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MEMORANDUM

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December 6, 2010

TO: Interested Persons

FROM: Kate Watkins, Economist, 303-866-6289

SUBJECT: State Spending Limitations: TABOR and Referendum C

This memorandum provides an overview of the Taxpayer's Bill of Rights (TABOR) spending limit¹ and the Referendum C cap.²

Summary

Since 1992, state fiscal year spending has been subject to TABOR, which limits spending of TABOR revenue to TABOR revenue retained or spent in the prior fiscal year grown by inflation and population growth. Referendum C, approved by voters in 2005, allows the state to retain and spend money from existing revenue sources above the TABOR limit each year beginning in FY 2005-06. The state may spend all revenue subject to TABOR for five years through FY 2009-10. Beginning in FY 2010-11, the state may retain and spend revenue above the TABOR limit up to a capped amount commonly called the "Referendum C cap." The Referendum C cap will grow from FY 2007-08 TABOR revenue levels by inflation plus population growth each year. In effect, Referendum C eliminated the "ratchet-down"³ effect, where spending decreases when revenue falls below the TABOR limit.

¹Article X, Section 20, Colorado Constitution.

²Section 24-77-103.6, C.R.S.

³The TABOR limit is based on prior year TABOR revenue levels grown by inflation plus population growth. The ratchet-down effect is a term commonly used to describe when revenue subject to TABOR falls below the TABOR limit resulting in the following year's limit falling below where it would have been had revenues met or exceeded the limit in the prior fiscal year.

The TABOR Amendment

Voted into the state constitution by the people in 1992, TABOR contains a number of substantive provisions that apply to districts,⁴ including: limitations on government spending of certain revenue, voter approval for certain types of tax increases, and voter approval for revenue changes. Each of these provisions are discussed below in the context of *state* spending. This memorandum does not address TABOR's application to local governments.

TABOR spending limit. TABOR limits the amount of revenue that the state may spend each fiscal year. Revenue in excess of the TABOR limit, commonly referred to as the "TABOR surplus," must be refunded to taxpayers, unless voters approve a revenue change as an offset. The formula for determining the state TABOR limit can be summarized as follows:

$$\text{State TABOR Limit} = (\text{Prior Year's TABOR Revenue}) \times (1 + \text{Inflation} + \text{Population Growth}) \\ + (\text{Voter-Approved Revenue Changes})$$

Inflation is measured by the Denver-Boulder-Greeley Consumer Price Index inflation rate published by the U.S. Bureau of Labor Statistics. Population growth is based upon estimates provided by the U.S. Census Bureau, which are subject to updates requiring periodic adjustments.

Voter approval for revenue changes. TABOR requires voter approval to retain revenue above the TABOR limit. An example of a statewide voter-approved revenue change is Referendum C, which is discussed below.

Voter approval for tax increases. TABOR also requires voter approval for any new tax, tax rate increase, mill levy increase, an increase in a property assessment valuation ratio, extension of an expiring tax, or a tax policy change causing a net tax revenue gain. Income tax rate increases or a new state definition of taxable income may not take effect until the next tax year. TABOR also prohibits certain types of taxes and provides that income tax law changes shall require all taxable net income to be taxed at one rate.

An example of a voter-approved tax increase is Amendment 35, which passed in November of 2004. Amendment 35 amended the constitution to increase taxes on cigarettes and other tobacco products and targeted the new revenue to fund health care and tobacco education and cessation programs. No voter approval is needed to decrease a tax imposed by statute.

Referendum C

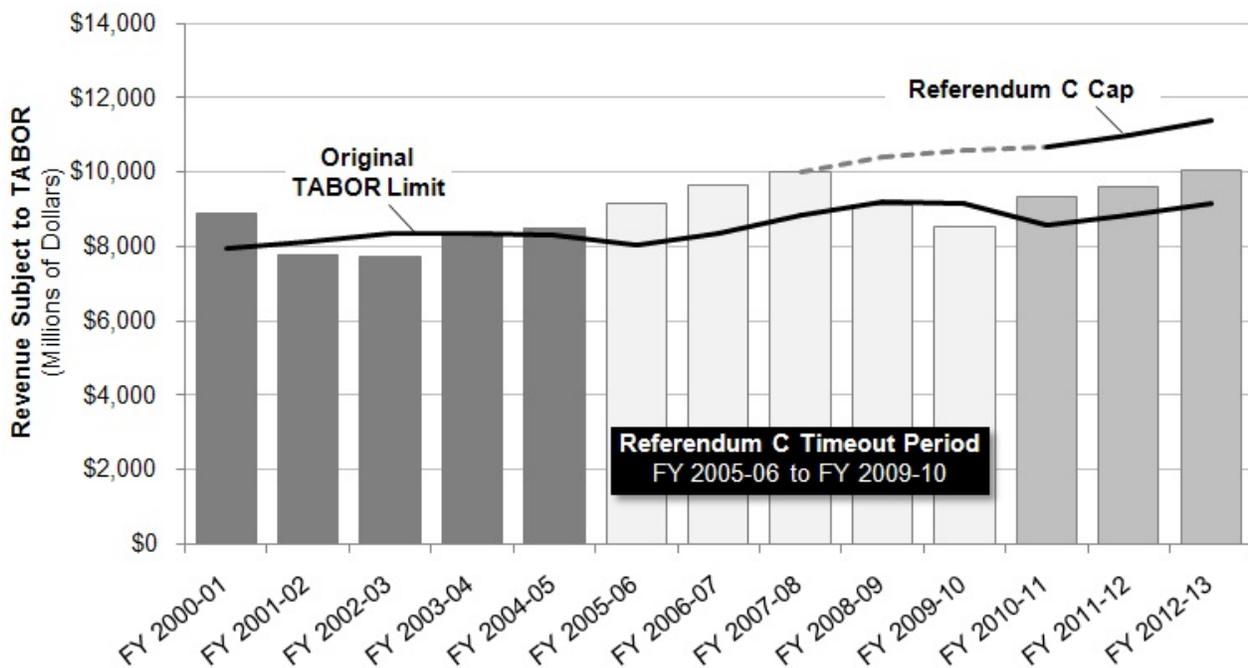
Referendum C, passed by voters in 2005, is a voter-approved revenue change that allowed the state to retain and spend all excess TABOR revenue collected above the TABOR limit for five years, from FY 2005-06 through FY 2009-10. This period of time is commonly referred to as the "five-year timeout period." After the timeout period, Referendum C allows the state to retain and spend all excess revenue up to a "cap", which is equal to the highest total state revenue for a fiscal

⁴Districts include state and local governments, excluding enterprises.

year during the timeout period adjusted by inflation plus population growth for each subsequent year. Revenue collected above the cap will be refunded to taxpayers via the TABOR refund mechanisms, which are discussed later in this document. FY 2007-08 will be the year with the highest revenue during the timeout period from which the cap will grow by inflation plus population growth.

Figure 1 shows actual and forecast revenue subject to TABOR and the TABOR limit from FY 2000-01 through FY 2012-13 based on the September 2010 Legislative Council Staff forecast. Additionally, the dotted line shows the projected Referendum C cap, growing from FY 2007-08 revenue. The line is dotted until FY 2010-11 because the Referendum C cap does not come into effect until then.

Figure 1
Revenue Subject to TABOR and the TABOR Limit



Source: Office of the State Controller.

*Legislative Council Staff projections based on the September 2010 forecast.

The state retained a total of \$3.6 billion as a result of Referendum C. The way this money is required to be spent is described later in this document.

What is the TABOR Ratchet-Down Effect?

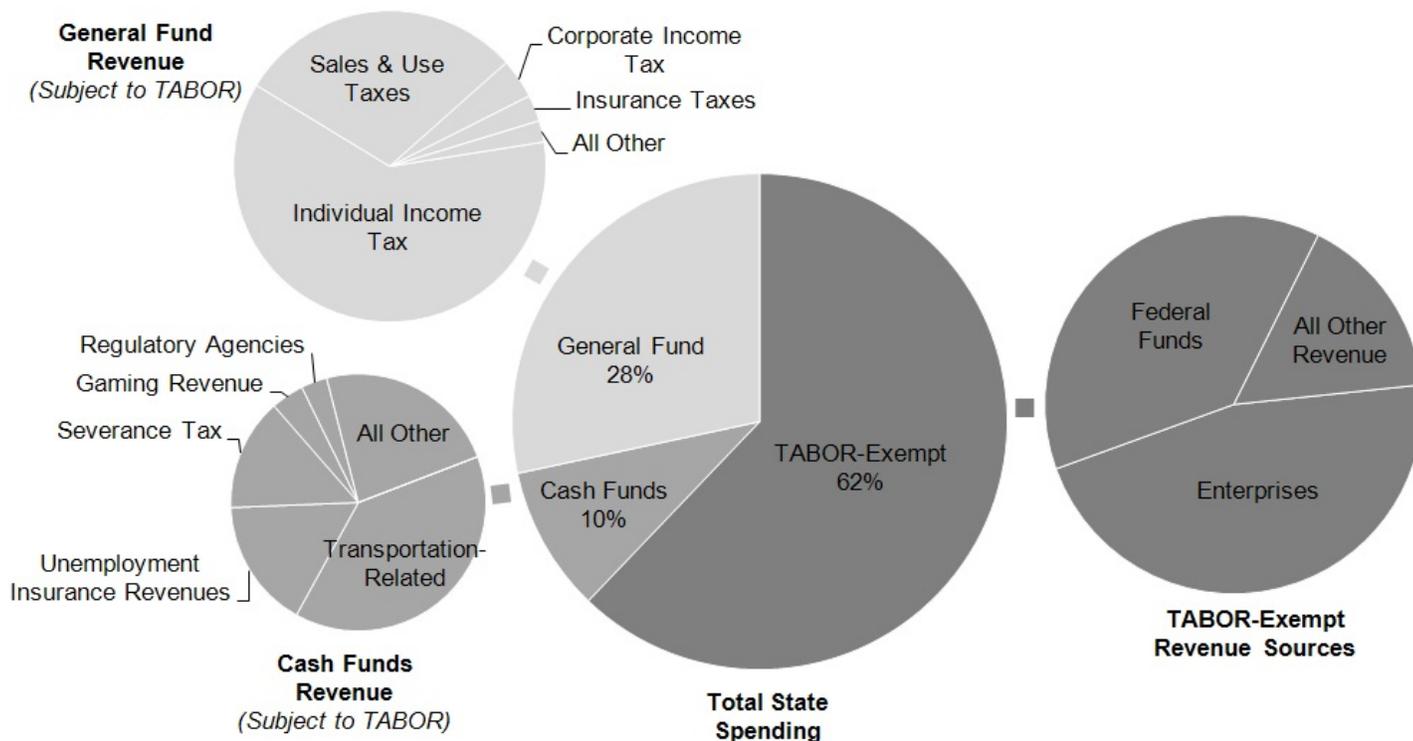
Prior to Referendum C, if TABOR revenue was less than the TABOR limit, the following year's limit was reduced to the level of reduced revenue plus inflation and population growth. The term "ratchet-down" has been used to describe the lowering of the limit. The ratchet-down effect occurred in FY 2001-02 and FY 2002-03 as a result of depressed revenues during the economic recession. In effect, Referendum C kept the state from ratcheting-down during the recession which

began December 2007 because the Referendum C cap will be calculated based on FY 2007-08 pre-recession revenue levels. Referendum C effectively eliminated the possibility of ratcheting-down because the cap grows by inflation plus population growth over the prior year's cap regardless of whether revenue subject to TABOR is above or below the cap.

What Revenue is Subject to TABOR and Referendum C?

The "TABOR base" is a term commonly used to describe revenue subject to TABOR spending limits. The TABOR base, which is used to calculate the following year's TABOR limit, is equal to the lesser of the TABOR limit or the amount of TABOR revenue collected during the prior fiscal year. Not all revenue is subject to TABOR spending limits. The TABOR limit *excludes* federal funds, gifts, employee pension contributions and fund earnings, damage awards, and property sales. Therefore, revenue from these sources is not included in the TABOR base. Additionally, enterprises are not subject to TABOR and are therefore not included in the TABOR base. In FY 2008-09, the spending of revenue subject to TABOR represented 38 percent of the total state budget. Figure 2 shows state expenditures by revenue source for FY 2008-09, including the distribution of TABOR versus TABOR-exempt revenue.

Figure 2
State Expenditures by Revenue Source, FY 2008-09



Source: Office of the State Controller and Joint Budget Committee Staff.

Note: Reappropriated funds are excluded from figures. Starting FY 2009-10 the Unemployment Insurance program gained enterprise status.

What is an Enterprise?

Enterprises, which represented the largest share of TABOR-exempt revenue in FY 2008-09, are self-supporting, government-owned businesses that receive revenue (usually from fees) in return for the provision of goods or services, and have the authority to issue revenue bonds. An enterprise must be designated so by the General Assembly, may only receive up to ten percent of its annual revenue from state and local government sources, and must otherwise be financially independent. Current enterprises include higher education auxiliary facilities, the State Lottery, College Assist and CollegeInvest, correctional industries, and the state nursing home system. More recently, the Unemployment Insurance Program, the State Fair Authority, the Student Obligation Bond Authority, the Division of Wildlife, and the Colorado Tolling Enterprise were granted enterprise status.

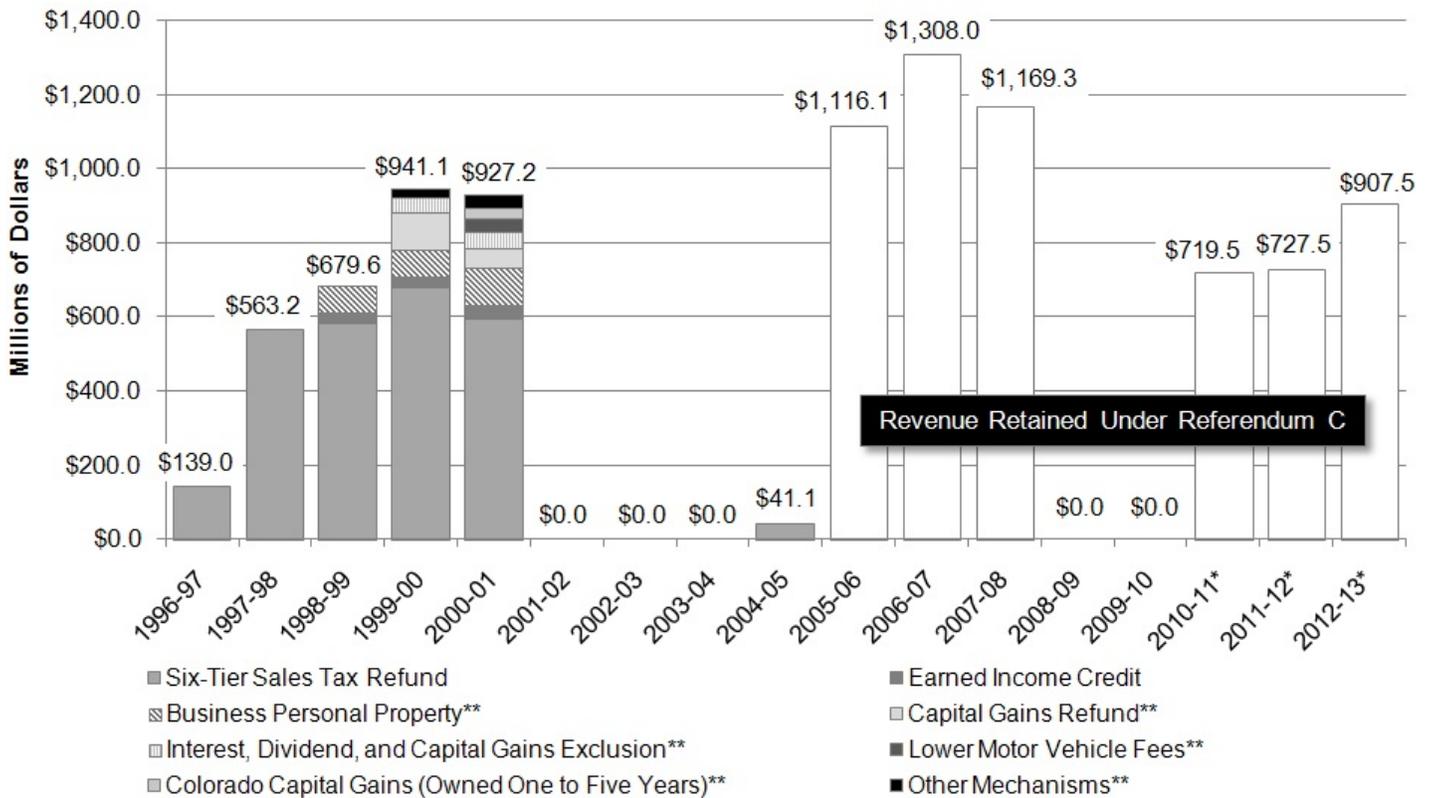
Changes in Enterprise Status. The TABOR base must be adjusted when a program's enterprise status changes. When a program becomes an enterprise, its revenue is no longer counted as TABOR revenue and the TABOR limit is reduced by that amount. Similarly, when a program loses enterprise status, its revenue is subject to the TABOR limit and the TABOR limit is adjusted upward accordingly.

How is the TABOR Surplus Refunded?

TABOR requires that the state refund any excess revenue collected over the limit to taxpayers within one year unless voters approve a revenue change that allows the state to keep all or part of the TABOR surplus. The General Assembly may statutorily determine how this "surplus" revenue is refunded. Figure 3 shows TABOR surplus refunds by mechanism from the first surplus year through the forecast period of FY 2010-11 through FY 2012-13. During the Referendum C five-year timeout period, the state was allowed to retain all surplus revenue, as is indicated in Figure 3 by the white bars. After the five-year timeout period, which ended in FY 2009-10, revenue collected above the Referendum C cap will be refunded to taxpayers via the TABOR refund mechanisms, which are detailed below.

To date, there have been six years when the state experienced a TABOR surplus. The mechanisms that refunded the surplus are shown in Figure 3. In total, Colorado taxpayers received nearly \$3.3 billion in refunds from the six surplus years. From FY 2010-11 through at least FY 2013-14, state revenue forecasts do not anticipate any TABOR refunds as revenue is not expected to exceed the TABOR limit.

**Figure 3
TABOR Surplus Refunds by Mechanism**



Source: Colorado Department of Revenue.
 *Legislative Council Staff projections based on the September 2010 forecast.
 **These refund mechanisms have been repealed.
 Note: Surplus is shown in the year revenue was collected; refunds occurred in the following year.

What are the TABOR Refund Mechanisms Under Current Law?

Over the course of TABOR's history, there have been 21 different refund mechanisms. However, under current law there are three: the six-tier sales tax refund, the Earned Income Tax Credit (EITC) refund mechanism, and the temporary income tax rate reduction. Each of these mechanisms is described in greater detail below.

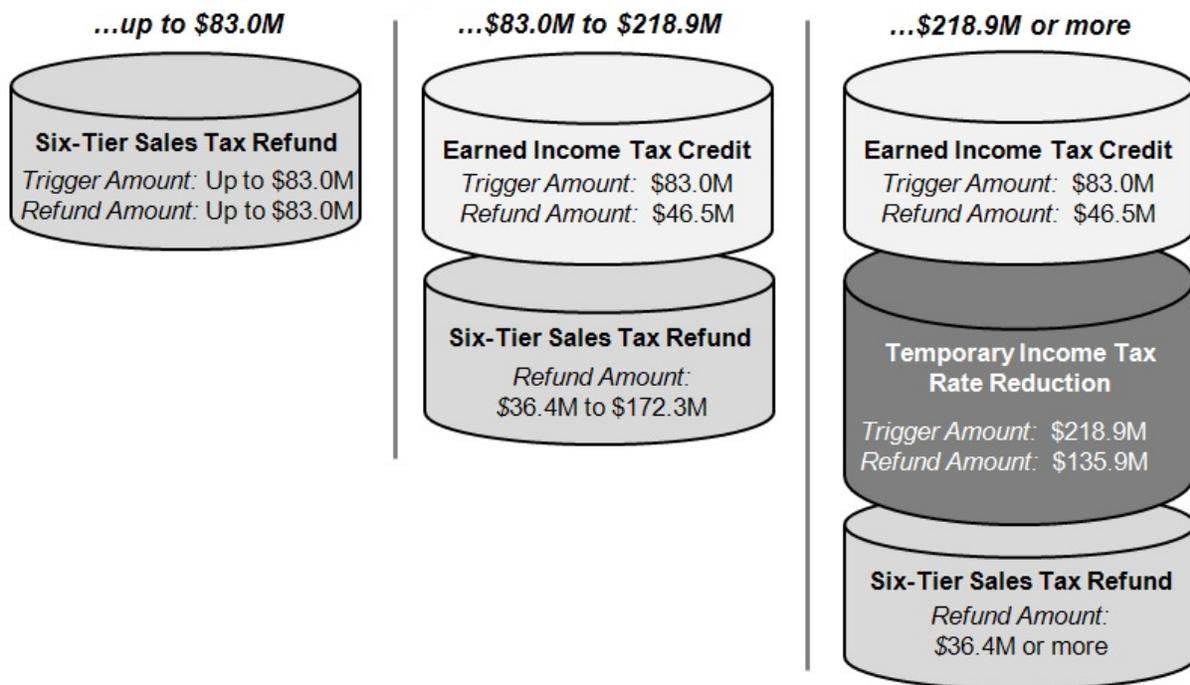
Six-tier sales tax refund. This refund mechanism allows individuals to receive a state sales tax refund based on six modified federal adjusted gross income tiers and the filing status of the taxpayer. The Department of Revenue sets the dollar amount of each tier and each tier's refund based on set percentages of the refund and number of taxpayers in each tier. The refund is distributed to the six tiers when the TABOR surplus is large enough to support at least a \$15 refund for each Colorado taxpayer. For instance, in FY 2010-11, this threshold is an estimated \$44.9 million. In the event of a surplus that is less than the \$15 per taxpayer trigger, an equal refund would be provided to each taxpayer regardless of income.

In terms of prioritization, the six-tier sales tax refund mechanism can be viewed as both the first and the last refund mechanism. It may be the first and only refund triggered in a year when the surplus is not sufficient to trigger other mechanisms. This was the case in FY 2004-05. In years when the surplus is large enough to trigger other refund mechanisms, the six-tier sales tax refund mechanism refunds any surplus revenue remaining after the other refunds are fully funded.

Figure 4 shows how the TABOR surplus would be refunded under current law based on the size of the surplus. All dollar amounts are estimates for FY 2010-11 based on the September 2010 Legislative Council Staff forecast.

Figure 4
TABOR Refund Scenarios Under Current Law

*If, in FY 2010-11, the TABOR Surplus was...**



Source: Dollar amounts are based on the September 2010 Legislative Council Staff forecast.
*This figure is for illustrative purposes. No TABOR surplus is projected for FY 2010-11.

Earned Income Tax Credit (EITC) refund mechanism. The Colorado EITC "piggybacks" off of the federal EITC, which provides a tax credit to individuals who work but do not earn high incomes. Qualifying Colorado taxpayers may receive up to 10 percent of the federal credit amount in TABOR surplus years. Only Colorado taxpayers who claim the federal credit may claim the state credit. For tax years 2009 and 2010, the federal American Recovery and Reinvestment Act (ARRA) expanded the EITC. To qualify for the EITC in these tax years, earned income and adjusted gross income for individuals must each be less than:

- \$43,279 (\$48,279 married filing jointly) with three or more qualifying children;
- \$40,295 (\$45,295 married filing jointly) with two qualifying children;
- \$35,463 (\$40,463 married filing jointly) with one qualifying child; and
- \$13,440 (\$18,440 married filing jointly) with no qualifying children.

The EITC refund mechanism is triggered when the TABOR surplus exceeds a threshold amount which is increased by a growth factor equal to Colorado personal income growth each year.

Temporary income tax rate reduction. This refund mechanism will first become available for TABOR surplus years starting in FY 2010-11. Under the refund mechanism, the state income tax rate would be temporarily reduced from the current rate of 4.63 percent to 4.50 percent. The rate reduction will occur in the tax year following the fiscal year in which there is a surplus. For example, if there were a surplus in FY 2010-11, the income tax rate would be temporarily reduced in tax year 2011.

The temporary income tax rate reduction is triggered when the state experiences a surplus equal to at least the EITC refund mechanism trigger plus the projected amount of the income tax rate reduction. As Figure 1 shows, this amount is projected to be \$218.9 million for FY 2010-11 (a \$135.9 million tax rate reduction plus the \$83.0 million EITC threshold).

How Is Revenue Retained by Referendum C Spent?

Retained Referendum C revenue (revenue above the allowable TABOR limit but below the Referendum C cap) is statutorily⁵ required to be spent on the following:

- health care;
- education, including public elementary and high schools, higher education, and capital construction projects;
- firefighter and police retirement plans; and
- strategic transportation projects.

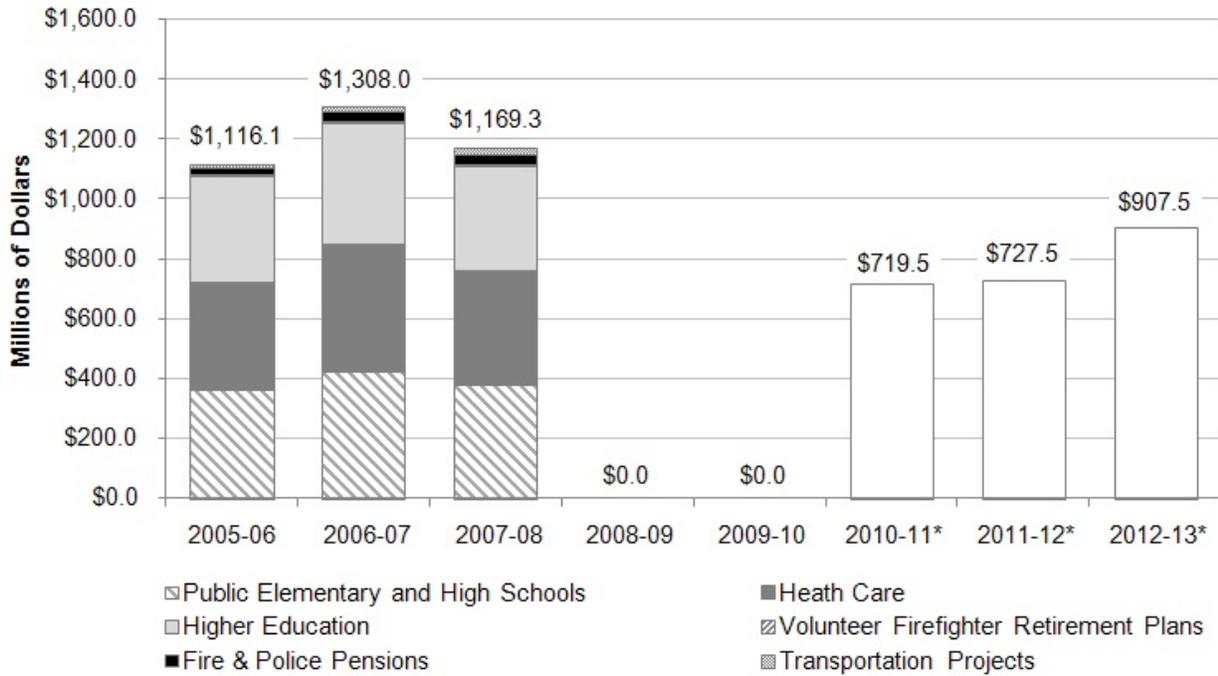
State statute⁶ allows that the first \$55 million in FY 2005-06, \$95 million in FY 2006-07, and \$125 million each year thereafter to be spent on any of the areas listed above. Any remaining revenue is required to be distributed evenly in thirds to public elementary and high school education,

⁵Section 24-77-103.6, C.R.S.

⁶Section 24-77-104.5, C.R.S.

higher education, and health care. The state retained a total of \$3.6 billion as a result of Referendum C during the five-year timeout period. Figure 5 shows the distribution of the retained revenue. No revenue was retained during FY 2008-09 and FY 2009-10 due to depressed revenue resulting from the economic recession. Based on the September 2010 forecast, \$719.5 million, \$727.5 million, and \$907.5 million will be retained in FY 2010-11, FY 2011-12, and FY 2012-13 respectively.

Figure 5
Spending of Revenue Retained by Referendum C



Source: Joint Budget Committee Staff.

*Legislative Council Staff projections based on the September 2010 forecast.