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Follow Easley's Lead

Spending Cap Should Be Tightened, Constitutional

Summary: Gov. Mike Easley has proposed an annual cap on the growth of state spending in North Carolina that would be tied to personal income growth. In considering the idea, lawmakers should examine recent data that show state spending caps to be effective particularly if they rebate excess revenues to taxpayers and enjoy constitutional, rather than just statutory, authority. Without a spending cap, it is likely that fiscal discipline will disappear as the state's economy recovers.

The governor's proposal would limit General Fund spending increases each year to a rolling 10-year average increase in the state's personal income as measured by the U.S. Bureau of Economic Analysis. A stronger proposal, which legislative sponsors in North Carolina have called a "Taxpayer Protection Act" and which emulates the Taxpayer Bill of Rights (TABOR) cap currently in operation in the state of Colorado, would limit annual spending increases to a combination of the projected inflation rate and the projected growth in the state's population.

The personal-income cap essentially requires state government to grow no faster than taxpayers can afford at existing tax rates. As personal income grows, then, the state government collects more revenue to be used to accommodate the service needs of a growing economy and to create new programs if desired. Actually, due to North Carolina's system of graduated income tax rates, tax revenues will often grow at a somewhat higher rate than personal income grows, as households are pushed into higher tax brackets.

The Taxpayer Protection Act focuses on spending rather than revenue. It assumes that the current overall level of state government spending is adequate to fund present and future needs — that any growth in expenditures beyond that needed to keep up with population growth and general inflation should be "paid for" by reducing lower-priority spending elsewhere in the budget. Because personal income typically grows faster than the combined rate of inflation and population growth, the TPA would allow North Carolina's tax burden to shrink over time, while the governor's proposal would essentially freeze the tax burden at its current level — which is the highest tax burden in the region and roughly twice what it was 20 years ago in real terms.

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Empirical Research on Tax and Expenditure Limits

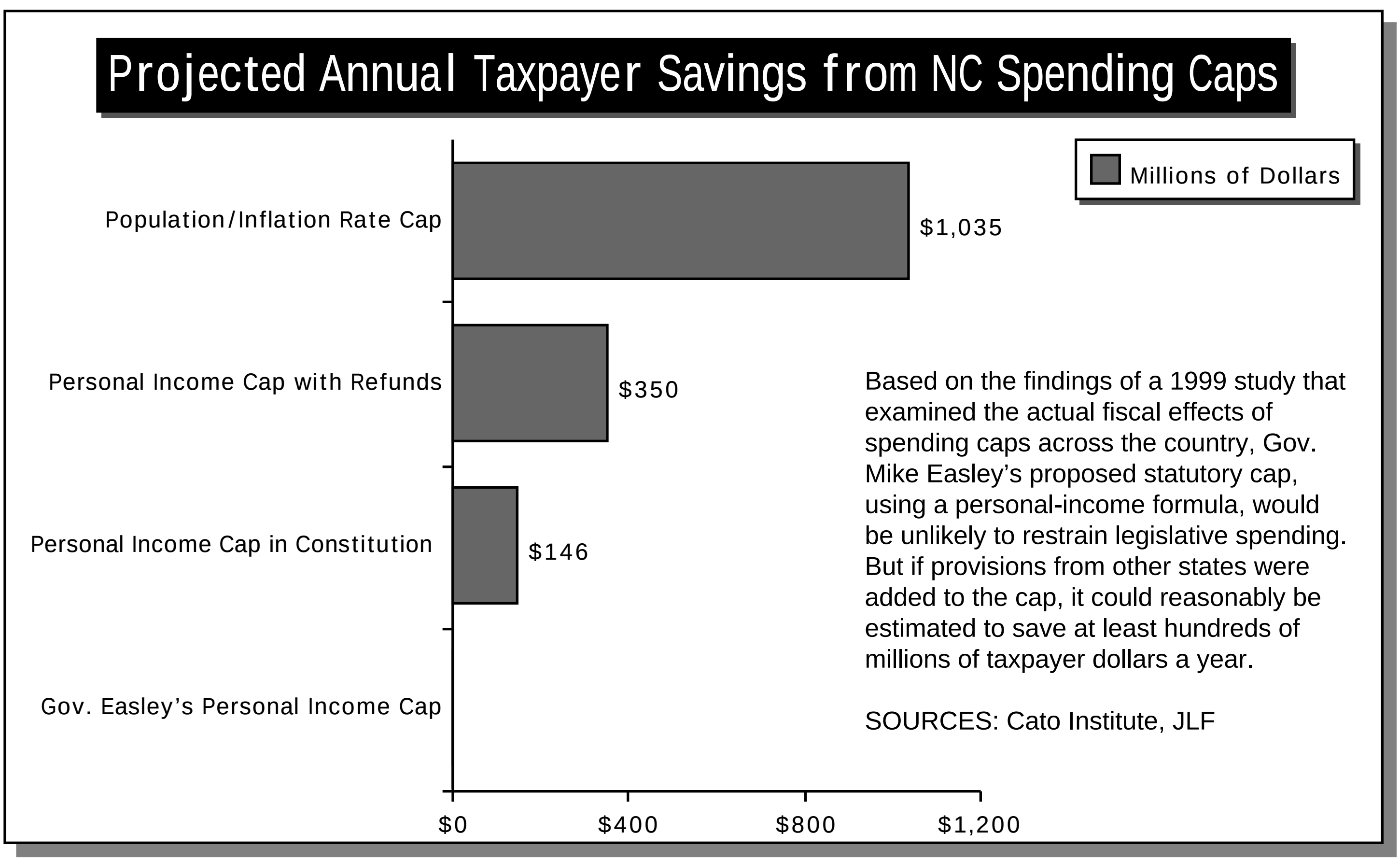
North Carolina policymakers need not decide how best to impose a spending cap as if the debate were purely theoretical. More than two-dozen U.S. states have some kind of tax or expenditure limit (TEL) that links annual spending growth to personal income, to inflation and population growth, or to some other variable. Some of these TELs are written in statute, others into the state constitution. Some rebate back to taxpayers the revenues not needed to fund permitted spending growth, while others let the excess revenues accumulate in emergency or trust funds (as Gov. Easley proposes). Some have carefully crafted provisions to keep states from shifting their spending to local governments, while others don't.

A 1999 study for the Washington-based Cato Institute examined nearly two decades of experience with these various kinds of TELs and used regression analysis to form some conclusions about the impact of spending caps on political behavior. In the real world of legislative budgeting, one cannot always assume that policies such as spending caps will easily predictable effects on final budget deficits. For example, many states have operated under spending caps and still have expanded government dramatically by shifting programs off-budget, seeking exceptions for capital or one-time expenditures that become ongoing items, or by using other loopholes and gimmicks. With a statutory spending cap, the problem is compounded by the fact that state legislatures can simply repeal or suspend the limits in years in which they find it difficult or undesirable to honor them.

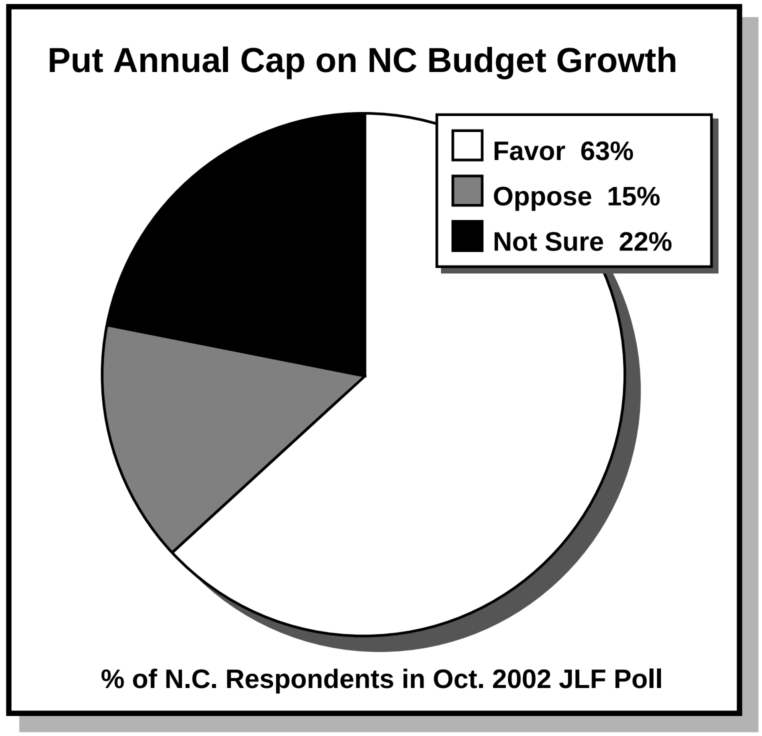
By modeling various TELs and other variables affecting state and local spending — such as general population growth, growth in school-aged and elderly populations, and economic growth — the Cato Institute research was able to generate the following empirical observations about spending caps:

- They are more effective in controlling spending when passed by citizen initiative than by state legislatures.
- They are more effective as constitutional provisions than as general statutes that future legislatures can suspend.
- They are much more effective when provisions exist to return unspent revenues to taxpayers rather than allowing revenues to accumulate in accounts that can be tapped in the future for legitimate or illegitimate purposes.
- They are much more effective when inflation and population growth are used as the basis for the cap rather than personal income growth.

These findings are illustrated in the nearby chart, which updates and applies the Cato findings for 1972-1996 period to North Carolina's fiscal situation today. While the governor's proposal, as is, offers at least the promise of controlling state spending



growth when the economy recovers in North Carolina, the experience of other states suggests that lawmakers would find effective ways to evade the cap over time, thus making it difficult or impossible to project taxpayer savings with confidence.



But the research also suggests ways that Gov. Easley's proposal can be strengthened to accomplish his stated goal. For example, the report found that states enacting TELs through initiatives had experienced taxpayer savings per year of approximately 0.45 percent of state and local spending per person. Using this finding as a proxy for the idea of placing a spending cap directly into the constitution — as most initiatives have done around the country — we can reasonably estimate that transforming Easley's proposal from a statute to a constitutional amendment, via a referendum vote, would generate savings of about $146 million per year.

Similarly, the Cato research found that tax-rebate provisions strengthened TELs considerably, leading to average spending reductions of about 1.08 percent. If Easley's proposal was modified to authorize annual rebates of unneeded revenues to taxpayers — perhaps after a minimum rainy-day fund balance in reached — we can reasonably estimate that spending would be about $350 million lower than would be the case without such a spending cap. Finally, Colorado's TABOR and a similar cap in Washington state have reduced spending by an average of 3.2 percent, so replacing Easley's personal-income cap with an inflation / population growth measure could lead to annual savings exceeding $1 billion.

Of course, it is important to keep in mind that spending caps alone don't "save" any taxpayer money. They are spurs to action. Governors and lawmakers must still identify specific ways of economizing, of reducing duplication and waste, and of shedding low-priority state programs so as to stay below a spending cap and fund needed expansion in such areas as education enrollment or prison capacity.

Why Not Let North Carolinians Vote on Easley's Plan?

The governor and other supporters of a state-run lottery in North Carolina have long argued that the people should be given their say on this controversial issue through the authorization of a binding, statewide referendum. The constitutionality of this idea remains in doubt — setting up and running a government lottery does not require any constitutional change, regardless of the merits of the idea. More to the point, there are a number of other issues that do involve matters of constitutional import and that attract widespread public support in opinion polls. Spending caps, for example, have routinely attracted the support of between 63 percent and 75 percent of North Carolina voters in surveys conducted for the John Locke Foundation and for other media and public policy organizations.

The governor has begun a welcome and healthy discussion about how best to tame the spending appetites of politicians and to forestall future budget deficits and tax increases. At the very least, his personal-income cap should be strengthened through a constitutional amendment which would deter future legislatures from evading the spending cap and establish a broad public consensus for fiscal discipline through a statewide referendum.

— John Hood, President

Notes

1. Michael J. New, "Limiting Government through Direct Democracy: The Case of State Tax and Expenditure Limitations," Policy Analysis No. 420, The Cato Institute, Washington, D.C., December 13, 2001.

2. "New Poll Gives Voter Views on Taxes, Local Funds, Other Issues," Press Release, John Locke Foundation, Raleigh, NC, October 17, 2002, http: / / www.johnlocke.org / press_releases / 2002101726.html.