Gallagher Amendment Whitepaper (8/29/18)

The Gallagher Amendment was part of a constitutional change to Colorado's property tax system proposed by legislative referendum as "Amendment #1" and adopted by Colorado voters in 1982. The amendment is named after former State Senator Dennis Gallagher, who was one of the prime sponsors of a successful amendment to the proposed language of "Amendment 1" that limited the potential contribution of residential real property to the state's total property tax pool.

While the Gallagher Amendment was intended to address specific challenges at a specific time when it was proposed and passed in 1982, changes in real estate market conditions over time and the passage of subsequent constitutional amendments which retroactively affect the Gallagher Amendment have created unforeseen and unintended consequences that are causing significant challenges for Colorado today.

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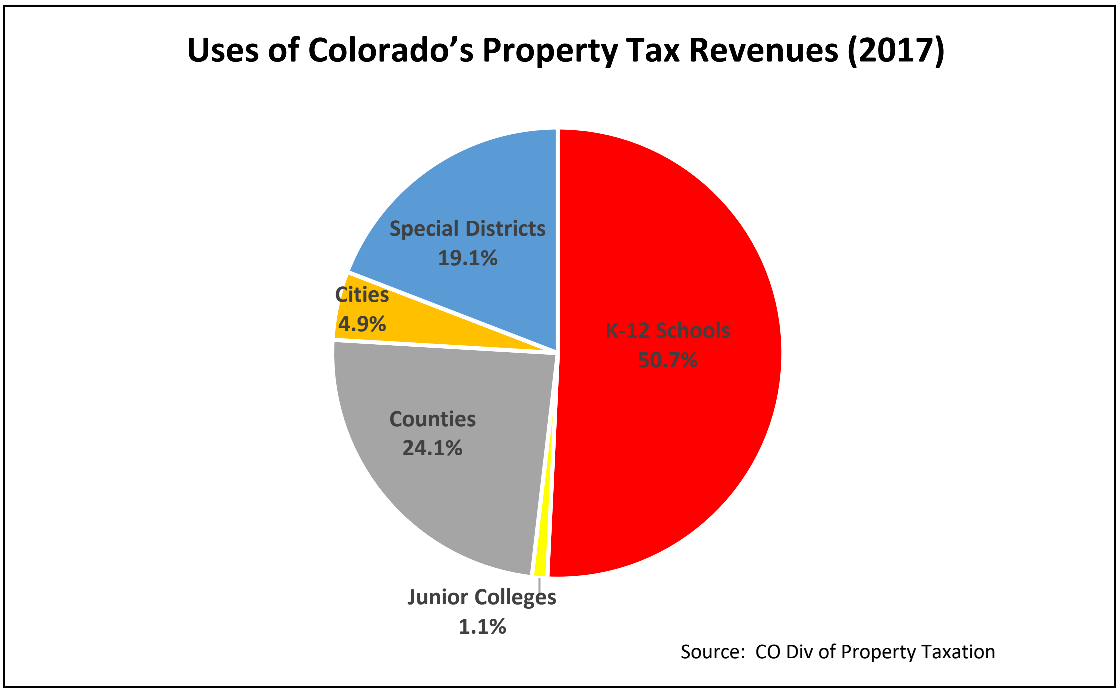
What is property tax?

Property taxes are used to pay for local government services. In 2017, just over 50% of property tax revenues were used to fund local K-12 school districts; the remainder supports local services provided by counties, special districts, and, to a lesser degree, cities and towns (which are primarily funded by sales taxes), including fire protection, recreation, water and sewer infrastructure, libraries and county road maintenance. Property taxes in Colorado are assessed, collected and spent locally.

Colorado has not imposed a state level property tax since 1964, and therefore property tax revenues do not pay for any state services like highways, prisons, or higher education; state services are paid for through a combination of the state income tax, the state sales tax, motor fuel taxes fees and other tax revenues. While property taxes are a significant source of funding for local governments in all states, only 14 states levy a statewide property tax. [1]



[1] From http://www.taxpolicycenter.org/briefing-book/how-do-state-and-local-property-taxes-work

> …[nationally] property taxes are a significant source of local government revenue, [but] they are a very small revenue source for most states. State governments levy property taxes in 36 states, collecting $13 billion in revenue from such taxes in 2013—about 1 percent of own-source general revenue ("own-source" revenue excludes intergovernmental transfers). Vermont relied on property taxes for 26 percent of state own-source general revenue in 2013, far and away the highest percentage in any state. Property taxes were 5 percent or more of state revenue in only six other states: Arkansas, Michigan, Montana, New Hampshire, Washington, and Wyoming. Fourteen states did not levy a state-level property tax.

How is Colorado's property tax calculated?
Colorado's property tax revenue is calculated by the following simple formula which includes three parts:

1) the "Base Property Value",
2) the "Assessed Property Value", and
3) the "Mill Levy.

<u>"Base Property Value"</u>
Nationally, it is common practice to establish the property tax base by starting with the market value of property. In Colorado, the property tax base is established every other year through a "reassessment" process performed by your locally-elected County Assessor. Changes in market conditions will result in your property's base value fluctuating with each reassessment.

<u>"Assessed Property Value" and "Assessment Rate"</u>
In many states, including Colorado, the base property value is amended by an "Assessment Rate" which is established for each class of property (Residential, Commercial, Agricultural, etc) in order to allow different classes of property to contribute to the total tax burden at different levels.[2] The Assessment Rates are set by law and in the state constitution. Different classes of property are assessed at different rates; for example, Commercial property (an office building) is assessed at 29% of its market value, whereas Residential property (a house) is assessed at a fluctuating rate which is currently 7.2%.

The "Assessed Value" is the taxable value of your property and is determined by multiplying your property's base market value by an "Assessment Rate" which has been established for your class of property. Because the taxable Assessed Value of your property is determined every two years by your local County Tax Assessor, your "Assessed Value" lags the actual market value by two years.

<u>"Mill Levy"</u>
The mill levy is the rate of tax that is applied to the assessed value of a property to determine property tax revenue. One mill is one dollar per $1,000 dollars of assessed value, therefore the "tax rate" for one mill would be .001 (1/1000). For example, if your property has a taxable value of $100,000, and the mill levy in your community is 1 mill (or an effective "tax rate" of .001), you'll pay $100 in taxes. Tax mills are approved by voters, and the mill levy on your property will include all of the various tax mills which voters in your jurisdiction (city, county, state and any special districts) have approved over the years.

Property Tax Revenue	=	**Assessed Property Value** (The taxable value of property.) Base Property Value (based on the market) **X** Assessment Rate (set by law and in the constitution)	X	**Mill Levy** (The rate of taxation.)

[2] For more detail on classification and how the process works in other states, see http://datatoolkits.lincolninst.edu/subcenters/significant-features-property-tax/The_Property_Tax_Base.aspx and http://datatoolkits.lincolninst.edu/subcenters/significant-features-property-tax/Report_Property_Tax_Classification.aspx

Here's a sample of an actual property tax statement for a resident of Jefferson County:

JEFFERSON COUNTY COLORADO FOUNDED 1861

REAL PROPERTY TAX STATEMENT
Tax Year / Payable
2017 2018

TIM KAUFFMAN, TREASURER
100 Jefferson County Pkwy, Suite 2520 Golden, CO 80419-2520
(PH) 303-271-8330 (FAX) 303-271-8359
http://jeffco.us/treasurer

PIN: **3001**	AIN: **29-**	TAG: **0018**	Bill #: **61**	Mort Code: **15114**

Property Address:

Current Owner

Legal Description

See reverse side of this form for additional information.
Payments may be made online at jeffco.us/treasurer.

Tax Authority / Other Charges	$ per thousand of assessed value Tax Mill Levy	Original Amount Due
R1 SCHOOL BOND REDEMPTION FUND	4.5500	83.21
R1 SCHOOL GENERAL FUND	38.3280	700.99
*CAPITAL EXPENDITURES	0.8280	15.14
*CONTINGENT FUND	0.0030	0.05
*COUNTY GENERAL FUND	14.1650	259.06
*DEPT OF SOCIAL SERVICES	1.2020	21.98
DEVELOPMENTAL DISABLITY FUND	1.0000	18.29
*LIBRARY FUND	4.0000	73.16
*ROAD & BRIDGE FUND	1.2220	22.35
WESTMINSTER	3.6500	66.75
*URBAN DRAINAGE&FLOOD C SO PLAT	0.0570	1.04
*URBAN DRAINAGE&FLOOD CONT DIST	0.5000	9.14
Sub Total	69.5050	1,271.16

Valuation	Actual	Assessed
Total	254,014	18,289

Messages

- Complete Legal Description is on file in the Assessor's Office.
- A copy of your tax statement was sent to your mortgage company

As you can see:

- The "Actual" property value is $254,014, and the "Assessed" value is only $18,289, therefore the "Assessment Rate" for this residential class of property is 7.2% ($18,289/ $254,014).
- One of the assessed taxes which Jefferson County voters had previously approved is to support the "Library Fund" which has a "Mill Levy" equal to 4.0 mills ($4.00 for each $1,000 of assessed property value), which means this homeowner pays $73.16 each year to support the Library Fund (4.0 mills x $18.289 of assessed value).

<u>Test Your Property Tax IQ:</u>

Q: How much would you pay in taxes if you owned a $300,000 house and your mill levy was 60 mills?

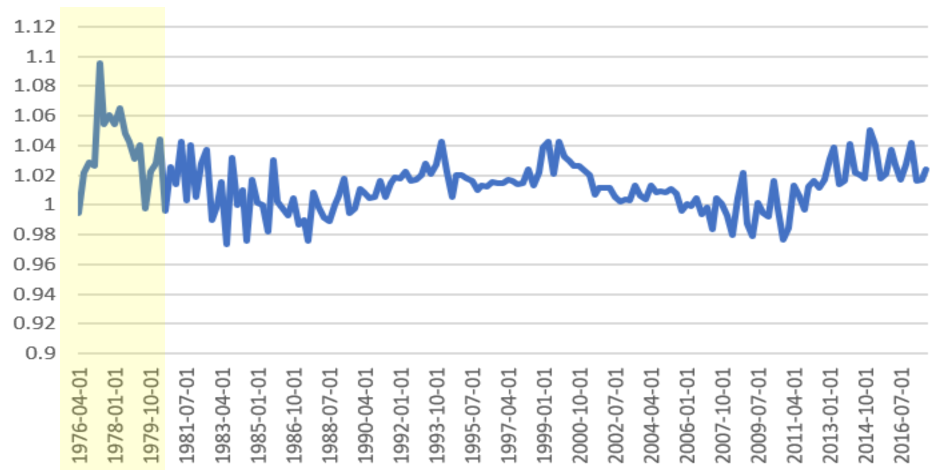
A: First, start with the base market value of your property = $300,000

Second, multiply your base market value by the Assessment Rate (7.2% for residences) to determine your Assessed Value = $21,600

Third, multiply your Assessed Value by your mill levy (60 mills/ $1000) = $1,296 in property tax.

Why did Coloradans adopt the Gallagher Amendment in 1982?
“Amendment 1” – which included the Gallagher Amendment – was the culmination of a property tax revolt that began in Colorado in the late 1970’s as a result of growing frustration among Colorado voters about the increasing property tax which they were paying as their property values grew. The late 1970s in Colorado were a time of extremely high inflation and high growth, especially along the Front Range, and these two factors contributed to causing property values to grow at a rate of about 1% per month from 1969 through much of the 1970s and beyond. Taxing authorities were either unwilling or unable to alleviate this frustration by lowering their mill levies enough to offset the growing property values and maintain a consistent tax revenue.

Colorado Home Prices Spiked in the late 1970’s
(% Change in Quarterly Denver-Aurora-Lakewood Home Prices)



Source: Federal Reserve Economic Research Division

Additionally, prior to the adoption of the comprehensive property tax reforms in “Amendment 1”, there was no statewide oversite to ensure that each county assessed property values in a consistent manner. Some counties chose not to reassess the value of some classes of property (i.e. Residential) in order not to increase the tax burden for those property owners, and some counties chose not to reassess ANY of their property during some scheduled reassessment cycles.

In 1982, the legislature formed a committee to study the problem and recommend solutions. House Concurrent Resolution (HCR) 82-1005, which included the Gallagher Amendment and was later referred to the ballot as “Amendment 1”, was the culmination of the committee’s effort to find a workable solution to the problem of increasing Residential property taxes.

How did “Amendment 1” and the Gallagher Amendment affect Colorado property taxes?
“Amendment 1” did several things:

1. “Amendment 1” reduced the tax burden for all property owners by reducing the property assessment rates for all classes of property.

Property Class	**Assessment Rate BEFORE Gallagher**	**Assessment Rate AFTER Gallagher**
Agricultural	30%	29.0
Commercial	30%	29.0
Industrial	30%	29.0
Residential	30%	Fluctuates, currently 7.2%
State Assessed	30%	29.0
Vacant Land	30%	29.0

(“Natural Resources” (i.e. mines and oil/gas wells) are taxed differently than land and buildings and based on the value of the resources produced.)

2. The Gallagher Amendment froze the ratio of the total value of Non-Residential and Residential property. When the Gallagher Amendment was proposed in 1982, Non-residential property made up 55% of the state’s total aggregate property valuation, and Residential property made up the other 45% of that total valuation. The Gallagher Amendment froze these relative ratios at the 1982 levels so that Residential property in Colorado would always constitute approximately 45% of the total property valuation.

   The Gallagher Amendment further required that the legislature adjust the Assessment Rate for Residential property every two years (up or down as might be necessary) to ensure that the aggregate statewide valuation for Residential property continue to represent only 45% of the state’s total property valuation. However, while the legislature HAS <u>lowered</u> the Residential Assessment Rate as the Gallagher formula required during times when the total value of Residential property was outpacing the value of Non-Residential property, the subsequent passage of the TABOR Amendment in 1992 has been interpreted to prohibit the legislature from conversely <u>raising</u> the Residential Assessment Rate when the Gallagher formula would accommodate an increase; in short, Gallagher has created an unsustainable and unstoppable downward spiral of the Residential Assessment Rate.

3. “Amendment 1” simplified the assessor’s methodology for determining the actual value of property. Prior to this amendment, different county assessors would use different appraisal methods involving some seven factors. Amendment #1 established a uniform appraisal methodology for all counties, involving just three factors of cost, market, and income.

4. “Amendment 1” created a statewide audit to ensure that every county assessed the value of property in a consistent and equitable manner. Prior to this amendment, different counties taxed different property in different ways which created inequities.)

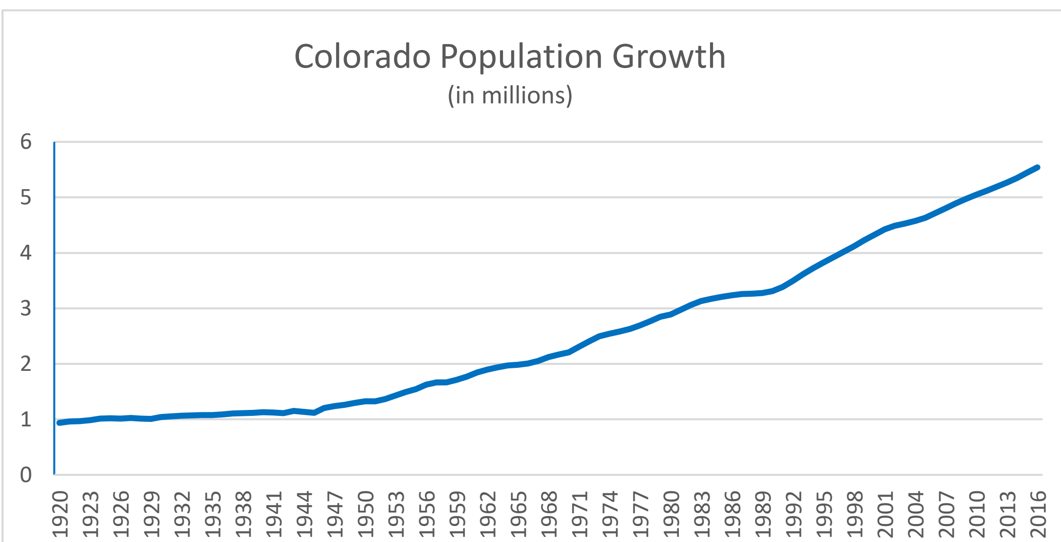
5. “Amendment 1” established that the actual value of agricultural land would be determined by its earning or productive capacity rather than its market value, which allowed agriculture land in high-growth areas to continue to be managed as a farm or ranch.

6. “Amendment 1” exempted certain property from taxation. These exemptions included: household furnishings and personal effects not used for the production of income; inventories of merchandise and material and supplies held for business consumption or for sale; livestock; agricultural and livestock products; and agricultural equipment used on a farm or ranch in the production of agricultural products. Many of these classes of property had been considered a nuisance tax based upon the complexity of the valuation (and the time and resources which it required) and the marginal revenue produced by the tax. (While Gallagher exempted RESIDENTIAL personal property from taxation, it maintained taxation on BUSINESS personal property.)

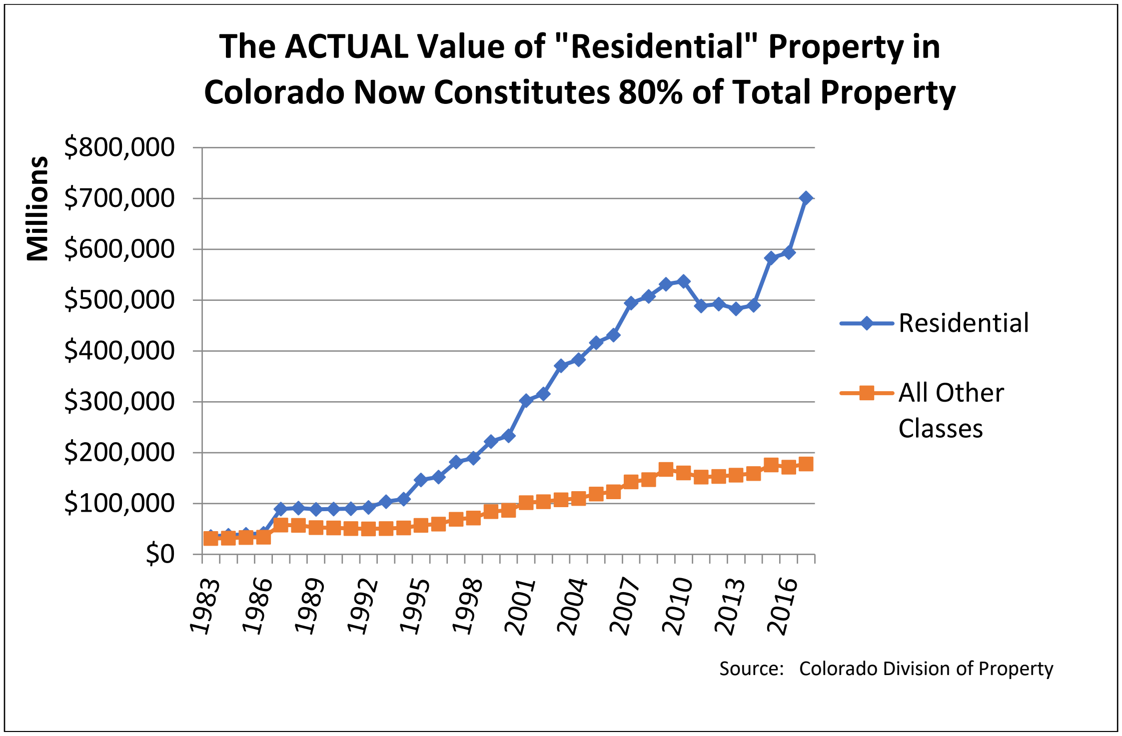
“Amendment 1” was adopted by Colorado voters in 1982 with 551,334 votes (65.5%) to 290,590 votes (34.5%).

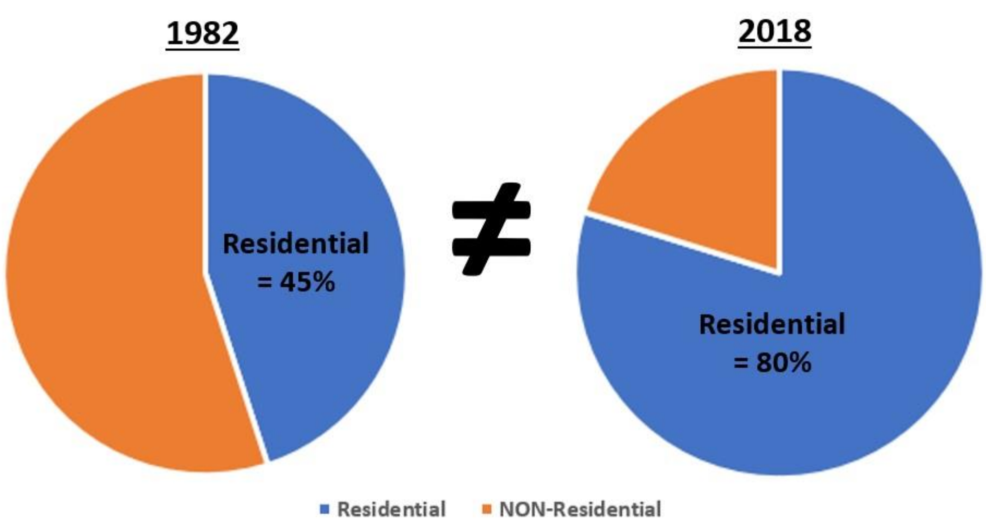
What have been the impacts of the Gallagher Amendment?
While the Gallagher Amendment was intended to address specific challenges at a specific time when it was proposed and passed in 1982, changes in real estate market conditions over time and the passage of subsequent constitutional amendments which retroactively affect the Gallagher Amendment have created unforeseen and unintended consequences that are causing significant challenges for Colorado today.

1) **The frozen Residential/ Non-Residential ratio is forcing down the Assessed Value of houses (from 30% in 1982 to 7.2% today) and jeopardizing community services which rely on that Residential property tax base.**
   Colorado’s robust population growth over the last three decades has resulted in the state’s total Residential property value significantly outpacing the growth of the state’s total Non-residential property value.

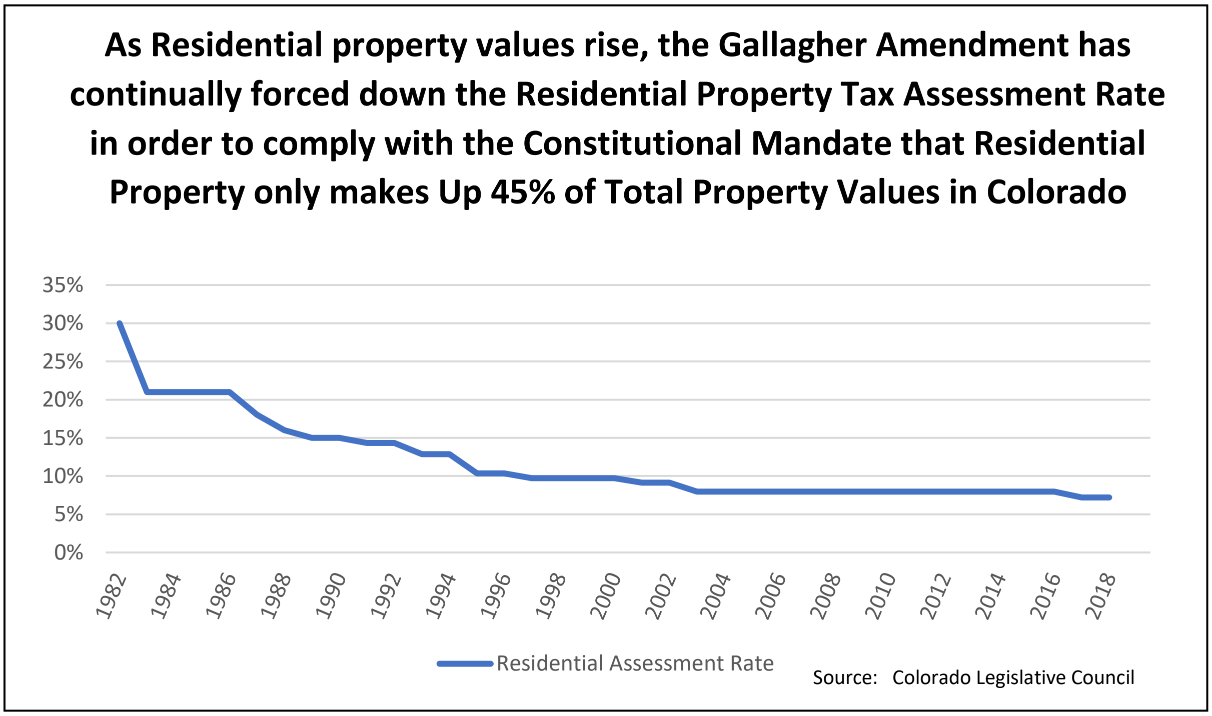


Today, Residential property makes up about 80% of the actual market value of all property in the state. However, because the Gallagher Amendment froze the ratio of Non-residential and Residential property values at their 1982 levels and limits the taxable value of all Residential property to never constitute more than approximately 45% of the state's total property valuation, the state has been forced to continually reduce the floating Assessment Rate for Residential property to maintain this frozen ratio.





As long as the growth in value of Residential property in the state outpaces the growth in the value of Non-Residential property, the Gallagher Amendment forces the Residential Assessment Rate down. When we adopted the Gallagher Amendment in 1982, this Assessment Rate for Residential property was 30%; today, it's been forced down to only 7.2% and is expected to continue to decline.



For example, the property tax collected on a $300,000 house in a local taxing district that collects 60 mills (mill rate of 60 mills per $1,000 = .06) would be:

	1981	**2017**	
Market Value of house	$300,000	$300,000	
X Assessment Rate	30%	7.20%	
X Mill Levy rate (60 mills)	.06	.06	
= Annual Property Tax collected	**$5,400**	**$1,296**	**(a reduction of 76%)**

This lower Residential Assessment Rate is great news if you're a homeowner because you're only paying a fraction of the property tax that you would otherwise pay without the Gallagher Amendment; however, this lower Assessment Rate is extremely challenging for local communities that rely on property taxes to provide local services like K-12 education and fire districts.

2) **The forced decline in the Residential Assessment Rate disproportionately and adversely impacts the poorest communities with the lowest rates of growth in Residential property values.**
Because the Gallagher Amendment sets the Residential Assessment Rate statewide, it requires that it be the SAME for all counties. And since the actual market value of Residential property

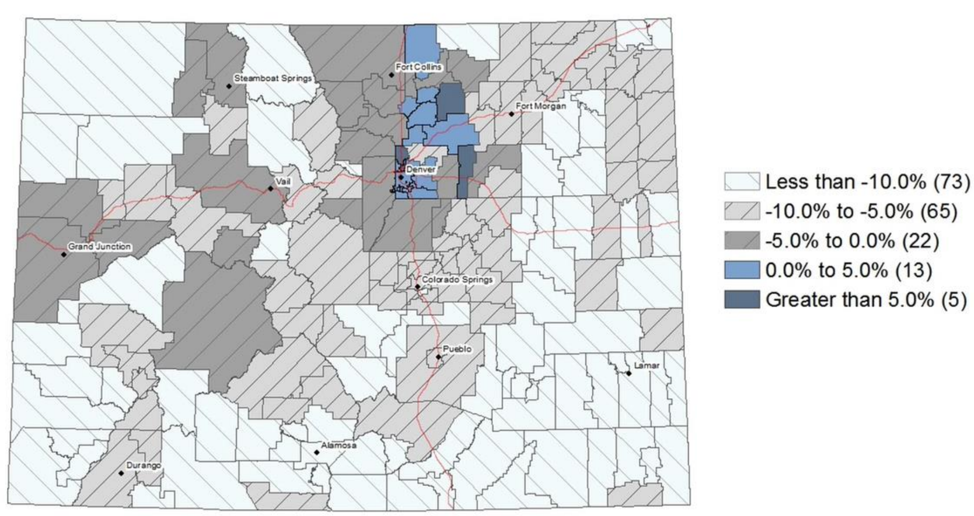
grows at DIFFERENT rates in different counties, the impact of the declining Residential Assessment Rate affects each county tax base differently; specifically, for those counties whose Residential values are growing more slowly, the declining Residential Rate causes a larger decline in the Residential property tax base.

For example, let's assume the Gallagher Amendment requires that the Residential Assessment Rate be reduced from 7% to 6% during a particular 2-year property assessment cycle; that 1% change amounts to a 14% decrease in the Assessment Rate (1% change divided by 7% rate), and…

1. If the market value of the average house within one jurisdiction grows at a rate which is EQUAL to the required 14% decrease in the Assessment Rate, then the 14% reduction in the Assessment Rate will cancel the 14% growth in market value, and therefore the Assessed Value of the average house and that jurisdiction's residential tax base doesn't change.
2. However, if the market value of the average house in another jurisdiction grows at a rate which is LESS than the 14% decrease in the Assessment Rate, then the 14% reduction in the Assessment Rate results in a lower Assessed Value of the average house and a reduction in that jurisdiction's residential tax base. For example, if the market value of the average house in this jurisdiction only grew by 8%, then a 14% required reduction in the Residential Assessment Rate would result in a net 6% reduction in the Assessed Value of the average house and a corresponding reduction in that jurisdiction's overall tax base.

   Typically, the state's poorest communities are located in rural areas which have the slowest growth in Residential market values, and therefore the Gallagher Amendment forces a reduction in their residential property tax base when the market value in other more prosperous communities is growing. As an example using school districts, the map below demonstrates the change in Residential Assessed Values by district from 2016 to 2017.

Change in Residential Assessed Values by School District, 2016 to 2017

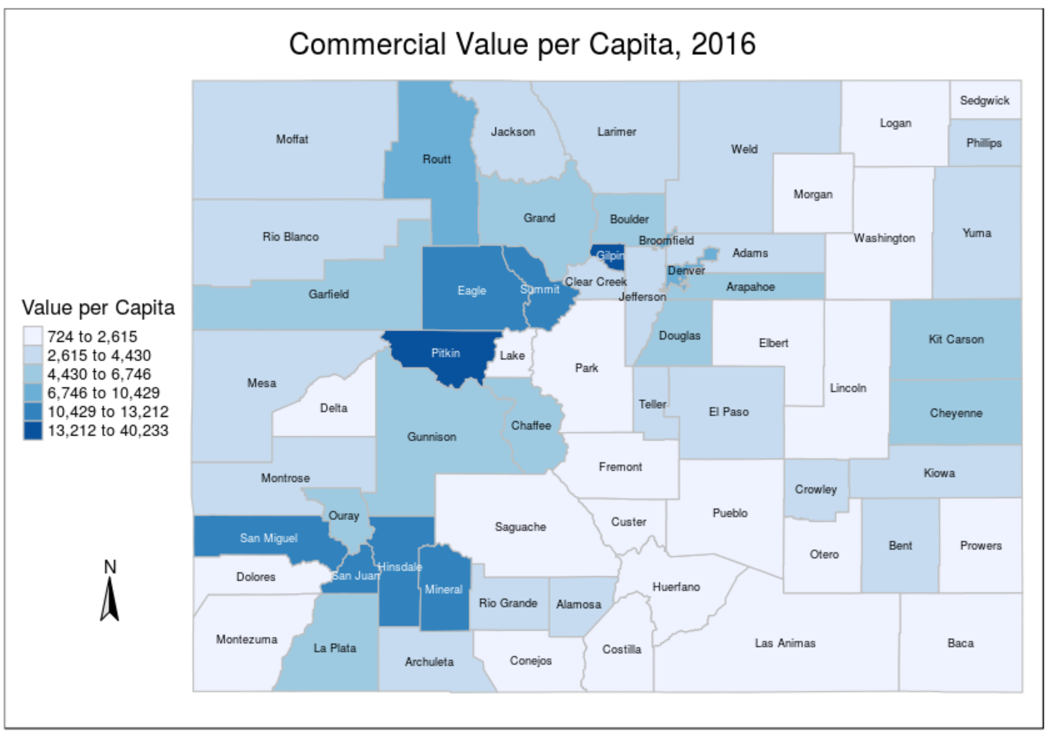


Colorado Legislative Council, 2017

Although some of this forced decrease in the Residential property tax base is offset by an increase in the value of Non-residential property in some communities, the Gallagher Amendment's frozen Residential/ Non-Residential formula is expected to decrease the overall tax base in 130 of Colorado's 178 School Districts in 2017[3].

3) **The forced declining Assessment Rate of houses disproportionately and adversely impacts communities with very little Non-residential property value.**
As the Gallagher Amendment's frozen Residential/ Non-residential formula forces a continual decline in the Residential Assessment Rate and Residential property tax base, communities may try to offset this by asking their voters to increase their Mill Levy (tax rate), however, this opportunity may be limited in areas of the state struggling with depressed property values or with little Non-residential property value, such as rural areas.

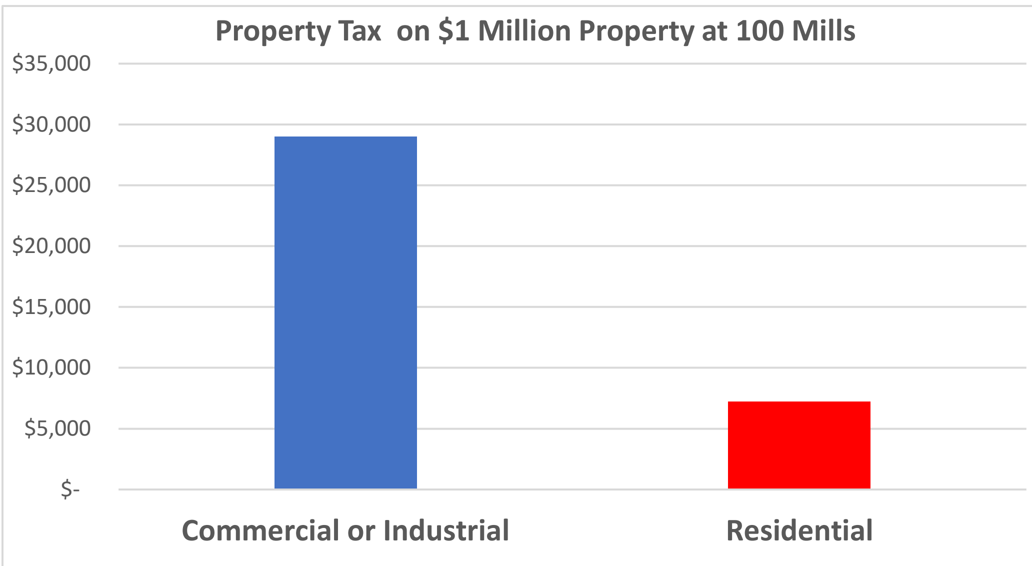
Rural areas are typically the same communities shown in the map above which have the lowest rates of growth in residential property values and therefore suffer the biggest decrease in their Residential property tax base as a result of the Gallagher Amendment's forced decline in the Residential Assessment Rate. These communities typically also have a very small Non-residential tax base on which to shift the property tax burden. Even if these communities can successfully petition their voters to approve an increase in their mill levy, it generates relative little revenue and places a disproportionate burden on their small Non-residential property owners, such as farmers who own Agricultural property.



[3] Colorado Legislative Council video presentation, 2017

4) **The forced decline in the Residential tax base, and subsequent efforts by local taxing authorities to increase their mill levy to offset this decline, unfairly shifts the property tax burden to Commercial/Business property owners which creates an unfriendly tax environment for growing and attracting businesses.**

As the Gallagher Amendment forces down the Residential Assessment Rate, the corresponding Assessment Rate for Commercial property is frozen at 29%. Therefore, when taxpayers vote to increase their mill levy to offset the effect of the declining Residential property tax base, the property tax burden is shifted to business property owners who are forced to pay for a higher mill levy at the higher fixed Commercial Assessment Rate. Currently, owners of Commercial and Industrial properties bear over 4X the property tax burden of Residential property owners on property with the same market value.



In addition to this increasing shift in the property tax burden from Residential to Commercial property owners, those same commercial businesses also have to pay property tax on their Business Personal Property which “Amendment 1” never exempted from taxation as it did with residential personal property.

5) **The Taxpayers Bill of Rights (TABOR) further complicates the property tax challenge created by the Gallagher Amendment.**

TABOR, which passed ten years after the Gallagher Amendment in 1992, complicates Gallagher in two ways:

1. Although not yet tested in court, while the Gallagher Amendment requires that the Residential Assessment Rate be LOWERED during times when the growth in Residential values outpaces the growth in Non-Residential Values, TABOR has been interpreted to prohibit the legislature from conversely abiding by Gallagher's requirement that the Residential Assessment Rate be RAISED during times when the formula would support such an increase. This results in an irreversible ratcheting down of the Residential Assessment Rate.
2. Because TABOR limits the amount of tax revenue which a taxing jurisdiction can collect without voter approval, it forces the mill levy to automatically be reduced, either permanently or with a temporary credit, when the growth in property values exceeds TABOR's revenue limit.
   Conversely, mill levies were traditionally allowed to float upward when property values decreased in order to counteract economic cycles and help protect local governments' primary revenue source. However, TABOR prevents the mill levies from increasing without a vote of the people. (NOTE: While most counties have "de-Bruced", this still doesn't allow them to increase mill levies without a vote of the people.)
   As a result of TABOR's forced reduction in mill levies when property values grow and the inability of those mill levies to conversely float upward when property values decline, the collision between TABOR and Gallagher has in some cases led to a structural ratcheting down effect on the mill levy and the resulting funding for local governments.

6) **The declining ability of local school districts to adequately fund K-12 education has shifted the K-12 funding burden from local school districts to the State.**

Local property taxes used to be the primary funding source for K-12 education in Colorado. In 1982, local property taxes funded 60% of K-12 education, and the state General Fund provided the other 40% of funding. A combination of interacting policies has shifted this burden to the state over time:

1. First, the Gallagher Amendment has reduced local property tax revenue by consistently forcing the Residential Assessment Rate down over time as the overall value of Residential property in the state has outpaced the overall value of Non-Residential property.

2. Second, because the TABOR Amendment forces the local mill levy down during times of net growth in property tax revenues, but conversely no longer allows that levy to float back up during times of decreasing property tax revenues, this has resulted in a gradual ratcheting-down of the local mill levy.

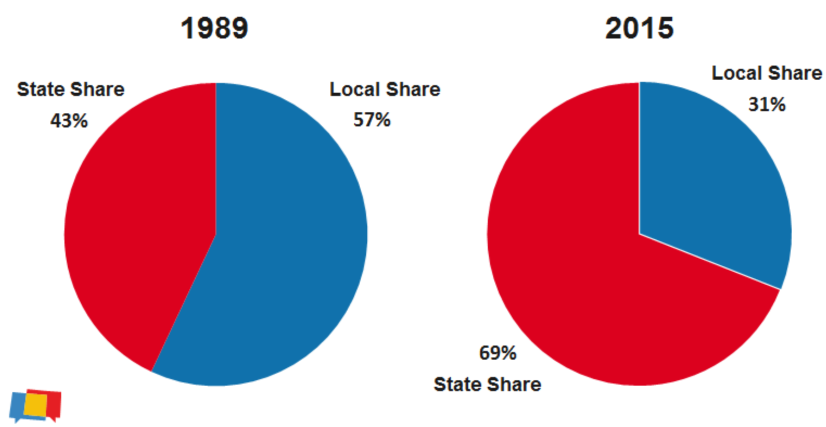
   Since 1992, the combination of both the declining Residential Assessment Rate and the declining mill levy has dramatically reduced the amount of local property tax revenue which School Districts receive.

3. Third, the School Finance Act, which is designed to ensure that every student in Colorado has the same opportunity for a quality education regardless of where the student lives and regardless of the student's unique personal and family circumstances,

requires that the State automatically backfill these reduced K-12 revenues. (For example, small rural school districts receive extra funding under the formula to make up for their lack of any economies of scale due to their small size and geographic isolation, and districts which have a high percentage of at-risk students receive extra money under the formula to help pay for their more expensive education.)

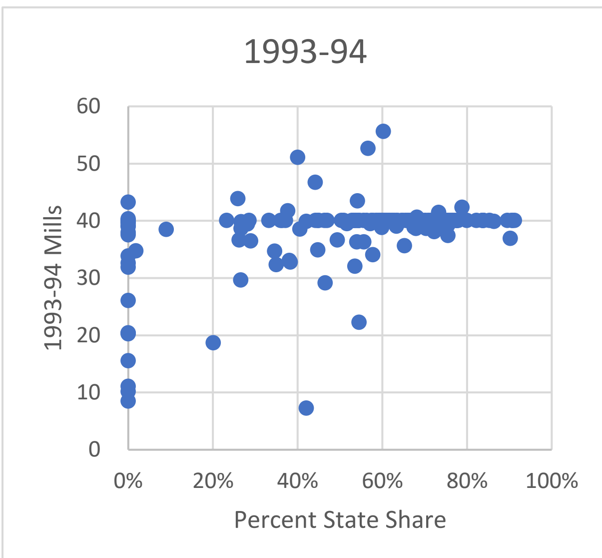
As the amount of funding which School Districts receive from local property tax revenues has declined, and as the State has subsequently had to backfill this declining local funding source, the burden of funding K-12 has gradually and consistently shifted from local governments to the State. The state now provides almost 70% of funding for K-12 schools, with local property taxes providing only 30% of funding. This increasing shift in the burden for funding local K-12 School Districts now consumes 40% of the state's General Fund, which leaves a shrinking amount of state funding to pay for other priorities like prisons and higher education.

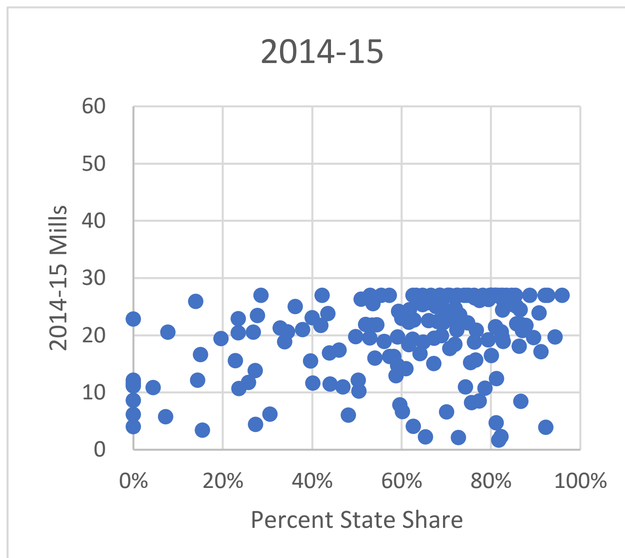
Shift in Responsibility for Funding Local School Districts: Local to State



The following scatterplots demonstrate the phenomena which led to the shift in responsibility for funding K-12 education from local property tax to the state General Fund. In FY 1993–94, only three School Districts had levies of 10 mills or less, and two of the three received very little state aid. Most districts levied a base mill of 40. By FY 2014–15, the picture had shifted. The modal mill was 27 and 21 districts had levies of fewer than 10 mills. Of those 21, 13 received at least half of their total program funding from the state, four received between 15 percent and 50 percent of their funding from the state, and four received little or no funding from the state.[4] While this change between 1993-2014 was largely as a result of TABOR's prohibition on allowing mill levies to automatically float upward as they have historically been allowed to do, the interaction with Gallagher's forced reduction in the Residential Assessment Rate was also a contributing factor.

<u>Declining School District Mill Levies</u>





[4] Represented from http://www.lincolninst.edu/publications/working-papers/measuring-impacts-tax-expenditure-limits-public-school-finance-colorado.

More Information about School District Mill Levies

- To limit the disparity in local school funding between, the State limits School Districts to collecting no more than 27 mills of local property tax revenue. Even if a School District could get voter approval to raise their base Mill Levy to this cap, there is no incentive for Districts to do so because the State would correspondingly reduce its contribution by an equivalent amount.
- School Districts can ask voters to approve additional funding through "Mill Levy Overrides" which are different than the base "Mill Levy" in that revenues from an "Override Levy" aren't counted against the State's contribution and therefore result in net additional revenue to the School District. However, the State prohibits school districts from collecting more than 25% of their total program from a Mill Levy Override.

Past Effort to Address the Gallagher Amendment

In 2003, Initiative 32 was placed on the ballot proposing to freeze the Residential Assessment Rate at 8.0% and eliminate Gallagher's requirement to maintain the 45:55 split between the total value of Residential and Non-Residential property. Proponents of the measure selected the 8.0% rate because the current Residential Assessment Rate at the time they drafted the measure was 8.04%, thus the proposed 8.0% rate represented a slight DECREASE in the current Residential Assessment Rate which proponents hoped would garner support for their proposal. Ironically, very shortly after proponents filed their ballot measure, the Residential Assessment Rate had to be revised downward slightly to 7.96% as a result of additional property valuation data which had been submitted late by Jefferson County; consequently, opponents of Initiative 32 could then argue that the proposed 8.0% frozen Assessment Rate was actually an INCREASE from the current rate of 7.96%, and this eroded support for the proposal. Although proponents outspent opponents $254k to $6k, Initiative 32 ultimately failed by a margin of 22:78.[5]

[5] https://ballotpedia.org/Colorado_Taxable_Value_of_Residential_Property,_Initiative_32_(2003)