

Controlling State Spending: A Responsible Alternative to TABOR

M. Kevin McGee
Department of Economics
UW Oshkosh
Oshkosh WI 54901
mcgee@uwosh.edu

November 2004

Proponents of TABOR – the Taxpayer’s Bill of Rights, the proposed amendment to Wisconsin’s constitution – are correct in saying that Wisconsin has a problem with government spending. But they have utterly failed to identify the source of this problem. As a result, their “solution” makes the problem worse in the short run, while leading to catastrophic results in the long run.

I will begin by outlining what I believe to be the real problem: that during economic expansions, the State’s Balanced Budget Requirement puts an excessively high cap on State government spending. I will then outline a mechanism that would more effectively limit government spending growth during these economic booms. Finally, I will discuss why TABOR would make the problem worse in the short run, while leading to untenable problems in the long run.

I. The Real Problem

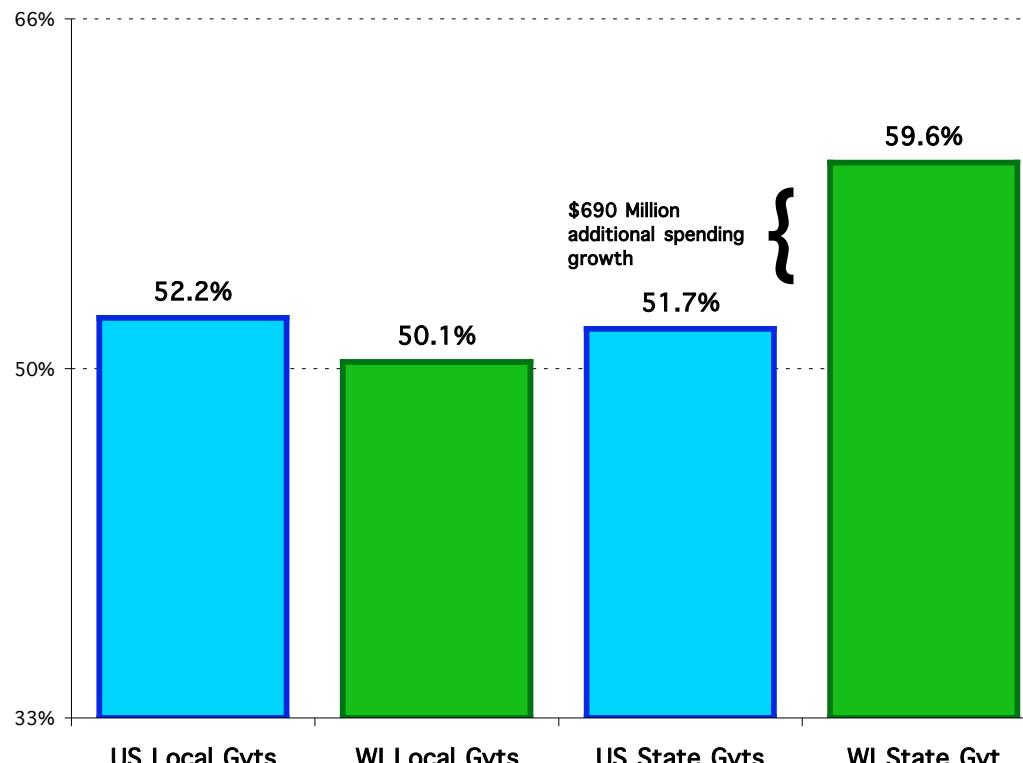
As Figure 1 shows, excessive growth in government spending in Wisconsin is a state spending problem, not a local spending problem. The figure uses data from the U.S. Census Bureau’s Census of Governments, for the years 1992-2000.¹ Only growth in direct spending is shown ; e.g. when the state increased its revenue sharing with local school districts, that was not recorded as a growth in state spending, but would be recorded as a growth in local spending of school districts used the extra shared revenues to spend more rather than tax property less. Also, Wisconsin’s 2000 tax rebate was not included as spending (although the Census Bureau recorded it as an expenditure); if it had been included, Wisconsin state spending would have grown 66% over the period.

Using 1992 as the base year, over the subsequent 8 years government spending by all state governments, all local governments in the U.S., and all local governments in Wisconsin all grew roughly 50%. As we will see, these are the roughly appropriate rates of spending growth. In contrast, Wisconsin state spending grew nearly 60% over the 8 year period. Had Wisconsin state spending grown only 51.7%, the average of all state governments, state spending in 2000 would have been \$690 million less.

¹ These years were selected because they are the only years for which data was available through the Census Bureau’s website. However, they also roughly coincide with the economic expansion of the 1990s.

Figure 1: State and Local Direct Spending Growth, 1992-2000

Source: <http://www.census.gov/govs/www/estimate.html>



Why did state spending grow so much more than local spending in Wisconsin? The answer is actually quite simple – to spend more, local governments have to raise tax rates, but state government doesn't need to. This happens because local governments rely on property taxes, but the state government is funded primarily through sales and income taxes.

Property taxes are collected on assessed property values. Even when property values rise, assessed values stay the same, so tax revenues don't automatically rise with inflation or income growth. Only new construction provides an “automatic” revenue boost. So typically, city councils and school boards have to vote each year on tax rate increases just to keep up with inflation, and face the wrath of the voters if they vote for a tax increase to raise spending unreasonably.

Income and sales taxes in contrast are collected on income and spending, that both automatically rise when the economy grows. During economic expansions state tax revenues grow rapidly without any votes for higher tax rates, so under the State's Balanced Budget requirement, the only current limit on spending, our state legislators can increase spending dramatically while still keeping their campaign pledges to “not raise taxes.” So the real problem is that, unlike local governments, our state government can spend excessively during economic expansions without

being held politically accountable. The obvious solution would be to create a mechanism, distinct from the Balanced Budget requirement, that reigns in state spending during periods of economic growth.

II. A Rational Solution

Let's begin by assuming there is some "right" level of government spending, that should be growing at some "right" rate overtime.² Under our current system, state spending grows too much during economic expansions, which may result in excess spending, but then is forced to contract sharply during recessions, perhaps resulting in inadequate spending during lean times. The obvious solution would be to reduce spending growth during boom times, saving the excess revenue in a rainy day fund that would prevent excessive spending cuts during recessions.

But how do we identify the "right" level of spending growth, and how do we hold the state to it? The key is to recognize that there are three sources of income growth (that leads to state revenue and spending growth), two of which are highly predictable and should be matched with increased government spending, and one of which might not.

Total state income rises annually for three reasons:

- 1) State population grows, typically at a rate of .5% to 1% a year. More people means more income, so more tax revenue. Population growth is usually relatively steady and predictable. If we want to maintain a constant level of spending per capita, spending growth should match population growth.
- 2) Inflation has pushed income up at a rate of 1.5% to 3.5% a year over the last decade. Inflation can typically be forecast reasonably accurately. If we want to maintain a constant level of real spending per capita, spending growth should match population growth plus the inflation rate.
- 3) Productivity gains increase real per capita income (RPCI). Increases in RPCI translate directly into increases in the standard of living, allowing most of us to consume more today than our parents or grandparents did at our age. RPCI is highly variable, rising rapidly in economic expansions and stagnating or even declining during recessions. RPCI growth is also the least predictable component of total income growth.

In the long run, government spending growth should keep up with RPCI growth as well. RPCI growth translated into higher salaries in the private sector; if public spending doesn't keep up, then either we reduce the number of police/teachers/game wardens per capita, or public salaries will not keep up with private sector salaries, and we won't be able to hire qualified police, teachers, or game wardens.³

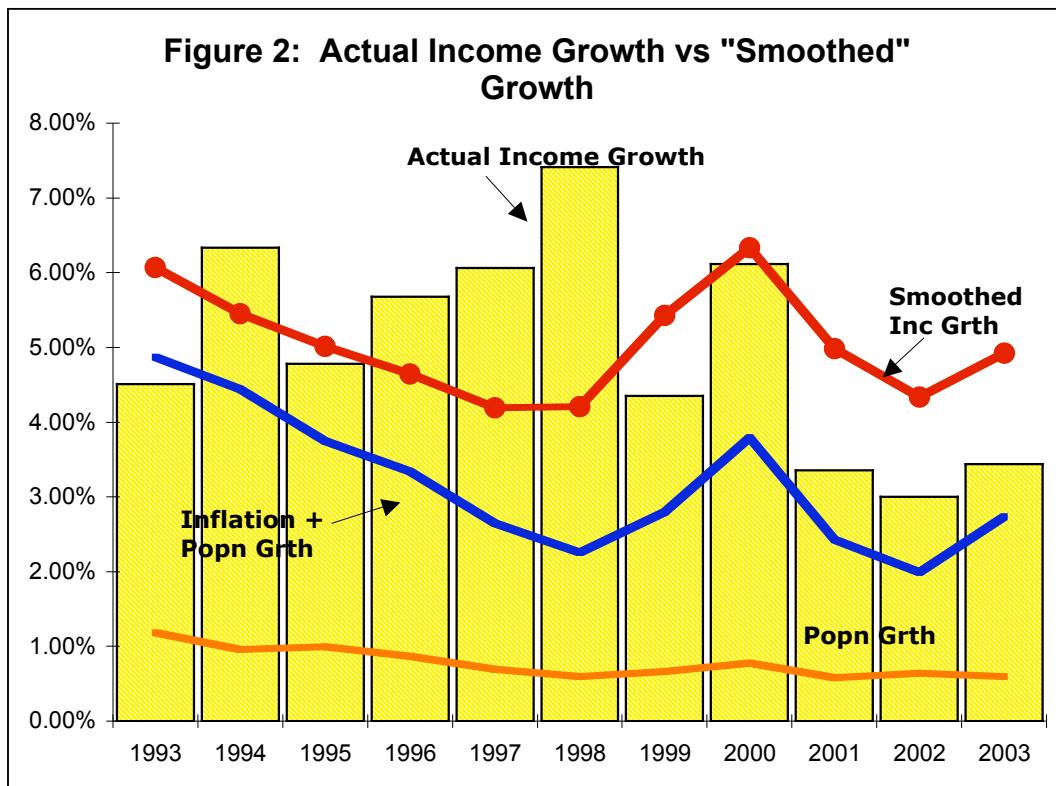
² Deller and Maher (2004) argue that Wisconsin's current level of government spending is not out of line with most other states. If so, we may already be near or at that "right" spending level.

³ See Reschovsky (2004) for a more complete discussion of this issue.

However, that does not imply that government spending should match RPCI growth every year, but only that it should match the long run trend. And since that long run trend can be easily estimated, it should be easy to calculate the desired rate of spending growth:

$$\begin{aligned}\text{Allowed Spending Growth} &= \text{"Smoothed Income Growth"} \\ &= \% \Delta \text{Popn} + \text{Inflation} + \text{Long Run \% } \Delta \text{RPCI}\end{aligned}$$

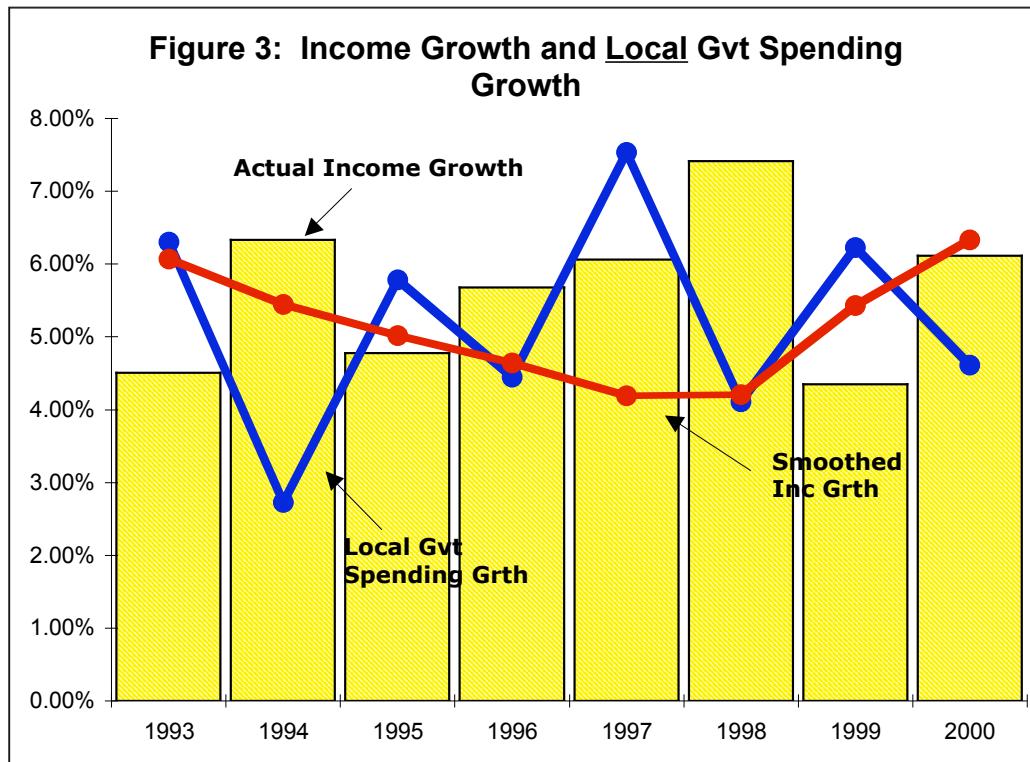
Figure 2 illustrates how “smoothed income growth” can be calculated. For each year from 1993 to 2003, I measured the actual rates of population growth and inflation. To calculate the rate of real per capita income growth, I measured the actual rate of RPCI growth over the previous 15 years, 16 years, etc., up to 25 years. So for 2003, I measured RPCI growth from 1988-2002, from 1987-2002, and so on, up to 1978-2002. I then averaged these 11 growth rates to get the “long run” growth rate for that year. That average growth rate, when added to population growth and inflation, gives the “smoothed income growth” pattern shown in Figure 2.



Notice from Figure 2 that actual income growth was quite a bit above smoothed income growth in 1996-1998, but well below smoothed income growth in 2001-3. Had we saved the additional tax revenue that income growth brought the state in the mid ‘90s, we could have weathered the recent recession without the major fiscal crisis that is still not fully resolved.

Figures 3 and 4 compare local and state spending growth to both actual income growth and smoothed income growth over the ‘90s expansion. As Figure 3 shows, local spending growth varied both above and below smoothed income growth, but was on average on target. Over the 8 years, smoothed income grew 49.8%, while total local

government spending grew 50.1% -- a virtual match. Hence local government growth is exactly on target, and there is no real need for any additional limits on local government spending.



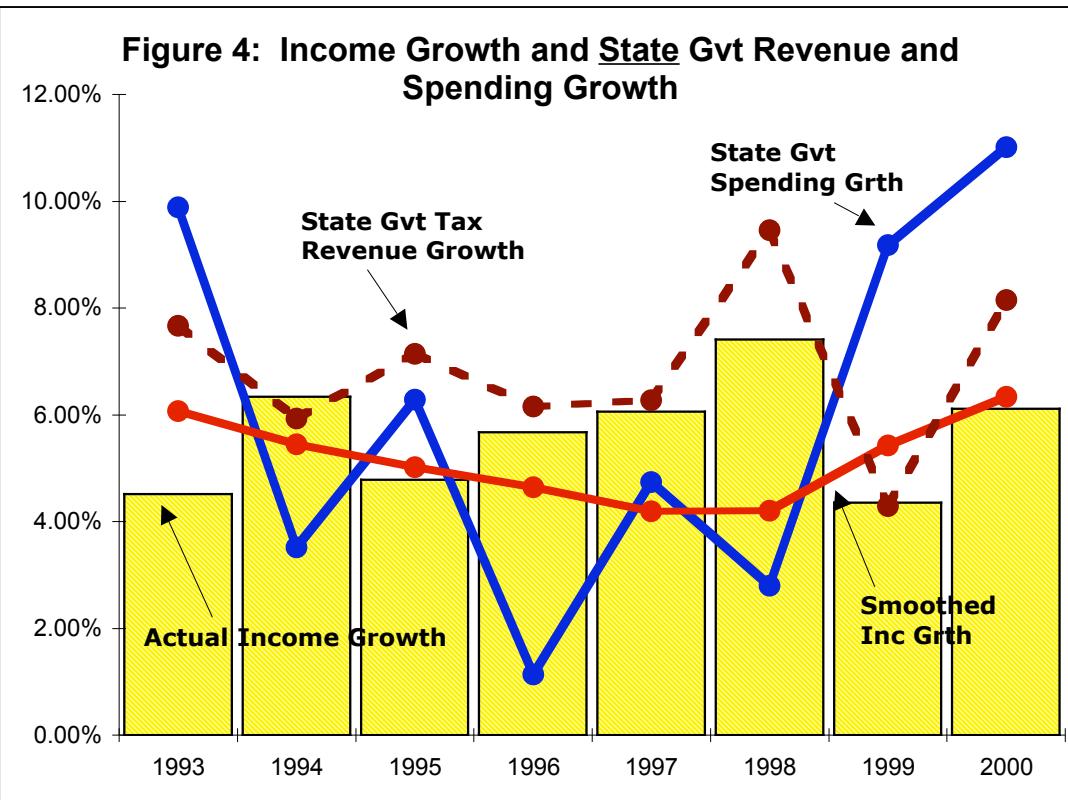
As Figure 4 shows, however, state spending growth dramatically exceeded smoothed income growth both in 1993 and in 1999-2000. In the latter period especially, the state was awash in the additional tax revenues that the economic expansion created. This led to a state spending spree, both in the big jump in state direct spending shown in Figure 4, as well as in the large tax rebate the state sent out in 2000, immediately before the recession hit.

Clearly, there is a need to limit state spending growth. And hopefully equally clearly, smoothed income growth provides a mechanism to do just that.

III. A Possible Constitutional Amendment

Each year the Department of Revenue uses its forecasts of population growth, inflation, and various components of RPCI growth to forecast state income over the next year or biennium. This forecast is then combined with state tax law to forecast state revenues. The State Constitution's balanced budget requirement currently limits state (proposed) spending to no more than this forecast revenue.

As we've seen, this balanced budget requirement does not limit state spending sufficiently during economic booms. Therefore, I would propose an additional spending limit, that limits state spending to no more than the Long Run Smoothed Forecast Revenue (LRSFR).



This LRSFR would be calculated by having the Department of Revenue estimate the long run growth rate of each component of income over the previous 15-25 years. Those growth rates would provide smoothed income forecasts for each income component. These could then be entered into the same formulas used to forecast actual revenue to forecast smoothed revenue as well.

If actual revenues exceeded LRSFR, the excess would go automatically into the state rainy day fund. If actual revenues fell below LRSFR, spending could be maintained at the LRSFR level, provided there are sufficient funds in the rainy day fund to cover the difference. Note that the current constitutional balanced budget requirement would still apply, but it would only come into play during recessions, once the rainy day fund is exhausted.

Notice also that any positive revenue “surprises” (when actual revenue exceeds forecast revenue) would automatically be fully saved in the rainy day fund, instead of immediately being used to fund additional spending.⁴

IV. Simulating the LRSFR Constraint over the Last Decade

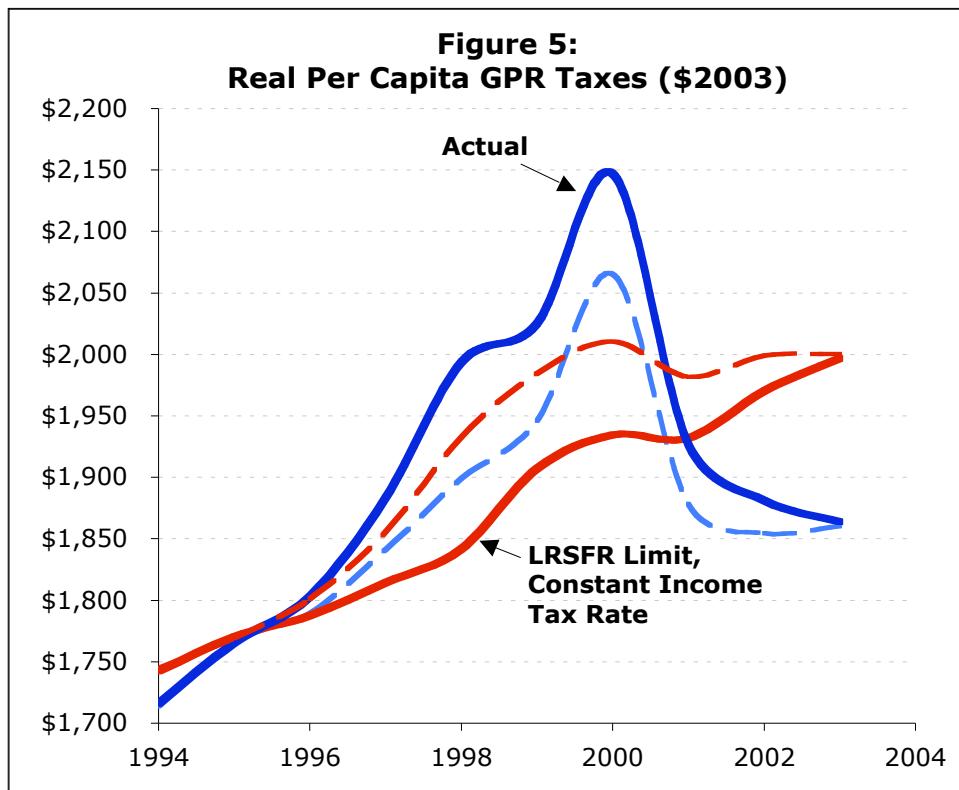
Figure 5 shows how the LRSFR limit would have impacted State GPR spending over the past decade, had it been adopted a decade ago.⁵ The uppermost heavy blue line shows actual real per capita GPR tax revenue from 1994 to

⁴ An exception would be during recessions when the rainy day fund is depleted. The revenue “surprise” could then be used to restore spending cuts below LRSFR.

⁵ The simulation uses data from Wisconsin’s Annual Fiscal Reports, 1996 to 2004.

2003, in 2003 dollars. Under the current Balanced Budget requirement, this revenue level is the only existing limit on State GPR spending.

The dotted blue line shows what the LRSFR spending limit would have been under actual tax rates.⁶ The LRSFR limit would have slowed spending growth until 2000, when the elimination of the property tax rent credit boosted revenue substantially.⁷ The large tax cuts effective in 2001 would have greatly reduced the spending limit, as they did under the Balanced Budget constraint. Throughout 1997 to 2002, the LRSFR limit would have forced the State to accumulate reserves in its rainy day fund.



As Figure 5 shows, there were two sources of GPR revenue instability over the past decade: cyclical variation in income growth and political variation in tax rates. To abstract from the latter, the red lines in Figure 5 simulate actual GPR revenue (dashed line) and the LRSFR spending limit assuming a personal income tax collecting a constant fraction of income over the entire decade.⁸

Had tax rates remained constant, actual tax revenue would have still risen rapidly (though less sharply) through 2000, then remained flat thereafter. The LRSFR limit would have slowed spending growth, allowing spending to

⁶ See Niederjohn (2004) for a discussion of Wisconsin's recent budget history.

⁷ For simplicity, I assume personal income tax revenue and sales tax revenue are exactly proportional to income, and that no other tax revenue varies with income. The former assumption fits the data very well; the latter probably understates the degree to which the LRSFR limit would have reduced State government spending.

⁸ The simulation assumes the personal income tax always collects 3.43% of personal income in taxes, which was the average collection rate from 1994 to 1997.

increase smoothly and continually through both the economic expansion as well as the subsequent recession. Interestingly, there would have been no need through 2003 to tap into the State's rainy day fund, which would have held substantial reserves at the beginning of the 2004 fiscal year.

The LRSFR limit would have slowed spending growth under either scenario. Perhaps, had the legislature had the LRSFR limit to reduce the free revenues available for it to play with, and to signal the transitory nature of those excess revenues, they would have been less likely to adopt the 2001 tax cuts that compounded the budget crisis that the recession created. At minimum, budget rules that require spending cuts to be enacted at the same time as tax cuts, and tax increases at the same time as spending increases, should supplement the LRSFR spending limit.

V. The Three Problems With TABOR

In contrast with the alternative outlined above, TABOR has three significant flaws. The first, inherent in both the original version of TABOR adopted in Colorado (hereafter CO-TABOR) and the revised version proposed in the 2004 legislature (WI-TABOR) is that the limit not spending, but spending growth. The second flaw, unique to WI-TABOR, is that it makes the boom-bust cycle of government spending worse, not better. And the third flaw, also shared by both TABORs, is that TABOR is unsustainable in the long run.

(1) Spending Growth Limit. Both TABORs limit spending growth rather than (as in the LRSFR limit) the level of spending. CO-TABOR sets the maximum spending growth rate at the inflation rate plus the population growth rate; WI-TABOR's maximum is 90% of the income growth rate. This paradoxically creates an incentive to spend wastefully.

Suppose you're allowed to spend no more than \$100 each month. Some month you earn over \$100, some months less than \$100, but as long as you have money saved, you'll be allowed to spend \$100. It's the end of the month, you've only spent \$95 so far, but there's nothing you really want to buy. What would you do? Perhaps you'll buy something you think you'll need next month, but there's also a reasonable likelihood that you'll save the \$5, in case next month's income is really low.

Now contrast that with a situation where you're only allowed to spend 25 cents more than what you spent the previous month. You're allowed to spend \$100 this month, and if you do, you can spend up to \$100.25 next month. But if you save the \$5, next month you'll only be allowed to spend \$95.25. Now what would you do?

TABOR's limit on spending growth creates a powerful incentive to spend today the maximum amount allowed. In contrast, the LRSFR limit caps total spending rather than spending growth. It therefore creates no perverse incentive to spend. On this count TABOR would have to be considered the inferior option.

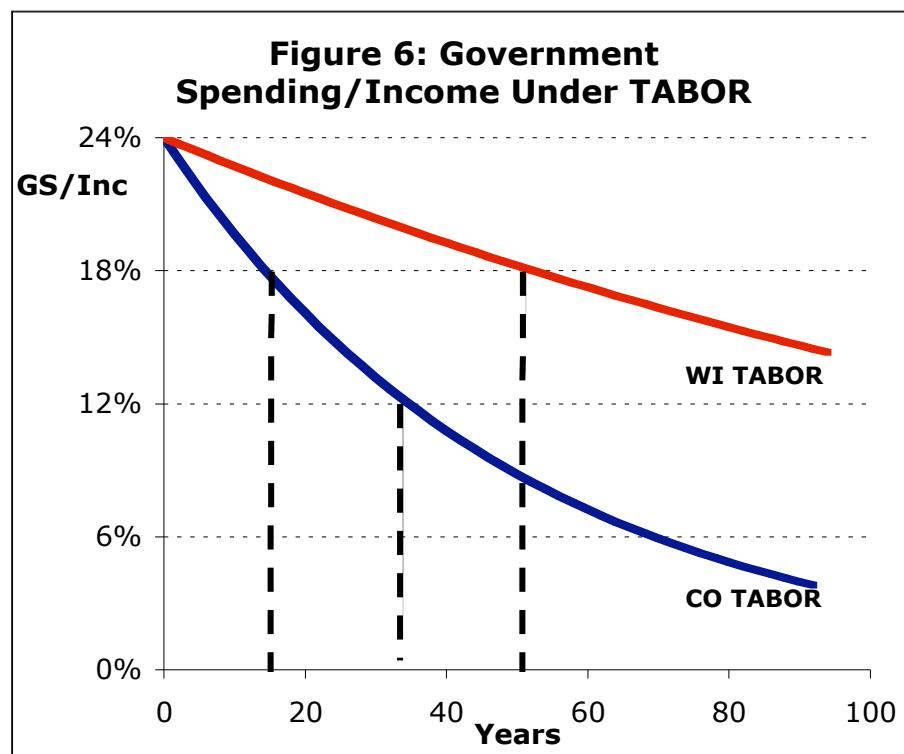
(2) Short Run Instability. WI-TABOR was designed to be less drastic than CO-TABOR, allowing government spending to grow at 90% of the income growth rate. But since income growth follows a boom and bust cycle,

expanding rapidly during expansions and stagnating during recessions, government spending will also be required to follow a boom and bust cycle.

Observe from Figure 4 that, had the state increased spending by 90% of income growth in 1994 through 1998, state spending would have grown more than it actually did. WI-TABOR clamps down on spending growth the least exactly when it's already growing too rapidly, and clamps down the most during recessions, when it's already being cut sharply.

But what is worse is that WI-TABOR mandates that cities, counties, towns, villages, and school districts all follow this same boom and bust cycle. So, rather than local government employment being a stabilizing factor in the economy, under WI-TABOR local government would be an additional source of instability, contributing to even wider swings in the economy.

Unlike WI-TABOR, the LRSFR spending limit controls spending evenly throughout the business cycle, stabilizing state spending. The LRSFR limit would not apply to local government spending, since that spending is already cyclically stable.



(3) Long Run Unsustainability. Both CO-TABOR and WI-TABOR require government spending to grow at less than the rate of income growth. Hence under both forms of TABOR, spending will be a shrinking fraction of income, forever.

Again, assume there is some “right” level of government spending, but that right now we’re spending more than the right amount. The appropriate policy would be to put the government on a diet, shrinking spending until we get back to the “right” level. But TABOR doesn’t stop there. It requires the diet to be permanent, so government spending continues to shrink, until it is nearly zero.

Figure 6 projects government spending as a fraction of income under both CO-TABOR and WI-TABOR. Assuming a population growth rate of 1%, inflation of 2.5%, and RPCI growth of 2%, under CO-TABOR government spending shrinks to half of its previous level relative to income every 35 years. Under WI-TABOR this shrinkage takes 4 times longer, but eventually we get to the same point.

A Constitution is the foundation of our entire system of government. It should be designed to last forever. There should be no room whatsoever within our Constitution for measures that, at best, may make sense for only the next 5 to 10 years. There should therefore be no room whatsoever for TABOR.

VI. Conclusion

The LRSFR spending limit stabilizes government spending around a constant long run spending/income ratio. WI-TABOR destabilizes government spending around an unsustainably declining spending/income ratio. I would hope that the rational choice between them is clear.

References

- Deller, Steven and Maher, Craig. *TABOR and Wisconsin: Do Employment Trends Justify Such a Measure?* The Robert M. La Follette School of Public Affairs, October 2004. Available at <http://www.cviog.uga.edu/projects/abfm/Deller.Maher.TABOR.Wisconsin.pdf>.
- Niederjohn, Scott. *Revenue Forecasting and the State Budget in Wisconsin*. Wisconsin Interest 13(3), Fall 2004, 33-40. Available at <http://www.wpri.org/allinterests.htm>.
- Reschovsky, Andrew. *The Taxpayer Bill of Rights (TABOR): A Solution to Wisconsin’s Fiscal Problems or a Prescription for Future Fiscal Crises?* The Robert M. La Follette School of Public Affairs, April 2004. Available at <http://www.lafollette.wisc.edu/facultystaff/reschovsky/reschovsky-resources.html>.
- State of Wisconsin. *Annual Fiscal Report, Budgetary Basis*, 1996-2004. Available at http://www.doa.state.wi.us/pagesubtext_detail.asp?linksubcatid=376.
- U.S. Census Bureau, *State and Local Government Finances*. 1991-2 through 1999-00. Available at <http://www.census.gov/govs/www/estimate.html>.