A Fiscal Roadmap for Colorado

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A New Fiscal Constitution

- Preserve and strengthen tax and expenditure limits
  - Restore TABOR provisions
  - Restore caps on property taxes
  - Revisit tax rebate provisions
  - Limit user fees to cover the cost of government services voluntarily chosen by citizens
  - Require a supermajority vote of the legislature to propose new taxes
- Eliminate the structural deficit in the state budget
  - Repeal Amendment 23
  - Create a rainy day fund
  - Impose a constitutional limit on annualization
- Limit debt
  - Impose strict limits on certificate of participation bonds and require supermajority vote of the legislature to issue these bonds
  - Eliminate unfunded liabilities in state pension and OPEB Plans
  - Require a supermajority vote of the legislature to propose new debt

Budget Reform

- Introduce priority budgeting
  - Identify core functions of state government
  - Require state agencies to evaluate programs as they relate to core functions
  - Prioritize programs
  - Impose a hard budget constraint
- Monitor the performance of state programs
  - Conduct performance reviews
  - Create competitive sourcing center
  - Conduct sunset review of state programs
- Reform state programs
  - Eliminate earmarks
  - Eliminate unfunded liabilities
  - Reform entitlement programs
  - Eliminate mandates

Narrative for A Fiscal Roadmap for Colorado

A New Fiscal Constitution

Colorado appears to be at a crossroad similar to that in California in the late 1980s. At that point California was a dynamic growing economy. That prosperity reflected a fiscal constitution that kept the growth of government in line with the growth of the private economy. The GANN Amendment, which was the precursor of the TABOR Amendment in Colorado, limited the growth of state revenue and spending to the sum of inflation and population growth. In the late 1980s, under pressure from the education lobby, the California legislature abandoned the GANN Amendment, and the rest is history. Over the last two decades, in the absence of an effective tax and spending limit state spending increased much more rapidly than personal income. To sustain this higher level of spending, taxes were increased to one of the highest levels in the country. Despite this higher tax burden the state incurred a structural deficit that required even higher levels of debt. California created one of the worst business tax environments in the country. Business investment and jobs left the state for other states with better tax climates. Population left the state for other states with lower tax burdens. California has experienced retardation in economic growth over the last two decades.

Shortly after California abandoned the GANN Amendment, Colorado enacted the TABOR Amendment through citizen initiative. In contrast to California, state spending in Colorado has grown at roughly the rate of the private economy. From 1993 to 2007 real per capita state spending grew 28 percent, while per capita GDP grew 30 percent. With an effective tax and spending limit in place Colorado has been able to lower tax burdens, creating one of the best business tax climates in the country. Colorado has attracted more business investment and jobs than most other states, achieving one of the highest rates of economic growth in the country.

The TABOR Amendment has worked much the way that it was intended, allowing Colorado citizens to decide how much government they want and are willing to pay for. If any jurisdiction wants to spend surplus revenue, or increase taxes or debt it must have voter approval. Many state ballot measures have been presented to Colorado voters since TABOR was enacted. Two of the six ballot measures seeking approval to spend surplus revenue were passed, and four were defeated. Eight ballot measures proposing tax increases were introduced, but only one of these measures passed. Of the four property tax measures introduced, two providing property tax relief to specific groups passed; two measures proposing property tax increases were defeated.

Polls reveal that Colorado citizens support the TABOR Amendment by a greater majority today than when it was enacted. Citizens support each of the TABOR provision by a large majority: the cap on the growth of revenue and spending; the requirement for voter approval to spend surplus revenue; and the requirement for voter approval to increase taxes and debt.

Despite this success, the TABOR Amendment is under attack in much the same way as the GANN Amendment in California. Special interests, who have been unsuccessful in weakening the TABOR Amendment at the ballot box, are eroding these tax and spending limits through statutes and executive orders.

In short we are seeing a stealth attack on our constitutional tax and spending limits similar to that in California, and in both states the courts have sanctioned this erosion in the fiscal constitution. If these trends continue the outcome in Colorado will be similar to that in California. The abandonment of effective tax and spending limits will result in fiscal profligacy that is not conducive to economic growth and prosperity.

However there is a different path that Colorado can follow. I want to lay out a fiscal roadmap that would enable Colorado to strengthen fiscal rules and fiscal policies conducive to economic growth and prosperity. If we follow this roadmap we can avoid the fiscal debacle occurring in California.

It is time to halt the attack on TABOR. We should preserve and strengthen our tax and spending limits by repealing some recent legislation. After Amendment 59 was defeated at the polls the legislature passed a bill that essentially gutted the Arveschaug/Bird provisions of the TABOR Amendment. The legislature also passed a bill discouraging local jurisdictions from imposing TABOR limits on local revenue and spending growth. When mill levies were scheduled to fall to bring property tax revenue growth in line with the TABOR limits, the Governor issued an executive order to freeze the mill levies. These statutes and executive orders should be rescinded.

The legislature has offset TABOR surplus revenues with a number of tax credits and rebates targeted to special interest groups. These targeted tax credits and rebates should be replaced with rebates linked to broad based sales and/or income taxes.

Both state and local jurisdictions have substituted fees for taxes, and imposed fees in excess of the cost of government services. Fees should be limited to true user fees, equal to the cost of government services citizens voluntarily choose. Other fees, and fees in excess of the cost of government services, should be treated as taxes subject to tax and spending limits.

Colorado's fiscal constitution could be amended to provide more effective tax and spending limits at both the state and local level. The legislature can now propose an increase in taxes with a simple majority vote. Colorado should follow the lead of other states and require a supermajority vote of the legislature to propose new taxes or increases in existing taxes.

The major source of structural deficit in the state budget is Amendment 23. Amendment 23 mandates constant growth in expenditures for education K-12, even when the economy is in recession and the state is experiencing a revenue shortfall. No interest groups should have such a privileged position in the state budget; the education lobby should have to defend a budget for education through the budget process each year, just like every other interest group. Amendment 23 should be repealed.

Amendment 23 earmarks a portion of income tax revenue for the Education Trust Fund, exempt from the TABOR limit. The education Trust Fund is sometimes referred to as a rainy day und. It is in fact a slush fund for the education lobby. The Education trust Fund should be replaced by a true rainy day fund. The income tax revenue currently used to fund the Education Trust Fund could be used to fund the rainy day fund. The legislature could then use the rainy day fund to finance any state program in periods of revenue shortfall.

Another source of the structural deficit in the state budget is annualization i.e. the use of one time money to fund ongoing programs. This problem has been exacerbated by the elimination of the cap on general fund spending. With that spending cap in place general fund expenditures were funded with permanent sources of revenue. One time money was used primarily to fund specific projects in transportation and capital construction. The elimination of the general fund spending cap means that one time money will now be used to fund ongoing programs. Not only will this leave less money for transportation and capital projects, it will exacerbate the structural deficit in the state budget. This is why it is so important to repeal the legislation that abolished the cap on general fund spending.

This problem of annualization is about to get a lot worse because of federal bailout money. Much of this one time money is earmarked for ongoing programs, such as Medicaid. When the federal bailout dollars disappear two years from now, it will be difficult to finance these ongoing programs.

The most effective solution to this problem would be a constitutional amendment to limit annualization. If a constitutional amendment capped the share of the state budget that could be financed with one time money at 10 percent, this would limit this source of structural deficit in the state budget. It would also send a message to the federal government that federal bailout money is not the solution to state fiscal problems, but rather a source of instability in state budgets.

The Tabor Amendment requires voter approval for increased debt. Of the four state ballot measures proposing increased debt, two passed and two failed. Colorado could strengthen the limits on debt in several ways.

Both state and local jurisdictions have circumvented the limits on debt by issuing certificates of participation (COPs). For example, when a ballot measure seeking approval for new debt in El Paso County failed, County Commissioners simply issued

COPs to finance the same project. The courts have ruled that COPs don't require voter approval because these are not general obligation bonds. Strict limits should be placed on the issuance of COPs by state and local jurisdictions; and a supermajority vote required for a jurisdiction to propose this form of debt.

The Government Accounting Standards Board guidelines require that state and local jurisdictions report unfunded liabilities in their pension and Other Post Employment Benefit (OPEB) plans as debt in their financial statements. Colorado state and local jurisdictions should report total debt to include these unfunded liabilities.

Unfunded liabilities in the Colorado Public Employees Retirement Association (PERA) have increased dramatically. The funding ratio has fallen well below critical levels for such pension plans. PERA is not meeting GASB standards, or Colorado statutes, that require these unfunded liabilities to be amortized over a thirty year period. The legislature should declare an actuarial emergency and fundamentally reform the pension plan to meet these standards. Colorado should follow the lead of other states and replace the defined benefit plan with a defined contribution plan.

The legislature can propose new debt with a simple majority vote. Colorado should follow the lead of other states and require a supermajority vote of the legislature to propose new debt or increases in existing debt.

Budget Reform

It is clear that learning to live with a hard budget constraint requires an entirely different approach to state budgeting than the traditional budgeting used in Colorado. Colorado should follow the lead of other states and introduce Priority Budgeting. In Priority Budgeting, budget allocations are based on a careful evaluation of how programs fit into the state's priorities, and how well those programs are working.

A Priority Budget Process was first employed by Governor Locke in the state of Washington, and this approach to budgeting has now been introduced in a number of other states as well. Faced with a revenue shortfall, the Governor ordered a review of the entire range of state programs and services. The administration began by identifying the major goals of state government. The administration worked with a 'guidance team composed of leaders of the public, private, and nonprofit sectors. The 'guidance team' was given the task of overseeing the prioritization process, and reviewing the budget with experts drawn from the different government agencies.

Each state agency is required to inventory each program that it administers. The agency must identify the goals of the program, the services performed, why they are performed, for whom they are performed, and the cost of the service.

The 'guidance team', working with experts drawn from the different state agencies then evaluates each program with reference to the goals it has established. Budget hearings are held by goal area, not by state agency. Each program that purports to contribute to that goal must make a case for its program along with other programs. The outcome of this budget review is to identify program duplication, opportunities for program cooperation, consolidation, and cuts.

The guidance team, working with state experts, ranks each state program with reference to the goals identified. Discretionary funds are allocated to each state program based on the ranking in achieving the specific goal. Funds are allocated to programs until all available funds allocate to that goal area are exhausted.

This identifies a budget cut line within each goal area below which state programs are not funded. A final evaluation is made in which each of these programs is given an opportunity to defend why their program should not be eliminated. The 'guidance team' must then determine if any of the programs below the cut line should be funded rather than programs above the cut line.

To make sure that tax dollars are spent wisely and consistent with Priority Budgeting, public officials must monitor and evaluate program performance. Colorado should follow the lead of other states in evaluating program performance. These techniques include performance reviews, competitive sourcing centers, and sunset advisory commissions.

Legislators often get into budget problems due to some fatal flaws in their budgeting process. A fatal flaw in Colorado's state budget is a lack of transparency and accountability. Colorado should follow the lead of other states to introduce a transparency act that require the publication of budget data on the state web site. This makes the budget information for each state agency readily available to citizens on line.

The budget must be comprehensive encompassing the entire range of government revenue and expenditures. There should be no off-budget revenue and expenditures that are not subject to review by the legislature.

Citizens have heard a great deal about earmarks reform at the federal level, but states have their own earmarks problems. Earmarks are usually off budget expenditures for pet projects that are tacked onto bills, usually at the end of the budget process. This is pork barrel spending that usually benefits constituents in a politician's district. Because earmarks spending is off budget the spending is often not subject to a critical review as part of the standard budgetary process.

Another example of off-budget expenditures that often have not been incorporated in state budgets and subject to legislative review are expenditures for pension and non-pension retirement benefits for public employees. PERA's defined benefit plan for public employees has incurred unfunded liabilities. New accounting rules require Colorado to estimate these unfunded liabilities and to identify them as debt obligations in the state budget.

One of the most common arguments that legislators use for not implementing prudent fiscal policies is entitlement programs imposed by the federal government. Programs such as Medicaid and welfare have accounted for a large and growing share of budgets in most states. Legislators argue that their hands are tied by federal mandates to fund entitlements, and the rising cost of these programs.

However, the most innovative states have sought waivers to have more flexibility in designing and funding their own entitlement programs. With these waivers states have been able to experiment with reforms to reduce the cost of entitlement programs.

The precedent for this more innovative approach to entitlements is welfare reform. As a result of welfare reform most states have significantly reduced the numbers of citizens on welfare. Millions of citizens have been moved from welfare to work. Much work remains to address the significant numbers of able bodied citizens who continue to rely on various forms of government transfers; but, the success of welfare reform is reflected in a significant reduction in the growth of welfare expenditures in the states.

States have had less success in reforming Medicaid, but, there is a precedent for reform of this entitlement program as well. Colorado should follow the lead of other states, such as South Carolina, that have begun to enact reforms in their Medicaid program to constrain the cost and improve the delivery of health services to the poor. The experience in South Carolina demonstrates that there is no reason why Medicaid spending, or any other entitlement spending for that matter, should not be subject to budget constraints imposed on other state programs.

South Carolina has begun the difficult task of holding down the cost of the Medicaid program. One of the first reforms was to begin a rigorous audit of Medicaid bills. These audits revealed that one out of every three Medicaid bills was fraudulent. Until the state began auditing these bills, fraudulent as well as legitimate charges were reimbursed.

South Carolina's Healthy Connections Reform plan is designed to both constrain cost, and give Medicaid recipients a choice in health care providers. In the past Medicaid recipients often did not have a primary physician. The incentive was to rely on hospital emergency room care for even minor medical treatment. Medicaid recipients visited emergency rooms 66 percent more often than other South Carolinians. The health care provided to the poor was both costly and time consuming. The quality of health care received by the poor was seriously lacking. Children on Medicaid were often not treated for asthma, diabetes, sickle cell disease, and other diseases where treatment at an early age is crucial.

The Healthy Connections Reform Plan has enabled South Carolina to begin to address these deficiencies in the Medicaid program. Certain categories of Medicaid recipients are given a choice of health care plans. They can choose a 'medical home network', in which they work with a family physician and nurses. Private health plans compete to enroll Medicaid recipients in their plan. The experience thus far is that this reform can both lower costs and improve the delivery of health care services to the poor. This will enable South Carolina to begin to reign in spending on Medicaid and live with a budget constraint.

One of the most intractable problems in state budgeting is that of mandates on spending imposed through constitutional, statutory, or judicial rules. In Colorado, as well as other states, the education lobby has successfully mandated increased expenditures for public education. Legislators often cite these mandates as an excuse for not pursuing prudent fiscal policies in education spending.

The education lobby has used the myth of a school 'funding crises' to argue that funding for public schools should be increased. Colorado has historically relied primarily on local funding for public schools. In terms of total state and local expenditures per capita for public schools Colorado is about average compared to other states.

But, the issue is not how much Colorado spends for public schools compared to other states; the issue is how to achieve better education outcomes. The goal should be a better educated and trained labor force. Education programs should be held accountable for performance, just as any other state program.

Much of the current debate assumes that student achievement in public schools is satisfactory, or better than satisfactory. This myth is usually supported by tests designed by teachers to prove that students are doing well in the public schools. Yet, SAT and ACT scores reveal that most students are not prepared for college, or for entry into the labor force; and, there is little evidence of improvement in these scores.

The education lobby has been successful in creating the myth that no viable alternative education model can work, and states must continue to muddle along with the current failed education model. The overwhelming evidence is that alternative education models, based on school choice, can significantly improve student performance.

Colorado should vigorously pursue policies that expand school choice, including: vouchers, charter schools, home schooling, internet education, etc. Colorado should follow the lead of other states in introducing vouchers for students in failing schools, and then expend the voucher system to all schools. When voucher systems have been introduced in other states there is consistently a greater demand for the vouchers than the numbers available. There is no better measure of the value of empowering parents to make education choices in the best interest of their children.

The voucher system introduced in Colorado's higher education system should be expanded to all post secondary education. Qualified students should be eligible for vouchers to help finance vocational as well as college education. They should be able to use these vouchers in private for profit post secondary institutions as well as colleges and universities. This would create a level playing field in which all post secondary institutions could compete.

The education lobby has used the myth of a school 'funding crises' to argue that funding for public schools should shift from local governments to the state. The share of the state budget allocated to public education has already increased significantly and is now approaching fifty percent.

The most rigorous economic analysis shows that shifting funding from local governments to the state results in poorer student performance. At the local level taxpayers are able to achieve some transparency and accountability in how their education dollars are spent. When funding shifts to the state, taxpayers lose this power to hold the public schools accountable. The education lobby then finds it much easier to influence a few hundred state legislators in pursuing an agenda that often has little to do with improved student performance.