebraska, for example, 70 percent of voters rejected the proposal. Earlier in the year, other TABOR-like proposals either did not qualify for the ballot or were disqualified and removed by courts. These included states such as Michigan, Missouri, Montana, Nevada and Oklahoma. The proposals all generally included a spending limit tied to population growth plus inflation and voter approval of tax increases.

As a result, the last five statewide votes on TELs, from 2005 to 2006, have all gone against new limits, or in the case of Colorado, relaxed an existing one.

While no single reason may exist to explain the results, out-of-state influences including financial support for petition drives and public relations activities, combined with the historical trend of good economic times reducing interest in new state fiscal limits, are among the p ble explanations for the defeat of tax and spending limits in the most recent elections.

TELs Engineering: Things to Consider if Designing a Fiscal Limit

The details matter in the design of a fiscal limitation mechanism and many questions must be answered. The Minnesota House Fiscal Analysis Department published in 2004 an issue brief with some of the questions to consider regarding a tax or expenditure limit (note 15). Here is an overview:

1. What is limited, revenues or expenditures? Does the limit apply to all revenues or spending, or are there exclusions?
2. Should the growth factor limit be population plus inflation, or state personal income growth? Which measures of inflation and population will be used?
3. How is the growth measure calculated (e.g., what time periods are used)?
4. Is the baseline revenue or spending a one-year amount or multi-year average?
5. What triggers the limit to be adjusted, and how often might that occur?
6. For revenue limits, is there a threshold after which a rebate is activated?
7. Is there a disaster or emergency exception?
8. Is an adjustment allowed for a major state-local funding relationship change?
9. Can a limit be overridden by a supermajority vote in the legislature?
10. Is there a sunset date on the fiscal limit?
11. Are any limits extended to local government revenues or outlays?

Conclusions

If state economies are volatile, state budget costs are higher than average inflation (such as for health care), or other external changes occur (such as natural disasters), then states with TELs may see pressure points develop when these forces and fiscal limitation m anisms come into contact. The level of flexibility in a TEL's structure to respond to sweeping changes or volatile fiscal environments w elp shape the responses legislatures make when these situations arise.

The most restrictive TELs will ensure that voters will have a direct say over fiscal issues in a state, and legislators will have reduced fiscal policy-making authority. In addition, interest groups whose funding priorities are exposed to fiscal restrictions may seek to carve out protections for those priorities.

State fiscal affairs are conducted in an atmosphere of continuous change resulting from economic fluctuations, demographic realities, intergovernmental relations and external factors. This makes it likely that the dual effort to deliver state government services and restrain state government growth will remain a delicate balance for the foreseeable future.

Legislative Supermajority to Raise Taxes--2007

State	Year Adopted	Initiative or Referendum	Legislative Supermajority Vote Required	Applies To...
Arizona	1992	I	2/3	All taxes
Arkansas	1934	R	3/4	All taxes except sales and alcohol
California	1979	I	2/3	All taxes
Colorado	1992	I	2/3	All taxes
Delaware	1980	R	3/5	All taxes
Florida	1971	R	3/5	Corporate income tax [1]
Kentucky	2000	R	3/5	All taxes [2]
Louisiana	1966	R	2/3	All taxes
Michigan	1994	R	3/4	State property tax
Mississippi	1970	R	3/5	All taxes
Missouri	1996	R	2/3	All taxes [3]
Nevada	1996	I	2/3	All taxes
Oklahoma	1992	I	3/4	All taxes
Oregon	1996	R	3/5	All taxes
South Dakota	1996	R	2/3	All taxes
Washington	1993	I	2/3	All taxes [4]

1. Constitution limits corporate income tax rate to 5%. A 3/5 vote in the legislature is needed to surpass 5%. If voters are asked to approve a tax hike, it must be approved by 60% of those voting to pass.
   Tax and fee increases can be voted on by the legislature in odd-numbered years.
3. If the governor declares an emergency, the legislature can raise taxes by a 2/3 legislative vote; otherwise, tax increases over approximately $70 million must be approved by a vote of the people.
4. Tax increases producing revenue that do not exceed the spending limit must be approved by 2/3 legislative vote; tax increases that produce revenue over the limit must receive 2/3 approval by the legislature and voters. The 2/3 tax increase supermajority was suspended for two years and reduced to a simple majority through June 30, 2007, by legislation enacted in April 2005.

Source: National Conference of State Legislatures, 2007.

State Tax and Expenditure Limits 2007

State	Year Adopted	Constitution or Statute	Type of Limit	Main Features of the Limit
Alaska	1982	Constitution	Spending	A cap on appropriations grows yearly by the increase in population and inflation.
Arizona	1978	Constitution	Spending	Appropriations cannot be more than 7.41% of total state personal income.
California	1979	Constitution	Spending	Annual appropriations growth linked to population growth and per capita personal income growth.
Colorado	1991	Statute	Spending	General fund appropriations limited to the lesser of either a) 5% of total state personal income or b) 6% over the previous year's appropriation.
	1992	Constitution	Revenue & Spending	Most revenues limited to population growth plus inflation. Changes to spending limits or tax increases must receive voter approval.
	2005	Referendum	Revenue & Spending	Revenue limit suspended by voters until 2011, when new base will be established.

Connecticut	1991	Statute	Spending	Spending limited to average of growth in personal income for previous five years or previous year's increase in inflation, whichever is greater.
	1992	Constitution	Spending	Voters approved a limit similar to the statutory one in 1992, but it has not received the three-fifths vote in the legislature needed to take full effect.
Delaware	1978	Constitution	Appropriations to Revenue Estimate	Appropriations limited to 98% of revenue estimate.
Florida	1994	Constitution	Revenue	Revenue limited to the average growth rate in state personal income for previous five years.
Hawaii	1978	Constitution	Spending	General fund spending must be less than the average growth in personal income in previous three years.
Idaho	1980	Statute	Spending	General fund appropriations cannot exceed 5.33% of total state personal income, as estimated by the State Tax Commission. One-time expenditures are exempt.
Indiana	2002	Statute	Spending	State spending cap per fiscal year with growth set according to formula for each biennial period.
Iowa	1992	Statute	Appropriations	Appropriations limited to 99% of the adjusted revenue estimate.
Louisiana	1993	Constitution	Spending	Expenditures limited to 1992 appropriations plus annual growth in state per capita personal income.
Maine	2005	Statute	Spending	Expenditure growth limited to a 10-year average of personal income growth, or maximum of 2.75%. Formulas are based on state's tax burden ranking.
Massachusetts	1986	Statute	Revenue	Revenue cannot exceed the three-year average growth in state wages and salaries. The limit was amended in 2002 adding definitions for a limit that would be tied to inflation in government purchasing plus 2 percent.
Michigan	1978	Constitution	Revenue	Revenue limited to 1% over 9.49% of the previous year's state personal income.
Mississippi	1982	Statute	Appropriations	Appropriations limited to 98% of projected revenue. The statutory limit can be amended by majority vote of legislature.
Missouri	1980	Constitution	Revenue	Revenue limited to 5.64% of previous year's total state personal income.
Missouri, continued	1996	Constitution	Revenue	Voter approval required for tax hikes over approximately $77 million or 1% of state revenues, whichever is less.
Montana*	1981	Statute	Spending	Spending is limited to a growth index based on state personal income. * In 2005 the Attorney General invalidated the statute, and it is not in force at this time.
Nevada	1979	Statute	Spending	Proposed expenditures are limited to the biennial percentage growth in state population and inflation.
New Jersey	1990	Statute	Spending	Expenditures are limited to the growth in state personal income.
North Carolina	1991	Statute	Spending	Spending is limited to 7% or less of total state personal income.
Ohio	2006	Statute	Spending	Appropriations limited to greater of either 3.5% or population plus inflation growth. To override need 2/3 supermajority or gubernatorial emergency declaration.
Oklahoma	1985	Constitution	Spending	Expenditures are limited to 12% annual growth adjusted for inflation.
	1985	Constitution	Appropriations	Appropriations are limited to 95% of certified revenue.
Oregon	2000	Constitution	Revenue	Any general fund revenue in excess of 2% of the revenue estimate must be refunded to taxpayers.

	2001	Statute	Spending	Appropriations growth limited to 8% of projected personal income for biennium.
Rhode Island	1992	Constitution	Appropriations	Appropriations limited to 98% of projected revenue (becomes 97% July 1, 2012).
h Carolina	1980 1984	Constitution	Spending	Spending growth is limited by either the average growth in personal income or 9.5% of total state personal income for the previous year, whichever is greater. The number of state employees is limited to a ratio of state population.
Tennessee	1978	Constitution	Spending	Appropriations limited to the growth in state personal income.
Texas	1978	Constitution	Spending	Biennial appropriations limited to the growth in state personal income.
Utah	1989	Statute	Spending	Spending growth is limited by formula that includes growth in population, and inflation.
Washington	1993	Statute	Spending	Spending limited to average of inflation for previous three years plus population growth.
Wisconsin	2001	Statute	Spending	Spending limit on qualified appropriations (some exclusions) limited to personal income growth rate.
Source: National Conference of State Legislatures, 2007.				

Resources:

- Americans for Prosperity Foundation. Washington, D.C. www.americansforprosperity.org
- The Bell Policy Center. Denver, Colo. www.thebell.org
- Cato Institute. Washington, D.C. www.cato.org
- Center on Budget and Policy Priorities. Washington, D.C. www.cbpp.org
- The Center for Tax Policy. Littleton, Colo. www.centerfortaxpolicy.org
- Economic Policy Institute. Washington, D.C. www.epi.org

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13. Adapted from NCSL's Talking Points on TABOR. Fiscal Affairs Program. 2004. http://www.ncsl.org/programs/fiscal/taborpts.htm
14. Brad Young. Presentation to Governing Magazine Conference. Washington, D.C. February 2005.
15. Revenue and Expenditure Limits. Issue Brief. House Fiscal Research Department. February 2004. http://www.house.leg.state.mn.us/fiscal/files/ibrevexp.pdf

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