TEXAS PUBLIC POLICY FOUNDATION

A Taxpayer Protection Amendment for Texas

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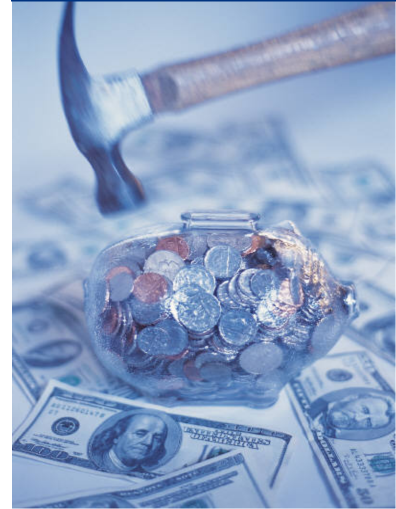

By Dr. Barry Poulson
Americans for Prosperity Foundation
Distinguished Scholar

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The Foundation's mission is to lead the nation in public policy issues by using Texas as a model for reform. We seek to improve Texas by generating academically sound research and data on state issues, and recommending the findings to policymakers, opinion leaders, the media, and general public.

The work of the Foundation is primarily conducted by staff analysts under the auspices of issue-based policy centers. Their work is supplemented by academics from across Texas and the nation.

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The public is demanding a different direction for their government, and the Texas Public Policy Foundation is providing the ideas that enable policymakers to chart that new course.

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A Taxpayer Protection Amendment for Texas

Technology, Regulation, and Markets

by Dr. Barry Poulson

Introduction

In 1973, Governor Ronald Reagan introduced Proposition 1—the nation's first tax and expenditure limitation (TEL), which was designed to restrain state government growth. Proposition 1 was voted down at the polls in November 1973. Days after the defeat, Governor Reagan wrote in the pages of National Review: "We have lost a battle, but this struggle will go on. The people will find a way to bring big government under control, to put a reasonable limit on how much of their income government may take in taxes. This idea will become a reality."[1]

Reagan was right. Tax and expenditure limits inspired by Proposition 1 have become a reality. Proposition 1 led to a nationwide tax revolt that, four decades later, has resulted in the passage of 28 tax and expenditure limitations. The most successful of the nation's TELs is Colorado's Taxpayer's Bill of Rights (TABOR) amendment. Passed in 1992, Colorado's TABOR (dubbed by Milton Friedman, "Proposition 1 look alike"[2]) limits the growth of state spending to the rate of population plus inflation. As a result, Colorado taxpayers have received more than $3 billion in surplus revenue since 1992.

In 1978, Texas enacted a constitutional limitation on state revenues that limited the growth of government to an average of personal income growth—a far more generous limit than Colorado's Taxpayer's Bill of Rights. That constitutional limit has proven an ineffective constraint on the growth of state revenues and expenditures. This study explores why Texas' existing tax and spending limit has failed to constrain the growth of state government. It also examines how Texas would benefit from a more effective tax and expenditure limit; this proposed measure will be referred to as the Taxpayer Protection Amendment.

The Taxpayer Protection Amendment proposed for Texas would: 1) limit the growth in state spending to the growth of population plus inflation, 2) ensure surplus revenue above this amount is invested in emergency and budget stabilization funds or returned to taxpayers, and 3) require voter approval for tax increases or any weakening of the amendment's limits.

This study simulates how the proposed Taxpayer Protection Amendment would have affected Texas had it been implemented in 1991. The proposed Taxpayer Protection Amendment would have constrained the growth of revenue and spending, and stabilized the budget over the business cycle. This Amendment would also establish a hard budget constraint that would create incentives for tax reform. Texas could begin to provide much needed property tax relief. The Amendment would set the stage for fundamental expenditure reforms in areas such as education, health care, corrections, and transportation.

This study will explore new tax and expenditure limits for Texas. To understand the rationale for this legislation, we begin with analysis of the relationship between taxes and economic growth. The potential for a negative relationship between taxes and economic growth is found early on in the history of economic thought.

Taxes and Economic Growth

The Views of Early Economists

Adam Smith was one of the first economists to suggest that higher tax rates could reduce tax revenues:

> "High taxes, sometimes by diminishing consumption of the taxed commodities, and sometimes by encouraging smuggling, frequently afford a smaller revenue to the government than what might be drawn from more moderate taxes."[3]

"High taxes, sometimes by diminishing consumption of the taxed commodities, and sometimes by encouraging smuggling, frequently afford a smaller revenue to the government than what might be drawn from more moderate taxes."

Adam Smith, Economist

Our first Secretary of the Treasury, Alexander Hamilton, had a similar view of taxes:

> "It is a signal advantage of taxes on articles of consumption that they contain in their own nature a security against excess… If duties are too high, they lessen the consumption: the collection is eluded; and the product to the treasury is not so great as when they are confined within proper and moderate bounds."[4]

Even John Maynard Keynes endorsed the concept of a negative relation between tax rates and tax revenues:

> "Nor should the argument seem so strange that taxation may be so high as to defeat its object, and that, given sufficient time to gather the fruits, a reduction of taxation will run a better chance than increase of balancing the budget."[5]

The Laffer Curve

As President, Ronald Reagan enacted tax reforms that significantly reduced the tax burden on citizens. This set the stage for the most rapid recovery and economic expansion of the post World War II period.

The potential negative relationship between tax rates and tax revenues was embodied in the famous Laffer curve. This was the rationale for lowering tax rates during the Reagan administration. Ever since then there has been a substantial debate within the economics profession regarding the relationship between tax rates, economic activity, and tax revenues.

The New Political Economy View

In the New Political Economy this concept is developed to explain how higher tax rates can reduce the tax base, and thereby reduce the revenue generated by the tax.[6] The central concept is that of a tax price. The assumption is that residents know both the level of taxes, and the level of government services. Resi-

dents are rational in searching for the highest level of government services consistent with the lowest possible tax price.

The tax price concept is especially relevant for state and local governments because residents can vote with their feet. If residents perceive that the tax price is too high, relative to the government services offered, they will move to another jurisdiction.

The tax price concept also helps to explain business location decisions. Businesses also consider the taxes they pay relative to the government services they receive. If government services are not worth the taxes they pay, businesses will relocate to another jurisdiction.

The mobility of residents and businesses in response to higher tax rates is an important factor in constraining the power of state and local governments to impose taxes. If residents and businesses respond to higher taxes by moving out of the jurisdiction, this will reduce the tax base.

A cursory review of Texas' economic trends suggests that the state is an underachiever in economic growth and development.

When tax rates are high, increasing tax rates can actually reduce tax revenues. The higher tax rates induce residents and businesses to leave the jurisdiction. The reduction in the tax base more than offsets the increase in tax rates, thereby reducing total tax revenues. At this point the jurisdiction could actually promote economic growth and generate more revenue by lowering tax rates.

This is an empirical question, and there is now a vast literature examining the effects of taxation on state and local economic activity. In a survey of this literature Bartick (1991) concluded that taxes have a significant negative effect on the location of economic activity in open economies.[7] More recent studies confirm his findings at both the state and local level.[8]

Taxes and Economic Growth in Texas

Texas is an Underachiever in Economic Growth and Development

A cursory review of Texas' economic trends suggests that the state is an underachiever in economic growth and development.

For example, income per capita in Texas has been significantly below the national average for the last three decades. This has not always been the case. There have been periods of more rapid growth in Texas. In the 1970s and early 1980s, Texas grew rapidly and income per capita converged toward that for the country as a whole.

But in the last two decades, Texas has been an underachiever in economic growth, and income per capita has again fallen significantly below the national average. Texas has begun to recover from the recent recession with increased income per capita. However, the gap between income per capita in Texas and that for the rest of the country remains.[9] In 1990, Texas ranked 32nd in the nation in personal income per capita; in 2005, Texas ranked 27th.

Underachievement in economic growth is most evident when we compare the performance of the Texas economy with that of neighboring states, such as Colorado.[10] In the 1970s, there was an oil boom. Both Texas and Colorado were growing at about the same rate with increases in income per capita more than 160 percent. In the 1980s, both states experienced a slowdown in economic growth; income per capita grew at about half the rate in the previous decade. In the 1990s, however, there was divergence in rates of economic growth—income per capita in Colorado increased 70 percent; in Texas, just 61 percent.[11] Today Colorado has the 8th highest income per capita in the country. Texas has recovered during the recent recession; but the gap in income per capita between Colorado and Texas is still almost five thousand dollars.

Texas has done somewhat better in terms of employment growth, but there is evidence of underachievement here as well. During the recession of the early 1990s, unemployment rates in Texas increased significantly above the national average. In 1992, the unemployment rate in Texas was 7.7 percent, compared to a national average of 6.4 percent. As the economy recovered from that recession, unemployment rates in Texas converged toward the national average. This pattern of unemployment was repeated in the most recent recession. In 2002, the unemployment rate in Texas was 6.5 percent, well above the national rate of 5.7 percent. As Texas has recovered from the recession, unemployment rates have again converged toward the national average.[12]

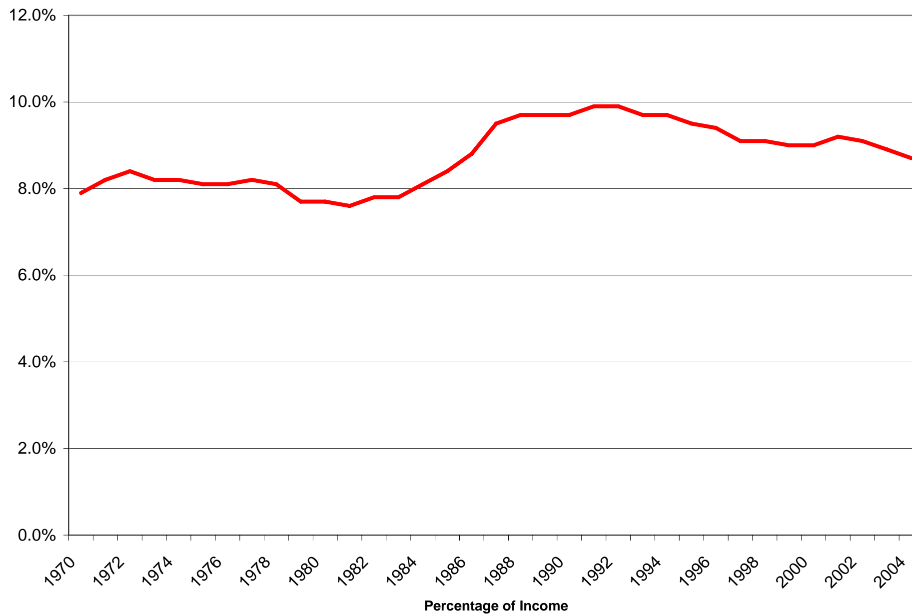
One must conclude that, over the past two decades, Texas is an underachiever in economic growth, especially when compared to the more rapidly growing states that have effectively constrained government spending such as Colorado. Many factors have contributed to this relative slowdown in economic growth in Texas.[13]

The Increasing Tax Burden on Texas Citizens

The Tax Foundation has compiled data on state and local tax burden as a percent of personal income for the fiscal years 1970-2006.[14] Historically, Texas has had a low tax burden compared to other states. In 1970, the state and local burden was less than 8 percent of personal income. At that time, Texas ranked 49th among the states with very low state and local tax collections as a share of income.[15]

From 1970 to the mid 1980s, the tax burden increased as a share of personal income, varying between 8 percent and 8.5 percent. In the late 1980s and early 1990s, there was a discontinuous increase in the tax burden reaching a peak of 9.9 percent of personal income in 1992. Since then, the tax burden has fallen back to 9.4 percent. Texas is currently ranked 44th nationally, well below the national average of 10.6 percent.[16]

Graph 1: Texas State and Local Tax Burden 1970 to 2004 (Percentage of Personal Income)



***Source**: The Tax Foundation.*

In the fiscal year 2000, local governments in Texas collected property taxes equal to $1,254 per capita, ranking the state 13th highest in the nation.

The record indicates that, while Texas has had a low state/local tax burden as a share of income, it has also experienced periods in which that tax burden has increased sharply. The tax burden peaked under the administration of Governor Ann Richards, but has fallen under the successor administrations of George W. Bush and Rick Perry.

Texas levies no personal or corporate income taxes. The major source of revenue for the state is the state sales tax.[17] The sales tax rate of 6.25 percent is well above the national median of 5 percent. Texas is ranked 19th nationally in sales taxes collected per person. Excise taxes in Texas are about average compared to those in other states. The gasoline tax is 20 cents per gallon (25th nationally). The cigarette tax is 41 cents per pack (39th nationally, though slated to rise by more than 200 percent).[18]

Texas is one of only 13 states that collect no state property tax. In the fiscal year 2000, local governments in Texas collected property taxes equal to $1,254 per capita, ranking the state 13th highest in the nation.[19] The median property tax paid on homes is $1,926—ranked as the 15th highest in the nation.[20] Property taxes as a percent of income are 3.53 percent, which ranks as the 12th highest in the nation.[21] Property taxes as a percent of home values are 1.82 percent, which is the second highest in the nation.[22]

The Tax Foundation ranks the business tax climate in the states using five different indices of the tax burden. Texas is ranked 7th highest in terms of business climate. Texas is ranked above all the neighboring states in business climate.[23]

Why Texas Should Not Enact an Income Tax

One of the criticisms often leveled against the tax system in Texas is that it is revenue inelastic; that is, as income increases, tax revenues increase less rapidly than the increase in income. This argument is often used by those who advocate an income tax for the state. They argue that income taxes should be the third leg of a stool in a state tax system that includes sales and property taxes.

There are several problems with this argument in support of income taxes. First, as this data demonstrates, it is not true that a revenue system based on state sales taxes and local property taxes cannot generate revenue growth comparable to income growth. In the late 1980s and early 1990s, state and local tax revenue in Texas increased more rapidly than income. This, of course, reflected increased sales tax rates and property tax rates. In the long run, state and local taxes as a share of income increased a full percentage point.

What critics of Texas' tax system are really arguing is that tax revenues should increase much faster than personal income.

Contrary to accepted wisdom, total tax revenues and sales tax revenues have more than kept pace with the growth of personal income in Texas. More importantly, sales tax revenues have proven to be a very stable source of revenue over the business cycle. In the recent recession sales tax revenue continued to grow at about the same pace they had over the previous decade. This is because households tend to maintain their consumption expenditures even when personal income is not growing or even when it is falling. From this perspective Texas has a very modern tax system. Sales tax revenues have more than kept pace with the growth of personal income, and have proven to be a very stable source of revenue.

The second problem with the argument for a state income tax is that it assumes that a growing percent of tax revenue as a share of income is optimal. Clearly this is not how Texas citizens view their tax system. After the sharp increase in the tax burden in the late 1980s and early 1990s, Texas citizens elected leaders who lowered their tax burden. Today polls show that most Texas citizens oppose a state income tax.[24]

What critics of Texas' tax system are really arguing is that tax revenues should increase much faster than personal income.[25] That has certainly been the case in other states, such as Ohio, in recent years.[26] Ohio is an interesting case study because in the 1970s Ohio had no income tax and a relatively low tax burden relative to income, similar to Texas today. However, Ohio introduced an income tax that generated income tax revenues whose growth far outstripped the growth in personal income. In periods of rapid economic growth income tax revenues increased much more rapidly than the growth in income; and, in periods of recession income tax revenues fell more sharply than the fall in income. The result was that *income tax revenues were very volatile over the business cycle*. In periods of recession when there were revenue shortfalls Ohio found it very difficult to balance the budget. There was great pressure to increase taxes and debt to offset the revenue shortfalls. In this way revenue and spending ratcheted up from one business cycle to the next. In the long run government revenue and spending increased significantly as a share of personal income.

The problems created by this ratcheting up of state revenue and spending were amply demonstrated during the recent recession when Ohio and other states experienced fiscal crises. Today, Ohio has one of the highest tax burdens in the country.

Texas has been fortunate to avoid such fiscal crises. However, even in Texas, state revenue and spending has outpaced the growth of personal income. This suggests that there is room for tax cuts and reform of Texas' tax system.

Local Property Taxes and Economic Growth in Texas

A number of studies have found evidence of a negative relationship between taxes and economic growth at the local level.[27] One of the most important of these recent studies examines Houston, Texas.[28] The Houston study is part of a broader study examining the impact of taxes on property values in four major cities in the United States.

The hypothesis is that when local governments provide good services relative to the taxes they impose, compared to other jurisdictions, this will cause residents and business to bid up property values. Conversely, if local governments offer poor services relative to taxes, this will cause property values to fall.

If property values fall when taxes are increased, this indicates that residents and businesses place less value on government services than it costs to provide them. If the fall in the property values is equal to or greater than the amount of the tax increase, this means that the residents and businesses value the government services provided at zero.

The study tests this hypothesis by estimating the effect of changes in tax rates on property values, while holding other factors that effect property values constant. For Houston the evidence shows that an increase in the property tax rate causes a decrease in property tax value. Further, the decrease in property tax value more than offsets the increase in property tax rate.[29]

We can conclude from this study that Houston is clearly on the wrong side of the Laffer curve. Property tax rates in Houston are so high that further increases in property tax rates will actually reduce property tax revenues. If Houston wants to promote economic growth and generate more property tax revenue it should lower the property tax rate.

The question is whether these findings are unique to Houston or extend to other cities as well. The study estimates elasticity in three other cities, New York, Minneapolis, and Philadelphia. In all four cities property values respond negatively to increases in property tax rates.[30]

There is every reason to expect that this negative relationship between property tax rates and property values would be found in other Texas cities as well. While Houston property tax rates are high, they are not out of line with property tax rates in other Texas cities. Texas has some of the highest property tax rates in the country.

Even in Texas, state revenue and spending has outpaced the growth of personal income. This suggests that there is room for tax cuts and reform of Texas' tax system.

Texas residents can reduce their property tax burden by moving to any other state except Wisconsin. This is important because it suggests that the mobility of residents and businesses is not within different jurisdictions within Texas; rather, it is mobility out of the state of Texas. Houston is not unique in this regard; most Texas cities are likely to find themselves on the wrong side of the Laffer curve. High marginal property tax rates are driving residents and businesses out of the state.

Readers might ask how Texas got into such a pickle. Why would cities such as Houston increase property tax rates to such a high level that they drive out residents and businesses? If the Houston city government was maximizing the welfare of citizens, they would raise property taxes only when residents and businesses value the government services provided at least equal to or greater than the cost of those services in the form of higher taxes. The explanation is that city governments may exert monopoly power, not unlike that exercised by monopoly firms in the private sector. The difference is that the government can impose a legal monopoly which may persist in the long run. In contrast, monopoly power in the private sector will be eroded by competition in the market place, unless protected by legal restrictions on competition.

Texas residents can reduce their property tax burden by moving to any other state except Wisconsin.

To the extent that the Houston city government can exert monopoly power, it can capture a portion of the revenue generated by property taxes in the form of a surplus. The surplus is equal to the difference between the revenue generated by the tax, and the value of services provided to citizens by the government.[31]

How that surplus is divided up depends upon the success of special interest groups in seeking privileges through the public sector. Part of the surplus may be captured by politicians and bureaucrats in the form of bribes, kickbacks, and other forms of corruption. Politicians and bureaucrats may be paid wage and non wage benefits in excess of the value of the services they provide. This is especially likely to be true when public sector employees are unionized. The wage, pension, and non pension benefits received by employees in the public sector often exceed that received by comparable employees in the private sector. Unfunded liabilities linked to pension and health benefits guaranteed public sector employees has emerged as a major problem for both state and local governments.

Special interest groups in the private sector may also capture a portion of the surplus. When private contractors are paid by governments in excess of the value of the services they provide, they capture a portion of the surplus. A portion of these payments may also be fraudulent. For example, it is estimated that one in four Medicaid bills is fraudulent, and only recently have state governments begun to audit such charges.

Finally, much of the surplus is transferred through entitlement programs. While these entitlement programs are defended as transferring income to the poor, in reality much of the income transferred is captured by the non poor.[32]

At all levels of government, the taxes imposed—and the revenue generated by those taxes—have little relationship to the value of government services provided. The explanation for these taxes is redistributive politics. We have become a transfer society in which special interests dominate fiscal policy decisions. Residents and businesses that pay taxes are engaged in a battle with special interests who view the government as a source of special privilege and income transfers. Tax and expenditure limits have emerged as a very powerful tool to protect taxpayers from the predatory activities of these special interests.

Tax and Expenditure Limits[33]

The Rationale for Tax and Expenditure Limits

Tax and spending limits are designed to address two problems: the increase in government revenues and spending relative to income in the long run and the volatility of government revenues and spending over the business cycle.[34]

Since World War II, the growth of government revenue and spending has outpaced the growth of income in most states.[35] One cause of this trend is the tendency of government to expand rapidly during periods of economic growth. In other words, a "ratchet up" of taxes and revenues often accompanies periods of economic growth.

Since World War II, the growth of government revenue and spending has outpaced the growth of income in most states.

In periods of prosperity, because income is rising, governments tend to increase spending to match the increase in revenues. However, when income growth slows or a recession hits, and revenues fall, governments are reluctant to cut spending. As a result, there is pressure to increase taxes to offset the budget shortfall. Over time, this "ratchet up" effect results in increased government revenues and spending relative to private income.

The Experience With Tax and Expenditure Limits in the States

A variety of different tax and expenditure limits (TELs) have been implemented in the states. In total, 28 states have implemented such limits.[36] Recent studies show that the most effective of these TELs constrain the growth of government revenue and spending to the sum of inflation and population growth. This type of tax and expenditure limit has been introduced in four states: California, Colorado, Missouri, and Washington. In all four states, the tax and spending limit has at various points both constrained the growth of government and stabilized the budget over the business cycle—forcing the states to prepare for economic downturns by restraining the growth of government spending during periods of rapid economic growth. In recent years, California, Missouri, and Washington have suspended their tax and spending limits.[37] In Colorado, however, the TABOR amendment remains the most effective tax and spending limit in the country.[38]

Colorado's Taxpayer's Bill of Rights (TABOR) Amendment

In 1992, Colorado voters approved the Taxpayer's Bill of Rights (TABOR) amendment with a 54 percent majority on the ballot.[39] TABOR is a constitutional amendment that includes the following provisions:

- Voter approval for all tax increases.
- Limits the amount that state and local governments may spend to the rate of population growth plus inflation.
- Surplus revenues above this amount must be returned to taxpayers.
- Existing limits may not be weakened without voter approval.

Since TABOR was passed in 1992, the Colorado legislature has not enacted a single state tax increase. TABOR constrains state government growth to the sum of inflation and population growth, and imposes similar constraints on the growth of local government. Surplus revenue above the TABOR limit must be returned to taxpayers. More than $3 billion in surplus revenue has been returned to taxpayers through tax rebates and tax cuts.

The Taxpayer's Bill of Rights amendment set the stage for fundamental tax reform in Colorado. Colorado has reduced state income taxes, the state sales taxes, and a wide range of other taxes, such as the business personal property tax.

The Taxpayer's Bill of Rights amendment set the stage for fundamental tax reform in Colorado. Colorado has reduced state income taxes, the state sales taxes, and a wide range of other taxes, such as the business personal property tax.

TABOR changes the debate over fiscal policy decisions. Usually the debate over fiscal policy is dominated by those most directly affected, i.e. the special interests who benefit from increased government expenditures. When politicians respond to these special interests the question is how to increase taxes and debt to finance higher levels of government spending.

TABOR gives citizens a new voice in fiscal policy. Citizens exercise this voice at several stages of fiscal decision making. Citizens first set a limit to the growth in government spending, imposing a hard budget constraint on politicians. Politicians must then set priorities for spending consistent with that limit. If politicians want to spend in excess of the limit, they must seek voter approval. Citizens, rather than politicians, then determine whether the benefits of government programs justify the additional expenditures. If politicians violate the limit, citizens have recourse through the legal system to recover the excess spending. Citizens must approve any increase in taxes or debt.

In Colorado, where TABOR has been in place for more than a decade, fiscal policies reflect this new voice for citizens. The state has rebated more than $3 billion in surplus revenue. Taxpayers have received rebate checks for hundreds of dollars from both state and local governments.

Critics argue that citizens should not be given this new voice in fiscal decisions. They argue that fiscal decisions should be left to the discretion of politicians. In

their view politicians are better informed, and better able to pursue the public interest without the constraints imposed by tax and spending limits. But citizens know that too often those decisions reflect special interests rather than the public interest.

TABOR *replaces ambiguous fiscal contracts between citizens and politicians with an explicit contract*. Citizens must be informed regarding any proposed increase in taxes or debt, what the money will be spent for, and what it will cost them. Most importantly, it is citizens, rather than politicians and special interests, who determine whether taxes and debt will be increased. When citizens have been given this voice they overwhelmingly support the constraints that TABOR imposes on fiscal policy decisions.

Colorado citizens have been exercising their voice in fiscal policy decisions for more than a decade under TABOR. This has proven to be an important experiment in direct democracy. The election results, when Colorado citizens vote on tax and debt increases, are very revealing. When these elections are held in small jurisdictions, such as special districts, the approval rate is very high, in excess of 90 percent in most years. One explanation is that the turnout for these elections is usually light. But another explanation is that at this level citizens are better able to hold the government accountable. The jurisdiction must identify a specific project and the cost of that project to individual citizens.

TABOR replaces ambiguous fiscal contracts between citizens and politicians with an explicit contract.

When these elections are held at the municipal level they pass about half the time. The state has asked voters for approval to increase taxes and spend surplus revenue several times since TABOR was enacted. Last year, for the first time, voters approved state expenditure of surplus revenue over the next five years.

The experience with direct democracy in fiscal policy in Colorado under the TABOR Amendment is in some ways not surprising. The Colorado Tax Commission conducted a survey of citizens' attitudes toward the tax system and government spending.[40] Citizens responded that they thought government wastes a significant amount of tax dollars at all levels of government; but they viewed government waste the greatest at the federal level, less at the state level, and least at the local level. From their perspective they are better able to monitor the expenditures of tax dollars and hold government officials accountable at the local level.

TABOR has reestablished the nexus between those who vote for tax increases and those who must pay the cost of the higher taxes. Almost every citizen, even those who pay little or no taxes, is confronted with the decision to allow the state to spend surplus revenue and forgo their rebate checks, or to keep the rebates. TABOR creates both the opportunity and incentive for citizens to become involved in fiscal decisions. All Colorado citizens, including those who pay little or no taxes, have an incentive to become informed regarding these ballot issues, to vote, and to monitor how their tax dollars are spent.

In Colorado, the citizens who vote on new taxes or debt and on the expenditure of surplus revenue, are also likely to be the citizens who will have to bear the burden of these fiscal decisions. The experience under TABOR in Colorado is that giving citizens a voice in fiscal policy results in more prudent fiscal decisions, and constrains the growth of government. TABOR has also achieved an egalitarian outcome, not by transferring income and wealth from a minority to the majority, but rather by vesting each citizen with a stake in the outcome of fiscal decisions.

A recent survey found that more than 60 percent of Coloradoans support the Taxpayer's Bill of Rights amendment—more than when it was passed a decade ago, suggesting that TABOR has become more popular over time.[41] Another recent survey commissioned by the Independence Institute and the Colorado Club for Growth found that the majority of Coloradoans still support the Taxpayer's Bill of Rights Amendment

A recent survey found that more than 60 percent of Coloradoans support the Taxpayer's Bill of Rights amendment—more than when it was passed a decade ago, suggesting that TABOR has become more popular over time.

The ALEC Model Tax and Expenditure Limit

Despite this popularity, the TABOR amendment has come under fire recently in Colorado because of the so-called "ratchet down" effect.[42] As described above, TABOR limits the growth of revenue to the sum of inflation and population growth. The limit applies to the previous limit, or to actual revenue, whichever is lower. When revenue falls in a recession, this sets a lower base against which the limit is applied. When revenue increases above the limit, surplus revenue must be rebated to taxpayers. The criticism is that these taxpayer rebates may be paid even though revenue has not yet recovered to the pre-recession level.

An alternative approach would be to hold the TABOR limit constant when there is a fall in revenue, and then trigger the limit once revenue has recovered to pre-recession levels. The proposal would also create a budget stabilization fund linked to the TABOR Amendment. In periods of economic growth, some surplus revenue could be set aside in a budget stabilization fund and then used to offset revenue shortfalls in periods of recession. This modified TABOR Amendment is the basis for a model tax and spending limit recently adopted by the American Legislative Exchange Council.[43] It is also the basis for the proposed Taxpayer Protection Amendment for Texas—the focus of this report.

Tax and Expenditure Limits in Texas

An Ineffective Constitutional Tax and Expenditure Limit

Texas citizens may be surprised to learn that the state Constitution already has a tax and expenditure limit. This surprise is certainly understandable, since the current limit has been relatively ineffective in constraining the growth of government. In order to understand the need for a Taxpayer Protection Amendment in Texas, it is first important to understand the flaws in the existing tax and spending limit.[44]

Texas passed an expenditure limit in 1978, the same year that the Ronald Reagan-inspired Proposition 13 property tax cap passed in California.[45] Article 8, Section 22 of the Texas Constitution states, "the rate of growth of appropriations from state revenues not dedicated by the Constitution" is restricted to the "rate of growth of the state's economy." The statute enabling this section of the Constitution is Chapter 316, Subchapter A of the Government Code. In that statute, economic growth is defined as total state personal income growth predicted for the next biennium. The Legislative Budget Board is responsible for determining economic growth under the statute.

This tax and spending limit has rarely constrained the growth of state revenue and spending. Understanding why begins by exploring several loopholes in the current limit.

The most important loophole is linking the limit to the growth of personal income. In effect, this is no limit because it locks state appropriations in as a share of income. In periods of rapid economic growth, this limit permits a rapid growth in revenue and spending. If income increases more rapidly than revenues, the limit imposes no constraint on spending. Even when revenues have increased more rapidly than the growth in income, legislators have found loopholes that enable them to circumvent the limit.

Texas passed an expenditure limit in 1978, the same year that the Ronald Reagan-inspired Proposition 13 property tax cap passed in California.

Another loophole is that the Legislative Budget Board (LBB) is given a great deal of discretion in estimating economic growth. There is also no restriction on dedicated revenues. As a result the gasoline tax and licensing fees, which are dedicated, can increase faster than the state economy. The Legislature also has discretion in shifting funds between dedicated and non-dedicated revenue so as to avoid constraints on spending.

Yet another loophole is that the Legislature has the discretion to expand the appropriations base. If the tax and spending limit would constrain spending in the second biennium, the Legislature can book spending in the first biennium, which increases the appropriations base in the second biennium.

Finally, the Legislature can declare an emergency and exceed the limit by a simple majority vote. While the Legislature never exploits this loophole, it is an easy hurdle to overcome.

The table on the following page reveals these flaws in the current tax and spending limit. In this analysis we make the heroic assumption that the Legislative Budget Board is able to perfectly predict the rate of growth in personal income in the coming year. In other words, predicted personal income growth is assumed to be equal to actual income growth. The limit on the growth in state spending is then equal to actual expenditures in the previous year times income growth in the current year.

The fact that the limit did not indeed constrain spending in these years cannot be explained away as due to forecasting errors. The fact is that the Legislature has been able to circumvent this limit.

Table 1: General Fund Expenditures and Current Expenditures Limit

Year	General Fund Expenditures ($ millions)	General Fund Expenditures (annual % change)	Current Expenditures Limit ($ millions)
1990	13,647		
1991	15,514	13.68%	14,336*
1992	13,596	-12.36%	16,707
1993	18,401	35.34%	14,325*
1994	19,845	7.85%	19,492*
1995	21,024	5.94%	21,061*
1996	24,636	17.18%	22,607*
1997	24,736	0.41%	26,824
1998	26,733	8.07%	26,965
1999	26,906	0.65%	28,417
2000	26,894	-1.04%	29,545
2001	29,003	7.84%	28,118*
2002	30,572	5.41%	29,331*
2003	30,656	0.27%	31,694
2004	29,390	-3.99%	32,590
2005	29,711	0.09%	31,685
2006	32,283	8.66%	
2007	31,843	-1.38%	

*years in which the expenditure limit should have been a binding constraint.

***Source**: Fiscal Survey of the States, National Association of State Budget Officers, various issues; Data for 2006 and 2007 is estimated.*

In seven years the expenditure limit was below actual expenditures, and the limit should have been a binding constraint. The fact that the limit did not indeed constrain spending in these years cannot be explained away as due to forecasting errors. The fact is that the Legislature has been able to circumvent this limit.

Even if the Legislature had been constrained by this limit this would have had a pro-cyclical impact on state spending. The limit would have been more binding in recession years than in years when the economy was growing rapidly. In

other words this limit builds in greater volatility in state spending over the business cycle. It is difficult to imagine more imprudent fiscal rules and fiscal policies. A prudent fiscal policy would set aside and retain money in the Budget Stabilization Fund in periods of prosperity, such as the 1990s, and then use those funds to offset revenue shortfalls in periods of recession, such as that experienced in the first years of the current decade.

The major flaw in the limit is that it simply locks in government spending as a share of personal income. Even if it had been a binding constraint, the limit would have failed to constrain the growth of spending or stabilized the budget over the business cycle. When the economy is growing and revenue is rising, state spending rises to match the growth in revenue. Texas does not have an effective Budget Stabilization Fund, so very little, if any, of the revenue is set aside to offset future revenue shortfalls. When a recession hits and revenue falls, the state experiences a fiscal crisis. It is difficult to reduce spending to match the fall in revenue. As there is no effective Budget Stabilization Fund to fall back on, elected officials therefore face great pressure to increase taxes to offset the revenue shortfall. The result is a ratcheting up of revenue and spending from one business cycle to the next.

A prudent fiscal policy would set aside and retain money in the Budget Stabilization Fund in periods of prosperity, such as the 1990s, and then use those funds to offset revenue shortfalls in periods of recession, such as that experienced in the first years of the current decade.

The Myth of Property Tax Relief in Texas

To understand why a new tax and expenditure limit is needed in Texas we must explore the myth of property tax relief. For many years Texas citizen have tried unsuccessfully to limit property taxes. Clearly these efforts have failed.

1) Texas has the 13th highest property taxes relative to income in the country
2) Local property tax revenues increased sevenfold, from $3.9 billion in 1980 to $28.2 billion in 2004.
3) While Texas is generally regarded as a low tax state, property owners bear a disproportionate share of the tax burden.

Increasing property taxes imposes a heavy burden on Texas citizens, especially on the least advantaged. This is reflected in the small share of people who can afford a home, and a growing number who can’t afford to keep their home.

1) Texas ranks 45th in the country in homeownership.
2) Texas foreclosure rates per capita are the fourth highest in the country, with 1 in every 549 households in the process of foreclosure in January 2006.
3) Many Texas homeowners now pay taxes equal to their monthly house payments.

It is important to understand why the Texas property tax limits have failed to constrain the increase in property taxes. In 1982, Texas enacted a statutory limit on property taxes based on assessment caps and revenue rollbacks. Texas imposes a very generous property tax assessment cap of 10 percent. Several measures have been introduced in the legislature to lower that assessment cap. Texas also provides for a revenue rollback only after property values are reassessed.

Each local jurisdiction then calculates a rollback tax rate. That tax rate must provide the same amount of revenue as in the prior year, plus an 8 percent "buffer." The rollback tax rate must also provide sufficient funds to pay current debt. If property tax revenues come in above the limit, citizens can petition for an election to rollback the increase to 8 percent.

There are several reasons why assessment caps and revenue rollbacks have failed to constrain the growth of property taxes:

1) The limit provides a generous 8 percent "buffer." Legislation has been introduced at both the state and local level to lower that rollback rate.
2) The limit is not triggered automatically. Citizens must first petition to put a referendum on the ballot, and then secure a majority vote to enforce the revenue rollback.
3) Exemptions are provided to some school districts to set rates above the rollback limit. This exempts a substantial share of revenue from the limit in those jurisdictions.
4) The limit lacks transparency and accountability. Legislation has also been introduced to try to increase transparency, and to make it easier for citizens to petition for a rollback election.

A constitutional Amendment passed in 1997 imposed a 10 percent appraisal cap on Homesteads. This type of limit has several flaws.

1) The 10 percent cap is too generous. Under this cap residential homestead property taxes can double in only seven years.
2) Capping appraisals does not limit homestead property taxes because it does not limit property tax rates. Property tax rates can be increased to offset any constraints imposed by appraisal limits.
3) Appraisal caps on homesteads can be distort homeowner decisions to sell their homes.
4) Appraisal caps on homesteads are inefficient to the extent that they result in lower taxes on residential compared to nonresidential property.
5) With a high turnover rate for property few individuals qualify for the benefits of appraisal caps on homestead property.
6) The appraisal caps lead to inequities between those who are eligible and those not eligible for the homestead exemption. In many cases the latter group are among the least advantaged.

The myth of local property tax relief persists despite the evidence from past state efforts to provide this relief. The Texas legislature has been largely unsuccessful in using state funds to provide local property tax relief in the past. Earlier this year the legislature voted to give property owners a reduction in their school property taxes over the next two years. There are several flaws in this approach to property tax relief.

1) The major flaw is the fungible nature of state and local funds, and the taxes used to generate those funds. When schools districts have received

funds from the state in the form of property tax relief they have often used those funds to boost spending. They are currently somewhat constrained in their ability to do so; however, city and county governments do not face these constraints when they choose to raise taxes or issue new debt.

2) In the long run property assessments and property tax rates are often increased, resulting in higher, rather than lower, property tax burdens. All one has to do is look at the annual double-digit increases in property tax revenues in many local jurisdictions over the past decade.

Because past efforts to provide property tax relief have failed, we are witnessing a property tax revolt in Texas. Homeowners have found their property taxes increasing at double digit rates. City and county governments have responded to the windfall of increased property tax revenues with double-digit growth in spending.

In Houston taxpayers have responded to this unconstrained growth in their city government by enacting a new tax and spending limit, that will be discussed in the following section

Because past efforts to provide property tax relief have failed, we are witnessing a property tax revolt in Texas. Homeowners have found their property taxes increasing at double digit rates.

Designing New Tax and Expenditure Limits for Texas

Houston's Proposition 2 Amendment

If Texas citizens are to receive property tax relief, they must impose an effective limit on spending and revenue at the local level. There is a precedent for this type of spending and revenue limit in Proposition 2, which was recently incorporated in the Houston City Charter (see the model legislation based on the Houston Charter Amendment in Appendix B).

Proposition 2 was designed along the same lines as our proposed Taxpayer Protection Amendment, incorporating important refinements in Colorado's Taxpayer Bill of Rights Amendment. It links a stringent tax and spending limit to an emergency and rainy day fund. This limit will both constrain the growth of spending and stabilize the budget over the business cycle.

When Proposition 2 was placed on the ballot through an initiative, the Houston City Council responded with its own watered down limit. The latter was clearly designed to preempt the more stringent Proposition 2 initiative drafted by a local taxpayer group. When both ballot measures passed, the mayor of Houston interpreted the result to mean that the weaker limit was the binding constraint.

The taxpayer group then successfully challenged that interpretation in the courts, so that the more stringent Proposition 2 is now in the city charter. The Houston City Council continues to attempt to undermine the limit imposed by Proposition 2.

The experience with Proposition 2 in Houston is a familiar pattern. Special interests and politicians who oppose constraints on revenue and spending use different tactics to block this legislation. They attempt to keep these measures off the ballot, or substitute weak watered down limits.

As Governor Perry has argued, Texas needs a more effective tax and spending limit. The state must be able to use surplus revenue above that limit to provide property tax relief. The current limit precludes the use of surplus revenue for property tax relief; and past efforts at property tax relief have failed.

A Taxpayer Bill of Rights (TABOR) Amendment

Over the past decade state spending has increased much more rapidly than inflation and population growth. Since 1991 the growth in state spending has exceeded the sum of inflation and population growth by 41 percent.[46]

A Taxpayer's Bill of Rights (TABOR) amendment is designed to constrain the growth of spending. In Table 2, a TABOR Amendment is simulated for the Texas economy. This simulation makes several simplifying assumptions. The limit is defined as the sum of inflation plus population growth. This limit constrains the growth in revenue the state can keep and spend each year. The assumption is that surplus revenue is rebated to taxpayers. If Texas had had a TABOR Amendment in place, more than $88 billion in surplus revenue would have been rebated to tax payers over this period.

Table 2: Simulating a TABOR Amendment (millions of dollars)

Year	General Fund Revenue ($ millions)	TABOR Limit (%)	TABOR Limit	TABOR Surplus
1990	13,927	5.04		
1991	15,776	6.56	14,679	1,097
1992	13,222	4.45	14,679	
1993	19,352	4.80	15,332	4,020
1994	20,443	5.05	16,068	4,375
1995	22,078	4.75	16,880	5,198
1996	24,831	4.70	17,681	7,150
1997	25,069	3.81	18,512	6,557
1998	27,379	3.57	19,218	8,161
1999	27,260	4.84	19,904	7,356
2000	25,648	5.67	20,867	4,781
2001	29,363	5.30	22,050	7,313
2002	28,516	3.17	23,219	5,297
2003	28,770	3.77	23,995	4,775
2004	30,828	3.11	24,848	5,980
2005	32,655	5.09	25,631	7,024
2006	31,901	5.88	26,936	4,965
2007	32,927		28,520	4,407

***Source**: Fiscal Survey of the States, National Association of State Budget Officers, various issues, data for 2006 and 2007 is estimated; U.S. Census Bureau data for population growth; Bureau of Labor Statistics for inflation.*

A Taxpayer Protection Amendment (TPA)

A Taxpayer Protection Amendment (TPA) is designed to both constrain the growth of government, and stabilize the budget over the business cycle. A TPA Amendment links the stringent limit of population growth and inflation, to an emergency and budget stabilization fund. In periods of prosperity, when revenue exceeds the limit, surplus revenue is allocated to the emergency and budget stabilization fund. When the economy enters a recession, money is transferred from the budget stabilization funs to offset the revenue shortfall (see Appendix A).

In the following table a Taxpayer Protection Amendment is simulated for the Texas economy. Several assumptions are introduced into the analysis. A 10 percent cap is placed on the emergency and budget stabilization fund. When the 10 percent cap is reached on this fund, additional surplus revenue is allocated to a property tax relief fund. In periods of recession money is allocated from the emergency and budget stabilization fund to offset the revenue shortfall. At that point the limit is held constant until revenue again exceeds the limit.

Table 3: Simulating a Taxpayer Protection (TPA) Amendment
(millions of dollars)

Year	General Fund Revenue ($ millions)	TPA Limit	TPA Surplus	Emergency and Budget Stabilization Fund	Property Tax Relief Fund
1990	13,927				
1991	15,776	14,679	1,097	1,097	
1992	13,222	14,679			
1003	19,352	15,332	4,020	1,533	2,487
1994	20,443	16,068	4,375	1,607	4,301
1995	22,078	16,880	5,198	1,688	5,117
1996	24,831	17,681	7,150	1,768	7,070
1997	25,069	18,512	6,557	1,851	6,474
1998	27,379	19,218	8,161	1,922	8,090
1999	27,260	19,904	7,356	1,990	7,288
2000	25,648	20,867	4,781	2,087	4,684
2001	29,363	22,050	7,313	2,205	7,195
2002	28,516	23,219	5,297	2,322	5,180
2003	28,770	23,995	4,775	2,396	4,701
2004	30,828	24,848	5,980	2,485	5,891
2005	32,655	25,631	7,024	2,563	6,946
2006	31,901	26,936	4,965	2,694	4,834
2007	32,927	28,520	4,407	2,852	4,249

***Source**: Fiscal Survey of the States, National Association of State Budget Officers, various issues, data for 2006 and 2007 is estimated; U.S. Census Bureau data for population growth; Bureau of Labor Statistics for inflation.*

The limit is first imposed in 1991. In that year, all of the surplus is allocated to the emergency and budget stabilization fund. In 1992 a recession brings a revenue shortfall. Money is then transferred from the budget stabilization fund to offset the revenue shortfall. The limit is held constant in 1992. In 1993 revenue growth again exceeds the limit. In that year part of the surplus is allocated to the emergency and budget stabilization fund, and the remainder is allocated to the property tax relief fund. In the remaining years surplus revenue is allocated to the emergency and budget stabilization fund; additional surplus revenue is allocated to the property tax relief fund.

Over the period as a whole almost $3 billion would have been allocated to the emergency and budget stabilization fund. More than $84 billion would have been allocated to the property tax relief fund.

Property Tax Relief

The following table compares this property tax relief fund to the actual local property taxes paid over this period. In this analysis it is assumed that property tax relief is provided through a lump sum rebate to property owners. An alternative would be to permanently reduce or eliminate some property taxes. For example, one study suggests that with this type of limit in place the property tax relief fund could be used to eliminate the school maintenance and operations property tax over the next couple decades.[47]

Table 4: Simulating Property Tax Relief
(millions of dollars)

Year	Property taxes	Property Tax Relief Fund	Property Tax Relief/ Property Taxes
1993	13,896	2,487	17.9%
1994	13,882	1,161	8.4%
1995	14,188	3,510	24.7%
1996	15,248	5,382	35.3%
1997	16,349	4,706	28.8%
1998	17,333	6,239	36.0%
1999	18,805	5,366	28.5%
2000	19,817	2,694	13.6%
2001	n/a	5,108	n/a
2002	24,521	2,975	12.1%
2003	n/a	2,419	n/a
2004	28,176	3,495	12.4%

***Source**: U.S. Census Bureau data for property taxes; table 4 for property tax relief fund.*

The share of property taxes offset by property tax relief varies from 8 percent in 1993 to 36 percent in 1997. It should be noted that the 1990s was a period of very rapid economic growth, accompanied by rapid growth in state revenue. State revenue is projected to grow at a slower pace in the current decade. Nonetheless, this analysis demonstrates that a TPA limit is just the ticket if Texas is to provide significant property tax relief to citizens. Even with slower economic growth Texas could be allocating property tax relief equal to 12 percent of property taxes paid with a TPA.

A Taxpayer Protection Amendment would impose a limit on the amount of property tax revenue that local jurisdictions could collect. That limit is equal to inflation and population growth. If property tax revenues exceed that limit local jurisdictions would have to reduce property tax rates to keep within the limit. In the following table this limit is calculated for property tax revenue growth over the period 1992 to 2004. By the end of the period property tax revenues would have been reduced one fourth with this limit. This would have provided almost $6 billion a year in property tax relief.

Table 5: Simulating A Property Tax Limit
(millions of dollars)

Year	Property taxes	Property Tax Limit
1993	13,896	13,807
1994	13,882	14,510
1995	14,188	15,273
1996	15,248	16,003
1997	16,349	16,797
1998	17,333	17,632
1999	18,805	18,400
2000	19,817	19,075
2001	n/a	19,876
2002	24,521	20,829
2003	n/a	21,910
2004	28,176	22,663

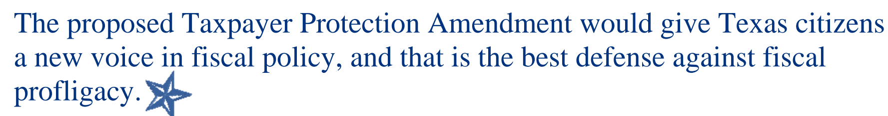
***Source**: U.S. Census Bureau data for property taxes; table 4 for property tax relief fund.*

Conclusion

What taxpayers have learned since Governor Reagan launched the tax revolt three decades ago is that fiscal policy is too important to be left to the discretion of politicians. The strongest bulwark against profligate fiscal policies is a fiscal constitution that imposes constraints on the power of politicians to increase the tax burden.

Although Texas has a state spending limit as well as revenue limit measures at the local level, these have largely been ineffective in checking the growth of government in Texas. Local property taxes are excessively high and have grown too fast in Texas, and they have stunted the state's economy. If the state of Texas had a spending limit based on population growth and inflation instead of the current limit based on growth in personal income, Texans could have saved $88 billion from fiscal 1990 through fiscal 2007.

The proposed Taxpayer Protection Amendment would give Texas citizens a new voice in fiscal policy, and that is the best defense against fiscal profligacy.



Endnotes

[1]Ronald Reagan, "Reflections on the Failure of Proposition #1," *National Review* (7 Dec. 1973).
[2]Milton Friedman, "Freedom's Friend," *The Wall Street Journal* (11 June 2004).
[3]Adam Smith, The Wealth of Nations, Book V, Chapter II; quoted in Haughwout, Andrew, Inman, Robert, Craig, Steven, and Luce, "Local Revenue Hills: Evidence from Four Cities, in Review of Economics and Statistics," Vol. 86, Issue 2 (May 2004) 1.
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[5]John Maynard Keynes, Collected Works of John Maynard Keynes, St. Martin's Press: 338, quoted in Haughwout, Andrew, Inman, Robert, Craig, Steven, and Luce, "Local Revenue Hills: Evidence from Four Cities, in Review of Economics and Statistics," Vol. 86, Issue 2 (May 2004) 1.
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[7]Timothy Bartik, "Who Benefits from State and Local Economic Development Policies?" Upjohn Institute: Kalamazoo, MI (1991).
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[9]U.S. Census Bureau
[10]While Texas is often compared to other states in the high plains, it is also competing with more rapidly growing states in the Rocky Mountain and Southwest regions.
[11]Op. Cit. U.S. Census Bureau
[12]U.S. Bureau of Labor Statistics
[13]"State Business Tax Climate Index Ranks State Tax Systems On How Friendly They Are to Business," The Tax Foundation: Washington, D.C. (22 May 2003).
[14]"Texas' Tax Burden Compared to the U.S. Average," The Tax Foundation: Washington, D.C. (7 Apr. 2004)
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[19]Ibid.
[20]U.S. Census Bureau, The Tax Foundation calculations, http://www.taxfoundation.org.
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[23]"State Business Climate Index Ranks State Tax Systems on How Friendly They Are to Business," *The Tax Foundation*, Nov. 4, 2004.
[24]Texas Voter Survey (June 11-15, 2003).
[25]Ibid.
[26]"The Facts on Ohio's Tax Climate," The Tax Foundation: Washington, D.C. (June 2006).
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[28]Haughwout, Andrew, Inman, Robert, Craig, Steven, and Luce, "Local Revenue Hills: Evidence from Four Cities, in Review of Economics and Statistics," Vol. 86, Issue 2 (May 2004). In addition to Houston the study examines the impact of taxes on economic activity in New York, Philadelphia, and Minneapolis.
[29]For Houston, the best estimate of the elasticity of the property tax base to the tax rate is -.76 in the short run, and -1.13 in the long run. What this means is that in the long run a 10% increase in the property tax rate will decrease the property tax base by 11.3%. In the long run property tax revenue will be lower (by -1.13%) than they were before the tax rate increase. The study reveals that residents of Houston do not place any value on recent increases in property tax rates. Each additional dollar in property tax revenues yields only $.21 in value for government services. This means that $.79 of each additional dollar in property tax revenue is captured as surplus by special interests.
[30]Op. Cit Haughwout, Andrew et. al., 6.
[31]In the "New Political Economy" literature this surplus is often referred to as a pure rent.
[32]*See* for example, Michael Tanner, "Welfare Reform Less Than Meets the Eye," Policy Analysis No. 473, CATO Institute (1 Apr. 2003).
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[34]The definition of the business cycle is based on the National Bureau of Economic Research measures of peaks and troughs in the growth of aggregate economic activity as measured by Gross National Product or Gross Domestic Product. For example, a recession is defined to occur after several continuous decreases in quarterly Gross National Product.
[35]David Hoffman, Ed., Facts and Figures on Government Finance, The Tax Foundation: Washington, D.C. (Nov. 2004) 191-271.
[36]Op. Cit. Poulson, "Tax and Spending Limits: Theory Analysis and Policy."
[37]For a discussion of the experience with tax and spending limits in these states, *see* Ibid, 10-16.
[38]Ibid, 10-16.
[39]Barry W. Poulson, "Colorado's TABOR Amendment: Past Trends and Future Prospects," Americans for Prosperity Foundation: Washington, D.C. (July 2004).
[40]Even in Budget Crises Coloradoans Support TABOR Amendment Limits on Taxes and Government Spending, Poll Analysis, Ciruli Associates: Denver, CO (15 Apr. 2003).
[41]Even in Budget Crises Coloradoans Support TABOR Amendment Limits on Taxes and Government Spending, Poll Analysis, Ciruli Associates: Denver, CO (15 Apr. 2003).
[42]Op. Cit. Poulson, "Colorado's TABOR Amendment."
[43]Ibid, passim.
[44]Texas also has constitutional and statutory limits on local government revenue and spending. For a critical analysis of these local tax and spending limits *see* Schlomach, "Tax and Expenditure Limitation Reform Is it Needed in Texas."
[45]Byron Schlomach, Ph.D., "Tax and Expenditure Limitation Reform: Is It Needed in Texas?" Texas Public Policy Foundation: Austin, TX (Aug. 2004).
[46]Fiscal Survey of the States, National Association of State Budget Officers, various issues.
[47]Byron Schlomach, Ph.D., "Reducing School M&O Taxes After 2008," Texas Public Policy Foundation: Austin, TX (Sep. 2006).

Appendix

Model Taxpayer Protection Act (State and Local)

BE IT RESOLVED BY THE LEGISLATURE OF THE STATE OF ___________________

SECTION 1. SPENDING LIMITS

A "state spending limit" is established equal to the total amount of state fiscal year spending in the preceding fiscal year increased by a percentage equal to the result obtained by adding any positive increase in the rate of inflation for the calendar year ending during the preceding fiscal year, plus any positive percentage change in state population during the calendar year ending during the preceding fiscal year. This state spending limit is the binding constraint on the total amount of revenue the state can spend in any fiscal year in which revenue exceeds the state spending limit.

For any fiscal year in which state revenue is less than the state spending limit for that year, the state spending limit for that fiscal year becomes the binding constraint on the amount of revenue the state can spend in all subsequent fiscal years until revenue again exceeds that state spending limit.

The maximum annual percentage change in each local district's fiscal year spending equals inflation in the prior calendar year plus annual local growth. "Local growth" for a non-school district means a net percentage change in actual value of all real property in a district from construction of taxable real property improvements, minus destruction of similar improvements, and additions to, minus deletions from, taxable real property. For a school district, "local growth" means the percentage change in its student enrollment.

SECTION 2. REVENUE LIMITS

The maximum annual percentage change in each local district's property tax revenue equals inflation in the prior calendar year plus annual growth, adjusted for property tax revenue changes approved by voters.

Regardless of reassessment frequency, valuation notices shall be mailed annually and may be appealed annually, with no presumption in favor of any pending valuation. Past or future sales by a lender or government shall also be considered as comparable market sales and their sales prices kept as public records. Actual value shall be stated on all property tax bills and valuation notices and, for residential real property, determined solely by the market approach to appraisal.

SECTION 3. BUDGET STABILIZATION FUND

For any fiscal year in which district revenue exceeds the district spending limit, the district shall deposit into a budget stabilization fund all of the excess revenue, except that the total amount in the budget stabilization fund may not exceed an amount equal to 10 percent of the district's spending limit for that fiscal year.

For any fiscal year in which district revenue is less than the amount of the spending limit for that year, the district shall transfer money from the district budget stabilization fund to the general fund from available funds in the minimum amount necessary to offset a shortfall of revenue below the spending limit. The district may also make expenditures from its budget stabilization fund, only by a majority vote to provide relief from taxes imposed by state or local government. Under no other circumstances shall money be transferred from the budget stabilization fund.

SECTION 4. TAX REFUNDS

The district shall return to the taxpayers the amount of any excess revenue received in any fiscal year that is not deposited into the budget stabilization fund. If the revenue received by the district in any calendar year, for the calendar year district's, or in any fiscal year, for fiscal year district's, exceeds the district's spending limit, it shall return to the taxpayers the amount of the excess revenue received in the calendar year or fiscal year, as applicable. The tax refund shall be made in the calendar year, for calendar year district, or in the fiscal year,

for fiscal year district, immediately following the calendar year or the fiscal year in which the district has the excess revenue.

Subject to judicial review, districts may use any reasonable method for refunding surplus revenue. This may include tax rebates and/or rate reductions. When possible these refunds should be proportional to the excess taxes paid; however, refunds need not be proportional when prior payments are impractical to identify or return.

SECTION 5. EMERGENCY SPENDING AND SUSPENSION OF SPENDING LIMITS

The state spending limit may only be exceeded in an emergency, as defined herein, or by a voter-approved suspension. The state spending limit may be exceeded only during the fiscal year for which the emergency is declared or suspension is approved. In no event shall any part of the amount representing a refund be the subject of an emergency request.

(a) Emergency spending may occur only if all of the following conditions are met: (1) The governor determines that an imminent threat to public health or safety exists and requests the legislature to declare an emergency; (2) the request is specific as to the nature of the emergency, the dollar amount of the emergency, and the method by which the emergency will be funded; and (3) the legislature thereafter declares an emergency in accordance with the specific terms of the governor's request by a two-thirds vote of the members elected to and serving in each house. The emergency must be declared in accordance with this section prior to incurring any of the expenses which constitute the emergency request. Emergency excludes economic conditions, revenue shortfalls or fringe benefit increases. Emergency expenditures shall be made only when funds are available in the budget stabilization fund. When the above conditions are met the State Treasurer shall transfer funds from the budget stabilization fund to the general fund in the amount of emergency expenditures authorized. The funds so transferred must be replaced in the budget stabilization fund from surplus revenue in the next fiscal year in which surplus revenue is available. Emergency spending does not modify the state spending limits applicable in subsequent fiscal years.

(b) A voter-approved suspension of the state spending limit may occur only if all the following conditions are met: (1) two-thirds of the members of each house vote to refer a suspension of the limits, up to a predetermined maximum, to the voters; (2) a ballot advisory in bold capital letters directly above the ballot title instructs voters: 'a "yes" vote on this measure will authorize the state to retain extra taxes and spend them in excess of constitutional limits by [insert amount of predetermined maximum additional spending.]'; And (3) the suspension is approved by a majority of eligible voters participating in a statewide general election.

SECTION 6. STATE MANDATES

The legislature may, by law, adjust any spending limit imposed under this section:
(a) To accommodate the transfer of services from any district subject to a spending limit under this section to any other such district, including the transfer of services that results from annexation. Any increase to a district's spending limit under this paragraph shall be offset with a corresponding decrease to the spending limit of other entities affected by the transfer of services.
(b) To reflect the elimination or reduction of a state mandated service.
The state spending limit under this section for any year shall be reduced by the amount of any reduction in that year in the aggregate amount of state aid to any of the categories of county, city, village, town, special purpose district, school district, or technical college district, as compared to the previous year.

A state law or administrative rule that increases a local governmental unit's expenditures may not be enacted or adopted on or after the ratification of this subsection unless the state pays the reasonable costs incurred by the entity to comply with the law or rule. This subsection does not apply to any law or rule that is enacted or adopted in order to comply with a requirement of federal law, including a requirement related to receiving federal aid.

No local governmental unit may be required under state law to increase its annual compensation for any employee or group of employees by a percentage that exceeds the allowable percentage increase in the spending limit for that local governmental unit under this section.

Except for public education through grade 12 or as required of a local district by federal law, a local district may reduce or end its subsidy to any program delegated to it by the general assembly for administration. For current programs, the state may require 90 days notice and that the adjustment occur in a maximum of three equal annual installments.

SECTION 7. ELECTION PROVISIONS

Starting (insert date) districts must have voter approval in advance for:
(a) any new tax, tax rate increase, mill levy above that for the prior year, valuation for assessment ratio increase for a property class, or extension of an expiring tax, or a tax policy change directly causing a net tax revenue gain to any district.
(b) Except for refinancing district bonded debt at a lower interest rate or adding new employees to existing district pension plans, creation of any multiple-fiscal year direct or indirect district debt or other financial obligation whatsoever without adequate present cash reserves pledged irrevocably and held for payments in all future fiscal years.

Election provisions are as follows:
(a) Ballot issues shall be decided in a state general election, biennial local district election, or on the first Tuesday in November of odd-numbered years. Except for petitions, bonded debt, or charter or constitutional provisions, districts may consolidate ballot issues and voters may approve a delay of up to four years in voting on ballot issues. District actions taken during such a delay shall not extend beyond that period.
(b) At least 30 days before a ballot issue election, districts shall mail at the least cost, and as a package where districts with ballot issues overlap, a titled notice or set of notices addressed to "All Registered Voters" at each address of one or more active registered electors. The districts may coordinate the mailing required by this paragraph (b) with the distribution of the ballot information in order to save mailing costs.

Titles shall have this order of preference: **"NOTICE OF ELECTION TO INCREASE TAXES/TO INCREASE DEBT/ON A CITIZEN PETITION/ON A REFERRED MEASURE."**
Except for district voter-approved additions, notices shall include only:
(i) The election date, hours, ballot title, text, and local election office address and telephone number.
(ii) For proposed district tax or bonded debt increases, the estimated or actual total of district fiscal year spending for the current year and each of the past four years, and the overall percentage and dollar change.
(iii) For the first full fiscal year of each proposed district tax increase, district estimates of the maximum dollar amount of each increase and of district fiscal year spending without the increase.
(iv) For proposed district bonded debt, its principal amount and maximum annual and total district repayment cost, and the principal balance of total current district bonded debt and its maximum annual and remaining total district repayment cost.
(v) Two summaries, up to 500 words each, one for and one against the proposal, of written comments filed with the election officer by 45 days before the election. No summary shall mention names of persons or private groups, nor any endorsements of or resolutions against the proposal. Petition representatives following these rules shall write this summary for their petition. The election officer shall maintain and accurately summarize all other relevant written comments.

Except by later voter approval, if a tax increase or fiscal year spending exceeds any estimate in (iii) for the same fiscal year, the tax increase is thereafter reduced up to 100% in proportion to the combined dollar excess, and the combined excess revenue refunded in the next fiscal year. District bonded debt shall not issue on terms that could exceed its share of its maximum repayment costs in (iv). Ballot titles for tax or bonded debt increases shall begin, **"SHALL (DISTRICT) TAXES BE INCREASED (first, or if phased in, final, full fiscal year dollar increase) ANNUALLY...?" or "SHALL (DISTRICT) DEBT BE INCREASED (principal amount), WITH A REPAYMENT COST OF (maximum total district cost), ...?"**

SECTION 8. ENFORCEMENT PROVISIONS

This amendment to the constitution takes effect (insert starting date) Its preferred interpretation shall reasonably restrain most the growth of government. All provisions are self-executing and severable and supersede conflicting state constitutional, state statutory, charter, or other state or local provisions. Other limits on district revenue, spending, and debt may be weakened only by future voter approval.

Individual or class action enforcement suits may be filed and shall have the highest civil priority of resolution. Successful plaintiffs are allowed costs and reasonable attorney fees, but a district is not unless a suit against it be ruled frivolous. Revenue collected, kept, or spent illegally since four full fiscal years before a suit is filed shall be refunded with 10% annual simple interest from the initial conduct.

SECTION 9. DEFINITIONS

Term definitions are as follows:
(a) "Ballot issue" means a non-recall petition or referred measure in an election.
(b) "District" means the state or any local government, excluding enterprises.
(c) "Emergency" excludes economic conditions, revenue shortfalls, or district salary or fringe benefit increases.
(d) "Enterprise" means a government-owned business authorized to issue its own revenue bonds and receiving under 10% of annual revenue in grants from all state and local governments combined.
(e) "Fiscal year spending" means all district expenditures except, as to both, those for refunds made in the current or next fiscal year or those from gifts, federal funds, collections for another government, pension contributions by employees and pension fund earnings, damage awards, or property sales. Fiscal year spending does not include 1) any appropriations to fund 'emergencies' as defined in this section; 2) any appropriations funded by a suspension vote pursuant to this section 3) any surplus revenues transferred or rebated pursuant to this section 4) the payment of principal and interest on bonds contracted specifically for the acquisition of tangible assets or the construction of public projects which are amortized over a period of at least 20 years; 5) the proceeds of any bonds expended before the end of the 2006-2007 fiscal year and the proceeds of any bonds contracted specifically for the acquisition of tangible assets or the construction of public projects which are amortized over a period of at least 20 years issued after November 7, 2006; 6) revenue from licenses and fees, if the money does not exceed the cost of issuing the license or providing the service associated with the license or fee.
(f) "Local growth" for a non-school district means a net percentage change in actual value of all real property in a district from construction of taxable real property improvements, minus destruction of similar improvements, and additions to, minus deletions from, taxable real property. For a school district, it means the percentage change in its student enrollment.
(g)"Inflation" means the percentage change in the United States Bureau of Labor Statistics Consumer Price Index for ____________, all items, all urban consumers, or its successor index.
(h)"Population" means the number of people residing in the state, excluding armed forces stationed overseas, as estimated by the annual census conducted by the Federal Census Bureau, and such number shall be adjusted to match the federal decentennial census.
(i) "Bonds" means any form of multi-fiscal year indebtedness, including non-recourse, limited tax general obligation bonds, or limited liability bonds.

About this Report

Texas has an ineffective expenditure limit, despite the fact that has been an issue of late due to property tax relief. Since its creation in 1978, the state expenditure limit should have been a constraint on state spending due to limited growth in personal income during several fiscal years, but loopholes built into the law have kept it from serving as that constraint. This paper proposes a tighter expenditure limit based on population growth and inflation that allows for a budget stabilization fund to prevent large downward swings in spending during recessions.

The result of tighter expenditure limits at the state and local level would be improved economic conditions for Texas, which has a high property tax burden. Texas has a choice of whether to follow the example of Colorado, which has restricted spending and reduced taxes and seen its economic condition rise. Or, Texas can follow the example of Ohio, which instituted an income tax, grew government considerably, and has suffered economically.

About the Author

Barry W. Poulson is a professor of economics at the University of Colorado, Boulder. Poulson is a Senior Research Fellow at the Texas Public Policy Foundation. He has been a Visiting Professor at several universities including: Universidad Autonomo De Guadalajara, Mexico; University of North Carolina; Cambridge University; Konan University, Kobe, Japan; and Universidad Carlos Tercera, Madrid, Spain. He is past President of the North American Economics and Finance Association.

Professor Poulson has served as a consultant on fiscal policy issues at both the state and national level. He is currently serving on the Commission to Strengthen and Secure PERA. He was a member of the Colorado Tax Commission, and Vice Chair of the State Treasurer's Advisory Group on Constitutional Amendments. Currently, Professor Poulson is an Americans for Prosperity Distinguished Scholar, Adjunct Scholar of the Heritage Foundation, and Senior Fellow of the Independence Institute. He is a member of the Task Force on Tax and Fiscal Policy of the American Legislative Exchange Council.