NATIONAL CONFERENCE *of* STATE LEGISLATURES

The Forum for America's Ideas

State Tax and Expenditure Limits—2012

Overview

The lingering state budget crisis, brought on by the Great Recession of 2007, has prompted renewed interest among policymakers in state spending caps and initiated a fresh look at 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 both. This paper reviews the use of state TELs and explores some of the policy issues associated with fiscal limits.

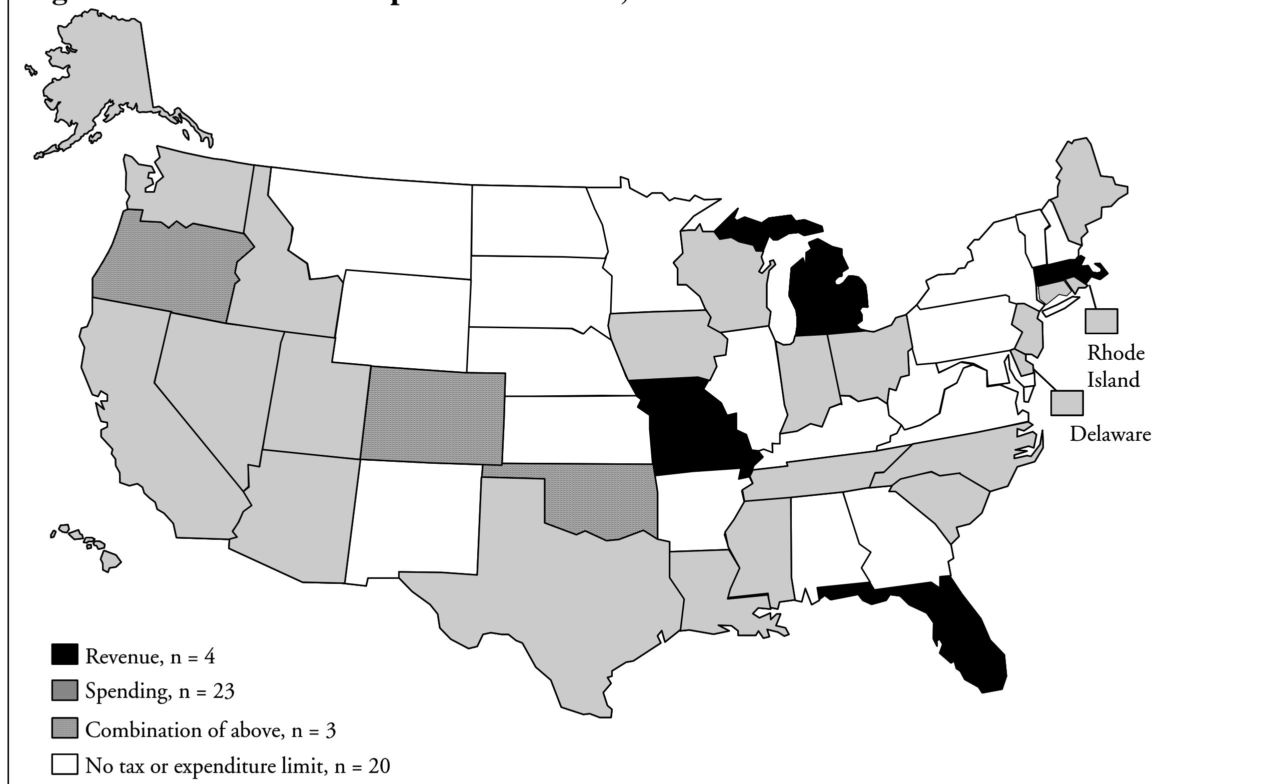
Thirty states presently operate under a tax or expenditure limitation. Twenty-three states have spending limits, four have tax limits, and three have both. About half are constitutional provisions and the other half are statutory.

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.

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.

Figure 1. State Tax and Expenditure Limits, 2012



Source: **National Conference of State Legislatures, 2012.**

Traditional limits refer to revenue, expenditure or appropriation limits. The features and restrictiveness of these limits vary considerably. Such variations make it difficult to categorize state TELs, but generally, they fall into one of the descriptions 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.

In addition to TELs, a number of states require voter approval or a legislative supermajority to raise revenues. These are not tax or expenditure limitations in the traditional sense; however, they can still constrain state revenue and expenditure options and in many cases, they are more restrictive than limits. For more information on supermajority requirements, please refer to NCSL's 2012 report, *State Supermajority Requirements for Revenue Increases.*

Features of Tax and Expenditure Limits

State laws and constitutions prescribe various methods and formulas to determine the limits on taxes and expenditures. These include both absolute limits on taxes and spending and limits on the size of revenue and spending increases. Generally, the formulas used in fiscal limits fall into two categories:

- **Population growth plus inflation**—this is viewed as the more restrictive formula. 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.

- **Percent of personal income**—this is generally less restrictive because 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.

Obviously different limit characteristics promote different results. Some of the variables are listed below, and all these factors contribute to the restrictiveness of state tax and expenditure limits.

- Is it statutory or constitutional? Constitutional amendments are usually more difficult to change than statutes.
- Is it a limit on revenues or expenditures? Spending is usually easier for state governments to control?
- What is the basis of the limit? If the base year chosen to limit expenditures is a high water mark for state spending, it is less likely the limit will be triggered.
- How much of the budget is limited? Often the TEL only applies to the general fund. How much of the budget does that really limit? How are earmarked funds treated?
- What are the provisions for change? Most states build in flexibility by providing provisions for emergencies or long-run changes in basic economic characteristics such as a declining population or ongoing recession.

- What are the provisions in the TEL for shifting program responsibility? Can government entities shift programs to one another?
- How are surplus funds treated? Surplus funds in most states go into rainy day or other special funds. However, a number of states require refunds of surplus revenues.

Table 1 lists the states with tax and spending limitations.

State	Year	Enacted in	Enacted by	Type of Limit	Main Features of the Limit	Surplus Provisions
Alaska	1982	Constitution	Referendum	Spending	A cap on appropriations grows yearly by the increase in population and inflation.	None
Arizona	1978	Constitution	Referendum	Spending	Appropriations cannot be more than 7.41% of total state personal income.	None
California	1979	Constitution	Citizen Initiative	Spending	Annual appropriations growth linked to population growth and per capita personal income growth.	Half to education; half refund
Colorado	1991	Statute	Legislature	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	Citizen Initiative	Revenue & Spending	Most revenues limited to population growth plus inflation. Changes to spending limits or tax increases must receive voter approval.	Refund
	2005	Statute	Referendum	Revenue & Spending	Revenue limit suspended by voters until 2011, when new base established.	
	2009	Statute	Legislature	Spending	Revised general fund appropriations limit to remove the 6% of prior year appropriations alternative, while retaining a limit based on 5% of total state personal income.	
Connecticut	1991	Statute	Legislature	Spending	Spending limited to average of growth in personal income for previous five years or previous year's increase in inflation, whichever is greater.	Reserve fund; debt reduction or other purpose approved by legislative supermajorit y

State	Year	Enacted in	Enacted by	Type of Limit	Main Features of the Limit	Surplus Provisions
	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	Referendum	Appropriations to Revenue Estimate	Appropriations limited to 98% of revenue estimate.	General fund
Florida	1994	Constitution	Referendum	Revenue	Revenue limited to the average growth rate in state personal income for previous five years.	Reserve fund
Hawaii	1978	Constitution	Convention	Spending	General fund spending must be less than the average growth in personal income in previous three years.	Refund or general fund
Idaho	1980	Statute	Legislature	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.	None
Indiana	2002	Statute	Legislature	Spending	State spending cap per fiscal year with growth set according to formula for each biennial period.	Reserve fund
Iowa	1992	Statute	Legislature	Appropriations	Appropriations limited to 99% of the adjusted revenue estimate.	Reserve fund
Louisiana	1993	Constitution	Referendum	Spending	Expenditures limited to 1992 appropriations plus annual growth in state per capita personal income.	Tax surplus fund for refunds or debt service
Maine	2005	Statute	Legislature	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.	Reserve fund
Massachusetts	1986	Statute	Citizen Initiative	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.	Reserve fund

State	Year	Enacted in	Enacted by	Type of Limit	Main Features of the Limit	Surplus Provisions
Michigan	1978	Constitution	Citizen Initiative	Revenue	Revenue limited to 1% over 9.49% of the previous year's state personal income.	Refunds or reserve fund
Mississippi	1982	Statute	Legislature	Appropri ations	Appropriations limited to 98% of projected revenue. The statutory limit can be amended by majority vote of legislature.	General fund and reserve fund
Missouri	1980	Constitution	Citizen Initiative	Revenue	Revenue limited to 5.64% of previous year's total state personal income.	Refunds or reserve fund
Missouri, continued	1996	Constitution	Citizen Initiative	Revenue	Voter approval required for tax hikes over approximately $77 million or 1% of state revenues, whichever is less.	
Montana*	1981	Statute	Legislature	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	Legislature	Spending	Proposed expenditures are limited to the biennial percentage growth in state population and inflation.	None
New Jersey	1990	Statute	Legislature	Spending	Expenditures are limited to the growth in state personal income.	None
North Carolina	1991	Statute	Legislature	Spending	Spending is limited to 7% or less of total state personal income.	General fund
Ohio	2006	Statute	Legislature	Spending	Appropriations limited to greater of either 3.5% or population plus inflation growth. To override need 2/3 supermajority or gubernatorial emergency declaration.	Reserve fund
Oklahoma	1985 1985	Constitution Constitution	Referendum	Spending Appropri ations	Expenditures are limited to 12% annual growth adjusted for inflation. Appropriations are limited to 95% of certified revenue.	General fund and reserve fund
Oregon	2000 2001	Constitution Statute	Legislature Referendum	Revenue Spending	Any general fund revenue in excess of 2% of the revenue estimate must be refunded to taxpayers. Appropriations growth limited to 8% of projected personal income for biennium.	Refunds

State	Year	Enacted in	Enacted by	Type of Limit	Main Features of the Limit	Surplus Provisions
Rhode Island	1992	Constitution	Referendum	Appropri ations	Appropriations limited to 97% of projected revenue.	Reserve fund
South Carolina	1980 1984	Constitution	Referendum	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.	Debt service or reserve fund
Tennessee	1978	Constitution	Convention	Spending	Appropriations limited to the growth in state personal income.	None
Texas	1978	Constitution	Referendum	Spending	Biennial appropriations limited to the growth in state personal income.	None
Utah	1989	Statute	Legislature	Spending	Spending growth is limited by formula that includes growth in population, and inflation.	None
Washington	1993	Statute	Citizen Initiative	Spending	Ten year average personal income growth.	Reserve fund
Wisconsin	2001	Statute	Legislature	Spending	Spending limit on qualified appropriations (some exclusions) limited to personal income growth rate.	Reserve fund

Source: National Conference of State Legislatures, 2012.

Reasons for Tax and Expenditure Limits

Fiscal constraints are not new to state governments. Many states are constrained legally from incurring debt and most state governments are required by constitution or statutes to adopt a balanced budget. However, over time, these requirements have not effectively stemmed growth of the public sector. There are three basic factors that influence the TEL movement.

General opposition to government expansion. Many taxpayers simply feel state governments are too big and too inefficient. They believe that public sector growth should be constrained, and that TELs, by making governments more accountable for expenditures and to voters, are a way to accomplish that goal. In addition, public support for state legislatures is very low as evidenced by the growing number of states with term limits. People are cynical about government and insecure about their economic well being. These things combine to make taxpayers distrustful of government fiscal policy.

Hidden tax increases. Taxes increase over time without a change in tax laws. At the state level, this occurs primarily with income taxes. If the state does not index income tax liability to inflation, over

time incomes increase, pushing people into higher brackets. A greater proportion of income goes to pay taxes without any real increase in purchasing power.

Overemphasis on a particular type of tax. Overreliance on one tax is usually not a significant motivating factor behind state limits, although at the local level, heavy reliance on property taxes has resulted in local property tax limits. However, in a few states, heavy reliance on a particular tax may cause concern among taxpayers.

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—growth based on personal income or inflation plus population seems reasonable;
- 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 some functions provided by state government—some of these functions may be more suited to the private sector;
- Help citizens feel empowered and result in more taxpayer satisfaction;
- Help diffuse the power of special interests;
- Offer a way to deny special programs;
- Possibly result in taxpayer refunds.

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 disproportionate cuts for non-mandated or general revenue fund programs;
- Fail to account for disproportional growth of intensive government service populations such as 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 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.

Have Tax and Expenditure Limits Been Successful?

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

- 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)

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.[1] Colorado was ranked the most restrictive TEL state and Rhode Island the least.

Similarly, a CATO Institute report finds that caps generally do restrain spending growth if they meet the following conditions: if they result from citizen initiative rather than statute, if they are based on population and inflation growth and if they require surplus refunds.[2] Without these provisions, however, they have not been very effective.

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.[3] 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."

On the other hand, a 2008 study by Kousser, McCubbins and Moule tested for the effectiveness of TELs across states and found that they are largely ineffective. This is primarily because state officials can circumvent them by raising money through fees or borrowing.[4]

1. Fiscal Cap Style TELs in the States: An Inventory and Evaluation. Phyllis Resnick. The Center for Tax Policy. 2004.
2. Michael New. *Limiting Government through Direct Democracy: The Case of State Tax and Expenditure Limitations*. CATO. 2001.
3. Andrew Reschovsky. The Taxpayer Bill of Rights: A Solution to Wisconsin's Fiscal Problems or a Prescription for Future Crises? State Tax Notes. July 26, 2004

[4] Thad Kousser, Mathew McCubbins and Ellen Moule. "For Whom the TEL Tolls: Can State Tax and Revenue Limits Effectively Reduce Spending?" *State Politics and Policy Quarterly* 8:331-361. 2008.

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.[5]

Examining another perspective, a 1999 California study looked at the ancillary effect of limits on borrowing 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 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.[6]

When analyzing the impact of all the various limits, it is important to look at not only whether the limit has led to less government, but also the quality of government services. The following questions may be helpful when analyzing the effects of tax and expenditure limits:

- Is the level of service at a desirable level?
- Has government accountability improved?
- Has government efficiency improved?
- Have the changes in revenue sources been positive?
- Has there been a shift in the responsibility of government functions?

Strategies to Manage State Tax and Expenditure Limitations

Regardless of whether or not they achieve the desired outcome, limits are here to stay. They have been around for nearly four decades and more than half the states have adopted them in varying degrees. The past 35 years demonstrate that state governments have managed to live with TELs, albeit with difficulty at times.

Listed below are several strategies that, while not necessarily considered good fiscal policy, are tactics to help states manage limits.

- Build up the state's rainy day fund so money is available for slow growth years.
- Shift responsibility to local governments if permitted.
- Go to voters only in cases of emergency.
- Maintain the revenue base during slow growth years by planning on one-time tax refunds rather than reducing the revenue base permanently.
- Earmark new taxes, when needed, for a popular program to encourage voter approval.
- Prioritize spending and try to spend less, perhaps some government functions can be met through the private sector.
- Index fees and increase them on a gradual basis to avoid a need for a large increase at one time.

5. Ronald Shadbegian. Do Tax and Expenditure Limitations Affect the Size and Growth of Government? Contemporary Economic Policy. January 1996.
6. Fiscal Rules and Bond Yields: Do Tax Limits Raise the State's Borrowing Costs? James Poterba and Kim Rueben. Public Policy Institute of California. 1999.

TELs up Close: Colorado's TABOR

Perhaps the most well known and most restrictive set of fiscal limits is Colorado's Taxpayers' Bill of Rights (TABOR). 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 taxpayers. If revenues fall, however, 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 lowest revenue collection year of the recession to the extent allowed by the rate of population growth and inflation. This is known as the "ratchet effect." Although citizens may vote to allow the state to keep the excess, TABOR limits the times when such votes may occur.

Colorado has another limit on spending growth. The original provision was known as Arveschoug-Bird, and was passed in 1991 by the General Assembly. It limited the growth of general fund expenditures to 6 percent more than the previous year, or 5 percent of personal income, whichever amount was lower. However, this changed in 2009. Legislation was enacted that removed the 6 percent of appropriations alternative, leaving intact a general fund expenditures limit based on 5 percent of personal income.

Colorado's early experience with TABOR was mostly positive since it coincided with several years of economic expansion. In addition, the state experienced very rapid demographic growth because of substantial migration (30 percent population growth from 1990 to 2000). Taxpayers saw considerable refunds as revenues above the limit were rebated. The General Assembly subsequently reduced personal income and sales tax rates to reduce surplus (returnable) revenues.

When the 2001 recession hit, the state economy contracted and created a very challenging fiscal environment. Tax collections declined to a level well below the TABOR limit, which became the new revenue base. This development, along with an additional constitutional provision (Amendment 23 was approved by voters in 2000 to fund education by inflation plus 1 percent), exacerbated the state's budget problems.

Because the TABOR cap limited revenue growth from the new lower base to the level of population growth and inflation, it essentially ensured that state revenue growth would remain below the rate of economic growth in the state. At the same time, Amendment 23 required an increasing share of allowable revenue growth to be directed toward 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. Following the pressure points exposed by the 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.

In 2005, Colorado voters approved a legislative referendum related to TABOR's allowable revenue base. Referendum C allowed the state to retain all revenues it collected over the next five years. In FY 2011, a new revenue base would be selected, and growth from that base would be limited to the increase in population plus inflation. This change effectively removed the 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 for five years that would have been required had allowable revenue collections been left at the former base level. However, in 2008, voters rejected a second initiative that would have indefinitely eliminated surplus refunds and placed those funds into an education account.

Other State TELs Actions

Colorado was not the only state to consider a TELs proposal in 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.

On the heels of Maine's limit, Ohio legislators approved a spending cap in 2006, which limits state spending growth to the percentage growth in population plus inflation or 3.5%, whichever is greater. It also imposed a two-thirds supermajority requirement or governor-declared emergency to exceed the new appropriations limit. Ohio remains the most recent state to impose a state spending limit in 2006.

But not for lack of opportunity. Since then, several states have contemplated tax and spending limits, but they have not become law: either they were rejected by voters or they did not have enough support in the legislature. 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.

Similarly in 2009, California voters rejected a new, stronger spending limit by a 66 percent majority. The proposed limit was based on unanticipated revenues above a ten-year historic trend, adjusted for short-term tax changes, or, in some cases, the rate of growth in population plus inflation. Revenue in excess of the limit would have been diverted to a rainy day fund. Voters in Maine and Washington also rejected ballot proposals that included spending limits tied to population plus inflation formulas and voter approval of tax increases.

In November 2012, voters in Oregon will address the issue of what to do with the revenue surplus. Under current law, excess revenues are refunded to individual and corporate taxpayers. The pending initiative asks voters whether the state should reallocate some of those funds to public education that are now rebated to corporate taxpayers. In addition, Florida residents will vote on a proposed constitutional amendment that replaces the existing state revenue limitation based on Florida personal income growth with a new state revenue limitation based on inflation and population changes. If it passes, it will be the first major tax and expenditure limit to be adopted in six years.

Conclusions

Even though states have not recently enacted new TELs measures, interest in spending caps remains high with both the public and policymakers. Every year, new proposals for limits are introduced and considered. Fiscal hardship during the past five years has brought more attention than ever to the state budgeting process, and the fine line that policymakers must walk in order to balance the budget each year.

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.

Other 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