



AgEcon SEARCH
RESEARCH IN AGRICULTURAL & APPLIED ECONOMICS

The World's Largest Open Access Agricultural & Applied Economics Digital Library

This document is discoverable and free to researchers across the globe due to the work of AgEcon Search.

Help ensure our sustainability.

Give to AgEcon Search

AgEcon Search

<http://ageconsearch.umn.edu>

aesearch@umn.edu

*Papers downloaded from **AgEcon Search** may be used for non-commercial purposes and personal study only. No other use, including posting to another Internet site, is permitted without permission from the copyright owner (not AgEcon Search), or as allowed under the provisions of Fair Use, U.S. Copyright Act, Title 17 U.S.C.*

Impacts of Tax & Expenditure Limits on Local Governments: Lessons from Colorado and Missouri

Judith I. Stallmann

University of Missouri-Columbia - USA

Tax and expenditure limitations (TEL) on state and local governments have been passed with the presumption they will limit the growth of government, raise government efficiency, and increase direct democracy by requiring voter approval of tax increases. Both the popular press and the academic literature focus on the impacts of TEL on state budgets. Yet at a time when decentralization and devolution are increasing demands on local government, TEL provisions are in some cases causing rigidity in local budgets and subsequent fiscal stress. The smaller the budget, the more significant the potential adverse effects of TEL, and small governments tend to be rural governments. While there is some evidence that governments under TEL become more efficient, governments typically look for ways to circumvent the restrictions as they become more severe, increasing inefficiencies and reducing both representative and direct democracy, the opposite of the intended effects of TEL laws. States would be wise to avoid TEL and instead utilize stricter reporting and auditing requirements. The latter are a more direct means of monitoring public sector management while allowing local governments the flexibility to adjust to local fiscal circumstances.

Impacts on Local Budgets

Some evidence of the impact of TEL can be found in the experience of Colorado and Missouri. At the state level, Colorado's "Taxpayer's Bill of Rights" (TABOR) law limits the growth of state expenditures to the rate of inflation plus the population growth rate. All surplus revenues are returned to voters. Missouri's constitutional amendment, known as the Hancock amendment, limits the growth in state revenues

to growth in personal income (Hembree, 2004). Local governments in Colorado face both expenditure and revenue limitations and all tax increases must be approved by voters (Brown, 2006). In Missouri, the growth of property tax revenues is limited and all tax increases (with one exception, as discussed below) must be approved by voters.

In general, the smaller the budget, the less flexibility to reallocate funds, so that even a small change can have major budget implications. Tax and expenditure limitations do not take into account all of the factors that may require increased expenditures at the state or local level and frequently ignore business cycles. In addition, they impose a one size fits all policy on all local governments rather than allowing local officials the flexibility to govern according to local circumstances and the needs of the local citizenry. In this environment, TEL would be expected to cause fiscal stress for local governments and higher stress might be anticipated for smaller governments, which tend to be rural.

Major factors that lead to demands for increased government expenditures include:

- Increased costs of providing existing services.
- Increased service demands due to increased population. As population increases, a higher quantity of each service is needed to meet the population change. At some point, new capacity—schools, sewers, etc.—needs to be added. Such capital expenditures are lumpy and increase average costs, requiring large expenditure increases.
- Increased demands for the quantity and quality of services because of per capita income increases. Public goods are usually normal goods, which

means that as incomes increase people demand more of them.

- Changing circumstances that require new public services. Decentralization of government functions to local levels and new demands due to unforeseen events increase fiscal pressures on local governments, the 9-11 terrorist attacks being the most obvious example.

Most TEL laws do not take all of these factors into account, leading to potential budget shortfalls. Brown (2006) investigated the impact of TABOR on Colorado municipalities and found it has created fiscal stress in municipalities, resulting in 356 elections for exemptions to spend existing revenues beyond TABOR limitations. Voters approved 325 of those requests.

While Missouri local governments reassess real property every two years, property values can only rise as much as the Consumer Price Index in the previous (single) year before property tax rates must be rolled back to a revenue-neutral rate. While inflation increases the costs of providing government services annually, local government revenues can only be adjusted upward for inflation every other year. Local governments that rely less on property taxes are not as affected by this constraint. Rural jurisdictions tend to rely more on the property tax because their sales and other tax bases are limited. Rural jurisdictions are therefore more likely to be adversely affected by the restrictions.

TEL may affect local governments in other ways. Reprioritizing or cutting state spending may indirectly cause local governments to spend more. For example, a cut in Medicaid reimbursement rates or a change in eligibility rules may increase un-reimbursed costs for local hospitals—many of which are publicly owned. Brown (2006) divided the state of Colorado into five regions to examine the effects of TABOR on local communities. In two of the three rural regions of Colorado, state revenues per capita to local governments have declined because of TABOR limitations. At the state level, education and public health have had disproportionate spending cuts. Rural Colorado hospitals serve a disproportionate share of the uninsured and elderly. Budget cuts have increased the use of private charity funds and financial write-offs in rural hospitals, threatening their finances (Bell Policy Center, 2005). Rural counties have the highest suicide rates while mental health programs have been eliminated or reduced. Funding for programs in rural community colleges has been eliminated (Bell Policy Center, 2005).

The Colorado Front Range region has not faced severe restraints from TABOR since property values

there are rising at a faster rate than population. In the rural southern region of the state, however, property values are rising, but population is rising faster, resulting in declining revenues per capita even as population growth increases demands for local public services, creating a risk of a self-perpetuating negative cycle (Brown, 2006). Because TABOR limits are based on growth in property values, slower growing regions face tighter expenditure limits, which may limit those regions' ability to offer services and infrastructure that could encourage growth.

Impacts on Efficiency

The objective of TEL is to reduce the growth of government spending, presumably forcing governments to become more efficient. There are several trends that suggest TEL laws may have that effect. But the very same trends may also imply fiscal stress. Additional research is needed to determine which factor is driving the changes described below. The trends include the re-prioritization of local government spending, increases in the use of fees and permits, and increases in the number of special districts for providing public services.

Since the passage of TABOR, Colorado municipalities have changed their spending priorities. Total operating expenditures, general government, public health, law enforcement and street maintenance expenditures per capita have decreased. Only solid waste, cultural and recreational expenditures per capita have increased (Brown, 2006). Whether those shifts represent an increase in efficiency or cutting of services that people want is unclear without further research.

A basic tenet of efficient allocation of resources is that those who benefit from the action pay for the costs. The use of fees and permits to finance municipal services has increased in Colorado (Brown, 2006). Mullins (2004) has also found that property tax limitations increase the use of fees. This may have a positive impact on efficiency because those who are benefiting from the service are paying for it. Fee revenues to Missouri local governments have increased 238 percent in real terms between 1992 and 2002 (U.S. Census Bureau, 1992 and 2002). Nationally the use of fees by local governments went up 27 percent. Depending upon the service and its cost, reliance on fees and permits could cause difficulties for poorer families.

The Bell Policy Center (2005) attributes the rise in the number of special taxing districts in Colorado to TABOR. The structure of the special districts may make them very efficient because they meet a particular demand of district voters who are paying for the

service (Tiebout, 1956). On the other hand, special districts may be created to provide public services that have been cut by other local governments. At the same time, some of the special districts may be too small to achieve the economies of scale necessary to provide low-cost services. Mullins (2004) also expresses concern that the increasing use of special districts fragments local government, making it too complex for citizens to understand and lowering accountability. In addition, the particular structure of a Tax Increment Financing District (TIF), in which one jurisdiction can unilaterally declare a district and garner all or part of the increased tax revenues that would have gone to overlaying jurisdictions, may lead to inefficiencies. A TIF district allows a jurisdiction to increase its tax revenues, and expenditures, without increasing taxes (RSMo Section 99.800 to 99.865). Generally, by using a TIF urban areas can gain tax revenues from a county, reducing the revenues for the unincorporated (rural) areas in the county. While unincorporated areas legally may be able to declare a TIF, they are practically excluded from the benefits of doing so because there usually is not an overlaying district whose tax revenues they can claim.

There is no evidence that local governments in general are mismanaged. If mismanagement is the concern, stronger reporting requirements and more vigilant monitoring by the state may be a more effective way to solve the problem. Some examples include requiring a standard budget reporting format and annual audits of local governments. The state can use the reports for analysis that would show local governments that stand out at either end of the management spectrum. Standouts can be further investigated, both to highlight good management practices and to show where improvements can be made. Allowing FISCAL flexibility COMBINED with reporting requirements is a more effective way to avoid mismanagement than applying a one-size fits all policy to all local governments in a state.

Impacts on Direct Democracy

An argument made in support of TEL laws is that they increase direct democracy by requiring citizen votes to raise taxes (Bell Policy Center, 2003). Colorado municipalities report that they are emphasizing voter education and seeking citizen input earlier and more aggressively than they did before TABOR (Brown, 2006). At the same time, the Bell Policy Center (2003) reports that only 30 percent of voters turn out in elections that focus on fiscal matters.

When local governments face revenue limitations combined with increased responsibilities from the

state, and perhaps increased or at least changing demands from citizens, they are motivated to “solve” these problems by looking for mechanisms and institutional changes to get around binding rules (Mullins, 2004). This is a form of public entrepreneurship which the state may not be able to control. Such practices can lead to new, creative and better government, or they may reduce both representative and direct democracy. Mullins (2004) argues that when a blanket policy is imposed on all governments it reduces both local officials’ and citizens’ control over the decisions of their local government, because it restricts their choices.

In Missouri, Tax Development Districts (TDD) may be formed to finance transportation projects that benefit properties in the district. A given project is financed with a new special assessment, property tax, sales tax or toll. When passed in 1990, a TDD coincided with the boundaries of an existing political jurisdiction and required approval by a majority of voters in the district. The law was not used until a change in 1998 allowed a district to be smaller than a political jurisdiction. Additionally, if there are no voters in the district, the owners of the real property in the district can file a petition with the District Court to form the district and put in place a tax or a toll (RSMo 238.200 to 238.375). Since that change in the law, the use of TDD has grown rapidly. In this instance, there is neither direct nor representative democracy.

TIFs in Missouri also reduce both direct and representative democracy because elected officials and the citizens of the overlaying jurisdictions have no effective voice in the declaration of the TIF, nor in the use of the resulting tax revenues.

Summary

Tax and expenditure limitations have been passed with arguments that they will limit the growth of government, increase governments’ efficiency, and promote direct democracy by requiring voter approval of tax increases. Existing research, as well as experiences in Missouri and Colorado, including trends in those states such as the re-prioritization of spending, the increased use of fees and permits, and the increased use of special districts may be signs of either improved efficiency or rising fiscal stress. Local governments facing fiscal stress because of TEL legislation may look for ways to circumvent the restrictions of the legislation, causing unanticipated inefficiencies and reducing both direct and representative democracy. The weight of the evidence suggests that local governments are stressed by TEL and are working hard to find alternative ways to fund public services.

Ironically, local governments petition the state to pass legislation, such as a TIF or TDD, that will enable them to circumvent the restrictions of TEL provisions. New legislation is passed to “correct” for previous legislation when the best idea would be to repeal the original legislation causing the problem. While state legislatures cannot repeal constitutional amendments, they can initiate the process. In addition, legislators can change other limitations on local governments as a way to provide fiscal relief, including repealing tax rate caps and allowing local governments a wider variety of tax options. Increased local control increases both representative and direct democracy. Vigilant state monitoring and reporting requirements are more direct ways of assuring good local government management than TEL, while also granting local governments the flexibility to adjust to their unique local fiscal circumstances.

References

- Bell Policy Center. 2005. TABOR Issue Brief: Rural Colorado. Bell Policy Center. Accessed January 13, 2006. <http://www.thebell.org/pdf/TB05Rural.pdf>
- Bell Policy Center. 2003. Ten Years of TABOR. Bell Policy Center. Accessed January 16, 2006. <http://www.thebell.org/pdf/taborexec.pdf>
- Brown, Tom. Not dated. The Effects of TABOR on Municipal Revenues and Spending in Colorado.” Center for Colorado Policy Studies, University of Colorado–Colorado Springs. Accessed January 13, 2006. <http://web.uccs.edu/ccps/pdf/Municipal%20Article.final.pdf>
- Hembree, Russ. 2004. The Hancock Amendment: Missouri’s Tax Limitation Measure. Report 49-2004, Missouri Legislative Academy, Truman School of public affairs, University of Missouri, Columbia. Accessed January 13, 2006. <http://truman.missouri.edu/uploads/Publications/MLA%2049-2004.pdf>
- Missouri Revised Statutes (RSMo). 2005. Chapter 238: Transportation Districts and Transportation Corporations, Special Projects.” August 28, 2005. Accessed January 18, 2006. <http://www.moga.mo.gov/statutesearch/>
- Missouri Revised Statutes (RSMo). 2005. Section 99.800 to 99.865. Real Property Tax Increment Allocation Redevelopment Act”. August 28, 2005. Accessed January 18, 2006. <http://www.moga.mo.gov/statutesearch/>
- Mullins, Daniel R. 2004. Tax and expenditure limitation and the fiscal response of local government: Asymmetric intra-local fiscal effects *Public Budgeting and Finance* Winter: 111-147.
- Tiebout, Charles. 1956. A pure theory of local expenditure. *Journal of Political Economy* 64: 416.
- U.S. Census Bureau. 2004. 1992 Census of Governments. State and Local Government Finances. Accessed January 18, 2006 <http://www.census.gov/govs/www/cog92.html>
- U.S. Census Bureau. 2004. 2002 Census of Governments. State and Local Government Finances. Accessed January 18, 2006. <http://www.census.gov/govs/www/cog2002.html>