

TAX AND EXPENDITURE LIMITATION PROPOSALS IN ARIZONA

A Report from the Office of the University Economist

Updated, 3 March 2011

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SUMMARY

Tax and expenditure limits (TEs) are laws or constitutional provisions that restrict the level or growth of government revenues or expenditures. Most limits are defined in terms of a maximum level or rate of increase that is tied to one or more economic measures, such as personal income, population, or inflation. A TEL was in place in 30 states in 2009. Most were adopted during the tax-revolt period of the late 1970s or during the 1990s. Arizona has a TEL, adopted in the late 1970s, that limits state government appropriations to a percentage of the state's personal income.

TABOR Provisions

Colorado's tax and expenditure limitation—the Taxpayer's Bill of Rights, popularly known by its TABOR acronym—was voter approved in 1992. It has been widely adopted by the anti-tax movement as the model that other states (and the federal government) should emulate. National and local groups have pushed TABOR-like proposals in numerous states, including Arizona; TELs similar to TABOR have been enacted in Ohio and Washington.

While TABOR has many provisions, two are of key significance:

- Government spending growth is restricted to the sum of inflation and population growth.
- The sum of inflation and population growth is applied to the prior year's actual expenditures—if expenditures are below the spending limit, then the spending limit permanently falls.

The first provision limits government growth to a more narrow measure than is in place in Arizona and most of the other states with a TEL. By using personal income as the basis for its limit, Arizona's existing TEL effectively incorporates inflation, population growth, and real per capita economic growth. The latter represents productivity growth, which has averaged between 1.5 and 2 percent per year. If government is allowed to grow at the pace of overall economic growth, its size as a percentage of the entire economy is constant, as is the tax burden. If government growth is limited to population growth and inflation, government's share of the economy will decrease over time and the quality and quantity of government services will be frozen at existing levels. The public sector will have no ability to respond to technological or societal changes that require additional spending, at least not without reducing funding for existing programs.

The second TABOR provision creates a "ratchet-down effect." Government revenues are highly cyclical, falling on an inflation-adjusted per person basis during economic recessions. By tying the inflation and population growth formula to actual spending when it is lower than the limit, spending cuts made during a recession in order to balance the budget become permanent. Under this provision, government's share of the economy—and the quality and quantity of public services—falls precipitously over time. Coloradans recognized this significant problem and voted for a referendum in 2005 that effectively eliminates TABOR's ratchet-down effect.

In addition to these broad concerns, an inflation and population growth rule has other shortcomings. The subpopulations served by government programs grow at different rates than the growth rate of total state population used in the formula. For example, over the 1993-to-2010 period (beginning with the base year for Colorado's TABOR), the state prison population in

Arizona expanded by 138 percent and the number of AHCCCS (Arizona's Medicaid program) beneficiaries increased 192 percent while the state's population grew by 81 percent.

Similarly, changes in the cost of providing public services are not adequately measured by the overall inflation rate. While the overall rate of inflation over the 1993-to-2010 period totaled 41 percent, medical care prices rose 93 percent and the cost of inputs for higher education institutions increased 78 percent.

While proponents point to TABOR as enhancing Colorado's economic growth during the 1990s, several studies found no relationship between TABOR and economic performance. In the last economic cycle (2001 through 2009), Colorado's economic performance slumped from above to below the U.S. average, with Colorado ranking near the bottom of the western states.

Arizona Proposals

Five bills and resolutions that would limit revenues or appropriations have been introduced in Arizona's 2011 regular legislative session. As of March 3, 2011, all were proceeding through the Legislature. One resolution would reduce the existing appropriation limit while the other measures would mimic TABOR. The two Senate bills each would mandate the publication of a TABOR-like spending limit and would force the Legislature to publicize any intent to exceed the limit, but would not actually restrict appropriations. In contrast, one resolution would constitutionally create an enforceable TABOR-like rule in Arizona that is applied to a measure of total appropriations from all state government funds. The House bill would limit general fund revenues. The latter resolution and the three bills incorporate both of the primary provisions of Colorado's TABOR.

Had Arizona's TEL that became effective in fiscal year 1981 included an inflation plus population growth limit, the impact on state government 30 years later would have been substantial. Even without a ratchet-down effect, the fiscal year 2011 budget would have been 22 percent less than the actual budget—which already reflects very substantial spending reductions made over the last three years. The budget would have been 59 percent less with the ratchet-down effect. Total appropriations (not just those in the general fund) in fiscal year 2011 would have been \$2.8 billion less than the actual \$12.8 billion without a ratchet effect and \$7.5 billion less with a ratchet effect.

These substantial effects would continue to grow in magnitude over a longer time span. Had an inflation plus population growth limit been in effect for the 50 years from 1959 through 2009, per capita state government revenues in fiscal year 2009 would have been 87 percent less than the national average. Revenues per \$1,000 of personal income would have been 84 percent below average and 79 percent below those of the next-lowest state. Total revenues would have been only \$2.8 billion, slightly more than one-sixth of the actual figure. For comparison, actual state government expenditures for elementary and secondary education alone was \$4.2 billion—and Arizona already ranks near the bottom of the states on per pupil K-12 expenditures.

Even before the recent budget cuts, government spending in Arizona was well below the national average and was falling over time relative to other states. Similarly, the state's tax burden was dropping and ranked 41st in the nation in 2008. Effectively, the adoption of any of the proposals

would at a minimum permanently lock in place the state's existing low level of public services. Four of the five pending bills and resolutions—those with TABOR-like provisions—would go much further, causing the quality and quantity of public services to fall much further over time. With funding reductions to services that businesses need, especially education and public infrastructure, the state's economic competitiveness would decline, as would the quality of life of the state's residents.

In addition to these legislative proposals, *The Executive Budget* issued by the office of Governor Brewer in January 2011 proposed budget reform that includes a spending limit. While the analysis in this report suggests that several issues in the Governor's proposed spending limit should be addressed, the Governor's proposal would be far less damaging to public services and to the Arizona economy than the three TABOR-like measures introduced in the Legislature.

Recommendations

As an alternative to the provisions of the Governor's proposal regarding a spending limit or any of the legislative TEL proposals, the existing constitutional spending limit is adequate to protect against increases in the size of state government. However, since spending has been so far below the limit for many years, the existing limit does not preclude permanent increases to spending from being made without an equivalent increase in revenues.

The most effective solution is for the Constitution to prohibit any permanent increase in spending from being made without an accompanying permanent increase in revenues of an equal magnitude (or equivalent decreases in other spending categories). Likewise, no permanent reduction to tax rates or bases would be allowed without corresponding reductions in spending of an equal magnitude (or equivalent increases in other revenues).

One exception would need to be made to these prohibitions. Spending would be allowed to rise without a permanent revenue increase (or offsetting spending reductions in other categories) following a recession during which spending reductions were made in order to meet the constitutional requirement to balance the budget. If significant changes were made to the state government's revenue system and to its rainy-day fund, instances of needing to use this exception would be very infrequent.

If an annual spending growth limit is deemed essential, the limit should be tied to the average change in inflation-adjusted per capita personal income over the latest economic cycle (or two cycles), adjusted for expected inflation and population growth over the next year. This would be more in line with the existing constitutional appropriation limit that is tied to personal income. Under this limit, government spending could increase no faster than the pace of the overall economy; state government would remain a constant share of the economy; and the tax burden would not rise.

Because current spending is far below historical levels due to the sharp recessionary-caused declines in revenues in recent years and to the structural deficit, current spending is an unrepresentative point for starting a new expenditure limit. Instead, the spending limit should be tied to fiscal year 2008 adjusted for subsequent inflation, population growth, and real per capita personal income growth.

INTRODUCTION

Five bills and resolutions to limit the size of state government were introduced in the Arizona Legislature early in 2011. Two are concurrent resolutions that require the assent of both legislative houses and an affirmative public vote to be added to the Arizona Constitution. The other three are bills that if approved by both houses and not vetoed by the Governor become statutory law 90 days after the end of the legislative session. In addition, the Governor has proposed several budget reform measures, including a spending limit.

Four of the five legislative measures introduced have clauses that are similar to the core provisions of the Colorado Taxpayer's Bill of Rights (TABOR). Since a multiyear track record of the impacts of Colorado's constitutional amendment on government and on the economy is available, the situation in Colorado is examined in this paper before addressing what might occur in Arizona if any of these bills and resolutions become law.

Colorado's TABOR is a specific type of tax and expenditure limitation (TEL). Arizona also has an existing TEL that was passed in 1978 and became effective in fiscal year 1980. Arizona's TEL limits appropriations to a percentage of personal income.

TAX AND EXPENDITURE LIMITATIONS

Various types of tax and expenditure limitations have been adopted in the majority of states. Proponents of TELs assert that without such restraints the normal political process will result in increasing tax burdens and a growing government sector over time. This had indeed been the case for the first 30 years after World War II, but the special factors that caused this increased size of state and local governments cannot be generalized to be a predisposition of state and local governments always to increase taxes.

Instead, the increase in the relative size of state and local governments after the war occurred for three primary reasons: (1) state and local government spending had fallen substantially during the war and thus was simply returning to prior levels; (2) the large size of the baby-boom generation caused demand for state and local government programs—especially education, the main use of state and local government revenues—to rise from the 1950s into the 1970s; and (3) the federal expansion of health and welfare programs that began during the 1960s mandated state and local governments to increase spending on these programs.

California's Proposition 13, which focused on property tax relief and was approved by voters in June 1978, is often credited as the first of the tax and expenditure limitation initiatives. After that, most limitations passed by states have applied to overall revenues or spending. California passed a more comprehensive TEL in 1979.

Most TELs have established some form of "fiscal cap" on revenues and/or spending. These fiscal caps have been based on two basic approaches: (1) a limit on total revenues or total spending as a proportion of some measure of the size of the total economy; or (2) a limit on the future rate of growth of revenue and/or spending.

In addition to these fiscal cap TELs, about one-third of the states have established the requirement of a supermajority vote (usually two-thirds) of the legislature for any tax increase.

The supermajority requirements are not TELs in the conventional sense since they do not directly limit revenue or spending growth. Three states go further, requiring voter approval of tax increases.

Although TELs could be adopted that would cause immediate cuts in spending or taxes, both the supermajority requirement and the fiscal caps that have been put into effect have been aimed at restricting the growth of the public sector or limiting its size to some proportion of the total economy.

TABOR is a fiscal-cap TEL. As of 2009, some form of fiscal-cap TEL had been adopted in 30 states. Some states, like Colorado, actually have more than one type of fiscal cap in force. The precise formulation of these fiscal-cap TELs differs widely. The key differences relate to whether the limit is on spending or revenue, how the limit is calculated, and the treatment of any surplus over the limit:

- Budget measure to which the limit applies
 - spending
 - revenues
 - estimated revenues
 - combination of spending/revenues/appropriations
- Calculation of the limit
 - sum of population growth and inflation
 - share of personal income
 - percent change of personal income
 - percent of revenue received
 - a variety of miscellaneous other systems
- Treatment of the Surplus
 - refund of surplus required
 - partial return of surplus
 - deposited into “rainy day” fund
 - used to retire debt
 - combination approaches
 - not specified

For a more complete comparative analysis of TELs, see Resnick 2004, Hill et. al. 2006, and Waisanen 2009.

COLORADO’S TABOR

The Colorado Taxpayer’s Bill of Rights is an amendment to the Colorado Constitution (Article X, Section 20) that was approved by voter initiative in 1992 and was first applied in fiscal year (FY) 1994. As stated in its first paragraph, the primary objective of the amendment was to limit the growth of government. To do so, it imposes limitations on the amount of revenue that government can collect and spend; it also requires voter approval of any tax changes that would increase revenues. TABOR applies to all levels of state and local government in Colorado.

Provisions

TABOR has a number of provisions. It is more comprehensive than most TELs.

Voter Approval of Tax Increases and Debt

TABOR requires prior voter approval of any new tax, any tax rate increase, any increase in the assessment ratio for a class of property, any extension of an expiring tax, or any tax policy change that would cause a net tax revenue increase. Voter approval is also required for the creation of most financial obligations that extend beyond the current year unless government sets aside enough money to fund the obligation in all years that payments are due. The requirement for voter approval can be temporarily suspended for tax increases in declared emergencies.

Spending (Revenue) Limits

TABOR limits the maximum annual percent change in government spending in a given fiscal year to the sum of the inflation rate (as measured by the Denver-Boulder-Greeley consumer price index) and a measure of growth in the prior year. For the state, the growth measure specified is the percent change in population (as estimated by the U.S. Census Bureau) in the prior year. For local governments other than school districts, it is the percent change in the valuation of real property in the jurisdiction; for school districts, the growth measure specified is the percent change in student enrollment.

Since TABOR classifies as spending any transfer of revenues into reserve accounts or to other governments, the limit effectively applies not only to spending but to revenues. Thus, in practice, TABOR operates as a limit on revenues that can be retained by government. The TABOR limit applies to spending of both general fund and cash fund revenues (both taxes and fees), but excludes federal funds, litigation settlements, gifts, and donations.

TABOR Surplus

Any revenue collected above the allowable TABOR limit for that fiscal year must be refunded to the taxpayers in the following fiscal year. The amendment does not specify the refund procedures to be used. With voter approval, a government may retain or spend all or a portion of its TABOR surplus.

Other Provisions

Prohibited Taxes. Any new or increased real estate transfer tax, local income tax, or state real estate property tax is prohibited by TABOR. Any state income tax change is required to have a single tax rate applicable to individuals and corporations with no surcharge and may not take effect until the following tax year.

Emergency Reserve. TABOR requires an emergency reserve equal to 3 percent of fiscal year spending. This reserve can only be spent in a declared emergency. The amendment defines “emergency” to NOT include economic or fiscal crises.

Voter Approval for Changes in Existing Revenue, Spending, or Debt Limits. Any changes that would weaken current limits on state or local government revenue, spending, or debt require voter approval.

Government Enterprises. Enterprises, defined as a government-owned businesses approved to issue revenue bonds that receive less than 10 percent of revenue from state and local taxes, are exempt from TABOR limitations.

Comparison of TABOR to Other TELs

Colorado's TABOR is generally considered to be one of the most restrictive TELs in the country. This evaluation is founded on the following characteristics of TABOR compared with other TELs:

- Growth in TABOR revenues is limited to the sum of the percent change in population and the inflation rate. This formula apparently is based upon the assumption that government spending should grow only if it has to provide services to a larger population or if the cost of providing services increases. It ignores any effects of increases in standard of living or other factors. In most years, this type of limit is more restrictive than a limit based on change in aggregate personal income.
- The TABOR limit is based upon the lesser of the prior year's limit or actual revenues in the prior year. Whenever Colorado's revenues are less than the allowable limit, a so-called "ratchet-down effect" occurs, with the lower actual revenue figure becoming the new base for calculating the next year's limit, and the TABOR limit is permanently reduced for subsequent years. This ratcheting down typically occurs during recessionary years when government revenues temporarily fall significantly. Colorado's method of selecting the limit is more restrictive than the procedures used by other states. For example, if the calculation is based only on the previous year's allowable limit or as a maximum percentage of personal income, no similar ratchet-down effect would occur. (Effectively, the ratchet-down effect in TABOR was eliminated in 2005 by the passage of Referendum C by Colorado voters. A discussion of Referendum C is included in a later subsection of this report.)
- TABOR establishes limits on general fund and cash fund revenues (hereafter referred to as TABOR revenues). Revenue limits generally are more restrictive than expenditure limits. In addition, TABOR applies to a broad definition of revenues, not just the general fund, and also applies to fees in addition to tax revenues.
- The Arveschoug-Bird limit, a second TEL in Colorado, also establishes limits on general fund appropriations. Their growth is limited to a maximum of 6 percent. In many years during the 1990s, this limit was more restrictive than the TABOR limit.
- TABOR requires the refunding of any surplus in the next fiscal year. Any other use of the surplus must be approved by the voters. In most other states, these funds can be put into a rainy-day fund or used for other purposes.
- Any change in the tax system that would result in a net increase in revenues must be approved by the voters. The TABOR limit applies to aggregate revenues, but this provision prohibits changes that would increase revenues from one tax to offset decreased revenues from another.
- The TABOR definition of an "emergency" specifically excludes economic conditions or fiscal crises.

Fiscal Impacts

Colorado's early experience with TABOR was benign due to the rapid economic and demographic growth the state experienced during most of the 1990s. By 1992, when TABOR

was adopted, Colorado had emerged from stagnant economic conditions of the late 1980s and early 1990s and joined other states in beginning a period of strong growth that lasted through 2000. Rapid population growth continued during the 1990s and in combination with moderate inflation produced annual TABOR growth factors averaging about 6 percent from FYs 1994 through 2001.

Even with robust economic growth, Colorado did not incur its first TABOR surplus until FY 1997, the fourth year of its existence. Revenues exceeded the TABOR limit for five consecutive years, resulting in a total of more than \$3.2 billion in TABOR surpluses that were refunded to taxpayers. (The only year since then with a refund was FY 2005, bringing the cumulative total refunds to \$3.3 billion.) Permanent cuts in both income tax and sales tax rates were enacted in 1999 and 2000, which reduced the stream of TABOR revenues (and the TABOR surplus) about \$1 billion per year (Johnson et. al. 2004).

TABOR did not specify the refund procedures to be used in years of a TABOR surplus or require that those procedures be voter approved. Lawmakers put in place many different mechanisms to refund TABOR surpluses. In FYs 1997 and 1998, all of the surplus was returned to taxpayers in the form of a sales tax refund that averaged \$56 in FY 1997 and \$219 in FY 1998. In FY 1999, the sales tax refund averaged \$231, but nearly 15 percent of the total refund went to a much smaller number of taxpayers in two special classes: those claiming an earned income tax credit (EITC, with an average refund of \$130) and businesses that paid personal property tax (average refund of \$1,539).

The number of tax breaks grew to 17 by 2001, when 36 percent of the total refund was allocated to special classes including capital gains, charitable contributions, rural health care providers, pollution-control equipment, and farmers. The sales tax refund that went to 2.8 million taxpayers averaged \$206 in 2001. The EITC credit that 211,000 taxpayers qualified for averaged \$156. These refunds were small compared to the roughly \$5,000 average refund received by those qualifying for the capital gains credit and the very small number qualifying for the rural health provider credit. Under current law, many of these tax breaks aimed at special-interest groups have been scrapped, leaving only three refund mechanisms: the sales tax, earned income tax credit, and a temporary income tax rate reduction (Watkins 2010).

Colorado's economic boom ended in 2001 as the combination of the dot-com crash, the national recession, and the impact of the September 11th attack hit the state hard. Personal income growth fell from second-fastest in the nation in 2000 to 49th in 2002. State revenues subject to the TABOR limit fell by 12.6 percent in FY 2002 and declined an additional 1.1 percent in FY 2003 (Colorado Office of Strategic Planning and Budget 2004).

The Legislature responded to the fiscal crisis with three policies to offset the revenue shortfalls: transferring monies from cash and reserve funds to the general fund; increasing existing fees and establishing new ones; and cutting spending. In the absence of a rainy-day fund, the Legislature used \$1.1 billion in one-time transfers from cash and reserve funds to prop up the general fund. To deal with revenue shortfalls to cover immediate needs and arguably to mitigate the ratchet-down effect, government officials in Colorado also increasingly relied on fee increases.

Proponents point to Colorado's TABOR as the most effective TEL, citing the billions of dollars in TABOR-generated refunds to the state's taxpayers (see for example Schlomach 2010). But TABOR also created serious negative impacts on the fiscal situation and the quality of life in Colorado by forcing substantial cutbacks in the level of government services. While all government activities came under increased budget pressure, some programs, such as Medicaid and corrections, whose budgets are driven by forces outside the control of normal budgeting considerations—federal mandates, sentencing laws, etc.—were not seriously affected. This meant that other programs bore a disproportionate share of the cuts.

A further confounding factor has been the inherent conflict between the state's TABOR and Amendment 23, which was passed by the electorate in 2000. TABOR led to reductions in elementary and secondary (K-12) education funding that forced school districts to increase class sizes and to cut many programs and services. In response, Amendment 23 requires spending on K-12 education to increase on a per pupil basis by the rate of inflation plus 1 percent for 10 years and by the inflation rate thereafter. Even with the mitigating effects of Amendment 23, Colorado's state and local government noncapital funding for K-12 education as a proportion of personal income fell from 32nd in the nation in 1992 to 46th in 2008.

With mandated programs and K-12 education at least partially shielded from budget cuts, higher education, public health programs, and capital projects were the hardest hit of the major areas of government. For example, higher education funding per resident student dropped by 31 percent (after adjusting for inflation) between 1995 and 2005. As a result, in terms of higher education funding as a proportion of personal income, Colorado declined from 35th in 1992 to 48th among the 50 states by the mid-2000s. Similarly, state funding for the Department of Public Health and Environment dropped by one-third as a proportion of personal income from 1992 to 2004 (Lav and Williams 2010).

Referendum C

The base for determining the following year's TABOR limit was reduced when actual revenues fell below the allowable TABOR limit in FYs 2002 and 2003, as a result of the recession that began in FY 2001 and the slow recovery from the recession. Actual revenue in FY 2002 was \$366 million lower than the limit. Similarly, revenue in FY 2003 was \$584 million lower than the limit. Because of the ratchet-down effect, the TABOR base for FY 2004 was \$950 million below the FY 2002 base. Thus, even when revenues rebounded, the base to which the state applied the formula was permanently shifted down by nearly \$1 billion.

The Colorado economy began to improve by 2004, but the ratchet-down effect in TABOR prevented the use of the rising tax revenues to restore the budget cuts that had been implemented due to the sharp declines in revenues during prior years. In response to this damaging situation, a legislative referendum was developed and approved by the voters in 2005. This Referendum C allowed the state to retain and spend all revenues collected above the TABOR limit during FYs 2006 through 2010. After this five-year "timeout period," the referendum eliminated the ratchet-down effect by establishing a Referendum C "cap" defined as equal to the highest total state revenue for a fiscal year during the timeout period adjusted for inflation and population growth. In subsequent years, a given year's Referendum C cap is based on the previous year's cap rather

than the prior year's spending. Any revenue collected above the cap will be refunded to taxpayers via the mechanism defined by TABOR.

Any revenues retained on account of Referendum C—revenue above the TABOR limit but below the Referendum C cap—by state statute must be spent only on health care, education, firefighter/police retirement plans, and “strategic” transportation projects. The law allowed the first \$55 million in FY 2006, \$95 million in FY 2007, and \$125 million each year thereafter to be spent on any of these areas. Any additional retained revenue must be distributed equally to K-12 education, higher education, and health care (Watkins 2009). During the first three fiscal years after the passage of Referendum C, retained revenues averaged about \$1.2 billion per year. However, no revenues were retained during FY 2009 or FY 2010 as a result of declining revenues due to the recession that began during FY 2008. The Colorado Legislative Council forecasts that the state will realize substantial retained Referendum C revenues for its forecast period of FYs 2011 through 2013, but will remain below the cap so that no TABOR refunds are forecast through FY 2013 (Colorado Legislative Council 2010b).

The spending allowed by Referendum C slowed the decline in funding for public services but has not been sufficient to undo the combined impacts of TABOR and two recessions since 2000. As of 2009, Colorado still ranked 45th among the states in total expenditures as a proportion of personal income, 48th for K-12 education, 49th for Medicaid, 48th for higher education, and 48th for highways (Colorado Fiscal Policy Institute 2009). It is important to recognize the state would have faced significant budget shortfalls had Referendum C not been approved. Therefore, the Referendum C money that has been spent was not really “new” money in many instances—rather it maintained programs and prevented them from undergoing cuts. It is impossible to estimate these effects because it would require knowledge of what budgetary actions the state would have taken had Referendum C not been approved (Colorado Legislative Council 2010a).

TABOR and Economic Growth

Colorado experienced rapid growth in economic activity in the 1990s. While proponents of TABOR claimed that the strong growth resulted from the shrinking government sector, the nonpartisan Colorado Legislative Council (2003) found no evidence that TABOR played any role in the expansion or subsequent contraction of business activity in the state. After a detailed analysis of the historical development of Colorado's economy, the Center on Budget and Policy Priorities concluded that the state's prosperity in the 1990s was fueled by long-term factors that were in place before the passage of TABOR. These included public and private investment, a highly educated workforce, and an advantageous Rocky Mountain location (Lyons and Johnson 2006). Similarly, based on a detailed econometric analysis, McGuire and Rueben (2006) concluded that TABOR did not boost Colorado's economy. Colorado enjoyed economic success brought by the boom in the telecom industry and related expansions in information technology industries. Arguably, this rapid economic expansion masked any adverse effects from TABOR until the inevitable economic downturn occurred in 2001.

Colorado's economic growth, measured in terms of real per capita gross domestic product (GDP), exceeded the national average in the six years prior to the implementation of TABOR. Among 10 western states, Colorado ranked fourth. This relationship continued through the first eight years of TABOR—through the end of the economic cycle in 2001. However, in the last

economic cycle (from the end of the 2001 recession through the end of the latest recession in 2009) Colorado's economic performance slumped. Its growth rate was below the U.S. average and the state ranked near the bottom of the western states.

TABOR, of course, is not the only factor that might be contributing to the lowered economic performance in Colorado. However, the apparent delayed effect of TABOR on economic performance is easily explained: (1) the fiscal problems caused by TABOR cumulate over time, and (2) it can take years for reductions in funding for education and physical infrastructure—key economic development factors—to have an impact on economic growth given the long time that companies take to decide on expansions or relocations.

A TABOR-LIKE LIMITATION IN ARIZONA

Arizona seems an unlikely candidate for a TABOR-like limitation. By “TABOR-like” the reference is to the two primary provisions of Colorado's TABOR: (1) growth in revenues is limited to the sum of the percent change in population and the inflation rate; and (2) the limit is based on actual revenues in the prior year, resulting in a ratchet-down effect.

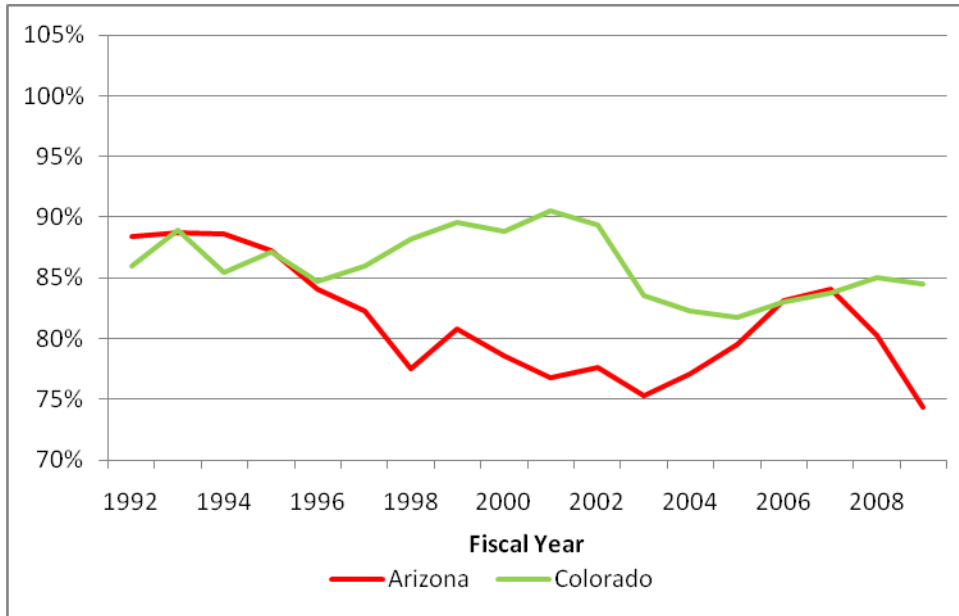
Arizona state government already has a TEL (Arizona Constitution, Article 9, Section 17) that limits total state appropriations to 7 percent of personal income. (The limit has increased over time to 7.41 percent to reflect the shift of certain public functions to state government from other governments.) Moreover, the overall tax burden in Arizona is already lower than in most states and lower than it was in the past. A series of state government tax cuts that began in the early 1990s resulted in a decline in Arizona's overall state and local government tax burden from 9.7 percent of per capita income in 1991 to 8.5 percent in 2008, ranking Arizona 41st among the 50 states (Rex 2009). Focusing on state government taxes since proposals for a TABOR-like rule in Arizona apply only to state government revenues, Arizona's relative tax burden is even lower.

State government own-source revenue (all revenue in all funds except that received from the federal government) is reported by the U.S. Census Bureau annually for each state. The figures for Arizona and Colorado are shown in Chart 1 expressed as a percentage of the national average. In FY 1993—the year preceding the implementation of TABOR—per capita revenues (the top graph) were nearly identical in Arizona and Colorado at 11 percent below the national average. Even with TABOR in place in Colorado, per capita revenues in Arizona fell to significantly below those in Colorado, except during the mid-2000s when the real estate boom in Arizona temporarily boosted state government revenues. In FY 2009, per capita revenues in Arizona were 12 percent less than in Colorado and ranked 47th among all states. Arizona's revenues fell so much because of a long series of significant tax reductions implemented during this period.

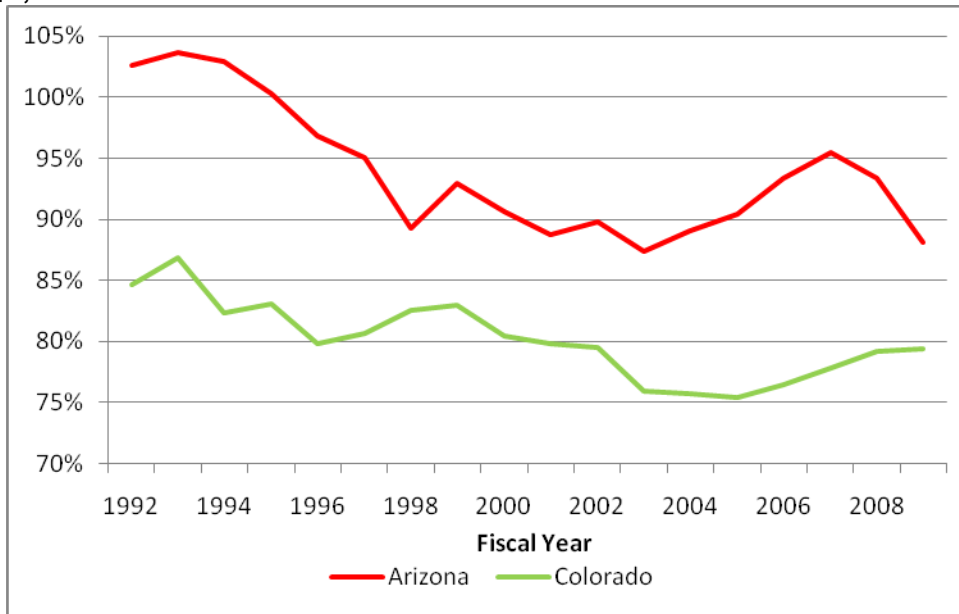
Instead of the per capita figure, the second graph of Chart 1 displays own-source revenue per \$1,000 of personal income, again expressed as a percentage of the national average. Per capita personal income in Arizona is substantially lower than in Colorado, causing Arizona's revenues relative to those in Colorado to appear higher rather than lower as in the per capita measure. (Historically, Arizona's per capita income was about 10 percent less than that in Colorado, but since the early 1990s the differential has fallen to 21 percent.) However, the trend over time is consistent with the per capita graph: as a percentage of the national average, Arizona's figure

**CHART 1
STATE GOVERNMENT OWN-SOURCE REVENUES**

PER CAPITA AS A PERCENTAGE OF THE NATIONAL AVERAGE



PER \$1,000 OF PERSONAL INCOME AS A PERCENTAGE OF THE NATIONAL AVERAGE



Source: U.S. Department of Commerce: Census Bureau (revenues and population) and Bureau of Economic Analysis (personal income).

dropped more than 15 percentage points between FYs 1993 and 2009, while the decline was only 8 percentage points in Colorado.

These conclusions are consistent with the findings of Edwards, Moore, and Kerpen (2003) who, in writing for the Cato Institute, noted that Arizona was one of the few states in the nation that did not reap a “windfall” in revenue collections in the 1990s.

The revenue for Arizona used in Chart 1 includes a voter-approved initiative in 2000 that increased the sales tax in order to increase education funding. If the revenue collections associated with this voter-led tax increase were subtracted from total own-source revenues, Arizona’s figures would be even lower.

Proposals

Almost every year since 2000, a concurrent resolution has been introduced in the Arizona Legislature for a constitutional change that would establish a TABOR-like rule in Arizona. Senate Concurrent Resolution (SCR) 1026, introduced in January 2011, is the latest version. In addition, Senate Bill (SB) 1408 and a similar bill (SB 1231) each could effectively create a TABOR-like rule in Arizona. House Bill (HB) 2707 would restrict revenues in a manner consistent with TABOR. A second resolution (SCR 1019) would restrict state government spending to a greater extent than is the case currently.

SB 1408

This bill would add a new section to statute that requires that the Joint Legislative Budget Committee, beginning in the year 2012, to compute and transmit “Truth in Spending” estimates for the following fiscal year in February of each year. Two estimates would be produced, one for the general fund and one for all state government appropriations from all sources. The estimates are to be calculated as the amount of current fiscal year appropriations adjusted for population growth and inflation.

While the bill does not prohibit appropriations beyond this limit, in any year that appropriations above the limit are recommended by the Legislature, a joint meeting of the House and Senate appropriations committees must be held in which a roll call vote will be taken. Further, the bill requires that the recommendation to exceed the truth-in-spending estimate be prominently publicized.

This bill was passed the Senate and sent to the House by March 3, 2011. If passed by the Legislature and not vetoed by the Governor, this bill would become law and would be in effect for the determination of the FY 2013 budget. If future legislatures are reluctant to exceed the truth-in-spending estimates due to fear of voter backlash or other reasons, then the bill effectively becomes a TABOR-like law, complete with a ratchet-down effect.

SB 1231

This bill also would add a new section to statute. Like SB 1408, this bill requires that the Joint Legislative Budget Committee publish early in each regular legislative session beginning with 2012 an appropriation limit equal to the amount of current fiscal year appropriations adjusted for population growth and inflation. SB 1231, however, is limited to the general fund. Exempted are

appropriations made for the repayment of outstanding debt incurred before June 30, 2011; and appropriations made to restore deferred payments from FY 2011 into the current fiscal year.

While SB 1231, like SB 1408, does not prohibit appropriations beyond this limit, in any year that appropriations above the limit are recommended, it requires that the Legislature also enact a separate concurrent resolution that acknowledges that the budget exceeds the limit and expresses the intent to authorize the expenditure of state general fund revenues in excess of that amount.

SB 1231 is narrower than SB 1408, applying only to the general fund and exempting certain appropriations from the limit. Otherwise, SBs 1231 and 1408 are two means to the same end, effectively differing only in the steps required of the Legislature to notify the public of a decision to exceed the limitation. Unless future legislatures choose to exceed the published limit, SB 1231 effectively becomes a TABOR-like law applicable to the general fund, complete with a ratchet-down effect. This bill was passed the Senate and sent to the House by March 3, 2011.

HB 2707

Labeled as the “Fiscal Accountability Act,” this bill would restrict general fund revenues. The limit would be the lesser of the prior year’s actual revenues or revenue limit, adjusted for inflation and population growth. Thus, the passage of this bill also would result in a ratchet-down effect. Unlike the other measures, inflation would be based on the consumer price index for the Phoenix metro area.

The bill also specifies that general fund appropriations cannot exceed the revenue limit. In the case of revenues in excess of the limit, the bill specifies the uses of those surpluses to be, in priority order, (1) repayment of general fund debt, (2) use in emergencies (a budget deficit would not constitute an emergency), (3) payments to the budget stabilization fund, and (4) refunds to those filing individual income tax returns.

SCR 1019

This resolution would amend the current TEL in the Arizona Constitution by lowering the existing appropriation limit of 7.41 percent to 7 percent in FY 2013 and to 6.4 percent in succeeding years. The amendment also would allow any resident to sue to enforce its provisions. To become effective, the resolution must be passed by the Legislature and receive an affirmative public vote at the next general election.

This is the least restrictive of the five bills and resolutions; it does not involve TABOR-like restrictions. However, the passage of this resolution would result in state spending being permanently below the historical norm. From FYs 1980 through 1995, appropriations exceeded 6.4 percent in all but one year. Since then, only in FYs 2006 and 2007 has the figure been above 6.4 percent. As of March 3, 2011, this resolution was awaiting a vote of the full Senate.

SCR 1026

The TEL mechanism proposed in SCR 1026 replaces the state’s current TEL and is similar in concept to Colorado’s TABOR but differs in some respects. The main features of the proposed budget rule, as amended, include:

- It repeals the existing appropriation limit and the ability to exceed the limit with a two-thirds legislative vote.
- Beginning in FY 2014, appropriated state revenues would be limited to a maximum of the previous year's appropriations adjusted by sum of the percentage changes in inflation and state population growth.
- Funds in excess of the limit may be appropriated for the budget stabilization fund (BSF). An upper limit for the BSF is established at 10 percent of the appropriations limit.
- Funds in excess of the limit may also be appropriated for a state emergency fund (SEF). An upper limit for the SEF is established at 5 percent.
- Funds in excess of the limit may be appropriated to "proportionally refund excess state revenues to taxpayers in the state."
- The limit may be suspended for one fiscal year in either of two ways:
 - With a two-third vote of the Legislature and approval of the governor, an exception can be placed on the ballot of either a regular or special statewide election, but the public vote must occur prior to the passage of the budget. The following year's limit reverts to the appropriation limit determined by formula rather than that passed by public vote. If an affirmative public vote to exceed the limit occurs three years in a row, then the limit is reset based on the most recent publicly approved appropriation.
 - If an "emergency" is declared, a three-quarters vote of the Legislature and approval of the governor creates an exception, but appropriations above the limit can only be used for extraordinary expenses that could not be foreseen. Budget shortfalls are explicitly excluded as a reason for an emergency.
- The resolution allows any resident taxpayer to sue to enforce its provisions.

As of March 3, 2011, this resolution had received a "do pass with amendments" from the full Senate and was awaiting the final vote.

Like Colorado's TABOR, SCR 1026 ties annual increases in revenues that can be appropriated to the sum of inflation and population growth. And like Colorado's TABOR mechanism prior to the approval of referendum C, the base for calculation of the current year's revenue limit is defined as actual appropriated revenues in the previous year rather than the previous year's limit—Arizona's proposed rule would incorporate the so-called "ratchet-down effect" that was identified as a weakness of Colorado's TABOR and corrected as part of Referendum C.

The proposed Arizona TABOR rule allows allocation of collections above the limit to be deposited in the BSF, which is designed to smooth out cyclical fluctuations in the state's general fund revenues by building up the BSF in good economic times when revenue surpluses exist and then drawing out monies to minimize budget cuts during recessions when revenues decline. The concept of putting revenues in excess of the limit in the BSF rather than mandating that all surplus revenues must be rebated to taxpayers in the next year as in Colorado's TABOR is a fiscally sound idea.

However, in each of the two recessions that have occurred since the creation of Arizona's BSF, the available funding was not adequate to offset the declines in revenue during the recession and to prevent significant spending reductions. It is beyond the scope of this discussion of tax and expenditure limits to go into a detailed discussion of the weaknesses of the current BSF statute (see Charney 2009), but significant changes are needed to Arizona's BSF before a link between

SCR 1026 and the state's "rainy-day" fund would be an effective tool to reduce the impact of economic cycles on the state budget.

Problems Created by a TABOR-Like Approach

Advocates argue that a TABOR rule is needed to keep the government sector and tax burdens from growing over time. They contend that it simply forces government to "live within its means" like the rest of us. While it may seem a reasonable approach to limit revenue growth by a formula that purportedly would allow government to maintain the current level of services and provides adjustments for inflation and increases in the population to be served, imposition of a TABOR-like rule actually forces the government sector as a share of the economy to shrink over time, as discussed earlier for Colorado.

There are several reasons why a limit based on an inflation-plus-population-growth formula leads to reductions in revenues and thus to public services:

- **Overall population growth does not reflect changes in many subpopulations served by government programs.** The subpopulations served by government programs grow at different rates than the growth rate of total state population used in the formula. For example, over the 1993-to-2010 period (beginning with the base year for Colorado's TABOR), the state prison population in Arizona grew 138 percent and the number of AHCCCS (Arizona's Medicaid program) beneficiaries increased 192 percent while the state's population grew by 81 percent.
- **The general rate of inflation does not reflect price changes affecting many public programs.** While technological change and productivity gains have made many goods cheaper to produce, these economic factors do not have the same cost-cutting effects on services, including the services provided by government. Many of these services rely on trained professionals, such as teachers and physicians, and the substitution of capital equipment for labor that raised productivity in many industries is less successful. In fact, technological change is one of the major factors that are increasing the cost of medical care. Thus, changes in the cost of providing public services are not adequately measured by the overall inflation rate, so that funding increases governed by a TABOR-like rule are not sufficient to maintain existing service levels. While the overall rate of inflation over the 1993-2010 period totaled 41 percent (based on the GDP implicit price deflator specified in SCR 1026), medical care prices rose 93 percent (based on the medical care component of the consumer price index) and the cost of inputs for higher educational institutions increased 78 percent (based on the Higher Education Price Index produced by the Commonfund Institute).
- **A TABOR-like rule does not allow for funding new programs or changes in existing ones that may result from changes in state law, federal mandates, or legal decisions.** AHCCCS and the School Facilities Board (the state agency that funds school construction) are two examples of state programs that have added hundreds of millions of dollars to the state budget. Similarly, formula-based budgeting does not allow the state to adjust to federal mandates that require states to spend more, as with the federal No Child Left Behind or Medicaid programs.
- **Setting the state budget limit to a fixed amount with adjustments only for increases in total population and the overall rate of inflation does not allow for changes in technology and society over time.** Had such a TABOR rule been adopted as part of the

Arizona Constitution at statehood in 1912, then the standards of that time for education (small shares of children finishing high school and very few attending college), transportation (dirt roads), technology (no computers), etc. would be all that Arizona could afford in the 21st century. Restricting public sector funds to levels that do not allow it to respond to technological/societal changes over time is particularly ironic since many of the technological improvements and other changes that have transformed the small, primitive territory of a century ago to the Arizona of today were provided by government programs and paid for with public funds.

The difference between inflation plus population growth and total economic growth—as measured by the state’s gross domestic product or personal income—has been approximately 1.7 percent per year over the last four decades. This 1.7 percent per year represents the productivity growth in Arizona’s economy. This productivity growth is the major factor contributing to increases in wage rates, household incomes, and living standards for Arizona’s residents. When productivity rises and results in gains in inflation-adjusted per capita income, government spending is able to increase by more than inflation and population growth without the government sector’s share of the overall economy growing and without tax increases or a growing tax burden. This is the fundamental concept behind the current Arizona TEL, which limits appropriations to a percentage of state personal income.

Most states with TELs have similar provisions to the existing TEL in Arizona, though several states have TELs in which the growth of revenues or spending is tied to the growth in state personal income rather than to the level of personal income. A budget limit that is linked to the size or growth of the state’s economy provides for the construction of public infrastructure and allows government programs to adapt to changes in technology and to respond to increasing societal demand for public services. A TABOR-like rule that freezes real per capita government spending, on the other hand, would not even maintain current service levels over time.

The negative effects of a budget rule based on population growth and inflation are amplified when the limit is tied to actual appropriations of the previous year. This feature, which is incorporated in SCR 1026, SBs 1231 and 1408, and HB 2707, causes the so-called ratchet-down effect when revenue declines during economic downturns push actual revenues below the limit and lead to permanent reductions in the size of the public sector. With each economic cycle, the public sector shrinks in size faster than it would without the ratchet effect.

Due to the significant reductions in revenues and expenditures over the last three years, SCR 1026, SBs 1231 and 1408, and HB 2707 all would be implemented based on historically low levels of state revenues/appropriations. They would lock in the very low spending that resulted from revenue drops during the worst recession in 70 years and from permanent tax cuts based on temporary revenue surpluses that resulted in a more than \$2 billion structural deficit.

Revenue Implications of a TABOR-Like Rule

TABOR is championed by proponents as a measure that keeps the government from growing. However, the following arithmetic demonstrates that application of TABOR-like rules—even without a ratchet-down effect—actually leads to substantial reductions in the share of the aggregate economy that comprises the public sector. These illustrations are directly applicable to

the Arizona economy, but the basic arithmetic conclusions are generally applicable to all economies.

For those with a taste for shrinking government, TABOR is a savory recipe. However, a shrinking government means reduced funding for education, infrastructure, and a host of other services used by most residents. With labor force quality and infrastructure the most important economic development factors, reduced public funding for education and infrastructure will cause the state's economic competitiveness to steadily fall over time.

While Colorado's TABOR applies to state and local governments, the proposals in Arizona (SCR 1026, SB 1231, SB 1408, and HB 2707) would impact only state government revenues. Therefore the following analyses focus only on state government revenues and appropriations. Though the general fund is the focus of most state budget discussions in Arizona, SCR 1026 and SB 1408 apply to all state government appropriations—the sum of the general fund and a large number of specialized funds. Thus, the following analyses focus on total revenues and appropriations.

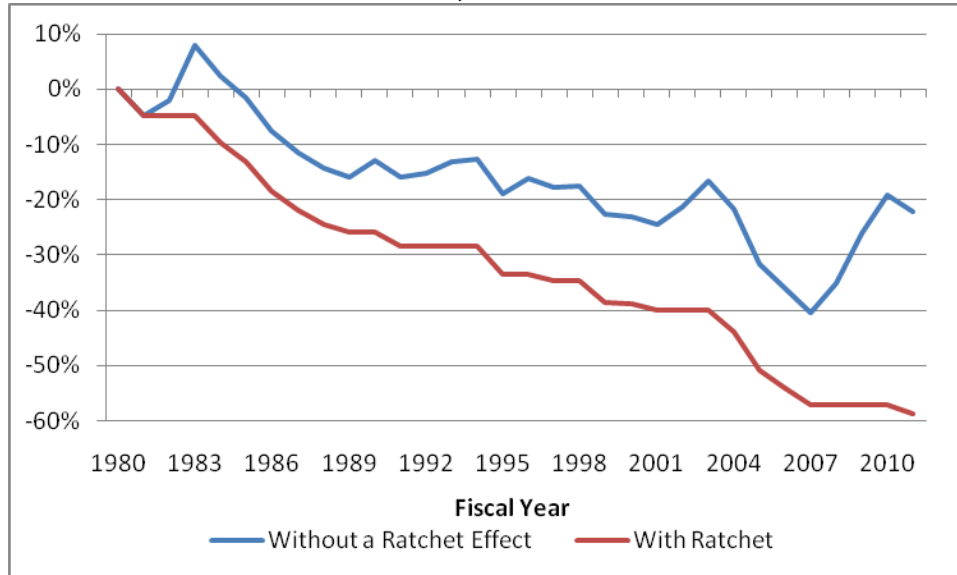
Simulations of what would have occurred to revenues and appropriations in Arizona had a TABOR-like provision been in effect in the past are presented using two measures. Arizona's existing TEL is based on a specific definition of appropriations that adds and subtracts certain items from the total appropriation figure reported in the appropriation reports. Since SCR 1026 uses the same definition, the time series of appropriations subject to the TEL and calculated by the Arizona Joint Legislative Budget Committee is used as one measure. Since data using this definition are not available for other states, or for Arizona prior to FY 1980, additional simulations use "own-source revenue" that is compiled for all 50 states by the U.S. Census Bureau. Own-source revenue excludes federal funds but otherwise is a comprehensive measure of state government revenues.

Using Actual Appropriations

Arizona's existing TEL went into effect for FY 1981. This is the starting point used for the simulation using the JLBC appropriations data. Two series were simulated. One is based on the language in SCR 1026, which would result in a ratchet-down effect. To calculate the ratchet effect, in any year in which the actual percent change in appropriations was less than the percent change allowed by the formula, the actual percent change was used to set the limit for the following year. The other series assumes that the formula is tied to the prior year's formula-generated limit rather than to actual appropriations, thereby eliminating the ratchet-down effect.

As seen in Chart 2, the effects of tying appropriation growth to inflation plus population growth start small but grow substantially over time—even in the case of no ratchet effect. The FY 2011 budget under the inflation plus population growth provision would have been 22 percent less than the actual budget, which already reflects very substantial spending reductions made over the last three years. The budget would have been 59 percent less with the ratchet-down effect. Total appropriations (not just those in the general fund) in fiscal year 2011 would have been \$2.8 billion less than the actual \$12.8 billion without a ratchet effect and \$7.5 billion less with a ratchet effect.

CHART 2
APPROPRIATIONS IN ARIZONA UNDER A TABOR-LIKE RULE COMPARED TO ACTUAL APPROPRIATIONS, BEGINNING IN FISCAL YEAR 1981



Source: Calculated from Arizona Joint Legislative Budget Committee (actual appropriations) and U.S. Department of Commerce: Census Bureau (population) and Bureau of Economic Analysis (inflation).

Actual appropriations in FY 1980 were 6.96 percent of personal income. In FY 2011, the actual share was down to 5.74 percent. The share under an inflation plus population growth provision would have been only 4.5 percent without a ratchet effect and just 2.4 percent including ratcheting.

These substantial effects that occurred over three decades would continue to grow in magnitude over a longer time span. The long-run negative effect of an inflation plus population growth rule was stated succinctly by Rep. Brad Young, chairman of Colorado’s Legislative Budget Committee: “There is a hole in the bottom of the boat—that is the TABOR spending limit. It works for a little while, but you go out in the future and you sink the boat.” (*Colorado Springs Gazette* 2004).

With a ratchet effect in place, the differential between actual appropriations and those allowed by an inflation and population growth formula continually grows. Without a ratchet effect, the differential, while generally becoming larger over time, fluctuates from year to year. The differential rapidly becomes larger during economic expansions, as during FYs 2004 through 2007, when surges in revenue allow appropriations to increase relatively rapidly. In contrast, during recessions, as in FYs 2002 and 2003 and again from FYs 2008 through 2010, the differential narrows due to a plunge in revenue collections.

Using Own-Source Revenues

The following simulation results are based on the U.S. Census Bureau’s own-source revenue series to allow comparisons with other states. The end point of the simulations is FY 2009—the most recent year for which these data are currently available. The first set of simulations uses the

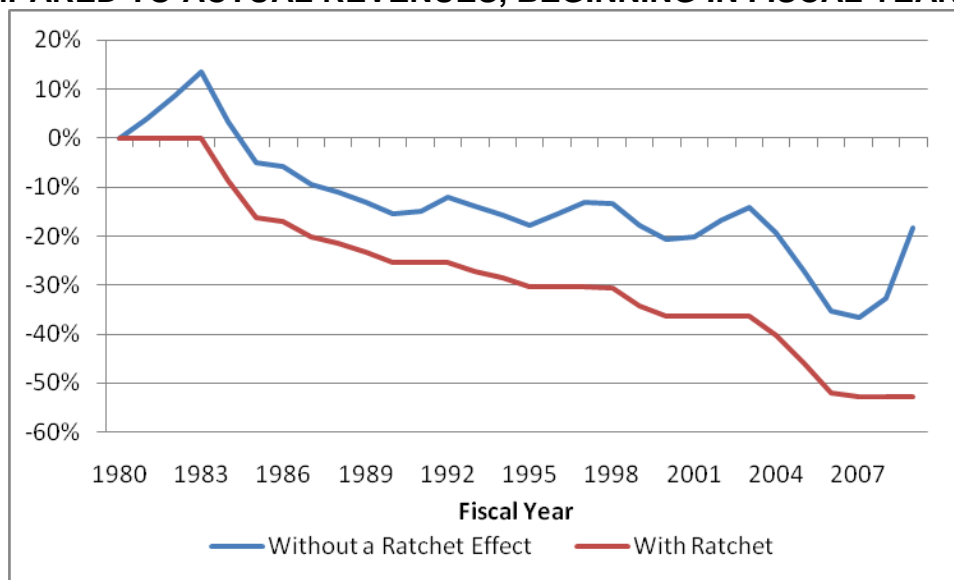
same FY 1981 starting point as in the simulations discussed in the previous section. As with the simulation of actual appropriations, two series—one with a ratchet-down effect and one without—were simulated.

As seen in Chart 3, even in the case of no ratchet effect, the FY 2009 budget under the inflation plus population growth provision would have been 18 percent less than the actual budget, which already reflects very substantial spending reductions made over the last three years. The effect is almost three times as large considering the ratchet effect. Appropriations in FY 2009 would have been \$2.9 billion less than the actual \$15.9 billion without a ratchet effect and \$8.4 billion less—less than one half of actual own-source revenues—with a ratchet effect.

Arizona’s own-source revenues in FY 1980 were 8.3 percent of personal income. In FY 2009, the actual share was down to 7.2 percent. The share under the proposed limit would have been only 5.9 percent without a ratchet effect and just 3.4 percent with ratcheting.

In FY 1980, Arizona’s total own-source state revenues were equal to the national average. By FY 2009, the state’s actual own-source revenue collections were 26 percent below the national average and ranked 47th on a per capita basis and 40th as a share of personal income. But if Arizona had adopted beginning in FY 1981 an inflation plus population growth budget limitation similar to the mechanism proposed in SCR 1026 (which would result in ratchet-down effects), the limit on appropriations from own-source revenues would have been 65 percent below the national average and ranked 50th on both a per capita basis and as a share of personal income. Arizona’s figure would have been more than 40 percent below the next lowest state. Even if the proposed budget rule was modified to eliminate a ratchet-down effect, the limit on appropriations

**CHART 3
OWN-SOURCE REVENUES IN ARIZONA UNDER A TABOR-LIKE RULE
COMPARED TO ACTUAL REVENUES, BEGINNING IN FISCAL YEAR 1981**



Source: Calculated from the U.S. Department of Commerce: Census Bureau (own-source revenues and population) and Bureau of Economic Analysis (inflation).

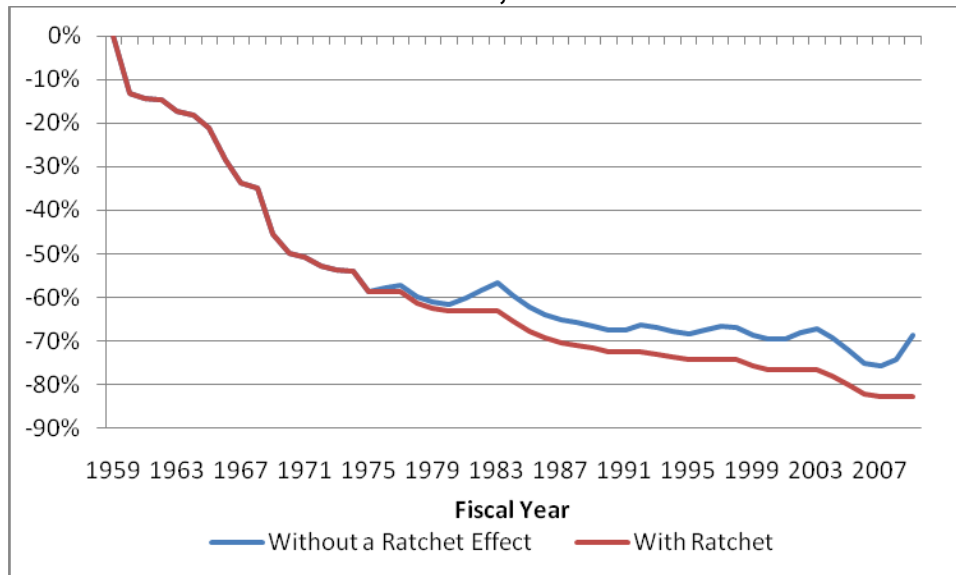
from own-source revenues would have been 39 percent below the national average and ranked 50th on both a per capita basis and as a share of personal income.

The negative consequences that a TABOR-like rule would have on the public sector become very clear when examined over a longer time horizon. Simple illustrations using historical Arizona data demonstrate how over time an inflation plus population growth rule would result in drastically shrinking the relative size of the public sector.

The effects of a TABOR-like rule show up over longer time periods simply because of the arithmetic compounding of minor differences in growth rates. This can be demonstrated dramatically by assuming that an inflation plus population growth rule had been in effect in Arizona for 50 years and looking at what the effects would have been between FYs 1959 and 2009 (see Chart 4).

In FY 1959, per capita own-source state government revenue was \$123 per Arizona resident (the equivalent of \$739 in 2009 dollars). With a budget limit mechanism similar to that proposed by SCR 1026, which includes ratchet-down effects, by FY 2009 the limit on own-source revenue would have been only slightly more than one-sixth of actual FY 2009 revenues. In fact, on a real per capita basis the FY 2009 limit would actually be 42 percent lower than the FY 1959 figure. In terms of share of state personal income, the limit for FY 2009 would have been 84 percent below the national average and 79 percent below the figure for Florida, the state currently ranked 50th.

CHART 4
OWN-SOURCE REVENUES IN ARIZONA UNDER A TABOR-LIKE RULE
COMPARED TO ACTUAL REVENUES, BEGINNING IN FISCAL YEAR 1960



Source: Calculated from the U.S. Department of Commerce: Census Bureau (own-source revenues and population) and Bureau of Economic Analysis (inflation).

Implementation in FY 1960 of an inflation plus population growth rule including the ratchet-down effect would have resulted in the state government's share of the Arizona economy shrinking from 6.5 percent of personal income in 1959 to 1.3 percent in 2009, less than one-sixth of the national average of 8.1 percent. The limit for total appropriated revenues in FY 2009 would have been only \$2.8 billion. For comparison, actual state government expenditures for elementary and secondary education alone in FY 2009 was \$4.2 billion and Arizona already ranks near the bottom of the fifty states on per pupil K-12 expenditures.

Even without ratchet-down effects considered, by FY 2009 the limit on own-source revenue would have been less than one-third of the actual figure. In terms of share of state personal income, the limit for FY 2009 would be 69 percent below the national average and 62 percent below the figure for the state currently ranked lowest. Implementation of an inflation plus population growth rule in FY 1960 without ratchet-down effects still would have resulted in the state government's share of the Arizona economy shrinking from 6.5 percent of personal income in 1959 to 2.2 percent in 2009, barely more than one-quarter of the national average.

FISCAL ALTERNATIVES FOR ARIZONA

Arizona's fiscal system has various shortcomings. However, a TABOR-like rule does little to resolve these issues and creates serious additional problems.

The revenue system is a significant concern due to its narrow and outdated base. The result is that revenue collections are highly cyclical and do not keep pace with economic growth. The Arizona Town Hall made a number of important recommendations regarding the revenue system in November 2009: <http://www.aztownhall.org/95>. The background report prepared for the Arizona Town Hall, *Riding the Fiscal Roller Coaster: Government Revenue in Arizona*, is available from the same website.

Subsequent to the Town Hall, a plan to create jobs, improve the state's economic competitiveness, and balance the budget was prepared: *Roadmap to Arizona's Economic Recovery: A Package to Create Jobs, Improve the State's Economic Competitiveness, and Balance the Budget*, available at <http://economist.asu.edu/public-finance>. A report prepared for the Arizona School Boards Association (accessible from the same website) went beyond the revenue system to examine the entire fiscal system. Other than the revenue system, of most significance is the need to strengthen the state's budget stabilization fund and to force a link between changes in revenues and changes in expenditures.

Most recently, a proposal included in *The Executive Budget* issued by the office of Governor Brewer in January 2011 (<http://www.ospb.state.az.us/documents/2011/FY2012-ExecutiveBudget-Summary.pdf>) addresses fiscal issues other than those of the revenue system.

Governor's Proposal

In the latest annual Executive Budget, budget reform is addressed in a manner very different from a TABOR-like provision. The Governor's proposal has four key planks: an annual limit on the percentage increase in spending, guidance on how to handle revenues greater than the expenditure limit, bolstering the budget stabilization fund, and strengthening executive branch powers regarding appropriations.

The Governor's Office acknowledges that the budget crisis in part results from the use of one-time revenue surpluses during years of strong economic expansion to make permanent tax reductions and permanent spending increases. To prevent a temporary revenue surplus in the future from resulting in a permanent spending increase, the Governor's proposal includes generally capping the level of expenditures to those in the prior year increased by the average revenue growth rate of the last 10 years.

To avoid the negative effects of the recent long and deep recession from unduly affecting the 10-year average revenue growth, the proposal limits the loss of revenue in any year to 2 percent (actual decreases in ongoing general fund revenues were 9 percent in FY 2008, 21 percent in FY 2009, and 10 percent in FY 2010). The Governor's proposal allows the spending cap to be adjusted for voter-approved revenue increases, changes in federal law, and court-mandated expenditures. In addition, the cap would be systematically rebased "to remain relevant."

The Governor's proposal also lays out a priority system for the use of excess revenues (revenue growth in a year in excess of the 10-year average) that occur in years of strong economic expansion:

1. Debt reduction
2. Rollover reduction
3. Budget stabilization fund deposits
4. One-time capital projects
5. Tax rebates

Also included in the Governor's proposal are three constitutional reforms. The first would place the operation of the BSF under constitutional controls that ensure that deposits to and withdrawals from the BSF are made according to formula and that inappropriate uses of the BSF are not allowed. In addition, the current cap of 7 percent would be increased to 15 percent, as in the original law passed in 1990.

The second proposed constitutional change would allow the Governor to quickly reduce appropriations when it becomes apparent that revenues for the current fiscal year will fall short of authorized appropriations. Third, in addition to the line-item veto of the legislatively passed budget that is already allowed, the Governor would be able to line-item reduce an appropriation—that is, rather than entirely accepting or rejecting an appropriation, a figure in between the two extremes could be selected.

Evaluation of Governor's Proposal

The Governor's proposal to strengthen the BSF and to prioritize the use of budget surpluses are fiscally sound ideas that would help resolve some of Arizona's fiscal problems. However, the proposal falls short of solving the identified problem of the use of one-time revenue surpluses to make permanent tax reductions and permanent spending increases. Its provisions for a spending limitation introduce significant problems, though not as severe as those resulting from a TABOR-like provision.

Though permanent tax cuts are not on the proposed list of uses of excess revenues, nothing in the proposal prevents the Legislature from making further permanent tax reductions. In fact, the

Governor has just called a special legislative session to reduce business tax burdens that will cost the state more than \$500 million in revenues once fully implemented. Over the last two decades, permanent tax reductions have created much greater problems than have permanent spending increases; tax cuts since the early 1990s have cumulated to nearly \$3 billion after adjusting for inflation and the state's population growth.

The proposed spending limit is intended to be a statutory change. To be effective, it needs to be included in the Arizona Constitution for the same reasons that the Governor proposes making the operation of the BSF constitutional.

The mechanism specified to determine the spending limit—a 10-year average revenue growth rate—has deficiencies. Though the proposed flexibility in the limit lessens these concerns somewhat, significant issues remain:

- The proposed flexibility in the spending limit does not include the case of a revenue increase or decrease passed by the Legislature. Various tax reductions that lowered revenues were passed by the Legislature during the last 10 years, reducing the 10-year average growth rate.
- The proposal makes no mention of allowing expenditures to recover from the deep cuts implemented over the last three years in order to balance the budget. Thus, these spending reductions would be made permanent.
- Revenue growth depends in part on both inflation and population growth. If the experience over the last 10 years is not representative of the current period, then the 10-year average is a poor choice for determining future expenditures.
- Revenues over time have not increased at the pace of economic growth due to the existing revenue system's shortcomings (including its narrow base and outdated tax code). Again, historical revenue collections are a poor basis for determining future spending limitations.
- Revenue growth fluctuates widely over an economic cycle. Rather than a 10-year average, it would be better to use the average of growth from the same point in the prior economic cycle (or, for a longer period, the same point of the cycle before that) through the latest year of the current economic cycle.

Although there are serious issues with the Governor's proposed spending limit that should be addressed, it would be far less damaging to public services and to the Arizona economy than the three TABOR-like measures introduced in the Legislature. Those measures create a rigid rule that would result in a huge decrease in the quality and quantity of public services over time. In contrast, the Governor's proposal allows some flexibility and revenues would not fall dramatically over time.

Recommendations

As an alternative to the provisions of the Governor's proposal regarding a spending limit, the existing constitutional spending limit is adequate to protect against increases in the size of state government. However, since spending has been so far below the limit for many years, the existing limit does not preclude permanent increases to spending from being made without an equivalent increase in revenues.

The most effective solution is for the Constitution to prohibit any permanent increase in spending from being made without an accompanying permanent increase in revenues of an equal magnitude (or equivalent decreases in other spending categories). Likewise, no permanent reduction to tax rates or bases would be allowed without corresponding reductions in spending of an equal magnitude (or equivalent increases in other revenues).

One exception would need to be made to these prohibitions. Spending would be allowed to rise without a permanent revenue increase (or offsetting spending reductions in other categories) following a recession during which spending reductions were made in order to meet the constitutional requirement to balance the budget. With an adequate BSF and with changes to the revenue system proposed in the reports cited above, instances of needing to use this exception would be very infrequent.

If an annual spending growth limit is deemed essential, it should be tied to the average change in inflation-adjusted per capita personal income over the latest economic cycle (or two cycles), adjusted for expected inflation and population growth over the next year. This would be more in line with the existing constitutional appropriation limit that is tied to personal income. Under this limit, government spending could increase no faster than the pace of the overall economy; state government would remain a constant share of the economy; and the tax burden would not rise.

Because current spending is far below historical levels due to the sharp recessionary-caused declines in revenues in recent years and to the structural deficit, current spending is an unrepresentative point for starting a new expenditure limit. Instead, the spending limit should be tied to FY 2008 adjusted for subsequent inflation, population growth, and real per capita personal income growth.

A fundamental problem with any attempt to “rein in spending” by imposing a TABOR-like rule or using a revenue growth rule such as proposed by the Governor is that such efforts fail to recognize that it is the Legislature’s responsibility to provide funding for certain public-sector functions that are explicitly discussed in the Arizona Constitution. In addition, the Legislature must follow federal law, which includes demands that state and local governments provide various public services.

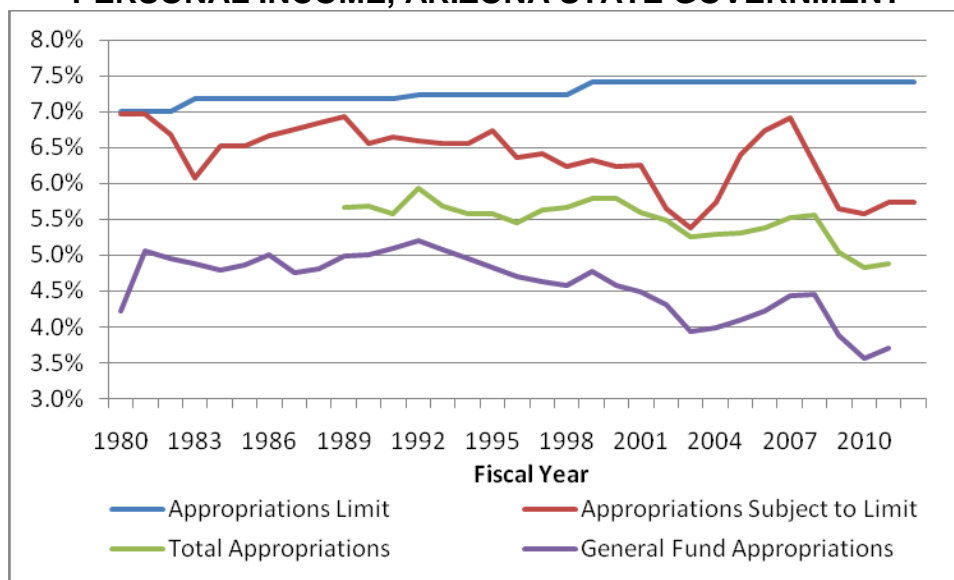
According to the Arizona Constitution, among other services, state government must provide “correctional and penal institutions, and institutions for the benefit of persons who have mental or physical disabilities” (Article XXII, Section 15). In particular, Section 10 of Article XI specifies that “... the legislature shall make such appropriations, to be met by taxation, as shall insure the proper maintenance of all state educational institutions, and shall make such special appropriations as shall provide for their development and improvement.”

The proponents of TABOR-like provisions implicitly assume that there is some underlying tendency for lawmakers to increase spending. Arizona’s existing appropriations limit already protects from state government becoming an ever-growing share of the economy. In reality, state government spending has decreased since the limit was put into the state’s Constitution (see Chart 5). Instead, the state’s fiscal problems largely result from the repeated reduction in tax

bases and rates over the last two decades that have resulted in significant decreases in revenues (see Chart 6).

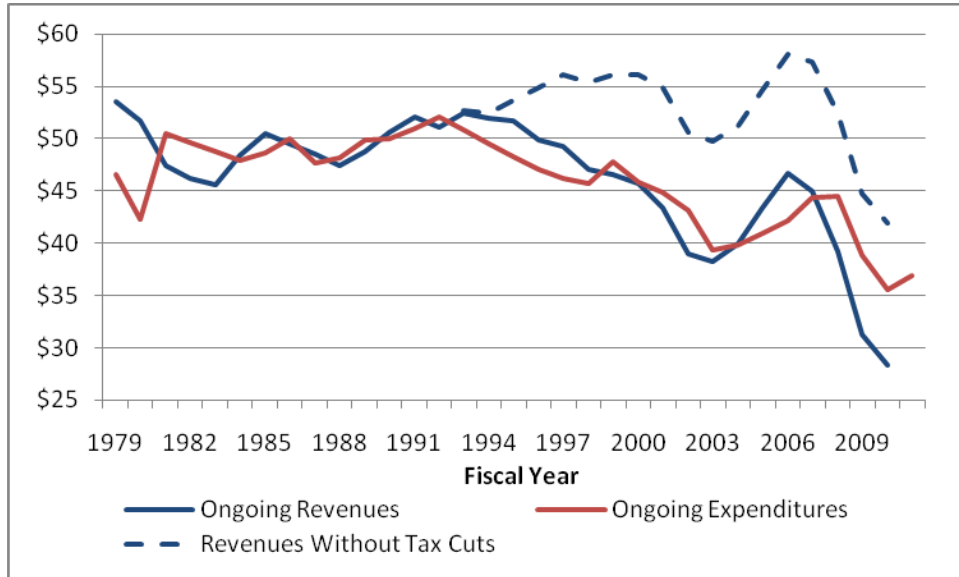
The solution to the budget imbalances is not to impose formula-driven expenditure rules. Instead, the Legislature needs to ask Arizonans what public services (in addition to those specified in the Constitution or in federal law) are desired. Then, the public must be asked to fully pay for public services. Asking people to pay for the public services they receive will be an effective deterrent to excessive spending. Indeed, the problem today is that there is often a complete disconnect between demands and willingness to pay for the costs of public service delivery.

**CHART 5
 APPROPRIATIONS AND APPROPRIATIONS LIMIT AS A PERCENTAGE OF
 PERSONAL INCOME, ARIZONA STATE GOVERNMENT**



Source: Arizona Joint Legislative Budget Committee.

**CHART 6
REVENUES AND EXPENDITURES PER \$1,000 OF PERSONAL INCOME,
ARIZONA STATE GOVERNMENT GENERAL FUND**



Source: Arizona Joint Legislative Budget Committee (revenues and expenditures) and the U.S. Department of Commerce, Bureau of Economic Analysis (personal income).

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