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# A Review of Tax and Expenditure Limitations and Their Impact on State and Local Government in Ohio

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# EXECUTIVE SUMMARY

Ohio has a rich tradition in limiting the appreciation of tax valuation. Beginning in the 1970's, the Ohio General Assembly instituted a property tax limitation initiative popularly referred to as House Bill 920 to limit the growth in the taxable or assessed valuation of residential properties. The success of Ohio's tax limitation initiative was quickly mimicked by California (Proposition 13) in the 1970's and Massachusetts (Proposition 2 1/2) in the early 1980's. Both were a part of a growing conservative movement that would sweep the country in the 1980's and provide a foundation for the future "tax payers bill of rights" (TABOR) efforts of the 1990's. Today's "tax expenditure limitation" (TEL) dialogue in Ohio is the next chapter in the broader national movement. The proposed TEL is not limited to concerns about escalating property taxes, but has been expanded to all forms of taxation. Like Colorado and Washington State, the recent TEL initiative in Ohio has broad implications on economic growth and on the ability of state and local governments to meet existing and future service needs.

The operationalization of the TABOR and TEL initiatives in several states has brought with it several concerns. In Colorado, the rapid economic growth of the early 1990's was met with a contrasting decline after the passage of the TABOR. These concerns led to the suspension of the Colorado TABOR in 2005. In Washington State, Initiative 601 and the subsequent Initiative 747 have finely tuned the "ratcheting down" of state and local taxes and revenues.

The success of these TABOR and TEL initiatives has brought Ohio back into the fray, with a TEL initiative sponsored by Secretary of State Kenneth Blackwell, attempting to join the November 2005 statewide ballot. The strategic withdrawal of that TEL initiative from the fall ballot has fueled the emergence of at least one alternative to the initial TEL proposal, as well as concerns for Ohio's future economic and fiscal stability.

TABORs and TELs are generally the result of voter dissatisfaction with the perceived escalating cost of government and increases in tax payments. Many states have adopted TELs – through constitutional or statutory measures, ballot initiatives, or by legislative enactment – in an effort to stem increases in government spending. TELs generally tie annual spending limits to a combination of the inflation rate and the population growth rate, typically involve the disposition of surplus state revenue, and are used as mechanisms to cap the rate of increase in specific tax rates, most often property tax rates. To date, 27 states have some form of TEL in place.

Ohio Secretary of State J. Kenneth Blackwell and Citizens for Tax Reform (CFTR) are championing a TEL that applies expenditure limits to all units of government and special districts in the state. Blackwell's proposed TEL (Ohio TEL) amendment to Ohio's constitution ties annual spending limits to one of two formulas: The expenditure limit can be increased by the combination of the inflation rate and population growth rate or by a 3.5 percent increase in governmental expenditures, whichever is larger. An alternative TEL model has been advanced by Ohio Attorney General Jim Petro, proposing a limitation measure through the Citizens' Amendment for Prosperity (Ohio CAP). The Ohio CAP proposal would cap taxes at 5.5 percent of the total business and personal income earned in the state, thus limiting state revenues to a fixed percentage annually and state revenue growth would be tied to growth in business and personal income.

Ohio was one of the first states to implement tax expenditure limitations as a relief measure for accelerating property tax rates due to high levels of inflation in the 1970s. Homeowners voiced their displeasure and pressured the government for some form of tax relief, and Ohio lawmakers responded with the passage of House Bill 920. House Bill 920 restricts property tax growth by preventing increases in tax receipts through inflation, and fixes the dollar amount of revenue that can be raised through property tax levies. Voters made it part of the state constitution in 1980.

While HB 920 has nearly universal support from the Ohio public, it has yielded some unintended consequences for Ohio's public schools. First, local taxing districts—especially school districts—are frequently before the voters campaigning for either renewal levies or increased operating levies to maintain operations. This leads to voter fatigue, and puts the school district leadership in a constant campaign mode. Second, voters who want to vote against their total tax burden only have a chance to express their sentiment through their votes on local property taxes, and the schools suffer disproportionately. Third, the state's school funding formula accounts for the current assessed value as if it is yielding property tax revenue without the constraints of HB 920. This means that districts with rapidly rising property values or with a great deal of new, high-value development are penalized in their state school funding.

The states of Colorado, Washington, and Michigan are among the 27 states that currently have TELs in place. Colorado's Taxpayer Bill of Rights (TABOR) is the most stringent of the tax and expenditure limits, and is similar in structure to Ohio TEL proposal. Washington, like Colorado, uses a formula of population plus inflation growth to determine growth in state spending. Michigan, unlike Colorado and Washington, uses a revenue-limiting mechanism based on personal income. Michigan underwent major fiscal changes in the mid-1990s as a result of the adoption of Proposal A, which shifted the K-12 grade educational funding burden from property taxes to a mixed tax collection system that emphasizes state sales tax revenue. A similar situation could occur in Ohio. Michigan 's law is also the model for Ohio CAP proposal. The CAP proposal was designed after the Headlee Amendment in Michigan, but it places tighter restraints on the total amount of revenue the state can collect. Where Michigan caps revenues at 9.49 percent, the CAP places a 5.5 percent restriction on revenues.

Although similar to the Colorado TABOR, the Ohio TEL proposal differs in several respects. Following a few recessionary years, Colorado saw its budgets decimated, with the effects of those cuts continuing for years due to the structure of the expenditure cap. However, under the Ohio TEL proposal, Ohio would:

- Guarantee maximum spending increases of 3.5 percent per year
- Safeguard unspent revenues. Any unspent revenue up to 15 percent over the budget is placed in a budget reserve fund (rainy day fund), and once the fund exceeds 15 percent of the budget, the surplus is refunded to the taxpayers (thereby fixing a second of TABOR's flaws)

The Ohio TEL proposal also departs from Colorado's TABOR in that accommodations are made for any subsequent constitutional amendments. When the state of Colorado passed a mandatory spending amendment for K-12 education, it affected the entire state budget. If there are any constitutionally mandated spending increases introduced into Ohio's fiscal arena, the Ohio TEL would be made null and void. The proposed Ohio TEL does not limit revenue collections and excludes all Medicaid funding, federal funds, tax relief—such as the 10 percent Homestead property tax rollback, and any other non-General Revenue Fund monies. The Ohio TEL appears to focus on the remaining portion of the state's General Revenue Fund budget.

Although the Ohio TEL is more carefully designed than its predecessors, the potential for ratcheting down spending remains. While the CFTR was prudent in inserting a provision that reduces the potential for an actual decline in expenditures with the alternative 3.5 percent cap on expenditure increases, the proposal does not account for severe downturns in the business cycle and the accompanying reduction in revenue. Any real reduction in the revenue stream will be associated with ratcheting down state spending accompanied by budget cuts and a constitutionally mandated delay in bringing the budget back to its previous size.

In Ohio, there are a number of structural concerns about the Ohio TEL proposal in particular. First, the proposal will introduce a great deal of fiscal uncertainty at the local level and increase the complexity and unpredictability of local finance, especially of school finance. The state is transitioning from the Tangible Personal Property Tax to the Commercial Activity Tax (CAT). This transition removes an important source of revenue from local school finances and the legislature will have to channel CAT collections to the schools by formula. While this change in the state's tax structure is important for the future development of the state's economy, the full impact of this structural change on local school districts is not known with certainty. At the same time, House Bill 920 remains in effect keeping local school districts leashed to the ballot box through renewal levies. Adding a TEL to these two new challenges to managing school districts is unwise and the interaction of the Ohio TEL proposal amendment with HB 920 could lead to a downward ratchet effect in K-12 education spending.

Second, there are three drafting or definitional issues regarding the Ohio TEL proposal that are unsettling. (1) The portion of the state budget that is covered by the Ohio TEL is not clearly defined. (2) The proposed amendment requires a majority of "electors" to approve spending above the Ohio TEL cap for all sub-state units of government. An elector appears to be an enrolled voter not those who vote in an election. (3) The proposal includes all "instrumentalities" of the state in the coverage of the TEL at the state level. Ohio law defines any board, commission, authority, public corporation, college, university, or other educational institution, or any other entity supported in whole or in part by funds appropriated by the general assembly, as an instrumentality of the state. This means that the state's budget would have to include the budgets of all of these special purpose state-supported enterprises. These institutions would lose their budget independence, their revenues could become part of the state's general revenue fund, and the fiduciary responsibilities of their boards become unclear.

Third, the Ohio TEL proposal appears to cover all units of governments and special districts with taxing authority. The ability of these units to tax in order to pay off general obligation bond issues will be limited, thereby hindering the ability of local and regional governmental units to respond to federal and court mandates. Regional and local governments will also be limited in their ability to invest in their own economic futures through community colleges and port authorities. Regions will also be limited in their ability to invest in amenities such as parks and zoos.

Fourth, the TEL will increase the risk of default on the part of all local governments and those special purpose state-supported enterprises that are determined to be instrumentalities of the state. This includes school districts, universities, and community colleges, as well as sewer and water authorities and park districts. The uncertainty of the impacts of the proposed amendment will increase public borrowing costs.

We do not believe that the proposed amendment was intended to affect units of government that operate enterprise funds such as the Turnpike Authority or universities, with the exception of the subsidy that they receive from the state budget. However, the uncertainty about the impact of the Ohio TEL on what can be interpreted as fees and sales, such as tuition payments, tolls, and even sales at hospitals run by state universities gives rise to the two most unsettling and potentially fiscally irresponsible features of the proposed amendment – the supremacy clause and the incentive advocacy groups will have to sue state and local governments over the interpretation and implementation of the Ohio TEL.

The proposed Ohio TEL contains a supremacy clause, making the provisions of the amendment superior to other existing laws and constitutional provisions. This is public policymaking with blinders and does not allow either the voters or the legislature to sort out conflicting statutes with consideration. The uncertainty that is injected into the policymaking process by the supremacy clause is compounded by the amendment's language that invites lawsuits against all levels of government and special districts in the state of Ohio over the implementation of the amendment. The fact that individuals and groups can sue the state over the amendment's implementation and collect fees if they win while state and sub-state governmental units cannot even recover their costs of successfully defending themselves unless the suit is declared to be frivolous, is an irresponsible invitation to jam the courts with fee-hungry advocates and legal opportunists.

Legalistic approaches to imposing tax and expenditure limitations pose a number of administrative challenges to the operation of state and local government. However, in our view this is not the most damaging prospect of either of the two proposed TEL amendments to Ohio's constitution. The largest threat is to the concept of representative democracy. Representative William Seitz wrote in his letter to the Ohio Chamber of Commerce that the Ohio TEL proposal is anti-republican. Seitz, writing on behalf of the Hamilton County delegation to the Ohio state legislature, stated that the proposed Ohio TEL "is unnecessary and potentially harmful constitutional gimmickry that emasculates the core legislative role of determining tax and budget policy." We agree. The Ohio TEL proposal is anti-republican and constitutes a radical affront to representative democracy. The amendment is fundamentally different from the constitutional requirement that state and local governments must have balanced budgets. That requirement is one of fiscal prudence. The Ohio TEL proposal is an assault on the concept of local government home rule and it is a restraint on the ability of government to respond to the public's collective investment and collective consumption/wishes.

The Ohio TEL proposal also would defeat a basic test of economic efficiency because it prevents local voters from tailoring packages of services and tax rates to meet their consumption preferences. The TEL would lead to a leveling of the tax-service offerings of local government. Economic theory and over two centuries of governmental practice in the United States demonstrates the allocative efficiency of having a number of competing local governments try to match the spending and tax-paying desires of individuals. It is desirable to have some units of local government that are tax-high service districts and have others at the other end of the spectrum. State government should intervene with a light hand when it comes to home rule spending decisions once constitutional mandated levels of service provisions are met.

The Secretary of State has dual and competing roles as both the sponsor of this ballot issue and as the Chief Elections Officer of the state of Ohio. His role as the initiator of the TEL Amendment should not prevent the Secretary acting in his role as the state's Chief Elections Officer and in acting on behalf of the citizens of Ohio. In his current capacity as Secretary of State there is a responsibility to clarify the ballot language that would allow Ohio's voters/electors to understand the intent and implication of the constitutional ballot issue. This has not been done.

# INTRODUCTION

Since the mid-1970s, many states have adopted tax or government expenditure limitations in an effort to slow or reverse increases in government spending. These limitations or TELs vary a great deal. They are either statutory or constitutional measures; some have been enacted through the initiative and petition referendum process, while others have been enacted by legislatures. Some limit tax collections; others govern expenditure growth, and a few do both. Some apply solely to state revenue sources, while others affect both state and local tax revenues.

In this paper, we examine the history, structure, and fiscal impact of TEL legislation. We do this to inform the debate that will take place in Ohio between now and the election of November 2006 about an expenditure limitation measure that has been initiated by Ohio's Secretary of State, Kenneth Blackwell, working with Citizens for Tax Reform (CFTR).

This report examines the history of TELs across the United States from their infancy in the mid-1970s through their current incarnation. Various TELs are reviewed, the forces behind their creation are discussed, and three case studies of the performance of TELs are presented, examining their structures and outcomes. In the first portion of the paper, we provide an overview of different forms of TELs and the economic pressures that led to their enactment. The second part of the paper provides the history of the TEL movement. In the third section, case studies of the performance of TELs in Colorado, Washington, and Michigan are presented. The fourth section is specific to Ohio. The history of tax limitation efforts in Ohio is discussed. This is followed by a description of the Ohio TEL proposal and the initial reaction to that proposal. The forces that have driven spending increases in Ohio are also examined in this section, with a discussion of how the Ohio TEL proposal would have influenced spending if it were enacted in 1996, and how the Ohio TEL proposal can affect future spending.

# TAX AND EXPENDITURE LIMITS: AN OVERVIEW

The first modern limit on taxation in the United States was made into law in Ohio in 1976 with the passage of House Bill 920. This bill effectively froze the amount of property taxes that state and local government could collect. House Bill 920 was crafted as a legislative remedy for rapidly increasing property taxes triggered by the intense inflation experienced from the mid-1970s to 1980. Ohio's voters made the law part of the state's constitution in 1980. In 1978, interest in tax limitation laws grew nationally with the passage of Proposition 13 in California. The popular support for Proposition 13 was again triggered by rapidly increasing land values; the proposition capped property tax collections. The same was evident in Massachusetts in 1980 when that state imported the concepts behind Proposition 13 and voted in its own property tax limitation measure, Proposition 2 1/2. In 1978, Michigan's legislature evolved the concept by moving beyond a property tax limit and approving a comprehensive tax limit. The next stage in the evolution of TELs took place in Colorado, where voters passed the Taxpayer Bill of Rights (TABOR) in 1992, which is both a tax and an expenditure limitation measure. TABOR limited increases in Colorado's state spending to the previous year's spending plus the combination of the inflation rate and the population growth rate. To date, 27 states have some form of TEL in place.

## What drives the creation of TELs?

Tax and expenditure limitations are generally the result of voter dissatisfaction with the cost of state government. The public finance environment has experienced two discernible waves of tax limitation efforts, the late 1970s and the early to mid 1990s. In both eras, dynamic individuals dedicated to reducing the size of state government led citizen tax revolt efforts. While Ohio's H.B. 920 and Proposition 13 sought specifically to ease the property tax burden on citizens, they ushered in a new period in public finance – the citizen initiated tax revolt. The second wave of TELs that began in the early 1990s was no different. At the time, many states were experiencing a recession while state tax collections continued to rise. This contradictory dynamic created environments in which voters supported limitations on government growth and spending.

## How do TELs work?

In general, tax and expenditure limitations have three main components. The first component is a spending limit. TELs typically tie annual spending limits to a combination of the inflation rate and the population growth rate. While TELs are the most common form of state spending limitation, three other limiting methods are also employed: (1) limit growth to some percentage of current general fund receipts, (2) limit spending growth to the same rate as personal income growth, or (3) limit growth in projected revenues. The second component of the legislation typically involves the disposition of surplus state revenue. In some cases unspent money, up to a designated percentage, is placed in a budget stabilization or rainy day fund. In the event that the state exceeds the predetermined percentage dedicated to the budget stabilization fund, the taxpayers of the state would enjoy a refund. However, in the case of Colorado’s TABOR, all unspent money is automatically refunded to taxpayers in the next budget year. The third component is a mechanism to adjust tax rates. TELs oftentimes require voter approval for any new taxes, tax increases, or changes in the tax structure.

## Types of TELs

There are three broad categories of TELs: tax/revenue limits, expenditure limits, and revenue and expenditure limits. Currently, there are five revenue limitations in place that tie revenue growth either to the previous years’ collections, revenue estimates, or growth in personal income. Any revenues collected above this amount are either placed in a budget stabilization fund or are refunded to the taxpayers. The most common type of restriction is an expenditure limitation. As of this publication, there were 30 expenditure or revenue limitations in place, with many states employing more than one restriction. Expenditure limitations are oftentimes tied to the combined annual growth in population and inflation, growth in personal income, or the size of the previous year’s budget. While these limitations predominate, several states have “appropriations to revenue” limits. These limitations restrict actual appropriations to a percentage of projected revenues. Finally, there are two states, Colorado and Washington that have a combination of revenue and expenditure limitations. These two states have garnered considerable attention, primarily due to their rigid budgetary environments. In both cases, spending is tied to growth in population plus inflation; what makes these states different is that Colorado provides immediate refunds to taxpayers with surplus revenue, while Washington places the surplus in a budget stabilization fund. Colorado and Washington are also noteworthy because the Blackwell TEL proposal is a derivative of these two efforts. The Petro CAP expenditure limitation proposal is a variant of Michigan’s law.

# THE EMERGENCE OF TELS

## California's Proposition 13

Popular interest in state tax and expenditure limits was stimulated by the anti-property tax campaign spearheaded by Californian Howard Jarvis in 1978. Jarvis captured populist anti-tax sentiment with his cry of "I'm mad as hell and I won't take it any more."[1] Jarvis' Proposition 13 grabbed the attention of California voters and the national press. He argued that he was defending hardworking Californians who could no longer afford their property tax payments and led a very public campaign. Proposition 13 passed by a nearly two-thirds majority. The act slashed property taxes by 57 percent, by limiting property tax rates to one percent of assessed value. Property assessment increases are limited to two percent annually.[2] When a house or commercial property is sold a new tax value is established using the sales price as the valuation. The property tax is then limited to one percent of the property's new value and annual increases in property taxes are limited by restricting annual increases is the assessed valuation to two percent per year. Proposition 13 shifts the property tax burden to new owners and away from long-time property owners. Proposition 13 was critical in convincing the residents of other states to adopt their own revenue-limiting measures.

## Ohio House Bill 920

The voters of Ohio anticipated California's property tax revolt by two years. During the mid 1970s and early 1980s the state experienced both high levels of inflation and its own tax revolt. Ohio's House Bill 920 was enacted into law in 1976. An initiative petition moved to make HB 920 part of the state's constitution as a pre-emptive move to thwart a public campaign similar to that enacted in California.

House Bill 920 effectively limited the growth of local voter-approved real property taxes by prohibiting any unvoted tax increases in real property revenue. HB 920 restricts property tax growth by preventing increases in tax receipts through inflation. The law fixes the dollar amount of revenue that a property tax levy can raise, not the tax rate, also known as the number of mills. If the tax base (property value) increases due to either inflation or demand pressure then the tax rate (the number of mills or millage) is reduced to keep the dollar yield from the assessed tax constant. The effect of HB

[1] Jarvis, H. (1985).
[2] Sears, D. and Citrin, J. (1985).

920 has been dramatic on local school districts. As school expenses rise, either in response to increased enrollment, state or federal mandates, or new capital or operating costs, educators must work with revenues that are at best stagnant, or they may decline in terms of their purchasing power due to inflation. Because the property tax serves as the chief revenue source for local school districts and because these tax revenues are not permitted to increase with inflation, school districts must continuously place levies before the voters in order to maintain performance and operations.[3] Requiring voter approval for any increase in real property tax has hamstrung school finance and led to an inundation of local tax levies on the ballot.

## History of TELs

Following the success of Proposition 13, several other states began implementing tax revenue-limiting mechanisms. Between 1970 and 1980, more than a dozen states enacted some type of property tax or levy issuing limitation. In the state of Michigan, residents passed the Headlee Amendment, an initiative-driven constitutional amendment that limits revenue collections to 9.49 percent of personal income annually. Revenue collections that exceed 9.49 percent by less than one percent are deposited into a rainy day fund, while any revenue collections greater than one percent over the 9.49 percent must be refunded to the taxpayers. The amendment received its name from supporter Richard Headlee, who at the time served as CEO of Alexander Hamilton Life Insurance Company. The Headlee Amendment was a major evolutionary step in the development of TEL legislation because it specifically limited total revenue collections through a constitutional amendment. Earlier efforts just restricted property tax collections legislatively.

The tax revolt turned into a prairie fire, stimulating residents throughout the nation to evaluate their state's taxing and revenue structures. As early as 1978, Hawaii and Arizona approved constitutional mandates to limit the expenditures of state government. Arizona and Hawaii enacted true TELs by passing revenue restrictions in favor of expenditure limitations. Over the next decade, 14 states would implement some form of expenditure limiting amendment or statute.[4]

Nine states followed Arizona and Hawaii's lead in adopting expenditure limits before 1986. Only two states enacted constitutional revenue limitations in the

[3] WVIZ. "The Legacy of House Bill 920: How it has affected school funding." WCPN 90.3 FM, Cleveland. 12 September 2000. Broadcast. 13 Oct 2005; and WVIZ. "School levies aim to fund better education". WCPN 90.3 FM, Cleveland. 1May 2001 Broadcast. 30 September 2005.
[4] Rafool, M. (2005).

same period. A majority of the TELs implemented between 1976 and 1986 used expenditure-limiting formulas based on a combination of personal income and population growth moving away from inflationary adjustments to limits.

Though difficult to quantify, other factors must be given consideration when trying to analyze the shift in limits from revenues to expenditures. For instance, voter polls taken in California and in the nation showed that citizens were unsatisfied with the level of taxation in states and the nation, despite the enactment of tax limits. Others have suggested that expenditure limits still allowed for the formation of a rainy day or reserve fund, while a revenue limit may take away that possibility. Mandy Rafool, author of *State Tax and Expenditure Limitations*, suggests that expenditure limitations are chosen over revenue limitations because, "expenditure limits curb state appropriations and generally are not as restrictive as revenue limits because it is easier for states to control spending levels than to anticipate incoming revenues accurately."[5] William Dougan considers an additional factor when he states, "Legislators or citizens…might easily find that a limit on total appropriations is preferable to setting an arbitrary limit on the budget of each bureau. Under a restriction on total new appreciations, each bureau competes with other bureaus for additional funds, so that the incentives to produce information about the demand for the services provided are not as attenuated as in the case of a fixed amount of spending per bureau."[6]

The early 1990s witnessed resurgence in grassroots efforts to enact TELs in the American states, with 10 new limitations enacted between 1990 and 2005. Scholars have offered various explanations regarding the source of the tax revolt revival. Poulson contends that the recession of the early 1990s generated renewed interest in limiting government growth and helped usher in a new wave of TELs. He points to two other specific developments that stimulated interest in tax limitations: a discrepancy in the long-term rates of growth in state revenues versus the growth of spending in states and the differing responses of state governments to the revenue shortfalls that corresponded with economic recessions.[7] Mullins offers a similar assessment, indicating that growth in property taxes and the local government's share of the state and local sector is the key factor in the passage of a TEL. Mullins concludes that voters in states with TELs became increasingly frustrated with the size and proportion of government spending in relation to the overall economy.[8] While Poulson and Mullins tie the resurgence and success of TELs to the broader economic conditions present in

[5] Rafool, M. (2005).
[6] Dougan, W. (1988).
[7] Poulson, B.D. (2004).
[8] Mullins, D. (2004).

American states, New, Stansel, and Johnson place significant emphasis on voter participation, asserting that direct democracy through the initiative process and voter dissatisfaction was on the rise in the early 1990s. New contends that direct democracy was expanding, pointing to the fact that voter initiatives in California grew from six in the 1960s to 62 during the 1990s. He cited the 1996 general election as an example. During the 1996 election, American voters encountered more than 90 statewide initiatives and an estimated 200 local initiatives or referenda.[9] Stansel suggests that the tax revolt returned in the 1990s as a broad-based political movement. He notes that between 1992 and 1994 five states enacted tax and/or spending limitations. Stansel further contends that the tax revolt of the early 1990s closely mirrored that of the 1970s, pointing to grassroots taxpayer sentiments that state governments had grown too large.[10]

Johnson, reviewing Colorado's TABOR amendment, reached a similar conclusion. He suggests that the American electorate in 1992 and 1994 was swelling with anti-tax, anti-government sentiments. Johnson supports these contentions by pointing to the turnover in the United States Congress in 1994 that was based in large part on promises of lower taxation, regulation, and government spending.[11] While there exists a diversity of hypotheses as to the root causes of the TEL resurgence, it is clear that the 1990s ushered in a new wave of tax limitation efforts across the American states.

The types of TELs implemented in the 1990s differ from the earlier wave of legislation. More recent TELs focus on limiting future state taxing and/or spending rather than reducing the existing tax burden. This new wave of TELs does this by establishing a base expenditure or revenue figure and then tying any future revenue or spending growth to specific factors, such as population growth, growth in personal income, or inflation. Beginning in 1990 and 1991, expenditure limitations began showing up throughout the United States. Colorado, Connecticut, New Jersey, and North Carolina enacted statutory spending limitations. In each case government spending was tied to growth in personal income. The current flavor of TEL was invented and initially popularized in 1992 with Colorado's Taxpayer Bill of Rights (TABOR). Colorado, Washington, Florida, Missouri, Louisiana, and Connecticut passed constitutional amendments limiting revenue growth, spending growth, or both.

[9] New, M. (2003).
[10] Stansel, D. (1994).
[11] Johnson, D. (2004).

## The Role of the Policy Entrepreneur

In many cases, tax and expenditure limitations have been promoted and advanced by a single wealthy or influential individual dedicated to the passage of restrictions on the scope of government. John Kingdon, in his work *Agendas, Alternatives, and Public Policies* advanced the notion of "policy entrepreneurs" or policy drivers into the public policy arena. A policy entrepreneur is an individual who has an interest in developing and promoting a new public policy. This individual oftentimes presents alternatives that stray from conventional policy. Further, these individuals recognize an opening or "window of opportunity" and utilize this situation to present their own unique policy perspective or solution. In each case study presented later in this report, a policy entrepreneur was instrumental in the advancement and implementation of a limitation.[12]

The development and evolution of tax and expenditure limitations in the American states can be traced to several prominent individuals dedicated to the notion of limited government. Arguably the first tax limitation entrepreneur was Ohio's George Voinovich. In 1976 George Voinovich, then Cuyahoga County Auditor, was concerned with rising property taxes. Voinovich recognized that rapid inflation was leading to high residential property taxes and voter unrest. In an attempt to ease the burden of property taxes, especially on seniors, Voinovich guided legislation through the Ohio House (H.B. 920) that limited the growth of local property taxes.[13]

The anti-tax sentiment continued to build nationally through the late 1970s with Howard Jarvis in California. Jarvis was successful in capturing the attention of both California's voters and the national media. His Proposition 13 was approved by nearly two-thirds of California voters and spawned a larger tax revolt movement throughout the United States. Jarvis was an expert at gauging citizen sentiment and successfully utilized public opinion to further his policy agenda.

Much like the state of California, Michigan realized a shift in public finance policy due in large part to the efforts of one dedicated individual, Richard Headlee, the Chairman of Taxpayers United for Tax Limitation, who advocated limiting tax increases on the residents of the state. Headlee packaged his policy as a means of managing public money more efficiently and equitably. Headlee was successful in shepherding an

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[12] Kingdon, J.
[13] WVIZ. "The Legacy of House Bill 920: How it has affected school funding." WCPN 90.3 FM, Cleveland. 12 September 2000. Broadcast. 13 Oct 2005

amendment (appropriately named the Headlee Amendment) through the state legislature that restricted the growth in state revenues in 1978.

The state of Colorado enacted its TABOR in 1992 under the leadership of California-transplant Douglas Bruce. Bruce's efforts provide insight into the three-part formula to enact radical public policy change: an articulate policy entrepreneur who has staying power, enough money to run numerous campaigns, and a policy window. Bruce began advocating for tax and spending limitations around 1988, but it was not until the "window of opportunity" presented itself, with the combination of an economic downturn, putting income pressures on voters coupled with an organized campaign; then Bruce seized the opportunity to introduce his form of fiscal restraint to Colorado's voters.

Currently, Tim Eyman is a dedicated anti-tax policy entrepreneur working in the state of Washington to enact legislation requiring state and local performance audits. Eyman views these audits as conduits to more open and efficient government spending. In Ohio, Secretary of State Ken Blackwell has taken the lead in promoting a TEL as a vehicle for enforcing fiscal restraint. Blackwell has garnered considerable local and national attention for his commitment to lower taxes. Like the entrepreneurs who came before Eyman and Blackwell, both see an opportunity to advance their policy objectives through a popular mandate. Policy entrepreneurs, when they are skilled politically, engaging, and thoughtful, have enjoyed marked success in selling their policy innovations in the policy arena.

## TEL: A Historical Timeline[14]

The starting point of the legislative timeline is set as 1971. The table below (Table 1) includes not only TELs, but also includes other major state tax cuts that indicate voter restiveness with state and local taxing.

[14] Rafool, M. (2005); and Preston, A. and Ichniowski, C. (2001).

**Table 1**

| Tax Expenditure Limitations: A Historical Timeline | |
|---|---|
| **1971** | Washington state passes a constitutional amendment restricting property tax to one percent of fair market value. State legislators increase assessments for 50 percent to 100 percent of market value. |
| **1976** | North Dakota lowers sales tax rates from four percent to three percent. |
| | Ohio passes HB 920 (it becomes a constitutional amendment in 1980) and limits property tax increases. |
| **1978** | California passes Proposition 13, lowering property taxes to one percent of the purchase price until the property is resold and reducing the property tax burden by nearly 53 percent. This sets off a nationwide reassessment of state taxing structures. |
| | Arizona enacts a TEL with a constitutional amendment that allows for growth of up to 7.23 percent in government spending each year. |
| | Delaware residents pass a TEL that limits appropriations to 98 percent of state revenues. |
| | Hawaii enacts a TEL that limits increases in state spending to the percentage of state growth. |
| | Illinois passes a TEL that limits state spending allowances. |
| | Michigan voters approve the 1978 Tax Limitation Amendment, otherwise known as the Headlee Amendment. This TEL allows state spending growth to rise with population plus the rate of inflation and also restricts revenue collection to 9.49 percent of annual personal income in Michigan. |
| | North Dakota voters vote to decrease personal income taxes and increase corporate income taxes. |
| | Nevada residents pass a bill limiting property tax rates, though due to a requirement for constitutional revisions to be passed by voters in two separate elections, the act later fail in 1980. |

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| 1978 (continued) | South Dakota residents require a two-thirds legislative majority before tax spending can be increased. |
| | Texas residents approve a TEL via a constitutional amendment that limits spending to the rate of state personal income growth. |
| | Tennessee voters approve a TEL through a constitutional referendum that limits state appropriations to state personal income growth. |
| 1979 | California residents pass a TEL using a constitutional amendment that limits annual state appropriations to personal income growth plus population increases. |
| | Washington State passes Initiative 62 that revises the 1971 property tax limit. Total state and local property tax collections are restricted to six percent of fair market value. |
| 1980 | The election of Ronald Reagan as president is seen by some as a sign of increasingly tax-reluctant citizens throughout the country. |
| | Idaho voters pass a TEL through a state statute that limits increases in state appropriations to 5.33 percent of state personal income. |
| | Massachusetts' voters adopt proposition 2 ½, limiting state property tax increases to 2.5 percent annually. |
| | Missouri voters pass a constitutional TEL that limits revenue increases to 5.64 percent of the prior year's personal income. |
| | Ohio House Bill 920 is adopted as a constitutional amendment. |
| | South Carolina approves a constitutional TEL that limits state spending increases to personal income growth or 9.5 percent of state personal income in the previous year, whichever is higher. |
| 1981 | Montana adopts a TEL through a state statute limiting state spending increases to a percentage of state personal income growth. |

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| **1982** | Alaska voters approve a constitutional TEL that limits state spending increases to population plus inflation. |
| | Colorado voters pass the Gallagher Amendment, which states that 45 percent of state property tax revenues must come from residential property and 55 percent must come from commercial property. |
| | West Virginia voters require a property tax reassessment that limits assessments to 60 percent of the market value. |
| **1985** | Oklahoma passes a constitutional TEL that limits spending increases to 12 percent of annual growth and limits appropriations to 95% of revenues. |
| **1986** | California voters require voter approval for any local property tax increases. |
| | A Massachusetts TEL is passed through a state statute that limits revenue collections to the average increase in state wage growth for the previous three years. |
| | Oregon freezes property tax rates at the 1986 level. |
| | Utah limits property tax rates to 2.4 mills. |
| **1989** | Utah passes a TEL via state statute that limits state spending increases to population plus inflation. |
| **1990** | Oregon enacts several property tax rates to between .5 and 1.5 percent, depending on the intended usage. |
| | New Jersey enacts a statutory TEL that limits state spending increases to growth in personal income. |

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| 1991 | Colorado adopts a statutory spending restriction that limits general fund appropriations to the lesser of five percent of total state personal income or six percent over the previous year's appropriations. |
| | Connecticut enacts a statutory TEL limiting budget growth to either average growth in personal income over the previous five years, or the previous year's increase in inflation, whichever is greater. |
| | North Carolina passes a statutory TEL that limits funding to seven percent or less of personal income growth. |
| 1992 | Colorado passes a Taxpayer's Bill of Rights (TABOR) that constitutionally limits state revenue collections and expenditures. Revenue is limited to population growth plus inflation. The state's voters must approve any changes in spending or tax increases. |
| | Connecticut voters approve an additional constitutional limit, but it does not receive the necessary approval of the state legislature. |
| | Iowa enacts a statutory TEL limiting appropriations to 99 percent of anticipated revenue collections. |
| | Rhode Island voters approve a constitutional TEL that limits state appropriations to 98 percent of anticipated revenue collections. |
| 1993 | Louisiana passes a constitutional TEL limiting state expenditures to 1992 appropriations plus annual increases in state per capita personal income. |
| | Washington enacts a statutory TEL, limiting state spending increases to the average inflation over the previous three years, plus population growth. |
| 1994 | Florida approves a constitutional TEL limiting revenue collections to the average growth in state personal income over the previous five years. |

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| **1996** | Missouri adopts a constitutional TEL limiting state revenue collections to 5.64 percent of the previous year's total state personal income . |
| **2000** | Oregon passes a constitutional TEL requiring that any general fund revenue in excess of two percent of the revenue estimate must be refunded to taxpayers. |
| **2001** | Oregon residents approve the passage of a statutory TEL limiting growth in appropriations to eight percent of projected personal income. |
| | Wisconsin adopts a statutory TEL limiting spending growth on qualified appropriations to the personal income growth rate. |
| **2002** | Indiana enacts a statutory TEL spending cap per fiscal year with growth according to the formula for each budget period. |
| **2005** | Maine voters approve a statutory TEL limiting growth in expenditures to the 10-year average of personal income growth, with a maximum of 2.75 percent. |

# CASE STUDIES

The states of Colorado, Washington, and Michigan are profiled to understand the impact of TELs that are currently in place. Each of these states has a TEL with an important structural characteristic. The state of Colorado's Taxpayer Bill of Rights (TABOR) is the most stringent of the tax and expenditure limits. Further, it is a good case for policymakers in Ohio to examine given its long history, similarity in structure to the Blackwell proposal, and the abundance of analysis that has been performed on the TABOR's impact on state finances. Washington, like Colorado, uses a formula of population plus inflation growth to determine growth in state spending. Michigan, unlike the other two states, uses a revenue-limiting mechanism based on personal income plus inflation. The Michigan model is important to understand because the state underwent major fiscal changes in the mid 1990s as a result of the adoption of Proposal A, which shifted the K-12 grade educational funding burden from property taxes to a mixed tax collection system. A similar situation could occur in Ohio. Also, the Michigan law is the model of Ohio Attorney General Jim Petro's alternative to the Secretary of State Ken Blackwell's proposed amendment to Ohio's constitution.

## State Profile – Colorado

The state of Colorado has a history of tax and expenditure limitations that date back to the mid 1970s. Colorado was one of the earliest states to enact a general fund limitation when the legislature approved the state's first TEL in 1977 (refer to Table 2). This early TEL used the previous year's appropriations as a baseline for future spending, limiting increases in appropriations to seven percent of the previous year's general fund appropriation. Although the legislation included a sunset provision that would have seen the provision expire in 1983, the legislature amended the provision in 1979 and abolished the sunset date. The collapse of the energy and construction industries in the 1980s led to a generalized state recession and reduced state revenues. The legislature responded to these twin downturns by lowering the existing growth rate in the TEL to six percent of the previous year's general fund expenditures in 1991. Colorado's citizens became increasingly unsatisfied with state government during this time period, believing it to be wasteful and ineffective.

**Table 2**

| | **Highlights of Colorado's Taxpayer's Bill of Rights (TABOR)** |
|---|---|
| ✓ | Passed in 1992 as a constitutional amendment by Colorado voters. Three general provisions:<br>▪ Expenditure growth is restricted to inflation growth in Denver-Boulder area plus statewide population change<br>▪ Any surplus revenue must be refunded to the taxpayers<br>▪ Any increase or change in tax rates must be approved by voters |
| ✓ | TABOR, which ratchets down spending, combined with a constitutional amendment passed in 2000 that increased spending on K-12 education (Amendment 23) created a flaw in the structure of state finances. |
| ✓ | Colorado has experienced increased spending for K-12 education, corrections, and Medicaid, and decreased spending in virtually all other areas. |
| ✓ | Although the state has experienced decreased spending in several key areas, public support for TABOR remains high. |
| ✓ | Spending decreased during the recession, but TABOR prevents rapid increases to past spending levels with the economic recovery. |
| ✓ | In November 2005, Colorado voters approved Referendum C retaining the TABOR surplus that is expected to occur over the next five years. The referendum was supported by 53 percent of the voters. The expected surplus equals $3.7 billion and will be used to meet mandated spending increases in K-12 education, deal with demographically generated increases in healthcare spending, and increase higher education spending. |

Citizen groups came together to develop the first ballot initiative aimed at limiting the size of state government in 1986. The 1986 proposed constitutional amendment would have reduced the taxing authority of state and local governments by requiring voter approval for any new or increased tax. The initial amendment drive was disconnected, inadequately funded, and ultimately failed at the polls. Citizen groups, led by California native Douglas Bruce, came together to support his first ballot initiative aimed at limiting state government in 1988. Bruce's goal was to implement a constitutional restriction on the size of state government, in terms of both taxing and spending capacity. This time the initiative was more aggressive and far more restrictive. The 1988 limitation again required voter approval for any new or increased taxes but also reduced state income taxes by 10 percent, limited local residential property taxes, and rolled back any state and local tax increases adopted between 1986 and 1988 that were not approved by voters.[15] Although better organized and well funded, this initiative also failed. Bruce was undeterred, championing a third initiative in 1990.

The 1990 initiative proposed a limit on state spending growth, a cap on local property taxes, and voter approval for new taxes. While the 1990 amendment enjoyed

[15] James

the greatest voter support of the three initiatives (49 percent), it also failed. The fourth try was the charm; a successful campaign was finally realized in 1992. Bruce mounted a well-funded and organized campaign, and a consensus developed among residents that taxes were too high. The Taxpayer's Bill of Rights (TABOR) became a national model for the voter-initiated TELs.

The economic and political climate in Colorado during the early 1990s was ideal for the passage of TABOR. The state had slipped into a recession, Bruce secured support from the state's Republican establishment, and polling showed that more than 63 percent of residents thought taxes were too high. In addition to these factors, there was little organized opposition to TABOR. Roy Romer, the governor at the time, was more concerned with passing a sales tax increase earmarked for education than he was in coordinating an opposition effort to TABOR. This meant that TABOR was largely unopposed, without alternatives for voters to consider. This recipe proved successful at the polls in 1992.

TABOR remains the most stringent tax and expenditure limit employed by any state. Colorado's TABOR is fundamentally a revenue limit and has three main provisions or components. First, it restricts growth in state revenue and spending to inflation plus the percentage change in population. The growth formula appears to be designed to keep real per capita state spending constant over time. For the purposes of TABOR, inflation is determined by The Bureau of Labor Statistics inflation rate for the Denver-Boulder area. The population rate is limited to the reported state population growth rate. Second, TABOR requires that surplus revenue above the defined limit be rebated to taxpayers. This is done in the year after the surplus has been accumulated. This revenue is commonly referred to as the TABOR surplus.[16] Third, simple majority voter approval is required for new taxes, tax rate increases, extensions of expiring taxes, and any change in tax policy that results in a revenue gain by government.

TABOR was politically popular during years of economic expansion, but when the 2001 recession hit the state, it created an extremely challenging fiscal environment. When the recession hit, revenue surpluses quickly disappeared. As surpluses disappeared and tax revenues continued to plummet, the state was still required to provide TABOR rebates for the previous year, while concurrently implementing reductions in state spending. TABOR proved to be a fiscal accelerator rather than a

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[16] Tax revenue is returned to citizens in a number of ways under the various TELs that are at work in the states. Tax rebates, tax refunds, and tax credits are the most common ways money is returned to individual taxpayers.

fiscal stabilizer, exacerbating the state's financial difficulties. To further complicate matters, the state did not maintain a budget stabilization (or rainy day) fund from which to withdraw funds, cushion the effects of the recession, or make the TABOR rebate payments. Therefore, there were little to no reserves to tap when revenues declined. Spending "ratcheted down" in Colorado.

Barry Poulson of Americans for Prosperity contends that Colorado faced a "structural deficit" that was the result of the recession plus the state's constitutional spending constraints. The state is forced to simultaneously grapple with TABOR's revenue restrictions and respond to constitutionally mandated spending for various programs.[17] While TABOR ratchets down the amount of revenue the state can spend, constitutional Amendment 23 ratcheted up state spending on K-12 education. In 2000, voters approved Amendment 23, a provision requiring annual growth in expenditures for K-12 education by a rate of inflation plus one percent through 2010 and just by the inflation rate thereafter. The new K-12 money comes from tax revenues, is earmarked for educational purposes, and is exempt from the TABOR spending limit. Further intensifying the situation are the state's constitutional provisions requiring a balanced budget and the prohibition of most forms of debt. Many critics of TABOR claim that the precarious balance between competing interests has led to the state's worst fiscal crisis in decades.

The effect of TABOR on state expenditures has been remarkable. Because more than two-thirds of state revenues are allocated by mandates to K-12 education, Medicaid, and corrections, the state legislature controls less than one-third of the budget. According to a study done by the Colorado Legislative Council staff, general fund spending on K-12 education has increased from 37 to 42 percent of the budget since the inception of TABOR. In addition to increased spending for education, general fund spending has increased in healthcare (including Medicaid) by 13 percent and spending in corrections has jumped by 19 percent. By contrast, spending on other state programs, such as higher education, human services, and judicial services, decreased by 28 percent.

The most striking decrease, however, was realized in the area of capital spending, where spending nearly stopped. Capital spending has declined by 97 percent.[18]

In December 2003, the University of Colorado conducted a study entitled,

[17] Poulson B.D. (2005).
[18] Poulson B.D. (2005).

*Surviving Financial Challenges in Colorado Public Higher Education*. The authors provide support to the assertion that the state has created a difficult environment in which to operate higher education. The study notes that during the period of FY1995 to FY2004, state spending on higher education student support has been reduced by more than $179 million. The TABOR ratchet and the 2001 recession forced the state to cut inflation-adjusted general fund spending on a per capita basis by 5.8 percent in fiscal year 2002, 7.4 percent in fiscal year 2003, and 2.2 percent in fiscal year 2004 (*The Economist*, October 8, 2005, p. 40). Colorado's economy started to recover in FY 2005 but the spending baseline is set to the FY 2004 levels, which are nearly 16 percent below 2001 levels on a per capita basis, and the constitutionally mandated increases in K-12 education continue apace.[19] Because TABOR restricts budget increases to a percentage of the previous year's spending and a rainy day fund does not exist to support spending levels during a downturn, then spending cannot quickly rebound to pre-recessionary levels. If TABOR were still binding in Colorado, it could take between five to eight years to reach FY 2001 spending levels in absolute dollar terms, not adjusting for inflation. We cannot calculate how long it would take to reach FY 2001 inflation-adjusted per capita spending levels. Some may consider this a desirable outcome from TABOR; however, Colorado voters decided otherwise in November 2005.

Public sentiment regarding TABOR and the growth of state government in Colorado remains divided. In November 2005, voters approved Referendum C, which allows the state use the TABOR surplus that is expected to occur over the next five years on operating expenses. The referendum was supported by 53 percent of the voters. The expected surplus equals $3.7 billion and will be used to meet mandated spending increases in K-12 education, deal with demographically generated increases in healthcare spending, and increase higher education spending. During the same election, however, residents of Colorado voted down Referendum D in an extremely close vote. Referendum D would have permitted the state to borrow $2.1 billion to fund road construction, capital construction for schools, and pay pensions for firefighters and police. The impacts of Colorado's TABOR are noted in Table 3.

[19] Office of the President, Office of the Vice President for Budget and Finance, University of Colorado. *Surviving Financial Challenges in Colorado Public Higher Education*. (2003).

**Table 3**

| | What we learned from the state of Colorado's TABOR |
|---|---|
| ✓ | Without guaranteed baseline spending level, states with tax and expenditure limitations face years of real dollar declines in state spending after recessions hit and recoveries begin. |
| ✓ | Tax and expenditure limitations should provide a safeguard against declining revenues by implementing a budget stabilization fund (rainy day fund). The state of Colorado does not employ a true rainy day fund, therefore, when revenues declined the state could not utilize revenues husbanded during economic good times. |
| ✓ | The state of Colorado operates under a unique fiscal structure. The state has constitutional requirements that limit revenue growth while at the same time a constitutional amendment exists requiring increased spending for education. This is a "structural deficit." |
| ✓ | TABOR has resulted in reductions in spending for higher education, human services, and judicial services. Further, capital spending has been all but eliminated with a 97 percent reduction in spending. |
| ✓ | Even in the face of decreased service delivery and suspended investment in public capital, residents of Colorado continue to support TABOR. |

## State Profile – Washington

Like many states throughout the country, Washington experienced a popular tax revolt of the late 1970s. Beginning in 1971, voters passed legislation limiting annual increases in local property tax collections to six percent. A year later, voters enacted the state's 55$^{th}$ constitutional amendment, which further restricted state property tax increases to one percent of the true and fair market value of real estate. Simultaneously, state legislators shifted the property tax assessment standards from 50 to 100 percent of their market value. In 1979, voters revised the 1971 property tax limit when they passed Initiative 62. Total state and local property tax collections were restricted to six percent of fair market value. Table 4 provides highlights of Washington's tax limitation movement.

**Table 4**

| | Highlights of Washington's Tax Limitation |
|---|---|
| ✓ | Washington was one of the first states to implement a TEL during the anti-tax resurgence of the early 1990s. The TEL, I-601, is statutory and can be overturned by a supermajority legislative vote. I-601 was one of the first TELs to utilize an expenditure growth formula of inflation plus population growth. Another unique aspect of I-601 is the requirement that the state not shift the burden of taxation to local governments. |
| ✓ | Though they passed a fairly effective TEL (effective in terms of accomplishing the goals stated in the proposal), Washington voters continued to pass ballot initiatives aimed at shifting or eliminating the state's tax burden. In 1998, I-695 was enacted, which reduced the motor vehicle excise tax. The tax was reduced a second time in 2001 when I-747 was passed. |
| ✓ | One key person, Tim Eyman, served as the motivating factor behind much of the success of the tax limiting mechanisms put in place in Washington. The presence of a single policy entrepreneur is common in a number of states. |

The support for these tax limits was bipartisan. The legislation passed during the early 1970s occurred with a Republican-controlled house, a Democratic senate, and a Republican governor. The legislative revisions of 1979 occurred with a Democrat-controlled senate, a split house, and a Democrat as governor.

Little in the way of tax reform occurred during the 1980s. In 1993, however, voters turned to the polls to enact Initiative 601, the state's first true TEL. Initiative 601 sought to influence five major aspects of state fiscal policy. These include: (1) annual limits on state general fund expenditures, (2) spending adjustments based on program funding shifts, (3) a future limit funding formula called "rebasing," (4) an emergency reserve fund, and (5) a supermajority legislature requirement (two-thirds) to approve spending increases above the formula.

The expenditure growth formula was based on the average of the previous three years' inflation rates plus the average of the previous three years' population growth rates. The practice of rebasing means that, "when actual expenditures fall below the spending limit, the future limits be based on the lower amount." Another unique aspect of I-601 is that it "prevented the legislature from circumventing the limit by devolving functions of the government to localities."

The effects of I-601 have been mixed. One study shows that in the four years prior to I-601's enactment, state spending increased by approximately 17 percent annually. In the four years following its implementation, state spending has had an average annual increase of 8.6 percent. In the first budget year after the implementation of I-601, public universities lost $39 million, while other public institutions, such as prisons and social services, lost about of $120 million in funding.[20]

In 2001, voters returned to the polls to pass Initiative 747, which limited state and local property tax increases to one percent annually. This bill revised state referendum 47, passed in 1997, which limited property tax increases to the rate of inflation. In each instance, a "substantial need" clause was left in place to allow for revenue that was collected in previous years and was not spent to be applied to future expenditures if revenue shortfalls occur. Initially, this clause allowed for increases of up to six percent (for instance, if the rate of inflation was three percent in 1999, but revenue collections only increased by 1.5 percent, the additional 1.5 percent could be added to the allowable revenue increase in a future year should a budget shortfall occur).

With the passage of I-747, the substantial need clause only allows untapped

[20] Lefberg, I. and Haugen, C. (1999),

revenue to be applied to collections should inflation fall below one percent, and then only up to one percent. While an increase in funding beyond one percent is allowable through a popular vote (termed a "lid lift"), districts are concerned with both voter fatigue, and the high public cost associated with running a potentially unsuccessful lid lift campaign with already limited funding.[21]

In 2005, Tim Eyman, Washington's anti-tax policy entrepreneur, sponsored another bill, I-900, aimed at requiring state and local performance audits; these audits are to be funded by an undedicated 16 percent of the state's sales tax revenues. Advocates claim the bill would increase the efficiency of state executive, legislative, and judicial leadership and provide accountability for the state's public sector. Critics, however, counter that the proposal is poorly drafted and ambiguous. The proposal was passed by voters in the November 2005 election. Lessons learned from Washington's TEL experience are noted in Table 5.

**Table 5**

| | What we learned from the state of Washington's TEL |
|---|---|
| ✓ | I-601, like Colorado's TABOR, has led to a decrease in state spending. |
| ✓ | In the first year after I-601 was implemented, state spending for higher education fell by $39 million, while state spending for other programs such as prisons and social services fell $120 million. |
| ✓ | I-747, an additional limit on local property tax increases, has hamstrung local governments and led to a decrease in funding for special districts (fire, EMS, libraries, etc.). |

## State Profile – Michigan

In 1978, Michigan voters passed a constitutional revenue limit, the Headlee Amendment. The Headlee Amendment sought to accomplish several things, including limiting state revenue collections to 9.49 percent of personal income, forbidding unfunded mandates from being placed on local governments in an attempt to shift the tax burden, and assuring that property tax growth never exceeds the annual rate of inflation. Any increase in revenue collected beyond 9.49 percent of personal income requires voter approval. The amendment also includes the use of a budget stabilization fund for a proportion of the revenues collected. The Budget Stabilization Fund (BSF) acts as a rainy day fund and requires that any time growth in state real personal income exceeds two percent that funds are to be appropriated to the BSF. In the event that revenue collections decline from the previous year's collections, money can be

[21] Idemoto, S. (2001).

withdrawn from the fund to offset budget shortages. The BSF also allows funds to be disbursed for economic stabilization purposes in the event that state unemployment rates rise above eight percent for any quarter. One unique aspect of the Headlee Amendment is that, unlike the many tax expenditure limitations being adopted throughout the country, the Headlee Amendment solely restricts revenue collections, as opposed to the numerous expenditure-limiting mechanisms. The highlights of Michigan's Headlee Amendment are shown in Table 6.

**Table 6**

| | Highlights of Michigan's Headlee Amendment |
|---|---|
| ✓ | The Headlee Amendment, passed in 1978, limits state revenue collections to 9.49 percent of state personal income annually. The Headlee Amendment solely restricts revenue collections, as opposed to the numerous expenditure-limiting mechanisms. |
| ✓ | It disallows unfunded mandates on local governments and requires voter approval for any collections beyond 9.49 percent. |
| ✓ | Headlee also established a budget stabilization fund for a proportion of the revenues collected. |

At the time of the amendment's 1978 adoption, it was depicted as a tool to manage state government funding more efficiently, not necessarily as a way to cut back on increases in state expenditures. Opponents of the proposal argued that the bill would drastically cut state government's ability to fund and maintain state programs, though this appears to have not been the case.

In 1993, a blue-ribbon state commission was formed to study the effects of the Headlee Amendment over the previous 15 years. The commission concluded that the amendment had been "fairly effective" in achieving its desired results. The exception was in fiscal years 1994-1996, after the passage of Michigan's comprehensive school finance reform legislation (Proposal A). Proposal A replaced the original educational funding system, based on property taxes, with a system based on tax revenues provided by a formula from the state. The new tax system put into place to fund schools on a statewide basis under Proposal A pushed revenue collections above the Headlee limit from 1994 to 1996. As personal income rose, the limit was reattained in 1997. Some communities have been adversely effected by the limits placed on property tax growth by the combined effect of the Headlee Amendment and 1994's Proposal A. Aside from re-calculating the traditional educational funding formula, Proposal A limited the annual allowable increase in property tax rates to five percent or the growth in the consumer price index, whichever is less. This has caused many communities to propose ballot initiatives to generate additional revenues for specific projects.

Overall, the Headlee Amendment appears to be much less divisive and politically contested than many of the other TELs that were reviewed. While a great deal of contention occurred prior to the adoption of the amendment, very few of the dire predictions made in Michigan have come to fruition, and overall state revenue growth has remained fairly steady while still allowing modest growth in program funding. The public policy challenges derived from the Headlee Amendment lie in the future. Three of Michigan's largest employers, Ford, General Motors, and Delphi, face major challenges that will affect the incomes of their current employees, and employees in their supply chain, and could lower the incomes of the companies' retirees. There is a chance that total personal income in the state could decline for a substantial period of time. The Headlee Amendment can be viewed as a tool to "right size" government in a more austere fiscal era or it can be seen as a hammer that prevents social services from being extended to the newly impoverished and fiscal aid being delivered to the state's major cities that will have to adjust to shuttered plants. What has come to light from the adoption of the Headlee Amendment is shown in Table 7.

**Table 7**

| | **What we learned from the state of Michigan's Headlee Amendment** |
|---|---|
| ✓ | A generous funding mechanism, such as allowing revenue to reach 9.49 percent of state personal income, can minimize the political difficulty of adopting TELs and allow for efficient annual increases in government growth while still maintaining a sense of government accountability. |
| ✓ | The development of a budget stabilization or rainy day fund can help to offset slow periods of economic growth by supplementing revenue shortfalls. |
| ✓ | The adoption of a TEL should be analyzed in terms of potential changes to the structure of funding major state programs in the future. For instance, the Headlee Amendment produced revenue shortfalls for three years due to the change in funding for education. |

# THE STATE OF OHIO

## Ohio History

During the mid 1970s, the state of Ohio experienced double-digit levels of inflation, leading to rapidly increasing property tax rates. Homeowners, especially seniors, began pressuring government for some form of tax relief. Lawmakers understood the political implications of the skyrocketing tax rates and attempted to stave off an impending tax revolt by introducing House Bill 920 in 1976. George Voinovich, then Cuyahoga County Auditor, ushered the bill through the state legislature. Voinovich, along with the Ohio legislature, had good intentions in enacting HB 920. There were, however, serious unintended consequences for the state's public schools.

House Bill 920 was voted into Ohio's constitution in 1980, creating a three-tier real property tax system: constitutionally approved inside millage, renewal levies, and operating (or new) levies. The constitution allows state and local property taxes up to a limit of one percent of fair market value by charter or with legislative approval. Since the state does not assess a property tax, this assessment "belongs" to localities. Any property taxes above the constitutionally sanctioned amount needs to be approved by a direct vote of the people. The one percent cap is equivalent to a property tax of 10 mills and is frequently referred to as the "inside millage" because it is inside the constitutional limit. House Bill 920 regulates the "outside millage." Inside millage is not subject to the constraints imposed by HB 920, and tax revenue generated by the inside mills can increase as the fair market value of the property appreciates.

House Bill 920 regulates the way property taxes are levied on millage outside of the constitutional restriction. Taxing jurisdictions—most frequently schools, library districts, counties for human service levies, community colleges, and special districts—go to the voters to approve property tax levies above the constitutional limit for a specific purpose and for a limited time period in order to yield a specified amount of tax revenue. If during the time the levy is in effect the average property values increase in a taxing district then the effective millage is reduced to keep the annual revenue earned by the tax the same over the levy's life.[22] When the time limit for the levy is reached, the tax sunsets and the taxing district then launches a campaign for a renewal levy,

[22] The value of individual properties will increase at different rates. If a property increases at a faster rate than the average in the taxing district, its property taxes will increase; if the property increases in value at a slower rate than the average in the taxing district, its taxes will decrease. This is known as tax equalization.

which will bring in the same amount of money as the expired levy.  If the district wants an increase in tax revenues, it campaigns for the renewal and an increase.  If the district confronts an increase in operating costs before the levy expires, the voters will be asked to vote for an increase, sometimes this is called an "emergency levy."  The bottom line is that a multi-year tax levy will diminish in its real, inflation-adjusted, tax revenue as operating costs increase.

There are three unintended consequences associated with the operation of HB 920 and they disproportionately effect public school districts.  First, the taxing districts—especially school districts—are frequently before the voters campaigning for either renewal levies or increased operating levies if they are to maintain their performance and their operations.   This leads to voter fatigue, and puts the school district leadership in a constant campaign mode.  Second, voters who want to vote against their total tax burden only have a chance to express their sentiment through their votes on local property taxes, and the schools suffer disproportionately.  Third, the state's school funding formula accounts for the current assessed value as if it is yielding property tax revenue without the constraints of HB 920.  This means that districts with rapidly rising property values or with a great deal of new, high-value development are penalized in their state school funding.  This accounting problem has been labeled "phantom revenue."

Policy makers and residents offer varying opinions on the success or failure of HB 920. On one hand, public opinion remains strongly in favor of 920 with a majority of voters unwilling to change the formula for local property tax collections. Further, there are some voters who appreciate a formula that requires local governments to continue to justify their current levels of spending and performance through tax levy renewal campaigns. However, numerous policy makers contend that the effect of HB 920 on K-12 education in the state of Ohio has been disastrous. One of the unintended consequences of 920 was that it severely constrained both the revenue and expenditure growth of local school districts. Most significantly, 920 does not allow local school districts' revenues, which depend on property taxes, to increase with inflation. When a local school district passes a levy, the effective millage, for the life of the levy, applies to the property values at the time the levy was passed. The result has been districts returning to the ballot frequently not only for levy increases but to maintain current millage. Norma Conner, Superintendent of North Olmsted schools, summed up the situation from the perspective of a leader of a school district: "We have no way to actually increase our revenues over time, simply just to keep up with inflation or increasing property values, and so consequently schools continually have to go back to the voters, spend time and countless hours that could have better been spent on the purpose of schooling, which is an educational mission, not a fundraising mission."

Robert Matsen, North Olmsted School District treasurer, underscored the difficulty of schools under 920 when he observed the difference in local jurisdictional and school district tax structures. Matsen notes that from 1995 to 2001 the city of North Olmsted enjoyed a 28 percent increase in tax revenues from local income, or wage taxes. If the school district had enjoyed that same increase, there would have been no need to go to the voters for increases. This is the dilemma faced by nearly every school district in Ohio in the wake of HB 920.

The state does have a legislative tool at its disposal to weaken the hold of HB 920 on local units of government that rely on the property tax, especially school districts. The state constitution’s one percent cap on “inside millage” allows unvoted state and local property taxes to equal one percent of fair market value. However, the legislature sets fair market value at 35 percent of assessed value. The legislature could change the rules on the calculation of inside millage by allowing the assessment ratio to move from 35 percent of fair market value to 100 percent. This would allow a larger portion of the property tax to adjust automatically with inflation or the increase in property values.

## The Ohio TEL Proposal

### The spending cap

Ohio Secretary of State J. Kenneth Blackwell is championing a TEL that applies expenditure limits to all units of government in Ohio. Blackwell and Citizens for Tax Reform (CFTR) are at the forefront of the effort to implement a tax and expenditure limitation in Ohio. Blackwell, like Douglas Bruce in Colorado and Tim Eyman in Washington, is a leader with a strong base of support from which to draw resources. While there is much debate surrounding the contents of the proposed TEL in Ohio, CFTR and Blackwell have moderated their earlier proposals for a TEL, taking into account many of the difficulties the state of Colorado encountered with TABOR.

The proposed TEL amendment to Ohio’s constitution ties annual spending limits to one of two formulas: The expenditure limit can be increased by the combination of the inflation rate and population growth rate or by a 3.5 percent increase in governmental expenditures, whichever is larger. The Ohio proposal differs from Colorado’s TABOR in several respects. During recessions, Colorado saw its budgets decimated, with the effects of those cuts continuing for years due to the structure of the expenditure cap. However, under the Ohio TEL proposal, Ohio would

- Guarantee maximum spending increases of 3.5 percent per year
- Safeguard unspent revenues. Any unspent revenue up to 15 percent over the budget is placed in a budget reserve fund (rainy day fund), and once the fund exceeds 15 percent of the budget, the surplus is refunded to the taxpayers (thereby fixing a second of TABOR's flaws)

The Ohio TEL plan also departs from Colorado's TABOR in that accommodations are made for any subsequent constitutional amendments. When the state of Colorado passed a mandatory spending amendment for K-12 education, it affected the entire state budget. If this were to happen in Ohio, the TEL would be voided. If there are any constitutionally mandated spending increases introduced into Ohio's fiscal arena, the TEL becomes null and void.[23] CFTR touts that its TEL limits only what is spent and not how money is raised, which is an important improvement over Colorado.

Also notable is the removal of a requirement that a supermajority of the legislature is needed to seek voter approval for exceeding the annual spending limits at the state level. Under the certified version of the Ohio TEL proposal that we inspected in fall of 2005, only a simple majority in the legislature is needed to seek voter approval for an increase in expenditures. However, any increase in state expenditures in excess of the TEL cap requires both a majority vote in the legislature and a majority vote "of the electors."[24]

The Ohio TEL proposal guarantees that local governments have a guaranteed appropriation of five percent of state revenues, and forbids state government from mandating local government expenditures without providing the revenue to support them. Since 1995, the local government fund has had "guaranteed" funding of 4.2 percent of state expenditures. House Bill 117 permanently set the state and local government fund's percentage share of state sales tax, use tax, personal income tax, public utility tax, and corporate franchise tax at 4.2 percent. While this level of spending has been pledged, the legislature has, in recent history, reduced this percentage to varying levels. While Blackwell's proposal guarantees that local government will receive a baseline level of spending of five percent of the state's own-source tax revenues, the source of the revenues going into the local government fund is unclear, as is its impact on other revenues that flow to other local political jurisdictions.

[23] All Ohio TEL information comes directly from the TEL amendment.
[24] We comment on the definition of an elector later in this report.

The CFTR proposed Ohio TEL has benefited from the experiences with state level tax and expenditure limitation efforts across the country. The proposed TEL does not limit revenue collections and excludes all Medicaid funding, federal funds, tax relief—such as the 10 percent Homestead property tax rollback, and any other non-General Revenue Fund monies. The Ohio TEL appears to focus on the remaining portion of the state's General Revenue Fund budget. The proposal is more thoughtful in its approach to limiting government spending than its predecessors in other states.

Although the Ohio TEL proposal is more carefully designed than its predecessors, the potential for ratcheting down spending remains. The expenditure base under the TEL is the amount of money spent in the previous year, and the spending cap allows additional spending of 3.5 percent or the formula cap, whichever is larger. The proposed limit applies only to those revenues the state is able to collect. Therefore the problems that Colorado experienced with recession-induced spending cutbacks lasting well into the recovery phase of the business cycle could manifest in Ohio if the proposed TEL is put in place. If the state were to encounter declining revenues and the budget stabilization fund is exhausted, as happened in the 2001 recession, then the state government would base its next year's budget on actual expenditures plus one of the two growth factors (3.5 percent or the combination of the inflation rate and the population growth rate) allowed by the TEL. Starting with the lower budget base potentially restricts any natural rebound in revenues that comes from the expansion phase of the economic cycle.

While Secretary Blackwell and CFTR were cautious enough to insert a provision that reduces the potential for an actual decline in expenditures with the alternative 3.5 percent cap on expenditure increases, the proposal does not account for severe downturns in the business cycle and the accompanying reduction in revenue. Any real reduction in the revenue stream will be associated with ratcheting down state spending accompanied by budget cuts and a constitutionally mandated delay in bringing the budget back to its previous size.

The problem of "ratcheting down" has created considerable budgeting problems in Colorado and is frequently pointed to as a major obstacle in restoring expenditure levels when revenues begin to rebound. However, it should be noted that the proposed Ohio TEL is superior to Colorado's in that budget growth can take place at 3.5 percent a year, rather than being restricted to the algebraic cap that combines inflation and population growth. So while declining revenues would undoubtedly place a strain on program funding in Ohio, the budget would rebound more rapidly than in Colorado. Despite the superiority of the Ohio proposal compared to Colorado's TABOR, the state of Ohio would likely encounter a harsh fiscal environment characterized by budget constraints and program cuts during a multi-year recession and a structural delay in rebuilding the budget once a recovery has been achieved.[25] Ratcheting down effects could be countered if a “TEL accelerator” became part of the proposal. An accelerator would permit the state to restore spending to pre-recessionary levels in the wake of business cycle downturns as long as the revenue was available to the state. Colorado’s experience demonstrates that including an accelerator to the Ohio TEL proposal would be prudent.

Colorado voters approved Referendum C in November 2005 allowing the state to temporarily retain and spend the budget surplus that is expected to be generated over the next five years, rather than fully comply with TABOR. The passage of Referendum C was necessary in order to keep approximately $3.7 billion to fund mandated spending increases in K-12 education, deal with demographically-generated increases in healthcare spending, and increase higher education spending. Prior to the vote on Referendum C, the governor’s budget director released information indicating that without passage, the state would need to close 11 state parks, raise state university tuition, cap the prison population, end instant background checks on firearms purchases, cut funding for healthcare for the poor, and eliminate inspections of ski lifts.[26]

One final consideration should be noted regarding the Ohio TEL proposal’s guaranteed baseline maximum spending level of 3.5 percent versus actual historical spending levels. Although rare, there are occasions in which the state spends below 3.5 percent, as it did in FY 2003 when the budget grew by only 2.83 percent, and as it is projected to do in fiscal years 2006 and 2007. Budget growth under 3.5 percent may be necessary during times of lean economic growth, but under the TEL proposal there is incentive to pursue the maximum spending growth when revenues permit.

The TEL proposal provides an incentive to the legislature and those who benefit from public spending to budget the entire “guaranteed” maximum increase in public

[25] Ohio budgets on a two-year cycle with the constraint that the budget must balance with revenues in each year, leading to budget adjustment bills during recessions. How the annual budgets would operate under a TEL is not clear. A two-year budget could be initially passed that complies with the TEL with spending kept under one of the two caps. Then if a recession hit and state revenues fell, the actual first year budget would be reduced once the budget is balanced against actual revenues. The actual first year expenditures would then become the base used to calculate the TEL amount in the second year of the biannual budget, not the amount that was included in the original budget resolution. Even if state revenues recovered in the second year and the original budget passed for the second year of the biennium could be achieved, the cap from the TEL would be binding.
[26] Couch & Fates, “Voters Say Yes to C”.

spending of 3.5 percent. At this point, it is revealing to examine Ohio's actual budget performance since 1996 and estimate to the best of our ability what Ohio's budget picture would have been if the Ohio TEL amendment had been in place since the mid-1990s.

**What would Ohio's budget look like under the proposed TEL?**

To understand the ramifications of the proposed constitutional TEL amendment on tax expenditures, a simulated expenditure model constructed by the Ohio House of Representatives budget staff was compared to actual budget expenditures. The Ohio House of Representatives budget staff examined the Ohio budget from fiscal year 1996 through the proposed 2005 budget. Determining what spending would be included under the proposed TEL was difficult, given the lack of information provided in the proposal on how to treat various sources of government revenue (an additional challenge to simulating the impact of the TEL proposal is that the accounting system currently in place in Ohio is not equipped to handle the determination of TEL-related budget categories).

Given the information available in the proposal's language, the House budget staff assumed that the Ohio TEL would include the state's own-source revenues from the General Revenue Fund less federal funding that passes through the state budget and less any state money paid toward property tax relief. Therefore, any state money that is dedicated to matching federal funds, such as Medicaid or poverty alleviation and job training money spent by the Ohio Department of Job and Family Services, is not to be included in the expenditure limitation. These exclusions are a judgment made by the staff as they wrestled with the language in the proposal. Also not included in the House's projections is any money paid by the state for property tax relief. After extracting these budget items, the House budget staff was able to identify how much state spending would be affected by an implementation of a TEL. From there, the House budget staff examined proposed TEL spending versus actual state spending from FY 1997 through the proposed fiscal year 2005 budget (see Table 8).

The budget estimates are produced for two reasons. It is important to determine if the TEL or the CAP proposal would have been binding under a set of assumptions about the size of the state budget as currently defined and with data that are reliable. The second reason for producing these estimates is to show the portions of the state's budget where real, inflation-adjusted increases in the state's General Revenue Fund spending have occurred. One person's definition of wasted government spending is another's definition of essential, or constitutionally mandated, government spending.

We caution, however, that the size of the budget and its composition will be radically different under the TEL than is the current General Revenue Fund budget. This is due to the expansive definition of government in the TEL. This major shift in definition makes it impossible to determine the TEL's actual impact. The TEL clearly includes all state revenue, including state spending that is required to meet federal matching requirements. The TEL also includes that the Homestead Property Tax Rollback be included as state spending because it is not a rebate that goes directly to taxpayers. It is a line item expenditure endorsed by the legislature. Finally, the TEL includes all "instrumentalities" of the state. This means that the total expenditures of all state-supported enterprises should be rolled up into the state's general budget. An instrumentality is defined as any "board, commission, authority, public corporation, college, university, or other educational institution, or any other entity supported in whole or in part by funds appropriated by the general assembly." This is a radical expansion in the definition of what is covered by the state budget, covering everything from the expenditures of state-supported hospitals, turnpike authorities, to the total budgets of universities and community colleges.

**Table 8**

**Ohio House Budget Staff Comparison Spreadsheet**

Ohio TEL Proposal (CPI + Population Increase or 3.5% baseline) v. Actual Spending

| Year | Blackwell Proposed Spending | Percentage Increase (CPI + Population Increase) | Percentage Increase (under Blackwell Plan with 3.5% baseline) | Actual State Spending | Percentage Increase | Difference |
|---|---|---|---|---|---|---|
| **1996** | $ 11,345,799,513.00 | | | $ 11,345,799,513.00 | | |
| **1997** | 11,742,902,495.00 | 3.31% | 3.50% | 11,924,571,319.00 | 5.10 | $ 181,668,824 |
| **1998** | 12,153,904,082.00 | 2.60% | 3.50% | 12,637,561,700.00 | 5.98 | $ 483,657,618 |
| **1999** | 12,579,290,724.00 | 1.86% | 3.50% | 13,426,810,019.00 | 6.25 | $ 847,519,295 |
| **2000** | 13,019,565,899.00 | 2.42% | 3.50% | 14,357,997,360.00 | 6.94 | $ 1,338,431,461 |
| **2001** | 13,489,572,227.00 | 3.61% | 3.61% | 15,506,575,293.00 | 8.00 | $ 2,017,003,066 |
| **2002** | 13,961,707,254.00 | 3.06% | 3.50% | 16,141,700,261.00 | 4.10 | $ 2,179,993,007 |
| **2003** | 14,450,367,007.00 | 1.78% | 3.50% | 16,598,088,550.00 | 2.83 | $ 2,147,721,543 |
| **2004** | 14,956,129,852.00 | 2.52% | 3.50% | 17,210,110,197.00 | 3.69 | $ 2,253,980,345 |
| **2005** | 15,479,594,396.00 | 2.96% | 3.50% | 17,871,266,727.00 | 3.84 | $ 2,391,672,331 |
| | | **2.70%** | **3.51%** | | **5.2%** | **$ 13,841,647,490** |

Source: Ohio House Budget Staff

Actual state spending is calculated using state-only GRF less property tax relief

The percentage increase in the budget under the Ohio TEL proposal is the higher of either the formula expenditure cap, the consumer price index plus the increase in population, or 3.5 percent. During the time period examined, 1996 through 2005, the formula expenditure cap was greater than 3.5 percent in only one year (FY 2001). In all other years, the combination of CPI and population growth in the state of Ohio was less than 3.5 percent. Therefore, the maximum increase in expenditures would have been 3.5 percent. Over the course of the time period examined, the average formula cap increase would have been 2.7 percent. How would the state's expenditure picture have changed if the proposed TEL had been in place since fiscal year 1996?

The second column of Table 8 displays what the state's budgeted expenditures would have been using the House budget staff's interpretation of the TEL proposal. In all fiscal years, with the exception of FY 2001, 3.5 percent was used as the escalator. The third and fourth columns show the two permissible growth factors. The bottom of the third column lists the average budget increase that would have been allowed if a Colorado-style formula TEL cap had been in place. The fourth column shows the more likely annual budget growth factor under the TEL proposal. The budget is assumed to grow at 3.5 percent in all years except fiscal year 2001 when the growth rate is assumed to be 3.61 percent. The average growth rate over this time period is shown at the bottom of the column. The factors in the fourth column were used to calculate the TEL budgets given in the second column. Actual state spending is in the fifth column, and the actual percentage increase in state spending is in the sixth column with the average given at the bottom of the column. The dollar difference between actual state expenditures and the estimated TEL-constrained budgets are displayed in the last column.

Actual spending was above the TEL level in all years with the cumulative difference being $13.8 billion. The annual difference is now about $2.4 billion. The actual increase in state expenditures was greater than 3.5 percent in all years with the exception of FY 2003. However, the budget picture changed markedly during the last legislative session, with budgeted expenditures being much below the TEL limits.[27]

The fact that the average annual increase in state expenditures was 5.2 percent from FY 1996 to 2005 leads to the question of how was the money spent. Representative William Seitz notes that over 85 percent of the state's General Revenue Fund is spent on K-12 schooling, Medicaid (healthcare for the poor, disabled, and low-

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[27] Representative William J. Seitz wrote that the "growth rate (state spending and federal match) is 0.89 percent in 2006 and 2.57 percent in 2007—far less than the 3.5 percent annual increase than the TEL would allow." (Letter to the Ohio Chamber of Commerce, no date).

income elderly), higher education, prisons and the justice system, legislatively mandated property tax rebates to homeowners, and debt service on bonds. Money collected from motor fuels taxes are restricted to roadway spending in the constitution. Highway funds that come from the federal highway trust fund and Medicaid spending were not included in the set of House budget staff's expenditure estimates because of their tie to federal funding. The Homestead Property Tax Rollbacks was also not counted as a covered expenditure by the House staff. However, under the language contained in the final version of the TEL, the Rollback would be an expenditure and state revenues used to match federal grant requirements would also be considered to be expenditures.

Figure 1 displays 1996 General Revenue Fund expenditures in 1996 dollars in the left-hand bar. Those expenditures are expressed in 2005 dollars so that the 1996 state expenditures can be compared to those for 2005 in the middle bar. The right-hand bar is based on fiscal year 2005 expenditures. The budget in 2005 was about $4.3 billion larger in real terms than it was nearly a decade before. The charts that follow show where the real increases have occurred.

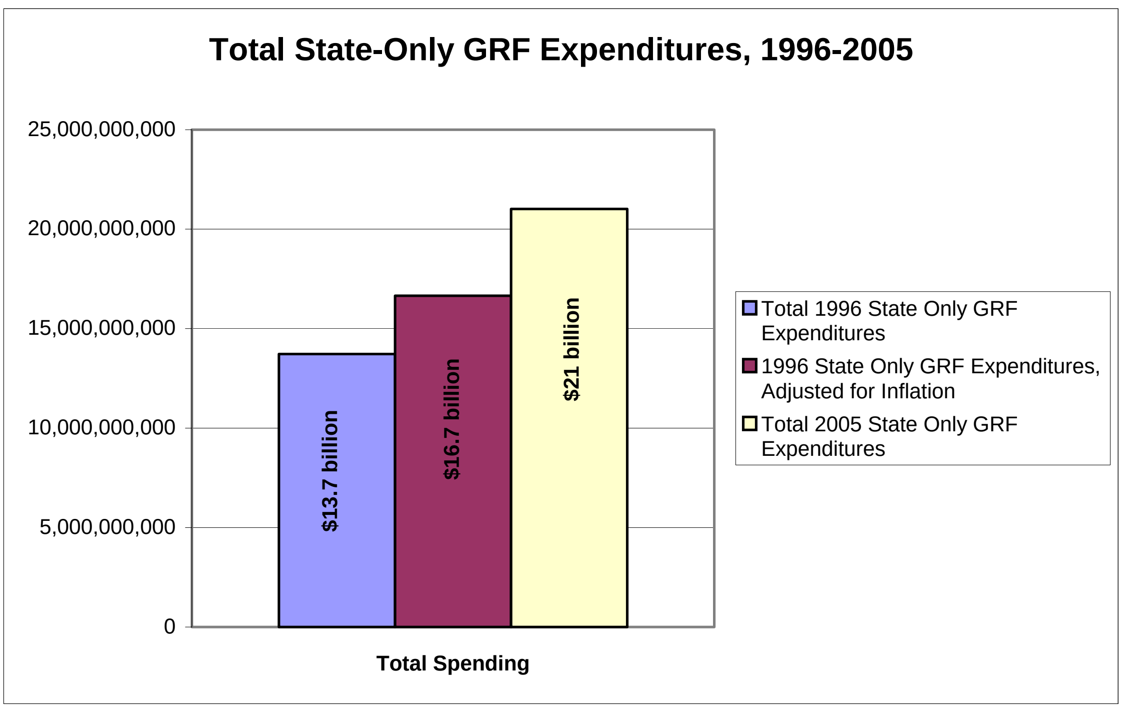


**Figure 1**

The largest real, inflation-adjusted increase in state expenditures from 1996 to 2005 was in the area of primary and secondary education. This reflects a conscious public policy choice on the part of the state's governors and legislatures to address the physical and fiscal condition of Ohio's public school system. Some of the response was triggered by the state Supreme Court finding the system of school finance to be unconstitutional. Other parts of the response were a determination to invest in public education in return for greater performance accountability on the part of the state's school systems.

School expenditures, expressed in 2005 dollars, were a bit below $6 billion in FY 1996 and increased by more than $2 billion in FY 2005 (Figure 2). This investment in education accounted for 48.8 percent of the real dollar General Revenue Fund Budget increase.

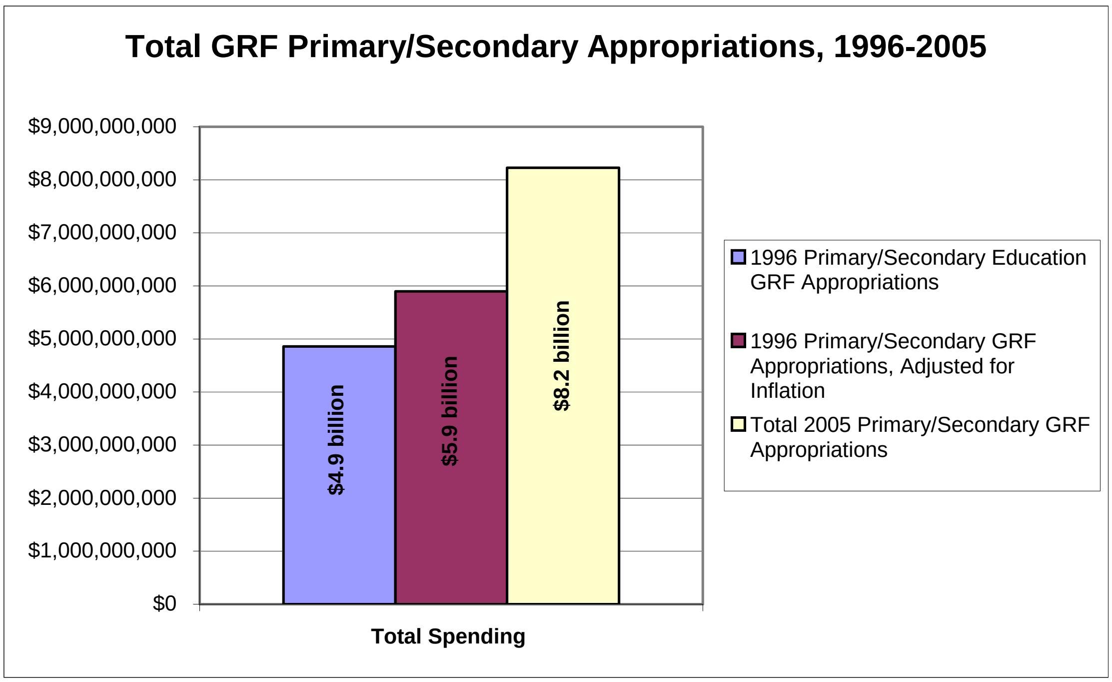


**Figure 2**

The other major areas of increase were the state-supported health and human services and the justice systems. The expenditure increases in these two areas were driven by different factors. The increase in spending on the justice system was a policy choice to deal more harshly with felony offenders coupled with a rise in drug use in the mid-to-late 1990s. Demographics also played a part in the increase; the echo from the baby boom hit the streets at the same time that crack hit Ohio. The Lucasville prison riot during the Voinovich administration also triggered more spending in the prison system.

Department of Corrections and Rehabilitation Spending in FY 1996, expressed in 2005 dollars, was approximately $400 million less than the amount spent in FY 2005. This represents a 31 percent increase in real spending (Figure 3).

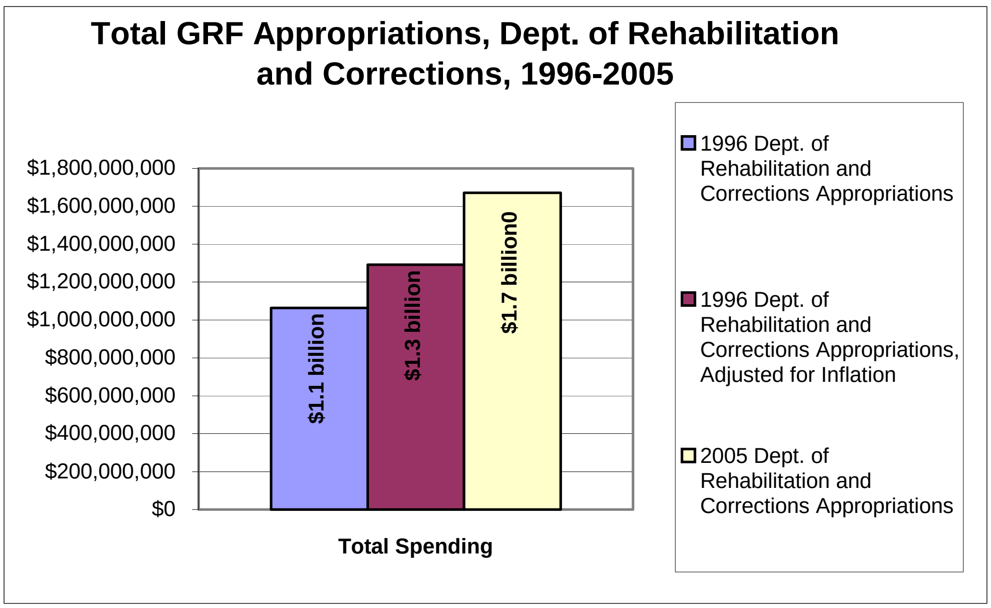


**Figure 3**

The data used to calculate public safety appropriations are approximate due to accounting changes over time, but they give a feel for the changes that have taken place. Inflation-adjusted spending in FY 1996 was about $1.4 billion, growing to nearly $1.8 billion in FY 2005 (see Figure 4).

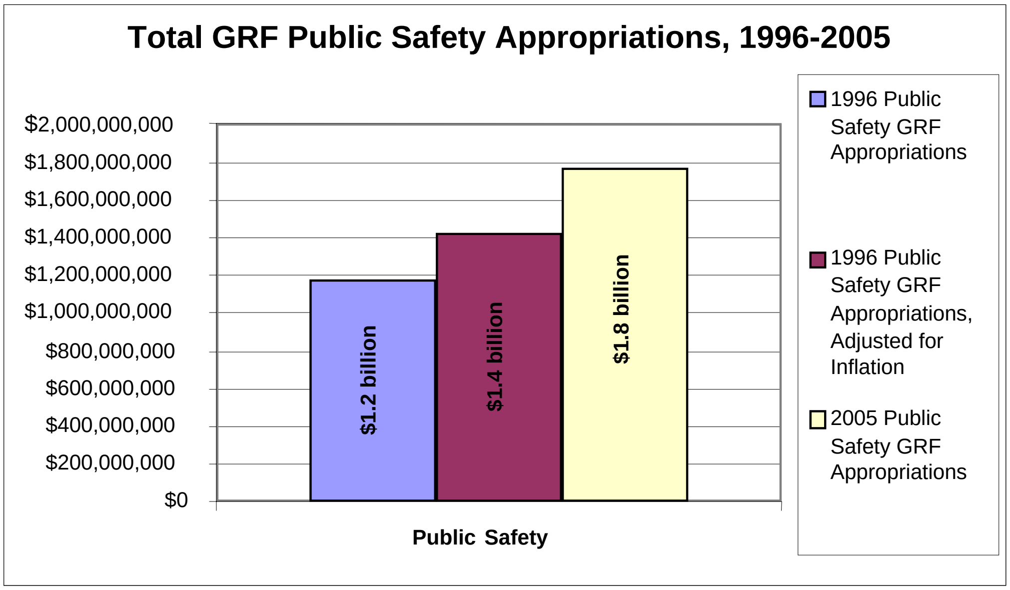


**Figure 4**

Increased real spending in the health and human services system is driven by three forces that are beyond the state's control and reliance on public resources is growing. First, there is a demographic reality in terms of growth in the elderly population, both in absolute numbers and in terms of their percentage of the population. People are living longer and the baby boomers have just started to retire. Second, proportionately fewer people are covered by private sector health insurance plans, and early retirees are losing their health insurance. Third, price inflation in healthcare is outpacing the general rise in consumer prices. The effect of these three forces is displayed in Figure 5.

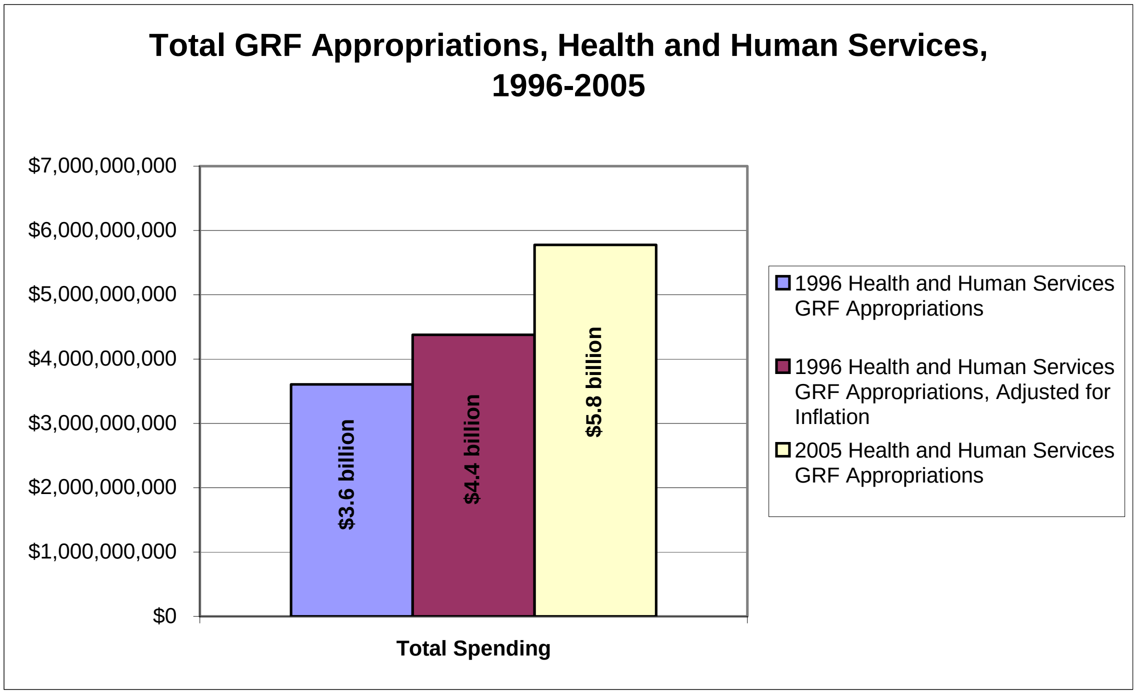


**Figure 5**

Health and human services spending in FY 1996, expressed in 2005 dollars, was $1.4 billion less than the amount that was spent in FY2005. This accounts for 32.6 percent of the real spending increase in the state budget.

Total General Revenue Fund spending increased in inflation-adjusted terms by approximately $4.3 billion from FY 1996 to FY 2005. The Department of Rehabilitation and Corrections accounted for about $400 million in this real increase. Health and human services accounted for about $1.4 billion of the increase, and K-12 schooling increased by $2.3 billion. These three spending areas account for 95 percent of the increase.

However, not all of the components of the state's budget increased during this time period. Higher education spending remained nearly constant in inflation adjusted, real dollar terms, while serving more students. Figure 6 shows that spending on higher education in FY 1996 was about $2 billion; expressing this figure in 2005 dollars brings it to $2.4 billion, which is the FY 2005 amount.

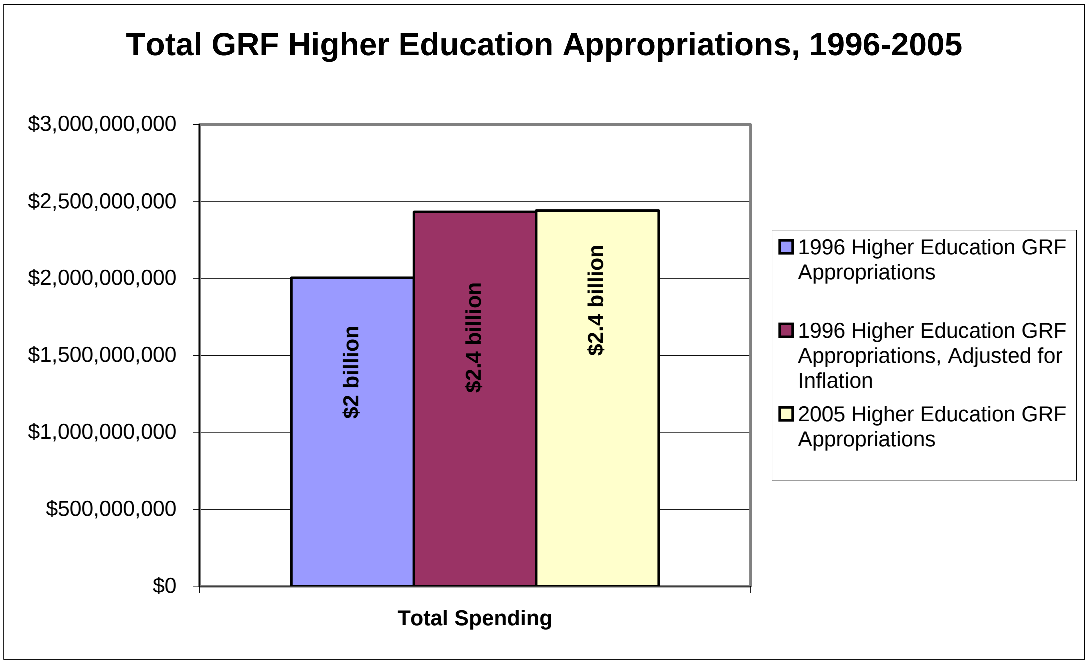


**Figure 6**

Representative William J. Seitz (R-Cincinnati) sent his analysis of the proposed Ohio TEL amendment to the Ohio Chamber of Commerce on behalf of the bipartisan Hamilton County legislative delegation, with the exception of Representative Brinkman.[28] The Hamilton County delegation opposes the proposed amendment. Seitz noted that the state of Ohio employs 3,000 fewer workers than it did in FY 2001, about half of the state agencies operate on less money than they did in FY 2001, the state enacted a 21 percent across-the-board income tax cut in 2005, restructured business taxes; and that the growth in the budget in FY 2006 and 2007 are at all-time lows. The delegation questions the necessity for the proposed amendment. In the next section, we discuss a number of features of the proposed TEL amendment that raise fundamental public policy concerns.

[28] Seitz, letter to the Ohio Chamber of Commerce, copy, no date.

## Questions About the Proposed Ohio TEL Amendment

This report aims to review and analyze the key provisions of the Tax Expenditure Limitation legislation proposed by Ohio Secretary of State Ken Blackwell. Throughout the course of the research, issues arose that can only be characterized as unanswered questions. Some are attributable to the varying opinions on the TEL, but most of them are a direct result of the ambiguous language contained in the TEL proposal.

### What is covered by the TEL?

The first major issue centers on determining what parts of Ohio's state budget would be affected if a TEL were implemented. Section 14(A) of the proposal reads:

> **State Spending Limitation.** The general assembly shall not increase aggregate state expenditures for a fiscal year by an amount that exceeds the aggregate state expenditures for the previous fiscal year beyond the allowable rate….
>
> Aggregate state expenditures are defined as "the sum of all state expenditures," except that "aggregate state expenditures" shall not include expenditures of moneys (a) received from a revenue source other than taxes, licenses, permits, fees or sales, (b) received from the federal government, (c) for refunds of any kind, or (d) made pursuant to a bill that authorizes "temporary expenditures" for relief from an emergency.

What is missing from this straightforward interpretation of the language in the TEL is a definition of what is the scope of state government. Section 14(F)(B) of the proposed amendment defines "state" to mean, "the state government including any branch, state office, authority, agency, board, commission, institution, instrumentality, or any other division or unit of state government which is directly supported with tax funds." The definition of "state" in the TEL requires that the meaning of the apparently innocuous term "instrumentality" be defined. This definition does not exist in the proposal. Lawyers suggested that the definition exists in the Ohio Revised Code (ORC) Section 4115.31 Definitions:

> **Instrumentality of the state** means any board, commission, authority, public corporation, college, university, or other educational institution, or any other entity supported in whole or in part by funds appropriated by the general assembly.

The combination of these three sets of definitions—state, instrumentality, and aggregate state expenditures—appears to require that a new, all-encompassing state budget be drawn up that incorporates the budgets of all of the instrumentalities of the state. Seeing that the TEL does not limit the revenues of state government but restricts the expenditures of the state, the legislature will have to set spending levels for all parts of the government currently covered by the General Revenue Fund Budget, the Homestead Tax Exemption, and the total spending of all state-supported universities and colleges (with the exception of federal grants but including all spending related to federal contracts), commissions, and authorities – including the Turnpike Authority – and public corporations that receive state funds. This is an aggressive definition resulting in an extremely complicated budget and a change the concept of an independent agency in the state of Ohio. A question arises as to the impact of this definition for the fiduciary responsibility and legal liability of the directors of these organizations. We did not investigate the impact on the independence of the state's retirement systems or on the fiduciary responsibility of their boards.

The House budget staff and the staff at the Center for Public Management at Cleveland State University, estimated the budget including the state's General Revenue Fund less the Homestead Exemption property tax rollback and less federal funds that flow through the state budget. This definition of revenues is an interpretation and not clearly stated in the proposal. A major area of uncertainty is the property tax rollback (The Homestead Exemption). The property tax rollback is an expenditure not a refund, so that it appears to be part of a state budget as defined by the TEL. While it is clear that federal funds that flow through the state's budget are exempt, state funds that are used to meet federal matching requirements are not exempt under a close reading of the language.

It is difficult to obtain reliable, replicable budget numbers on the possible impact of the TEL. This is partially due to the fuzziness of the language and partially due to the fact that the state's accounting system is not set up with the TEL in mind. Because Ohio's accounting system is not equipped to break down spending in the same manner that the TEL would, it is difficult to fully depict the impact of the proposal on the operations of the state of Ohio.

**What is an elector?**

Section 14(A) states that the general assembly can go above the expenditure caps if it passes a specific bill and makes that bill subject to "a vote of affirmation by a majority of electors at the next statewide special, primary, or general election occurring more than 60 days after the filing of such bill with the secretary of state. If a majority of electors voting at such an election approves the bill, the bill shall take effect thirty days after the election."

This language makes us ask: What is an "elector?" The secretary of state's website indicates that an elector is an enrolled voter and the language requires "affirmation by a majority of electors." More importantly, Article 5, Section 1 of the state's constitution states:

> "Every citizen of the United States, of the age of eighteen years, who has been a resident of the state, county, township, or ward, such time as may be provided by law, and has been registered to vote for thirty days, **has the qualifications of an elector, and is entitled to vote at all elections**."

And, the Ohio Revised Code 3503.01 on the age and residence, assignment of electors states:

> "Every citizen of the United States who is of the age of eighteen years or over and who has been a resident of the state thirty days immediately preceding the election at which the citizen offers to vote, is a resident of the county and precinct in which the citizen offers to vote, and has been registered to vote for thirty days, has the qualifications of an elector and may vote at all elections in the precinct in which the citizen resides."

> Section N then defines terms:

> " 'Elector' or 'qualified elector' means a person having the qualifications provided by law to be entitled to vote."

If these passages define the term elector, then this provision means that a majority of enrolled voters is required to pass an increase in spending above the cap. However, the last sentence in Section 14(A) stipulates "if a majority of the electors voting at such an election approves the bill…" If this language holds, then the requirement is for a majority of those who vote in an election. This issue comes around again in section 14(E) Tax and Spending Limits on Political Subdivisions which is discussed next.

**What are the implications for local government?**

Most of the public's attention over the proposed TEL focuses on its impact on the expenditures of state government and overlooks its impact on the "political subdivisions" of the state. The Ohio TEL's proposed expenditure cap is sweeping in its impact on county and local governments in the state, as well as special districts and school districts. The impact of the proposed TEL on local school districts is exceptionally murky due to the interaction that would occur between the TEL and House Bill 920, which governs special elections for local property tax levies. This raises three questions: What units of government are covered? What are the election requirements? What is the impact on House Bill 920? We only have a clear answer to the first question.

**What units of government are covered?**

Section 14(E)(1) states: "No political subdivision of the state shall (a) increase aggregate political subdivision expenditures for a fiscal year by an amount that exceeds the aggregate political subdivision expenditures for the previous fiscal year beyond the allowable rate for a political subdivision, (b) levy a new tax, or (c) increase the rate of an existing tax, without first obtaining the approval of a majority of electors in that political subdivision."

A political subdivision is defined as "any county, municipality, village, township, education district, library district, other special district, or other taxing district of the state which is directly supported by tax funds."

The proposed constitutional amendment is clear: all political subdivisions of the state are covered as are all taxing district in the state. This includes, counties, cities, villages, townships, school districts, and any other special district—port authorities, sewer and water districts, park districts, community colleges—that use the property tax or other tax source to fund their operations.

Section 14(F)(1) defines "aggregate political subdivision expenditures," as the sum of all expenditures, except for money received from both the state and federal governments. It does not include "grants, gifts, donations, or bequests which are to be expended for purposes specified by the donor." And, "aggregate state expenditures" includes expenditures supported by "taxes, licenses, permits, fess, or sales" in section 14(F)(2).

What if the organization is a public corporation and is not supported by taxes but by fees and funds passed through the state budget? Our reading of the proposal leads us to think that if the special purpose public corporation does not have taxing power then it is not directly covered by the proposed amendment at the local level. However, if they are determined to be an “instrumentality of the state,” their budget will be rolled up into the state budget and be subject to the TEL at the state level. This means that the actual budget will be set by the legislature. The organization will not have a direct TEL cap – its budget can rise and fall with the legislature’s wishes. However, the overall state TEL budget cannot exceed the TEL caps.

The experience in both Colorado and Washington State indicate that when extremely tough budget choices are made, higher education will be disproportionately cut. However, ancillary revenues may not be covered by the proposed amendment. This interpretation is reinforced by section 14(F)(1), which states that money spent (d) “pursuant to an ordinance or resolution which … (v) receives the affirmative vote of not less than three-fifths of the members of the legislative authority of that political subdivision.” Special purpose public corporations are not legislatures; they are corporations. We note below that this interpretation is not shared by Policy Matters Ohio and Policy Matters thinks that ancillary income will be covered, as was the experience in Colorado. This difference in interpretation is an example of the difficulty in understanding the proposal.

The proposed amendment does present challenges to special districts with taxing authority. First, the amendment assumes that the authority is in existence and has a budget that serves as a base for the expenditure cap. The proposal does contain section 14(E)(2), which allows for annexation, the creation of new political subdivisions, geographic consolidations, or changes in boundaries. This section states that the “total costs are not increased as a result of annexation, creation, consolidation or change in boundaries.” This section further states that the expenditure limitation goes into effect with “the fiscal year immediately following the annexation, creation of a new political subdivision, or consolidation or change in the boundaries of a political subdivision.” Therefore, the amendment assumes that the service is already being delivered and that if a new authority is put into place, the cost associated with the service delivery is spun into the new organization. This assumption will prove to be problematic in rural jurisdictions that are urbanizing when demand for sewer and water authorities, park districts, and possibly new specialized school or health districts arise.

A second problem will arise for special districts that must respond to unfunded federal mandates. The amendment forbids unfunded mandates being passed from the state to its political subdivisions. It does not anticipate unfunded mandates from the courts or federal government being passed to county or local governments. A good example lies with the federal U.S. Environmental Protection Agency (US EPA). The US EPA is involved in vigorous rulemaking around clean water. The agency is pressing for aggressive investments to separate stormwater runoff from sanitary wastewater. The EPA is also tightening rules related to surface water runoff that can end up in Lake Erie and the Ohio River and is tightening water quality standards. None of these activities is being funded by the federal government. Yet all of the bonds that will have to be sold to respond to these mandates will have to be repaid with tax or fee money subject to the proposed amendment.

A third problem awaits port authorities that float revenue bonds to pay for port-related infrastructure, waterfront investments to change the character of Ohio's waterfront cities, or to support economic development activities. Bond repayments come from revenues generated from the beneficiaries of the bond. These revenues can take the form of a rent payment, be done through a Tax Increment Financing District, or may come from a payment made in lieu of taxes (i.e. a fee). All of these forms of payment may be classified as an aggregate expenditure and subject to the formula cap. Port authorities that receive revenue from county property taxes will also face restrictions from that source of funding. If the port authority receives funds from the state, then it becomes an instrumentality of the state.

Finally, community colleges will be restricted in responding to local service demands. At present only six counties in the state of Ohio fund a portion of the operation of their community colleges through the property tax. The proposed Ohio TEL amendment will make it much more difficult for the other counties to support their educational activities through that revenue source. However, because community colleges are an instrumentality their budgets will have to be established by the legislature. It is unclear if they get to retain their revenue sources or if their revenues become part of the state budget. Of course, this will mean increased pressure on the state budget and a loss of local autonomy and weakened home rule.

**What are the election requirements for local government?**

The confusion over the definition of an elector is discussed above. At the local level, the definition of an elector is crucial to the exercise of local democracy and fiscal stability. Section 14(E)(1) clearly states that no political subdivision can exceed the TEL cap "without first obtaining the approval of a majority of electors in that political subdivision." The language used in 14(A)(3) on statewide issues that requires "a majority of electors voting" is missing. If the word "electors" enrolled voters, then the language is clear: the political subdivision of the state can only exceed the TEL-improved spending caps with the vote of the majority of enrolled voters, not of a majority of those voting.

Table 9 below contains data from 2000 to 2005 illustrating the practical importance of how an elector is defined. The top half of the table contains election data for the state of Ohio and its seven most populous counties. The pattern is unmistakable; voter turnout is highest in presidential election years (2000 and 2004), next highest in the even numbered non-presidential election years when Ohioans go to the polls to elect their governor and federal legislative representatives, and lowest in the odd-numbered years when local issues dominate. What is critical is to note that turnout exceeds 50 percent of the electors (those enrolled to vote) only in presidential election years.

The state's most populous counties exhibit the same pattern as the state as a whole. However, the pattern is more pronounced in Franklin County, where the odd-year elections turnout less than 30 percent of enrolled voters. This is most likely due to the large number of student and transient voters who live in Franklin County. They are motivated to vote in the presidential election but skip the local races.

The point is that if it takes a majority of those enrolled to vote to pass a new tax or to adjust a local expenditure cap then the only elections where this can take place is during a presidential election, and the chance of passage by a majority of registered voters is slim.

The lower portion of Table 9 contains voter turnout records for the 2003-2005 elections for a selection of municipalities in Cuyahoga County. They were selected for geographic and socio-economic diversity (the records for 2000 to 2002 were not available). The pattern is the same; only Parma and Strongsville came close to having a majority of their enrolled voters vote in an off-year election. How the word elector is defined is critical to the fiscal future of local government under the proposed amendment.

**Table 9**

**Election Turnout for the State of Ohio and Ohio's Seven Largest Counties**

| Year | 2005 | 2004 | 2003 | 2002 | 2001 | 2000 |
|---|---|---|---|---|---|---|
| State | 40.3 | 71.8 | 36.6 | 47.8 | 36.0 | 63.7 |
| Cuyahoga | 36.1 | 68.3 | 32.4 | 45.9 | 37.4 | 58.1 |
| Franklin | 29.6 | 63.1 | 25.6 | 40.4 | 22.8 | 61.3 |
| Hamilton | 35.9 | 75.5 | 34.0 | 47.4 | 37.1 | 65.6 |
| Lucas | 42.8 | 74.0 | 35.4 | 48.7 | 42.6 | 62.4 |
| Montgomery | 40.1 | 73.4 | 33.8 | 50.0 | 31.3 | 63.9 |
| Stark | 41.5 | 71.6 | 38.4 | 47.9 | 38.9 | 67.7 |
| Summit | 38.9 | 76.4 | 39.7 | 49.9 | 39.7 | 65.6 |

source: Ohio Secretary of State, Election Results, January 11, 2006
http://www.sos.state.oh.us/ElectionsVoter/electionResutls.aspx

Election Turnout for Cuyahoga County and Select Municipalities

| Year | 2005 | 2004 | 2003 |
|---|---|---|---|
| Cuyahoga County | 36.1 | 68.2 | 32.9 |
| Bay Village | 48.8 | 64.9 | 46.8 |
| Beachwood | 38.3 | 55.6 | 19.7 |
| Cleveland | 31.3 | 53.1 | nd |
| Euclid | 36.4 | 59.8 | 41.3 |
| Lakewood | 28.6 | 59.8 | 46.1 |
| Parma | 41.5 | 65.2 | 49.1 |
| Solon | 46.1 | 66.7 | nd |
| Strongsville | 38.1 | 64.5 | 53.1 |

nd no data available at the municipal level
source: Cuyahoga County, Board of Elections, January 11, 2006
http://boe.cuyahogacounty.us/BOE/results/history.htm

Election turnout: votes cast divided by registered voters, or registered electors

## How does local school funding operate?

The proposed TEL Amendment's impact on K-12 education is far from clear. The legislature retains its ability to shift funds in the GRF under the TEL cap. If the legislature wants to spend more on K-12 education and shift from other types of spending, as has happened in Colorado, it is free to do so. However, section 14(E)(1) limits the growth in own-source (local property taxes and fees) financed school expenditures (fees) within local districts under the TEL formula. This would put districts that are not spending at capacity or are due to renew their levies soon after the TEL is enacted at a fiscal disadvantage, because they will be operating from a low initial expenditure base.

Another serious concern is the interaction of the TEL with House Bill 920. House Bill 920 is the property tax limitation measure that was discussed earlier. Property tax revenue collected under HB 920 declines in real, inflation-adjusted value over time as school districts periodically go to the voters for levy approvals. The combination of HB 920 and the proposed TEL could send school districts to the ballot box more frequently to keep their spending base closer to the TEL limit, or they can watch their funding base decline. The TEL is a formula for either annual levy campaigns for local school districts or for long-term degradation in school funding through a slow and steady ratcheting down of local fiscal resources for K-12 education. It is designed in such a way that the downward ratchet will not be immediately apparent. It could take a decade for its corrosive effects to be noticed by the average resident or voter. The TEL will make it more difficult for communities to willingly invest in their schools and students. “Frills,” such as Advanced Placement classes and writing coaches, will be among the first set of savings taken from the schools.

More disconcerting is the apparent requirement that school levies will have to pass by a majority of electors. Districts have enough trouble getting majorities of those voting. They will not be able to get a majority of the enrolled voters with anything short of the most dire fiscal emergency. School bands and sports teams will be taken hostage across the Buckeye state with increased frequency.

**How does the change in state business taxes effect schools under the TEL?**

The state of Ohio allows local schools to collect a large portion of the Tangible Personal Property Tax (TPPT) to fund local operations. Under business tax reform, the Corporate Franchise Tax and TPPT are being phased out over five years and replaced with the Corporate Activities Tax (CAT). The TPPT funds received by local school districts are to be replaced by formula from the state’s General Revenue Fund. Because the TEL would be binding before this transfer in school funding takes place, that state budget and local school budgets can be thrown into disarray, largely due to accounting.

The TPPT and local funding are currently not part of the state budget. However, when the TPPT phases out and the CAT is phased in, the source of spending changes from the local school budget to the state’s budget. This switch in funding will result in an accounting-driven increase in the state budget that will fall prey to the TEL and trigger major shifts in state spending patterns. If schools are held harmless, then other parts of the state budget will suffer major cutbacks.

**How does the TEL formula work for local governments?**

The application of the TEL formula to local governments is spelled out in section 14(F)(4). The inflation rate will remain the Consumer Price Index for all urban consumers in the Midwest region and the population growth rate will be the estimates provided by the US Bureau of the Census. If a growth rate is not available for the political subdivision, then the rate for the county that contains the unit of government will be used. There will be some benefit to slow-growing or declining parts of counties and a small cost to the more rapidly growing portions. However, slow-growing counties will most likely prefer the lighter yoke of the 3.5 percent growth factor and opt out of the formula cap.

**How will the local government fund operate?**

Another unanswered question surrounds the issue of local government funding. Section 14(D) appears to enhance the state's local government fund. This section pledges that annual support of "not less than five percent of the aggregate state expenditures for the preceding fiscal year shall be appropriated to the local government fund by the general assembly." The purpose is to provide "a minimum level of state funding to political subdivisions." The proposed amendment also promises not to enact any unfunded mandates in section 14(C).

At first blush the language is clear: at least five percent of the state's aggregate expenditures flow to local government—it is assumed by most that this means cities, townships, and villages. However, the proposal goes on to say that these moneys are to flow through the county budgets (if it is a pass through from the state, it does not affect the county's TEL cap). Each county will receive a "proportional" amount, where proportional is not defined but we assume that it means a per capita allocation; however, the exact formula is up to the legislature to define. Each county is then to "distribute its proportional share of those monies to one or more, but not necessarily all, of the political subdivisions in that county, in accordance with legislation enacted by the general assembly." There will be a great deal of uncertainty in how the legislature operationalizes the county allocation process and another bout of uncertainty as county commissioners engage in their rule making. It is our interpretation that county commissioners will have to decide which local political subdivisions gain access to the local government funds. This includes all local governments and special districts that currently have access to the property tax. In Cuyahoga County's case, this includes cities, villages and townships along with the community college library system, the Metroparks, and possibly the Regional Transit Authority, sewer and water authorities, and K-12 school systems. Fee for service organizations would be exempt.

There are a large number of uncertainties in the proposal. The proposal refers to the local government fund, which has been traditionally restricted to municipalities, townships, and villages. However, the proposal also refers to "funding local political subdivisions." As noted above, a local political subdivision is defined in the proposed amendment to include "educational district, library district, other special district, or other taxing district of the state which is directly supported by tax funds." Does this now mean that K-12 educational spending will count as part of the five percent local government set aside? Does it mean that this broader list of local governments has access to the state's Local Government Fund? Or does it mean they have access to these funds in the county's disbursement formula?

Is this five percent of the total budget, five percent of the TEL budget (state-only GRF minus property tax relief), some combination of both, or none of the above? The Ohio TEL proposal is not clear on the source of the money for local governments. Further, it is not clear what exactly the five percent will consist of. Is the proposal referring specifically to the Local Government Fund, which is funded annually at a rate of 4.2 percent of the state's sales tax, use tax, personal income tax, public utility tax, and corporate franchise tax? If this is the case, then the TEL proposal includes a significant increase in local funding. Or, does the proposal refer to all or some combination of local government spending (e.g. the local government fund, local debt service support for indigent defendants and K-12 funding)? If the proposal ensures five percent for all local government support, then it represents a significantly lower baseline of spending than exists currently.

**How will the Rainy Day Fund operate?**

Section 14(B) establishes a budget reserve fund, or rainy day fund, and makes provision to rebate money from the fund back to state income taxpayers if certain provisions are met. The section reads in part:

> Moneys in the budget reserve fund may be expended for any lawful purpose, provided that, if at any time the amount of moneys in or accrued to the budget reserve fund exceeds 15 percent of the aggregate state expenditures for the preceding fiscal year, the excess moneys shall be refunded to the taxpayers…

The Ohio TEL proposal places any unspent revenue, up to 15 percent over the budget, into the budget reserve fund. If there is a surplus at the end of a budget year, money flows into the rainy day fund. Half of all unencumbered money in the GRF plus all unencumbered state funds outside of the GRF will be transferred into the rainy day fund (the other half must be rebated to individual state income-tax taxpayers by an unspecified formula). The amendment also allows the legislature to make appropriations into the rainy day fund. Section 14(B)(3) states that when the fund's balance is more than 15 percent of the previous year's aggregate state expenditures, the surplus is to be distributed to state income taxpayers by formula.[29]

What is not clear is under what circumstances and to what degree the rainy day fund would be utilized. There is also an assumption in the proposal that the legislature will not spend down the fund during good times by declaring a tax refund before the rainy day fund is fully funded. The proposed TEL does not define the conditions under which the rainy day fund would be used to supplement declining revenues, nor does it outline whether or not the fund would be exhausted before resorting to other revenue-enhancing measures. The CFTR was mindful of TABOR's shortcomings when introducing a budget stabilization fund into Ohio's TEL, but they fell short in illustrating when and how it would be used. Our reading of the amendment indicates that the budget reserve fund is to be used if there is a revenue shortfall in meeting a state budget that complies with the previous year's TEL cap and that the legislature has discretion in this matter. Spending from the rainy day fund may also be budgeted into a forthcoming budget as long as that budget complies with the TEL formula.

**Is this a gateway to unchecked litigation?**

The proposed constitutional amendment has two extremely disturbing features for a piece of legal writing that will require substantial interpretation by the courts. Section 14(G)(6) states that taxpayers or classes of taxpayers have a standing right to sue to compel compliance, and that they can recover costs and reasonable attorney fees. To make sure that the legal incentive structure is uneven, the state or political subdivision that is sued cannot be awarded its costs or legal fees unless the suit is deemed to be frivolous.

We have outlined a large number of issues that need to be defined under our interpretation of the proposed amendment; each raises the potential for litigation. Clause 14(G)(6) is irresponsible due to the poor drafting of the proposed Amendment. Our concern is highlighted when Section 14(G)(1) is read, which instructs that the "provisions of this section [of the constitution] shall be liberally construed for the purpose of effectuating the purposes thereof…" The enabling language in the proposal also contains a supremacy clause. Section 14(G)(4) holds that in the case of a conflict between existing law and existing portions of the constitution, the provisions of the proposed constitutional amendment controls. This clause is a portal to the Law of

[29] The TEL proposal does not allow for the rebates to go to business and commercial taxpayers, which will raise equal treatment questions if a rebate ever takes place.

Unintended Consequences.

The proposed TEL amendment of Ohio's constitution is poor public policy. A sign of a well thought out piece of legislation is one that analysts can estimate what the impacts of the law will be. Analysts may not be able to estimate impacts down to the penny, but should at least be able to indicate the general direction and scope of the impacts. The TEL is so poorly drafted that this is impossible.

The Secretary of State has dual and competing roles as both the sponsor of this ballot issue and as the Chief Elections Officer of the state of Ohio. His role as the initiator of the TEL Amendment should not prevent the Secretary acting in his role as the state's Chief Elections Officer and in acting on behalf of the citizens of Ohio. In his current capacity as Secretary of State there is a responsibility to clarify the ballot language that would allow Ohio's voters/electors to understand the intent and implication of the constitutional ballot issue. This has not been done.

## Interest Group Reaction

Interest groups and public policy organizations in Ohio have taken opposing views on what a TEL would mean for Ohio. At the forefront of the policy debate is the Buckeye Institute, which favors the TEL and the Coalition for Ohio's Future and The Center for Community Solutions, who oppose the TEL proposal.

In December of 2004, the Buckeye Institute, in conjunction with the Independence Institute, issued a policy paper titled *Should Ohio Limit Government Spending and Taxes*? The report contended that Ohio has evolved from a state with one of the nation's lowest tax burdens to a state with one of the highest, making Ohio an unattractive place for families and preventing the creation of thousands of jobs. As evidence, the Institute points to the fact that Ohio's tax burden has consistently exceeded the national average, and that since 1994 personal income growth in the state has lagged the rest of the nation. Further, the Buckeye Institute cites Richard Vedder's estimate that a one percentage point increase in the state personal income tax is associated with economic growth falling by 3.5 percent as evidence that tax increases are correlated to declining economic conditions. The authors contend that this has occurred under the watch of Ohio's legislators, as they have been unable to restrain spending, citing a nominal state spending increase of 63.4 percent since 1994.

The Buckeye Institute supports a Tax and Expenditure Limit (TEL) as a possible solution to the problem of high taxes and unrestrained spending by government. It notes that there are currently dozens of TELs in place, but the effective ones have three provisions: (1) the TEL is part of the constitution and limits are not amended without approval of voters, (2) state spending and revenue growth are limited to inflation plus population growth, and (3) surpluses are automatically directed to a rainy day fund or, over a certain threshold, refunded to taxpayers. The original TEL proposed in Ohio by CFTR and Secretary of State Blackwell contains many of the features recommended by the Buckeye Institute.

The Buckeye Institute then makes its case for TELs as a means of fiscal discipline at the state level. TELs determine the rate of increase of taxes, expenditures, or both. These limits create hard budget constraints for state policymakers to work within. According to the Institute, these hard constraints do not interfere with the legislature's ability to set priorities and fund specific programs and agencies.

The Buckeye Institute then makes a case for what it terms as "the next generation TEL." These TELs are expected to be more effective in addressing the tradeoff between supporting state finances and restraining government growth. To achieve both goals, the Institute suggests that a next-generation TEL must introduce an effective limit on the revenue government can spend, determine the base of the TEL, and govern how the surplus revenue above the TEL limit is allocated or disbursed to the budget stabilization fund. To do this, the Buckeye Institute recommends defining the TEL limit as the sum of the inflation rate and population growth rate. Further, the Institute recommended linking the TEL to a budget stabilization fund. In this situation, a portion of the surplus is accumulated in a budget stabilization fund to be used when revenues fall short during a recession. Finally, the authors estimate the savings that Ohio would have enjoyed had a TEL been in place from 1996 to 2002. They contend that spending in Ohio would have been $9 billion lower in 2002, and the cumulative savings would have been between $22 and $24 billion from 1996 to 2002. The authors then project that if a TEL had been put in place in 2005, the savings over the next 10 years would equal $79 billion. Nowhere in the analysis do the authors attempt to demonstrate what this savings would mean in terms of services that the state would not have provided or when decreases would or should have taken place within the budget. These estimates are also much higher than those presented in this report.

In contrast to the Buckeye Institute, the Center for Community Solutions and the Coalition for Ohio's Future make a case for keeping a TEL out of Ohio's fiscal landscape. The Coalition for Ohio's Future is a bi-partisan organization made up of more than 125 groups dedicated to the defeat of the TEL proposal. Its position is that a TEL amendment would "introduce a faulty system that could wreak havoc at the state and local levels of government." They suggest that TELs are gimmicks that force governments into rigid budgetary requirements that ultimately are detrimental to the residents of the state. The Center on Budget and Policy Priorities, working in conjunction with the Center for Community Solutions, published a report entitled *A State of Decline: What a TABOR would mean for Ohio* in April 2005. This report compares Ohio's budget and the Ohio TEL proposal to a Colorado-style TEL (which is significantly more restrictive than the proposal in Ohio). This report provides commentary on the types of spending cuts that would need to be made if a TEL were implemented. The authors found that if a TABOR were in place in Ohio, a total of $19 billion would have been trimmed from the budget from 1995 to 2004. Again, this estimate is higher than the one presented here. One reason for the difference is in the years covered by the estimates.

John Corlett, a Senior Fellow and Director of Public Policy at the Center for Community Solutions, produced a comparative report in January 2005 that examined the state of Colorado to the state of Ohio. In each category that Corlett identified (education, healthcare, support for children, and human services spending) Ohio outpaced Colorado in spending. This examination was intended to demonstrate that Ohio should not follow Colorado down the path to a TABOR because of the deep pool of services that are provided by the state of Ohio. The differences in Corlett's estimates and those used in this report are primarily due to the time the work was conducted. The work of the two research centers was based on an earlier version of the Ohio TEL proposal that was nearly identical to Colorado's TABOR. Our work is based on an improved, more flexible version of the TEL. This is the version that has been certified by the Attorney General for the voters.

Policy Matters Ohio is also critical of the proposed TEL amendment, citing in its July 2005 report that the TEL would generate substantial lawsuits due to the amendment's ambiguous provisions. Authored by Research Analyst Dr. Jon Honeck, *Flawed by Design: A Review of the Proposed Tax and Expenditure Limitation Amendment*, finds several structural problems within the TEL amendment. Primarily, Honeck notes that the TEL's supremacy clause ensures that the TEL would prevail in the event of conflict with any other section of the state's constitution. The TEL language mandates that unencumbered funds be collected each year, thus posing potential conflicts with sections of the constitution that restrict the use of fuel taxes and workers' compensation funds. The report finds that the TEL imposes an overall cap on state spending and a separate spending cap on local governments, for tax revenues and also for revenues raised from certain voluntary transactions such as lottery ticket sales. Honeck's interpretation of the proposed amendment finds that large portions of public university spending may be subject to the spending cap, such as tuition, fees, and ticket sales to sports and entertainment events. Honeck's report states that the TEL's requirement that the state pay for "mandates" on political subdivisions fails to define the term "mandates," thus leaving an open interpretation that may lead to litigation. The report notes that this would overturn the established relationship between the state and its political subdivisions because political subdivisions may then be able to object to state laws passed to comply with federal mandates.

Honeck's report raises further objections to the proposed TEL amendment, stating that the tax refund mechanism of the TEL would pool revenue from various fees and taxes and give it to individuals who paid the income tax. Individuals or businesses that paid a fee for a specific program or license may see little of this refund. The report also notes that by using a pro rata method for tax refunds, the TEL would direct the bulk of the tax relief to the wealthy rather than to the low income individuals who pay more in sales and excise taxes each year than income taxes. Other objections of the TEL noted in the report are that the TEL does not specify how to implement the spending cap formula in school districts and other taxing districts that cross political boundaries, and that both the state and local spending limits cover capital expenditures even though voters have already authorized general obligation bonds for these expenditures.

Coupled with the Center for Community Solutions are some state lawmakers who view TELs as an obstacle that limits the state's ability to set strategic policy initiatives and to respond to funding priorities. The Ohio House of Representatives issued a paper in January 2005 noting that if a Colorado-style TEL had been in place since 1997, the state would have spent $19 billion less. In order to accommodate this significant decrease in state spending, dramatic budget cuts would have been necessary. The Ohio House of Representatives Chief of Staff recently speculated that in such a tight budgetary environment, little funding would be available for anything beyond Medicaid and correctional facilities.

## Ohio's CAP Proposal

In the wake of Colorado's vote allowing the state to retain the TABOR surplus, Ohio Attorney General Jim Petro advanced his own version of legislated fiscal restraint. Petro's proposal, the Citizens' Amendment for Prosperity (CAP), would cap taxes at 5.5 percent of the total personal income earned in the state, thus limiting state revenues to a fixed percentage of personal income annually. The CAP would also require the state to maintain a budget stabilization fund (rainy day fund) during times of economic growth. The rainy day fund will be capped at five percent of that year's general revenue fund. If the fund exceeds its limit, the surplus will be rebated in the form of income tax credits. If tax revenues exceed the cap by more than 2.5 percent, the overage will also be rebated with income tax credits. In both cases, each taxpayer would have an equal percentage credit to apply to their income taxes. Finally, the Ohio CAP deviates from the Ohio TEL in that it exempts local governments from CAP restrictions.

Ohio's CAP is modeled after the Headlee Amendment in Michigan, but it places tighter restraints on the total amount of revenue the state can collect. Where Michigan caps revenues at 9.49 percent, the CAP places a 5.5 percent restriction on revenues. Attorney General Petro noted that the legislature would place the CAP on the November 2006 ballot. If the legislature decides against placing it on the ballot, Petro has indicated that he will attempt to gather enough signatures to place it through the referendum process.

# State Expenditure Limitations as of 2005

| State Expenditure Limitations - 2005 | | | | |
|---|---|---|---|---|
| **State** | **Year** | **Constitutional or Statutory** | **Type of Limitation** | **Components of Limitation** |
| **Arizona** | 1978 | Constitutional | Expenditure | State spending cannot exceed 7.41 percent of the state's total personal income. |
| **Delaware** | 1978 | Constitutional | Appropriations | State appropriations cannot exceed 98 percent of revenue estimates. |
| **Hawaii** | 1978 | Constitutional | Expenditure | State general fund spending must be lower than the average growth in personal income for the previous three years. |
| **Michigan** | 1978 | Constitutional | Revenue | State revenues cannot grow more than one percent over 9.49 percent of the past year's personal income. |
| **Tennessee** | 1978 | Constitutional | Expenditure | State expenditures are limited to the growth in personal income. |
| **Texas** | 1978 | Constitutional | Expenditure | Appropriations are limited to growth in personal income. |
| **California** | 1979 | Constitutional | Expenditure | Annual growth is capped by the growth in population and personal income. |
| **Nevada** | 1979 | Statutory | Expenditure | Spending is limited to biennial growth in state population and inflation. |
| **Idaho** | 1980 | Statutory | Expenditure | General fund appropriations are limited to 5.33 percent of estimated state personal income. The provision excludes one-time expenditures. |
| **Missouri** | 1980 | Constitutional | Revenue | State revenues are limited to 5.64 percent of the previous year's personal income. |
| **South Carolina** | 1980 & 1984 | Constitutional | Expenditure | Growth in expenditures is limited to either: a) growth in personal income or b) 9.5 percent of state personal income, whichever is larger. The provision further limits the total number of state employees in SC to the ratio of employees to total population. |
| **Montana** | 1981 | Statutory | Expenditure | Expenditures are limited to a state personal income growth index. |
| **Alaska** | 1982 | Constitutional | Expenditure | The state limits appropriation growth annually to the increase in population and inflation. |
| **Mississippi** | 1982 | Statutory | Appropriations | State appropriations are limited to 98 percent of revenue estimations. This limit can only be amended by a majority vote of the legislature. |

| State Expenditure Limitations – 2005 (continued) | | | | |
|---|---|---|---|---|
| **State** | **Year** | **Constitutional or Statutory** | **Type of Limitation** | **Components of Limitation** |
| **Oklahoma** | 1985 (2) | Constitutional | Expenditure and Appropriations | Spending is limited to 12 percent of annual inflation-adjusted growth. Further, the state limits appropriations to 95 percent of revenues. |
| **Massachusetts** | 1986 | Statutory | Revenue | State revenues may not exceed average growth of state wages and salaries for the previous three years. |
| **Missouri** | 1986 & 1996 | Constitutional | Revenue | Voters added to the state's existing revenue limitation in 1996, by requiring voter approval for any tax increase over $77 million or one percent of state revenues, whichever is less. |
| **Utah** | 1989 | Statutory | Expenditure | Expenditure growth is capped through the use of a formula including growth in inflation and population. |
| **New Jersey** | 1990 | Statutory | Expenditure | Spending is limited to growth in personal income. |
| **Colorado** | 1991 | Statutory | Expenditure | General fund appropriations are limited to the lower of five percent of personal income or six percent of the previous year's appropriations. Although this statutory limitation remains in place, it has not been utilized since TABOR was inserted into the state constitution. |
| **Connecticut** | 1991 | Statutory | Expenditure | State spending is limited to the larger of either the average growth in personal income over the previous five years or the previous year's inflation. |
| **North Carolina** | 1991 | Statutory | Expenditure | Expenditures are limited to seven percent or less of personal income in state. |
| **Connecticut** | 1992 | Constitutional | Expenditure | Following the statutory provision in 1991, voters in the state approved an additional limit. However, it has yet to receive a 3/5 vote in the state legislature. |
| **Iowa** | 1992 | Statutory | Appropriations | The state limits appropriations to 99 percent of the revenue estimation. |
| **Rhode Island** | 1992 | Constitutional | Appropriations | The state limits appropriations to 98 percent of projected revenues. |
| **Colorado** | 1992 | Constitutional | Revenue & Expenditure | Revenues are limited to combination of population growth plus inflation. Any changes in expenditures must be approved by state voters. |
| **Louisiana** | 1993 | Constitutional | Expenditure | Spending is limited to 1992 spending levels plus annual personal income growth in the state. |

| State Expenditure Limitations – 2005 (continued) | | | | |
|---|---|---|---|---|
| **State** | **Year** | **Constitutional or Statutory** | **Type of Limitation** | **Components of Limitation** |
| **Washington** | 1993 | Statutory | Expenditure | Expenditures are limited to inflation averages over the previous three years, plus the growth in population. |
| **Florida** | 1994 | Constitutional | Revenue | Florida may only collect taxes equal to the mean growth rate over the past five years. |
| **Oregon** | 2000 | Constitutional | Revenue | The state provides refunds to taxpayers any time general fund revenues exceed two percent of the project revenue estimate. |
| **Oregon** | 2001 | Statutory | Expenditure | Growth in appropriations is limited to eight percent of projected personal income. |
| **Wisconsin** | 2001 | Statutory | Expenditure | Qualified appropriations (some exempted) are limited to the annual growth in personal income. |
| **Indiana** | 2002 | Statutory | Expenditure | The state caps expenditures annually to a formula for growth. |
| **Massachusetts** | 2002 | Statutory | Revenue | Amended 1986 provision - allows for growth of revenues equal to inflation in government purchasing plus two percent. |
| **Maine** | 2005 | Statutory | Expenditure | Spending growth is restricted to the 10-year average of growth in personal income or 2.75 percent, whichever is higher. |
| *Source: Mandy Rafool. "State Tax and Expenditure Limits - 2005", National Conference of State Legislators* | | | | |

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