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TAX AND EXPENDITURE LIMITS AND REVENUE VOLATILITY

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REVENUE VOLATILITY

Because states tax different types of business and consumer transactions, their tax revenue is susceptible to economic cycles. Consequently, the amount of tax revenue flowing into their coffers tends to fluctuate with these cycles. Volatile revenue flows could undermine efforts to budget, plan, and deliver services.

In 2015, [The Pew Charitable Trusts] scored states' [overall revenue volatility] based on 1995-2013 tax revenue, after controlling for the effects of revenue changes.

Alaska had the most volatile overall revenue flow, fluctuating within 34.4% above or below its overall trend, while South Dakota had the least volatile overall flow, fluctuating within 2.6% above or below its overall trend. Most states' volatility ranged from 3% to 7%. Connecticut scored in the upper end of this range—6.5%.

ISSUE

What are tax and expenditure limits (TELs) and which states impose them? Do TELs reduce or eliminate the effects of revenue volatility on state budgeting?

SUMMARY

TELs are fiscal rules states adopt in their constitutions or statutes to limit the growth of state budgets. TELs vary in the degree to which they restrain states' ability to increase or decrease taxes, spending, or both. For example, TELs added to constitutions tend to be more stringent than those incorporated in statute.

Stringent TELs, along with other factors, may aggravate revenue volatility, according to political scientist Tucker Staley, who studied the relationship between TELs and revenue volatility over 37 years, from 1969 to 2005. Staley grouped TELs according to their relative stringency and measured the degree to which a state's revenue fluctuated over specified periods. He also examined how other political, demographic, economic, and geographic factors affected volatility.

Staley found "strong evidence" showing that more stringently binding TELs increase revenue volatility.

Other factors associated with volatility include authorization for citizen initiative and referenda, legislative capacity to adjust revenue and expenditures, unemployment, and dependence on property taxes.

TELs

Purpose

TELs are rules intended to control or restrain the growth of state budgets. Some TELs do this directly by limiting the extent to which expenditures can increase each year (i.e., expenditure limits). Tax limits (also referred to as revenue limits) attempt to do so indirectly by limiting the extent to which revenue can increase each year. The extent to which these limits, singly or in combination, restrain budget growth depends on their structure.

Components

TELs have the same general structure, regardless of whether they limit the growth of taxes or expenditures. But their components vary, and those differences affect the extent to which they restrain tax or expenditure increases. Most TELs limit the annual growth in taxes or expenditures to changes in an economic or demographic growth factor and specify rules for overriding the limit. Table 1 outlines TELs' components and identifies the components that determine their restrictiveness.

Table 1: Structural Components of TELs and their Restrictiveness Qualities

Component	*Options*	*Restrictiveness*	*Comment*
Target	Spending	Least	The extent to which a TEL restricts budget growth depends on whether it applies to spending or revenues and whether any types of spending or revenue are excluded from the limit. Tax limits appear to be more restrictive than spending limits.
	Revenue	More	
Growth Factor	Personal Income	Least	Growth factors determine the degree to which taxes and spending can increase from year to year. Population and inflation tend to grow more slowly than personal income, thus increasing a TEL's restrictiveness.
	Population	More	
	Inflation	More	
Overrides	Simple Majority	Least	TELs with override rules potentially reduce their restrictiveness. The extent to which they do so depends on factors such as the minimum number of votes needed to override the TEL.
	Supermajority	More	
	Legislative and voter approval	Most	
Adoption Method	Legislative proposal	Least	Adoption methods could make it easy or hard to adopt or change a TEL. It is relatively easier for a TEL enacted by the legislature to be changed or repealed than one adopted by a constitutional convention.
	Initiative	More	
	Referendum	More	
	Constitutional Convention	Most	
Codification	Statutes	Least	Statutory TELs are less restrictive than constitutional ones because the requirements and procedures for changing a law are less stringent that those for amending a constitution.
	Constitutional Amendment	Most	

States with TELs

As Table 2 shows, at least 31 states have TELs: 25, including Connecticut, limit only expenditures; four limit only revenue; and two limit both. Fourteen states have constitutional TELs; 14, statutory; and three, including Connecticut, have combined constitutional and statutory TELs.

Table 2: States with TELs

State	*Type of Limit*	*Growth Restriction*	*Legal Basis*
Alaska	Expenditure	Annual cap on appropriations increases based on population and inflation growth	Constitution
Arizona	Expenditure	Appropriations limited to 7.41% of total state personal income	Constitution
California	Expenditure	Annual growth in appropriations limited to population and per capita personal income growth	Constitution
Colorado	Expenditure and Revenue	Expenditure growth limited to lesser of 5% of total state personal income or 6% increase over prior year appropriations Revenue generally limited to population growth plus inflation	Constitution and statute
Connecticut	Expenditure	Expenditures limited to greater of average growth in personal income for previous five years or prior year's increase in inflation	Constitution and statute
Delaware	Expenditure	Appropriations limited to 98% of revenue estimate	Constitution
Florida	Revenue	Revenue growth limited to average growth rate in personal income for previous five years	Constitution
Hawaii	Expenditure	General fund spending cannot exceed average growth in personal income for previous three years	Constitution
Idaho	Expenditure	General fund appropriations cannot exceed 5.33% of total state personal income	Statute
Indiana	Expenditure	Annual spending cap set by formula	Statute
Iowa	Expenditure	Appropriations limited to 99% of adjusted revenue estimate	Statute
Louisiana	Expenditure	Expenditures limited to 1992 total state appropriations plus annual growth in state per capita personal income	Constitution
Maine	Expenditure	Expenditure growth limited to 10-year average of personal income growth, up to 2.75%	Statute
Massachusetts	Revenue	Revenue growth limited to three-year average growth in wages and salaries	Statute
Michigan	Revenue	Revenue limited to 9.49% of prior year's state personal income	Constitution
Mississippi	Expenditure	Appropriations limited to 98% of projected revenue	Statute
Missouri	Revenue	Revenue limited to 5.64% of prior year's total state personal income; tax increases over $77 million or 1% of state revenues, whichever is less, require voter approval	Constitution
Montana	Expenditure	Expenditure growth limited to a growth index based on state personal income (Attorney general invalidated statute in 2005)	Statute
Nevada	Expenditure	Proposed expenditure growth limited to biennial percentage growth in state population and inflation	Statute
New Jersey	Expenditure	Expenditure growth limited to growth in state personal income	Statute

Table 2 (Continued)

State	Type of Limit	Growth Restriction	Legal Basis
North Carolina	Expenditure	Expenditures limited to 7% or less of total state personal income	Statute
Ohio	Expenditure	Appropriations growth limited to greater of 3.5% or population plus inflation growth	Statute
Oklahoma	Expenditure	Expenditures limited to 12% annual growth adjusted for inflation and appropriations limited to 95% of certified revenue	Constitution
Oregon	Expenditure and Revenue	Appropriations limited to 8% of projected biennial total personal income State must refund taxpayers if general fund revenues exceed 2% of revenue estimate	Statute for expenditure limit Constitution for revenue limit
Rhode Island	Expenditure	Appropriations limited to 98% of projected revenue	Constitution
South Carolina	Expenditure	Spending growth limited to greater of average growth in personal income or 9.5% of total personal income for prior year	Constitution
Tennessee	Expenditure	Appropriations growth limited to growth in total personal income	Constitution
Texas	Expenditure	Biennial appropriations growth limited to growth in state personal income	Constitution
Utah	Expenditure	Spending limited according to formula that includes population growth and inflation	Statute
Washington	Expenditure	Spending growth limited to inflation over previous three years plus population growth	Statute
Wisconsin	Expenditure	Spending growth for specified appropriations limited to personal income growth rate	Statute

Source: National Conference of State Legislatures, *State Tax and Expenditure Limits—2010*

As the table shows, the growth factors vary widely among the states. Most of the states with expenditure limits limit spending based on a percentage of personal income (e.g., Arizona, 7.41%) or the average growth rate in such income over a specified period (e.g., Maine, 10 years, up to 2.75%). States with revenue limits limit revenue growth based on the average growth of personal income (e.g., Florida, five years) or a percentage of that income (e.g., Michigan, 9.49% of the previous year's state personal income).

DO TELs REDUCE REVENUE VOLATILITY?

Perils of Volatility

Volatile revenue flows undermine a state's efforts to plan and deliver services, according to University of Central Arkansas political scientist Tucker Staley ("The Effects of TELs on State Revenue Volatility: Evidence from the American States," *Public Financing and Budgeting*, Spring 2015). "In general, the more stable a state's revenue stream is, the easier it is for state policymakers to effectively budget and avoid the messy cycle of taxing and cutting to provide services to citizens," he stated.

Research Method

Staley examined the relationship between revenue volatility and TELs by measuring changes in each state's total annual revenue over four-, eight-, and 12-year periods after grouping the states based on the degree to which their TELs constrain budget growth (i.e., low-, medium-, and high-stringency TELs).

Staley also examined whether other factors besides the TELs correlated with revenue volatility. These factors included each state's political climate, demographic makeup, manufacturing workforce, and geographic region.

Findings

A TEL's stringency appears to affect a state's revenue volatility. Low-stringency TELs, such as statutory TELs that limit only expenditures, do not have a significant impact on volatility over the four- and eight-year period and appear to have a slight impact over the 12-year period. States with such TELs include Arkansas, Indiana, and Wisconsin.

Medium stringency TELs, on the other hand, "significantly impact revenue volatility for all measures." States with these TELs include Connecticut, Montana, and Washington.

"States with more stringently binding tax and expenditure limits—in addition to other political, demographic, economic, and geographic factors—are associated with greater levels of state revenue volatility," States with the most stringent TELs, according to Staley, are Colorado, Florida, Louisiana, and Missouri.

The other factors Staley found that correlate with revenue volatility include authorization for voter initiatives or referenda, the capacity of legislatures to keep revenue flows stable, high unemployment, and the extent to which a state depends on property taxes.

Analysis

Because states tax different types of economic transactions, tax revenue goes up and down with the economic cycle. Tax limits restrict a state's ability to even out those fluctuations by adjusting tax rates or bases. Consequently, TELs could make states more vulnerable to economic cycles and, as Staley suggested, trigger a chain reaction that increases revenue volatility.

When revenues drop during an economic downturn, TELs prevent legislators from increasing revenues to maintain services and cover other costs, thus "creating a 'ratchet down' effect in many states where spending cuts are more likely than revenue increases." The spending cuts coupled with lower revenues disrupt program planning and reduce service levels. Depending on a TEL's components, legislators may try to maintain service levels by increasing user fees, selling more bonds, or using other revenue sources besides taxes.

When the economy turns around, the TEL's growth factor could prevent legislators from increasing revenues to previous levels. But, as Staley notes, "even under the most stringent TELs state policymakers usually find a way to increase revenue," thus triggering "large jumps in revenue in order to pay for deficiencies in previous budgets thus increasing volatility."

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