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A TAX LIMITATION FOR GEORGIA?

The Tax Payers Bill of Rights Study Committee was established in the 2005 session of the Georgia General Assembly (HR 340) to investigate the possibility of imposing a tax or expenditure limitation for Georgia. This Policy Brief discusses the evidence that has been presented regarding the need for a tax or expenditure limitation and the issues associated with the design and effect of a tax or expenditure limitation.

No one has proposed a specific limitation, but there is a presumption that a limitation similar to what has been adopted by Colorado might be considered for Georgia. In Colorado, expenditure increases by the state government and each local government are limited to the percentage growth in population and inflation. Therefore, this Policy Brief uses that limitation as the basis for the analysis presented here.

Need For a Limitation

There have been at least two reports published regarding the possibility of imposing a tax or expenditure limitation in Georgia. The Georgia Public Policy Foundation (GPPF) argues for the need for a limitation while the Georgia Budget and Policy Institute (GBPI) argues against the need for a limitation.[1]

The GPPF points out that for Georgia, total state and local taxes as a percentage of total personal income (state and local tax burden) increased over the period 1970 to 2005 and that this increase was larger than the average for the other states. Thus, the GPPF concludes that, "Georgia's elected officials have not provided a strong bulwark against increasing tax burdens." They further state, "Georgia's mediocre record in controlling the growth in government spending and maintaining a low tax burden on its citizens suggests [a need for the adoption of a tax limitation.]"

The GBPI, on the other hand, considers the increase in state expenditures per capita adjusted for inflation for the period 1991 to 2004. The GBPI argues that most of this increase is due to explicit policy decisions such as increasing prison sentences, raising teacher salaries, and the Homeowners Tax Relief Credit. The GBPI also notes that state tax burden between 1980 and 2005 has been relatively stable, ranging generally between 5.5 percent and 6.0 percent and for the past four years was less than 5.5 percent. Thus, the GBPI concludes that, "Georgia is not a state with a high tax burden or a state budget growing 'out-of-control.'"

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Can both organizations be correct? In terms of their facts, both organizations are correct. But is the evidence they present sufficient to draw the conclusions they do?

Consider first the evidence presented by the GPPF. The evidence that the GPPF presents makes for a very weak case in support of a limitation. According to the data presented by the GPPF, the state and local tax burden in 1982 in Georgia was 9.6 percent and in 2005 it was 9.8 percent. (These numbers are estimates generated by the Tax Foundation, and thus are subject to prediction error. Therefore, the difference may be just a statistical artifact.) While the tax burden did increase in the 1990s, it has since fallen. So, the increase in the tax burden between 1970 and 2005 actually occurred during the 1970s.

The GPPF points out that in 2005, Georgia ranked 31st in terms of tax burden while in 1970 it ranked 41st, which the GPPF suggests is further evidence that taxes are out of control. However, these ranking are sensitive to small changes in taxes. For example, if taxes for the average person in Georgia had changed by $100 in 2005, Georgia's ranking would have been 24th if taxes had gone up and 41st if they had gone down by $100. In other words, relatively small changes in taxes can lead to large changes in the rankings.

In addition, the GPPI suggests that the increase of about $1 billion in the state budget for fiscal year 2006 is evidence that "… the democratic process (e.g., fear of reprisals from voters) is an inadequate restraint on politicians who seek to curry campaign contributions from special interests and to bring home goodies to garner voters." One simply cannot draw such a conclusion from the fact that the budget increased. The increase comes after several years of budget cuts and slow growth; inflation adjusted per capita state budgeted expenditures for fiscal year 2006 are still less than for the pre-recession years.

More importantly, one cannot draw the conclusion that the increase in the state and local tax burden is evidence or proof of a need for a tax or expenditure limitation. The issue is whether the increase in expenditures (and thus taxes) exceeded what citizens wanted. The GPPF implicitly assumes that expenditures in 1970 were at the appropriate level, or at least closer to the appropriate level than in subsequent years. But it is also possible that current expenditures are closer to the appropriate level than the level in 1970. In 1970, according to GPPF, Georgia was ranked 41st in terms of state and local tax burden. This means that expenditures in Georgia were low relative to the rest of the country. It is thus possible that expenditures were too low in 1970 and that the growth in taxes over the past 35 years was simply an effort to get public services up to the level desired by the voters.

Voters have demands for public services like better roads, more parks, and better education just as they have demands for private goods like food, housing, and clothes. As income increases, household demands for both private goods and public services increase. Furthermore, as the population becomes more urbanized, the need or demand for public services (and thus public expenditures) increases. Income per capita in Georgia grew faster than the national average over the period 1970 to 2005 and the state has become more urbanized. Thus, it is not unexpected that in Georgia taxes as a share of income have increased relative to other states. Note, however, this argument does not imply that the increase in tax burden in Georgia was the appropriate increase.

The GBPI, on the other hand, relies on trends in state expenditures during the period 1980 to 2005, and argues that the growth between 1991 and 2004 in inflation-adjusted per capita state spending can be largely explained by explicit policy decisions.

What about the GBPI's evidence and explanation? First, the GBPI ignores local government spending, which grew about 4.8 percent faster than state government spending during the 1990s. Second, while explicit policy decisions are associated with the increase in state expenditures, this does not mean that the policy is what the citizens wanted or that they were good policies. Some individuals might argue that increasing prison sentences (which resulted in an increase in correction expenditures) was a bad policy. Others may suggest that increasing teacher salaries was a bad policy since it has not resulted in increased public school performance. Thus, it could be argued that having a tax or expenditure limitation would have prevented the state from implementing bad policies. (This is not to suggest that these were necessarily bad policies.) The evidence does suggest that the increases in expenditures are largely due to the adoption of explicit policies and not pork-barrel type spending.

Colorado just voted by referendum to suspend its limitation for five years. Some want to take that as evidence that such a limitation doesn't work. But if the objective in Colorado was to strictly limit the growth in state and local expenditures, the limitation was actually very successful. But if the objective was to just to moderate the growth of expenditures in Colorado, the limitation probably failed because it did much more than moderate expenditure growth. It should be pointed out that the budget problems in Colorado were only partly due to the limitation. One particular feature of the limitation along with a companion proposition made the limitation very difficult to deal with. One of the features of TABOR was that the growth in expenditures was based on the previous year's actual expenditure. Thus, when the recession hit and revenues declined, that lower expenditure level became the basis for future allowable expenditures growth. Because any tax increase had to be voted on by the public, it was not politically feasible to make up for the loss in revenue due to the recession.

Colorado also adopted a proposition that required that expenditures on K-12 education increase by an amount equal to the percentage increase in enrollment plus inflation plus 1 percent. Thus, education expenditures had to increase faster than total expenditures. That meant that over time, K-12 spending was taking up a larger and larger share of total spending. Expenditures on all other public services were being squeezed.

Neither the GPPF nor the GBPI point out that unlike many states, Georgia gives the governor sole authority to determine the expenditure level since he sets the revenue estimate, and that at the end of the fiscal year, expenditures cannot exceed revenue. In many states a committee, typically comprised of the leadership from the House, Senate, budget office, and the governor, has to agree on the size of the revenue estimate. This is a process that by its nature yields compromises, frequently in the form of agreement over increases in expenditures. And, unlike Georgia, in many states the budget must balance only at the time it is proposed, so it is easy to over project revenue, thus increasing expenditures. This does not mean that expenditures in Georgia are not too high, only that the fiscal institutions make it more difficult to exceed the expenditure level the public prefers than in other states. It is relevant that all of the three bond rating agencies have given Georgia their highest possible bond rating; those rating are not given out to fiscally imprudent state governments.

If the evidence presented does not demonstrate whether there is a need for a tax or expenditure limitation, what is needed to determine whether state expenditures (and thus taxes) have increased too rapidly and thus are too large? One possible approach to answering that question involves identifying a set of expenditures that the public would agree to delete from the budget, with a commensurate cut in taxes. Of course, everyone can find something in the budget that he or she could get along without, but it might be something that someone else needs, or at least wants. If a Colorado-like limitation on expenditures had been imposed in 1990-91 in Georgia, then expenditures in fiscal year 2004 would have had to be about $1 billion less than actual expenditures of $15.8 billion. So, if one can identify $1 billion that should be cut from the adopted budget and that the public would agree should be cut, then he or she has grounds for supporting a Colorado-like tax or expenditure limitation for state government. A similar experiment could be done for local governments, although clearly that is a much harder task.

Of some relevance is a telephone survey the Fiscal Research Center conducted. In response to a question about how the state should address a revenue shortfall, 56 percent said to cut expenditures, while the other said either raise taxes or do some of both.[2]

Issues in Designing a Tax or Expenditure Limitation

Tax and expenditure limitations are a blunt instrument for controlling the growth in expenditures or taxes. Consider a Colorado-like limitation, which establishes expenditures per capita at the time the limitation is adopted as the maximum allowable (inflation-adjusted) per capita expenditure level. There are two problems with this limitation. First, such a limitation does not allow for increases in need or demand. As noted above, individuals have demands for public services like roads, education, and parks. Increases in income and changes in demographics will lead to increases in the per capita demand for public services. Such a limitation would be like limiting calories per family member equal to its current calorie intake. A family that currently has a small male child would have a real problem as the child turned into a six foot teenager.

Second, it assumes that the current level is the appropriate level, and does not allow for adjustment if it is not the appropriate level. Consider school systems in Georgia. There are substantial differences in expenditures per student, with a ratio of better than 2 to 1 between the highest and lowest spending system. A Colorado-like limitation would make those differences permanent. If a low spending district decided it needed to increase spending per student, or the property tax base increased so that the community could afford to increase spending, it would not be allowed to do so.

In addition, the year that is select as the base is arbitrary but can have a major influence in the effect of a limitation. For example, if a limitation had been imposed in Georgia beginning in fiscal year 1989-90, then in 2004 allowable state expenditure would have been $14.8 billion, which is $1 billion less than actual expenditures. However, if the limitation had started one year later, in 1990-91, allowable expenditure in 2004 would have been only $13.8 billion, which is $2 billion less than actual expenditures. Allowable expenditures thus differ by $1 billion depending on which of the two years was the start date.

Presumably, the rational for using population growth and inflation is to account for increases in the population served and in the cost of providing a given level of service. But, as the GBPI points out, population may not be the appropriate benchmark for public service needs, and changes in the consumer price index may not reflect increases in the cost of providing government services.

There are 23 states that have a state tax or expenditure limitation. Of these, 4 (Alaska, Colorado, Nevada, and Washington) have a state limitation that uses population growth and inflation to determine the allowable increase in expenditures or taxes. Only Colorado bases the allowable increase on the prior year's revenue. The other 3 states base the limitation on a base year and calculate the allowable increase from that base. There are 18 states that limit expenditures or taxes to either the growth in personal income to some fixed percent of income, with the percents varying from 5 percent to 9.5 percent. One state has a fixed allowable percentage increase in spending. While most states have imposed some sort of limitation on property taxes, 5 states have imposed limits on the growth of total expenditures or revenues of municipalities and counties. Three of these states use population growth and inflation as the basis for allowable growth.

If Georgia is going to have a limitation, and the objective is to moderate the growth in government spending, then setting the limit as a maximum percentage of income would be a better policy option than a Colorado-like limitation. Furthermore, as the GPPF suggests, there needs to be some override provision to allow for special circumstances and emergencies. Requiring a vote of the citizens probably would not provide sufficient flexibility to allow the government to respond to an emergency. Ten of the states with limitations allow overrides by supermajority votes (60 percent, 66 percent, or 75 percent) of the representative body, while 3 also require a voter approval.

Imposing a limit on expenditures usually is for the purposes of controlling taxes. Exemptions are allowed for expenditures funded by grants, legal settlements, etc. Such exemptions should be part of any Georgia limitation.

If a limitation is imposed in Georgia, there are likely to be efforts by governments and citizens to circumvent the limitation. There will likely be increased attempts to use tax credits to avoid the limitation. For example, rather than making payments to Pre-K programs directly to the schools, the state could have the parents pay tuition and then give a 100 percent refundable credit to the parent for the tuition they pay. The latter keeps the expenditure and taxes off the books, but accomplishes the same objective, government financing of Pre-K programs. One should also expect that special associations will arise to provide public services that are cut out of the budget. Such privately provided public services, however, will be available only to those citizens willing and able to pay. And there is substantial evidence that a tax limitation will result in an increase in fees.

A tax or expenditure limitation would be a significant change to Georgia's fiscal apparatus. If improperly designed, it could have very undesired consequences. Georgia has a reputation for being fiscal conservative, and thus it should require substantial evidence of the need for a limitation, and the magnitude of the problem before acting. If it is determined that the growth in expenditures has not been substantially larger than what would be appropriate, the state would be wise to consider more tailored alternatives before adopting a tax or expenditure limitation.

NOTES:

1. E. Frank Stephenson, "Limiting Government Spending in Georgia," Georgia Public Policy Foundation, September 9, 2005, available at: http://www.gppf.org/article.asp?RT=14&p=pub/Spending/TelGeorgia.htm. Georgia Budget and Policy Institute, "The Truth About TABOR (Taxpayers Bill of Rights): What it Would Mean for Georgia," September 12, 2005, available at: http://www.gbpi.org/pubs/20050912budget.pdf.

2. Peter Bluestone, *What Georgians are Thinking about Taxes III*, FRC Brief No. 105, April 2005, Fiscal Research Center. Available at: http://frp.aysps.gsu.edu/frp/frpreports/ brief104/brief104.pdf

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