Backgrounder

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Colorado's Taxpayer's Bill of Rights Should Not Be Breached

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A serious effort is underway in Colorado to bypass the effective tax and spending controls imposed by the Taxpayer's Bill of Rights (TABOR) and permanently increase the size of the state government. TABOR limits how fast state tax revenues can grow by requiring that the state refund taxes collected over the limit to the taxpayers. Therefore, TABOR also, in effect, limits spending. This has kept the burden of state government low and has led to a stronger state economy.

But TABOR is under attack. Elected officials have placed Referendum C on the ballot for this fall, asking Colorado citizens to let the legislature keep (and spend) $3 billion in surplus taxes over TABOR limits instead of refunding those revenues to the taxpayers. As voters ponder this referendum, it is helpful to examine why TABOR was necessary and why it should be retained.

TABOR's Background

Colorado voters passed TABOR in 1992 to end the undisciplined spending and tax increases of the 1980s, which increased the effective state income tax rate by 15 percent and the gasoline tax by 214 percent.[1] Chart 1 shows how effective TABOR has been in controlling spending. Before TABOR, state spending increased dramatically in relation to taxpayers' ability to pay, even briefly surpassing the national average. After TABOR, the burden of government declined and Colorado's competitiveness with the rest of the nation improved.

Talking Points

- Colorado's Taxpayer's Bill of Rights (TABOR) imposes sensible tax and spending limits on the state government, reducing the burden on taxpayers and creating a better climate for economic growth.
- Rather than make politically difficult belt-tightening decisions, lawmakers proposed Referendum C to bypass these limits for five years.
- Referendum C is not a five-year "time-out," but a $3 billion tax increase that will permanently change TABOR, increase the size of government, and pose long-term fiscal risk.
- Colorado citizens should not abandon TABOR's sensible budget controls that protect their pocketbooks and the economy because of a well-intentioned but misguided mandate that puts other important services on a collision course with K–12 education.

This paper, in its entirety, can be found at: *www.heritage.org/research/taxes/bg1873.cfm*

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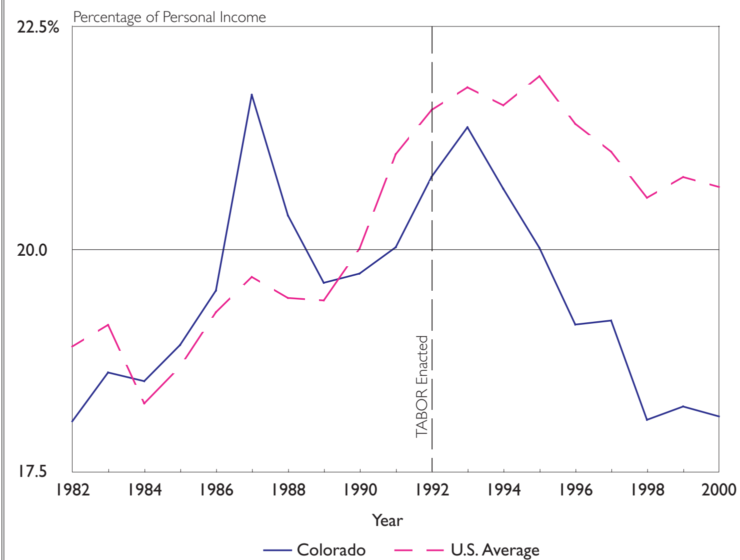
One of the fundamental reasons to enact revenue and spending limits is to protect taxpayers from constantly rising demands on their pocketbooks. This in turn fosters a better environment for economic growth. Government can still grow, but at a slow and predictable rate. Elected officials must then make honest, conscious decisions about where to direct resources across all state programs.

This means putting an end to the mentality of spending freely in the good years and raising taxes to cover those expenditures in the bad years—something that is as vital from a personal perspective for families trying to provide for their needs as it is from an economic perspective. TABOR has served that purpose well, effectively protecting both Colorado families and the state economy from the ill effects of increasing taxes and government spending.

Chart 1 B 1873

Colorado State and Local Spending Burden as a Percentage of Personal Income, Before and After TABOR



Sources: Heritage Foundation calculations based on data from the U.S. Bureau of the Census, State and Local Government Finances; U.S. Department of Commerce, Bureau of Economic Analysis, Regional Economic Accounts, at *www.bea.gov/bea/regional/data.htm* (July 20, 2005); and Office of Management and Budget, *Historical Tables, Budget of the United States Government, Fiscal Year 2006* (Washington, D.C.: U.S. Government Printing Office, 2005), pp. 29–30, Table 2.1, at *www.whitehouse.gov/omb/budget/fy2006/pdf/hist.pdf* (July 20, 2005).

Why Taxes and Government Spending Are Counterproductive

High taxes harm economic performance. Evidence from countries around the world clearly establishes that countries with lower government tax and spending burdens fare better than countries with high government burdens, and the experiences of U.S. states support this conclusion.[2]

In fact, just the act of raising taxes harms economic performance and undermines the relative competitiveness of a locality, state, or nation. The businesses fleeing high-tax states such as California to lower-tax states like Nevada are ample evidence that taxes are an integral part of the decisions that entrepreneurs and CEOs make when deciding where to locate or relocate a business. High or increasing taxes retard new business formation and expansion, thereby slowing job creation and wage growth.

Government spending can also harm the economy because it crowds out productive private-sector activity by taking away resources and reallocating them based on political considerations rather than economic decisions. Moreover, government spending encourages unproductive choices, such as choosing welfare over work, and discourages productive choices, such as relying on subsidized programs like retirement and housing rather than saving for such things. Finally, government spending inhibits innovation because government is more centralized and bureaucratic than the private sector, which is constantly seeking new opportunities and improvements to maximize the bottom line.[3]

1. "TABOR Legislative Handbook," Independence Institute *Issue Paper* No. 1–2000, January 2000, at *i2i.org/articles/1-2000.pdf* (July 21, 2005).
2. Daniel J. Mitchell, Ph.D., "The Impact of Government Spending on Economic Growth," Heritage Foundation *Backgrounder* No. 1831, March 31, 2005, at *www.heritage.org/Research/Budget/bg1831.cfm*, and Steve Moore, "States Can't Tax Their Way Back to Prosperity: Lessons Learned from the 1990–91 Recession," American Legislative Exchange Council, *The State Factor*, October 2002, at *www.alec.org/meSWFiles/pdf/0229.pdf* (July 21, 2005).

Referendum C: A Permanent Tax Hike

Some have described Referendum C, the Colorado Economic Recovery Act, as a five-year time-out that would not change TABOR or raise taxes and would allow state spending to catch up after the recession. However, this logic unravels upon closer analysis.

A $3 Billion Tax Increase. Referendum C is designed to permanently increase Colorado's government *and* tax base. It would authorize the legislature and governor to ignore the TABOR limit and spend all of the tax revenues collected by the state over the next five years. This may sound innocuous, but it really means that approximately $3 billion[4] will go to government bureaucrats instead of to Colorado's families. This is a tax increase, plain and simple.

Those who favor this "fix" argue that it is really not a tax increase because tax rates will not go up, but this ignores that any law that allows more tax collections to remain in the state's coffers to finance government programs takes money away from families and businesses. If passed, Referendum C will take an average of $600 from every man, woman, and child in Colorado,[5] whether or not proponents choose to call it a tax increase.

Changes in TABOR. This tax increase would be permanent. Referendum C is being described as a five-year "time-out" that will not change TABOR, but in fact it will *permanently* and explicitly increase the TABOR limit because it allows the state to retain significantly more revenue (and therefore increases the base from which the TABOR limit is calculated). Not only would this let elected officials take a time-out from tough policy and fiscal decisions that families and businesses must face every day, but it would also give them a bonus for doing so.

This violates the very spirit of TABOR, which demands that politicians practice fiscal responsibility and protect the taxpayers from freewheeling spending in the good years and tax increases in the bad years. TABOR was passed after years of such misbehavior, and any steps to weaken its strong limits will signal the end of its effectiveness.

Long-Term Risks. Referendum C would also set up a risky scenario for Colorado's financial future. Five years of unlimited government spending would entrench the demand for more spending by politicians, ever-growing government programs, and a myriad of special interests. This is precisely what happened when California undid the Gann Amendment, its version of TABOR. Unbridled growth in state spending led to huge increases in debt and taxes, which continue to drive jobs and businesses away from California, and the state budget has still not recovered. If Colorado revenues and spending are allowed to grow without limits for the next five years, TABOR will be rendered irrelevant and more "time-outs" will surely follow.

Government spending creates constituencies that exert powerful influence over elected officials and policymakers to protect their interests, but the taxpayers have no such advocates. Only TABOR can protect the interests of Colorado's families and taxpayers from such forces.

TABOR Protected Colorado's Families and Economy

In the 10 years after TABOR was passed in 1992, the state government refunded over $3 billion to taxpayers—about $3,200 for a family of four. The state also experienced a much stronger economy after TABOR. For example, job growth in the 10 years after TABOR was nearly double that in the 10 years before TABOR, and nearly all of this increase was in the productive private sector. Colorado also

3. Mitchell, "The Impact of Government Spending on Economic Growth."
4. Estimates vary between $2.9 billion and $3.6 billion. See Andrew T. LeFevre and Rea S. Hederman, Jr., "Report Card on American Education: A State-by-State Analysis 1976–2001," American Legislative Exchange Council, October 2002, at *www.alec.org/meSWFiles/pdf/Education_Report_card.pdf* (July 21, 2005).
5. $2.9 billion divided by estimated Colorado population of 4.8 million in 2010. See U.S. Bureau of the Census, Population Division, "Interim State Population Projections, 2005," Table 6, April 21, 2005, at *www.census.gov/population/projections/PressTab6.xls* (July 21, 2005).

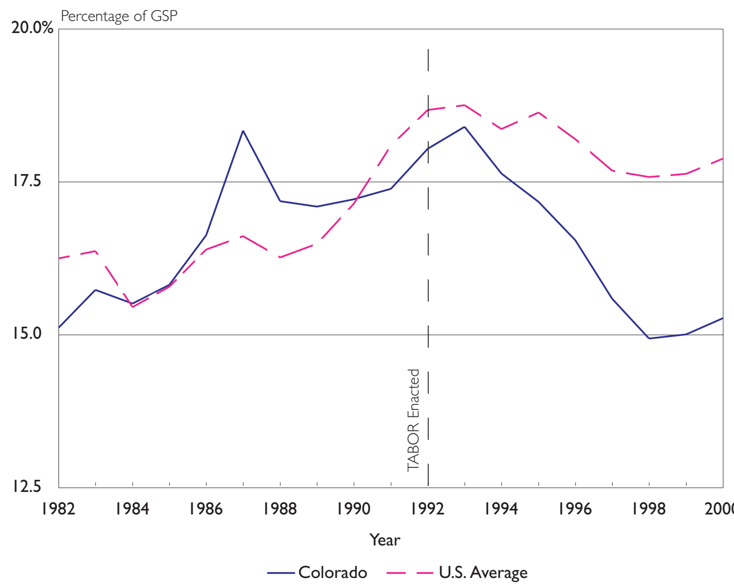
saw higher per capita personal income growth after TABOR.[6]

The late 1990s was a period of prosperity for most states, so it is important to realize that Colorado's performance not only improved after TABOR, but also was better than the national average. Chart 2 shows that, as TABOR took effect, its impact on the state's economy was realized almost immediately. Government spending in Colorado shrank as a share of the economy, freeing vital resources for the private sector. While the burden of government in other states also declined, Colorado performed markedly better and improved its competitive position vis-à-vis the rest of the nation.

Colorado experienced similar improvement in the state's economy and personal income after TABOR, both in real terms and relative to the rest of the nation. (See Charts 3 and 4.) Because a broad array of factors influence state and national economies, it is impossible to say with any certainty how much of this improvement is due to TABOR. However, it is safe to say that lower taxes and spending result in a better economy, and Colorado's experience before and after passage of TABOR confirms this.

Chart 2 B 1873

Colorado State and Local Spending Burden as a Percentage of Gross State Product, Before and After TABOR



Sources: Heritage Foundation calculations based on data from the U.S. Bureau of the Census, State and Local Government Finances; U.S. Department of Commerce, Bureau of Economic Analysis, Regional Economic Accounts, at *www.bea.gov/bea/regional/data.htm* (July 20, 2005); and Office of Management and Budget, *Historical Tables, Budget of the United States Government, Fiscal Year 2006* (Washington, D.C.: U.S. Government Printing Office, 2005), pp. 29–30, Table 2.1, at *www.whitehouse.gov/omb/budget/fy2006/pdf/hist.pdf* (July 20, 2005).

The *Real* Budget Facts

The clamor raised by supporters of Referendum C makes it seem as if the state budget was slashed because of TABOR. However, total state spending has gone up every year since TABOR passed. This year's budget increased 4.2 percent while the combined growth in population and inflation was only 1.3 percent.[7] State spending on K–12 education, corrections, and Medicaid increased the fastest, although some programs such as public health, natural resources, and agriculture are below their peak levels in fiscal year 2001.

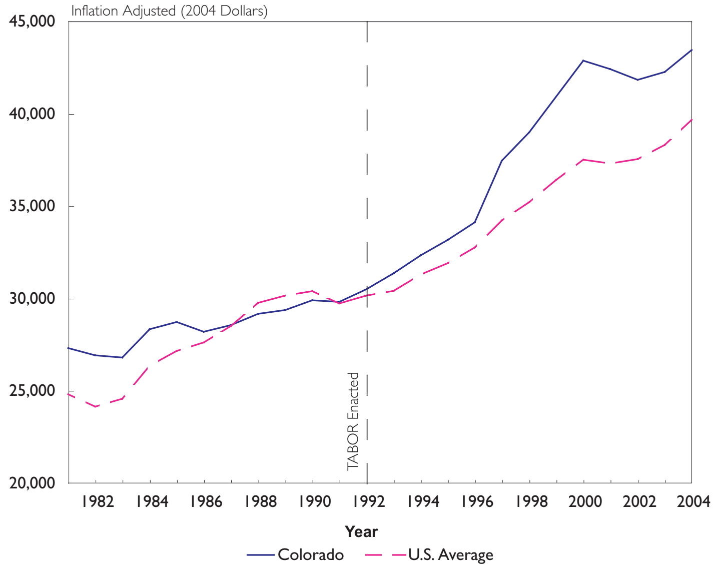
This indicates that the legislature is doing exactly what it should do: prioritizing spending of taxpayer dollars just the way that Colorado families prioritize spending their paychecks. When costs go up for medical bills or gasoline, they tighten their belts on lower priorities like Starbucks, the movies, or even an extra car for their children. Legislators proposing Referendum C simply do not want to be forced to make the tough belt-tightening decisions that are politically difficult because of intense special-interest lobbying.

6. Fred Holden, "A Decade of TABOR/Ten Years After: Analysis of the Taxpayers' Bill of Rights," Independence Institute *Issue Paper* No. 8–2003, June 2003.

7. Ari Armstrong, "Colorado Budget Overview," Free Colorado *Colorado Freedom Report*, July 7, 2005, at *freecolorado.com/2005/07/budget.html* (July 21, 2005). This number is somewhat controversial as Colorado Legislative Council staff revised the number down to eliminate new double-counting of appropriations in higher education. Significant additional double-counting is included elsewhere in the budget but was not excluded since it has occurred for years. Their original growth calculation was 7.7 percent.

Chart 3 B 1873

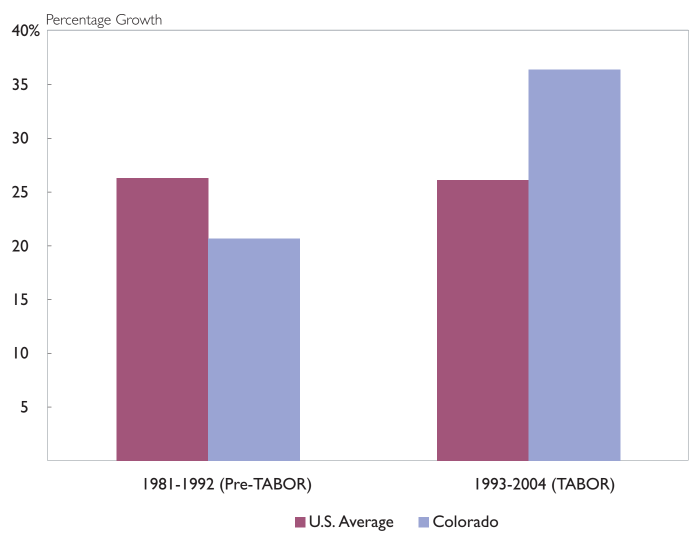
Colorado Per Capita Gross State Product, Before and After TABOR



Sources: Heritage Foundation calculations based on data from the U.S. Bureau of the Census, State and Local Government Finances; U.S. Department of Commerce, Bureau of Economic Analysis, Regional Economic Accounts, at *www.bea.gov/bea/regional/data.htm* (July 20, 2005); and Office of Management and Budget, *Historical Tables, Budget of the United States Government, Fiscal Year 2006* (Washington, D.C.: U.S. Government Printing Office, 2005), pp. 29–30, Table 2.1, at *www.whitehouse.gov/omb/budget/fy2006/pdf/hist.pdf* (July 20, 2005).

Chart 4 B 1873

Colorado Per Capita Personal Income Growth, Before and After TABOR



Source: Heritage Foundation calculations based on data from U.S. Department of Commerce, Bureau of Economic Analysis, Regional Economic Accounts, at *www.bea.gov/bea/regional/data.htm* (July 20, 2005), and Office of Management and Budget, *Historical Tables, Budget of the United States Government, Fiscal Year 2006* (Washington, D.C.: U.S. Government Printing Office, 2005), pp. 29–30, Table 2.1, at *www.whitehouse.gov/omb/budget/fy2006/pdf/hist.pdf* (July 20, 2005).

TABOR Helped Colorado's Budget

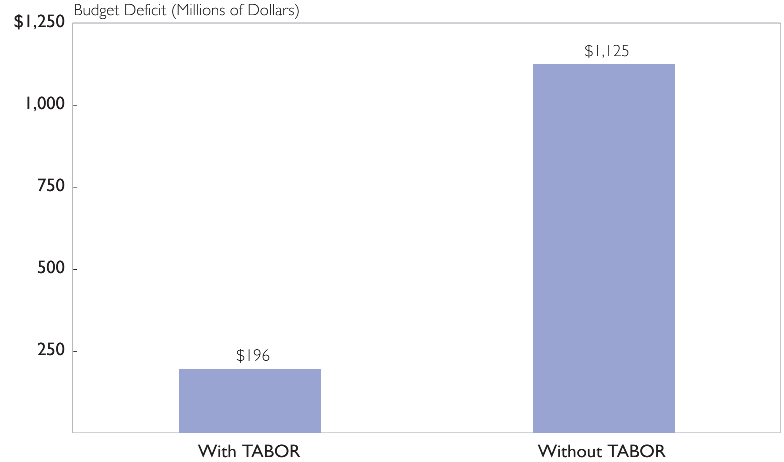
Since its inception, TABOR has been crucial in protecting the interests of individuals, families, and the economy from the harm caused by higher taxes and government spending. Because revenues cannot grow faster than the common-sense combination of inflation plus population growth, TABOR resulted in taxpayer refunds of $3.25 billion over 10 years[8] and a reduction in the state income tax rate from 5 percent to 4.63 percent.[9] Because Colorado has a balanced budget requirement, spending cannot grow faster than revenues. This makes TABOR, in effect, also a limit on spending.

Many are mistakenly blaming the state's past budget woes on TABOR. The reverse is actually true. Because the Colorado legislature was forced to limit spending in the 1990s and return excess revenues to the taxpayers, the state budget did not grow as extravagantly in Colorado as it did in other states. California is the prime example of lavish state spending during the 1990s, spending every dime of additional tax revenue. As a result, when the recession hit, California faced an unprecedented structural deficit from which it has still not recovered. By contrast, Colorado faced a relatively minor budget downturn brought on by declining revenues, not by TABOR.

Thanks to TABOR, Colorado's legislature was limited to spending $7.9 billion of the $8.9 billion in revenues collected in 2001. The rest was returned to the taxpayers. In 2002, revenues fell to $7.8 billion because of the recession, leaving a budget deficit of $196 million.[10] Without TABOR, Colorado would likely have followed the example of most other states and spent the entire $8.9 billion in revenues in 2001, leading to a budget deficit of $1.1 billion in 2002. (See Chart 5.) TABOR not only returned money to the taxpayers, but also shielded the budget from periodic economic volatility.

Chart 5 B 1873

The Effect of TABOR on Colorado's Budget Deficit in 2002



Sources: Chris Atkins "An Analysis of Misleading Attacks on Colorado's Taxpayer Bill of Rights," Tax Foundation, March 25, 2005, at *taxfoundation.org/news/show/316.html* (June 30, 2005), and Colorado Office of State Planning and Budgeting, "The TABOR Surplus and TABOR Refund Mechanisms," September 2004, at *www.state.co.us/gov_dir/govnr_dir/ospb/specialreports/taborsurplus-sep2004.pdf* (June 30, 2005).

Education

The real culprit in the state's continued budget woes is Amendment 23, which requires the state to spend an ever-increasing share of the total budget on K–12 education *and* directly takes money from TABOR revenues. TABOR protected the state budget from a structural deficit during the recession by

8. Holden, "A Decade of TABOR."
9. Barry W. Paulson, Ph.D., "Colorado's TABOR Amendment: Recent Trends and Future Prospects," Americans for Prosperity Foundation, July 2004, at *www.americansforprosperity.org/news/pdf_paulson0704a.pdf* (July 21, 2005).
10. Colorado Office of State Planning and Budgeting, "The TABOR Surplus and TABOR Refund Mechanisms," *Special Report*, September 2004, at *www.state.co.us/gov_dir/govnr_dir/ospb/specialreports/taborsurplus-sep2004.pdf* (June 30, 2005). See also Chris Atkins, "An Analysis of Misleading Attacks on Colorado's Taxpayer Bill of Rights," Tax Foundation, at *taxfoundation.org/publications/printer/316.html* (June 30, 2005).

requiring fiscal discipline, but Amendment 23 put education directly at odds with other vital state services like transportation and public health by mandating increases in education spending. Hence, while TABOR forces politicians to prioritize spending on the state budget just as families and businesses must do, Amendment 23 gives education a free spending pass and places a huge portion of the budget off-limits from critical examination and assessment each year.

Every program, no matter how valuable, can have inefficient, wasteful, and obsolete features that should be ferreted out and eliminated. Education is no exception. While increasing education spending seems like a worthy goal to ensure academic success, the evidence overwhelmingly shows that increasing education spending has no direct bearing on improving student performance.[11] In the past two decades, states have funneled vast amounts of money into K–12 education, but this has not translated into increased achievement. For example, according to the American Legislative Exchange Council, none of the states with the biggest increases in per pupil spending or the biggest decreases in pupil–teacher ratios ranked in the top 10 in academic achievement.[12]

Focusing on spending takes attention away from reform of education policy itself. Competition among programs jockeying for limited state funds would be more likely to focus debate on whether the educational programs in question achieve results or not. Amendment 23 rests on the false premise that spending directly influences academic achievement. A more significant question than how *much* money is spent is how that funding is *delivered*, whether through a monopolistic public school system or through a more competitive system of parental choice.

Amendment 23, by guaranteeing that education spending will grow faster than TABOR, is putting tremendous pressure on other parts of the budget. Prudent fiscal policy demands that lawmakers be able to make conscious decisions in the context of the total budget and evaluate all of the state's needs and priorities together. Otherwise, the result will be fragmented and reactionary decisions. Limited resources should be put where they are most needed, but walling off a fourth of the state's budget and placing it on autopilot prevents honest discussion and deliberate decision making.

Colorado should not abandon TABOR's sensible budget controls because of well-intentioned but misguided mandates that put other important services on a collision course with education. Amendment 23 should be reformed so that policymakers can evaluate all budgetary needs and make calculated decisions in the context of limited resources. Rather than blame TABOR, Colorado citizens should demand that the education establishment improve educational outcomes by becoming more effective at *what* they do, not in *how much* they spend.

The Ratchet Effect and Reforming Government

While TABOR protected Colorado from huge structural budget deficits, it also permanently ratcheted down the growth in spending after revenues dropped. If revenues drop, as they did in 2003 and 2004, the TABOR limit is calculated using this lower base (total revenue from the previous year).[13] (The TABOR limit actually grew slightly and never declined during this period.[14])

11. Eric Hanushek, "The Economics of Schooling: Production and Efficiency in Public Schools," *Journal of Economic Literature*, Vol. 24 (September 1986), pp. 1141–1177. See also John Chubb and Terry Moe, *Politics, Markets and America's Schools* (Washington, D.C.: Brookings Institution Press, 1990), p. 336.
12. LeFevre and Hederman, "Report Card on American Education."
13. The TABOR limit is calculated in two steps. First, the *TABOR base* is identified. The base is either the previous year's TABOR limit or actual tax revenues, whichever is *lower*. Second, the *TABOR limit* is calculated by increasing the base by the previous year's inflation rate and state population growth rate.
14. Colorado Office of State Planning and Budgeting, "The TABOR Surplus and TABOR Refund Mechanisms," and Colorado Office of State Planning and Budgeting, "Revised June 2005 Revenue Forecast," memorandum, June 21, 2005, at *www.state.co.us/gov_dir/govnr_dir/ospb/economics/cep/2005/cep2005-06.pdf* (July 21, 2005).

However, when revenues recover, the TABOR base is not allowed to jump back up to the previous level, but rather must grow slowly.

Colorado's TABOR has long been viewed as the gold standard of tax and spending limits because of its tough limits on spending, including this ratcheting down effect. Other states that are considering a TABOR have not set the bar as high as Colorado. Eliminating TABOR's ratchet effect would be far preferable to giving spending and revenue growth a free pass as Referendum C would do.

However, a better alternative is to take advantage of the ratchet effect to force state government to seek the same types of innovation that the private sector relies on to achieve a competitive edge. In the private sector, the constant competitive pressure to reduce costs forces firms to embrace organizational change and cost-reducing technologies. Firms change not only the way that they do things, but also what they do. Few such pressures exist in government, which is one reason why the public sector is inherently more inefficient than the private sector.

One of TABOR's strengths is that it brings just such outside pressure to bear on policymakers, and the ratchet effect magnifies this pressure. Under Referendum C, the legislature will have no incentive to streamline government operations, and government bureaucracies will be under little or no pressure to control wasteful spending.

Elected officials will always face hard choices when looking out for the taxpayer, and this was certainly the case for Colorado this year. "Priority Colorado,"[15] a blueprint for streamlining Colorado's government, was compiled specifically to help the governor and legislature balance the budget without a tax increase. Among the proposal's key recommendations are:

- **Reducing** overhead costs and increasing efficiency across all agencies by consolidating administrative functions such as accounting and human resources;
- **Eliminating** wasteful program duplication and overlap by consolidating similar agencies and departments;
- **Making** state services more cost-effective by requiring competitive bidding for work that can be done by the private sector, following the successes of other states such as Florida;
- **Reforming** the Medicaid program, one of the biggest budget pressures in Colorado (and most other states); and
- **Improving** purchasing programs by using methods adopted successfully in other states.

Sadly, Colorado's legislative leadership dismissed this report. Rather than seizing the opportunity to restructure the government and achieve long-term savings for Colorado's taxpayers, the legislature actually increased state spending by 4.2 percent this year and then asked for a permanent tax and spending increase under Referendum C.

Conclusion

Contrary to what TABOR's opponents predicted, TABOR has not wrecked the state's economy or budget. Colorado's citizens were protected from huge structural deficits and paid less in taxes thanks to TABOR's refunds and permanent tax cuts. Moreover, the state's economy grew faster than the national average after TABOR. Regrettably, Amendment 23 put K–12 education spending on autopilot and walled it off from the rest of the budget, putting other vital programs at odds with education.

Rather than take the necessary steps to reform Amendment 23, lawmakers ignored the budget-balancing options outlined in "Priority Colorado" and chose the easy path of a $3 billion permanent tax hike. Referendum C is a serious effort to undo TABOR. Those who say that this is just a minor fix are mistaken. In reality, it violates TABOR's basic tenet of forcing the state's leaders to live within modest means. The proposed five-year "time-out" would render TABOR irrelevant by ratcheting up

15. Geoffrey F. Segal, "Priority Colorado: Balancing the Budget While Preserving TABOR and Colorado's Quality of Life," Independence Institute *Issue Paper* No. 4–2005, February 2005, at *www.independenceinstitute.org/articles/IP_4_2005.pdf* (July 21, 2005).

demand for bigger government. Breaching TABOR's limit will not sate the appetites of big spenders and entrenched government programs for taxpayer money, but instead will make it only too easy for them to ask for another time-out.

The true spirit of TABOR is to protect Colorado taxpayers from the freewheeling spending practices of elected officials and the growing burden that government places on their pocketbooks. TABOR should remain unbreached.

—*Alison Acosta Fraser is Director of the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation. Keith Miller, Research Assistant in the Roe Institute, contributed to this paper.*