Reading the fine print: How details matter in tax and expenditure limitations

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Acknowledgments

The authors would like to thank Antoniya Owens for her outstanding research assistance and Matthew Nagowski for his careful and diligent fact-checking.

For their thoughtful comments on a draft of this report and additional insights, the authors would like to thank the following individuals: Ellen Frank, The Poverty Institute; Shelly Geballe, Connecticut Voices for Children; Daphne Kenyon, D.A. Kenyon & Associates; Catherine Reilly, Maine State Planning Office; and Gary Sasse, Rhode Island Public Expenditure Council.

Finally, we would like to thank Lynn Browne, Phil Primack, Carrie Conaway, and Bob Tannenwald for their comments on numerous drafts and their support as we researched and wrote this paper.

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NEPPC
October 2006
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Introduction

At least 30 states, including Connecticut, Maine, Massachusetts, and Rhode Island, operate under “tax and expenditure limitations” (TELs): formula-based budgeting requirements that apply specific limits to expenditures, appropriations, or revenue collections by state or local government. More than a dozen states considered TELs in 2006. Legislation proposing a new TEL to further limit General Fund appropriations in Rhode Island was introduced; Maine citizens will vote on a more restrictive TEL this November.

Several factors, including a desire for lower taxes and a belief that additional measures are needed to keep government spending in check, drive this interest in TELs. This paper discusses such arguments. It also examines how TELs affect state budgets, in part through a simulation of the impacts of current or proposed TELs in Maine and Rhode Island. The general finding is that while TELs can limit the growth in state budgets, the actual relationship between TELs, tax burdens, and state economic competitiveness is more complex than can be captured by any single budgetary formula. Determining whether government, at whatever level, is too big or is growing too fast is a contentious issue. Setting an optimal rate of governmental growth is similarly fraught with challenges. After all, one person’s wasteful program is another’s essential service. Even many voters who support TELs do so out of a desire to enhance governmental efficiency, not to reduce the level of public services. But even the best-written TELs cannot guarantee that governments will respond to formal fiscal restraints by maximizing efficiency before cutting service levels.

Because they tend to be arbitrary, TELs can sometimes weaken the ability of state and local governments to respond to changing conditions and challenges, from natural disasters to unanticipated infrastructure or human service needs. Just as policy makers should be responsive to constituent concerns about spending and taxes, they must also consider the possibility of unintended consequences from a TEL. They must balance theory with careful attention to a TEL’s specific language and details.

Background

TELs formally limit how fast a government’s revenues, spending, or appropriations may grow; they are applied at the state or local level, or both. Examples of state-level TELs include Connecticut’s expenditure limitation and Colorado’s Taxpayers’ Bill of Rights (TABOR). Connecticut, the first state in New England to pass a state TEL, limits state general budget expenditures to the lesser of the five-year average of personal income growth or five-year average rate of inflation. Colorado’s TABOR, which limits growth in most state revenues to population growth plus inflation and requires voter approval for any new taxes, is generally considered the most restrictive state TEL. TELs have also been applied to local revenue collections. Local TELs include Massachusetts’ Proposition 2½ and California’s Proposition 13. Proposition 13, passed in 1978, was the first in a series of initiatives across the United States often referred to as the taxpayer revolt. It placed a 1-percent ceiling on local property tax rates, limited the assessed value of property to its 1975 value, and required voter approval for additional
property taxes. Massachusetts’ local TEL—Proposition 2½—places a ceiling on the amount of revenue a community can raise through property taxes. More recent TELs apply limits to both state and local budgets. Proposals in both Maine and Rhode Island combine limits on state spending with local limits on property taxes. We focus on state-level TELs.

All TELs contain two basic elements: the base to which they are applied and a growth index. The base can be on either the revenue or the spending side of the fiscal equation. TELs can limit outlays, appropriations, or specific pieces of each; TELs may apply only to taxes or to all revenue sources, including intergovernmental transfers and fees. The growth index is the annual rate at which a TEL allows government expenditures, appropriations or revenues to grow from the established base. States typically use one of two methods to index growth: (1) the inflation rate plus population growth or (2) personal income growth.

TELs may also establish rules for how to treat revenues collected in excess of the established limits. Some TELs require that these surpluses be immediately returned to taxpayers through rebates; under other TELs, surpluses are invested in state budget stabilization funds. Some TELs combine multiple approaches. Another important design component of a TEL is how it can be overridden. This generally depends upon how the TEL was adopted. Statutory TELs typically require a majority or supermajority vote by the legislature to be overridden. Constitutional TELs generally include specific override provisions that can be more difficult to implement.

**Arguments and assumptions**

**Argument one: Without a TEL, government grows faster and becomes larger than the public wants or needs.**

Proponents contend TELs are necessary because existing measures to keep government spending in check are insufficient. They dispute the belief that elected officials in a representative democracy always, or even usually, implement the tax and spending preferences of their constituents. An alternative theory—known as the Leviathan model of government—holds that elected officials, concerned primarily about their own bureaucracies, generally seek to extract more tax revenues than most voters would consider appropriate. Because voters find it difficult to monitor or evaluate tax and spending choices, they cannot hold elected policymakers accountable. Additionally, special interests may be better able to express their tax or spending preferences than the average taxpayer. This may also lead to a government that is larger than the public wants or needs. In such an environment, proponents argue, TELs are needed to force governments to behave in concert with public wishes, which in turn improves constituents’ perceptions of government.

However, a TEL is not agnostic about the appropriate rate of government growth. Indeed, TELs are based on the thesis that there is an ideal maximum rate of government growth or size of government. When government exceeds this ideal, it becomes less efficient or the public/private mix of goods and services tips too far in favor of the government. TELs try to approximate an ideal rate of growth, using external indicators of economic growth or fiscal need.

There is a rich debate about the appropriate model of government fiscal behavior. While some evidence supports the Leviathan theory, and the ability of TELs to tame it, these issues are far from settled. Even if one believes that government grows too fast without formal constraints, it is still problematic to specify the maximum rate at which government should grow. Yet designers of the growth formulas embedded in TELs must do just that. It is not clear, however, that the ideal maximum rate of government can be reduced to a formula. The demand for government services changes with shifts in conditions, preferences, and demographics. Furthermore, government responsibilities change: The federal government, has increased mandates on state government and local governments are increasingly asked to provide services previously funded by the state. Thus, while TELs may help to “tame the Leviathan,” they are also arbitrary and, as a result, can sometimes be too tight.

Consider, for example, potential prob-
lems with the population plus inflation growth index used in many proposed TELs. This index implies that the per capita need for public services never changes and that spending can increase only if the population grows or the dollar’s purchasing power decreases. Yet, not all populations use or demand the same package of government services. Studies show that school-aged and elderly populations consume more government services per capita than other groups. States with a high proportion of either thus need to provide more services per capita. Demographic projections suggest that northern New England will face this dilemma acutely in the next 30 years as its population ages. Additionally, some evidence indicates that demand for state and local public services grows in proportion to income, not population. Furthermore, what is the best measure of inflation? The measure most commonly used in TELs—the Consumer Price Index (CPI)—may not adequately capture the increase in prices faced by governments in a particular state. The CPI and other inflation measures look at the bundle of goods purchased by households, not by state governments, which spend most of their budgets on education, employee compensation, health care, transportation, and other infrastructure maintenance. While the U.S. Bureau of Economic Analysis estimates changes in the price of providing state and local services, this indicator does not include transfer payments, such as Medicaid, which are a part of the cost of government.

The other commonly used growth index—the rate of growth in personal income—can be considered an indicator of ability to pay. Many believe that government should not grow faster than taxpayers can afford. Also, as taxpayers’ incomes increase, they are likely to demand more or better government services. However, this measure is also imperfect. Places where income grows slowly may have an increased need for government expenditures, such as Medicaid.

Finally, some research suggests that in supporting TELs, voters may hope for improved operational efficiency in government, not an actual reduction in government services. Economists Daniel Mullins and Phillip Joyce write, “Studies of public support for tax and expenditure limitations find that limitations are supported because of a desire for lower taxes and more efficiency in government, rather than any desire for reduced public services. In essence, voters attempted to lower the price of the existing service package.” No one can guarantee, however, that public officials will meet TEL requirements by maximizing efficiency first and then cutting service levels if necessary.

Argument two: A lower tax burden is critical to state economic competitiveness.

Proponents of TELs often believe that formal limitations can help a state become more competitive by imposing sensible tax and spending limits on state government, reducing the burden on taxpayers and creating a better climate for economic growth. Like firms, states also compete, and a variety of studies assert that a lower tax burden is critical to state economic competitiveness. Because taxes diminish profitability and disposable household income, high tax burdens may inhibit a state’s ability to attract and retain firms and households.

Taxes are only one of an array of factors considered by households and firms in making location decisions. Studies on taxes and economic development have produced varying results. Early research found that taxes had only a limited effect on economic competitiveness. More recent research suggests that taxes may matter, but no studies have shown definitively how much. Other research suggests that the impact of taxes on business location and investment decisions is likely to be small relative to the cost and availability of skilled labor, proximity to markets, access to raw materials and supplies, and utility costs.

However, the tax factor plays a more prominent role in determining where a firm locates and expands within a metropolitan area, where non-tax characteristics are relatively uniform. Given the fact that much of New England’s economic activity and labor markets cross state boundaries, tax differentials may be more significant in New England than elsewhere in the country. Further, different kinds of taxes matter to different constituencies. For example, families with children may be willing to pay
higher taxes for better public amenities such as education, but executives and others facing high income taxes may choose to locate their households and even their corporate headquarters in states with lower tax rates. In short, even if taxes are important to economic competitiveness, no one-size-fits-all solution exists.

Moreover, spending also matters. Research suggests paying for tax reductions by cutting public services that are valued by businesses and households can compromise a state’s economic competitiveness.

**Argument three: TELs can promote greater fiscal discipline, which promotes fiscal stability.**

Proponents also claim that TELs can promote a stable fiscal environment. A stable revenue system collects adequate resources to fund public services and obligations in both the short and long term while maintaining a predictable tax environment, despite the ups and downs of the business cycle. To the extent that taxes do influence business location decisions, research suggests that the stability and predictability of the tax level may be more critical than the amount of tax levied. In a 2004 article for *Trade & Industry Development* magazine, Angelos Angelou wrote that “…more than ever, companies seek predictability and avoidance of risk in their tax burden” when making site location decisions.

Proponents argue that TELs enforce the fiscal discipline necessary to achieve the desired level of fiscal stability. Governments otherwise tend to increase spending during an economic expansion. Then, rather than cutting back on funding existing programs when economic conditions sour, governments’ inclination is to find additional revenues to finance them, leading to government expansion. Under this “ratchet effect” theory, expenditures move steadily upward over time. TELs, proponents argue, break the ratchet effect by forcing governments to grow relative to a formula, rather than growing a lot when the economy is expanding rapidly and failing to cut back when economic growth slows.

Research suggests that TELs may reduce the degree of volatility associated with business cycles. A 1994 paper by James Poterba investigated the ability of TELs and other fiscal tools to stabilize budgets by exploring how state budgets responded to unexpected revenue shortfalls. Following a recession, Poterba found, states with TELs experienced lower tax increases than states without them. Some TELs also earmark revenues for existing budget stabilization funds—reserve accounts for emergencies or extraordinary circumstances—that are widely used to promote fiscal stability. For example, TELs in both Maine and Rhode Island direct a portion of excess revenues to budget stabilization funds. However, it is not necessary to have a TEL in order to have a budget stabilization fund; many states use budget stabilization funds in absence of a TEL.

TELs may also affect fiscal stability by increasing bond interest rates because bond prices are sensitive to repayment prospects. A 1999 paper by Poterba and Reuben investigated the impacts of expenditure and revenue TELs on borrowing costs and found that they have very different effects. On average, states with binding revenue limitations paid 17.5 basis points more on their debts than states with no limits and states with binding expenditure limitations paid 4 basis points less than states without limits. This evidence suggests that the bond market rewards states that have expenditure limitations because they increase the likelihood that the debt will be repaid by reducing competition for government funding. In contrast, the bond markets are wary of states with revenue limitations because of a lack of confidence in the state’s ability to repay debts under constrained resources. Fiscal stability is compromised by the higher cost of debt because states that choose to borrow will face higher debt service payments, crowding out other spending. States that choose not to borrow may be unable to fund large infrastructure projects critical to economic development.
The devil is in the details: Where theory and practice meet

The design of a TEL will lessen or increase its overall impact on government spending. As noted earlier, a TEL has three major structural features: the growth index, the base, and how easily it can be overridden. This section briefly notes how details of each design feature can affect outcomes (intended or otherwise).

The growth index

The growth index—the annual rate at which a TEL allows government expenditures, appropriations or revenues to grow—is a powerful determinant of its impact. Depending on the growth index chosen, a TEL can either be stringent or simply an upper bound for growth that is rarely, if ever, reached.

As discussed previously, states typically use one of two measures to index growth: either population growth plus inflation or personal income growth. This is where details matter. If the measure used is population growth plus inflation, for example, which index of inflation is used? Several indices of inflation measure changes in the price of different sets of goods and have different outcomes. No single index adequately reflects price inflation faced by state government. Similarly, total personal income growth includes growth due to inflation, while real personal income takes inflation into account. To some these seem like semantics, but they have real budgetary implications.

Furthermore, the timeliness of data used to create growth indices complicates the ability of a TEL to match theory and practice. The index may rely on a single year’s growth or may take a multi-year average. While calculating the specific growth index for any given budget year, analysts must often rely on data that lags between one and three years. Rather than growing along with actual changes in population, inflation, or personal income, government would grow at a lagged rate. This problem is compounded when states rely on historic averages. In the case of population data, states have to wait for the next decennial Census—up to ten years—for confirmation of the annual estimates. For example, the 2000 Census revealed that annual population estimates throughout the 1990s underestimated population growth in many states. Using projections of future income growth, population, or inflation rather than past data causes problems, too, because the limitations of economists’ forecasting ability mean that such projections run the risk of getting it wrong. All of these can cause a growth index to be out of sync with changes in the economy.

The base

Just as the details of the growth index can affect a TEL’s impact, so too does how the base is defined. The three key elements of the base are what part of the budget it covers; the level of government managing that budget; and whether the base year is fixed or changes from year to year.

The base can refer to an amount of money expended, collected, or appropriated. As important as what a TEL does cover is what it does not cover. Revenues or expenditures not covered by a TEL may expand more rapidly than expected. In order to meet established and emerging public needs, governments may shift revenues away from taxes towards charges and user fees, increase the use of tax expenditures to fund public programs, shift payments from one fiscal year to the next, or increase debt load. For example, Connecticut’s spending cap applies to all state spending except payments on state debt, state grants to distressed municipalities, and first-year expenditures on federal mandates or court orders. Not coincidentally, the percent of Connecticut’s transportation fund and general fund expenditures dedicated to debt service payments increased from 7 percent in 1990 to 13 percent in 2005.

In addition to causing restructuring within budgets, applying a TEL at the state level can shift responsibilities to localities and vice versa. Limiting state or local revenues is like squeezing one end of a balloon. Pressures on spending at one level lead to increased spending at the other. According to a 1996 report by Mullins and Joyce, “The shifts that have occurred in the structure of state and local governments over the past thirty years are undeniable (and well documented). Revenue systems have been altered... and service-delivery
The ratcheting-down effect

Imagine a state government with a $10 billion budget in year one, collected from all revenue sources. In year two, state revenue collections drop by $500 million, so that year’s budget is only $9.5 billion. Government officials make sacrifices to fit the new budget, such as scaling back or eliminating spending. In the following year—year three—improving business conditions enable the government to collect revenues of $10.3 billion, a “normal” year.

Suppose that the government had been operating under a formal expenditure limit based on actual outlays in the previous year plus a growth index of 3 percent. Then, the government’s spending in year three would be constrained to $9.785 billion (spending in the previous year plus 3 percent), even though its revenue collections had risen back to a level sufficient to support the level of services to which it had been accustomed before the bad times had hit. Spending increases would also be constrained in future years, because they would still be irrevocably indexed to the $9.5 billion the government had spent during the year of financial difficulties.

Suppose, however, that the government’s spending in year two were limited to the amount of income in the base year (year one) plus 3 percent. In subsequent years, maximum spending would equal allowable spending in the previous year, plus 3 percent. Under this formula, the government would have been allowed to spend $10.3 billion in year two and $10.609 billion in year 3 ($10.3 billion plus 3 percent). The government’s allowable spending would continue to grow at 3 percent every year, regardless of how much it actually spent during the previous year.

Provisions for overriding

Another important detail is how a TEL can be changed or reversed. The ability to revise or temporarily override a TEL depends on how it was established. TELs passed through legislation can generally be overridden by the legislature in majority or supermajority vote. If a TEL is written into the state’s constitution, it often requires a majority vote by the general electorate to override. This can be a lengthy process. A direct vote by the general electorate usually requires concerted effort to place an override on the ballot. Then the issue can only be voted on during elections, and the costs in terms of both time and money to advocates and government can be large. This was the case in Colorado this fall, when voters passed a five-year moratorium on TABOR-mandated tax refund requirements. Changing the details of the TEL can be equally difficult. The TABOR proposal in Maine would require voter approval and a super-majority vote by the legislature to approve any future revenue increases.

How the details shape outcomes: New England examples

To better understand how TELs work, we have modeled the potential impact of several recent TEL proposals in New England. Rather than rely on inherently problematic economic forecasts, we instead examine what would have happened if the TEL had been enacted in 1994. This also allows us to illustrate how the details work, rather than argue for or against the application of a TEL for any future purpose. Simulations of TELs under consideration and recently applied in Maine and Rhode Island show that if the limits were first applied in 1994, all of the limitations would have curbed growth in state budgets from...
the mid-1990s to the present. If the desired goal is simply smaller government with no ideal size in mind, then any of these TELs would have succeeded (though it is possible that the 1990s may not be representative of future spending trends or public needs). If one is trying not just to reduce the size of government in general but to approximate a particular desired size or rate of government growth, then the details of a TEL matter more. These simulations are intended to illustrate how the details of each TEL work in practice. For example, in Maine, how the growth indices are defined—and the scope of the base to which they apply—determines the extent to which government is limited. And, Rhode Island’s TEL formula becomes more restrictive if the TEL is first applied in a year following budget cuts.

Maine’s general fund appropriation limitation, LD-1, took effect in July 2005. A citizen initiative for a more comprehensive expenditure and revenue limitation will be before voters in November 2006. Rhode Island legislators considered, and the Governor endorsed, a new proposal to limit state appropriations that did not pass but may be considered again next legislative session.7

Simulation 1: Maine’s LD-1 and TABOR

Background

LD-1: In 2004, Maine considered a variety of tax reform and relief proposals. These included a citizen’s initiative to cap property tax values, similar to California’s Proposition 13 and several other tax relief and reform proposals initiated by the business community and the Maine Municipal Association. The state legislature responded by passing a law, LD-1, that applies limits to all levels of government, with some important exceptions. LD-1 limits the growth of state general fund appropriations, county assessments, municipal property taxes, and school budgets. At the same time, it increased state aid for education and targeted property tax relief programs (i.e. the homestead program and the circuit tax breaker program).8 LD-1’s growth index is based on the average growth rate of the previous 10 years in both real personal income and population. Real personal income growth is defined as the growth in nominal personal income minus inflation. If Maine falls into the lowest two-thirds of states in terms of tax burden, LD-1 would then allow predicted inflation to be added to the growth index.9

Maine’s Taxpayers’ Bill of Rights (TABOR): In 2006, even stricter limitations were proposed as an alternative to the limits LD-1 applies at the state level, which advocates felt failed to sufficiently constrain government growth. Proponents of TABOR argue that LD-1, by limiting only general fund expenditures, cannot effectively reduce the size of Maine’s state government. They borrowed the name from Colorado’s TABOR, but not the exact formula. If approved by voters in November’s referendum, Maine’s TABOR would limit general fund, highway fund, and quasi-governmental and special revenue fund expenditures. Annual spending could increase only by population growth plus inflation.10 Unlike LD-1,
TABOR would also limit the ability of government to increase revenues.

**Simulated effects**

To simulate the effects of LD-1 and the proposed TABOR on the Maine’s general fund, we use FY 1994 as the first year in which the TELs’ growth limits are applied. Since LD-1 limits appropriations and TABOR limits actual spending, we simulate their effects on appropriations and expenditures, respectively. Although expenditures and appropriations are not exactly the same thing, they historically differ little, so we feel comfortable in comparing LD-1’s impact on appropriations to TABOR’s impact on expenditures.

As the chart below shows, had their growth limits first been in effect in 1994, both LD-1 and TABOR would have limited general fund expenditures. Early on, TABOR and LD-1 would have restricted expenditures similarly, to growth ranging between 2.5 percent and 3.6 percent. In the late 1990s, TABOR would have been more restrictive than LD-1, but by 2004 both TELs would have again had similar effects.

Over the period analyzed, TABOR’s growth index was slightly more restrictive than LD-1. Between 1994 and 2005, LD-1 would have limited allowable annual growth in general fund appropriations to an average of 3.0 percent, while TABOR would have restricted expenditure growth to a slower average annual rate of 2.8 percent. However, this small difference compounds. Between 1994 and 2005, aggregate general fund appropriations allowed under LD-1 would have been $3.4 billion less than what was actually appropriated over the same period. TABOR would have limited aggregate state general fund expenditures by an additional $498.5 million, or $3.9 billion less than what was actually expended between 1994 and 2005.

Looking at average growth rates masks the relative volatility of TABOR, as shown in the chart above. A growth index that changes annually, like TABOR, reflects annual changes in population and prices but may compromise longer-term planning. On the other hand, a multi-year or averaged growth index that is more stable, like LD-1, may be more arbitrary because it forces government to provide the same basic services over time, irrespective of short-term increases in prices and population growth.\(^{11}\)

Another important difference between TABOR and LD-1 is that TABOR’s overall impact on Maine’s budget is larger, because its limits apply to more of Maine’s budget. LD-1’s base is the general fund, while TABOR’s base also includes the highway fund and other special revenue funds. Between 1994 and 2005, TABOR would have limited aggregate spending in the general fund, highway fund, and other special revenue fund by $4.9 billion relative to actual expenditures from these funds. If applied between 1994 and 2005, TABOR would have required the state to cut $1.4 billion more in expenditures than LD-1. Further, Maine’s TABOR may be even more restrictive over the long term because it requires a super-majority of the legislature and majority approval by citizens in order to raise new fees or revenues. LD-1 does not limit the state’s ability to collect fees or revenues.

It is important to note that estimates of the annual and cumulative effect of LD-1 and TABOR depend crucially on when the TEL is first applied, and that even the same formulas applied several years earlier would not have been binding. If both TELs were
first applied in 1990, the limits established by TABOR and LD-1 would have been a ceiling for growth that was not exceeded between 1992 and 1997. Average allowable growth rates under LD-1 and TABOR would have been 3.5 percent because of higher population, inflation, and personal income growth during this period. Additionally, a recession limited New England state revenue collections and expenditures in the early 1990s. As the chart on page 10 illustrates, it is not always the case that TELs limit state government spending.

Simulation 2: Rhode Island’s proposed TEL

Background

We simulate the potential impact of a TEL proposal introduced, but not enacted, in the 2006 Rhode Island legislative session. The base of the proposed TEL is total state general revenue appropriations (including all supplemental appropriations) for the fiscal year after the TEL is passed. It intends to allow state spending to grow at no more than 1.5 percent above the annual rate of inflation. At the end of the fiscal year, revenues that have not yet been appropriated would flow into a series of secondary accounts. First, these revenues would be transferred to the budget reserve account until the amount of money in the account equaled 5 percent of general revenues for that fiscal year. Then, any remaining revenues up to 2 percent of total general revenues would be used for capital expenditures or to fund state pension obligations. Revenues remaining after these two accounts were filled would be refunded to taxpayers.

Rhode Island currently operates under an appropriations TEL that limits general fund appropriations to 98 percent of estimated general fund revenues. In addition, state law caps increases in local property tax levies. Several provisions to further limit state and local spending were proposed and enacted during 2005–2006 legislative session. First, the current cap on local property tax increases will be lowered from 5.5 percent to 4 percent over the next six years. Second, a binding constitutional question will be on the November ballot that would lower the cap on general fund appropriations to 97 percent of estimated revenues. Clearly, Rhode Island has a great deal of interest in lowering taxes. A TEL proposal, such as the one simulated, may reemerge during the next legislative session.

Simulated effects

Our results suggest that, had Rhode Island’s proposed limit used FY 1993 as the base year, it would have reduced appropriations over the following decade; however, limits would not have been binding until FY 1997. We assume that the capital projects account is used in its entirety whenever money is available and that the budget reserve account is never used during this time. The chart on page 11 compares general revenue appropriations under the proposed TEL to actual appropriations and shows what would happen to excess revenues. The simulation finds that Rhode Island would have lowered spending by approximately 16 percent by 2005 and that taxpayers would have received refunds starting in
FY 1998, assuming no changes in the tax system. Allowable expenditures would have grown at the rate of inflation—which varied from 2.4 to 3.0 percent over the period analyzed—plus 1.5 percent. The budget reserve account, as well as funds spent on capital projects and pensions, would have grown commensurate with general revenue collections after FY 1998.

Because Rhode Island’s proposed allowable growth rate uses a static base year, the year it is passed makes a big difference on its impact. To better understand this, we simulated the effect of passing the TEL just one year later. In FY 1994, legislators appropriated $20 million less to the general fund than in FY 1993. If FY 1994 were the base year, then allowable appropriations would have been lower than actual appropriations every year limits were applied, and by FY 2005 allowable appropriations would have been only 80 percent of actual appropriations. From 1994 through 2005, the total effect of first applying limits in 1994 as opposed to 1993 would be $1.1 billion less in appropriations.

If first applied in 1994, Rhode Island’s TEL would not have been binding until 1997; by 2005 allowable appropriations would have been 16 percent lower than actual appropriations

Note: Analysis assumes the TEL was passed in FY 1992, so that FY 1993 would be the base and FY 1994 would be the first year that limits were applied.
Sources: Rhode Island Budget as enacted FYs 1999 through 2007, National Association of State Budget Officers, Bureau of Labor Statistics
## Key features of LD-1, TABOR, and Rhode Island’s proposed TEL

<table>
<thead>
<tr>
<th>Maine’s LD-1</th>
<th>Maine’s TABOR</th>
<th>Rhode Island’s TEL proposals</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Base</strong></td>
<td>General fund appropriations in the previous year</td>
<td>General fund, highway fund, quasi-governmental and special revenue fund expenditures in the previous year. Quasi-governmental agency expenditures include funds such as public higher education institutions.</td>
</tr>
<tr>
<td><strong>Growth Index</strong></td>
<td>Spending growth is limited to the annual percentage change in population of the prior calendar year plus the annual percentage change in CPI for the prior calendar year.</td>
<td>Inflation plus 1.5 percent. Inflation is calculated as the annualized percent change in CPI from the end of the base fiscal year (June 31st) to the December 31st before the new FY. 1.5 is added to this percent change to get the inflation plus 1.5 percent annual growth rate. This is then compounded to calculate the growth index from the base year to the new fiscal year.</td>
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### Calculation details

- The limits are calculated biennially based on a fixed year appropriation amount as of December 1st of even-numbered years.
- The limits would be adjusted annually on December 1st based on the prior year’s expenditures.
- Limits would be calculated annually based on the difference between December 31st before the new fiscal year and June 31st of the base year. This means that the longer the TEL is in place, the less volatile the limit is.

### What happens to revenues above the limit?

- Budget resources (which includes revenue, transfers, and budgeted balance forward) that exceed the appropriation limitation amount are transferred at the close of the fiscal year to the budget stabilization fund.
- 80 percent of revenues collected in excess of limits would be transferred to the Tax Relief Reserve Fund, and 20 percent would be transferred to the Budget Stabilization Fund.
- Revenues in excess of allowed appropriations are first applied to the budget reserve account. Up to 5 percent of general fund revenues for the new fiscal year can be in the budget reserve account. Revenues remaining are then spent on capital projects or state pensions; up to 2 percent of general fund revenues can be used for these. Any remaining revenues would be refunded to taxpayers.

### How can limits be overridden?

- The state limits may be exceeded by a majority vote by the legislative body in the event of the following extraordinary circumstances: catastrophic events; unfunded or under-funded state or federal mandates; citizens’ initiatives or other referenda; court orders or decrees; or loss of federal funding. As a statutory limit, it is not legally binding on the Legislature.
- At the state level, TABOR’s spending limits may be exceeded by two-thirds vote of each the House and Senate and approval of voters. The same requirements must be met for any increases in state revenue. As a statutory limit, it is not legally binding on the Legislature.
- The Rhode Island General Assembly would be able to override the spending restrictions with a two-thirds majority vote in the case of an emergency. The limits applied by the proposed TEL would automatically expire after 10 years. At that time, voters again vote on the TEL. As a constitutional amendment, it would require approval by the House, Senate and a ballot initiative put to voters in order to remove the TEL before that time.
Recommended reading


Endnotes

3 Some of the most illustrious public finance economists—most notably Richard Musgrave and Nobel Prize winner James Buchanan—have vigorously debated the validity of the Leviathan theory.
4 In the long term, fiscal stability also depends on recognizing and accommodating emerging demographic trends and changing preferences.
5 Common measures of inflation include the consumer price index (CPI) and the implicit GDP price deflator for personal consumption (IPD). Both look at the bundle of goods purchased by households, not by state governments. The main goods purchased by households include food, fuel, clothing, housing, and financial services; for state and local government the largest budget items include education, welfare, employee compensation, and transportation maintenance. There is also an IPD for state and local government which includes expenses such as compensation for government employees and purchases of goods and services by government (such as computers, office supplies, etc.). However, the IPD for state and local government does not include transfer payments which include public welfare payments and debt services. Finding an index that adequately covers these prices is problematic. Whether using the increase in prices faced by consumers under- or over-estimates the price changes faced by state and local government is difficult to determine because there is no one state and local government growth index. However, a simple comparison of IPD for personal consumption and IPD for state and local government shows that over the past 30 years the annualized rate of growth of prices for personal consumption was 3.8 percent and the annualized rate of growth of prices for state and local government was 4.3 percent. This indicates that prices for many government expenditures are growing faster than those for consumers and CPI or IPD for personal consumption would likely under-estimate prices faced by state and local governments.
6 However, Colorado’s revenue limitations have not been removed from the state constitution. State revenue growth is still limited to population growth plus inflation and any changes to spending limits or tax increases still require a majority of voters’ approval.
7 Joint Resolution 2006—H 7485. Introduced by Representatives Winfield, Mumford, Petrarca, Picard, and Watson on February 16, 2006 to the Rhode Island House Finance Committee. This legislation formed the basis for the Governor’s non-binding ballot initiative that was to be on the November 2006 ballot. However, in May the General Assembly passed legislation banning the governor from placing non-binding questions on the ballot and then overrode the governor’s veto of the bill. In August, the Rhode Island Supreme Court upheld this legislation.
8 LD-1 mandates increased state aid for education; thus, state aid for education is exempted from spending limits until the state share amounts to 55 percent of total education costs. Once the state assumes responsibility for the established percentage, school education funding is subject to established appropriation limits. The simulations in this paper do not account for the separate education spending growth allowance.
9 LD1 defines state tax burden as the total amount of state and local taxes paid by Maine residents per $1,000 of income, as determined by the State Tax Assessor based on data from the U.S. Department of Commerce, Census Bureau and Bureau of Economic Analysis.
10 Section 6: 1994S “Expenditure Limitations” of the original proposal for Maine’s TABOR applies the defined growth factor to the prior year’s spending. Our analysis assumes that “spending” means actual expenditures.
11 TABOR’s annual growth index fluctuates more than LD-1’s because of the formula’s details. TABOR’s limit is calculated each year with the most current available data. LD-1’s growth index has a ceiling on growth of 2.75 percent and uses 10-year averages of population and real personal income to determine allowable growth, both of which have the effect of smoothing allowable growth. Further, LD-1 applied the same growth index to both years of its biennial budget, whereas TABOR applies a new growth index each year.
12 The budget reserve account is intended for use in the event of an emergency, defined as “an extraordinary event or occurrence that could not have been reasonably foreseen or prevented and that requires immediate expenditure to preserve the health, safety, and general welfare of the citizens of the state of Rhode Island.” In order for funds to be used, the governor must make a request, and two-thirds of the entire membership of each house must approve. For the purposes of our simulation, we assume no catastrophic event that requires the use of the budget reserve account during this time period.