Issue Backgrounder

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Tax and Spending Limits:

Theory, Analysis, and Policy

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Tax and spending limits (TELs) are budgetary rules that determine how much taxes and/or expenditures can increase from one year to the next. TELs can be statutory or constitutional rules. Statutory TELs can be modified by legislative action, while constitutional TELs can only be modified by a majority vote of citizens. TELs may originate through a legislative statute or referendum, or they may be initiated by citizens in states that provide for this form of direct democracy. TELs are now in place in 26 states.

Two recent developments have stimulated renewed interest in TELs in the U.S. The first is divergence in levels and long-term rates of growth in state revenue and spending in the states. At least some states with TELs appear to have been more successful than other states without TELs in constraining the growth of government. Whether or not this fiscal discipline is a result of the impact of TELs has been the subject of a large and growing empirical literature. The second development is the diverging response of the states to the revenue shortfalls that have accompanied the recent recession. States have responded differently to deficits in their budgets: some states cut spending; other states raised taxes; and a few states, such as California, have accumulated debt of a magnitude greater than that which has occurred in any previous recession. Sorting out the impact of TELs and other budget rules as an explanation for the different response of states to revenue shortfalls has emerged as a major research question.

The recent literature on TELs includes more rigorous econometric analysis, and more thorough case studies of TELs in individual states. These studies provide important insights into the design and implementation of TELs. Recent empirical studies support the 'public choice' view that budget institutions significantly affect fiscal policy. TELs, as well as other budget rules, can significantly reduce state and local spending. The most effective TELs are ones that:

a. are constitutional rather than statutory
b. limit the growth of government spending to inflation and population growth rather than other aggregate measures of economic activity
c. provide for immediate refunds of surplus revenue above the TEL limit
d. are linked to other budget rules, most importantly to balanced budget requirements.

Budget rules also affect the way that states respond to revenue shortfalls by cutting expenditures and/or raising taxes. States with TELs experience lower tax increases in periods of recession than states without TELs.

State response to a deficit is also affected by the general fund balance. The general fund balance is a broad measure of the total reserves available to stabilize the budget. States with low general fund balances must make larger spending cuts in response to budget deficits. In some states these reserves are allocated to a budget stabilization. There is also evidence that tax increases as a fraction of the deficit are larger in states with low general fund balances.

When surplus revenue is generated above the TEL limit, some states simply return the revenue to the general fund to finance expenditures. The allocation of surplus revenue to finance government spending will redistribute income from those who paid the excess taxes to those benefiting from government spending. Special interest groups are often successful in earmarking revenue that is then exempt from the TEL limit and used to finance expenditures benefiting their constituents.

Some TELs mandate tax cuts and tax rebates when revenue exceeds the TEL limit. One approach would return the surplus revenue to those who paid the excess taxes. Rarely is this achieved; the tax cuts and tax rebates have the effect of redistributing income from those who paid the excess taxes to others who may have paid little or no taxes.

The next generation of TELs is designed to achieve an optimum tradeoff between constraining the growth of government and stabilizing government budgets over the business cycle. These TELs link a stringent tax and spending limit to a budget stabilization fund. New TELs embodying elements of this design have now been proposed in half a dozen

states in recent years, including Colorado.[1]

Decision makers must pay attention to the design of TELs if they are to have a significant impact in constraining government spending. Empirical evidence indicates that well designed TELs impose fiscal discipline on elected officials; poorly designed TELs do not. Political and legal institutions can (and have) eroded the effectiveness of TELs through legislation and court decisions. In some states this influence was apparent in the original design of a weak and ineffective TEL. In Colorado erosion in the effectiveness of our TELs is primarily the result of legislative actions and court decisions that have weakened various provisions of the TEL.

Colorado was one of the first states to impose a statutory cap on the growth of state spending. In 1978, a cap of 7% was placed on the growth of general fund expenditures. In the late 1970s some surplus revenue above that limit was rebated to taxpayers. When recession hit in the early 1980's Colorado, like other states, responded by increasing taxes to balance the budget. That increase in taxes ratcheted up government spending at rates in excess of the growth in state income in subsequent years. The Colorado TEL, like many other statutory TELs, was simply ignored by the legislature.

In the late 1980s citizens organized to put a more stringent TEL on the ballot. After several failed attempts the TABOR Amendment was enacted in 1992 through citizen initiative. TABOR is the most stringent TEL introduced in any state. TABOR restricts the growth in state revenue and spending to inflation plus the percentage change in state population. Surplus revenue above that limit must be rebated to taxpayers.

The TABOR limit ratchets-down the amount of revenue the state can keep and spend as revenue falls. The TABOR limit is determined by applying the sum of inflation and population growth to actual TABOR revenues or the TABOR limit, whichever is lower. When revenue falls in a recession, that lower revenue then sets a new base against which the sum of inflation and population growth is applied.

The TABOR Amendment also placed a procedural constraint on the power of government to raise taxes. Voter approval is required for any new taxes, tax rate increases, extension of an expiring tax, or tax policy change directly causing a net revenue gain. Voter approval is also required for state and local government to retain and spend revenue in excess of the limit.

In a failed attempt to preempt this stringent TEL from being introduced through citizen initiative the legislature enacted a statutory TEL. In 1992 the Arveschaugh-Bird Amendment placed a cap on general fund appropriations equal to the lesser amount of 5% of Colorado personal income in the calendar year two years prior to the start of the fiscal year or 6% over the previous year's general fund appropriation, with exceptions for federal mandates and court orders.

Over time the Legislature has interpreted the 6% statutory cap as a floor rather than a ceiling on the growth in general fund expenditures. The reason is that the general fund spending in a given year determines the base against which the spending cap is applied in determining the amount of general fund spending permitted in the following year. The distortions this introduces in state spending have become very evident in recent years.

For the foreseeable future the Arveschaugh-Bird amendment will have little if any impact on state fiscal policies. This is because the 6% limit on the growth in general fund expenditures will not be a binding constraint on the legislature. That limit is significantly above the limit imposed by the TABOR Amendment

Initially the TABOR Amendment was non-binding because the growth in state revenues was less than the TABOR limit. The first year in which TABOR became a binding constraint was 1997. Over the next five years more than $3 billion in surplus revenue was either rebated to taxpayers, or offset by tax reduction. A referendum to spend a portion of the surplus revenue was defeated by taxpayers.

The Legislature has also chosen to interpret the TABOR limit as a floor rather than a ceiling on the revenue that the state can keep and spend. This introduces distortion and inefficiency in state finance, and the problem has become especially evident in the current fiscal crises. Even if it might be prudent for the Legislature to hold revenue and spending growth below that permitted by the TABOR limit, the Legislature has often failed to do so.

The Legislature has interpreted TABOR so as to erode the constraints imposed by the limit, and to exacerbate the fiscal crises resulting from the current recession. The Legislature chose to retain the surplus revenue generated in the current year in the general fund reserve, and to finance rebates from the surplus revenue generated in the following year. This scheme worked fine when revenues were rising in the boom years; but the flaw in this scheme became apparent in the current fiscal crises. With recession the TABOR surplus disappeared, and the state had to finance a rebate from reductions in current state spending. The decision of the Legislature to finance taxpayer rebates from revenues received in the year after the TABOR surplus is generated has exacerbated the fiscal crises. The Legislature has also chosen to increase the TABOR limit to adjust for undercounting of population growth in the last decade. This permitted the state to retain and spend more revenue over the coming decade.

A different set of problems has resulted from the way in which the legislature has chosen to offset surplus revenue More than 20 bills have been passed offsetting the TABOR surplus with tax rebates and tax cuts. Most of the TABOR surplus has been generated by the income and sales taxes; and some of that surplus has been offset by rebates and reductions in the income and sales taxes. However, the increased use of targeted tax cuts and tax rebates to benefit narrow interest groups means that less of the surplus is refunded to the people who paid the excess taxes.

A major problem emerged when a constitutional provision was introduced requiring constant growth in expenditures for education K-12 from income tax revenue earmarked for that purpose and exempt from the TABOR limit. This Amendment, which requires a constant ratcheting up of expenditures for education K-12, combined with the TABOR Amendment, which ratchets government revenue down, places the legislature in an untenable position. The legislature has discretion over less than one third of the state budget because more than two thirds is mandated by the required expenditures for education K-12, Medicaid, and prisons. When the recession resulted in a revenue shortfall the legislature was required to make draconian cuts in higher education and social services. In the long run these provisions in the fiscal constitution will result in a structural deficit, which is prohibited by the balanced budget provision of the Colorado Constitution. The Colorado legislature is now considering changes in each of these constitutional provisions in order to avoid a future fiscal crisis.2

Finally, in Colorado, TELs have been more effective in constraining local government than state government. The result is that financing for education K-12 has shifted significantly from local government to the state government in Colorado. The TABOR Amendment requires the state to backfill local governments whenever state legislation has a negative impact on local government revenues. When the state enacted a cut in the business personal property tax it was required to backfill local governments for the loss of revenue resulting from this tax cut. Despite these provisions, the financing and administration of some programs, such as education K-12, has shifted from local government to the state government.

Colorado is currently experiencing the worst fiscal crises in decades. While tax and spending limits have been effective in slowing the growth in state government in the long run, they have not been very effective in smoothing the growth of state revenue and spending over the business cycle. Colorado does not have a true budget stabilization fund. The current fiscal crises reveals the need for such revenue and expenditure smoothing in state government during periods of recession and slower economic growth.

Legislation has been introduced in Colorado that would link the TABOR limit to both an emergency reserve fund, and a budget stabilization fund.

Endnotes

[1] The author has been consulting with these states as a member of the American Legislative Exchange Council (ALEC) Task Force on Tax and Fiscal Policy.
[2] For insight into this controversy see (Treasurer's Advisory Group on Constitutional Amendments 2003).

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