

# The Taxpayer's Bill of Rights: Evidence from Colorado and Implications for Arizona

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## INTRODUCTION

For those interested in one of the most extreme state tax and expenditure limitations (TELS), TABOR – Colorado’s initiative that limits the funding of most expenditures to annual revenue growth restrained by the sum of annual population growth and inflation rates – would seem to be exactly the right choice. To some, the initiative simply limits government to spend within its means. However, the analysis in this paper reveals that, true to the language in the 1992 Colorado initiative, TABOR limits government growth, and over time the public sector, as a share of the overall economy, declines sharply – crowding out opportunities for investments in strategic initiatives or opportunities for tax reform that may be popular with large voter constituencies or the business community. Advocates point out that provisions in TABOR do allow for voter overrides, but these are costly in both time and money, and until the overrides take place, government is hamstrung. A simpler, more efficient alternative would be to elect fiscally conservative legislators and hold them accountable for prudent fiscal decisions that strike the right balance between a tax base conducive to economic growth and strategic investments that provide public sector infrastructure, nurturing the business climate and promoting the health and well-being of the citizenry.

The paper first outlines the TABOR amendment in Colorado and examines its fiscal consequences for that state. It then examines the potential impact of a TABOR in Arizona.

## WHAT IS TABOR?

The Taxpayers’ Bill of Rights, popularly known by the acronym TABOR, is an amendment to the Colorado Constitution [Article X, Section 20] approved by initiative in 1992. As stated in its first paragraph, the primary objective of the amendment was to limit the growth of government. To do so, it requires voter approval of any tax changes that would increase revenues and imposes limitations on the amount of revenue that government can collect and spend. TABOR applies to all levels of state and local government in Colorado.

### **Voter Approval of Tax Increases and Debt**

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

## **Spending (Revenue) Limits**

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

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

## **TABOR Surplus**

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

## **Other Provisions**

### Prohibited Taxes

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

### Emergency Reserve

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

### Voter Approval for Changes in Existing Revenue, Spending, or Debt Limits

Any changes that would weaken current limits on state or local government revenue, spending, or debt require voter approval.

## Government Enterprises

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

## **THE RATIONALE FOR TAX AND EXPENDITURE LIMITATIONS**

Various types of tax and expenditure limitations (TEL) have been adopted in more than half of the 50 states. Proponents of TELs assert that without such restraints the normal political process will result in increasing tax burdens and a growing government sector over time. California's Proposition 13, which focused on property tax relief, is often credited as the first of these initiatives, but the trend in most states has been to broaden the measures into restrictions on taxation or spending in general. (This phenomenon includes California, which passed a more comprehensive TEL in 1979.)

Most TELs have been based on two basic approaches:

- 1) A "fiscal cap" establishing a limit on state revenues and/or expenditures – These limits have been defined in various ways but most often by (a) setting a limit on total revenues or total spending as a proportion of some variable measuring the size of the total economy; or (b) setting a limit on the future rate of growth of revenue and/or spending.
- 2) A "supermajority" requirement – This approach seeks to limit the growth of government by requiring either a supermajority of the legislature (usually two-thirds) or voter approval for any tax increase.

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

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

1. Spending or Revenue Limit – A majority of the states have limits that apply to spending (16). Four have limits on revenue; three have TELs that limit appropriations to the estimated revenue; and three (including Colorado with TABOR) have limitations that are some type of combination of revenue/spending/appropriation limits.

2. Calculation of the limit
  - a. Colorado (TABOR) and three other states use the sum of population growth and inflation to calculate their limits
  - b. Four states base their limits on a percent of state personal income.
  - c. Seven states use the percent change in personal income to calculate their limits.
  - d. Three states use a combination of share of personal income and percent change in personal income.
  - e. Four states limit appropriations to a percentage of revenues received.
  - f. Five states have miscellaneous other systems.
3. Treatment of the Surplus
  - a. Colorado (TABOR) and only one other state require the surplus to be refunded.
  - b. Five states have a system that provides for partial return of the surplus.
  - c. Six states put any surplus into a "rainy day" fund.
  - d. Four states transfer the surplus into other reserve funds
  - e. One state requires any surplus be used to retire debt.
  - f. Ten states make no provision for any surplus.

[For a more complete comparative analysis of fiscal cap TELs, see Resnick 2004.]

### **HOW DOES TABOR COMPARE WITH OTHER STATE TAX AND EXPENDITURE LIMITS?**

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

1. TABOR establishes limits on General Fund and Cash Fund revenues (hereafter referred to as TABOR revenues). Revenue limits generally are more restrictive than expenditure limits. In addition, TABOR applies to a broad definition of revenues, not just the General Fund, and also applies to fees in addition to tax revenues.
2. Growth in TABOR revenues is limited to the sum of the percent change in population and the inflation rate. This formula apparently is based upon the assumption that government spending should grow only if it has to provide services to a larger population or if the cost of providing services increases. It ignores any effects of increases in standard of living or other factors. In most years, this type of limit is more restrictive than a limit based on change in aggregate personal income.
3. The Arveschoug-Bird limit, a second TEL in Colorado, also establishes limits on General Fund appropriations. Their growth is limited to a maximum of 6 percent. In many years during the 1990s, this limit was more restrictive than the TABOR limit.
4. TABOR requires the refunding of any surplus in the next fiscal year. Any other use of the surplus must be approved by the voters. In most other states, these funds can be put into a rainy day fund or used for other purposes.
5. The TABOR limit is based upon the lesser of the prior year's limit or actual revenues in the prior year. Whenever Colorado's revenues are less than the allowable limit, a

so-called “ratchet-down effect” occurs, with the lower actual revenue figure becoming the new base for calculating the next year’s limit, and the TABOR limit is permanently reduced for subsequent years. This method is more restrictive than the procedures used by other states. For example, if the calculation is based only on the previous year’s allowable limit or as a maximum percent of personal income, no similar ratchet-down effect would occur.

6. Any change in the tax system that would result in a net increase in revenues must be approved by the voters. The TABOR limit applies to aggregate revenues, but this provision prohibits changes that would increase revenues from one tax to offset decreased revenues from another.
7. The TABOR definition of an “emergency” specifically excludes economic conditions or fiscal crises.

### **FISCAL IMPACTS OF TABOR ON THE STATE OF COLORADO**

Colorado’s early experience with TABOR was benign due to the rapid economic and demographic growth the state experienced during most of the 1990s. By 1992, when TABOR was adopted, Colorado had emerged from stagnant economic conditions of the late 1980s and early 1990s and entered a period of strong growth that lasted through 2000. Personal income growth averaged 8.2 percent per year during the 1990-2000 decade – ranking it second only behind Nevada. Even with robust economic growth, Colorado did not incur its first TABOR surplus until Fiscal Year 1997, the fourth year of its existence. The state’s population growth rate was the third-fastest in the nation during the 1990s, averaging 2.7 percent per year. This rapid population growth in combination with moderate inflation (3.6 percent over the 1992-2000 period) produced annual TABOR growth factors averaging about 6 percent for the FY1994 – FY2001 period.

Starting in FY1997, revenues exceeded the TABOR limit for five consecutive years, resulting in a total of \$3.2 billion in TABOR surpluses over the FY1997 – FY2002 period. In addition, permanent cuts in both income tax and sales tax rates also were enacted in 1999 and 2000, which reduced the stream of TABOR revenues (and the surplus) about \$1 billion per year [Center for Budget and Policy Priorities 2004].

Unfortunately, the boom ended in 2001. The combination of the dot-com crash, the national recession, and the impact of Sept. 11<sup>th</sup> hit the state hard. Personal income growth fell from second-fastest in the nation in 2000 to 49<sup>th</sup> in 2002. State revenues subject to the TABOR limit declined by 12.6 percent in FY 2002 and an additional 1.1 percent in FY2003 [Colorado Office of Strategic Planning and Budget 2004].

The Legislature responded to the fiscal crisis with three policies to offset the revenue shortfalls: transferring monies from cash and reserve funds to the General Fund; increasing existing fees and establishing new ones; and cutting spending. In the absence of a rainy day fund, the Legislature used \$1.1 billion in one-time transfers from cash and reserve funds to prop up the General Fund. To deal with revenue shortfalls to

cover immediate needs and arguably to mitigate the ratchet-down effect, government officials in Colorado also have increasingly relied on fee increases. The Massachusetts Taxpayer's Foundation (MTF) reports that Colorado's ranking of combined state and local fees per capita soared from 10<sup>th</sup> highest overall in 1992 to sixth highest in 2002. (In contrast, Arizona residents pay very low fees. The state ranked 45<sup>th</sup> on a per capita basis in 1992 and 50<sup>th</sup> in the 2002 survey – some \$760 per person – lower than Colorado.)

Because of TABOR's ratchet-down effect, whenever actual revenue is less than the allowable TABOR limit, the base for determining the following year's limit is reduced. This occurred in both FY2002 and FY2003. Actual revenue in FY2002 was \$366 million lower than the FY2002 limit. Similarly, revenue in FY2003 was \$584 million lower than the limit. Because of the ratchet-down effect, the TABOR base for FY2004 was \$950 million below the FY2002 base, and so even if revenues rebound, the base to which the state applies the formula is permanently shifted down by nearly \$1 billion. The Colorado Office of Strategic Planning and Budget's September 2004 forecast indicates that TABOR surpluses will begin to appear again as early as the current fiscal year [Colorado Office of Strategic Planning and Budget 2004] even though the state has a structural deficit estimated by some in the range of \$500 million [Poulson 2004].

Colorado's fiscal problems were exacerbated by conflicting voter-approved initiatives. First, the Gallagher amendment limits residential property taxes to only 45 percent of the total property taxes collected. To maintain this restriction, assessment ratios on residential property have been reduced to about 8 percent in comparison with non-residential assessments of 29 percent – a disparity even larger than is observed in Arizona. Some business advocates argue that the existence of TABOR has limited their progress in addressing this disparity.

Perhaps a greater contributor to the current fiscal crisis in Colorado is the inherent conflict between the state's TABOR and Amendment 23 that requires spending on K-12 to increase on a per-pupil basis by the rate of inflation plus 1 percent. As a result, agencies other than K-12 have borne the brunt of the reductions that have taken place over the last several years. Table 1 reveals that funding for health care, K-12 education, public safety, and even local affairs have continued to grow despite the fact that the latter two have seen reductions in funding that comes from the state. Higher education, regulatory and environmental agencies have seen the slowest growth over the period, with support from the General Fund plummeting. The Colorado Fiscal Policy Institute concludes from this information that "many departmental activities that could be funded with fees, special revenues or federal funds instead of taxes, were 'refinanced' at least in part, in order to reduce their General Fund dependence." [Fiscal Policy Institute, November 2004]

<b>Table 1</b>		
<b>FUNDING BY AGENCY</b>		
<b>Percent Change, FY 02 over FY 01</b>		
	<b>% General Fund Growth</b>	<b>% All-Funds Growth</b>
Health Care Policy	24.0	31.0
Education	18.5	34.3
Judicial	6.3	12.3
Corrections	18.0	15.5
Public Safety	-1.2	32.2
Military-Veterans Affairs	-4.3	10.2
Higher Education	-21.3	8.6
Revenue	-21.9	9.2
Law	-22.5	8.8
Natural Resources	-23.2	10.4
Personnel & Administration	-45.6	19.6
Regulatory Agencies	-47.9	5.3
Public Health & Environment	-59.7	9.4
Local Affairs	-60.7	32.3
Treasury	-85.5	-2.8
Governor	-20.8	-4.0

Source: Colorado Fiscal Policy Institute, November 2004

The fiscal challenges posed by TABOR in Colorado have impacts on the overall economy. Joe Blake, President and CEO of the Denver Metro Chamber of Commerce, believes that TABOR has been an impediment to needed tax reform in Colorado. The fiscal constraints imposed by TABOR have made it impossible to reduce business property taxes where, like Arizona, business property is assessed at rates far higher than are residential property owners. Blake also laments the lack of strategic investments in transportation and higher education that are the direct result of TABOR restrictions. As the fiscal challenges loomed in Colorado, bond rating agencies decreased their ratings on state projects, citing the uncertainty of the revenue streams available. As a result, capital projects cost more than they would in the absence of TABOR.

The *Denver Business Journal* reports [December 2004] that business groups have aligned behind making significant changes in Colorado's TABOR. On their agenda is tax reform (the business property tax), water issues, and economic development. But addressing the serious fiscal issues – including funding for higher education and transportation – is tied to achieving fiscal stability. Denver Metro Chamber's Blake contends "it is no longer satisfactory to say you need to keep cutting to make the state the kind of state that will grow... and attract jobs."

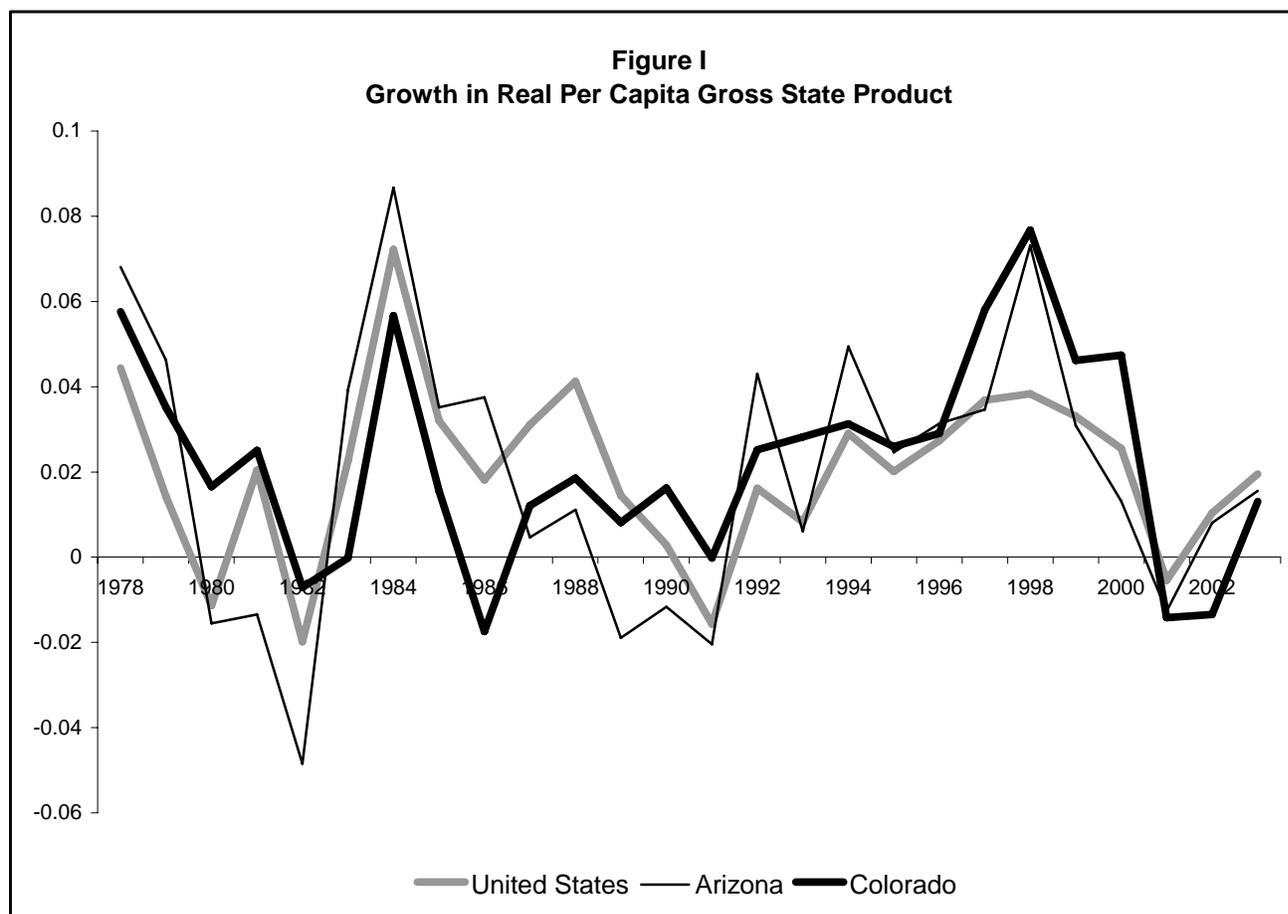
Proponents of TABOR may argue that it sends a clear signal of fiscal responsibility and austerity to businesses considering relocation to Colorado. But the measure drives tax relief and control for overrides to individual taxpayers rather than a pro-business initiative per se. The business sector wants relief from business taxes and regulations and, at the same time, an education/transportation/ infrastructure that supports both

vibrant consumer markets and skilled labor markets. And an important ingredient in this mix is fiscal stability. It is not clear that states with tax structures that shift disproportionate burdens from residents to corporations will foster business expansion over the long run.

### **TABOR AND ECONOMIC GROWTH IN COLORADO**

Colorado, along with a number of states and regions across the nation, experienced rapid growth in economic activity. What role did TABOR play? Joe Blake of the Denver Metro Chamber of Commerce contends that no one in the business community believes that TABOR was responsible for the economic expansion Colorado experienced in the 1990s. The nonpartisan Colorado Legislative Council [2003] reports there is no evidence that TABOR played any role in the expansion or contraction of business activity in Colorado over the last decade. Indeed, Colorado enjoyed the economic success brought by the boom in the telecom industry and related expansions in information technology industries. Arguably, the economic boom created by this rapid economic expansion masked any adverse effects from TABOR until the inevitable downturn occurred in 2001.

Figure 1 depicts growth in Colorado state real per capita Gross State Product along with similar growth rates for Arizona and the United States as a whole. Colorado led both Arizona and nation in the late 1970s and early 1980s; then both Arizona and Colorado lagged the nation in the late 1980s as both states experienced the real estate adjustments associated with the savings and loan crisis, and Colorado lagged as interest in alternative sources for energy (e.g. oil shale) waned. Throughout much of the 1990s both Colorado and Arizona again led the nation in real per capita state GSP growth, then they lagged the nation in the most recent downturn. Growth in real per capita GSP in Arizona in the 1990s was nearly as large as that in Colorado. But, no doubt growth in Silicon Valley (not depicted) was even more rapid – despite a far more onerous tax environment than in either Arizona or Colorado.



Source: Bureau of Economic Analysis and author calculations.

### THE FUTURE OF TABOR IN COLORADO

The fiscal impasse in Colorado has the business community on edge. TABOR necessitates immediate action on the part of Colorado lawmakers, and business community advocates are clearly concerned, as should any business contemplating relocation to Colorado. Chuck Berry, president of the Colorado Associate of Commerce and Industry, reports: "Our overall objective is increased job creation in Colorado. We want the economy to fully recover. We really hope that they will not introduce and vote for legislation that will increase the cost of doing business." Colorado technology companies are also worried about the consequences. The *Denver Business Journal* [December 2004] reports that industry officials like Les Wyatt of PeopleSoft/Oracle are pushing for adequate funding for education while considering tax policies that help companies conduct research and development – all while keeping taxes to a minimum.

According to the *Denver Business Journal* [December 2004], Bob Moody, executive director of the Colorado chapter of the National Association of Industrial and Office Properties, says: ".... TABOR needs fixing. We are watching higher education get

screwed, and for most of the business community, higher ed is a big economic development issue.”

Colorado’s conservative Governor Bill Owens, one of two governors who received the highest conservative rating from a recent Cato report, has said that several key changes must take place in order for the state to “make the needed investments in transportation, higher education and other essential services.” [*Denver Business Journal*, December 2004]. Among Owens’ recommendations are to ask voters for permission to retain some \$500 million in expected TABOR surplus revenues and to amend TABOR to eliminate the ratchet effect during and following recessions.

### **ARIZONA AS A TABOR CANDIDATE**

Arizona seems an unlikely candidate for a TABOR limitation. First, the state already has a TEL, which prevents appropriations of revenue collected from growing faster than the overall pace of the economy. Article 9 section 17 of the Arizona Constitution reads,

*The legislature shall not appropriate for any fiscal year state revenues in excess of seven per cent of the total personal income of the state for that fiscal year as determined by the economic estimates commission. The limitation may be exceeded upon affirmative vote of two-thirds of the membership of each house of the legislature on each measure that appropriates amounts in excess of the limitation.*

History has shown that appropriations have rarely threatened this TEL limit.

Second, the Massachusetts Taxpayers Foundation report indicates that Arizona state and local revenue collections fell from \$164.60 per \$1,000 of personal income in 1992 to \$142.75 in 2002, and the ranking among the states plummeted from 18<sup>th</sup> highest to 39<sup>th</sup>. Arizona’s relative position in revenue collection among the states [see Table 2] dropped from 34<sup>th</sup> to 47<sup>th</sup> on a per capita basis, according to the Massachusetts study, using the most recent census data [Massachusetts Taxpayers Foundation 2004]. The 2002 figure is also below the 1972 level of \$158.92. On a real per capita basis, collections have grown just over 1 percent on average since 1972 and less than half of that since 1992.

<b>Table 2</b>							
<b>TOTAL TAXES AND FEES: ARIZONA</b>							
<b>(Combined State and Local Collections)</b>							
<i>Fiscal Year</i>	<i>Per Capita (Current Dollars)</i>	<i>Rank</i>	<i>Per \$1,000 of Personal Income</i>	<i>Rank</i>	<i>Tax &amp; Fee Collection Growth 1992-2002 (annual average)</i>	<i>Personal Income Growth 1992-2002 (annual average)</i>	<i>Real Per Capita Tax &amp; Fee Growth 1992-2002 (annual average)</i>
1992	\$2,726	34	\$163.26	18			
					6.3%	7.7%	0.4%
2002	\$3,640	47	142.74	39			

Source: Massachusetts Taxpayers Foundation and U. S. Census, U.S. CPI used as the price deflator, Bureau of Economic Analysis, author calculations

The District of Columbia Tax Study [2004] reveals that the Phoenix metro area is relatively kind to taxpayers represented by hypothetical families of four [see Table 3]. The Phoenix area ranks among the bottom 10 in tax burdens for the largest city in each of the 50 states, and well below median and mean levels across the nation. This result holds for families at low, moderate, and high income levels.

<b>Table 3</b>		
<b>ESTIMATED BURDEN OF MAJOR TAXES FOR A FAMILY OF 4 BY INCOME, 2003</b>		
<b>\$25,000</b>		
	<b>Total Taxes</b>	<b>Rank</b>
Phoenix	\$1,338	42
National Average	\$1,816	
National Median	\$1,740	
<b>\$50,000</b>		
	<b>Total Taxes</b>	<b>Rank</b>
Phoenix	\$3,025	44
National Average	\$4,172	
National Median	\$4,070	
<b>\$75,000</b>		
	<b>Total Taxes</b>	<b>Rank</b>
Phoenix	\$4,782	44
National Average	\$6,832	
National Median	\$6,805	
<b>\$100,000</b>		
	<b>Total Taxes</b>	<b>Rank</b>
Phoenix	\$6,901	42
National Average	\$9,203	
National Median	\$9,391	
<b>\$150,000</b>		
	<b>Total Taxes</b>	<b>Rank</b>
Phoenix	\$10,888	41
National Average	\$13,859	
National Median	\$14,011	

Source: Tax Rates and Tax Burdens in the District of Columbia,  
A Nationwide Comparison, August 2004

Arizona already has reaped benefits that might accrue from the label as a fiscally conservative state. It is hard to find evidence of anyone who has a different assessment of the state's standing when it comes to fiscal conservatism. But questions do remain about the state's willingness to build an education/transportation/communications infrastructure that can support quality growth that will maintain high living standards for all Arizonans.

### **THE IMPACT OF A TABOR RULE ON ARIZONA REVENUE COLLECTIONS**

TABOR is no doubt championed by proponents as a measure that compels government to "spend within its means" – with rates of growth limited by the simple sum of population growth and inflation. However, the following arithmetic demonstrates that application of TABOR rules led to substantial reductions in the share of the aggregate economy that comprises the public sector. For those with a taste for shrinking government (as a component of a state or region's economy) with time, TABOR is a

savory recipe. These illustrations are directly applicable to the Arizona economy, but the basic arithmetic conclusions will apply in most states or regions.

There are a number of ways to design a TABOR rule. For purposes of both illustration and comparison with other states, we examine the implications for restricting growth in collections on the combined state and local level to the sum of population growth and inflation. Alternatives clearly exist. Focusing only on state revenues (about 50 percent) of the combined state and local collections would change the scale of discussion, but the findings of the analysis would not be materially different. That is, if applied exclusively to state revenues, the simulations would portray a shrinkage of state collections as a share of overall economic activity at essentially the same rates as observed in the simulations in this section.

The basic arithmetic of TABOR and its consequences for Arizona tax collections can be seen by examining the amount of tax and fee collections that take place at the state and local level across the states.<sup>1</sup> In 1992, Arizona's total state and local collections were 12.2 percent below the national average and ranked 34<sup>th</sup> among the 50 states on a real per capita basis, according to census estimates, and 18<sup>th</sup> as a share of personal income [see Table 2]. By the year 2002, the state's collections were 20.8 percent below the national average and ranked 47<sup>th</sup> on a per capita basis and had slipped to 39<sup>th</sup> as a share of personal income – about 6.2 percent lower than the state average. Indeed, using the CPI to control for inflation, real per capita tax and fee collections grew only 0.4 percent per annum from 1992 through 2002 while growth across the 50 states averaged 1.5 percent on a real per capita basis.

Aggregate nominal personal income growth averaged 7.7 percent from FY 92 through FY 2002, while total nominal revenue from own sources grew 6.3 percent on an annual average basis. The basic picture of Arizona suggests that over much of the 1990s, tax and fee collections actually were growing 1.4 percent per annum slower than the overall economy (6.3 percent vs. 7.7 percent) and that the tax burden, measured against total population or total personal income, declined in comparison with other states.

These numbers suggest that imposing a TABOR-type restriction on all taxes and fees collected in Arizona (ignoring ratchet-down effects) would not have had much impact in the last 10 years because the state's collections did not grow substantially above the TABOR limit. Indeed, with real per capita growth in collections at 0.4 percent per annum, collections in the state only exceeded the TABOR restriction (a rate of zero on a real per capita basis) by 0.4 percent! These conclusions are consistent with the findings of Edwards, Moore, and Kerpen [2003] who, in writing for the Cato Institute, noted that

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<sup>1</sup> The analysis is based on comparison tables published by the Massachusetts Taxpayers Foundation [2004] that utilize U.S. Census data on total tax and fee collections. The numbers used by the MTF can be obtained by dividing census own source revenues by state for each fiscal year by the "prior" calendar year personal income number published by BEA. We verified the per capita numbers by checking the Arizona numbers with population data from DES. All adjustments for prices in the analysis are conducted using the national CPI.

Arizona was one of the few states in the nation that did not reap a “windfall” in revenue collections in the 1990s.

If TABOR had been imposed across the board on all state and local taxes and fees in Arizona in 1992, assuming no ratchet-down effects, revenue available to state and local governments would have been 23 percent below the national average in 2002 (rather than the actual 20 percent) [see Table 4]. With TABOR, Arizona would slip to 33 percent below the average in 2012, assuming current growth trends prevail for the decade for the other 49 states. Even without TABOR, if current trends were to continue, per capita state and local collections in Arizona would be 28 percent below the national average by 2012. If TABOR had been imposed in 1992, Arizona would have ranked 49<sup>th</sup> in taxes and fees per capita and 44<sup>th</sup> as a share of personal income in 2002. By 2012, the state would rank last among the states in combined state and local tax and fee collections. If TABOR were imposed in 2002, Arizona collections would be some 31 percent below the national average by 2012.

<b>Table 4</b>			
<b>Hypothetical Simulations from 1972</b>			
<i>Year Imposed</i>	<i>As of 2002</i>	<i>As of 2012 (with TABOR)</i>	<i>As of 2012 (w/o TABOR)</i>
1992	-22.9%	-33.4%	
			-27.7%
2002	-19.7%	-30.6%	

\* Table entries represent percent departure of Arizona combined state and local tax and fee collections on a real per capita basis when compared with the average among the 50 states. Scenarios to 2012 assume rates of growth for the 50 states from 1992-2002 occur for the next 10 years.

Finally, the Arizona TABOR simulation demonstrates that the ratchet-down effect is likely to make TABOR even more restrictive. As discussed in the definition of the Colorado TABOR, ratchet-down effects occur because TABOR limits for a given year are established by growing from the prior year TABOR limit or actual revenue, whichever is less. Based upon census data, actual revenue in Arizona grew less than a TABOR limit in five of the last 10 years. Adjusting the TABOR limit to the realities of Arizona revenues would have left it some 11 percent below the level actually collected in the year 2002.

### **LONG-TERM IMPLICATIONS OF A TABOR RULE**

The negative consequences that a TABOR rule would have on the public sector really become clear when examined over longer time horizon. Simple illustrations using data

observed in Arizona, for perspective, reveal that a TABOR would result in substantially shrinking the relative size of the public sector in comparison with the overall economy.

Table 5 presents the basic landscape for Arizona.<sup>2</sup> Total own source revenues in Arizona generally have grown just slightly slower than overall personal income growth and slightly above the simple sum of population and inflation growth over the past 30 years.

<b>Table 5</b>					
<b>BASIC FACTS</b>					
<b>(Average Annual Growth)</b>					
	<b><i>Own Source Revenue Growth*</i></b>	<b><i>Personal Income Growth**</i></b>	<b><i>Population Growth**</i></b>	<b><i>CPI Inflation**</i></b>	<b><i>TABOR Rule (No Ratchet)</i></b>
72-02	9.65%	10.04%	3.48%	5.04%	8.52%
82-02	7.99%	7.80%	3.22%	3.39%	6.61%
92-02	6.29%	7.80%	3.41%	2.66%	6.07%

\* Fiscal year: Combined State and Local Collections

\*\* 71-01, 81-01, 91-01

Source: Census data, BEA, DES and author calculations

In contrast, suppose total state and local collections had grown at exactly the same rate as personal income since 1972. In this case, collections in 2002 would have been \$158.92 per \$1000 of personal income, about 4.4 percent higher than the national average, and would have ranked 18<sup>th</sup> overall – the same ranking Arizona maintained in 1992.

Now suppose that a TABOR rule had been imposed on all state and local revenues in 1972. Assume that NO ratchet effects apply (which would result in substantially lower collections). With TABOR, net collections would have grown about 1.1 percent slower per annum over the 30 years and would have totaled about \$104.73 per \$1000 in personal income, some 31.2 percent below the national average and 12.9 percent below number 50, New Hampshire, in the 2002 rankings [see Table 6].

<sup>2</sup> Growth rates for total own-source revenues refer to fiscal years and growth rates for personal income, population, and prices refer to calendar years. Setting personal income, population and price indices as averages over two calendar years or at the second calendar year of the two years spanned by the fiscal year would slightly change the arithmetic but have NO substantive impact on the basic conclusions reached in this analysis.

<b>Table 6</b>			
<b>TABOR HYPOTHETICALS</b>			
	<i>Total State &amp; Local Collections per \$1,000 in Personal Income</i>	<i>Rank</i>	<i>% Departure from Average State</i>
Today	\$142.74	39th	-6.2%
Hypothetical: 72-2002 @ PI Growth	\$158.92	18th	+4.4%
Hypothetical: 72-2002 Simple TABOR Rule	\$104.73*	50th	-31.2%

\* 12.8% below New Hampshire, #50 in 2002

Source: Data sources for Table 2 and author calculations

The effects of a TABOR rule show up over longer time periods simply because of the arithmetic of compounding minor differences in growth rates. This can be demonstrated dramatically by assuming that the rates of growth in personal income, population and prices for the 1992-2002 period will prevail over the next 10, 50 and 100 years respectively. In 2002, total Arizona state and local collections per \$1,000 in personal income were \$142.74. Under a simple TABOR rule (with no ratchet-down effects), collections would total \$121.29 per \$1000 in 10 years, \$63.21 in 50 years and only \$28 per \$1,000 of personal income in 100 years. These figures suggest that under a simple TABOR rule, the state and local government sector would shrink from about 14 percent of the aggregate economy today to under 3 percent in 100 years [Table 7]!

Comparisons with other states are obtained by allowing their revenue bases to grow at the rates they have grown over the most recent decade – just allowing them to continue on the same trend. Arizona collections plummet from today's number of 6.2 percent below the state average, to over 80 percent below the state average!

<b>Table 7</b>		
<b>PROSPECTIVE SIMULATIONS</b> <b>(10yr, 50yr, and 100yr scenarios)</b> <b>Simple TABOR Rules</b>		
	<i>Total State &amp; Local Collections per \$1,000 in Personal Income</i>	<i>% Departure from Average State*</i>
2002	\$142.74	-6.2%
2012	\$121.29	-20.3%
2052	\$63.21	-58.5%
2102	\$28.00	-81.6%

\*Actuals in 2002, simulated in future years by allowing AZ revenues to grow at TABOR restricted rates and other States to grow at the average annual rates observed over the last 10 years. Source: Massachusetts Taxpayer's Foundation, Census, and author calculations.

Adding ratchet-down effects (assuming recessions at approximately one per decade) would hasten the descent sharply. Based upon similar growth assumptions but including cyclical fluctuations in the revenue stream, the size of the state and local sector in Arizona would drop from 14 percent to 7 percent of the total economy in 20 years and to less than 3 percent after 50 years.

All simulations to this point have been based on applying TABOR to the combined state and local revenue of the state. This is reasonable in light of the stated intent of the legislation in Colorado. Moreover, it facilitates comparisons with revenues collected in other States. However, Table 8 examines the impact of a TABOR restriction on total state collections and General Fund collections. Estimates suggest that the impact on major revenue categories is quite dramatic. Within 20 years (assuming some ratchet effects), total state collections including the General Fund plus all highway taxes and charges, university tuition, and all state user fees, shrink in scale to a percent of personal income that is just slightly greater than the share the General Fund is today. To understand the impact, presume that the General Fund is used today to incur all the expenditures now covered by highway taxes, tuition, and general fees – without using any money from these sources! Basic arithmetic suggests that significant cuts must occur somewhere. In 50 years (again assuming ratchet effects), all revenues available to all levels of state and local government will be (as a share of aggregate income) less than the General Fund is today. The impact can be gauged by thinking about how difficult it might be to finance all of state and local government (all education, all police, fire, etc.) today with \$6.4 million (about 35 cents on each dollar that is currently available to state and local government). Some might argue that TABOR is an attempt at efficient government or forcing government to “live within its means.” These simulations suggest that TABOR is simply a plan to relegate government to an insignificant role in the economy.

**Table 8**  
**TABOR Impact Simulations**

		General Fund	Total State	Combined State and Local
FY-05 Dollars(est.)	Billions of current Dollars	6.4	10.6	19.8
		percent of personal income		
Share of Personal Income (est.)		4.70%	7.80%	14.60%
Simulated Shares (% of personal income)				
TABOR 10 years				
	no ratchet down	3.91%	6.48%	12.10%
	ratchet down	3.22%	5.34%	10.00%
TABOR: 50 years				
	no ratchet down	2.03%	3.37%	6.30%
	ratchet down	0.97%	1.60%	3.00%
TABOR: 100 years				
	no ratchet down	0.90%	1.50%	2.80%
	ratchet down	0.40%	0.67%	1.25%

Note: Simulations based on assumption that personal income grows at average annual rate observed over the past decade and that the TABOR rule grows at the average annual rate observed over the past decade.

Ratchet down simulations are obtained by simulating business cycles at the frequency observed in the past decade, approximately one episode per decade.

The long-run negative effects that a TABOR rule would have on the Arizona economy was stated succinctly by Rep. Brad Young, chairman of Colorado's Legislative Budget Committee: "There is a hole in the bottom of the boat – that is the TABOR spending limit. It works for a little while, but you go out in the future and you sink the boat." [*Colorado Springs Gazette*, March 2, 2004].

### SUMMARY AND CONCLUSION

Some proponents argue that TABOR simply forces government to "live within its means." The fiscal crisis that Colorado is enduring, coupled with the numerical illustrations presented above, show instead that the application of a TABOR rule

actually results in shrinkage of government as a share of the economy over time, resulting in reductions that go well beyond a simple conservative fiscal agenda.

But there also are serious limitations placed on responsible public policy by Colorado's TABOR rule:

- A TABOR rule inhibits the tax system from acting as an automatic stabilizer. An efficient stabilizer would take money out of the economy during expansions and buffer downturns by injecting funds when economic conditions erode. TABOR preempts this stabilization feature by restricting the transfers into a rainy day fund when revenues grow above TABOR limits.
- Expansion periods provide opportunities for states and regions to address long-run infrastructure (transportation/communication/education/water/environment) needs. TABOR simply returns surpluses to taxpayers, limiting or preventing spending on these initiatives.
- Business advocates argue that TABOR inhibits tax reform for tax codes that become unbalanced or outdated. Often, there is simply no opportunity to deliver tax relief in needed areas.
- The mechanism for rebating surpluses to taxpayers in Colorado need not be optimal or free from political haggling. There is no evidence that the particular redistribution formula adopted by Colorado has nurtured the business climate in the state.
- In Colorado, TABOR has forced the state to conform to federal laws, resulting in unintended tax cuts.

Clearly, TABOR is consistent with a political agenda aimed at shrinking state and/or local government as a share of the overall economy. But setting politics aside, it is difficult to understand why a TABOR rule is superior to an effort to plan for business cycle fluctuation by setting and maintaining tax rates at low rates across a broad base of taxpayers, both individuals and businesses alike.

The rates are optimal when the trend growth in revenue is just sufficient to support infrastructure investment and social needs over time. In expansionary periods, policymakers should "save" any surplus in a budget stabilization fund or take opportunities to make strategic investment that accrue benefits over a long time horizon. The stabilization fund should be built in sufficient quantity to support spending needs when inevitable business cycle downturns occur. Prudent policymakers would leave some room for discretion in this fiscal planning model rather than setting the maximum growth at some arbitrary level – like a TABOR limit.

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