A REPORT FROM THE CENTER FOR COLORADO'S ECONOMIC FUTURE

Issue Brief

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Colorado's State Budget Tsunami

Summary

Two recessions in this decade have underscored a structural flaw in the revenue system that supports much of Colorado's state government. Although tax and fee collections have fallen precipitously, funding obligations are growing for the largest portions of the General Fund budget. The legislature's difficulties in balancing the books for fiscal years 2009 and 2010 will likely be repeated in the following year as lawmakers are compelled to find additional money for public schools and Medicaid, and they struggle to replace one-time money used to prop up current spending. Other General Fund programs will suffer as a result.

If a balanced revenue system is one that generally produces revenue in sync with economic activity, evidence suggests that Colorado's system is out of kilter and responds to economic conditions in an exaggerated way. In these uncertain times, the long-term fiscal stability of state government is at stake. A comprehensive examination of Colorado's state and local revenue system was last undertaken a half-century ago, during the recession of 1957-58. Similar previous studies also were conducted at pivotal points in Colorado's history, and they provided useful gauges for policymakers. The *Center for Colorado's Economic Future* believes it is time for another comprehensive study.

Introduction

Forced to fill holes totaling $1.8 billion, Colorado lawmakers have had an extraordinarily tough job balancing the state government's books for fiscal years 2009 and 2010.

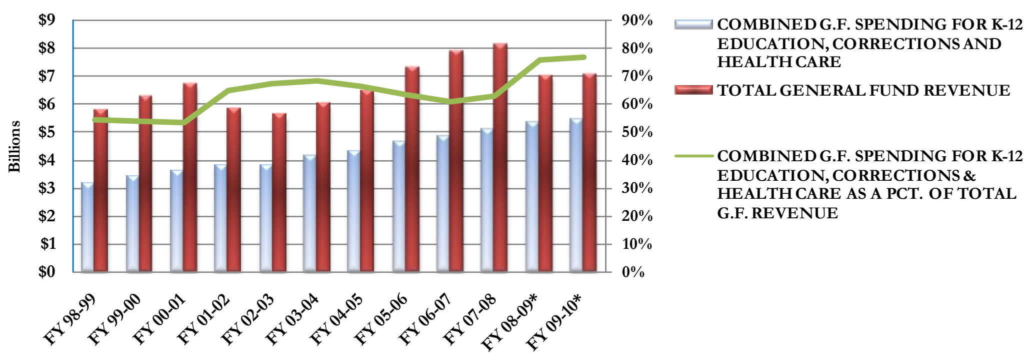
Next year's financial troubles likely will be as bad or worse.

At least one underlying issue is structural: The largest departments of state government are growing more than twice as fast as tax dollars are coming in, leaving a lot less money available for other needs. It is a math problem exacerbated by two recessions in a decade and impacted by constitutional constraints on revenue, tax cuts and spending mandates for certain programs. All of these factors have helped to create a state government fiscal system that is on the verge of becoming unworkable.

Most of the sales, excise, and income taxes collected by the state flow into the General Fund, the $7.5 billion account that supports the primary operating functions of the government. This pot of money grew at an average annual rate of 1.9 percent from FY 1998-99 to FY 2008-09, the fiscal year that ended June 30. Over the same period, the combined budgets of the three largest parts of the General Fund – K-12 education, corrections and health care (most of which is the state's share of Medicaid spending) – grew 5.4 percent annually on average.[1]

Education, prisons and health care consumed about 54 cents of every General Fund dollar a decade ago. They now eat up nearly 76 cents of every General Fund dollar, and that figure will jump to 91 cents in five years if the average growth rate continues. Eventually, at this rate, there would be no money for other programs.

K-12 Education, Prisons and Health Care Spending vs. General Fund Revenue



* Estimate
Sources: Joint Budget Committee; Colorado Legislative Council

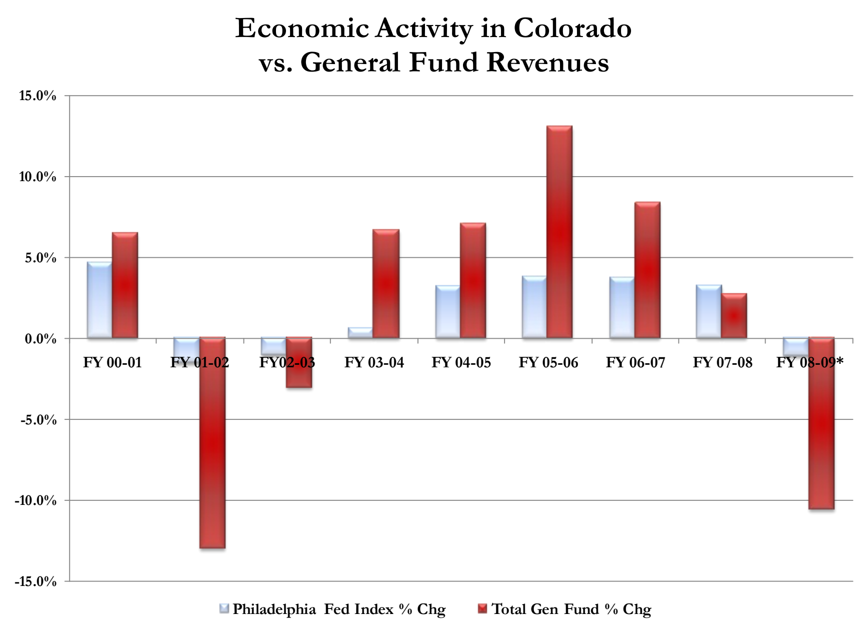
Much has happened in the last decade to redraw Colorado's fiscal landscape. The current recession and an economic downturn from 2001 to 2003 are just part of the picture. While the economy was booming in the late 1990s and early 2000s, voters approved a constitutional amendment mandating increases in funding for K-12 education. Legislators, meanwhile, cut taxes that would have meant an extra $700 million coming into the General Fund last year and mandated that any excess General Fund reserve go to transportation and capital construction projects. Referendum C, approved by voters in 2005, set a five-year timeout from the revenue constraints of the Taxpayer's Bill of Rights and has let the state keep an estimated $3.6 billion in additional tax dollars. But a new revenue cap goes into effect in FY 2010-11.

By then, the disparity between revenue growth and the amount needed to pay for ever-growing demands on state government is likely to be even wider. A fundamental cause appears to be an imbalance in the state's fiscal system. One measure of a balanced fiscal system is that it generally produces revenue in sync with economic activity. When a system responds in an exaggerated way to economic changes, whether by producing too much revenue relative to the economy or too little, problems can result. If tax receipts increase too rapidly without a solid foundation of corresponding economic growth, the government may be reaching too deeply into the pockets of taxpayers. But if tax receipts fall too sharply relative to the economy, necessary government services may have to be cut.

There is evidence suggesting that Colorado's revenue system often responds to economic conditions in an unbalanced way. In seven of the last nine years, individual income tax collections have been substantially ahead or behind changes in personal income in Colorado as well as changes in salary and wage income. For example, wage and salary income *increased* by an estimated 1.7 percent, comparing the first three quarters of FY 2008-09 to the same period in FY 2007-08, and total personal income *went up* an estimated 2.5 percent during that time, yet state individual income tax collections for FY 2008-09 *fell* an estimated 14.8 percent from the previous year. A similar pattern emerges comparing total General Fund revenues and the Philadelphia Federal Reserve coincident index, a broad measure of economic activity in Colorado

[1] The problem can appear somewhat better or worse depending on the period of time being examined. The gap between General Fund revenue growth and spending growth for the three largest departments increases to four percentage points looking at a span that starts one year later – from FY 1999-00 to FY 2008-09 – because tax collections were much higher in FY 1999-00, near the peak of the dot-com bubble, than in the previous year. But there is still a two-percentage point difference taking the eight-year period from the height of the dot-com bubble in FY 1999-00 to the height of the housing bubble in FY 2007-08.

benchmarked to state gross domestic product. For example, the index declined by an estimated 1.1 percent for FY 2008-09, but total General Fund revenues fell an estimated 10.6 percent in that period.



* Estimate
Sources: Colorado Legislative Council; Federal Reserve Bank of Philadelphia

State revenues have fallen so sharply, lawmakers had to plug gaps totaling $1.4 billion to balance the books for fiscal years 2009 and 2010. Then, well after the 2009 legislative session had ended, they found out they were short another $384 million.

Actions taken to balance the budgets for FY 2008-09 and FY 2009-10 have included: Forcing some state employees to take unpaid days off, cutting Medicaid payments to doctors and hospitals, draining cash funds raised from dedicated sources such as inspection fees and severance taxes, closing a prison for women and suspending a property tax break for seniors. General Fund appropriations for the new fiscal year rely heavily on a massive injection of economic stimulus money from the federal government.

Lawmakers have been told the General Fund is another half-a-billion dollars in the hole for FY 2010-11, the budget they will start working on in January. But that shortfall figure is based on keeping appropriations at current budgeted amounts. It does not account for inflationary increases or growth in Medicaid caseloads and prison populations. It also does not reflect large mandated boosts for K-12 education.

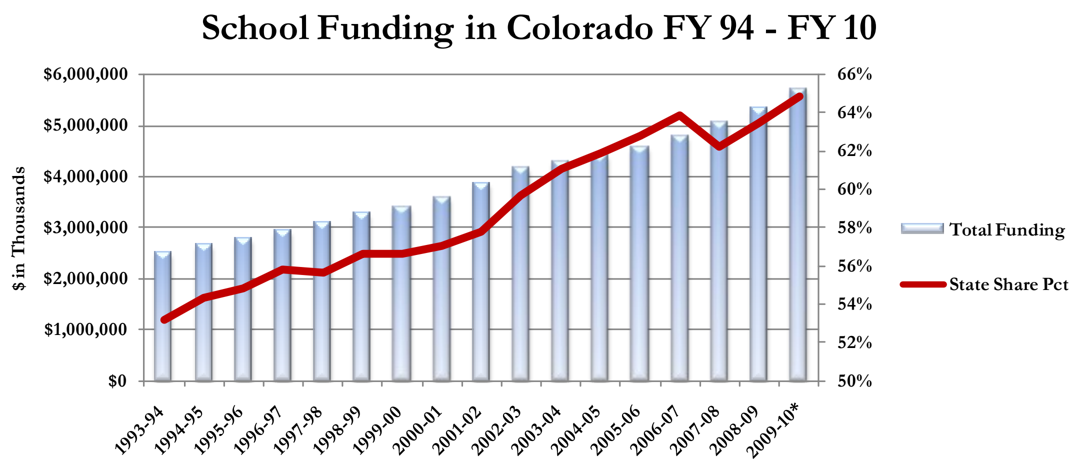
The budgetary tsunami that washed over Colorado government last fall and winter was likely just the first wave. More tidal waves in FY 2010-11 threaten to keep the General Fund underwater and lawmakers struggling to find new lifelines. Public schools and Medicaid could swallow even bigger slices of the revenue pie, forcing other programs and agencies such as higher education and human services to battle for the less than 24 percent of General Fund dollars that aren't already committed. Ultimately, it could mean more hikes in college tuition, deeper cuts in state government services or more fees to pay for them, or a ballot box request for higher taxes.

Tidal Wave #1 —
Public School Funding

Right away, when lawmakers start the budget process for FY 2010-11, they will be pressed to find an extra $311 million for public schools – a nearly 10 percent increase over General Fund expenditures for K-12 education from the previous fiscal year. That amount is not included in the $489 million shortfall projected by Legislative Council and it may be a conservative estimate.

The reasons for the big jump in state support stem from the unequal partnership between state government and Colorado's 178 school districts, and how funding mandates and the recession affect that partnership.

Money to pay for public schools in Colorado comes from two primary sources: local property taxes and state General Fund appropriations. The total amount distributed to districts each year is



* Proposed
Source: Colorado Legislative Council

determined by a complex formula based on the number of pupils and characteristics such as district size, cost of living and the number of at-risk students.

Districts will get a total of nearly $5.7 billion in FY 2009-10. Local property taxes will kick in about $1.9 billion of that and specific ownership taxes slightly less than $150 million. The remaining 65 percent – $3.7 billion – will come directly from the state.

A decade ago the state's share was much lower – 57 percent. Several factors have combined to increase the burden on the state to finance schools while easing the load carried by local property taxpayers. One major factor is Amendment 23, a constitutional provision approved by Colorado voters in 2000 that requires per-pupil funding to be increased each year by the rate of inflation plus 1 percent through FY 2010-11, and by the rate of inflation each year thereafter.

This constitutional mandate to augment funding for K-12 education is affected by TABOR, which limits the role of property taxes in the financing of schools. TABOR prohibits increases in local tax rates (mill levies) without voter approval. Because tax rates cannot go up, the amount that local property taxes contribute to schools is directly related to the ebbs and flows of taxable property values throughout Colorado.

A third factor is a provision of the state constitution called the Gallagher Amendment. This provision effectively prevents the taxable value of residential property (homes, apartment buildings, condominiums and even some hotels) from growing as fast as the property's market value. With the Gallagher Amendment keeping the taxable value of property low and TABOR keeping tax rates from increasing, the property tax share of school funding grows slower than it would otherwise. That growth has not kept pace with Amendment 23's mandated funding increases.

When property values stagnate, property tax collections stagnate. The state not only must pay for its own proportionate share of Amendment 23 funding increases, it must make up for the inability of local property taxes to pay their share. There is even more of an imbalance when property values decline.

Think of it as you (state taxes) and a friend (local property taxes) splitting a $20 lunch. You each have $10 but your friend can contribute only $1 of the $4 tip. So you cover the difference and put in a total of $13, an extra 30 percent, while your friend puts in only $11, an extra 10 percent.

The next time you go for lunch your friend has only $9. You not only have to come up with the extra dollar to pay the tab but the entire $4 tip. Your friend's share goes down 10 percent while yours goes up 50 percent!

The first scenario more or less describes Colorado's school finance partnership for the last several years. The second scenario describes how it is projected to be in the near future.

Driving the estimated $311 million increase in General Fund expenditures for schools in FY 2010-11 is a projected drop in the total assessed value of property statewide of 1.8 percent. Also figuring into the calculation by Legislative Council is an inflation forecast of 1 percent for FY 2010-11, which would put that year's required per-pupil increase at 2 percent (inflation plus 1 percent in keeping with Amendment 23).

But the legislature is likely to face an even bigger increase in school funding than is currently expected. There are reasons to believe the property valuation forecast is too optimistic, which would make the General Fund increase for schools in FY 2010-11 considerably more than $311 million. One reason is that Legislative Council released its property tax forecast last December before a steep drop in employment. Job growth is a key driver of the assessed valuation forecast. In December, it was thought that employment in Colorado would fall by about 0.7 percent in 2009. By June, forecasters adjusted this estimate to a 3.6 percent decline – more than five times worse. This will likely be reflected in the next assessed valuation forecast, to be released in December 2009.

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So how will the state pay for its extra share of the K-12 education bill in FY 2010-11? The State Education Fund, created by Amendment 23, was supposed to help avoid situations like this. The fund, which receives a little more than 7 percent of state income taxes every year, was designed to be a savings account that would grow throughout the years. It would lessen the impact of the School Finance Act on the General Fund and pay for other educational programs.

But the state's obligation to pay for schools is such that the State Education Fund balance may virtually disappear by FY 2010-11. Most of the state's share would have to come from the General Fund, leaving much less available for other programs. If the General Fund appropriation for K-12 education increases by $311 million in FY 2010-11, that amount would represent 67 percent of all General Fund revenue growth currently forecast for that fiscal year.

In order to address the school funding problem, the legislature may consider cutting some optional school programs, such as preschool, and changing some aspects of the school finance formula to still comply with Amendment 23. But these moves are not likely to raise enough money to lessen the problem to any meaningful extent. More drastic measures may be needed that affect the entire General Fund budget.

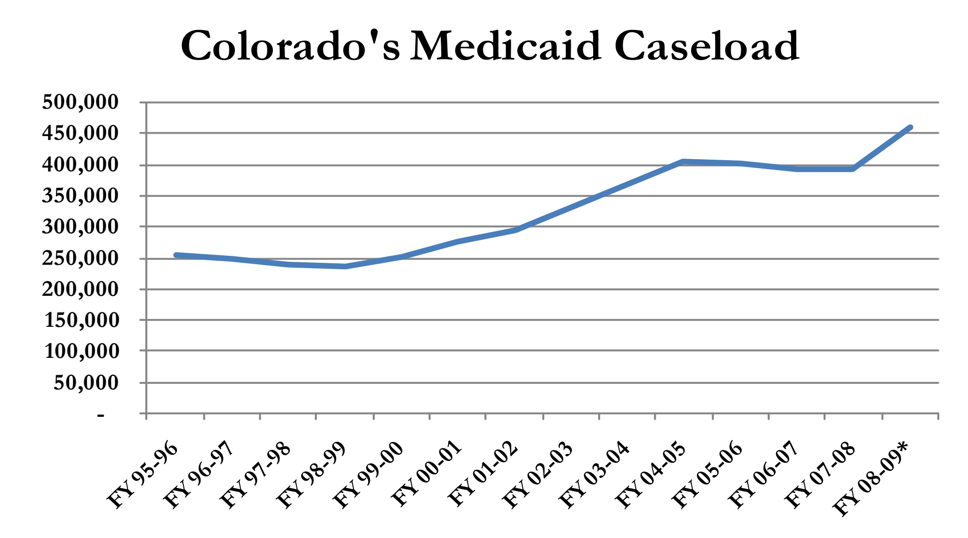
Tidal Wave #2 — Medicaid

The budget for Medicaid has vexed Colorado lawmakers for decades. Program costs were so out of control in the early 1990s that the General Assembly passed a bill to make Colorado the first state to pull out of the state-federal partnership that provides health care to the poor and people with disabilities. Then-Gov. Roy Romer vetoed the legislation, worried that Colorado would lose federal matching funds if it couldn't get a waiver to start its own program.

Back then, the state's portion of Medicaid spending amounted to about $450 million a year – about 14 percent of the General Fund budget. In FY 2008-09, the state's share topped $1.4 billion – about 20 percent of the General Fund.

Several factors are pushing the Medicaid budget higher: caseload growth, the rising cost of medical services and supplies, and recipients using more services. Caseload growth is driven by population increases, policy changes that affect eligibility and economic cycles like the current recession, which is putting more people on Medicaid in Colorado at a faster rate than at any time in the program's 40-year history. The statewide caseload grew a startling 19 percent in the 18 months from November 2007 to May 2009.

In a recession, the state's ability to pay for exploding Medicaid expenses is limited by declining sales and income tax revenues caused by higher unemployment. Directing a bigger chunk of the General Fund to Medicaid in bad economic times takes money from other programs. The stimulus bill passed by Congress in February temporarily relieves this pressure, pumping more than $700 million extra into the General Fund over 27 months starting with three quarters of FY 2008-09.



* Caseload as of May 31, 2009
Sources: Joint Budget Committee; Colorado Department of Health Care Policy & Financing

Those federal dollars from the American Recovery and Reinvestment Act were crucial in helping state lawmakers balance the budgets for fiscal years 2009 and 2010. But Colorado will have to wean itself from the Medicaid stimulus starting in FY 2010-11, while it is likely the caseload will still be high, and the state will get no extra help from the federal government the following year. That's when people are expected to start dropping off the Medicaid rolls, although caseloads historically have not returned to pre-recession levels once the economy recovers after a downturn.

Not long after the General Fund must absorb the loss of Medicaid stimulus money, it will be forced to swallow a $32 million-and-growing deficit projected for the Health Care Expansion Fund. This is a pot of money created by Amendment 35 in 2004 that expanded eligibility for Medicaid and Child Health Plan *Plus* (CHP+), a program that provides health and dental insurance to low-income children and pregnant women who are not eligible for Medicaid.

The Health Care Expansion Fund, which receives 46 percent of tobacco taxes, built up a reserve in its first three years of existence. But expenditures from the fund – currently about $120 million annually – now exceed the amount flowing in. By FY 2012-13, the fund is expected to be $31.6 million in the hole and even larger deficits are expected after that, with tobacco tax revenues stagnating at about $76 million a year and program expenditures growing. A deficit had been projected for FY 2011-12, but the infusion of federal stimulus cash pushed it out a year.

It will be a strain for the General Fund to absorb a shortfall in the Health Care Expansion Fund in addition to projected growth in traditional Medicaid and CHP+ programs, which before the recession was expected to be 7.9 percent a year nationally. The staff of the legislature's Joint Budget Committee has warned that either another funding source must be found or benefits of recipients covered by the fund will have to be cut. One possibility would be to divert proceeds from a new hospital provider fee that is intended to reduce the state's medically uninsured population by 100,000.

Groups supported by the HCE Fund include:

- Legal immigrants ($15 million state match in FY 2009-10)

- Adults with incomes between 34 percent and 60 percent of the federal poverty level ($17.6 million in FY 2009-10)
- Emancipated foster children, ages 19 to 21 ($5 million in FY 2009-10)
- Children with disabilities (expanded waiver slots totaling $12 million in FY 2009-10)
- Low-income, uninsured women seeking prenatal care ($2 million in FY 2009-10)
- Adults and children added by no longer requiring a Medicaid asset test ($34.1 million in FY 2009-10)

Long-term care is yet another Medicaid issue looming for Colorado as well as the rest of the nation. Community and institutional services already make up more than a third of Medicaid expenditures and are among the program's fastest-growing cost drivers. As the baby boomer generation retires and approaches old age, the demand for long-term care is expected to rise much more rapidly. Long-term care, especially in a nursing home, is expensive – often tens of thousands of dollars a year. Many Americans do not have insurance coverage for long-term care and it is not covered by Medicare, the federal health insurance program for people 65 and older. Medicaid is the insurer of last resort for many older Americans who need long-term care, although they must be poor to qualify.

A study done for the health insurance industry projected that Colorado will spend $18.1 billion (in 2008 dollars) on Medicaid long-term care from 2008 to 2027, with costs rising at an average annual rate of 4 percent.[2] Joint Budget Committee analysts don't expect dramatic growth in the long-term care caseload for a decade or so, but expenditures already are rising fast. Total state and federal spending on long-term care services in Colorado jumped from $531.3 million in FY 2001-02 to an estimated $874.3 million in FY 2009-10, an average annual growth rate of 6.4 percent – 2½ times faster than General Fund revenue grew on average over the same period.

Tidal Wave #3 — Replacing One-time Money

The FY 2009-10 General Fund budget is propped up by as much as $1 billion in one-time money, much of which lawmakers will be hard-pressed to replace when they start tackling the finances for FY 2010-11. The inflow of revenue would have to pick up dramatically if they expect to fund government services at current levels, and that's not likely. Even though General Fund revenues are expected to increase 6.8 percent in FY 2010-11 as the economy improves, the amount in the General Fund available for spending is expected to decline 2.4 percent because one-time money will no longer be there.

More than half of the one-time money for FY 2009-10 comes from the federal government's economic stimulus package: about $382 million for Medicaid, $150 million that reduces General Fund expenditures for state colleges and universities, and $45 million that Gov. Bill Ritter is designating for K-12 education and other areas.

Another $281 million has been transferred to the General Fund from other sources, mostly cash accounts that support numerous state programs and efforts ranging from tobacco education to capital construction. The legislature also saved tens of millions of General Fund dollars by refinancing several programs, requiring that they temporarily be bankrolled entirely by cash funds. An example is a bill that replaces $6 million in General Fund appropriations for the Supplemental Old Age Pension Health and Medical Care Program (a medical assistance program for older Coloradans who are indigent and not old enough to qualify for Medicare) with money from that program's cash fund.

Money flows into cash accounts from fees collected for specific purposes. In most cases, budget writers tapped into cash fund surpluses without affecting the programs themselves. But once these surpluses are used up, it can be years before they are replenished. After transferring hundreds of mil-

[2] Daniel I. Shostak & Paul A. London, "State Medicaid Expenditures for Long-Term Care 2008-2027," Strategic Affairs Forecasting, September 2008, 14.

lions of dollars from these funds to balance the General Fund budgets for FY 2008-09 and FY 2009-10, Joint Budget Committee staffers don't expect to unearth a hidden mother lode to help fix next year's problems.

The legislature also "found" about $150 million each for fiscal years 2009 and 2010 by lowering the reserve requirement from 4 percent to 2 percent of General Fund appropriations. When the reserve requirement reverts to 4 percent in FY 2010-11, lawmakers will need about $300 million to restore the budget cushion unless they change the statute again. Colorado's reserve is low compared to other states – only five require less than 4 percent – but a bill passed in 2009 is designed to eventually raise the requirement to 6.5 percent of appropriations.

Not included in the one-time money sources for FY 2009-10 are one-year program cuts such as the suspension of the senior citizen property tax exemption. That saved $91.5 million but will cost at least that much the following year unless the General Assembly suspends the exemption again.

Conclusion

There is little question the financial difficulties faced by Colorado's state government during this decade's two recessions will continue into the future. The problem is mathematical – there is simply not enough money to pay for the government we have created and the services many of us have come to expect. Barring a quick and dramatic turnaround in the economy, it appears that the current fiscal system cannot be sustained much longer.

Historically in economic crises, the governor and General Assembly have been able to jerry-rig the system to keep the state afloat long enough to get to the next crisis. Their efforts to remedy the budget problems of fiscal years 2009 and 2010 have been herculean. But it is clear the situation we now face should not be addressed with baling wire and chewing gum. Plainly said, the time for jerry-rigging has passed; our fiscal system needs an overhaul.

Nobody would attempt to overhaul an automobile engine without consulting a shop manual, collecting all the necessary tools and seeking the advice of a good mechanic. The engine of state government – its fiscal system – is every bit as intricate and interrelated as the engine of a car. It can be overhauled, but doing it right requires expertise, information and analytical tools.

So how do we suggest the system be overhauled? First, it should be thoroughly examined. That means focusing on what fuels the system as well as how efficiently it runs. Are revenues from taxes, fees and fines sufficient and are they obtained from a broad, sustainable spectrum of sources? Are services provided by the government of the highest quality at the lowest possible cost? Is the system well organized and are the services being provided necessary and appropriate?

Second, state government doesn't exist in a vacuum – especially in Colorado. Compared to other states, we have a very limited and small state government but a robust and growing network of local governments. There are 3,223 units of local government in Colorado and more are created regularly – a staggering 767 since December 2004, an increase of 31.2 percent in that time. In 2007, Colorado ranked 22nd in population but fourth in the nation in the number of special districts behind Illinois, California and Texas. Local governments in Colorado employ nearly three times the number of workers employed by state government. Clearly, an examination of government financing in Colorado should include local governments.

The engine of state government — its fiscal system — can be overhauled. But doing it right requires expertise, information and analytical tools.

Third, the first steps of the overhaul process should be undertaken by nonpartisan experts assembled to compile factual information and provide analysis. Although Colorado voters and policymakers ultimately are the ones to set the course and drive state government forward, the process initially must not be geared toward promoting a public policy agenda or political ideology. It should produce only facts and options for improvement.

The analysis should focus on:

- Equity – Are some forms of business activity or some taxpayers in different economic circumstances treated unfairly?
- Efficiency – Does the structure of the fiscal system correspond to the structure of the state's economy?
- Productivity – Does the system produce sufficient revenues to sustain the delivery of appropriate governmental services?
- Elasticity – Does the system respond too severely to changes in the business cycle?
- Sustainability – Are sufficient monitoring and accountability gauges in place to alert elected officials and voters to systemic problems so that adjustments can be made?

So why hasn't a study like this been done? It has. Colorado has a long history of comprehensive evaluations that led to overhauls of its fiscal system. Each study was undertaken at a critical time in our state's history. Each was instrumental in casting light on the state's path to a more stable future.

The first study was published in 1930, just after the stock market crash of 1929 as Colorado and the nation entered the Great Depression. It was authored by a professor at the University of Kansas and funded by local chambers of commerce throughout the state. The study examined proposals to create a local sales tax and a state income tax, and it evaluated the property tax limitation that existed at that time.

Dr. Eugene Halaas of the Bureau of Business and Social Research at the University of Denver conducted the second study. Published in 1938, it evaluated the rapid tax law changes of the 1930s.

A series of studies in 1946 and 1947, following World War II, constituted the third effort. Commissioned by the University of Colorado, they evaluated each major state and local tax source.

The fourth and most recent study was published in February 1959, after the state's long post-war economic expansion. It was commissioned during the 1957-58 recession by Gov. Steve McNichols and conducted jointly by experts at DU and CU. This was the most comprehensive examination of the state's economy, the structure of state and local government, and the state and local tax system ever undertaken in Colorado. It took two years to complete at a cost of $2 million in today's dollars and produced 27 recommendations for improving Colorado's economic health, 22 of which were implemented over a 23-year period from 1960 through 1983. The study recommended several tax reforms and a reorganization of 138 semi-autonomous boards, commissions and agencies of state government into 20 principal departments.

The four previous studies differed in scope, but in each case Colorado's leaders sought ways to evaluate the state's financing system and the public sector investments necessary for a healthier Colorado. These studies provided roadmaps for policymakers that proved useful decades into the future.

Once again, Colorado finds itself at a pivotal moment in history. Now is the time to look to the future and meet the challenges that lie there with intelligence and foresight. On this, the 50th anniversary of the last comprehensive examination of the state's fiscal engine, it is once again time to take a critical look at where we are and start the process of a much-needed overhaul.

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The Center for Colorado's Economic Future at the University of Denver is an independent, nonpartisan organization that conducts research on matters related to Colorado's fiscal health, trends affecting the state's economy and proposed legislation relating to taxation and public spending.