

Should Wisconsin Handcuff Politicians Who Control the Public Purse?

Executive Summary

A proposed constitutional amendment would fundamentally change the framework for setting tax and spending levels in Wisconsin. The proposal, AJR 55, would impose the following constitutional constraints at both the state and local level:

- caps on spending;
- public referenda on tax increases (or extensions) and new bonding;
- a process for returning revenue growth above the spending caps to the taxpayers via automatic rate cuts; and
- detailed requirements for emergency funds and budget stabilization funds.

AJR 55 is modeled in many respects after the so-called taxpayer bill of rights (TABOR) in Colorado. Proponents note that Colorado enjoyed substantial economic growth in the 1990s, while it significantly reduced taxes as a percentage of income. Opponents also point to Colorado, but focus on the state's declining bond rating, its sharp increase in unemployment in recent years, and the fact that it ranks at or near the bottom in many areas of education spending and health care.

Although backers and opponents of AJR 55 disagree on many points, there seems to be general agreement that the resolution would significantly reduce state and local spending over time. The automatic tax rate cuts would ratchet down taxes when the economy is growing well, and the resolution would ratchet down spending when economic growth slows or halts.

Reducing or limiting the size of government is an intended effect of constitutional amendments like AJR 55. However, the proposal is also likely to have some very significant unintended consequences:

- The experience elsewhere illustrates that a government body may find it necessary to slash spending during an economic downturn, even as it is required to return "excess" funds from the prior year.
- Because setting aside reserves counts as spending, program spending may have to be cut when reserves are built up.
- During an ongoing economic slump, the constitutional requirements could require using any available revenue growth for reserves, even as the need for safety net services is increasing.
- Schools and other local governments would have great difficulty responding to reductions in state aid or redistribution of aid among localities.
- AJR 55 could impede local economic development initiatives, such as the use of TIFs.
- The amendment is likely to gradually shift the state tax burden more heavily upon lower-income taxpayers because it creates a constitutional preference for income tax rate cuts, rather than other more progressive tax relief.

The most fundamental and critical question is whether the Constitution should contain rigid standards for things such as spending caps, automatic tax reductions, and detailed reserve requirements. Should the State Constitution tie the hands of elected officials and absolve them of many of their current budget responsibilities?

Although some of the arguments for AJR 55 have a populist appeal, inflexible constitutional constraints would also have unintended consequences and could severely limit the ability of state and local governments to respond to rapidly changing fiscal conditions.

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Introduction

State legislators who pushed unsuccessfully for a property tax freeze last year are pursuing a new and more permanent method of limiting state and local spending and taxes. They have introduced a constitutional amendment that would fundamentally change how fiscal decisions are made at both the state and local level in Wisconsin.

The proposed amendment would restrict the authority of state lawmakers and local officials to increase spending and raise taxes, without first getting public approval in a referendum. The issue is heating up and could be voted on soon in one or both houses of the Legislature.

The proposed amendment

Assembly Joint Resolution 55 was introduced in November 2003 by Representative Lasee and Senator Reynolds, and it received a public hearing in December. AJR 55 would amend the Wisconsin Constitution to restrain state and local spending and tax increases. A comparable measure, SJR 56, has been introduced in the state Senate by Senator Welch, who is running against Senator Feingold for the United States Senate.

Like any constitutional amendment, the resolution must be approved in two consecutive sessions of the Legislature and then in a public referendum. The Governor has no role in the process. Senator Welch said in January that he would like to see the Legislature approve the amendment this session and again early in the next biennial session, which might bring it to a public vote for ratification as soon as April 2005.

The resolution is modeled after constitutional provisions in Colorado known as the Taxpayers Bill of Rights, or "TABOR." Specifically, AJR 55 would do the following:

- Limit "spending" growth for the state and public schools to the inflation rate plus the

change in population (or the school district's enrollment).

- Hold spending growth for counties and municipalities to the inflation rate plus the increase in new construction.
- Require approval in a public referendum for any increase in state or local taxes (except for a state emergency tax), extension of an expiring tax, or any new state or local bonding.
- Allow the Legislature to approve, by two-thirds vote in each house, short-term "emergency" tax increases that do not first have to be approved by the public.
- Establish specific requirements in the Constitution for funding levels that must be set aside in an emergency fund and a budget stabilization fund (at both the state level and for local governments).
- Require tax rates to be cut in order to return any "excess" funds to the taxpayers, unless the public votes for a spending change that allows more to be spent or saved.

The Wisconsin Manufacturers and Commerce Association (WMC) has given AJR 55 a strong endorsement and energetic support, as have several other business groups. Another organization that is actively supporting constitutional spending restraints in Wisconsin and in other states calls itself Citizens for a Sound Economy. CSE, which professes to have more than 6000 members in Wisconsin, says that it "has been building a citizen army across the country" and "has beaten back tax hikes, most recently in Alabama and Oregon." CSE pledges an "unprecedented effort" to win support for AJR 55.

The Wisconsin Council on Children and Families is among the groups that have

registered against AJR 55. Others include many local government bodies and associations, Wisconsin Citizen Action, Wisconsin Education Association Council (WEAC), and many other labor groups.

Although it appears likely that AJR 55 will be voted on in the current legislative session, the measure's proponents are considering changes to address some of the criticisms of the proposal. Because no changes have been announced to date, the analysis in this paper is based on the original version of the resolution.

Spending Caps

The proposed constitutional amendment is less rigid in the short run than the proposed property tax freeze because it allows for inflationary increases, and it factors in the growth in the state population (or, in the case of schools, changes in pupil enrollment). Nevertheless, there are a variety of potential problems with the proposed spending limitations.

First, it is important to note that the resolution defines "spending" to include any increases in the reserve funds. In other words, the constitutionally required amounts that must be put into both an emergency fund and a budget stabilization fund would count against the spending cap. That could require a significant cut in real spending for education or human services during a period when the state (or local government) is starting to come out of a recession after drawing down its reserves.

Another criticism that has been leveled at the amendment is that basing a spending limit on the consumer price index (CPI) is too restrictive. Current trends in school spending demonstrate the problem. School expenditures are largely for personnel costs, which are being driven by health insurance costs that are increasing at many times the rate of the CPI. And the spending growth calculations do not account for variables such as rising numbers of special needs students, or rising levels of incarceration.

A related concern is illustrated by the latest recession. Inflation has been very low, but the recession led to very large increases in Medicaid and BadgerCare caseloads. The proposed amendment would make it very difficult for a state or local government to cope with caseload increases.

Reserve Funds

The resolution sets out rather detailed requirements for building up state and local "budget stabilization" and "emergency" funds. In view of the state's longstanding failure to establish a rainy day fund, the commitment to build up reserve funds has some appeal. However, a basic question raised by the resolution is whether standards for building up, tapping and replenishing budget reserves should be spelled out in a document as inflexible as the state constitution.

The details of the resolution are somewhat complex and in a couple of instances are ambiguous. At the risk of oversimplifying, AJR 55 would put in place the following constitutional standards for a budget stabilization fund:

1. After the amendment is ratified, each government unit must build a budget stabilization fund at the rate of one percent of estimated spending each year – until that reserve grows to at least 4 percent, but not more than 15 percent of estimated spending.
2. Any subsequent reduction of the fund below 4 percent would trigger a requirement to increase the stabilization fund over the next four years, again at a minimum rate of one percent of spending per year. Since these increases are on top of the amounts already in the fund, it appears that the reserve might have to grow as high as 7 percent of estimated spending.
3. Money in the stabilization fund can only be spent with the approval of two thirds

of the members of each house of the legislature or two thirds of the local governing body.

In addition to that budget stabilization fund, each government unit must build up an “emergency fund,” at the rate of one percent of spending per year, but capped at 3 percent after 3 years. These funds could be expended by a majority vote of the governing body.

The combined effect of these reserve requirements is that the state and local governments must build reserves at the rate of 2 percent of spending per year for each of the first three years after ratification of the amendment, plus one more percent in the fourth year. Similar requirements would be triggered after either of the funds is tapped in a time of fiscal hardship.

As previously noted, the resolution’s definition of “spending” includes any amounts being set aside in the reserve funds. Thus, the combination of spending caps and requirements to shift money into both reserves could severely restrict the ability of elected state or local officials to appropriate sufficient funds for programs they administer.

It is unclear whether a governing body could vote to tap either the stabilization fund or the emergency fund during a year when it is constitutionally required to put funds into the reserves. That is one of a number of questions that might need to be litigated if the constitutional amendment is approved.

The ratchet effect

The overall effect of this sort of constitutional amendment is to downsize government. One reason for the downsizing is that the state or local government will probably have to cut spending if a recession reduces revenue or if there is a cut in aid from another level of government. On the other hand, if the economy bounces back a year or two later, any increased tax revenue that exceeds the spending growth cap (which is driven off the

recently reduced base) has to be returned to taxpayers by reductions in tax rates.

The net result is a ratcheting down of taxes when the economy is growing and a ratcheting down of spending when it is not. And because the Wisconsin amendment adds requirements for building and replenishing reserve funds, spending might also need to be cut in the early stages of an economic recovery.

Cyclical swings in state revenue in Colorado and Oregon have resulted in situations where the state must give back “excess” revenue from a previous year (when the economy was doing well), even while the state is beginning to slash programs because of a recessionary dip in revenue collections.

The Bell Policy Center in Colorado described the implications of the ratcheting down phenomena there:

“The state will never recover the costs associated with increases in inflation and population during the economic downturn. Reductions in mental health services, Medicaid for legal immigrants, libraries etc. are virtually impossible to restore.”

Local complications

Local governments could experience a number of other difficulties, in addition to those faced by the state. These are just a few:

State reductions in aid or property taxes – In times when money is tight, state lawmakers often cut aid to local governments (a practice sometimes referred to as “shifting the shaft”). Obviously, there have been many examples of that in recent years. Adoption of the constitutional amendment would greatly complicate matters for local officials, who would have to get approval via a public referendum just to offset those cuts with increased local revenue.

In recent years the state has also crimped local property tax collections in at least a

couple of ways. For example, the state cut local taxes on agricultural property, which significantly affected many rural areas. AJR 55 would require any local government experiencing a cut in property tax rates to hold a public referendum before it could replace the lost tax revenue by increasing tax rates.

Declining enrollment – Schools that are experiencing declining enrollment could face reduced spending limits because of the pupil component in the spending cap formula. Since some of the schools' costs are fixed, reduced enrollment does not translate into a proportional cut in real costs. Schools already face that problem to some extent in the current cost control formula, but the proposed resolution would make the statutory problem more permanent and potentially less flexible by putting it into the Constitution.

Mandated services – Many of the services delivered by local governments are mandated by the state. Counties, in particular, often have to pay for expensive services directed by a court for children in the juvenile justice or child welfare systems. The ability of local governments to comply with state mandates and court orders could be complicated greatly by constitutional limits on their spending authority.

The housing bubble – Housing valuations have skyrocketed in recent years, propelled in part by the lowest interest rates in decades. Rapidly rising assessments have allowed local governments to reduce property tax rates. However, if interest rates rise appreciably, the bubble in housing prices might burst, or at least lose some air, and assessed values could drop. If the proposed constitutional restrictions are in place when such a drop occurs, local governments would be hard-pressed to adjust rates simply to maintain current levies.

Economic development – At the municipal level, local officials have expressed concerns that the proposed constitutional changes could make it very difficult to use tax incremental financing and might raise interest costs for

projects using revenue bonding, because local bond ratings could suffer.

Emulating Colorado

Proponents of AJR 55 often point to Colorado as the model for imposing constitutional restrictions on the ability of elected officials to raise taxes or spending. The resolution's principal Assembly author, Representative Lasee, notes, "between 1995 and 2000, Colorado's personal income grew 51%, second in the nation." He adds that "Colorado shrunk the size of government by \$114 per person per year."

Critics of this type of amendment point to many other facts about Colorado, including its declining bond ratings. They reference a report on the state's economy that noted a doubling in the state unemployment rate in recent years and said:

"since year-end 2000 Colorado has had a net job loss of almost 80,000 or 3.5% compared to 1.1% for the US."

The Bell Policy Center contends that there is no evidence that TABOR contributed to Colorado's strong economic growth in the late 1990s. It notes that there was comparable growth throughout the Rocky Mountain region and that "other states with less stringent caps or more permissive tax policies grew as fast or faster."

One thing on which there is agreement is that TABOR has significantly reduced spending in Colorado; however, different people do not necessarily view the cuts in the same light. A November 2003 column by Wade Buchanan, director of the Bell Policy Center, painted the following picture of his home state:

"By 2000, we [Colorado] had fallen to 50th in K-12 spending per \$1,000 of personal income. Even during the carefree '90s, the state fell behind in per capita spending for higher education and public health. By 2000, Colorado spent less than most other states on public health

care services (as a percent of GSP), was at the bottom in on-time immunization rates, was at the bottom in prenatal care, had the highest rate of uninsured low-income children in the nation, was almost last among states in high school graduation rates, ranked almost last in higher education and the arts, and had a growing list of unfunded highway projects.”

Colorado also did not fare well in a rating of state tax systems contained in the February 2003 issue of *Governing* magazine. That rating system, which is part of the Government Performance Project, evaluated each state’s tax system on the basis of adequacy of revenue, fairness to taxpayers, and management of the system – with each of those components getting a maximum score of four stars. Out of a possible 12 stars, Wisconsin received 8 and Colorado received just 5 (including just one star for tax adequacy). The *Governing* report card said:

“TABOR has complicated Colorado’s fiscal life so much that some of its original supporters have soured on it. ‘In hindsight,’ says Republican Senator Ron Teck, ‘I wouldn’t vote for it again.’ ”

Voter approval

The most fundamental question raised by AJR 55 is whether we can trust elected officials to make fiscal decisions involving spending levels and taxes. Proponents of the amendment clearly believe that the answer is “no.” They want to constitutionally tie the hands of state and local politicians who currently have the authority and responsibility to control the purse strings in Wisconsin.

Of course, the provisions in the bill giving voters the responsibility for tax and spending choices have considerable populist appeal. The amendment would propel Wisconsin in the direction of Colorado and other western states, where tax and spending choices are primarily determined by direct vote at the ballot box. While the constitutional

amendment would give citizens much more direct control of tax and spending choices, it would take from the officials we elect the ability to make fundamental choices about fiscal policy and severely restrict their ability to respond to emergency or fluid situations.

The February 2003 issue of *Governing*, referenced above, contains a brief article about direct citizen control of fiscal decisions, including the following:

“When citizens put their hands directly on the tax levers, it often gets much harder for states to pay the bills. California, whose Proposition 13 became the poster boy for hobbling ballot box measures, is just one name on a list of states that are choking on tax policies put in place by voters. Washington, Oregon and Colorado are just a few of the others confronted with adequacy problems thanks to these measures.”

Tax Fairness and Flexibility

An argument made against the resolution by labor groups, such as the AFL-CIO, is that its intent is to “channel citizen anger away from demanding a fairer tax system in Wisconsin and our nation.” That argument is a very interesting one, but requires that we surmise the intent of the measure’s proponents. On the other hand, it appears much safer to conclude that the adoption of the amendment would lock in existing inequities and would tend gradually to make the tax system more regressive.

One problem with addressing fiscal policy issues by constitutional amendment is the inflexibility of this approach. The Colorado experience helps illustrate this concern. The *Governing* magazine report card notes:

“Colorado not only has restricted its ability to make positive changes for the future — it has locked in ill-considered changes of the past. ...That has led to a system in which localities depend heavily on their local-option sales taxes. Localities

are allowed to set their own rates and create their own exemptions from the tax base, which make it difficult for businesses to figure out their tax liabilities. Companies describe Colorado as ‘a nightmare to do business in,’ says Phyllis Resnick, of the Center for Tax Policy, affiliated with the University of Denver.”

The inflexibility of constitutional restrictions on budget decisions makes it much more difficult to address existing tax inequities. For example, in a period of strong economic growth, it would be hard for a state legislature to use increased tax revenue for refundable tax credits targeted to low-income families, because those tax credits would be counted against the spending cap.

Constitutional amendments like TABOR also tend over time to increase inequities in the distribution of the state tax burden. This is a likely outcome of AJR 55 because it would create a constitutional preference for income tax rate cuts, instead of other types of tax relief. AJR 55 requires that “excess” revenue be automatically returned to taxpayers in the form of rate reductions. At the state level, those rate cuts will most likely be made in income tax rates, thereby reducing one of the more progressive elements of state taxes. It would become much more difficult for the state to reduce exemptions and credits that help reduce the regressivity of the tax system.

These theoretical concerns about the likely effects of TABOR to disproportionately reduce taxes for the rich seem to be borne out by the actual experience in Colorado. *Governing* magazine gave the Colorado tax system a low grade in the category of tax fairness. (Colorado got two stars out of a possible four; Wisconsin got three stars.)

An analysis released early in 2003 by the Institute for Taxation and Economic Policy found that the richest one percent of Colorado taxpayers paid just 6.1 percent of their income in state and local taxes in 2002, compared to 9.9 percent of income for the 20 percent of

Coloradoans at the bottom of the income scale. When the federal offset of state and local taxes is figured in, the imbalance is even more dramatic – 4.4 percent for the top one percent of Coloradoans, versus 9.9% of income for those at the bottom.

Conclusion

The primary objective of the proposed constitutional amendment, AJR 55, is to limit spending in Wisconsin, and the amendment would no doubt achieve that objective. It would require tax cuts any time stronger economic growth pushes revenue above the spending limits and would ratchet down spending when economy is not growing.

In addition, AJR 55 would spell out in considerable detail the percentage of state and local funds that must be set aside in two different reserve funds, regardless of what else is happening with respect to revenue growth or spending needs.

Regardless of whether one believes that spending in Wisconsin needs to be reined in, the even more fundamental question is whether a constitutional amendment is the appropriate way to achieve that objective. In essence, the resolution says that we should tie the hands of elected officials because they can no longer be trusted to make decisions about spending and taxes. The resolution’s proponents believe the public should be given direct control over those fiscal choices.

The arguments for the resolution have an obvious populist appeal, but putting into the Constitution such things as requirements for spending caps, automatic tax reductions, and detailed reserve standards would severely limit the ability of state and local governments to respond to rapidly changing fiscal conditions.

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