Policy Perspective

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Texas' Appropriations Limit

Considerations for Future Reform

by Byron Schlomach, Ph.D., chief economist and director of the Center for Fiscal Policy Studies

At the end of the 3rd Called Session of the 79th Texas Legislature, appropriations from state tax revenues not dedicated by the state's constitution stood only $80 million below the constitutional appropriations limit. That limit, in the state's constitution since 1978 and rarely a significant factor in the biennial budget exercise, played an unusually significant role during the special session completed last May.

Though the Comptroller announced the Legislature had an $8.2 billion surplus at its disposal, the state's appropriations limit only allowed the designation of an additional $3.9 billion in new state spending for the rest of the 2006-2007 biennium. The Legislature chose to provide approximately $2.4 billion in property tax relief (or in discretion for school districts to increase locally-financed spending) and $1.4 billion in net new spending on public education.

Additional significant local property tax relief using the state's surplus would have counted as new state spending and technically run afoul of the appropriations limit. Although there is no doubt the original proponents of Texas' appropriations limit intended it to protect taxpayers, in this instance it had the effect of limiting the amount of tax relief taxpayers could enjoy—tax relief Texans had already funded by paying more in taxes than the Legislature earlier anticipated and arguably more than Texans want in government.

Seven Needed Reforms to Texas' State Appropriations Limit

A strong expenditure limit:

1. Is self-contained within the state's constitution, not requiring enabling legislation;
2. Applies to *all* spending whereas Texas' only applies to that funded by non-dedicated taxes;
3. Bases the expenditure growth limit on the sum of population growth and inflation whereas Texas' is based on growth in personal income;
4. Requires voter approval for growth in appropriations to exceed the limit where Texas' only requires a majority vote of the Legislature;
5. Encompasses all levels of government within a state though Texas' only applies to the state;
6. Requires disbursement of surplus funds to taxpayers and/or into a special reserve account in order to make up for periodic shortfalls. Texas has the rainy day fund but no provision for tax refunds or decreases with budget surpluses; and
7. Includes spending adjustments according to actual rather than predicted growth rates keeping long-term expenditure growth in check. Texas has no such safeguard.

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The eventual fate of the remaining $4.3 billion (or more by January of 2007) in surplus will be decided by the 80th Legislature which meets in January 2007. If the surplus continues to grow, it is possible the state's appropriations limit could once again prove itself to be a constraint to both tax relief and increased expenditures. Although the legislature was unwilling to consider a simple majority vote to declare an emergency and bypass the appropriations limit for the purpose of property tax relief, it may well have to take such a vote in January for the sake of additional spending. Representatives of the Teacher Retirement System have already testified to the need for a supplemental appropriation for the current biennium that would exceed the $80 million of discretion remaining before the current limit is violated.

State's Appropriations Limit

Thirty states now have what are generally classified as *tax and expenditure limits* (TELs). The National Conference of State Legislatures has identified four broad categories of TELs. These include: expenditure limits, revenue limits, appropriations limited by revenue estimates, and combinations of the previous three. Texas fits into the fourth category. It has a hybrid of expenditure and appropriations limits.[1]

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Actually, Texas has *two* limits on appropriations. The more stringent limit, in the sense that it always plays a role during the budget-writing process, is that appropriations cannot exceed the Comptroller's revenue estimate. Article III, Section 49a of the Texas Constitution prohibits deficit spending by the state. The budget must balance; thus, the Comptroller must certify that a budget for a coming biennium is balanced by prognosticating state revenues for the two future fiscal years. Occasionally, the Comptroller's revenue estimate has been sufficiently over the mark that the state's reserves could not cover a shortfall caused by an unexpectedly weak state economy, triggering special budgetary legislative sessions. Often, these have resulted in increased taxes.

The appropriations limit—or expenditure limit—is in Article VIII, Section 22 of the Texas Constitution. Very simply, it says that appropriations from state tax sources not dedicated by the constitution may not grow faster than the state's economy. The constitution leaves it to the Legislature to determine how growth of the state's economy is determined. In statute, the Legislature has pegged the economic growth rate to growth in overall state personal income but it also gives discretion to a special committee to determine a "more comprehensive definition" of economic growth.[2]

The Legislative Budget Board (LBB) is in charge of determining the level of personal income growth for a pending biennium. It does this by soliciting estimates of that growth rate for the biennium from economic consulting firms as well as the Comptroller's Office. The LBB then is free to pick one of the estimates or average any number of the estimates or to throw out all the estimates and pick a growth rate of its own choosing. The bottom line is that there are no real guidelines for how the LBB should prognosticate personal income growth for a future biennium, although current practice appears to be in good order.

Once a growth rate is determined it is applied to the current biennium's appropriations and this calculation determines the next biennium's appropriations limit. Appropriations for a current biennium, it should be noted, are not complete until very near the end of a regular legislative session. The Legislature has the ability to appropriate additional funds to the biennium in which the Legislature meets. As of January in odd-numbered years, when the Legislature first meets in regular session, more than eight months remain before the next biennium begins. Each major appropriations act is written for a biennium that does not begin until the following September. In the meantime, the Legislature is free to pass new appropriations to the current biennium as long as they do not violate the appropriations limit determined two years earlier. There are no provisions in the law for revising an appropriations limit once it is initially determined.

Limitations of Texas' Appropriations Limit

Expenditure limits were invented due to the need for some sort of automatic protection for taxpayers, who are at a disadvantage vis-à-vis those who would raid the public treasury. Taxpayers work hard and put in long hours and have little time to devote to fully inform themselves of what is happening in government. There are also financial costs of being fully informed. At the same time, no single government program costs an individual taxpayer very much. This gives even less incentive for busy taxpayers to defend their pocketbooks. Thus, the voices most often and loudly heard by elected representatives with the power of the purse are those demanding more taxpayer resources. The costs of their activism are outweighed by the rewards these activists get from the public treasury.

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The automatic nature of Texas' brand of expenditure limit is not as strong as it might first appear to be. There are four major reasons for this. First, the limit is on a subset of appropriations—only those funded by non-dedicated tax revenue sources. Spending from federal funds is not part of the limit. Spending from fee, lottery, and constitutionally dedicated tax revenues is not part of the limit, either. Less than half of all appropriations are covered by the limit.

Second, if personal income grows more slowly than anticipated by the LBB in determining the growth limit, there is nothing to keep expenditures from growing faster than *actual* personal income growth. For example, if personal income growth is predicted to be 10 percent in a biennium, appropriations and expenditures can grow 10 percent as well. But if personal income subsequently grows only 8 percent, expenditures can still increase 10 percent if the funds are available. This also means the base for the next appropriations limit calculation will be bigger than it should be.

In fairness, it must be pointed out that the balanced budget requirement in the constitution provides some safeguard for taxpayers. In a recession, when tax revenues are falling, expenditures have to fall accordingly. Still, the expenditure limit is based on prognosticated growth, so it is entirely possible a tax increase could result in expenditure growth in excess of actual personal income growth. The state's reserves can provide a cushion to protect against a tax increase. Though a tax increase seems politically infeasible, the Legislature can—and, indeed, has—raised taxes in an interim when the budget was in danger of going into deficit. This could be done without violating the constitution or current statute and without passing an emergency resolution in order to comport with the state's appropriations limit.

Third, only a bare majority of the Legislature is required to declare an emergency allowing spending over the established appropriations limit. Thus far, this has never happened. There are obvious political limitations for elected representatives voting to violate the appropriations limit, but political limitations are not automatic limitations. Political limitations require voters to take action through letter-writing and phone campaigns and then carry through with voting threats. An expenditure limit does provide a focus and an issue, but political action becomes necessary due to an automatic protection's shortcomings, not due to its strengths.

Fourth, Texas' expenditure limit does not include local government. That means the Legislature is free to pass costly mandates on to local government, possibly even effectively transferring state responsibilities to the local level. In fact, due to the structure of public education finance law, local school property taxes have effectively helped to finance state spending without that spending being subject to the state's expenditure limit.[3]

Seven Characteristics of a Strong Expenditure Limit

Texas has a weak expenditure limit provision in its constitution. In almost 30 years of its existence it has played essentially no part in limiting spending. The balanced budget requirement has arguably done more to limit spending. Texas' expenditure limit has, instead, seemed to only limit local property tax relief. To understand just how weak Texas' TEL is, characteristics of a strong TEL should be explored and several of these characteristics have been identified.[4]

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First, a strong TEL is self-contained in the state's constitution. There is no need, in other words, for enabling legislation. While this adds length to an already lengthy constitution in Texas, it is nonetheless necessary in order to prevent the Legislature from changing the fundamentals of the limit through a simple majority vote—all that is necessary in order to change a statute. While legislators can be called to account politically for such an action when it disadvantages taxpayers, the voting booth is generally a very indirect and uncertain sanction.

Second, a strong TEL applies to *all* spending except, perhaps, that funded from federal grants. An advantage to including federal funding under a TEL would be the decreased likelihood that federal policy would dictate state policy. State spending might be less likely to migrate to federal priorities that require a state funding match if appropriations based on federal funding are also limited. Budget writers might otherwise be tempted to pursue unlimited federal funding with what state funding they have at their disposal. On the other hand, there is an argument not to include federal funding. The state legislature does not have complete control over its availability.

With dedicated funds such as fuel taxes for roads and the lottery for education included under the expenditure limit it might be argued that these expenditures could crowd out other kinds of spending. For example, if fuel tax revenues rise very fast, this fact alone could force a higher priority on road construction and even reduce needed spending in other areas. This would occur because a total expenditure limit is finite and road expenditures would necessarily constitute a higher proportion of that finite limit since fuel taxes are dedicated.

The reality, in contrast, is that there is little evidence that dedicated sources of revenue have risen faster, on average, than others. Another reality is that dedicated sources of revenue, especially those dedicated to education, generally only fund a small proportion of the total spending for the purpose to which they are dedicated. An exception to this is roads, but fuel taxes have not risen fast.

Third, a strong TEL has a more stringent growth rate calculation than one based on personal income growth.[5] Most states base their TELs' growth rates on personal income growth. Colorado, widely considered to have the most restrictive TEL, bases its growth limit on the sum of inflation and population growth. Personal income is a relatively expansive growth limit in the United States because its growth reflects a rising standard of living. Total personal income, on average, is rising faster than inflation and population growth alone would cause it to rise. A limit based on personal income allows government to grow at least as fast as the economy.

Population growth and inflation together are, indeed, relatively restrictive. As population grows it would be expected that government would have to grow with it to some extent. More roads, schools, prisons, law enforcement officers, and administrative personnel, among other things, are needed to take care of more people. Inflation does not just increase costs for the population at large, but costs for everyone are driven upward, including costs for government. A growth limit equal to the sum of population growth and inflation would not allow government to grow even at the same rate as the economy. Indeed, held to this growth standard, government would shrink relative to the economy.

What constitutes the "right" growth rate peg depends heavily on one's philosophical and practical point of view with respect to the proper role of government. Many do not like the idea of government's growth being restricted at all. They see little wrong with government growing relative to the economy and would like to see it grow further and faster. Their view of government's proper role is an expansive one that envisions government providing a number of goods and services that have traditionally remained in the private realm.

Others see any growth rate that allows government to maintain its current size relative to the economy as allowing government to continue at a size that is already unhealthy. While few would argue that government should disappear altogether there is an argument to be made that we can certainly afford to have it shrink relative to the economy. This point of view sees government in a support role. As technology improves and standards of living rise so that individuals are increasingly able to provide for themselves, less government is needed. In fact, it is entirely possible for government to grow in absolute size but not as fast as a growing economy and still have the right amount of government for a healthy society.

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Fourth, a strong TEL requires voter approval for growth in appropriations to exceed the limit. Right now, in Texas only a bare majority of the Legislature is required for an emergency to be declared and the growth limit exceeded. Minimally, there should be at least a two-thirds vote requirement in the Legislature. Preferably, there would be a general election similar to that which recently occurred in Colorado.

Fifth, a strong TEL encompasses all levels of government within a state, safeguarding against transfers of unfunded mandates. That is, all levels of government would be limited in their growth to inflation plus the growth rate of their constituent populations. This would help prevent circumvention of the TEL by "passing the buck" from the state level to local levels through the transfer of responsibilities. Also, by writing the law to adjust to the transfer of responsibility, a TEL would not prevent local tax relief funded by state surpluses.

Sixth, a strong TEL requires excess funds to be disbursed to taxpayers and into a special reserve account in order to make up for shortfalls that will inevitably occur in some years. The reserve account helps prevent a "ratchet down" effect on state spending as has occurred in Colorado. Other excess funds would, ideally, be rebated to taxpayers. Tax rebates present a special problem for Texas since there is no state tax system that collects information about individual Texas taxpayers. In Texas, a method for generally reducing taxes as a way to return money to taxpayers would have to be devised.

One suggestion for dealing with excess funds is to use them to fund reductions in school property taxes. This presents a problem in that other local government entities can then take a school tax reduction as an opportunity to increase their property taxes. Other methods might be to temporarily decrease the sales tax rate with the possibility that temporary decreases could become permanent.

Seventh, a strong TEL includes spending adjustments according to actual growth rates so that over the long term expenditures would grow at about the same rate as the growth rate limit. Right now, as was noted above, it is possible for growth in the expenditures currently under the Texas expenditure limit to bear little resemblance to the growth limit—that of personal income. Obviously, it would still be necessary to prognosticate growth rates for the sake of budgeting, but there should be some historical check, with teeth, that requires expenditure growth to comport with actual growth in the pegged variable or variables over time.

Criticisms of Colorado's TABOR (Taxpayers' Bill of Rights)

Colorado's expenditure limit (popularly referred to as TABOR) has been heavily criticized for its restrictive growth limit based on population growth and inflation. Another factor that is often recognized as a flaw in Colorado's TABOR even by TABOR proponents is its tendency to "ratchet down" spending as a result of recessions. There are other criticisms as well, mainly having to do with philosophical positions on the size and proper role of government.[6]

Growth Rate Peg

Colorado's TABOR uses the sum of population growth and inflation as its growth rate peg. Opponents of expenditure limits complain that population demographics do not remain constant over time. Population might be increasing, for example, due to the influx of a large number of poor people. Of course, this begs the question: If Colorado's standard of living was declining due to the restrictions of TABOR, why would poor people be flocking to that state? This criticism makes little sense from a logical standpoint. It makes even less sense when you consider that Colorado's economy has been very healthy. In 1990 Colorado's inflation-adjusted personal income per capita was a little more than $100 greater than the average of the nation; by 2003 it was almost $3,000 greater.[7]

Critics also complain that demographics change and this can mean increased costs for government. For example, an aging population is a reason cited for a growing government. On the other hand, a more youthful population, it is implied, is another reason to increase government spending faster than the population growth plus inflation formula would allow.

Another complaint is that costs facing government are growing faster than the general inflation rate as computed from the consumer price index. No one ever asks the question of why that is the case. Economic reasoning yields a sound, powerful, and not-too-reassuring reason.

There are really only two basic reasons prices go up. Either demand increases faster than supply increases or supply decreases faster than demand decreases. Put another way, demand increases and/or supply decreases cause inflation. Now, there are a number of factors that might increase demand as well as a number of different factors that might decrease supply. However, if prices (or costs) in a particular sector of the economy continually rise faster than in other sectors, there must be some sort of persistent supply or demand effect. With respect to government-provided services, there is a persistent demand effect. It's called government.

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Government generally offers services for a zero or greatly reduced price. People react rationally by consuming as much of these services as they reasonably can. They act as if there is no such thing as scarcity. But, there is ALWAYS scarcity, which means that every government program that will ever exist will be over-subscribed. There will always be limits to what can be provided, but with government providing a service for free there will never be limits to the amount of the service people want. Like a dog chasing his tail, government will always be trying to fulfill the new demand for an expanded service. At the same time policymakers are chasing their tail trying desperately to meet demand that can never be met as costs naturally increase. Spending increases push up government costs and there will never be enough money to completely fill demand for a government service.

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To get control of this never-ending, spiraling, inflationary cycle government is in, we must limit what government can spend, force prioritization, and recognize that attempts to ignore or defy the laws of economics are doomed to failure.

Rate of Government Growth

Opponents of expenditure limits complain that government services suffer when expenditure limits are in effect. The clear implication of opponents' claims is that government services retrograde and society in general suffers. Statistics cited include Colorado's ranking compared to other states in its spending on various government programs.

With respect to health care, the stress of limited government critics is on "covered" individuals under socialized and private health insurance programs. For example, they complain that too few elderly and young Coloradans are covered by health insurance and that too few poor Coloradans are covered by Medicaid. They also cite reduced access to prenatal services and a lack of vaccinations.[8] However, no evidence is presented that the overall health of Coloradans was negatively affected by the reduced rate of expenditure growth in the state health care programs.

In fact, the percentage of births to mothers who received no or late prenatal care in Colorado has slightly improved since 1992 when TABOR was put in place. The percentage of low birth weight babies has increased slightly but the percentage with "very low" birth weight has stayed constant in recent years. Infant mortality has improved considerably.[9]

Opponents of expenditure limits do not look at the amount of actual spending Colorado is doing in various areas. Instead, they look at spending relative to personal income. This is the primary statistic referenced in looking at education. For example, it is stated that, "Between 1992 and 2001, Colorado declined from 35th to 49th in the nation in K-12 spending as a percentage of personal income." The same source says that average per pupil K-12 spending in Colorado was $379 below the national average in 1992 but $809 below the average by 2001.[10]

According to Census Bureau statistics, Colorado's average per student expenditures on primary and secondary education rose from $5,359 in 1992 to $8,651 in 2004. These figures show Colorado $207 below the national average in 1992 and only $152 below the national average in 2004. Colorado's expenditure per student ranking went from 26th in 1992 to 25th in 2004.[11] To be sure, Colorado's relative expenditures and ranking did fall until Coloradans passed an initiative to dedicate large sums of money to public education. Part of the reason for shortfalls in other areas was due to this initiative. Nevertheless, even though Colorado's public education spending is well below the national average in 2000, only eight other states had a higher proportion of their population who were high school graduates.[12]

Bottom line, whether proponents of a bigger government are talking about higher education, public education, health care, or law enforcement, their issue is only with spending, not results. Higher education spending per student in Colorado has declined, but that does not mean fewer people get college degrees. It might instead mean that institutions of higher education have to become more efficient. It is well documented, for example, how few classes professors are required to teach in the United States and that this work load has shrunk. One way of achieving efficiency in higher education and making do with a few less dollars could simply be having tenured professors teach an extra class or two per year.

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Spending is not the same thing as accomplishment or achievement. When emphasis is placed on greater spending as a measure of greater achievement, progress is actually *not* likely to occur. There are a lot of ways to spend money in the name of health care without improving anyone's health. Emphasis must always be placed on effectiveness and that carries with it a responsibility to set priorities and to recognize the costs associated with choices. Big government advocates ignore costs, for all intents and purposes.

Competition for Funding

As these examples demonstrate, advocates for higher government spending too often fail to make the case that their preferred programs truly need additional money, particularly in relation to the needs of other programs. In other words, their arguments are based on the premise that all government programs need more money to achieve desired social goals. There is no credence given that progress is possible outside of government action. Certainly no credence is given to the possibility that government can exacerbate some problems and programs should be eliminated. Seemingly anathema is the notion that performance gains can be achieved via efficiency. Thus it is no surprise that little or no attention is paid to the prioritization of spending.

Government programs have a tendency to expand because those who demand the services behave as if scarcity is not an issue. But scarcity is *always* an issue—a truth that not only requires, but demands, that priorities be determined.

It may well be that even the least valuable government program is still worth the costs to taxpayers. However, it is completely wrong to assume that all government programs, by virtue of their very existence, equally deserve funding. As has already been noted, government programs have a tendency to expand because those who demand the services behave as if scarcity is not an issue. But scarcity is *always* an issue—a truth that not only requires, but demands, that priorities be determined.

Legislative Program Expansion Versus Available Funding

Twice in recent years, the state of Colorado enacted new laws which required significant increases in expenditures of funds. One was the Colorado Legislature's passage of new, strict sentencing laws that required a good deal more prison time. These new laws were apparently passed with too little consideration of how much they would cause spending to increase. A similar situation occurred when the public passed the education initiative mentioned above which required significantly increased education spending.[13]

Opponents of Colorado's TABOR complained that it did not allow for adequate funding in the area of corrections and education. And it is true that these two demands for funding certainly created an increasingly uncomfortable environment for lawmakers who had to offset considerable increases in spending on corrections and public education with cuts somewhere else. This is not an example of a design flaw or undesirable outcome of TABOR, though. In fact, it is a perfect example of one of the benefits of TABOR—in this case, how it uncovers the Legislature's disregard for proper planning and an inability or unwillingness to confront the true costs of legislative actions.

"Ratchet Down" Effect

Colorado's TABOR almost necessitates that the base on which future expenditure growth limits are based will gradually fall. During recessions, when government revenues are reduced, so are expenditures. This lower expenditure level then becomes the basis on which the next budget period's expenditure limit is based. Eventually, another recession will occur and the base will be reduced again. The result is a gradual ratcheting down of per capita expenditures.

The ratchet down effect did not have to happen. Allowable growth in expenditures under Colorado's TABOR is based on inflation and population growth, not the amount of taxes collected. In other words, Colorado's lawmakers could have raised taxes and stayed below the expenditure limit. Colorado voters might have agreed to a tax increase during recessions because, due to their TABOR, they could be assured of future tax rebates in good economic times. The TABOR would have ensured that government growth would not have gotten out of control even in the event of tax increases. Obviously, political realities prevented this scenario from occurring, regardless of the possibilities.

Proponents of Colorado-style TELs now recognize that there is a need for what is usually called a budget stabilization fund. During economic expansions, some excess revenues would be deposited in this fund to be drawn down during economic contractions and, thus, allow for continued expansion of the budget at the expenditure limit rate or at least partially mitigating the ratchet down effect.

The solution to the ratchet down effect that was already built into Colorado's TABOR was a temporary suspension provision. Coloradans always had the right to suspend the TABOR limit subject to a popular election. After previous failed attempts to do so, in the fall of 2005, Coloradans voted to suspend TABOR for five years, thus allowing their Legislature to inflate the base for the future. No doubt there is now a considerable ratcheting up of expenditures taking place. After the five years are up, ratcheting down will occur again unless TABOR's basic provisions are changed. It remains to be seen if this cycling effect will have any deleterious effect on Colorado's long-term economic health. It can be said, however, that there is no evidence that the ratcheting down of spending had any deleterious economic effects. Even opponents of TELs have had to attempt to explain Colorado's strong economic showing during TABOR's hey day.[14]

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Interestingly enough, as a result of the spending frugality of the 2003 (78th) Legislature combined with the lack of frugality in 2005, Texas' own ratchet down effect limited Texans' property tax relief. Since the enactment of Texas' TEL in 1978, recessions and the resultant revenue squeezes have seen tax increases in Texas—until 2003 when spending cuts and other methods were used to avoid increasing taxes. In 2003, the base on which the expenditure limit is calculated did not rise even enough to keep up with inflation and population growth. The limited 2003 appropriations for the 2004 and 2005 fiscal years thus reduced the potential appropriations for the 2006 and 2007 fiscal years—the years in which property tax relief was enacted. At the same time, if there was a provision allowing for transfer of funding responsibilities that did not violate the expenditure limit, this would not be an issue at all.

Conclusion

Texas' TEL is flawed and needs to be improved. One improvement would be to more stringently define the expenditure limit based on population growth and inflation instead of personal income growth. Another improvement would be to establish stricter guidelines for deposits into a budget stabilization fund such as the rainy day fund. Local governments should also be included in a general state TEL law. The law should be entirely contained in the state's constitution without much reliance on future legislative discretion. Finally, there should be some type of reconciliation provision that keeps spending from exceeding actual growth rates of whatever limiting variables are selected.

Tax and expenditure limits are growing, not shrinking, in popularity. More states have recently been added to the list of those who have some sort of limit. As a result, opponents of protections for taxpayers have stepped up the shrillness of their rhetoric. The challenge now is to set aside rhetoric and work to improve TELs by addressing the legitimate concerns of honest people on both sides of the issue.

Byron Schlomach, Ph.D., is the chief economist and director of the Center for Fiscal Policy Studies at the Texas Public Policy Foundation. Contact Byron Schlomach at: bschlomach@texaspolicy.com.

Endnotes

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