LEGISLATIVE BUDGET BOARD

Constitutional Limitations on Spending

PRESENTED TO THE HOUSE APPROPRIATIONS COMMITTEE

URSULA PARKS, LEGISLATIVE BUDGET BOARD

MAY 18, 2016

Constitutional Spending Limits

The Texas Constitution includes four limitations on state spending:

- Debt limit
- Welfare spending limit
- Pay-as-you-go limit
- Limit on the growth of certain appropriations (a.k.a. spending limit)

The 2016-17 budget is within all of these limits

Debt Limit and Welfare Spending Limit

Debt Limit

- Texas Constitution, Article III, Section 49 (j)
- Limits the authorization of additional state debt if in any fiscal year the resulting annual debt service payable from the unrestricted General Revenue Fund exceeds 5 percent of the average annual unrestricted General Revenue Funds for the previous three years
- Approved by voters November 4th, 1997

Welfare Spending Limit

- Texas Constitution, Article III, Section 51-a
- Provides that the state funds appropriated for assistance grants on behalf of needy dependent children and their caretakers (i.e., Temporary Assistance for Needy Families [TANF]) shall not exceed 1 percent of the state budget in any biennium
- Approved by voters August 25, 1945

Pay-as-You-Go Limit

- Texas Constitution, Article III, Section 49a
- Requires that all appropriations are within available revenue in the fund from which the appropriations are made
- Approved by voters on November 3rd, 1942

What Appropriations are Limited by Pay-as-You-Go?

The Comptroller of Public Accounts is constitutionally required to certify whether appropriations are within estimates of available revenue. However, the commonly used term “the pay-as-you-go limit” only applies to General Revenue appropriations. Revenue available to certify GR appropriations under the pay-as-you-go limit include the beginning balance in the General Revenue Fund, collections deposited to the General Revenue Fund (less GR deposits reserved for transfer to the Economic Stabilization Fund and the State Highway Fund), and as a result of funds consolidation, unappropriated General Revenue–Dedicated account balances available for certification.

- Due to federal, constitutional or statutory provisions, certain accounts in General Revenue do not count against the pay-as-you-go limit
- General Revenue-Dedicated appropriations reduce the overall amount of General Revenue-Dedicated balances counted towards certification
- While certain Other Funds are estimated in the Biennial Revenue Estimate, as they are not General Revenue, they do not count against pay- as-you-go. Major such funds include:
    - Economic Stabilization Fund
    - State Highway Fund
    - Mobility Fund
    - Property Tax Relief Fund

Spending Limit: Constitution

- Texas Constitution, Article VIII, Section 22
- Limits the rate of growth in appropriations from one biennium to the next
- Approved by voters on November 7th, 1978

  (a) In no biennium shall the rate of growth of appropriations from ***state tax revenues not dedicated by this constitution exceed the estimated rate of growth of the state's economy****. The legislature shall provide by general law procedures to implement this section.*

Spending Limit: Statute

Government Code Chapter 316

- Provides the general law referenced in the Constitution, and directs the LBB to establish:
  - The current biennium’s level of appropriations subject to the limit;
  - Estimated rate of growth in the state’s economy from one biennium to the next; and
  - The subsequent biennium’s limit on appropriations subject to the limit.
- It also requires that the rate of growth be defined as the growth in personal income

What Appropriations are Controlled by the Spending Limit?

Only appropriations funded with tax revenue not dedicated by the Constitution are subject to the limit

- Sales tax
- Motor vehicle sales tax
- Franchise tax
- Cigarette and tobacco taxes

Appropriations funded with tax revenues are not subject to the limit if the Constitution requires the tax revenues to be used for a certain purpose

- Motor fuel taxes are constitutionally dedicated for transportation and education
- 25 percent of oil and natural gas production taxes are constitutionally dedicated for education

Appropriations funded with non-tax revenues are not subject to the limit

- Fee, fines, penalties
- Interest and investment income
- Lottery proceeds

LBB Adoption of Growth Rate

- The Legislative Budget Board meets on or before December 1 every year before session to adopt an estimated rate of growth in the Texas economy and the resulting spending limit for the next legislative session
- Forecasted growth rates are provided by well known state and national economic forecasters to LBB staff and presented to the Legislative Budget Board
- The Legislative Budget Board is allowed to adopt any forecasted growth rate and is not limited to any of the provided growth rates

Does the Limit Ever Change?

The adopted rate of growth does not change over the biennium. The base to which it is applies may change, based both on changes to revenue and changes to appropriation levels. For example:

- Changes to actual appropriations for the base biennium affect not only spending limit capacity for that current biennium but also the limit itself for the subsequent (adopted) biennium; and
- Changes to revenues affecting the “mix” of revenue supporting appropriations can shift spending limit capacity.

Tax Changes and Appropriations

- Changes in state or local revenue do not by themselves affect state appropriations
- In most cases, a change to a tax simply reduces or increases available revenue and has no direct affect on appropriations
- However, if a tax change affects state funding formulas, statute could trigger changes to appropriation amounts and methods of finance to fully fund the program

Spending Limit Implications:
Property Tax and Franchise Tax Reductions

The Foundation School Program is, per the Texas Education Code, an entitlement program funded with a mix of state and local funds. To the extent local funds decrease for any reason, state appropriations are increased in order to fund the entitlement. Similarly, a reduction to a non-Foundation School Fund state method of finance for the entitlement program, for any reason, will result in a commensurate increase to appropriations from the Foundation School Fund (GR).

Local Property Tax Cut

- Under current law, the Foundation School Fund (GR) is appropriated to replace any lost local revenue as a result of a local property tax cut
- Shifting funding from local funds to General Revenue funds will create additional General Revenue appropriations subject to the spending limit

Franchise Tax Cut

- Both the Foundation School Fund (GR) and the Property Tax Relief Fund (Other Funds) are subject to the constitutional spending limit
- Swapping one for the other (for example, reducing franchise tax deposits in the Property Tax Relief Fund and replacing that revenue with GR) will not materially change how much General Revenue may be appropriated under the spending limit

Can The Limit Be Exceeded?

The legislature may adopt a concurrent resolution to exceed the adopted spending limit:

- The concurrent resolution requires a majority of each chamber.
- The adopted limit has only been exceeded once: In 2007 the Legislature passed Senate Concurrent Resolution 20, which authorized spending above the adopted limit in order to accommodate $14.2 billion in increased state spending associated with funding property tax relief.

Spending Limit Proposals

Various proposals would change:

Base - spending that is subject to the limit

Growth Rate - the measure of economic growth

Timeframe – prospective to retrospective

84th Legislation - Senate

- The Senate passed an additional, statutory limit on spending which was not ultimately enacted
- Base: Applied to all General Revenue and General Revenue-Dedicated appropriations
- Growth Rate: Restricted by average growth of population and inflation during current and next biennia
- Timeframe: Average of both retrospective and prospective growth rates

84th Legislation - House

- The House passed an additional, statutory limit on spending which was not ultimately enacted
- Base: Applied to all non-federal appropriations by spending category
  (1) transportation;
  (2) public primary and secondary education;
  (3) higher education;
  (4) health care;
  (5) public safety and corrections; and
  (6) other general government
- Growth Rate: Restricted by the rate of growth for each spending category based on (1) the estimated rate of growth in the population served in that spending category and (2) the estimated rate of inflation in a representative set of goods and services for that spending category
- Timeframe: Prospective growth aligned with budget cycle

Restrictions in Other States

- Thirty-one states have restrictions on government spending and tax collections. The restrictions vary considerably in design and scope, but the general goal is to restrain government spending and tax collections
- Appropriations Limit
  - Appropriations growth is limited by growth in an economic index such as personal income, gross state product, or population and inflation
- Revenue Limit
  - Revenue collections are limited by growth in an economic index such as personal income, gross state product, or population and inflation
  - Excess revenue collections can be refunded to tax payers or placed in a rainy day fund
- Growth Factor in Other States
  - Twenty use personal income as a growth factor
  - Five use population and inflation as a growth factor
  - Others restrain growth using alternative measures such as limiting appropriations to a percentage of the revenue forecast (ranging from 95 to 97 percent)

Contact the LBB

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TEXAS PUBLIC POLICY FOUNDATION
Testimony

May 2016
Center for Fiscal Policy

Conservative Path to Limiting the Footprint of Government

Presented to the House Appropriations Committee to Strengthen Texas' Limit on Appropriations

by the Honorable Talmadge Heflin, Director

Chairman Otto and Members of the Committee:

My name is Talmadge Heflin and I am the director of the Center for Fiscal Policy at the Texas Public Policy Foundation, a non-profit, non-partisan free market think tank based here in Austin. Thank you for inviting me to speak today on the interim charge to examine spending limit options and recommend reforms.

My remarks today are based on the Foundation's research findings that the current spending limit doesn't effectively limit Texas' budget growth and what reforms would strengthen it.

Texas has done better economically and fiscally than most states during the last fifteen years. However, one area that still needs improvement is consistently controlling the state's budget growth. Since all government spending must ultimately be paid for by taxation, limiting budget increases is essential for a competitive economy that supports prosperity.

The 84th Texas Legislature appropriated $209.1 billion for the 2016-17 budget period, which is a 2.9 percent increase from the previous period's expected expenditures. This conservative budget, defined as below population growth plus inflation, must be the first of many given past excessive budget trends. Population growth and inflation are two economic measures that account for most of the cost of funding public goods and services to a changing population. It is also noteworthy that these measures are added together because the addition of these two metrics accounts for economies of scale whereby the average cost of providing public services declines over time.

Legislators have recently practiced some budget constraint, particularly during the 2003, 2011, and 2015 legislative sessions when they passed budgets that increased by less than population growth plus inflation. However, in 2005 and again in 2013 spending by subsequent Legislatures increased substantially, erasing all of the gains from previous sessions. Specifically, the total budget is up an estimated 9 percent above the pace of compounded population growth plus inflation since the 2004-05 budget. This excessive increase has burdened Texans with higher taxes and fees to sustain elevated spending levels and slowed economic growth.

While occasionally passing conservative budgets is beneficial, Texas needs to keep past budget cycles from repeating by passing a stronger statutory spending limit. After conducting our own study and reviewing other research in search of which spending limits effectively restrain a government's budget, we find that Texas' spending limit can be traced back to several design flaws:

- **The current limit covers less than half of the budget**. In Article VIII, Section 22(a) of the Texas Constitution, the only appropriations subject to the spending limit are those derived from "state tax revenues not dedicated by this constitution," which is about 45 percent of the 2016-17 total budget. By not capping more than half of the budget, legislators are left with perverse incentives.
- **The current measure is not a reliable indicator for the budget's growth rate**. The Texas Constitution requires that the limit be based on the growth in the state's economy, which is statutorily identified as personal income growth. Research shows that this measure's instability leads to costly fiscal volatility and uncertainty.

continued

- **The budget limit relies on a projected measure of economic growth.** Since several groups submit estimates of personal income growth to the Legislative Budget Board in November before a regular legislative session for the next two fiscal years, the projections are for about 33 months. The difficulty of accurately predicting this growth rate leads to large discrepancies between actual and projected growth rates.

With so many hindrances to budgetary prudence, it is easy to understand why Texas' spending limit has failed to effectively limit the state budget. With just a few changes, legislators can vastly restrain the growth of government by passing a conservative spending limit that allows Texans the best opportunity to prosper.

While using actual past population growth plus inflation data is sufficient in most cases, the day may come when inflation reaches levels like the 1970s that would not lead to a prudent spending limit. To avoid this concern, the Foundation suggests using the lowest rate of either population growth plus inflation, personal income, or gross state product for the two fiscal years immediately preceding a regular legislative session. This would allow Texans to have the ability to sufficiently fund essential government programs and no more.

Specifically, our recommended conservative spending limit includes:

- Passing a conservative spending limit that makes the following statute changes to Section 316 of the Government Code:
    - Applying the limit to Texas' total state budget.
    - Basing the limit on the *lowest* growth rate of the Census Bureau's measure of state population plus the Bureau of Labor Statistics' measure of inflation for the consumer price index for all items, the Bureau of Economic Analysis' measure of total state personal income, or the Bureau of Economic Analysis' measure of total gross state product for the two fiscal years immediately preceding a regular legislative session when the budget is adopted; and
- Putting a constitutional amendment on the ballot to change Article VIII, Section 22(a), such that a supermajority vote of two-thirds in each chamber instead of a simple majority is required to exceed the limit.

We would then suggest that any funds available above this limit, along with cuts in the budget or dollars above the rainy day fund limit, be used to keep the bottom line of the budget from growing. This can be done by passing legislation that would allow legislators to use those dollars in a fund to return them to the taxpayers by temporarily reducing the state's sales tax rate for a determined period and rate based on the amount in the fund. We've called this the Sales Tax Reduction (STaR) Fund.

Although the sales tax is in the name, a reduction in the sales tax rate is not the primary objective of the STaR Fund. The purpose is to reduce or restrain the bottom line of the budget. The secondary effect is reducing the sales tax rate because it has the broadest base and is the easiest to administer. Passing legislation to put the STaR Fund in place this session would allow it to be available in the 2019 Legislative Session, just in time for the implementation of the reformed conservative spending limit.

These reforms would help legislators limit the size and scope of the Texas budget, allowing Texans the opportunity to improve their well-being and achieve their dreams with their own resources.

Thank you for your time and I look forward to answering your questions. ★

Comments on the State Spending Limit

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In no biennium shall the rate of growth of appropriations from state tax revenues not dedicated by this constitution exceed the estimated rate of growth of the state's economy.

Simplify the Spending Limit Base. The base in the spending limit is "appropriations from state tax revenues not dedicated by this constitution," which has no corresponding element in the general appropriations act. Consequently, the Legislative Budget Board must do a complex "cross-walk" of general revenues in order to determine how to apply the spending limit. The base of the spending limit should be simplified to apply to discretionary funds appropriated by the legislature—i.e. general revenue related funds (general revenue, the available school fund, the foundation school fund, the state textbook fund and the property tax relief fund).

Publish the Calculation of the Spending Limit as an Informational Item in the Appropriations Bill. Though all materials relating to the initial calculation of the spending limit at the start of the legislative session are readily available, how the final appropriations bill is scored relative to the spending limit is not. The appropriations bill should include an informational rider that identifies the appropriations within the bill that are subject to the limit and how they compare to the adopted limit. If necessary, LBB staff should be authorized to adjust the numbers based on the Comptroller's certification estimate.

Limit What You Control: Appropriations currently affected by the spending limit are not fully at the control of the legislature. For example, federal law governs much of what must be spent on Medicaid while other parts of the budget may be governed by court orders. The legislature often must spend additional funds to comply with factors such as these, which are beyond their control, and which may "crowd out" spending in other programs. The spending limit should apply to those items of expenditure that are under the discretion of the legislature; consideration should be given to exclude those expenditures necessary to comply with federal or court mandates. Otherwise, the state could be forced to cut spending, for example, to public education in order to make room under the spending limit for increased Medicaid expenditures—even if it had sufficient funds available for both. In such a circumstance, the state essentially delegates its budget authority to Washington.

Local School Property Taxes. Texas school finance is a shared responsibility between the state and local school districts. The greater the property wealth of a school district, the less state aid it qualifies for. Consequently, as school property values rise, the formula demands for state education funding diminishes. Taxpayers still pay more in taxes, but the reduced level of required state aid counts as a spending cut to the state budget. Further, in times of fiscal duress, the state can change the school finance formulas to increase the reliance on local property taxes— technically *cutting* the state budget while essentially *raising taxes* on property owners! The spending limit should either include an estimate of local school taxes, or at least not allow the state to credit itself a reduction in state spending for public education that is the result of rising local property taxes.

May 18, 2016

Testimony on Interim Charge – Article VIII, Section 22 Constitutional Spending Cap

Eva DeLuna Castro, deluna.castro@cppp.org

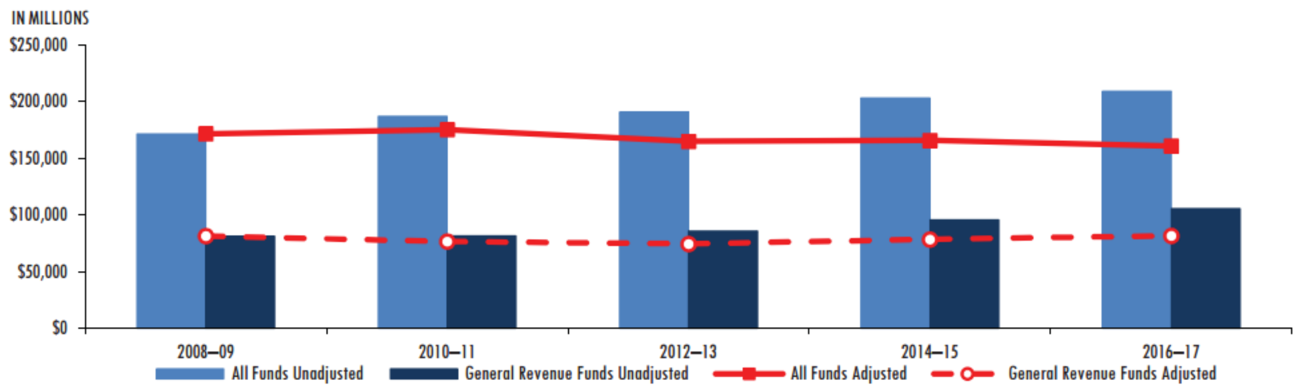
Combined with the Texas Constitution's Article III, Section 49a "Pay As You Go" Limit, the Article VIII provision that limits growth in certain appropriations (i.e., of tax revenues not constitutionally dedicated) has succeeded in keeping the state budget one of the proportionately smallest in the nation. In 2015, Texas ranked 50th in state spending per resident, according to data compiled by the National Association of State Budget Officers. The 2013 U.S. Census Bureau survey on state government finances ranks Texas 42nd in state taxes per capita.

CPPP opposes making the Article VIII, Section 22 cap more restrictive. The Senate and House have voted to exceed the cap only once, in 2007 (SCR 20), to implement school property tax rate reductions required by 2006's HB 1 (Third Called Session). Further restrictions would only serve to reduce legislative authority and flexibility in writing future state budgets that respond to the state's needs.

Following is a series of charts prepared by the Legislative Budget Board documenting how state spending has remained relatively flat, adjusted for population and inflation, even after significant additions such as border security ($800 million in General Revenue-related appropriations in 2016-17). Annotations by CPPP are shown in green or red.

FIGURE 19
TRENDS IN STATE GOVERNMENT EXPENDITURES, 2016–17 BIENNIAL APPROPRIATIONS

(IN MILLIONS)	ALL FUNDS				GENERAL REVENUE FUNDS			
	UNADJUSTED		ADJUSTED FOR POPULATION AND INFLATION		UNADJUSTED		ADJUSTED FOR POPULATION AND INFLATION	
BIENNIUM	AMOUNT	PERCENTAGE CHANGE	AMOUNT	PERCENTAGE CHANGE	AMOUNT	PERCENTAGE CHANGE	AMOUNT	PERCENTAGE CHANGE
2008–09	$172,131	N/A	$172,131	N/A	$81,639	N/A	$81,639	N/A
2010–11	$187,517	8.9%	$175,762	2.1%	$81,931	0.4%	$76,795	(5.9%)
2012–13	$190,755	1.7%	$165,421	(5.9%)	$86,016	5.0%	$74,593	(2.9%)
2014–15	$203,301	6.6%	$166,259	0.5%	$96,073	11.7%	$78,568	5.3%
2016–17	$209,103	2.9%	$161,329	(3.0%)	$106,008	10.3%	$81,788	4.1%

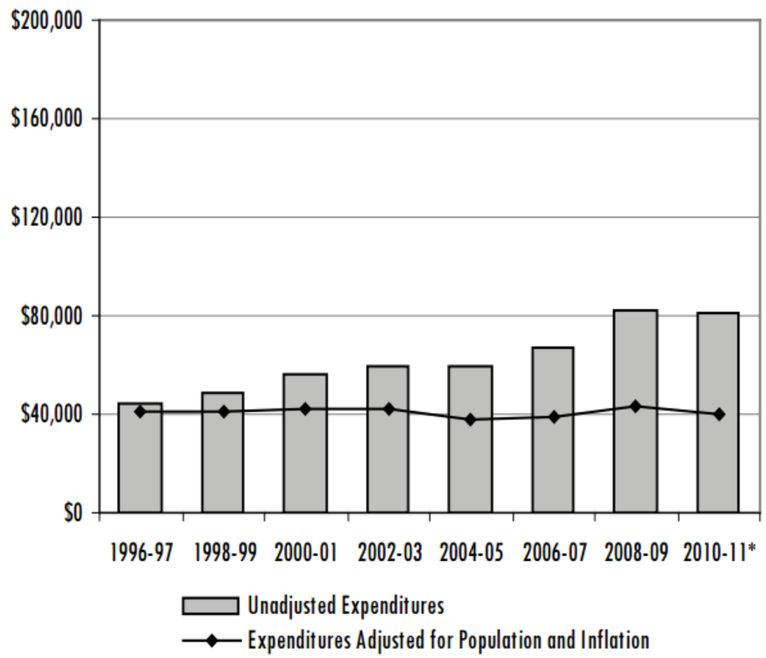


SOURCE: Legislative Budget Board. *Summary of Appropriations for the 2016-2017 Biennium*, February 2016, page 20.

FIGURE 15
TRENDS IN STATE GOVERNMENT EXPENDITURES, 1996–97 TO 2010–11 BIENNIA

IN MILLIONS

GENERAL REVENUE FUNDS



*Estimated.
SOURCES: Legislative Budget Board; Comptroller of Public Accounts.

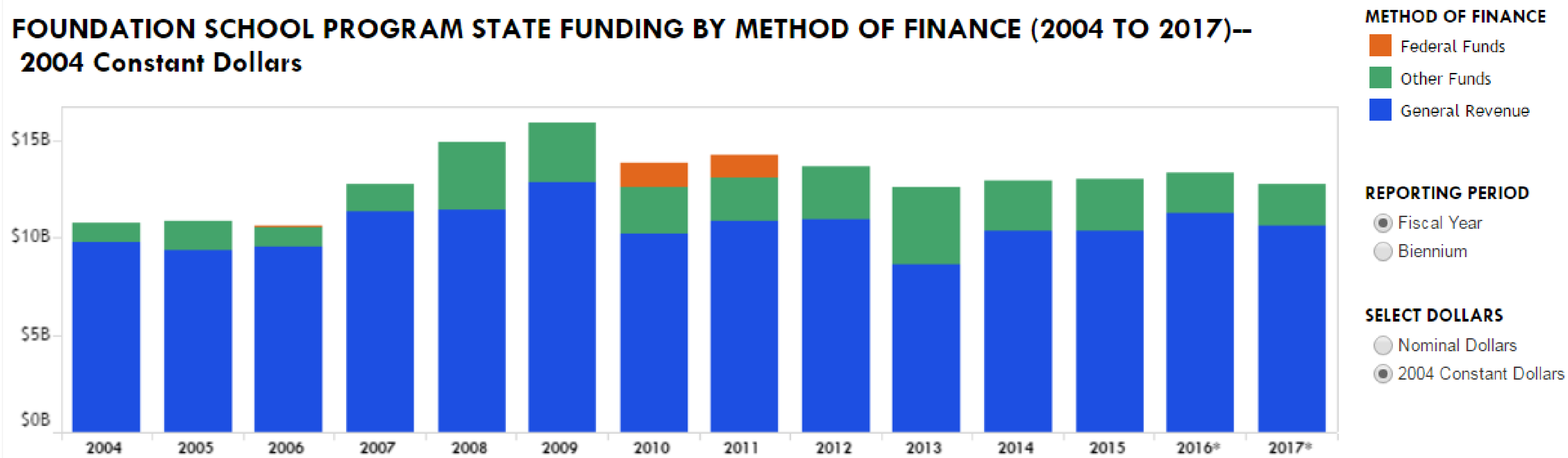
FIGURE 16

IN MILLIONS	GENERAL REVENUE FUNDS			
	UNADJUSTED		ADJUSTED FOR POPULATION AND INFLATION	
BIENNIUM	AMOUNT	PERCENTAGE CHANGE	AMOUNT	PERCENTAGE CHANGE
1996–97	$44,686	NA	$40,620	NA
1998–99	$48,890	9.4	$41,034	1.0
2000–01	$55,747	14.0	$42,561	3.7
2002–03	$59,918	7.5	$42,317	(0.6)
2004–05	$58,956	(1.6)	$38,264	(9.6)
2006–07	$67,208	14.0	$39,188	2.4
2008–09	$81,639	21.5	$43,504	11.0
2010–11*	$80,614	(1.3)	$40,071	(7.9)

2008-09 increase includes General Revenue needed to implement $14 billion reduction in local property taxes called for in HB 2, 2006, 3rd called session.

Fiscal Size-Up 2010-11, page 9, December 2009.

FOUNDATION SCHOOL PROGRAM STATE FUNDING BY METHOD OF FINANCE (2004 TO 2017)-- 2004 Constant Dollars



Federal Funds in fiscal years 2010 and 2011 consist of stimulus funding provided by the American Recovery and Reinvestment Act of 2009.

Fiscal year 2008 is the first year of full implementation of the property tax reduction enacted under House Bill 1, 79th Third Called Session, 2006, which reduced local school district property tax rates by one-third.

Inflation and Population Adjustment

The Legislative Budget Board uses a standard method of deflating nominal dollars. This method adjusts current and historical expenditure/appropriation totals into FY 2004 dollars based on compounded population and inflation growth. Compounded population and inflation growth for this adjustment is based on data from Moody's Analytics.

Prepared by the Texas Legislative Budget Board-Applied Research and Performance Audit Team
Source: **Legislative Budget Board**
PPM#: **1617**. Last Updated: **2/3/2016**

Historical Funding for Border Security

Total All Funds Appropriations for Border Security
(In Millions, All Funds)

Biennium	DPS	TPWD	Gov.	TDCJ	TMD	TABC	TCOLE	TOTAL	BIENNIAL INCREASE
2008-09	$ 108.2	$ 2.1	$ -	$ -	$ -	$ -	$ -	**$ 110.3**	
2010-11	102.1	4.3	13.3	0.5	-	-	-	**120.1**	9%
2012-13	212.9	4.7	4.0	0.5	-	-	-	**222.1**	85%
2014-15	478.9	11.2	6.8	0.5	59.0	-	-	**556.2**	150%
2016-17	789.4	9.9	38.4	0.5	-	1.2	0.2	**839.6**	51%
TOTAL:	**$ 1,691.5**	**$ 32.2**	**$ 62.4**	**$ 1.9**	**$ 59.0**	**$ 1.2**	**$ 0.2**	**$ 1,848.3**	

Includes Operation Stonegarden Federal Funds in FY 2014-2017

Source: LBB
Update: State Funding for Border Security, September 1, 2015 - February 29, 2016, Presented to the Joint Committee on Border Security, May 2016.

About CPPP
The Center for Public Policy Priorities is an independent public policy organization that uses research, analysis and advocacy to promote solutions that enable Texans of all backgrounds to reach their full potential.

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TESTIMONY ON STATE SPENDING LIMITS
TO THE HOUSE COMMITTEE ON APPROPRIATIONS
By
Billy C. Hamilton
May 18, 2016

Mr. Chairman and Members: My name is Billy Hamilton. I currently serve as Executive Vice Chancellor and Chief Financial Officer of the Texas A&M University System. Our System appreciates the efforts of the Legislature and this committee in supporting the funding of Higher Education in the last legislative session.

However, I am not here today to testify in my role as a member of the Texas A&M System. Instead, I am testifying based on work I did in my past roles as chief revenue estimator and Deputy Comptroller of Public Accounts. Those positions and my later work for the Task Force on the State Budget Crisis, a national group that studied the future of state finances following the recent recession, gave me some knowledge of spending limitations in other states, which Chairman Otto asked that I briefly share with you.

I want to point out that I am confining my comments to state-level limitations. Most states, including Texas, impose limitations on local expenditures, but these limits aren't covered in what follows.

Tax and Expenditure Limitations

Tax and expenditure limitations often are discussed together, and in fact, the entire area of state fiscal policy often is abbreviated "TELs." TELs are broadly defined as rules intended to control or restrain the growth of state budgets. Some TELs do this by limiting how much expenditures can increase each year. These are expenditure limits. Others limit tax growth and are known as revenue limits. They attempt to limit spending indirectly by limiting the extent to which revenue—and therefore spending—can increase in a year. A majority of TELs emerged during the "tax revolt" of the late 1970s or the economic recession of 1990-91.[1] The Texas spending limit was enacted in 1978 at about the same time that the "tax revolt" was spreading nationally in the wake of voter approval of Proposition 13 limiting local property taxes in California in June 1978.

The spending limits enacted in the late 1970s and early 1990s were often driven by difficult budget times or periods when taxes or spending was rising quickly relative to income. Despite the recession of recent years, there have been few new tax or expenditure limits enacted since the turn of the century. The four most recent limitations were enacted in Indiana in 2002, Maine in 2005, Ohio in 2006, and Illinois in 2011. The Illinois limit was enacted in

[1] The Tax Policy Center, "What are tax and expenditure limits," undated. Available at: http://www.taxpolicycenter.org/briefing-book/what-are-tax-and-expenditure-limits

conjunction with a temporary income tax increase in 2011. The temporary tax increase has expired and so has the limitation—at the end of 2015.

Comparisons of TELs at any level of detail are difficult because, according to a National Conference of State Legislature (NCSL) analysis, “no two TELs are exactly alike in their design and characteristics,” although the general goals are similar.[2] The NCSL report identified four categories of TELs that will be familiar to anyone who has knowledge of the limits used in Texas. They include expenditure limits, revenue limits, appropriations limited by revenue estimate, and hybrids that combine some or all of the first three. Within these categories, some TELs also may include certain exceptions and exemptions, for example including some types of spending but excluding others. For example, spending related to federally funded programs often is excluded from spending limits.

Today, more than half of the states have enacted some kind of tax or expenditure limit. The number of states with tax and expenditure limitations tends to vary depending on who is counting and what their definition of TELs includes. An analysis prepared by the National Association of State Budget Officers last year found that 28 states had TELs in 2015.[3]

Twenty of the 28 states had spending limits that resemble the Texas’ constitutional spending limit, although their calculation methodologies vary.[4] Five had revenue limits, and three states had limits on both spending and revenues. As of the 2015 count, legislatures had enacted 17 TELs, nine were passed as voter initiatives, and two emerged from constitutional conventions.

The Texas Limitations

Texas likely goes further than just about any other state in the range and variety of TELs in its law. There currently are four, all built into the constitution. They include:

- A debt limit in Article III, Section 49(j) that limits the authorization of “additional money debt” if in any fiscal year the resulting annual debt service payable from unrestricted General Revenue exceed 5% of the average annual unrestricted GR for the previous three years. According to the Bond Review Board, the Constitutional Debt Limit (CDL) was 1.38% for outstanding debt and 2.65% for outstanding plus authorized but unissued debt. For FY 2014 these figures were 1.20 and 2.71, respectively, and represent an increase of 15.0 percent and a decrease of 2.2 percent, respectively.[5]

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[2] Bert Waisanen, “Tax and Expenditure Limitations,” National Conference of State Legislatures, 2012. Available at: http://www.ncsl.org/research/fiscal-policy/state-tax-and-expenditure-limits-2010.aspx

[3] National Association of State Budget Officers, “Budget Processes in the States,” Spring 2015. Available at: https://www.nasbo.org/sites/default/files/2015%20Budget%20Processes%20-%20S.pdf

[4] Virtually all states have TELs if local government limitations are included.

[5] Texas Bond Review Board, “Debt Affordability Study,” February 2016. Available at: http://www.brb.state.tx.us/pub/bfo/DAS2016.pdf

- A welfare spending limit also contained in Article III, Section 51-a, which provides that state spending on assistance to needy children and their caretakers to no more than 1 percent of the total state budget (Art. 3, sec. 51-a(b)). Federal matching funds and administrative expenses are not included under this cap.

- The "pay-as-you-go" limitation in Article III, Section 49a of the Constitution, which requires all appropriations to be within the available revenue in the fund from which the appropriations are made and requires certification of the Appropriations Act by the Comptroller of Public Accounts that those conditions are met.

- And a spending limit contained in Article VIII, Section 22 of the Constitution, which limits the rate of growth in appropriations from one biennium to the next so that in no biennium can the rate of growth from appropriations from state tax revenue not dedicated by the Constitution exceed the estimate rate of growth in the state's economy based on a growth rate determined under a separate statute by the Legislative Budget Board. Under statute, the rate of growth is defined as the growth in personal income.[6] (In a side note, Chancellor Sharp pointed out to me that he was the co-author of the bill creating the Constitutional limit on appropriations.)

Limitation Components

Although the basic idea is the same in all of the TELs—to curb government spending directly or indirectly—there are significant differences in how the limits are applied and how ironclad the TELs are in imposing tax and spending controls.

One reason for the variability of tax and expenditure limitations is that several policy factors make up any individual limitation measure, and these affect how the limit works. As the accompanying Table 1 shows, the different components of state-level TELs include: (1) the method of adoption, (2) whether the limitation is codified in statute or the constitution, (3) whether the limitation is targeted at revenue or expenditure, (4) the growth factors used, and (5) how hard it is to override the limitation.

Three methods of adoption have been used by the states. TELs have been created by state legislatures, by initiative or referendum (I&R), and on rare occasions by constitutional convention. By far the most common method is by legislative action or by legislative action followed by voter approval. However, direct voter approval of limitation initiatives isn't uncommon, particularly in states with a strong I&R tradition. The limitations in nine states were created by direct voter initiative.

In some states limitations are statutory; in others they are codified in the state constitution. Statutory limitation are more easily modified or rescinded by the legislature, so constitutional TELs are generally considered more effective tools to restrain government's size.

[6] Texas Government Code, Chapter 316.

TABLE 1: Strutural Components of Tax and Expenditure Limitations and Their Restrictiveness Qualities			
Component	**Options**	**Restrictiveness**	**Comment**
Target	Spending Revenue	Least More	The extent to which a TEL restricts budget growth depends on whether it applies to spending or revenues and whether any types of spending or revenue are excluded from the limit. Tax limits appear more restrictive than spending limits.
Growth Factor	Personal Income Population Inflation	Least More More	Growth factors determine the degree to which taxes and spending can increase from year to year. Population and inflaton tend to grow more slowly than personal income, thus increasing a TEL's restrictiveness.
Overrides	Simple Majority Super Majority Legislative and voter approval	Least More Most	TELs with override rules potentially reduce their restrictiveness. The extent to which they do so depends on factors such as the minimum number of votes needed to override the TEL.
Adoption Method	Legislative approval Initiative Referendum Constitutional Convention	Least More More Most	Adoption methods could make it easy or hard to adopt or change a TEL. It is relatively easier for a TEL enacted by the legislature to be changed or repealed than one adopted by a constitutional convention.
Codification	Statute Constitutional Amendment	Least Most	Statutory TELs are less restrictive than constitutional ones because the requirements and procedures for changing a law are less stringent than those for amending a constitution.
Source: State of Connecticut, Office of Legislative Research, "Tax and Expenditure Limits and Revenue Volatility," Report No. 2016-R-0040, February 26, 2016. Available at: https://www.cga.ct.gov/2016/rpt/pdf/2016-R-0040.pdf.			

There also are differences in what the limitation, whether statutory or constitutional, covers. The most obvious variation is revenue versus expenditures. Of the two, limits on appropriations are more common. A study by the Connecticut Office of Legislative Research found that the most common type of spending cap ties the growth in a state's budget to growth in a measure based on one or more of the following: state population, personal income growth or inflation. Texas, for example, bases its spending limit on the forecast growth in the economy as measured by the growth in personal income. Other states use other methodologies. Washington state limits increases in spending to the 10-year average growth in personal income. Some states, including Delaware and Rhode Island, don't use personal income as a measure but limit spending to a percentage of projected revenue—98 percent in both states—for the next fiscal year.

Colorado's spending can't exceed 5 percent of state personal income, while Idaho limits appropriations to 5.33 percent of personal income. Arizona has a constitutional limit on expenditures of 7.41 percent of state personal income. Connecticut limits growth to the average percentage growth in personal income over the last five years or the rise in the Consumer Price Index over the preceding 12 months, whichever is greater. Seven states, including California, modify their caps based on population growth and usually either inflation or personal income or both. For example, the Utah limit is adjusted based on a combination of inflation (or deflation) and changes in population. California uses population and personal income, as does Alaska. Oklahoma's expenditures can't grow more than 12 percent plus inflation and provides the state can only spend 95 percent of what's available.

Here in Texas, the spending limit is specifically defined. Only appropriations funded with tax revenue not dedicated by the state constitution are subject to limitation. That includes familiar tax sources like the sales tax, excise taxes, motor vehicle sales tax and margin tax—although a portion of the taxes also are dedicated to specific uses. The constitution provides that tax revenues to be used for a specific purpose, such as motor fuel taxes dedicated to transportation and education, aren't subject to limitation. Finally, appropriations funded with non-tax revenues—fees and penalties, investment income and lottery proceeds—aren't limited.

Limitations on revenue growth are fewer in number but similarly varied in structure. Missouri's Hancock Amendment limits revenue growth revenue to 5.64 percent of personal income multiplied by the greater of state personal income in the previous calendar year or the average state personal income over the previous three calendar years. Any excess over one percent is refunded to taxpayers. Less than one percent is transferred to the general fund. The Hancock Amendment also requires the approval of voters if taxes and fees would increase above a certain amount that's calculated annually. Colorado limits most general revenues to an index of population plus inflation growth over amounts from fiscal year 2007-08, with the excess either returned to taxpayers or used to reduce debt.

In Texas, the amounts available for appropriation from General Revenue-related funds is limited to the amount estimated to be available from those funds by the Comptroller. However, the Comptroller also estimates revenue from all state funds as well as GR-related funds.

Some TELs have even more policy wrinkles. For example, a few states prohibit lawmakers from avoiding or mitigating the limit through the use of unfunded mandates or transfers of program responsibility to local governments. However, it's more commonly the case that how restrictive a tax or spending limitation is depends on the ability of the governor and legislature to override the cap. Several states have what appear to be restrictive TELs but require only simple legislative majorities to override them.

Fourteen states have legislative supermajority—usually three-fifths or two-thirds of both legislative houses—or voter approval requirements for new taxes, a different sort of limitation. Depending on the state, requirements may pertain to all taxes or to specific revenue sources, such as corporate or sales taxes. To pick one example, Utah requires a three-fifths vote in both houses to override a spending limit.

Some of the more restrictive revenue limits require that surplus revenues go back to taxpayers as rebates or be sequestered in rainy day funds. Four states—Colorado, Hawaii, Missouri and Oregon—have the rebate provisions providing that excess revenues be returned to the taxpayers in the form of tax cuts or rebates or that the funds be used to reduce state debt. Utah requires the excess to be used for debt service or emergency reserves with any remaining excess refunded to the taxpayers.

The Limits of Limitation—Colorado's TABOR

Colorado's TABOR law, enacted in 1992, is often judged by experts to be the nation's most restrictive tax and expenditure limitation and also provides a case study in the limits on limitations. TABOR applies to all taxing units in the state and requires that voters directly approve all tax rate and property tax assessment increases as well as the imposition of new taxes. The law also explicitly prohibits particular types of taxes. TABOR also limits general revenues to the previous year's revenues adjusted for population growth and inflation. All excess revenues must go back to Coloradans through tax reductions or cash rebates. Only voters can override these provisions or any other spending or revenue limits.

The restrictive nature of TABOR worked well for the state's taxpayers until it didn't and then it became a major problem for the state. Passage of TABOR came at the start of nearly a decade of record economic growth in Colorado. During those years, TABOR limited the amount of revenue governments could collect and spend. Taxpayers received TABOR refunds on their state income taxes, and local property taxes also had to be ratcheted down. Some local governments found TABOR's restrictions too constraining, and hundreds of cities, counties, school districts and special districts successfully appealed to voters over the years for temporary reprieves from some TABOR provisions.

The more serious negative impacts of TABOR came with the recession of 2001-03. Tax revenues fell, and the state government had only a 4% cushion to fall back on. Lawmakers were forced to make hundreds of millions of dollars in budget cuts. By 2005, the state's economy was again growing strongly. But what came to be called TABOR's "ratchet effect" prevented the state legislature from using the growing revenues to restore spending in vital budget areas cut during the recession. Caught in a bind that only promised to grow worse, legislators and then-Governor Bill Owens developed a budget compromise that would give Colorado state government a five-year "time-out" from TABOR's revenue and spending limits. Following the voter approval requirements in TABOR, they referred the measure, called Referendum C, to the state's voters. It was approved in the November 2005 election.

Pros and Cons of TELs

The National Conference of State Legislatures offers the following list of pros and cons of tax and expenditure limits. Arguments in <u>favor</u> of TELs include:

- Make government more accountable;
- Force more discipline over budget and tax practices;
- Make government more efficient;
- Make governments think of creative ways to generate revenues—for example, advertising on state-owned facilities;

- Control the growth of government;
- Enable citizens to vote on tax increases and determine their desired level of government service;
- Force government to evaluate programs and prioritize services;
- Raise questions about the advisability of some functions provided by state government;
- Help citizens feel empowered and result in more taxpayer satisfaction;
- Help diffuse the power of special interests;

The arguments against state tax and expenditure limitations as well.

- Shift fiscal decision making away from elected representatives;
- Cause disproportional cuts for non-mandated or general revenue fund programs;
- Fail to account for disproportionate growth of intensive government service populations like the elderly and school-age children;
- Make it harder for states to raise new revenue so that scarce resources may be shifted between programs;
- Cause a "ratchet-down" effect where the limit causes the spending base to decrease so that maximum allowable growth will not bring it up to the original level;
- Result in excess revenues that are difficult to refund in an equitable or cost-effective manner;
- Result in declining government service levels over time;
- Fail to provide enough revenues to meet continuing levels of spending in hard economic times;
- Shift the state tax base away from the income tax to the more popular (but regressive) sales tax if voter approval is required;
- Shift the tax base away from broad taxes (property, sales and income) to narrowly defined sources such as lotteries and user fees.

Effectiveness of TELs

Probably the one common feature of all tax and expenditure limitations is criticism that they don't work. For example, a 2013 report from the American Enterprise Institute concluded: "The evidence reported here is unambiguous: TELs have little effect on state and local outlays, and efforts to utilize such policies as tools with which to impose spending restraint are unlikely to prove effective."[7] A number of academic studies have been completed over the past two decades to examine how well TELs work and what other implications they may have had for state fiscal policy. Some studies have found them effective in some cases but not in others. Other studies have found unintended consequences, such as increased local spending pressures or increased bond costs. As one study in 1996 concluded: "Most TEL laws are not designed to stop public sector growth but are intended to cap it relative to personal income growth.

[7] Benjamin Zycher, "State and Local Spending: Do Tax and Expenditure Limits Work?" American Enterprise Institute, May 2013. Available at: http://www.aei.org/wp-content/uploads/2013/05/-state-and-local-spending-do-tax-and-expenditure-limits-work_152855963641.pdf

Evidence indicates that the design of TEL laws increases the elasticity of government size (and growth) with respect to income. Thus, TEL laws, as they currently are written, allow states with high income growth to keep increasing the size of the public sector. Meanwhile, they prevent states with low income growth from doing likewise. While TELs restrict government size and growth in states with below average income, in general they have no significant effect on the size or growth of government."[8]

A more recent study by the Rockefeller Institute of Government at the State University of New York found that while earlier studies had found that TELs had mixed results, its findings supported the idea that state-level TELs reduce state and local spending on a real, per capita basis.[9] However, the study offered some caveats: "But they also suggested that these effects are not neutral with respect to spending or revenue sources. State-level TELs may, for instance, exert significant negative effects on public safety spending, while they may increase the share of the state budget going to transportation functions, perhaps because transportation projects are often paid for through revenue sources (such as tolls, gas taxes, and federal grants) not covered as strictly by TELs as other sources." They found that TELs also lead states and localities to become more dependent on fees and charges, while relying less on property, individual income, and corporate income taxes. Curiously, state and local governments were also found to become less dependent on federal transfers, "possibly due to constraints on state and local governments' capacities to raise matching funds for federal grants-in-aid."

My own view is that the Texas limitations, at least, provide a ceiling on governmental growth and a bright line indicator of fiscally responsible spending. That line amounts to spending that increases no more than the growth of the economy consistent with the amount of revenue available as estimated by an independent officer of the state government, the Comptroller. It is true that lawmakers here and in other states must sometimes work around the limits, but that is generally because in their judgment the state's needs in areas like education, health care prisons and so on require a certain level of expenditure. In this regard, the best defense against overspending is not an "automatic" control mechanism but the people—the lawmakers who develop the state's budget and whose first priority is to balance that budget. In Texas, we have been fortunate to have a conservative legislature that is mindful of those responsibilities.

It certainly would be possible tighten the tax and spending controls currently in place by expanding the spending included or by redefining the limitation to some measure that is more conservative than personal income growth. For example, Senate Bill 9 from the last legislative session that would have changed the way the Legislative Budget Board (LBB) calculates the state spending-limit. The original Senate bill based the spending limit growth rate not on

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[8] Ronald Shadbegian, "Do Tax and Expenditure Limitations Affect the Size and Growth of State Government?" *Contemporary Economic Policy,* Volume 14, Issue 1, pages 22–35, January 1996.

[9] Suho Bae and Thomas Gais, "The Effects of State-Level Tax and Expenditure Limitations on Revenues and Expenditures," Rockefeller Institute of Government at the State University of New York, May 21, 2007. Available at: http://www.rockinst.org/pdf/government_finance/2007-05-21-the_effects_of_state-level_tax_and_expenditure_limitations_on_revenues_and_expenditures.pdf

personal income growth but on the estimated combined growth in population and inflation, a figure that generally is below the growth in personal income in Texas in recent years. The House, concerned about the impact on future Legislatures, preferred a measure that would have factored in how different areas of government spending grow at different rates. The bill died at the end of the last legislative session.

Of course, regardless of the spending limit, the Legislature kept spending very much within the bounds of available revenue, and that has served the state well in the months since the Legislature adjourned by helping to cushion the state's finances against the precipitous drop in oil and natural gas prices. So, my view is that there is no substitute for responsible legislative action on the budget.