The road to 2009

Almost three decades of constitutional amendments, legislative acts and economic ups and downs

To understand how Colorado finds itself in its current fiscal condition, it is helpful to look back at some critical decisions made by legislators and voters over the last 27 years, and at some of the economic and political factors that drove those decisions.

In **1982**, near the end of a period of strong economic growth, voters passed the **Gallagher Amendment** to shield homeowners from significant property tax increases due to rapidly rising home values. The amendment ensures the overall share of statewide property tax revenues paid by homeowners remains at roughly 45 percent of the total, with commercial property owners paying the other 55 percent.

Since Gallagher passed, the total value of residential property in Colorado has grown three times faster than the total value of commercial property. To maintain the 45-55 share split in overall revenues, the assessment rate for residential properties has been cut repeatedly while the commercial rate has remained the same.[1]

In **1991**, the legislature passed **Arveschoug-Bird**, a statutory 6 percent cap on annual growth in General Fund appropriations to operating budgets. This provision, named for its legislative sponsors, is usually referred to as a spending limit. It is better understood as a spending formula because it directs where money can be spent rather than limiting how much can be spent. General Fund revenues collected above the 6 percent are still spent by the state – just not for operating expenses, such as educating students or paying for medical care. Currently, revenues that top the 6 percent limit are largely used to fund transportation and capital construction needs.

In **1992**, voters approved the **Taxpayer's Bill of Rights**, or **TABOR**, a constitutional amendment with wide-ranging implications for all levels of state government. TABOR requires voter approval of tax increases. It also limits revenues, which at the state level cannot increase from one year to the next by more than the increase in population plus inflation. Over time, these limits have been shown to force cuts in government services,[2] and they can only be overridden by a vote of the people. Another of TABOR's provisions bars the weakening of spending limits without a vote of the people – a provision that until recently many interpreted to mean Arveschoug-Bird, originally passed by the legislature, could only be changed by popular vote.

Among the most far-reaching effects of TABOR is that it shifts the most important fiscal decisions (taxes and spending) away from elected representatives and to the voters. For the most part, state fiscal policy is no longer made by 100 elected legislators and the governor – it is made by more than 2.5 million registered voters.

In **1997**, the legislature passed **Senate Bill 1** to allow General Fund revenue to be used for transportation projects once the 6 percent Arveschoug-Bird cap has been reached. For several decades, revenues from the gasoline tax and other sources traditionally used for transportation have not kept pace with need. This is largely due to increased fuel-efficiency of automobiles – motorists pay the same amount of taxes per gallon of gasoline but drive further on that gallon. Once the Arveschoug-Bird cap is reached, SB 1 allows a little over 10 percent of state sales and use tax revenues to move to the Highway Users Tax Fund, an amount meant to represent the share of those taxes attributable to purchases of vehicles and related items such as tires and auto parts.

During the **1990s**, Colorado and the rest of the nation experienced **unusually strong economic growth**. From 1991 to 2001, Colorado was the third-fastest-growing state as measured by state gross product and by employment growth. State revenues grew with the economy, far exceeding the state's TABOR limit. Between 1997 and 2001, TABOR required the state to rebate a total of $3.2 billion in revenues that came in above the TABOR limit.

At the end of the decade, the legislature cut sales and income taxes by about $1 billion. The goal, based on an assumption of continued strong economic growth, was to stop collecting revenues that would just have to be returned.

In **2000**, voters passed **Amendment 23**, a constitutional amendment that requires per-pupil funding for K-12 education to increase by inflation plus 1 percent each year through FY 2010-11. The 1 percent kicker expires in FY 2011-12, but per-pupil K-12 funding must still increase each year by inflation thereafter. The purpose of Amendment 23 was to help Colorado's funding for public schools catch up to the national average.

Following the Sept. 11 terrorist attacks and the stock market bust in **2001-02**, the nation (and Colorado) experienced a significant **economic downturn**. This, combined with the effects of the tax cuts enacted by the legislature, resulted in an unprecedented drop in state revenues. Because the Colorado Constitution requires a balanced budget, this in turn forced the state legislature to slash state services.

Meanwhile, faced with a continued gap in transportation funding, in **2002** the legislature passed **HB 1310** to transfer two-thirds of the General Fund excess reserve to the Highway Users Tax Fund. The other third is set aside to build, repair and maintain state buildings. The General Fund excess reserve is what is left over after overall revenues satisfy all other obligations, including General Fund operating budgets, the 4 percent statutory reserve, and transfers to Transportation under SB 1.

Interactions among these and other constitutional and statutory provisions have often produced consequences beyond those intended.

The interaction of the Gallagher and TABOR amendments, for example, caused a major decline in the local tax base for public schools, requiring significant backfill from the state. From 1989 to today, the local share of education funding has dropped from 57 percent to 36 percent – a historic shift toward state funding for public schools.[3] In part to counter this, in 2006 the legislature voted to remove a provision of the 1994 School Finance Act mandating that local school districts reduce their mill levies whenever they experienced TABOR surpluses. Some have challenged the Legislature's authority to take this step, and the matter is pending before the state Supreme Court.

The decline in the local property tax base in turn helped spur passage of Amendment 23. By 2000, Colorado had slipped well below the national average for funding its schools. By requiring funding for public schools to increase faster than inflation, Amendment 23 was designed to help Colorado's schools catch up.

Protecting public school funding from cuts during the economic downturn, Amendment 23 exacerbated the problem for other parts of the budget. As a result, budget cuts fell heavily in other areas. By 2004-05, appropriations to colleges and universities were 21 percent below where they were in 2001-02, despite continued inflation and enrollment growth.

The tax cuts enacted by the legislature before the economic downturn contributed to the severity of the revenue shortfall in 2002-03. While the intention may have been to stop collecting excess revenues that would have to be returned as the economy grew, the actual effect was to greatly exacerbate the decline in revenues as the economy stalled out.

And as revenues finally started to recover with the economy in 2004, Colorado began to feel the full effects of the so-called ratchet mechanisms in both TABOR and the Arveschoug-Bird formula, which lowered both the state revenue limit and the General Fund allocation cap by roughly $1 billion during the economic downturn. The effect was to lock in recessionary spending levels. It was comparable to a reservoir that could not be refilled after severe drought, making the low-water mark from the drought the new high-water mark for the future.

In **2005** voters passed **Referendum C** to bypass TABOR's ratchet effect and allow state revenues to recover with the economy. Ref C allows the state to retain all revenues it collects for five years (FY 2005-06 through FY 2009-10), regardless of the TABOR limit. For FY 2010-11 and beyond, Ref C lets the state government retain all revenues up to a new "excess state revenues cap" – a cap that still is based on growth in population and inflation but that no longer has a ratchet effect during downturns.

In its first three years, Referendum C allowed the state to retain an additional $3.6 billion, or about 14 percent more than it otherwise would have. Roughly 60 percent of that could be spent on General Fund services, allowing the budgets for K-12 schools, higher education, health and other programs to partially, though not entirely, recover from the downturn.[4]

But because Referendum C did not address the ratchet in the Arveschoug-Bird formula, nearly 40 percent of the revenues it generated (or $1.4 billion) was automatically transferred to transportation ($1.17 billion) and capital construction ($243 million).

In **2008**, the nation entered its **second major economic downturn in a decade**, with state revenues expected to drop by at least $1 billion from previous projections. And while the new revenue limit established by Referendum C will allow revenues to recover with the economy, the ratchet that remains in the Arveschoug-Bird formula is expected to reduce the amount of these revenues that can be spent on General Fund programs by $1 billion or more each year in the future.

That is how we got to where we are today. One clear lesson from the recent past is that an attempt to address a specific problem will often have unintended consequences – and often in areas seemingly unrelated to the original purpose of the measure. As Colorado moves forward from here, we need to be especially attentive to the effect of our actions on all areas that matter to our future.

This summary is adapted from *Looking Forward, Colorado's Fiscal Prospects after Ref C*, the Bell Policy Center, Colorado Children's Campaign and the Colorado Fiscal Policy Institute, 2007. (Available at www.thebell.org)

End notes

[1] Colorado Division of Property Taxation 2006 Annual Report, Section II, pages 10 and 14.

[2] *Ten Years of TABOR*, The Bell Policy Center, 2003.

[3] *Understanding Mill Levy Stabilization in Colorado, Colorado Children's Campaign*, April 9, 2007.

[4] *Looking Forward, Colorado's Fiscal Prospects after Ref C.*