



CENTER FOR TAX POLICY

EXECUTIVE REPORT

IMPLICATIONS OF THE TABOR RATCHET FOR COLORADO'S BUDGET, FY 2001-02 THROUGH FY 2009-10 October 2005

EXECUTIVE SUMMARY

In order to help inform the public debate about amending TABOR (Colorado's tax and expenditure limitation law), the Center for Tax Policy undertook an economic analysis of the impact of the law's so-called "ratchet" provision on Colorado's budget over the next five years. The study was funded by Rose Community Foundation.

The resulting report, "Implications of the TABOR Ratchet for Colorado's Budget, FY 2001-02 Through FY 2009-10," 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 of its analysis.

The study defines the ratchet; examines the impact of the recession and the ratchet on Colorado's budget in the last three fiscal years; and analyzes anticipated future impacts from the ratchet through fiscal year 2009-10. It makes no recommendations.

WHAT IS THE "RATCHET"?

TABOR's basic formula says state spending increases in any given year may grow by an amount that reflects population growth and inflation. The state must use as the basis for that calculation the lesser of the previous year's revenue limit or actual revenue collections. The "ratchet" occurs when revenues drop below the previous year's spending level, thereby reducing (ratcheting down) the base for spending. Even if actual revenues return to or exceed the level they were at before a revenue shortfall, the base will remain lower because of the initial ratchet.

When state revenues fell by 17 percent in 2001-02, that immediately dropped the baseline for calculating allowable state expenditures in all future years. Dropping the baseline meant less room for the state to retain revenue generated by taxes and fees before refunding TABOR "surpluses" to voters. Dropping the baseline also meant the state could never have available for appropriation the same level of revenue it would have had if the revenue shortfall had never happened, even when state revenues rebound to their previous levels. This, then, is the "ratchet effect" that this report examines.

As a result of the ratchet, the FY 2005-06 state budget—the first to experience the ratchet in conjunction with sufficient estimated revenue to require TABOR refunds—is approximately equivalent to the state budget in FY 2001-02, despite the fact that both the state's population and the rate of inflation have increased in the intervening years.

THE RATCHET WILL RESULT IN A “STRUCTURAL DEFICIT”

Under the TABOR ratchet, 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 was before the shortfall, adjusted for population growth and inflation. A situation where, for the foreseeable future, projected funds available for appropriation are 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 policy are structured. This differs from 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.”

THE RATCHET-DRIVEN STRUCTURAL DEFICIT WILL REQUIRE MAJOR CUTS IN PROGRAMS AND SERVICES

Colorado is forecast to have a large and growing structural deficit over the next five years. According to the General Assembly’s Legislative Council, the cumulative deficit is projected to be \$627.9 million by FY 2009-10.

To cure a structural deficit, there must either be a *permanent* increase in revenues or a *permanent* decrease in expenditures. Although Colorado will actually collect sufficient revenues over the next five years to more than cover the projected structural deficit (see table below), TABOR as currently written will not allow the state to keep and spend those revenues. Instead, TABOR will require the state to return to taxpayers the difference between revenue collected and allowable expenditures under the ratchet-driven expenditure limit.

Cumulative Forecast of Structural Deficit and Estimated TABOR Refunds Under Current Law					
	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
<i>Source: Legislative Council June 21, 2005 Forecast</i>					

It is important to note that the revenues to be refunded over the next five years would not have been “surplus”—the state would have been allowed to spend them under the TABOR limit—had the initial ratchet-down never occurred. Colorado’s allowable spending is approximately \$1 billion lower than it would have been had it not been for the recession and the resulting ratchet.

It should be noted that there are some one-time actions that the state could take to delay dealing with the structural deficit. It could, for example, sell some state buildings and lease

them back to the state. However, these types of short-term approaches are not the subject of this report, as they do not address the underlying, structural causes of the deficit. Such approaches are similar to dealing with personal debt by making your mortgage payment with a credit card.

FOUR POSSIBLE SCENARIOS FOR CLOSING THE RATCHET-INDUCED STRUCTURAL DEFICIT

There is no way to know exactly which programs and services the state would cut to address the projected structural deficit in order to balance the state budget, as required by the Colorado Constitution. Accordingly, the report analyzes four potential scenarios for budget cuts over the next five years. These are not specific proposals, but rather examples selected to illustrate the magnitude of the actions that would be necessary. (Note: Scenario 1 below extrapolates over the next five budget years, through FY 2009-10. Scenarios 2-4 calculate only through FY 2006-07 because the impact through that time is sufficiently illustrative; extending the estimates to later years would not materially alter the outcome.)

Scenario 1 – Make across-the-board reductions proportional to those made since FY 2001-02.

Finding: If future cuts were distributed in the same ratio as those in the last two budget years, by FY 2009-10 four state departments (Agriculture, Local Affairs, Public Health and Environment, and Regulatory Agencies) would lose more than 50 percent of their budgets, the Treasury Department budget would be eliminated and there would still be a deficit.

Scenario 2 – Eliminate General Fund funding for smaller departments.

Finding: If the entire General Fund budgets for the 13 smallest Colorado state departments were eliminated, just 73% of the projected deficit would be closed by the end of FY 2006-07. Ninety-five percent of the state General Fund goes to six departments: Judicial, Corrections, Human Services, Education, Higher Education, and Health Care Policy and Financing. (The General Fund includes most state revenue collections except for certain fees and federal funds.) The remaining 5 percent of the General Fund is distributed among 13 other departments, such as Public Safety, Regulatory Affairs, and Natural Resources.

Scenario 3 – Target cuts to programs in large departments.

As noted above, Colorado's six largest departments account for 95 percent of the General Fund. To close the structural deficit, some of the programs and services administered by one or more of these departments would have to be cut. Such cuts could take myriad forms; the report examines the impact of cuts to the College Opportunity Fund and Medicaid.

Scenario 3A: Eliminate College Opportunity Fund

Finding: Completely eliminating the College Opportunity Fund would address only about 80 percent of the deficit in FY 2006-07. The College Opportunity Fund (essentially a voucher program for undergraduate students that accounts for a significant portion of state funds directed to higher education) is currently worth about \$317 million (\$2,400/student for just over 132,000 eligible students). Eliminating the Fund would have a significant economic ripple statewide as

enrollments shrink. To illustrate: a separate study conducted on behalf of Northeastern Junior College in Sterling found that \$107 million in total regional earnings, and approximately 4,600 jobs, are associated with the economic contribution of the College. That study also concluded that the state's investment in the College translates into ongoing annual savings of more than \$1 million, because of reduced demand for social services and unemployment.

Scenario 3B: Eliminate or reduce non-mandatory Medicaid services and populations.

Finding: To close the structural deficit at the end of FY 2006-07 would require the elimination of nearly 83 percent of current spending on non-mandatory Medicaid populations and services. In FY 2001-02 (the last year for which quantifiable data were available), the state dedicated just over 48 percent of the Medicaid budget to non-mandatory populations and services. Examples of currently covered, non-mandatory services and populations that might be cut include a large proportion of seniors in nursing homes, prescription drugs, intermediate care facilities, personal care services and psychologist's services, to name just a few. This could put at risk children, the elderly and those with mental illness, among others.

Scenario 4: Convert the Division of Parks within the Department of Natural Resources to enterprise status.

Finding: Converting the Division of Parks to enterprise status would address only 1.25 percent of the structural deficit at the end of FY 2006-07.

Governmental entities that receive less than 10 percent of their budgets from the general tax base may be declared enterprises, making them exempt from TABOR revenue limits. 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 even grow over time.