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CENTER FOR TAX POLICY

TAXPAYER REPORT

IMPLICATIONS OF THE TABOR RATCHET FOR COLORADO'S BUDGET, FY 2001-02 THROUGH FY 2009-10

October 2005

INTRODUCTION

This past summer, the Center for Tax Policy undertook an economic analysis of the so-called “ratchet” provision in TABOR (the Taxpayer’s Bill of Rights), which is an amendment to Colorado’s constitution concerning tax and expenditure limits. The analysis was conducted in order to help inform the public debate about whether to amend TABOR. The findings from the analysis are presented in this report. Funding for the study was provided by Rose Community Foundation.

On November 1, 2005, Colorado voters will go to the polls to consider Referenda C and D. These two ballot measures would allow the state to retain excess TABOR revenues (the TABOR surplus) through the 2009-10 fiscal year and earmark the retained revenues to support programs in health care, K-12 education and higher education, and authorize bonding capacity to support capital improvements to the transportation system, K-12 school buildings and higher education facilities. The measures would also eliminate the impact of TABOR’s ratchet on the state budget. It is this last aspect of TABOR and these referenda—the implication of the ratchet—that is the subject of this report.

The **ratchet** refers to a provision in TABOR whereby the base for calculating allowable state expenditures is permanently “ratcheted down” for all future years after any year in which actual revenue collections fall below the state’s expenditure limit. The effect of the ratchet on the state’s budget appears to be one of the least well-understood points of TABOR, particularly the fact that without the ratchet all projected revenue through FY 2009-10 would be legally available to the state under the TABOR expenditure limit. That is, if TABOR were in place with all its provisions except for the ratchet, Coloradans would not be engaged in the current debate over whether to permit the state to retain the estimated \$3.6 billion surplus; there would be no surplus.

This study uses data from the Legislative Council (the non-partisan analytical arm of the Colorado General Assembly), the legislature’s Joint Budget Committee and Colorado state agencies as the basis for its analysis.

In the sections that follow, this report:

- Presents background information on the recessionary budget cuts since FY 2001-02;

- Explains the ratchet effect in more detail; and
- Analyzes Colorado’s future under the ratchet by exploring four alternative scenarios for staying within the TABOR limits if the ratchet remains in the law.

THE RECESSIONARY BUDGET CUTS SINCE FY 2001-02

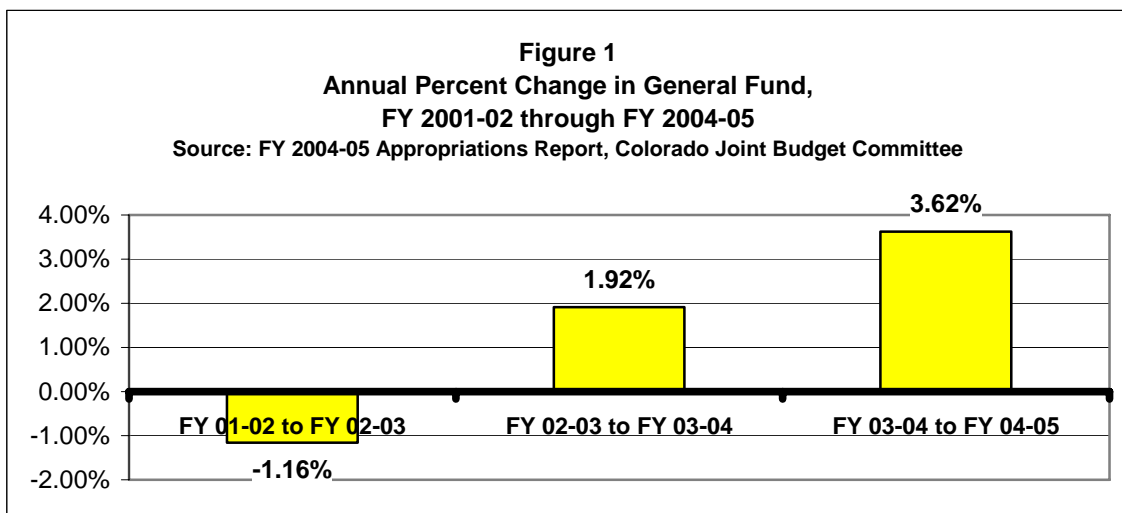
In order to fully understand the state’s future budget position, particularly the impact of the projected deficit in the General Fund and its relationship with TABOR’s ratchet, it is necessary to have some background on both the cuts to and squeeze on the General Fund that occurred as a result of the FY01-02 recession and the associated ratchet. The sections that immediately follow provide that background before addressing the ratchet’s impact on the future.

As will be highlighted later in this report, the ratchet did not cause the budget cuts; the recessionary decline in state revenues did. However, the ratchet will make it difficult to restore any of the cut programs or even maintain the level of programs and services currently provided, even with the improving economy, unless some public services are cut.

Before looking more closely at the specific departments and services impacted by the recession, it is important to better understand the dynamic taking place within the state’s General Fund overall. (The *General Fund* is mainly derived from income and sales tax revenues and can be appropriated for any state purpose. It is distinguished from *Cash Funds*, which are generally come from fees collected for certain specific purposes such as wildlife management, and federal funds.) The section that follows lays out the dynamic.

Budget “Cuts” and The Squeeze on the General Fund

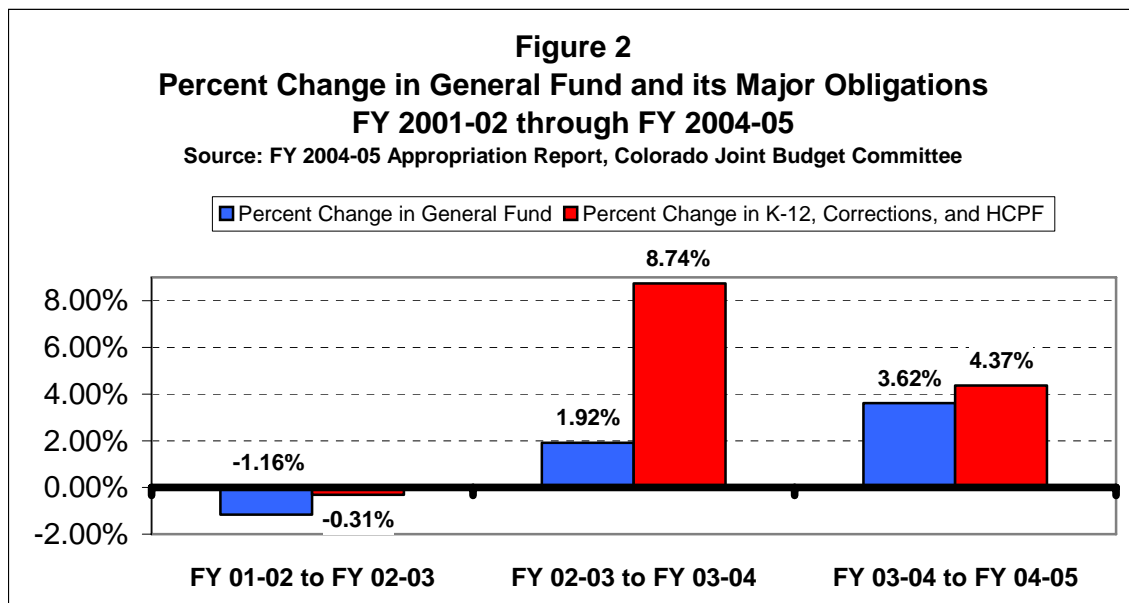
The use of the term “cut” to describe the budget actions the state has taken since the 2001 recession has been the subject of much debate. Those who see programs being eliminated or reduced refer to that phenomenon as a budget cut. Others who see overall year-to-year growth in the General Fund for most years argue that it is inappropriate to talk about cuts when total state expenditures are actually growing in absolute dollars. The resolution to those conflicting positions requires a better understanding of the dynamic taking place within the state budget in general and the General Fund in particular.



Between FY 01-02 and FY 04-05¹ the General Fund increased from \$5.586 billion to \$5.831 billion. Every year but one saw year-to-year growth in the fund (see Figure 1). By any definition of the word, the General Fund experienced a cut between FY 01-02 and FY 02-03. However, in the other years, although the General Fund experienced modest growth, programs and services were reduced, leading to the confusion over the term “cut.”

A myriad of phenomena converged to result in programmatic cuts even as the overall General Fund was increasing. The most salient is the impact of inflationary and demand increases for particular programs, particularly Medicaid. During recessionary times, Medicaid caseloads usually increase as a result of increased unemployment and more people qualifying for state assistance. Couple this with the fact that medical inflation generally increases at a rate in excess of overall inflation, and very quickly Medicaid begins to command larger proportions of the General Fund.

As non-discretionary programs such as Medicaid (which is managed by the Department of Health Care Policy and Financing) command a greater and greater percentage of a shrinking or more modestly growing General Fund, the ultimate result is the squeezing of other programs in order to continue funding for the mandated or non-discretionary programs. Including the other two largest, non-discretionary programs—Corrections and K-12 Education—further exacerbates this effect. Figure 2 demonstrates this impact.



Ratchet Causes a Structural Deficit

The ratchet in TABOR works such that once the state has a serious shortfall in revenues, as it did in 2001-02, the state budget will never be able to catch up to where it had been before the shortfall, adjusted for population growth and inflation. This problem arises, not because actual revenues are expected to be insufficient, but because the ratchet provision in TABOR will not allow the state to spend all of the revenues it collects.

¹ The source for these numbers and calculations is the FY 2004-05 Appropriation Report. The numbers for FY 01-02 and 02-03 are actuals while the numbers for the remaining two fiscal years are appropriations.

A situation where, for the foreseeable future, projected funds available for appropriation will be less than the amount needed to continue services at current levels is called a “*structural deficit*”—that is, a deficit related to how revenue and budget policies are structured.

A structural deficit is unlike an ordinary deficit, which is a short-term problem. According to the Center for Politics and Public Affairs in Pennsylvania:

A state with an ordinary deficit is like a person with a bad cold—miserable for a while, but in time one gets over it. But a state with a structural deficit is more like a person with a chronic disease. Time will only make it worse.

Structural deficits may be resolved in one of two ways: by increasing revenues or by reducing expenditures. TABOR’s ratchet, experienced during the recession, makes it progressively more difficult to increase revenue to the General Fund sufficient to fund the normal rates of increase experienced by the non-discretionary programs, or even to the 6 percent appropriation limit.² As a result, the only manner in which to balance the structural deficit in the General Fund is through programmatic cuts, even though those cuts may be occurring during years of modest General Fund growth. For the remainder of this analysis, the word “cut” will be used in such a manner. That is, “**cut**” will refer to program or service reductions resulting from the structural deficit that cannot be funded with increases in revenue.

Budget Actions Taken between FY 2001-02 and FY 2004-05³

In the years between FY 2001-02 and FY 2004-05, \$974,244,635 worth of budget actions was taken in order to balance the General Fund. “**Budget actions**” include any actions taken by the state to keep expenditures within allowable limits. This includes such things as cutting program budgets, limiting eligibility for certain services, borrowing from Cash Funds, deferring expenses from one year to the next, recategorizing certain expenditures so that they are off-budget, etc.

While a large number of budget actions between FY 2001-02 and FY 2004-05 were direct programmatic or service cuts, others were replacement of General Fund support to a program with funding from another source, particularly in the area of K-12.⁴ It is important to note, however, that even General Funds that were replaced with other funding sources often required reductions somewhere, most often in the programs supported by those alternative sources of funds.

² This is due to the dynamic between the Arveschoug-Bird 6% limit and the TABOR limit. According to the Colorado Legislative Council Staff, “**Arveschoug-Bird** is a statutory limit on General Fund Appropriations. Unlike TABOR, which limits all state revenues, Arveschoug-Bird applies only to General Fund appropriations. Arveschoug-Bird limits state General Fund appropriations to an annual increase of 6% over the prior year or, in total, 5% of state personal income.” As revenues to the cash funds, particularly the unemployment insurance fund, increase, they take up room under the TABOR limit, thus leaving less room for growth in the General Fund. TABOR’s ratchet further exacerbates this interaction.

³ The data for this section come from a Colorado Joint Budget Committee memo of November 9, 2004, *Update on Summary of Actions Taken to Balance Prior Year Budgets*

⁴ Although Table 1 shows K-12 as having sustained the largest cut during the economic downturn, the true story is more complex. See explanation below under “K-12.”

Table 1
Total Value of Actions Taken to Balance the State Budget,
FY 2001-02 through FY 2004-05

Source: Update on Summary of Actions Taken to Balance Prior Year Budgets,
Colorado JBC memo, 11/9/04

	<i>Value of Budget Actions</i>	<i>Percent of Total Cuts</i>
Agriculture	\$ 6,430,679	0.66%
Corrections	\$ 47,033,691	4.83%
K-12	\$ 284,308,227	29.18%
Governor	\$ 2,262,801	0.23%
Health Care Policy	\$ 100,529,343	10.32%
Higher Education	\$ 177,355,653	18.20%
Human Services	\$ 117,358,066	12.05%
Judicial	\$ 17,804,000	1.83%
Law	\$ 2,713,491	0.28%
Legislature	\$ 7,556,813	0.78%
Local Affairs	\$ 8,036,085	0.82%
Military Affairs	\$ 365,197	0.04%
Natural Resources	\$ 11,647,609	1.20%
Personnel	\$ 6,280,000	0.64%
Public Health	\$ 18,171,589	1.87%
Public Safety	\$ 9,833,695	1.01%
Regulatory Agencies	\$ 1,772,717	0.18%
Revenue	\$ 22,947,302	2.36%
State	\$ 1,200,000	0.12%
Treasury	\$ 85,237,677	8.75%
Statewide	\$ 45,400,000	4.66%
TOTAL	\$ 974,244,635	100.00%

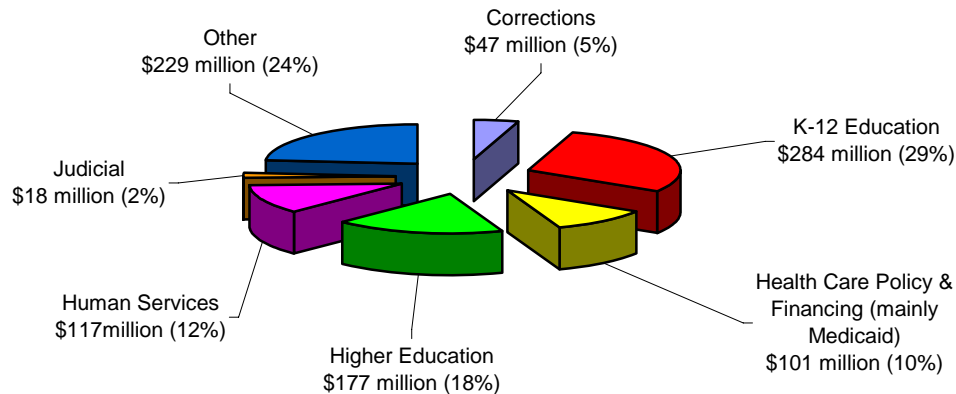
Of the 20 state departments supported by the General Fund, the six largest departments⁵ shouldered 76.41 percent of the total actions. Table 1 and Figure 3 show the total, cumulative four-year impact to each department. The six largest departments are indicated with bold lettering.

Budget Actions: A Closer Look

As noted above, the six largest departments in state government accounted for just over 75 percent of total budget balancing actions taken. Of those six largest departments, Corrections and Judiciary, on a percentage basis, absorbed relatively small portions of the total budget actions taken. The majority of the budget balancing in the General Fund was borne by four departments: K-12 Education, Higher Education, Health Care Policy and Financing, and Human Services. Interestingly, these four departments, more than almost any others, directly serve citizens across all demographic groups and throughout all regions of the state. As a

⁵ They are Corrections, Education, Health Care Policy, Higher Education, Human Services and Judicial.

Figure 3
Major General Fund Departments and Their Total Budget
Reductions, FY 2001-02 to FY 2004-05
Total 4 year reductions \$974,244,635



result, not only do the services provided by these departments have primary economic effects throughout the state; but, they also have secondary effects, as the regional nature of these services contribute to the economic well-being of local communities across Colorado. The sections below outline these impacts in further detail.

K-12

Although Figure 3 above shows K-12 as having been subject to the largest budget actions during the economic downturn, the true story is more complex. With its constitutional protections, many parts of K-12 education are not subject to reductions. Therefore, alternative means of funding must be found in times of reduced General Fund support. In the case of the recent recession, the major alternative source of funding was the State Education Fund (SEF). The true legacy of the economic downturn in the area of K-12 was the draining of the SEF by General Fund borrowings, rendering the SEF unavailable to support K-12 funding in the immediate future.

Higher Education

As with K-12, perhaps the greater legacy of the recession on higher education in Colorado is not the specific cuts made during those fiscal years, but rather the decision to overhaul its funding mechanism and allow the entire system of higher education within the state to declare itself an enterprise under TABOR. Under TABOR, a governmental function that receives less than 10 percent of its total funding from the general tax base may declare as an “enterprise” and thus be exempt from the revenue and spending limit. In the years prior to enterprise declaration, higher education tuition counted as TABOR revenue and thus counted toward the limit on revenue growth. With the declaration of enterprise status, higher education tuition will no longer count against the state’s revenue limit. This provides schools more latitude on tuition policy, particularly the ability to replace lost state support with increased tuition and fees.

Health Care Policy and Financing

The Department of Health Care Policy and Financing (HCPF) experienced just over \$100 million in program cuts over the four-year period. Almost 90 percent of these were cuts to the Medicaid program and, as such, directly affected many of the approximately 380,000 people covered statewide. The majority of the additional 10 percent of the HCPF cut was associated with the Colorado Indigent Care Program and the Children's Basic Health Plan, also directly affecting citizens dependent upon such programs for health care services.

The short discussion presented above outlines the impact of budget actions between fiscal years 2001-02 and 2004-05. These actions were necessary due to the weak economic condition of the state during that period. TABOR's ratchet did not affect the budget during that time, but it will have a significant impact during the economic recovery currently underway. The remainder of this report examines the ratchet and its possible impacts in the future.

THE RATCHET EFFECT EXPLAINED

The ratchet effect, although not a technical term, refers to TABOR'S mechanism that rebases the state's allowable revenue budget at the level of actual revenue collections during a recession. In order to better understand this phenomenon, it is necessary to understand the revenue limit in TABOR. Essentially, beginning with the base year of 1992, state government was permitted to grow by an increment of population plus inflation applied to the base year. In each subsequent year, the previous year's revenue limit effectively becomes the base to which the population plus inflation growth factor is applied. This sort of measured revenue growth continues as long as the following two conditions hold:

- Population plus inflation remains positive, which it has throughout the state's history with TABOR, and
- The state collects revenue sufficient to support allowable fiscal year spending under the limit.

It is when this second condition fails to hold that the ratchet takes effect, as the population plus inflation growth factor then applies to the previous year's *actual* revenue collections rather than the level of growth *allowable* under the limit. Essentially, the previous year's base is the lesser of actual revenue collections and allowable revenue under the limit. When the previous year's revenues fail to support allowable collections under the limit, the subsequent year's base is reset at actual revenues and the growth factor is then applied. It is this rebasing that results in the phenomenon that Coloradans refer to as the ratchet effect.

One of the better explanations of the effect of the ratchet on units of government comes from the Colorado Municipal League's (CML) 1999 guide to TABOR. Although CML's treatment of the subject was directed at local governments, the following discussion of the ratchet effect is germane to all levels.

Under TABOR ..., there is no provision whatsoever for ... accounting for cyclical revenue swings that may occur over a multi-year period. This aspect of TABOR may lead to the so-called "ratchet-down" effect when ... revenues decline in any single year. For example, if ... actual receipts decline in a particular year, the ...

revenue base ratchets downward also to the new, lower amount. Then, if the ... economy rebounds robustly in the next year with an accompanying healthy increase in ... revenues, the [state] may not be able to keep and spend the entire increase if it exceeds the year-to-year limitation. This could occur even if the rebound year simply takes the [state] back to the gross revenue amount it enjoyed two years previously. TABOR does not concern itself with how revenue in any particular year relates to two years before; it strictly controls the revenue in relation to the immediate preceding year.

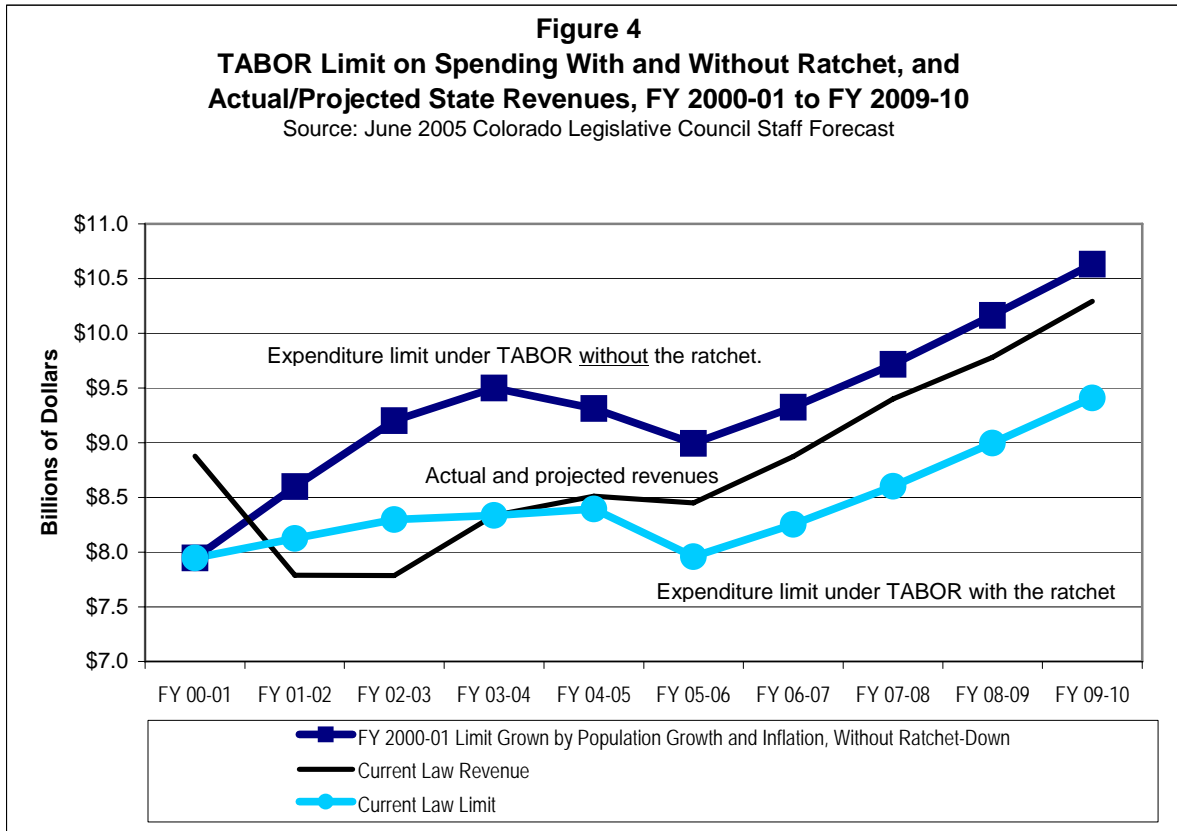
Essentially, once rebasing or ratchet occurs, the state can never recover revenue that it would have captured had the rebasing never happened. Compare this to the manner in which families manage budgets. Naturally, when family income drops, members tighten their belts and reduce spending. The situation may even become sufficiently dire that expenditures once considered necessities are eliminated from a family budget. When family income rebounds, however, many goods and services previously eliminated are restored to the family consumption bundle. Often, this restoration, particularly in the period of catching up, requires spending all of the newly earned family income.

If families imposed a ratchet upon themselves such as the one imposed in TABOR, otherwise available income would become artificially unavailable for catching up from the bad times. It is unreasonable to believe that families would continue to deny themselves essential services by deeming newly earned income unavailable for such purposes. Yet, this is precisely what TABOR's ratchet does to state revenue.

If a Family's Budget Included a Ratchet

It is illustrative to compare the impact of the ratchet on state spending to how families manage budgets. Assume a family with two wage-earners earns a combined \$50,000 a year. It spends the entire amount on such things as housing, food, transportation, day care, etc. Then one parent loses his/her job and the family's annual income drops to \$25,000. The family responds by adjusting its spending accordingly. If that family were subject to the ratchet, it would mean that, even when the family replaces the previously lost income, they could not readjust their spending back up to the previous \$50,000 level. They would be tied to the \$25,000 ceiling.

Latest estimates show that the current year's state budget, the first to experience the ratchet coincident with sufficient estimated revenue to require TABOR refunds, is at the 2000-01 level. That is, while the estimated TABOR refund is \$116.7 million in FY 2005-06, the allowable budget under TABOR will be sitting at FY 2001-02 levels,⁶ requiring additional estimated programmatic reductions of \$55 million in that year. Visually, the ratchet effect may be better demonstrated in Figure 4.



Prior to fiscal year 2000-01, revenue collections by the state were sufficient to support allowable growth under the TABOR limit. This changed with the economic downturn. Had the economy not faltered in the early part of 2001, the limit under TABOR would have followed the square-hatched trajectory—representing allowable growth of population plus inflation applied to the previous year's limit⁷—shown in Figure 5. However, with the recession, the state failed to collect enough revenue to support total allowable growth under the limit. That decline rebased or ratcheted the budget down to the trajectory represented by the circle-hatched line. The difference between the two trajectories represents the extent to which the budget has been ratcheted down under TABOR.

⁶ Figure 4 demonstrates that the allowable budget will be at FY 00-01 levels; however, that figure accounts for the declaration of enterprise status by the University of Colorado. When CU was declared an enterprise, the base budget was adjusted to reflect the elimination of that program from the TABOR limit.

⁷ The decline in the allowable limit in FY 2004-05 and again in 2005-06 is due to the certifying of first CU (in '04-05) and then the rest of the system of higher education (in '05-06) as enterprises. Once an activity is classified as an enterprise under TABOR, its revenue is not subject to the revenue retention limit and must be eliminated from the base.

Currently and for the foreseeable future, the allowable budget under TABOR’s ratchet sits at a level approximately \$1 billion lower than the spending limit would have been had it not been for the recession and the resulting ratchet. Without a change to the law, this difference will persist and even amplify over time. Superimposing the revenue projections on this picture (see the solid line in Figure 4) demonstrates that the ratchet effect is estimated to result in approximately \$3.6 billion of unavailable revenue to the state over the next five fiscal years. **It is important to note that all of this revenue would have been legally available under the TABOR limit had the ratchet never occurred.**

As with the family required to tighten its belt in times of economic struggle, it was the recession and the resulting decline in state revenues rather than the ratchet that necessitated the budget cuts of the past four years. However, unlike the family that restores goods and services when its economic circumstances change, the state will be unable to do the same during periods of economic recovery. It is during these periods of post-recessionary recovery and expansion that the ratchet effect is fully felt.

THE GENERAL FUND STRUCTURAL DEFICIT: LATEST ESTIMATE

The latest Legislative Council forecast projects the structural deficit for the state’s General Fund through the 2009-10 fiscal year. By the definition employed in that analysis, the calculation of the structural deficit for the General Fund is based upon the 6 percent appropriation limit. As noted above, this analysis is not intended to evaluate the appropriateness of that particular specification of the structural deficit,⁸ but rather to evaluate the impact of the limit on programs and services in the future.

Table 2 outlines the annual and cumulative structural deficit identified in the forecast as well as the latest estimate for TABOR refunds. There are generally two ways to close such a deficit: spending cuts and revenue increases (including borrowing). However, under current law, due to the impact of TABOR’s ratchet and the interactions between the General Fund and other state revenues, the only method currently available to close this deficit is expenditure cuts. Most other, one-time stop-gap measures, such as borrowing from Cash Funds or delaying the state’s employee payday by one day, have been exhausted.

Table 2					
Forecast of Cumulative Structural Deficit and Estimated TABOR Refunds					
Source: Colorado Legislative Council June 21, 2005 Forecast					
	FY 05-06	FY 06-07	FY 07-08	FY 08-09	FY 09-10
Cumulative Structural Deficit =Amount of Program Cuts Needed to Balance the Budget:					
	\$ 55.0 million	\$ 394.3 million	\$ 555.3 million	\$ 588.7 million	\$ 627.9 million
Estimated TABOR Refund:					
	\$ 116.7 million	\$ 490.5 million	\$ 618.7 million	\$ 799.1 million	\$ 881.5 million

⁸ Structural deficits occur when budgeted expenditures exceed available revenue on an ongoing basis.

TABOR's ratchet, by effectively rebasing the budget when the recession hit, provides for less available room for the state to retain the revenue generated by the current tax and fee system of funding state programs. Furthermore, the interaction between the General and Cash Funds under TABOR serves to further squeeze the General Fund, as a growth in Cash Fund revenues (e.g., for the unemployment compensation fund) takes up room under the TABOR limit that would otherwise be available to fully fund the 6 percent available appropriation increase in the General Fund. **Thus, although revenue will be generated by the state sufficient to close the structural deficit in the General Fund, under current law the state is legally obligated to refund a portion of this revenue as TABOR surpluses even while the General Fund fails to grow at its legal 6 percent limit.**

Had the ratchet never occurred, the trajectory of the TABOR limit would have permitted for the retention of all state revenue estimated to be generated during the forecast period. (See Figure 4.) Instead, **without approval to retain excess revenue as provided for in Referendum C, the state will be required to close the structural deficit through expenditure cuts while at the same time refunding surplus revenues that would not have been surplus had the ratchet never occurred.**

COLORADO'S FUTURE UNDER THE RATCHET: IMPACTS ON THE GENERAL FUND

As with all analyses, it is important to outline the parameters that define the project. What follows in the remainder of this report is a series of scenarios intended to illustrate the magnitude of the budget problem facing the state if the TABOR ratchet is not eliminated and its impact is fully felt.

In developing these scenarios, we did not independently estimate the size of the structural deficit projected by the state. Instead, we relied upon the forecast⁹ prepared by the Colorado General Assembly's non-partisan Legislative Council research staff. In that vein, it is important to note that forecasts are built upon the best possible information available at the time. As such, it is unlikely that, as the years in the forecast period unfold, the magnitude of the deficit remains exactly as predicted currently.

It is imperative to appreciate that the ultimate programmatic decisions inherent in balancing the budget lie with the political process that will be undertaken by the General Assembly. There is not a publicly available, pre-determined list of programs that will be reduced or eliminated to balance the budget. Instead, those decisions will evolve over time. Therefore, the discussion that follows should not be taken as a definitive statement or even a roadmap of what will happen if the ratchet is not removed from TABOR. Rather, the scenarios presented in the sections that follow outline some of the many options available to the General Assembly as it works to close the structural deficit over the next few years.¹⁰

⁹ For all of the scenarios the level of the structural deficit came from the Legislative Council's June 21, 2005 forecast.

¹⁰ Note that closing the General Fund structural deficit by increasing revenue is largely precluded by the interaction of the TABOR and Arveschoug-Bird limits and the impact of the ratchet.

It is unlikely that any of the exact scenarios set forth below will actually occur in the precise manner in which they are outlined. Rather, they are intended to simply demonstrate the magnitude of the budget problem facing the state, particularly through the FY 2006-07 fiscal year, should the full effect of the ratchet be felt.

SCENARIO 1: Future Cuts Mirror Previous General Fund Budget Actions

As noted earlier, between FY 01-02 and FY 04-05, the Legislature took just over \$974 million in actions to balance the General Fund (see Table 1). A November 2004 Joint Budget Committee memo outlined those actions at the department level. From this memo, we were able to calculate the percentage of total actions associated with each General Fund department. Applying those same percentages to the predicted annual and cumulative structural deficit in the future provides one scenario of the impact and magnitude of potential future cuts.

It is important to note that this scenario is the least realistic of the ones presented here as, for a variety of reasons outlined below, many departments can no longer bear cuts of this magnitude. However, this allocation provides a starting point for discussion.

Table 3 demonstrates the relative FY '09-10 impact on department budgets should future cuts be allocated in the same proportions as past actions. It was derived by inflating each department's FY '05-06 appropriation by the estimated General Fund growth over the intervening years and then taking the allocated cut as a percentage of the projected department budget in FY '09-10. It is, however, important to note that the larger departments such as Education, Health Care Policy and Financing, and Corrections—because of mandated increases, caseload growth, and inflationary pressures separate from the rate at which the General Fund grows—will increase at rates greater than the estimated rate of growth of the General Fund. Therefore, Figure 5 on the next page, which represents cuts as a percentage of estimated FY 2009-10 budget, is simply a straight line estimate rather than an actual representation of the burden each department would face should future cuts be allocated in the same proportion as past ones.

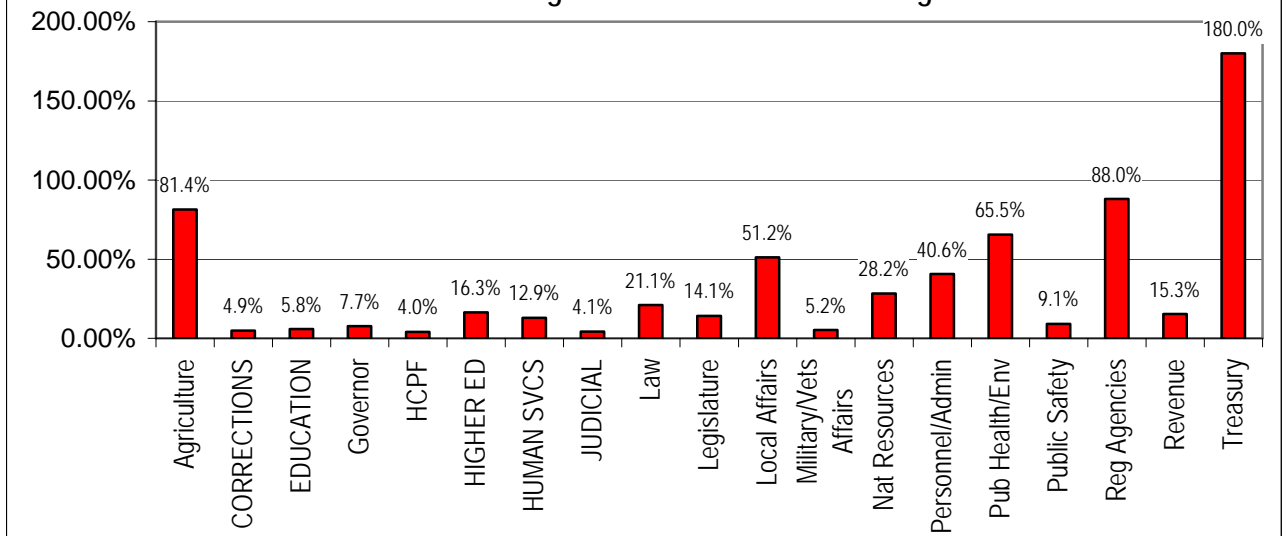
Table 3 Scenario 1: Future Cuts Mirror Past General Fund Budget Actions¹¹							
	FY 01-02 through FY 04-05 Percentage Cuts	FY 05-06	FY06-07	FY07-08	FY08-09	FY09-10	Cumulative Five Year Impact
Agriculture	0.66%	\$363,000	\$2,239,380	\$1,063,260	\$220,440	\$258,720	\$4,144,800
Corrections	4.83%	\$2,656,500	\$16,388,190	\$7,781,130	\$1,613,220	\$1,893,360	\$30,332,400
Education	29.18%	\$16,049,000	\$99,007,740	\$47,008,980	\$9,746,120	\$11,438,560	\$183,250,400
Governor	0.23%	\$126,500	\$780,390	\$370,530	\$76,820	\$90,160	\$1,444,400
<i>Continued on next page</i>							

¹¹ The Cumulative Difference calculated by the Legislative Council includes compounding. Therefore the annual “shortfall” was derived from reducing the current year shortfall amounts by the previous year’s utilizing the LCS Cumulative Difference.

Table 3 (continued)
Scenario 1: Future Cuts Mirror Past General Fund Budget Actions

	FY 01-02 through FY 04-05 Percentage Cuts	FY 05-06	FY06-07	FY07-08	FY08-09	FY09-10	Cumulative Five Year Impact
Health Care Policy	10.32%	\$5,676,000	\$35,015,760	\$16,625,520	\$3,446,880	\$4,045,440	\$64,809,600
Higher Ed	18.20%	\$10,010,000	\$61,752,600	\$29,320,200	\$6,078,800	\$7,134,400	\$114,296,000
Human Services	12.05%	\$6,627,500	\$40,885,650	\$19,412,550	\$4,024,700	\$4,723,600	\$75,674,000
Judicial	1.83%	\$1,006,500	\$6,209,190	\$2,948,130	\$611,220	\$717,360	\$11,492,400
Law	0.28%	\$154,000	\$950,040	\$451,080	\$93,520	\$109,760	\$1,758,400
Legislature	0.78%	\$429,000	\$2,646,540	\$1,256,580	\$260,520	\$305,760	\$4,898,400
Local Affairs	0.82%	\$451,000	\$2,782,260	\$1,321,020	\$273,880	\$321,440	\$5,149,600
Military Affairs	0.04%	\$22,000	\$135,720	\$64,440	\$13,360	\$15,680	\$251,200
Natural Resources	1.20%	\$660,000	\$4,071,600	\$1,933,200	\$400,800	\$470,400	\$7,536,000
Personnel	0.64%	\$352,000	\$2,171,520	\$1,031,040	\$213,760	\$250,880	\$4,019,200
Public Health	1.87%	\$1,028,500	\$6,344,910	\$3,012,570	\$624,580	\$733,040	\$11,743,600
Public Safety	1.01%	\$555,500	\$3,426,930	\$1,627,110	\$337,340	\$395,920	\$6,342,800
Regulatory Agencies	0.18%	\$99,000	\$610,740	\$289,980	\$60,120	\$70,560	\$1,130,400
Revenue	2.36%	\$1,298,000	\$8,007,480	\$3,801,960	\$788,240	\$925,120	\$14,820,800
State	0.12%	\$66,000	\$407,160	\$193,320	\$40,080	\$47,040	\$753,600
Treasury	8.75%	\$4,812,500	\$29,688,750	\$14,096,250	\$2,922,500	\$3,430,000	\$54,950,000
Statewide	4.66%	\$2,563,000	\$15,811,380	\$7,502,600	\$1,556,440	\$1,826,720	\$29,260,140
TOTAL	100.01%	\$55,005,500	\$339,333,930	\$161,111,450	\$33,403,340	\$39,203,920	\$628,058,140

Figure 5
Scenario 1: Future Cuts Mirror Past General Fund Actions:
Cuts as a Percentage of Estimated FY 09-10 Budget



Careful review of the departmental impacts underscores the implausibility of departments bearing future reductions in proportion to those taken in the past.

For example:

- Treasury, because of the previous elimination of the senior homestead credit, had a disproportionately large reduction in its budget during the recession. A reduction of that magnitude in the future would eliminate the department almost twice over.
- The General Fund reductions taken by K-12 education to date were backfilled with borrowings from the State Education Fund, thus ameliorating the impact of such actions. In the future, however, such borrowings will not be available as the fund balance in the State Education Fund was eliminated by the past borrowings. Any further cuts will need to be absorbed without funds to serve as backfill while also complying with the requirements of Amendment 23.¹²
- The four departments of Agriculture, Local Affairs, Public Health and the Environment, and Regulatory Agencies, if allocated future cuts in the same proportion as past ones, would see more than 50 percent of their operating budgets eliminated by FY 09-10, with a fifth, Personnel and Administration, experiencing just over a 40 percent cut.

Factoring in the infeasibility of sustaining the past cuts to Treasury, the cuts to these departments would be even greater. Given these circumstances, it is highly unlikely that the allocation of cuts to close the structural deficit would follow the proportions experienced in the past.

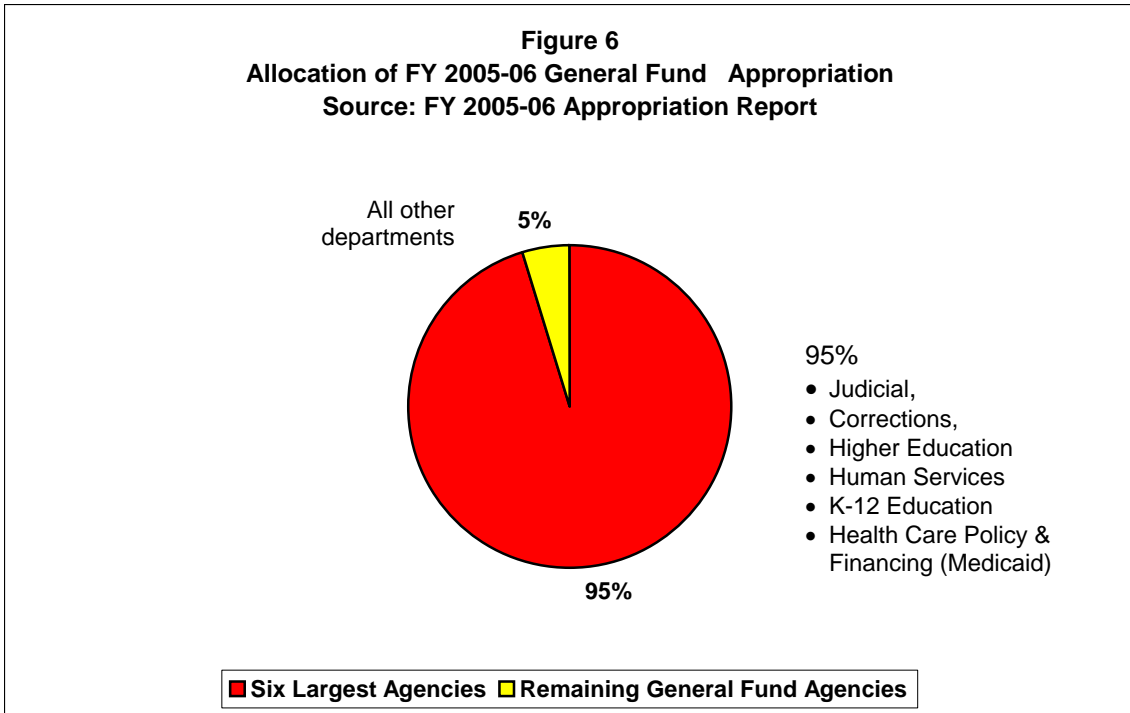
Obviously, many factors are involved in determining what the outcome of future cuts will be. The above picture, although largely infeasible, helps to conceptualize the magnitude of the reductions that will be necessary to close the structural deficit. Given that all programs and departments already sustained across-the-board cuts, a more likely scenario is that the structural deficit will instead be closed through the total elimination of programs or even, in the most dire of cases, entire departments, as discussed in the next section.

SCENARIO 2: Complete Elimination of General Fund Funding for Most Departments

In conversations with state budget directors across the country, several directors have said that, **given the pressures facing state budgets, in the future, many states may be reduced to undertaking just three functions: educate, medicate and incarcerate.** Although some may dismiss this as hyperbole, in Colorado's case, closing the structural deficit while protecting the non-discretionary functions of education, health care and corrections might ultimately leave the state with little else supported with general tax dollars.

The Legislative Council's June 2005 forecast identifies a structural deficit of \$55 million in FY 2005-06. As the forecast notes, the FY 05-06 shortfall may be covered by the statutory reserve in the General Fund, but this will not be a sustainable strategy for the five-year forecast period as the structural deficit widens. To give an idea of the magnitude of the

¹² Amendment 23 refers to an amendment to the Colorado Constitution that guarantees a funding increase for the state's public school systems for 10 years. The public school budget must increase at the rate of inflation plus 1 percent each year.



problem, this section states the structural deficit in terms of the departments which that level of budget supports. Again, this is not to suggest that the deficit will be closed in this manner, through wholesale elimination of departments, but rather to provide a sense of scope by stating the problem in terms of departmental budgets.

To better understand this scenario, it is necessary to understand the allocation of the General Fund. Ninety-five percent of the 2005-2006 General Fund appropriation is dedicated to the six largest departments: Judicial, Corrections, Human Services, Education, Higher Education, and Health Care Policy and Financing (see Figure 6). For the FY 2005-06 appropriation, this translates to just over \$5.9 billion for those six departments, with the remaining ones receiving a combined \$285.8 million.

By the end of FY 06-07, just under \$400 million must be cut to close the gap. This means that **eliminating General Fund funding all but the six largest state departments would achieve just under 73 percent of the necessary reductions.** Colorado's General Fund would, in fact, only be left "educating, incarcerating, and medicating." Table 4 below lists the departments sharing the \$287 million in General Fund budget reductions.

<ul style="list-style-type: none"> • Agriculture • Governor • Law • Legislature • Local Affairs • Military and Veterans Affairs 	<ul style="list-style-type: none"> • Natural Resources • Personnel and Administration • Public Health and the Environment • Public Safety • Regulatory Agencies • Revenue • Treasury
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** It should be noted that some of these departments are primarily funded with Cash and/or Federal Funds.*

SCENARIO 3: Dedicated Cuts to Large Programs

By the end of FY 2006-07, balancing the General Fund will require reductions of the magnitude of \$400 million. As was demonstrated above, even the elimination of 13 departments would achieve just short of three-fourths of the necessary reductions, and it is obviously infeasible to completely eliminate from the workings of the state all of the functions associated with the 13 departments. As a result, closing the gap in the General Fund is almost guaranteed to require major program cuts in the six largest General Fund departments. The discussion that follows outlines what such cuts might look like in two programs: Higher Education's College Opportunity Fund and Health Care Policy and Financing's Medicaid program.

Scenario 3A: Eliminate Funding for the College Opportunity Fund

Senate Bill 189, passed in 2004, established a system by which the General Fund provides support directly to the undergraduate students in the state rather than to the institution. The bill established the College Opportunity Fund (COF), essentially a voucher, which in the current year is worth \$2400 per student full time equivalent (FTE). It is important to note that the value of the COF in future years is in no way fixed at \$2400 per student FTE.

According to the Colorado Commission on Higher Education, Colorado's colleges and universities enrolled just over 132,000 resident undergraduate FTEs in 2004-05 (see Table 5).

Table 5 College Opportunity Fund (COF): Number of Recipients and Total Value of Fund Disbursement per College/University		
Institutions of Higher Education	Resident Undergraduates FY 2004-05	FY 2005-06 COF Based on 04-05 Enrollment Levels
University of Colorado-Boulder	16,208	\$ 38,899,200
University of Colorado-Colorado Springs	5,081	\$ 12,193,920
University of Colorado-Denver	5,656	\$ 13,575,432
University of Colorado-Health Sciences	378	\$ 908,160
Colorado State University-Education & General	16,378	\$ 39,306,720
Colorado State University - Pueblo	3,197	\$ 7,673,520
Fort Lewis College	2,733	\$ 6,559,200
Colorado School of Mines	2,468	\$ 5,923,440
University of Northern Colorado	8,875	\$ 21,299,760
Adams State College	1,503	\$ 3,608,280
Mesa State College	4,286	\$ 10,287,360
Metropolitan State College of Denver	14,263	\$ 34,230,408
Western State College	1,545	\$ 3,706,920
Arapahoe Community College	4,571	\$ 10,969,368
Colorado Northwestern Community College	895	\$ 2,148,912
Community College of Aurora	3,396	\$ 8,151,096
Community College of Denver	5,045	\$ 12,107,832
Front Range Community College	9,629	\$ 23,110,248
Lamar Community College	637	\$ 1,528,800
Morgan Community College	962	\$ 2,308,128
<i>continued</i>		

Table 5 (continued)			
College Opportunity Fund (COF): Number of Recipients and Total Value of Fund Disbursement per College/University			
Northeastern Junior College	1,403	\$	3,367,968
Otero Junior College	1,237	\$	2,967,912
Pikes Peak Community College	6,717	\$	16,120,080
Pueblo Community College	3,946	\$	9,470,088
Red Rocks Community College	4,523	\$	10,854,120
Trinidad State Junior College	1,454	\$	3,490,704
Aims Community College	2,954	\$	7,090,488
Colorado Mountain College	2,277	\$	5,464,800
TOTAL	132,218	\$	317,322,864

Assuming enrollment levels for 2005-06 consistent with previous levels, the total current value of the COF, given the per FTE amount of \$2400, is just over \$317 million. **Comparing this with the cumulative \$394.3 million structural deficit as of the end of FY 2006-07, at the current enrollment and COF rates, complete elimination of the newly created higher education voucher would address only about 80 percent of the problem.**

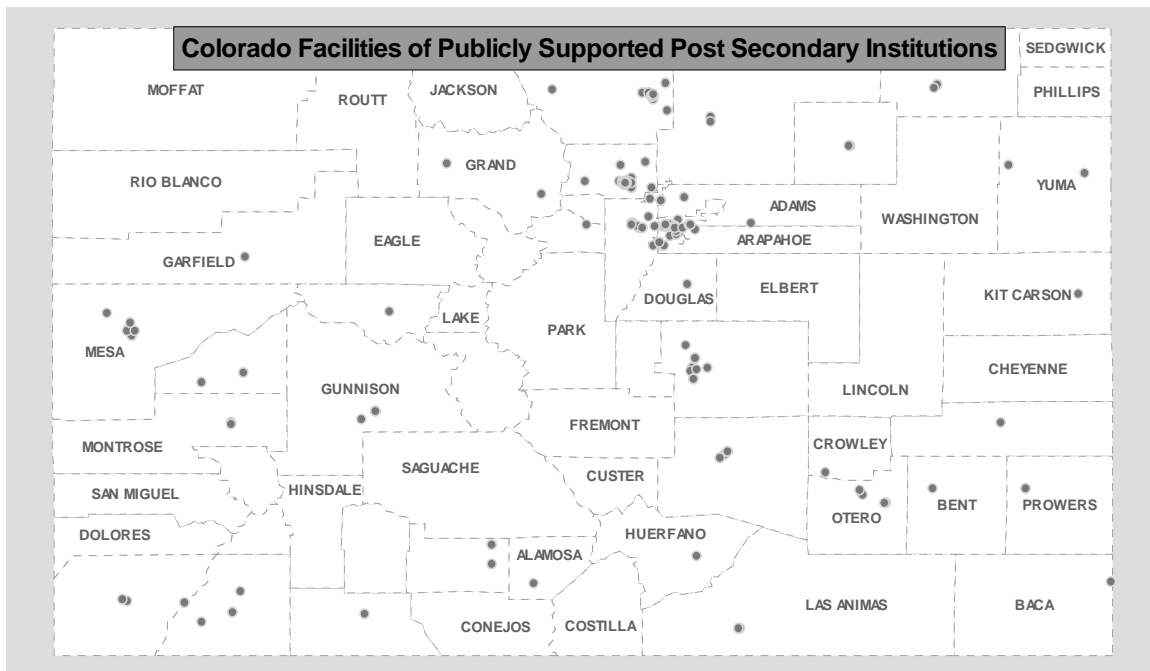
The COF, together with state support for financial aid, represents the majority of state support for undergraduate post secondary education in the state. Graduate programs are supported by fee-by-service contracts with the institutions. Therefore, any future reductions to Higher Education are likely to affect all areas of support, not simply the COF. However, regardless of the form of any cuts, the impacts are likely to reverberate regionally throughout the economy.

When most Coloradans think about their system of higher education, they tend to think only of the main campuses of each of the institutions. However, colleges and universities often have facilities, programs, and ancillary campuses away from the main campus. For example, there are extension campuses, campus-run businesses such as bookstores, health centers, and research centers located throughout the state. A simple search on a commercially available mapping software application for all public university facilities within Colorado yielded the map shown in Figure 7 on the next page. As the map demonstrates, the state's system of higher education impacts many of the state's 64 counties. These facilities in turn generate economic activity for these regions that would be foregone or significantly reduced with cuts to the support for these programs.

A recent study¹³ conducted on behalf of Northeastern Junior College quantified the economic impact of that facility on the region. The authors of the study tracked benefits in four major areas: the private benefit of higher earnings captured by former students, and the social benefits associated with regional economic growth, avoidance of social costs and the overall return to the taxpayers for their support of the college. In all cases, the analysis found a positive net benefit both to the individuals and the region.

¹³ The study was conducted on a contract with CCBenefits, which applied its economic model to the region served by Northeastern Junior College. The executive summary to the study is available on the Web at <http://forms.njc.edu/publications/socioeconomicbenefits1a.pdf> and the full study may be found at <http://forms.njc.edu/publications/socioeconomicbenefitsmainreport.pdf>.

Figure 7



Specifically, the study found that students receive a 23 percent rate of return on their investment in higher education. Assuming that some graduates remain in the region following the completion of their education, their increased earnings generate additional economic activity through increased spending. Overall, the study found that, on an annual basis, \$107 million of total regional earnings and approximately 4,600 jobs are associated with the economic contribution of the College. Furthermore, the study found that the state's \$6.2 million investment in the College resulted in a current dollar annual ongoing savings of \$1.1 million annually. These savings accrue from the reduction in demand for social services in the areas of health, corrections, welfare, and unemployment claims.

Similarly, a recent study found that Adams State College imparted positive economic impacts on its region, the San Luis Valley, whose counties rank among the least affluent in the state. The results of the March 2005 study showed that the 3,500 students and approximately 500 faculty have a combined spending power that generates a total annual economic impact of just over \$70 million in the San Luis Valley. This is the largest single source impact of any organization in the region and equates to 20 percent of the personal income in Alamosa.¹⁴

In addition to the regional economic benefits that Adams State provides, it also serves its local population with the opportunity to receive a college degree. 47 percent of Adams State students are from low-income families, and the college considers as its mission the provision of educational access to the poorest socio-economic region of the state. A large majority of

¹⁴ Adams State College's Economic Impact Analysis and Report, San Luis Valley & Colorado, San Luis Valley Development Resources Group, March 2005. The report is available on the web at http://www2.adams.edu/news/asc_economic_report.pdf.

the student body are first-generation college students, and increased tuition rates can represent a hardship for families of the San Luis Valley. The administrators at Adams State estimate that 20 percent of the students they serve will drop out of school if tuition exceeds \$2,000.¹⁵ A reduction to the COF—essentially an increase in the tuition burden to students—would impact both the students and the region.

Scenario 3B: Eliminate Coverage of Medicaid Non-Mandatory Populations and Services

The Medicaid program is the jointly funded federal/state public health insurance plan that pays for acute care and long-term care for the poor and medically indigent. The federal government does not mandate that states maintain a Medicaid program; however, in order to qualify and receive matching federal dollars, states must have a program.

Under federal law, certain mandatory populations (e.g., the aged, blind and disabled people, and children) with low family incomes must be served by each state that has a Medicaid program. In addition, the law permits states to offer services to certain non-mandatory populations and cover certain optional services. Table 5 lists the optional populations and

Table 5 Non-Mandatory Populations and Services Currently Covered Under the Colorado Medicaid Program		
Optional Populations	Optional Services for Mandatory Populations	
<ul style="list-style-type: none"> • “300%ers” – Individuals who earn up to 300% of the SSI (Social Security Income) payment level and are in need of long-term care services through institutional care or in a community setting. Individuals may require nursing home care and consequently can be an expensive group to serve. • Medicaid Buy In – (This program had not been implemented as of December 2004.) This group includes Coloradans who have previously been eligible for Medicaid but are no longer, possibly due to improved medical or financial situation. They may elect to buy into Medicaid coverage. • Children Covered Under the Home and Community-Based Services (HCBS) Waiver – Children who would not normally be eligible for Medicaid because their family income is too high but are eligible based upon medical situation and risk of institutional care. • Non IV-E Foster Care – Foster care children ineligible for Medicaid through Title IV-E. • Breast and Cervical Cancer Treatment Patients – Women diagnosed with breast or cervical cancer who meet income requirements but are not in one of the mandatory coverage populations (e.g., aged, blind, pregnant, etc.) and have no insurance coverage. This population was added in 2001. 	<ul style="list-style-type: none"> • Podiatrists • Optometrists • Psychologists • Nurse anesthetists • Private duty nursing • Clinic services • Physical therapy • Occupational therapy • Speech, hearing and language disorders • Prescribed drugs • Prosthetic devices • Eyeglasses • Diagnostic services • Screening services • Inpatient care for 65+ in institutions for mental disease 	<ul style="list-style-type: none"> • Preventive services • Rehabilitative services • Intermediate care facilities • Mental health services • Inpatient psychiatric services for under age 21 • Nursing facility for under age 21 • Emergency hospital services • Personal care services • Transportation services • Case management services • Hospice care • Respiratory care

¹⁵ Interview with Julie Waechter, Public Information Officer

services currently covered by the Colorado Medicaid program. It should be noted that there are additional non-mandatory services and populations that Colorado does not cover. Elimination or reduction of access to optional Medicaid services or populations is one option available to the legislature as it works to close the structural deficit.

In FY 2001-02, the last year for which quantifiable data were available, the state spent just over 48 percent of the Medicaid budget on optional populations and services. Applying that percentage to the latest General Fund appropriation for Medicaid of approximately \$1 billion yields an estimate for General Fund funding in the vicinity of \$480 million for Medicaid options. **To give a sense of magnitude, it would require eliminating nearly 83 percent of the estimated amount spent on Medicaid optional services and populations to close the deficit by the end of FY 2006-07.**

SCENARIO 4: Convert the Division of Parks to Enterprise Status

Under TABOR, units of government that receive less than 10 percent of their budgets from the general tax base may be declared enterprises. The implication of enterprise status is that the revenue associated with that program is then exempt from the TABOR limit on revenue, freeing up room under the limit for other functions. In addition, enterprise activities have more flexibility to set fee policies, as they no longer compete with other government functions for space to accommodate their revenues under the limit. Since TABOR's passage in 1992, a number of state functions have been declared enterprises. They include:

- Higher Education Auxiliary Facilities
- State Lottery
- Higher Education Student Loan Program
- Correctional Industries
- State Nursing Home System
- State Fair Authority
- Student Obligation Bond Authority
- Division of Wildlife
- Department of Agriculture's Brand Board
- All Institutions of Higher Education
- Petroleum Storage Tank Fund
- Colorado Tolling Enterprise

One of the recommendations that often surfaces as a strategy for closing the General Fund deficit is to spin off additional functions as enterprises. State Parks is one function that is often cited as a candidate for enterprise status.

A quick review of the mix of funding for State Parks reveals a trend away from the General Fund and toward fee-based funding. Table 6 on the next page shows that, while total funding between FY 01-02 and FY 05-06 has increased by just over 15 percent, the contribution from the General Fund has decreased by 9.4 percent. Currently, 16.5 percent of the total support for Parks comes from the general tax base, near to the 10 percent requirement for enterprise status.

Table 6
Sources of Funding and for the Division of Parks and Visitation,
FY 01-02 through FY 05-06
All dollars in millions (M)

Funding Source	FY 01-02	FY 02-03	FY 03-04	FY 04-05	FY 05-06	FY 05-06 Versus FY 01-02
General Fund	\$5.813 M	\$5.547 M	\$5.179 M	\$5.474 M	\$5.264 M	-\$0.649 M
Percent change	-19.4%	-4.6%	-6.6%	5.7%	-3.8%	-9.4%
Total Funding	\$27.638 M	\$27.928 M	\$28.526 M	\$29.510 M	\$31.907 M	\$4.3 M
Percent change	13.1%	19.9%	18.2%	18.5%	16.5%	15%
Visitation	10,610,000	10,542,000	10,926,000	11,477,000	11,869,000	1,259,000
Percent change	0.8%	-0.6%	3.6%	5.0%	3.4%	1.1%

Source: 2005-06 Appropriation Report. General Fund Appropriation includes centrally appropriated items funded in the Executive Director's Office

Even a complete defunding of the General Fund support for Parks would address just 5 percent of the \$55 million structural deficit in the current fiscal year. By FY 2006-07, when the cumulative deficit increases to almost \$400 million, the relative gain from such an action is close to an immaterial 1.25 percent of the problem. For this modest gain, the Parks system would then be vulnerable to the vacillations of the market and the weather and their impact on growth in user fees. At current visitation rates, complete elimination of General Fund support (which is more than is required for enterprise status) would require an average increase of less than \$0.50 per visit.

Even if many other state functions were also to convert to enterprise status, the impact on the deficit would likely be negligible.

CONCLUSION

If state revenues continue on the path projected for the next five budget years, Colorado will find itself in the unusual position of experiencing a budget deficit despite rising revenues. Because the TABOR ratchet has brought allowable state revenues to a level approximately \$1 billion below what they would have been in the absence of the recession and the resulting ratchet-down, refunds will be required. Yet anticipated expenditures—themselves increasing as a result of population growth and inflation—will continue to outpace allowable spending. Under current law, this problem will persist and grow over time.

Forecasts prepared by the Colorado Legislative Council estimate a structural deficit in the General Fund each year throughout the forecast period (through FY2009-10). Again, structural deficits result when the budgeted expenditures necessary to maintain public services exceed the estimated revenue available to support those services on an ongoing basis. In most states, structural deficits occur because the state fails to collect revenue at levels sufficient to fund the commitments of the state. In Colorado, the cause would be more rightly identified as TABOR's ratchet.

All state revenue estimates forecast revenue more than sufficient to close the structural deficit, and without any change to tax policy in the state. However, TABOR's ratchet restricts the state from retaining all the revenue it is forecast to collect, revenue that would have been available to the state were all the provisions of TABOR in place except for the ratchet. As a result, instead of funding the General Fund to a level sufficient to close the structural deficit, the State will be required to issue refunds while cutting programs in order to balance the General Fund.

To better understand the magnitude of the reductions facing state budget-writers, this paper has examined four possible of many possible scenarios. Again, these scenarios were presented not as actual descriptions of the specific reductions to be made, but rather to demonstrate the sizable budget cuts that will have to be made if the ratchet remains in TABOR.

ABOUT THE CENTER FOR TAX POLICY

The Center for Tax Policy (CTP) is a non-profit organization that disseminates non-partisan information and research reports to assist business and government leaders in developing and implementing fair tax policy in Colorado. Since 1946, CTP has been the "watchdog" for taxpayer interests. For more information, visit www.centerfortaxpolicy.org.