35. State Fiscal Policy

State legislatures should

- return all future surpluses to taxpayers by cutting taxes or issuing tax refunds and
- control spending by enacting a strong tax and expenditure limitation.

The State Spending Spree

The state fiscal crunch that most legislatures confronted recently resulted from excess spending during the last decade. For starters, the state governments grew faster than the federal government. Between 1990 and 2002, total federal government spending rose by 60 percent. State spending doubled during the same period. That is far faster than population growth plus inflation.

As the economy slowed and large budget gaps started appearing, state budgets did not shrink in size even if the rates of growth declined. Spending continued to rise: in 2002, for example, when revenue was expected to decline by an average of .7 percent, state appropriations still rose by 1.2 percent.

After adjusting for inflation and population growth, the budgets of seven states (Mississippi, Arkansas, West Virginia, Missouri, Pennsylvania, New Mexico, and Utah) more than doubled between 1991 and 2002 (Table 35.1). Real state spending grew faster in the 1990s (4 percent annually) than in the go-go 1980s (3.4 percent annually).

This is a case of history repeating itself. In the 1980s few states resisted the pressure to use surplus revenues from the economic boom to create costly new programs. As a result, when the economy slipped into recession in the early 1990s, many states found themselves in the worst fiscal crunch

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Table 35.1
Real per Capita Spending Increases, 1991–2002

Rank	State	Increase	Rank	State	Increase
1	Mississippi	137%	26	Nebraska	76%
2	Arkansas	117%	27	South Dakota	76%
3	West Virginia	116%	28	New Hampshire	75%
4	Missouri	114%	29	Montana	74%
5	Pennsylvania	108%	30	Indiana	73%
6	New Mexico	103%	31	Illinois	73%
7	Utah	102%	32	Florida	72%
8	Oklahoma	99%	33	Washington	70%
9	Minnesota	97%	34	Maryland	70%
10	North Carolina	95%	35	Georgia	68%
11	Tennessee	95%	36	Connecticut	68%
12	South Carolina	95%	37	Rhode Island	67%
13	Kentucky	93%	38	Vermont	67%
14	Texas	93%	39	Virginia	67%
15	Oregon	89%	40	Michigan	63%
16	California	88%	41	Delaware	63%
17	Colorado	88%	42	New York	62%
18	Maine	86%	43	New Jersey	62%
19	Kansas	86%	44	Louisiana	59%
20	Alabama	83%	45	Massachusetts	50%
21	Wisconsin	83%	46	Nevada	49%
22	Iowa	81%	47	Hawaii	47%
23	Ohio	80%	48	Wyoming	46%
24	Idaho	79%	49	Arizona	36%
25	North Dakota	76%			

SOURCE: Authors' calculations based on Bureau of Census data.
NOTE: Alaska is excluded.

in decades. The recession caused revenue growth to slow, but demands to meet all the new spending commitments did not slow.

Deficits Caused by Spending, Not Tax Cuts

Some analysts try to blame recent tax cuts for the budget gaps. Although there was widespread tax cutting in the late 1990s, tax cuts tapered off substantially in FY02, and tax increases began anew in FY03. Besides, the tax cuts of the 1990s were very modest compared with the huge spending increases that took place. Indeed, roughly two of every three surplus dollars between 1996 and 2002 went to new spending, with just one dollar going to tax cuts. In other words, spending increases were twice as big as recent tax cuts.

Even with tax cuts in many states in the 1990s, state revenues still boomed. In fact, the states that had the 10 highest rates of growth in revenue per $1,000 in personal income between 1995 and 2002 had larger deficits as a percentage of state spending than the 10 states that had the lowest revenue growth rates. The same holds true for spending trends: the states with the 10 fastest rates of growth in real per capita spending had larger deficits on average than the states that maintained control over spending.

If states had not cut taxes in the 1990s, today's budget gaps would be even larger because extra revenue would have fueled even more spending. It is simply not true that states that cut taxes had higher deficits than those that did not. Indeed, the opposite is true. If the money is available, it will be spent. Tax cuts are valuable not just because they lower tax burdens but also because they remove the temptation to spend.

Tax Policy and Economic Growth in the 1990s

It is important to emphasize the value of tax cuts in general, and income tax cuts in particular, because the evidence shows that states that reduce taxes improve their prospects for economic growth. For example, a 1996 study by Zsolt Besci of the Federal Reserve Bank of Atlanta found that ''relative marginal tax rates have a statistically significant negative relationship with relative state growth averaged for the period from 1961 to 1992.'' The message of the study for state governments is that ''lowering aggregate state and local marginal tax rates is likely to have a positive effect on long-term growth rates.'' A study for the Joint Economic Committee of Congress by Richard Vedder of Ohio University came to a similar conclusion. A study by Thomas Dye of Florida State University found that states with no income tax had higher personal income growth (and smaller government growth) than states that had an income tax.

Tax changes enacted in the states in the 1990s offer a useful laboratory in which to explore the effects of tax policy. It is useful to compare the economic performance of the 10 states that increased taxes the most with the economic performance of the 10 states that cut taxes the most during 1990–2002 (see Table 35.2). The results suggest that when states reduce taxes they improve their relative economic performance.

Businesses and jobs migrated to low-tax states in the 1990s. Job growth averaged 25 percent in the top 10 tax-cutting states, higher than the national

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Table 35.2
Taxes and State Economic Performance, 1990–2002

	Top 10 Tax-Cutting States	50-State Average	Top 10 Tax-Hiking States
1990–2002 revenue increases (per $1,000 of personal income)	($8.23)	$3.10	$15.35
Employment, 1990–2002	24.63%	22.34%	17.62%
Personal income, 1990–2002	91.7%	86.43%	78.6%
Population growth, 1990–2002	17.5%	16.01%	14.4%

SOURCE: Authors' calculations.

average of 22 percent, while the top 10 tax-hiking states experienced employment growth of just under 18 percent.

Wealth grew faster in the tax-cutting states than in the tax-hiking states. Indeed, tax-cutting states saw personal income grow over 5 percentage points faster than the national average, while the tax-hiking states saw below-average personal income growth.

Citizens voted with their feet and migrated to the tax-cutting states in greater numbers. Population growth averaged 17.5 percent in tax-cutting states but only 14.4 percent in the tax-hiking states. Again, growth in this variable outstripped the national average in the tax-cutting states.

If tax cuts caused fiscal deterioration as some observers allege—indeed, many of the tax hikes promoted over the past few years were predicated on ''saving'' a particular state's bond rating—then the bond ratings of the 10 tax-cutting states should be worse than the bond ratings of the 10 tax-raising states. But the opposite is true. For the tax-cutting states, the average Standard and Poor's bond rating in 2002 was between AAA and AA. For the tax-raising states, the average bond rating was between AA and A.

Restraining Government Growth in the States

The big problem for the people who tried to restrain the growth of government in the 1990s was not just fighting the spending appetites of members of both parties but also the tide of revenue that fueled those spending desires. With an economic recovery on the horizon, the time is ripe to put into place restrictions on government growth before the genie of the revenue boom is out of the bottle. Once states find themselves in surpluses again, the temptation to spend it all is likely to be irresistible to many. That acquiescence to more spending will only put the states back into the same, or worse, position they were in at the end of the 1990s once revenue flags again in the next economic downturn.

The best thing a state can do is to put into place a strong tax and expenditure limitation (TEL) that keeps government from growing without bound. Those limits, which are usually very popular with voters and taxpayers, would restrict the ability of state legislatures to spend beyond a particular growth rate.

During the tax revolt in the 1970s, a number of states adopted TELs as a mechanism to limit the growth of government. By 1982 TELs had been enacted in 17 states. TEL enactment slowed along with the fervor of the tax revolt in the prosperous 1980s; only 3 states enacted TELs between 1983 and 1990. However, during the early and mid-1990s, TELs enjoyed a resurgence of sorts; by 1996, 6 additional states had enacted TELs. Currently, 26 states operate under some kind of TEL.

Not all TELs are created equal. Some work better than others. Indeed, most of the TELs in the states currently are either toothless or don't hold spending to a strict enough baseline.

What Makes a Good TEL?

Property 1: Limiting the Growth of Expenditures and Revenues to the Inflation Rate Plus Population Growth

An overwhelming majority of the TELs that have been passed since 1976 limit growth in state expenditures and revenues to state personal income growth. However, two states, Colorado and Washington, have recently enacted TELs that limit growth in state expenditures to the inflation rate plus population growth.

That is a more stringent limit. Over the years the rate of growth in personal income has been significantly greater than the inflation rate. Between 1980 and 1990, growth in real personal income exceeded the inflation rate plus population growth by more than 38 percentage points. It should also be noted that holding increases in expenditures to increases in personal income, as most TELs do, sets a relatively low limit for a state to maintain. Between 1980 and 1990, the ratio of state and local direct general expenditures to personal income actually fell in 27 of the 49 states considered in our analysis.

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Property 2: Refunding Surpluses to Taxpayers Immediately

Another feature that is worth examining is the provision that mandates immediate refunds of any surpluses to taxpayers. Thus far, four states (Colorado, Michigan, Missouri, and Oregon) have enacted TELs that mandate immediate refunds of revenues that exceed the limit established by the TEL. Such a provision would strengthen any TEL because it would make it difficult for state government to collect or spend excess revenues. In addition, it would give citizens and watchdog groups a greater incentive to see that the provisions of the TEL were enforced. An examination of the recent budgetary history of the four states that require immediate refunds indicates that such refund provisions enhance the effectiveness of TELs in another way. Namely, they create a strong incentive for state legislators to cut taxes when it appears that revenues are going to exceed the limit.

If a state enacts a TEL that mandates immediate refunds of surplus revenues, state legislators have the option of allowing revenues to exceed the limit and then subsequently refunding the revenue. However, there are logistical and political problems with doing that. First, it is nearly impossible to refund the sales tax. Also, although it is possible to enact refunds of income or property taxes, legislators dislike doing so. That is because high-income citizens would obtain a high percentage of the refunds, and legislators do not like to be charged with favoring the rich over everyone else. As a result, a powerful incentive is created for legislators to cut taxes before the end of the fiscal year so that revenues will no longer exceed the limit. Indeed, case studies indicate that Michigan, Missouri, and Colorado (three of the four states that mandate taxpayer refunds) have enacted tax cuts in response to the prospect of having revenues exceed the limit mandated by their TELs.

How Well Do These Sorts of TELs Work?

Regression analysis can examine this question. In our model, the dependent variable is the annual change in per capita state and local direct general expenditures in 1996 dollars. The analysis examines the effects of TELs with provisions for immediate refunds and TELs that limit growth in expenditures to the inflation rate. Demographic and economic variables are also included to take into account the uniqueness of each state.

The results, which are summarized in Figure 35.1, support the idea that certain features can greatly enhance the effectiveness of a TEL. From this

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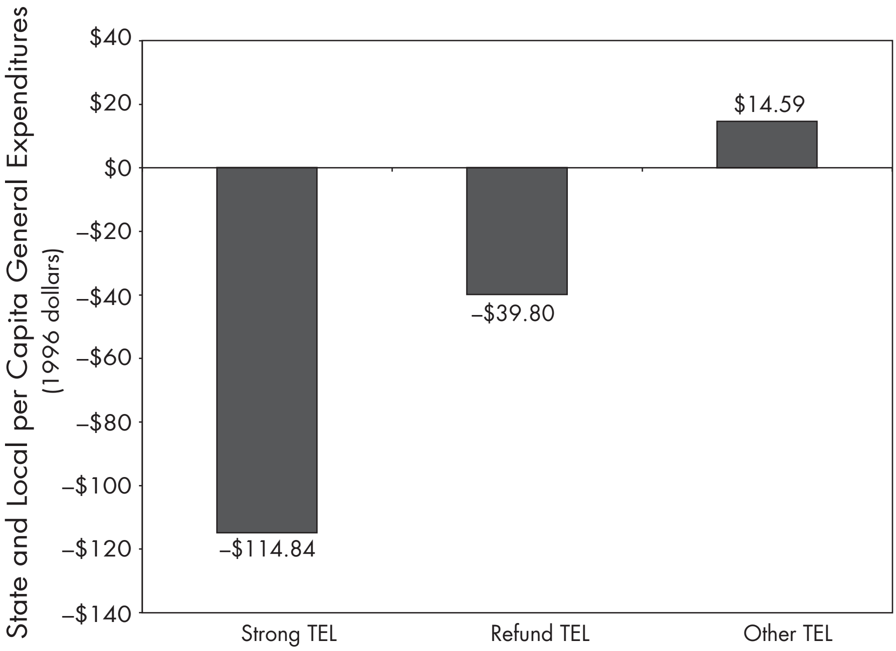
Figure 35.1
Effectiveness of TELs by Feature



SOURCE: Authors' calculations.

regression it appears that TELs that limit increases in spending and revenue to the inflation rate plus population growth have the most promise for reducing spending. If a state passes a TEL that limits expenditures to the inflation rate plus population growth, the regression equation predicts that every year the TEL will reduce per capita state and local direct general expenditures by approximately $114.84. The results indicate that we can be more than 98 percent confident that these TELs have a negative effect on state and local direct general expenditures.

Likewise, if a state passes a TEL that does not limit state expenditures to the inflation rate plus population growth but includes a refund provision, the regression equation predicts that the TEL will reduce per capita direct general expenditures by $39.80 annually.

Finally, the regression analysis suggests that other TELs that neither limit expenditures to inflation nor have immediate refund provisions appear ineffective at reducing state expenditures. Indeed, the model predicts that if a state passes a TEL that has neither of these two provisions, that state's

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per capita direct annual general expenditures will actually increase by $14.59. Overall, this analysis provides strong evidence that TELs can be effective tools for limiting the growth of state expenditures, but only if they are designed properly.

A Closer Look at Washington and Colorado

The two TELs passed by Washington State and Colorado that limit the growth of expenditures to the inflation rate have been especially effective at reducing per capita government expenditures. Colorado's TEL was passed in 1992 and took effect in FY94, and Washington's TEL was passed in 1993 and took effect in FY96. Taking a look at what worked well—and what didn't—is instructive.

Case Study: Colorado

In the past 25 years Colorado has enacted three separate TELs. In 1977 Colorado was one of the first states to adopt a general fund appropriations limit. The legislation limited increases in state appropriations to 7 percent over the previous year's general fund appropriations. Due to expire after FY83, the law was amended in 1979 and extended indefinitely. However, during the mid to late 1980s Colorado's economy suffered a downturn due to the collapse of the energy and construction industries, and revenues were consistently below the limit mandated by the TEL.

In 1991 the General Assembly of Colorado adopted another statutory general fund appropriations limit. This one reduced the existing limit by one percentage point, mandating that general fund expenditures could increase by no more than 6 percent. However, this legislation included generous exemptions for spending on education and federal mandates. Colorado's citizens became increasingly frustrated by what they believed to be government inefficiency and the perceived inequities in the state tax system. Many people became involved with a grassroots movement to reform state and local taxes. In 1986, 1988, and 1990 they succeeded in placing on the ballot initiatives that would limit taxes and spending. Those initiatives lost by narrower margins each time.

Finally, in 1992 the Taxpayer Bill of Rights (TABOR), also known as Amendment One, passed and added Article X, sec. 20, to the state constitution. TABOR has three primary components. First, all tax increases have to be approved by taxpayers. Second, it mandates that the existing TELs, passed in 1977 and 1991, cannot be weakened without taxpayer approval. Third, it includes the most stringent TEL of any state. TABOR limits growth in state spending and tax increases to inflation plus population growth. It mandates that any revenue collected over the limit be refunded to the taxpayers. It requires that the limit be adjusted when responsibility for government programs is transferred. Finally, the limit is constitutional, not statutory, which makes it difficult to amend.

This particular ballot initiative generated a firestorm of controversy. Gov. Roy Romer, a Democrat, sharply criticized the measure on numerous occasions. He said that defeating the measure was the ''moral equivalent of fighting the Nazis at the Battle of the Bulge.'' He warned of an economic Armageddon with passage of TABOR and said that the Colorado border would soon have to be posted with signs reading ''Colorado is closed for business.'' Public employee unions and the education lobby quickly lined up in opposition to TABOR. Even the *New York Times* criticized TABOR, calling it potentially the most radical change in any state government that year.

Others argued that TABOR was bad policy because the demands for state services, such as schools, prisons, and highways, seemed likely to increase faster than the rate of inflation. They also contended that Colorado needed to spend more on those services because, in previous years, Colorado's spending increases for education and highways had been considerably below the national average. Despite those warnings, TABOR passed with more than 53 percent of the vote in 1992 and took effect in FY94.

Since 1994 the legislature has had to rebate substantial amounts of tax revenues to stay underneath the limit. Colorado enacted taxpayer refunds of $139 million in 1997, $563 million in 1998, $679 million in 1999, and $941 million in 2000. In addition to its rebate provisions, TABOR forces both state and local government to obtain voter approval to raise taxes. Although many municipalities have sought and won voter approval to increase taxes, statewide initiatives have fared poorly. In every year from 1993 to 1999 a proposal to either increase taxes or circumvent TABOR was on the Colorado ballot. Those included a 1993 initiative to increase the sales tax, a 1997 gas tax increase, and a 1999 effort to use part of the surplus for road and school construction. Each of those statewide initiatives was defeated. However, in 2000 Colorado residents did approve Amendment 23, which increased state aid to public education and reduced the TABOR surplus for both 2000 and 2001.

Case Study: Washington State

During the last 20 years Washington State has passed two TELs by citizen initiative. The first one, Initiative 62, was passed in 1979 and

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limited increases in state revenues to the rate of growth in personal income. However, the state suffered a recession shortly after passage of the initiative, and it never became a serious constraint since the limit was higher than what the state could spend. In fact, in 1993 the legislature was able to pass a $1 billion tax increase to balance the FY94–95 budget and remain within the limit. However, that tax increase provoked a backlash and provided the impetus for putting another TEL, Initiative 601, on the ballot in 1993.

Initiative 601 imposed a limit that was stricter than the limit set by Initiative 62. Initiative 601 limited increases in state expenditures to the inflation rate. In addition, it stopped the legislature from circumventing the limit by devolving functions of state government to the localities. It explicitly prohibited the legislature to impose on local governments any responsibility for new programs unless the legislature fully reimbursed the local governments for the cost of the programs. Initiative 601 passed by 1 percent of the vote.

In 1994 the Washington legislature passed a supplemental budget to ensure that it was in compliance with the TEL that was scheduled to take effect in FY96. The legislature instituted some targeted budget cuts, mostly in administration, social services, and prisons, to save more than $120 million in the new biennium. The legislature increased spending for some items, such as highways and school construction, on the grounds that those were one-time-only expenses and would be off the budget in FY96. As a result, the budget base was not swollen from previous spending levels and would be easier to sustain in the new biennium.

Finally, some agencies were directed to begin planning for cuts. For instance, public colleges were directed to trim expenses by $39 million to help pay for faculty and staff pay raises. Because of those spending reductions, the budget was under the TEL's limit in FY96 and FY97. In subsequent years the state legislature took steps to reduce taxes when it appeared that the government was collecting high levels of revenue. In FY98 and FY99 the legislature instituted modest targeted tax cuts of $38.5 million and $19.7 million, respectively.

Since spending was being restrained, voters in the state of Washington desired more substantial tax relief. In 1998 Washington voters passed Initiative 695, which reduced the motor vehicle excise tax by $30 and saved taxpayers $256 million. In 1999 Washington residents voted to repeal the motor vehicle excise tax. That reduced the tax burden on Washington residents by an additional $1.1 billion over two years.

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However, Washington's Initiative 601 was weaker than Colorado's Taxpayer Bill of Rights in one important respect. Initiative 601 was a statutory measure whereas TABOR is a constitutional amendment. That makes Initiative 601 easier to amend, and possibly weaken. Indeed, that is precisely what happened in the spring of 2000 when the Washington legislature wanted to pass a budget that would have exceeded the limit mandated by the TEL. The legislature succeeded in obtaining the necessary supermajority to suspend the TEL, and the governor signed the budget into law. The long-term effects on the budgetary practices of the state of Washington remain to be seen.

Conclusion

It is vital that state legislatures control their spending habits. The surpluses that are bound to appear again when the economy picks up steam will be a temptation to those who like big government. Strong spending restraints are very popular with voters in the states in which they have been tried. Legislators would be well advised to keep that in mind next time they risk alienating taxpayers by creating an expensive new government program.

Suggested Readings

Becsi, Zsolt. ''Do State and Local Taxes Affect Relative State Growth?'' Federal Reserve Bank of Atlanta *Economic Review,* March–April 1996.

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Vedder, Richard. ''The Effects of Taxes on Economic Growth: What the Research Tells Us.'' Texas Public Policy Foundation, March 29, 2002.

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