Rockefeller Institute Policy Brief

May 21, 2007

THE EFFECTS OF STATE-LEVEL TAX AND EXPENDITURE LIMITATIONS ON REVENUES AND EXPENDITURES

Suho Bae and Thomas Gais

State-level tax and expenditure limitations (TELs) are designed to restrain and control the size and growth of government budgets at the state and local level. These fiscal mechanisms are enacted through voter initiatives or referenda or simply through legislation. New Jersey was the first state to pass a TEL in 1976. Most recently, Maine and Ohio enacted statutory spending limits in 2005 and 2006, respectively. Many arguments are made for and against state-level TELs and their effectiveness.[1]

This brief summarizes what is known about TELs, including their spread, variation, and effects. Our basic points include the following:

- State-level TELs appear to produce their intended effects. Although findings to date show some inconsistency, the preponderance of the evidence indicates that states with TELs experience somewhat slower growth in revenues and expenditures.
- These effects are stronger where TELs are more restrictive, that is, when TELs are part of the state's constitution and ceilings on revenue or spending increases are tied to slow-growing indices, such as population and inflation.
- TELs may not be neutral with respect to different types of expenditures and revenue sources. Their negative effects on spending and revenues may be greater for certain functions and revenue sources, and some effects may even be positive.
- Thirty-one states now have state-level TELs. They are quite diverse, including states from all regions of the country and fiscal capacities.
- The spread of TELs may have slowed in recent years. Most state-level TELs were adopted during or soon after downturns in state fiscal conditions in the late 1970s and early 1990s. However, despite the fiscal crisis in nearly all states in fiscal years 2001-03, few states adopted new TELs or strengthened existing ones.

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1 For arguments for and against state-level TELs, see M. Rafool, *State Tax and Expenditure Limits — 2005 (*Washington, D.C.: The National Conference of State Legislatures, 2005).

These conclusions are based on our reading of other studies of state-level TELs as well as our own analyses. These latter, more extensive analyses are available on request or on the Institute's website.[2]

The Incidence, Growth, and Diversity of State-Level TELs[3]

Thirty-one states now have state-level TELs. They are listed in the Appendix. The most striking characteristic of this list is its diversity. Although TELs are most common among states west of the Mississippi, they are nonetheless found in all major regions of the U.S. TELs also cut across state fiscal capacity (often measured by per capita personal income), which is one of the more important factors related to states' level of expenditures. Thus, sometimes TELs attempt to restrict spending and revenues in states that otherwise have the resources to expand government expenditures and taxes, while sometimes TELs may compound problems of raising revenues and paying for public programs in states with weak resource bases.

The figure below shows the changing number of states with state-level TELs from 1977 to 2006. The number of states with TELs decreased from seventeen to sixteen states in 1983, when New Jersey's TEL expired.[4] But this reversal is an exception. For the most part, the spread of TELs is cumulative, with few cases of elimination. As shown in Figure 1, most TELs were enacted in two periods, the late 1970s and the early 1990s, times when states experienced serious budget deficits, mainly because of economic recessions. Between 1975 and 1980, fifteen states enacted TELs, while eight states enacted TELs between 1990 and 1995. Thus, by the end of 1995, twenty-seven states had state-level TELs. Few TELs were passed during economic booms, such as the late-1990s.

TELs may have lost some of their popularity in recent years. Since 2005, efforts were made in ten states to enact new state-level budgetary restrictions, or to make existing TELs more stringent and restrictive in controlling the size and growth of government budgets. But most of these attempts were unsuccessful.[5] In the November 2006 general elections, voters refused to approve new proposals of state-level TELs in three states (Maine, Nebraska, and Oregon). Other proposals of state-level TELs failed to qualify for that year's ballots or were stopped by court decisions. They included Michigan, Missouri, Montana, Nevada, and Oklahoma. In 2005, TEL proponents in Califor-

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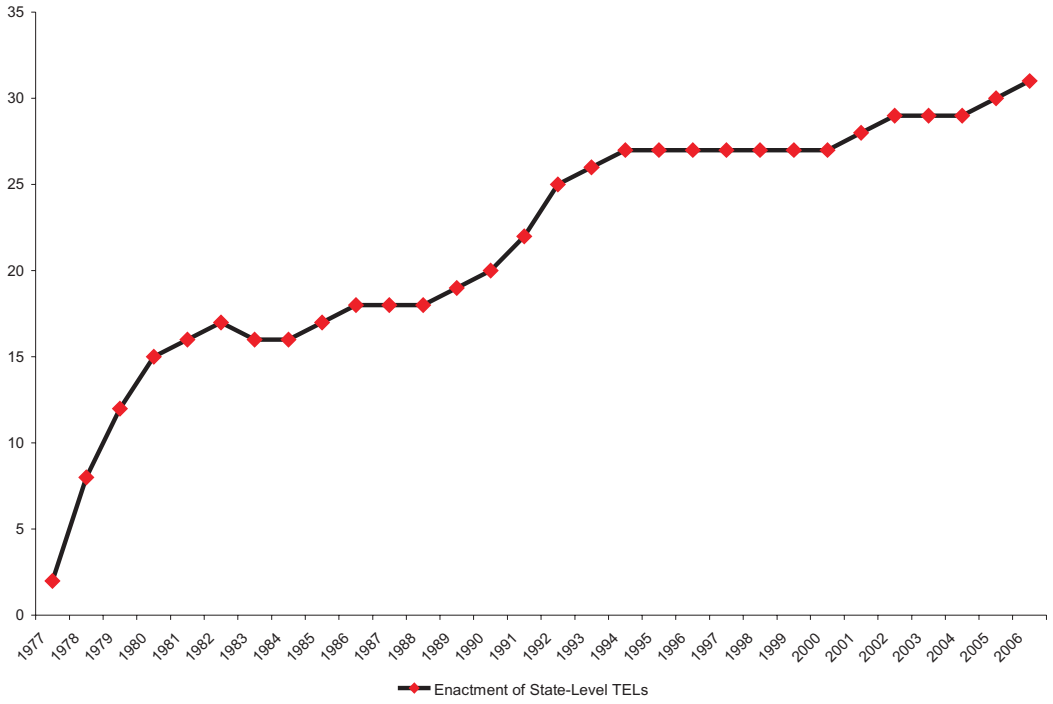
2 See the authors' working paper, "Do State Budgetary Institutions Really Matter for State and Local Expenditures? State-Level Tax and Expenditure Limitations and Voter Approval/Supermajority Legislation Requirements for Tax Increases," presented at the Fall Research Conference of the Association for Public Policy and Management, Madison, WI, November 2006. A copy of this paper is available at www.rockinst.org/statetaxandexpenditurelimits.pdf. Copies are also available by contacting Dr. Suho Bae at baes@rockinst.org.

3 For more information on state-level TELs, see B. W. Poulson, *Tax and Spending Limits: Theory, Analysis, and Policy, (*Denver, CO: Independence Institute, 2004) and Rafool (2005). Also see Chapter 1 "Tax and Expenditure Limits: An Overview"; Chapter 2 "The Emergence of TELs" in E. Hill, M. Sattler, J. Duritsky, K. O'Brien, and C. Robey, *A Review of Tax Expenditure Limitations and Their Impact on State and Local Government in Ohio* (Cleveland, OH: The Center for Public Management, Maxine Goodman Levin College of Urban Affairs, Cleveland State University, May 2006).

4 The state enacted a new state-level TEL in 1990.

5 For recent developments in state-level TELs, see National Conference of State Legislatures, *Tax and Expenditure Limits: the Latest.* http://www.ncsl.org/programs/fiscal/tels2006.htm and National Conference of State Legislatures, *Touch Times for Tax and Expenditure Limits.* http://www.ncsl.org/programs/fiscal/tels06vote.htm.

Figure 1. Number of States with State-Level TELs, 1977 – 2006



nia tried to strengthen existing TELs by further limiting spending growth, but that effort failed to get the voters' approval. Voters in Colorado relaxed the state's existing TEL (the "Taxpayer's Bill of Rights," or TABOR) and allowed the state to retain all revenue surpluses for five years.

Interestingly, as already noted, few TELs were enacted during or shortly after the most recent state fiscal crisis — a significant change from previous fiscal downturns. The reasons for the slowdown in TELs' diffusion are unclear. Perhaps the remaining states without TELs have political characteristics that diminish their popular appeal, or constitutional or other institutional characteristics that make it harder to pass TELs. Perhaps the fact that many states cut taxes in the late 1990s, before the latest recession, reduced the strength of anti-tax sentiments. At this point, however, we simply do not know whether the spread of TELs has reached a long-run plateau, or whether it has only experienced a short-run hiatus.

State-level TEL institutional characteristics vary across states (see the Appendix). One major difference is between state-level TELs that become part of a state's constitution and those that are enacted in statutory form. In general, when TELs are enacted in a state's constitution, they are more difficult to abolish, and more restrictive in restraining government tax revenues and spending outlays. Seventeen states have TELs in their constitutions, while fourteen have them in statutes.

Another difference concerns whether state TELs limit spending or revenues. Twenty-four states have spending limits, four states have revenue limits, and three states have limits on both spending and revenues.

A third difference among states with TELs concerns the specific growth factors or indices they use in restricting spending or revenues. Two types of growth factors popularly used as fiscal re-

straints in state TELs are personal income growth, and a combination of population growth and inflation. Personal income growth is the least restrictive, as it grows more rapidly than either population or inflation, and it is also more strongly related to other measures of state economic performance than a combination of population growth and inflation.[6] Some states with TELs use other measures, such as estimated revenue growth, and state wages and salaries.

The fourth difference involves how surplus revenues are treated. Some states refund taxpayers — most restrictive — while others use them for either debt retirement or rainy day or emergency funds. Some states have no specific provisions on surplus revenues.

Effects of State-Level TELs: Summary of Prior Studies

Previous studies have examined the effects of *local-level* TELs on local government spending, tax revenues (especially property taxes), revenue structures, and state-local fiscal relations.[7] Some studies have focused on the effects of state-level TELs on the size and growth of state government budgets. Overall, these studies have produced mixed results. Some studies found that state-level TELs significantly reduced state government growth.[8] But other studies failed to confirm this result.[9] One study found that the effects of state-level TELs depended on fiscal capacity: TELs allowed high-income states to increase government size and growth, while they restricted government expansion in low-income states.[10]

One study found that particular institutional characteristics were important. Limiting increases in either spending or revenues to a combination of population growth and inflation, and refunding

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6 P. Resnick, *Fiscal Cap Style TELs in the States: An Inventory and Evaluation* (Taxpayer Report), (Denver, CO: The Center for Tax Policy, 2004).

7 For example, see J. J. Knudsen, "The Impact of Property Tax Limitations on School Funding and Performance." *Government Finance Review* (October 2001): 18-21.; D. R. Mullins, "Tax and Expenditure Limitations and the Fiscal Response of Local Government: Asymmetric Intra-Local Fiscal Effects," Symposium Tax and Expenditure Limitations: A Quarter Century after Proposition 13 – Dedicated to the Memory of Franklin J. James, *Public Budgeting and Finance* 24 (2004): 111-147.; D. R. Mullins and P. G. Joyce, "Tax and Expenditure Limitations and State and Local Fiscal Structure: An Empirical Assessment," *Public Budgeting and Finance* 16 (1996): 75-101.; A. Preston and C. Ichniowski, "A National Perspective on the Nature and Effects of the Local Property Tax Revolt, 1976-1986." *National Tax Journal* 44(2) (2001): 123-145.; R. J. Shadbegian, "The Effect of Tax and Expenditure Limitations on the Revenue Structure of Local Government, 1962-1987," *National Tax Journal* (June 1999): 221-237.

8 For example, see D. Bails and M. A. Tieslau, "The Impact of Fiscal Constitutions on State and Local Expenditures," *Cato Journal* 20 (2000): 255-277.; H. W. Elder, "Exploring the Tax Revolt: An Analysis of the Effectiveness of State Tax and Expenditure Limitation Laws," *Public Finance Quarterly* 20 (1992): 47-63.; M. J. New, *Limiting Government through Direct Democracy: The Case of State Tax and Expenditure Limitations,* Policy Analysis No.420 (Washington, D.C.: Cato Institute, 2001).

9 See D. Bails, "A Critique on the Effectiveness of Tax-Expenditure Limitations," *Public Choice* 38 (1982): 129-138.; D. Bails, "The Effectiveness of Tax-Expenditure Limitations: A Reevaluation," *American Journal of Economics and Sociology* 49 (1990): 223-238.; P. G. Joyce and D. R. Mullins, "The Changing Fiscal Structure of the State and Local Public Sector: The Impact of Tax and Expenditure Limitations," *Public Administration Review* 51 (1991): 240-253.; R. J. Shadbegian, "Do Tax and Expenditure Limitations Affect the Size and Growth of State Government?," *Contemporary Economic Policy* 14 (1996): 22-35.

10 Shadbegian (1996).

surplus revenues to taxpayers, were effective in reducing the overall level of state and local spending.[11] Another study attempted to estimate the economic effects of Colorado's TABOR, but it failed to find any significant positive effects on state economic performance.[12]

No studies to date have examined the effects of state-level TELs on spending allocations and revenue structures in state and local governments. Yet TELs may have different effects across functional areas and revenue structures. For example, in states like Colorado where increases in revenue or spending are limited to population growth plus inflation, if the overall population growth is lower than the under-24 population growth, state-level TELs might negatively affect per-pupil spending on education.[13] State-level TELs might have selective effects by not applying equally to all spending areas and revenue sources. For instance, restrictions on taxes may have no effect on revenues from fees, charges, tolls, and lotteries. Or, if a functional area is disproportionately supported by federal grants (without state matching requirements) or other revenue sources not regulated by the TEL, a TEL may have little or no effect on spending in that area.

Effects of State-Level TELs: Summary of New Empirical Findings

To expand our understanding of the effects of state-level TELs, we conducted econometric analyses of TELs on annual expenditures and revenues at the state and local level. To estimate their effects, data on the effective dates and characteristics of state-level TELs were collected in fifty states for the 24-year period, 1977 to 2000. Revenue and spending data came from the U.S. Census Bureau's State and Local Government Finance Survey.[14] To control for the effects of other factors on revenues and expenditures, many control variables were included in the empirical estimation, including state personal income, state economic structures, socio-demographical characteristics, political and institutional characteristics, and dummy variables used to estimate year and state fixed-effects.[15]

This section of the report summarizes the major empirical findings from these empirical estimations. These findings should be considered tentative, since econometric estimates of the effects of TELs have, as noted above, typically varied from one study to another. Conclusive findings will depend on whether these results continue to hold up after using somewhat different model specifications, estimation methods, and data sources. Nonetheless, these preliminary findings raise important policy questions.

Our analyses found, like some of the other previous studies, that state-level TELs significantly reduce the overall level of state and local spending (when spending is adjusted for inflation and

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11 New (2001).

12 T. J. McGuire and K. S. Rueben, *The Colorado Revenue Limit: The Economic Effects of TABOR,* Briefing Paper (Washington, D.C.: Economic Policy Institute, 2006).

13 McGuire and Rueben (2006).

14 The data series ends in 2000 because the Census Bureau stopped collecting comprehensive *annual* data on local governments after that year until 2003.

15 A *dynamic* panel model approach was employed for analyses of state-level TELs on state and local expenditures, while a *static* approach for analyses on revenue structures. A copy of the paper reporting these analyses may be found at www.rockinst.org/statetaxandexpenditurelimits.pdf.

state population). This effect is stronger when TELs are stringent and restrictive in the state and local budgetary process: for example, when they become part of the state constitution, or when they limit revenue or spending growth to slow-changing indices, such as population growth plus inflation.

The estimated effects of TELs are neither large nor trivial. The table below illustrates this point by showing the estimated effects of state-level TELs on direct state and local expenditures per capita, based on our statistical analyses. For illustration, we show the estimated changes — due to the presence or absence of a TEL — in state and local spending by the median state (median, that is, in terms of state and local expenditures per capita, FY 2000). The top lines show that the presence of a TEL is estimated to reduce the median state's per capita expenditures by $105, from $5,867 to $5,762, a change of 1.8 percent. A larger change is expected when we perform the same analysis but use a more discriminating measure of TELs, one that runs from no TEL to the strongest TELs, i.e., those written in state constitutions and whose limits on spending or revenues are tied to population growth and inflation.[16] The median state would then see a reduction in per capita spending of an estimated $207, a change of 3.5 percent, if one compares the case of no TEL to the strongest TEL.

We also found that TELs may have different effects on different areas of spending. For instance, when the stringency and restrictiveness of state-level TELs are taken into account, state-level TELs have significant *negative* effects on the *level* of state and local *public safety* spending. Also, when the stringency and restrictiveness of state-level TELs are accounted for, state-level TELs have significant *positive* effects on the *share* of *transportation* spending in total spending (though not its actual level). Our study found no statistically significant impact of state-level TELs on spending in four other functional areas: education, health and hospitals, quality-of-life and amenities, and public welfare.

The analyses also found that state-level TELs have different distributional effects across revenue sources. Not unexpectedly, after the adoption of state-level TELs, state and local governments become less dependent, in terms of revenue share, on property, individual income, and corporate income taxes. Interestingly, they become *more* dependent for their revenues on fees and charges, such as sewerage charges and lotteries. TELs do not appear to have a significant impact on sales taxes. Finally, they appear to reduce federal intergovernmental transfers to states, perhaps because states are less able to put up state matching funds in order to draw down additional federal dollars (as is the case for Medicaid).

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16 The stringency and restrictiveness of state-level TELs were measured as follows: (a) it is coded as 0 (no TEL), if state-level TELs are *not* in effect in a state and a year; (b) a 1 (unrestrictive TEL) if they are in effect in a state and year but they are not codified in the state constitution, and they do not limit the growth in spending or revenues to population growth plus inflation; (c) 2 (more restrictive TEL), if they are codified in state constitutions *or* if the growth in spending or revenues is limited to population growth plus inflation, but not both; and (d) 3 (most restrictive) if they are codified in state constitutions *and* if the growth in spending or revenues is limited to population growth plus inflation growth. As of 2006, nineteen states have no TEL; twelve states have a value of unrestrictive TELs; seventeen states have a value of more restrictive TELs; and two states are coded as having the most restrictive TELs.

Table 1. Estimated Effects of State-Level TELs on Direct Expenditure Per Capita (FY 2000)

Classification	*State-Level TELs*	*Median Direct Expenditure Per Capita (FY 2000)*	*Difference in Per Capita Spending Due to TEL*
State-level TELs (dummy variable form)	No TEL	$5,867	$0
	TEL in effect	$5,762	- $105
State-level TELs (stringency index)	No TEL	$5,867	$0
	TEL is in effect but is not restrictive	$5,797	- $70
	TEL is more restrictive	$5,727	- $139
	TEL is most restrictive	$5,659	- $207

Conclusions and Implications

The spread of state-level TELs has slowed in recent years. Although economic recessions appeared to strengthen anti-tax and anti-spending efforts in the 1970s and the early 1990s, the most recent state fiscal crisis produced little change despite efforts in several states to enact new state budgetary restrictions or make existing ones more restrictive. Most such efforts failed to get placed on voters' ballots, or they failed to win approval from voters. Only two states, Maine and Ohio, enacted spending limits in 2005 and 2006 — through state legislation, not voter initiatives.

Prior studies found mixed results when they estimated the effects of state-level TELs on spending and revenues. Our tentative findings strengthened the claim that state-level TELs reduce total state and local spending on a real, per capita basis. But they also suggested that these effects are not neutral with respect to spending or revenue sources. State-level TELs may, for instance, exert significant negative effects on public safety spending, while they may increase the share of the state budget going to transportation functions, perhaps because transportation projects are often paid for through revenue sources (such as tolls, gas taxes, and federal grants) not covered as strictly by TELs as other sources. TELs also lead states and localities to become more dependent on fees and charges, while relying less on property, individual income, and corporate income taxes. States and localities also become less dependent on federal transfers, possibly due to constraints on state and local governments' capacities to raise matching funds for federal grants-in-aid.

These findings have many implications. Because of the spread of these budgetary rules to many states, public spending on some functional areas, such as public safety, may be inhibited nationally. In addition, state-level TELs may make state and local revenue systems more dependent on regressive revenue sources, such as fees and charges, and less dependent on progressive sources, such as property and income taxes.

Finally, TELs, particularly now that their spread has slowed, may have created an important and not easily reversible divide in the American federal system: between the states that have strong TELs and those that do not, a divide that may eventually produce large differences in spending and revenue priorities across the states.

APPENDIX: State-Level TELs

STATE	State-Level Tax and Expenditure Limitations (TELs)					
	Year Adopted	Method Adopted	Method of Codification	Fiscal restraints	Type of Limit	Treatment of Surpluses
Alaska	1982	Referendum	Constitution	Population growth plus inflation	Spending	
Arizona	1978	Referendum	Constitution	State personal income growth	Spending	
California	1979	Initiative	Constitution	Population growth plus state personal income growth	Spending	Allocated into emergency funds and budget stabilization funds, and/or to tax cuts/rebates or debt reduction.
Colorado	1977	Legislature	Statute	Increase in appropriations limited to 7% of the previous year's appropriations.	Spending	
	1991	Legislature	Statute	Increase in appropriations limited to 6% of the previous year's appropriations.	Spending	
	1992	Initiative	Constitution	Population growth plus inflation	Revenue & spending	Allocated to tax cuts/rebates or debt reduction.
Connecticut	1991	Legislature	Statute	State personal income growth or inflation, whichever is greater.	Spending	Allocated into emergency funds and budget stabilization funds, and/or to tax cuts/rebates or debt reduction.
	1992	Referendum	Constitution (voter approved, but has yet to receive 3/5 legislative approval)			
Delaware	1978	Referendum	Constitution	Appropriations limited to 98% of revenue estimate.	Spending	Returned to general fund or other expenditure accounts.
Florida	1994	Referendum	Constitution	State personal income growth	Revenue	
Hawaii	1978	Constitutional Convention	Constitution	State personal income growth	Spending	Allocated to tax cuts/rebates or debt reduction.
Idaho	1980	Legislature	Statute	State personal income	Spending	
Indiana	2002	Legislature	Statute	State spending cap per fiscal year with growth set according to formula for each biennial period.	Spending	
Iowa	1992	Legislature	Statute	Appropriations limited to 99% of the adjusted general fund receipts.	Appropriations	Returned to general fund or other expenditure accounts.
Louisiana	1979	Legislature	Statute		Revenue	Allocated into emergency funds and budget stabilization funds, and/or to tax cuts/rebates or debt reduction.
	1993	Referendum	Constitution	State personal income growth	Spending	Only allowed for debt reduction.
Maine	2005	Legislature	Statute	State personal income growth	Spending	
Massachusetts	1986	Legislature	Statute	State wages and salaries	Revenue	Allocated into emergency funds and budget stabilization funds, and then to tax cuts/rebates or debt reduction.
	2002	Legislature	Statute	Annual growth limited to inflation in government purchasing power plus 2%.	Revenue	
Michigan	1978	Initiative	Constitution	State personal income	Revenue	Allocated into budget stabilization funds, or tax refunds.
Mississippi	1992	Legislature	Statute	Appropriations limited to 98% of revenue estimate.	Appropriations	Allocated to general fund, then budget stabilization fund, and a special education fund.
Missouri	1980	Initiative	Constitution	State personal income	Revenue	Refunded to taxpayers or transferred to general fund.
Montana	1981	Legislature	Statute	State personal income growth	Spending	
Nevada	1979	Legislature	Statute	Governor's proposed expenditures limited to population growth plus inflation.	Spending	
New Jersey	1976 (expired in 1983)	Legislature	Statute	State personal income growth	Spending	Allocated to emergency and budget stabilization funds.
	1990	Legislature	Statute	State personal income growth	Spending	Allocated to emergency and budget stabilization funds.
North Carolina	1991	Legislature	Statute	State personal income	Spending	Returned to general fund or other expenditure accounts.
Ohio	2006	Legislature	Statute	Spending limited to population growth plus inflation, or 3.5%, which is greater.	Spending	Allocated to emergency and budget stabilization funds.
Oklahoma	1985	Referendum	Constitution	Expenditure limited to 12% annual growth adjusted for inflation; 95% of certified revenue.	Spending & appropriations	Allocated to emergency and budget stabilization funds.
Oregon	1979	Legislature	Statute	State personal income growth	Appropriations	Refunded to taxpayers.
	2000	Initiative	Constitution		Revenue	Refunded to taxpayers.
	2001	Legislature	Statute	State personal income.	Appropriations	
Rhode Island	1992	Referendum	Constitution	Appropriations limited to 98% of projected revenue.	Appropriations	Allocated to emergency and budget stabilization funds.
South Carolina	1980	Referendum	Constitution	Average growth of state personal income in previous three years or 9.5% of personal income, which is greater.	Spending	Allocated to tax cuts/rebates or debt reduction and targed expenditures.
	1984	Referendum	Constitution			
Tennessee	1978	Constitutional Convention	Constitution	State personal income growth	Spending	
Texas	1978	Referendum	Constitution	State personal income growth	Spending	
Utah	1989	Legislature	Statute	Spending limited to formula incl. population growth, sate personal income, and inflation.	Spending	
Washington	1993	Initiative	Statute	Population growth plus inflation	Spending	Allocated to emergency and budget stabilization funds.
Wisconsin	2001	Legislature	Statute	Personal income growth	Spending	

NOTICE: The author constructed the table from Clemens et al (2003), New (2001), Mullins and Wallins (2004), Poulson (2005; 2006), and Rafool (2005).