Financing Colorado's Future - A Fresh Look at the Funding of State Government

Summary of Findings

The echoes of the recently ended Great Recession are helping to close Colorado's General Fund structural gap. The Great Recession ushered in unprecedented monetary stimulus, driving up equity markets and supporting the recovery in real estate, ultimately resulting in a robust state revenue recovery. At the same time, sustained low levels of inflation and the recession-induced delay in household formation have helped to alleviate demographic and cost pressures in the two largest programs in the state budget: Medicaid and the state share of K-12 education.

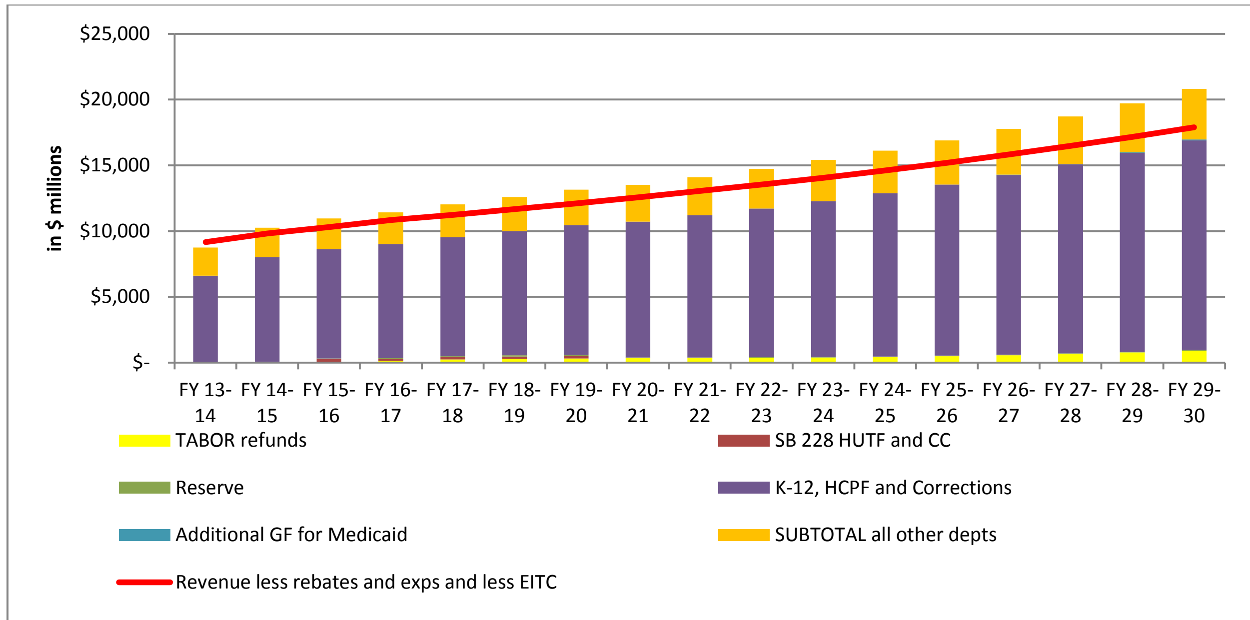
However, offsetting this good news for state lawmakers is the effect of Colorado fiscal policy, specifically the Taxpayer's Bill of Rights (TABOR). In 2017 TABOR will require the General Fund to make refunds to taxpayers under the state's financing mechanism for its 2009 and 2013 Medicaid expansions, just as the General Fund is forecast to experience a rapidly increasing shortfall between program costs and revenue.

The findings from this study are an update to work originally commissioned by the Colorado General Assembly in 2010. The original resolution, SJR10-2, authorized our research team to undertake a comprehensive study of the Colorado tax system. The study was completed in 2011 and concluded that by fiscal year 2024 a structural imbalance in the state budget would result in only enough revenue to support Medicaid, K-12 education, and corrections. Economic, demographic, and tax policy factors were found to be exerting increasing expenditure pressure on the two largest state programs, the state shares of K-12 education and Medicaid, while at the same time dampening the productivity of state tax revenues, particularly the sales tax. The resulting structural financing gap was determined to be severe.

The 2011 study forecasted a gap of $3.5 billion between the cost of General Fund Programs and General Fund revenue in FY 2024-25. The updated 2013 forecast pegs the FY 2024-25 gap at nearly $1.52 billion, almost a 57 percent reduction in the gap forecasted in 2011. As good as this news is, the gap is estimated to almost double in the five years from FY 2024-25 to FY 2029-30. The gap will cause cuts to a variety of programs funded by the General Fund in each year of the forecast. Beginning in FY 2016-17,

these cuts will occur at the same time the state will be required to pay for taxpayer refunds under TABOR. The juxtaposition of cuts in General Fund programs, which could include cuts to schools, higher education, and a variety of other programs, at the same time the state is returning "surplus" funds to taxpayers under TABOR, will be puzzling to many Colorado citizens.

Figure 1. Colorado's Structural Gap: 2013 Model



Three main forces are affecting the level of the gap in the current model relative to the gap projection from the 2011 work. Two are direct echoes of the Great Recession and ironically are helping to close the structural gap. The third is acting on the gap in the opposite manner and is a direct result of Colorado fiscal policy.

Echo of the Recession #1: Economic and Demographic Forces Alleviating Pressure on State Spending

Continued low inflation rates; lower population forecasts by the State Demography Office, especially in the younger age cohorts which reflect a delay in fertility rates and household formation; and lower health care inflation rates all have combined to reduce General Fund spending forecasts. Offsetting these lower spending forecasts are slight increases in cost-per-inmate projections for the Department of Corrections and a slight uptick from our 2011 forecast in spending for other departments of state government as state revenues rebounded.

The slight uptick in spending for 17 departments outside of the "Big 3" (the Colorado Department of Education, the Department of Health Care Policy and Financing, and the Department of Corrections), showed restraint on the part of the state. The state used a large share of rebounding revenue to bolster

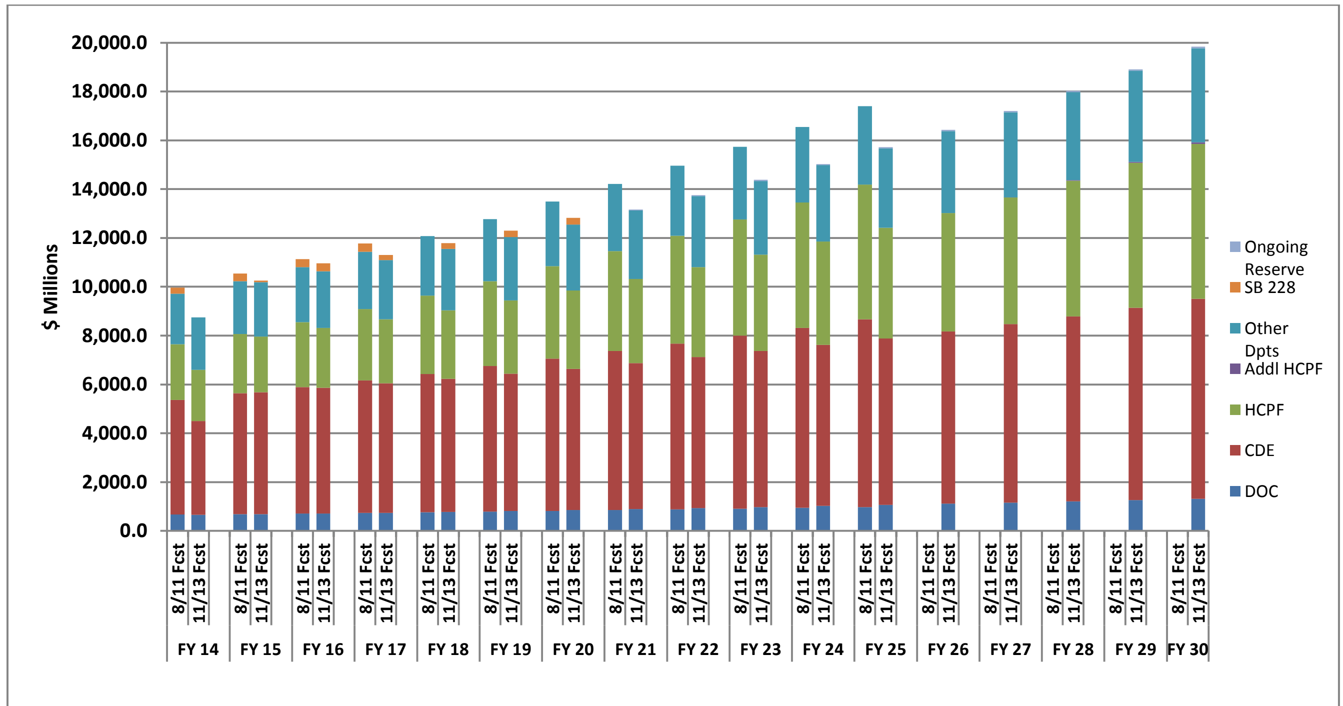
the state's General Fund reserve, build reserves in the State Education Fund, pre-pay the state's obligation for the funding of Old Hire Fire and Police Pensions, and limit a number of new appropriations to one-time or short-term spending. On the other hand, the Earned Income Tax Credit was made permanent, along with the Child Care Credit if triggered by federal action on the Marketplace Fairness Act and the restoration of the Elderly and Disabled Homestead Exemption.

Overall, spending for the other 17 departments receiving General Fund appropriations is estimated to grow by almost $35 million more than the 2011 forecast by FY 2024-25. When combined with the $92 million increased spending forecast for the Department of Corrections by the same year, spending increases of $127 million will offset savings by the Colorado Department of Education (CDE) and the Department of Health Care Policy and Financing (HCPF).

Lower rates of inflation and reduced pupil counts attributable to recession-caused reductions in fertility and household formation combine to reduce expected CDE and State Education Fund appropriations by $871.2 million by FY 2024-25. Lower rates of general inflation, lower rates of health care inflation forecast for the various eligibility categories of the Medicaid program, and lower population forecasts combine to reduce expected appropriations for HCPF. In addition, the state's decision to participate in expansion of the Medicaid program under the federal Affordable Care Act and to finance that expansion through the Hospital Provider Fee enacted in 2009 by HB09-1293 also alleviates pressure on the General Fund under the Medicaid program. In total, General Fund appropriations for HCPF are forecast to be $988.9 million less than our previous forecast for FY 2024-25.

In sum, Figure 2 shows that when reductions in CDE and HCPF spending forecast for FY 2024-25 are offset with the increases in spending for the DOC and other departments, spending is now forecast to be $1.7 billion less than previous estimates. Figure Y also shows that the spending levels previously forecast for FY 2024-25 will be exceeded by FY 2027-28 under the updated forecast.

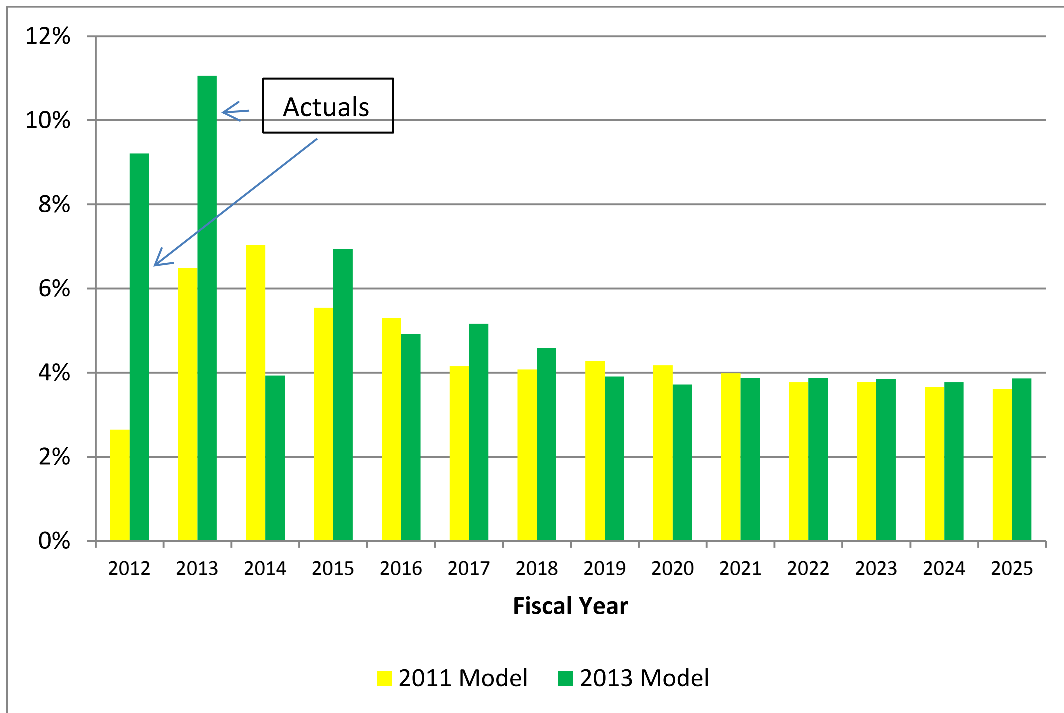
Figure 2. Comparison of August 2011 and November 2013 General Fund Spending Forecasts by Department



Echo of the Recession #2: Stimulative Monetary Policy is Stimulating State Revenues

In the wake of the Great Recession, the Federal Reserve has taken extraordinary measures to stimulate a national economic recovery. Unprecedented levels of monetary stimulus have resulted in strong equity market performance and a commitment to keeping interest rates low has aided a recovery in housing. As a result, in FY 2013, for only the third time since FY 2000, state tax revenues once again grew year over year by more than 10 percent. While revenues are not forecast to maintain their double-digit growth rates, higher than previously forecast revenue growth is expected to persist through many years of the current forecast. Figure 3 shows this relationship for year-over-year growth rate forecasts for General Fund revenue.

Figure 3. General Fund Revenue Growth: 2011 and 2013 Model Comparison



By maintaining accommodative monetary policies, the Federal Reserve is stimulating stronger growth in the Colorado economy which is helping the state tax system to replenish its depleted coffers, and as a result, is dramatically increasing the revenue base from which future years' revenues will grow. For that reason, fiscal year 2025 gross General and State Education Fund revenue is now is projected to be $1.4 billion or 9.98 percent higher in the 2013 model than in the previous model. The higher revenue projection, however, is partially offset by reductions from the newly enacted Earned Income Tax Credit, the recently restored Elderly and Disabled Homestead Exemption, and the return of TABOR refunds, all of which were not relevant when we modeled revenue in 2011. Federal Reserve policy, although not directly intended to do so, is helping to boost current state revenues, and this higher revenue base is helping the state to close the structural gap into the future.

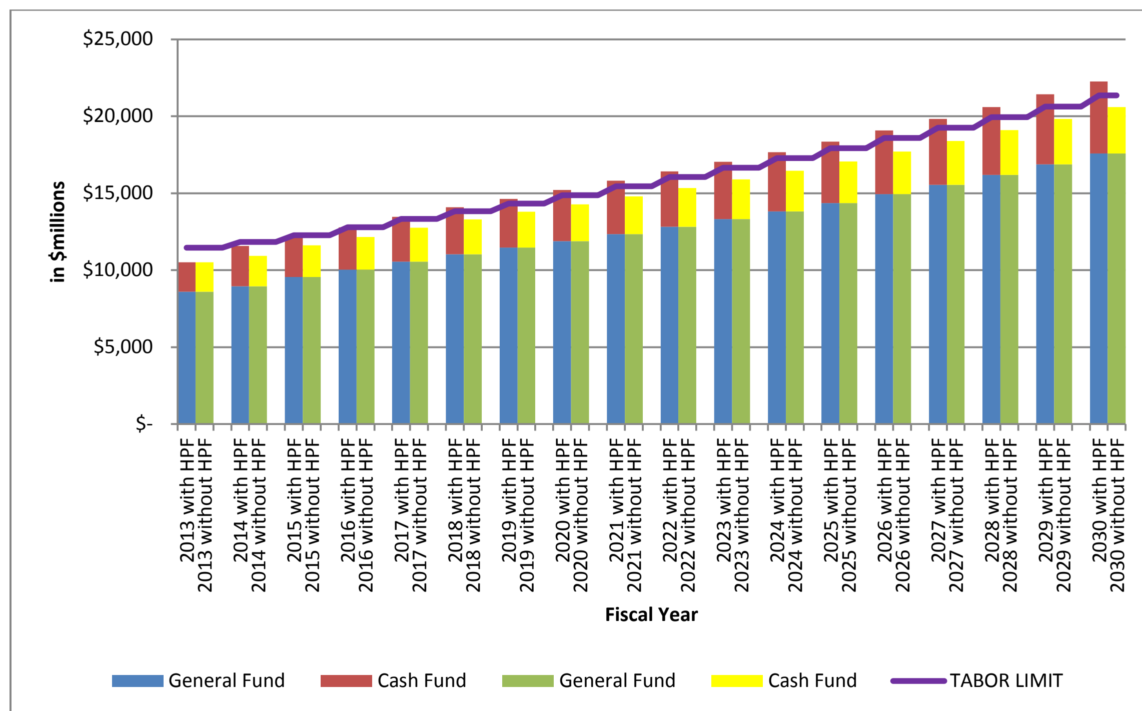
The Hospital Provider Fee and TABOR: Strange Bedfellows

The Hospital Provider Fee, created in 2009 by HB09-1293, assesses a fee on the net revenue of Colorado hospitals. The fee is imposed by the State Medical Services Board and is limited by federal law to not exceed 6 percent of net hospital revenue. The fees generated were initially used to pay for the state's share of the cost for the 2009 expansion of the Medicaid program as well as for supplemental payments to hospitals for unreimbursed Medicaid/Medicare costs and the cost of indigent care, among other things. When the state elected to expand Medicaid eligibility under the Affordable Care Act, the Hospital Provider Fee (HPF) was tapped to pay the state's share of the expansion under SB13-200. The hospital provider fee is expected to generate revenue of $575 million in FY 2014-15, growing to a little less than

$1.28 billion in FY 2024-25 and $1.66 billion in FY 2029-30. The federal limit of 6 percent of net hospital revenue is expected to be reached in FY 2026-27 and the fee will be limited by the cap each year thereafter. After the HPF cap is reached in FY 2026-27, the General Fund will once again be responsible for paying a small share of the costs of Medicaid expansion as well as the other programs it finances.

The HPF is not exempt from the TABOR limits as amended by 2005's Referendum C, so its rapid growth will cause the TABOR limit to be exceeded in FY 2016-17 and for each year thereafter throughout our forecast horizon. Without the inclusion of HPF revenue within the TABOR limit, the state TABOR limit would not be exceeded, so it is solely responsible for TABOR refunds each year. Overall, the TABOR refund, which is occurring solely as a result of the HPF, accounts for about 31 percent of the structural gap in FY 2029-30.

Figure 4. TABOR Refunds with and without the Hospital Provider Fee



Options for Further Consideration

Closing the gap may be approached with short-term and long term strategies. In the short term, there are two discrete actions that would serve to close a majority of the gap through the early 2020s: extending the state sales tax to personal services and exempting the hospital provider fee revenue from TABOR. In the longer term, other structural realignments of revenue and expenditures will be required.

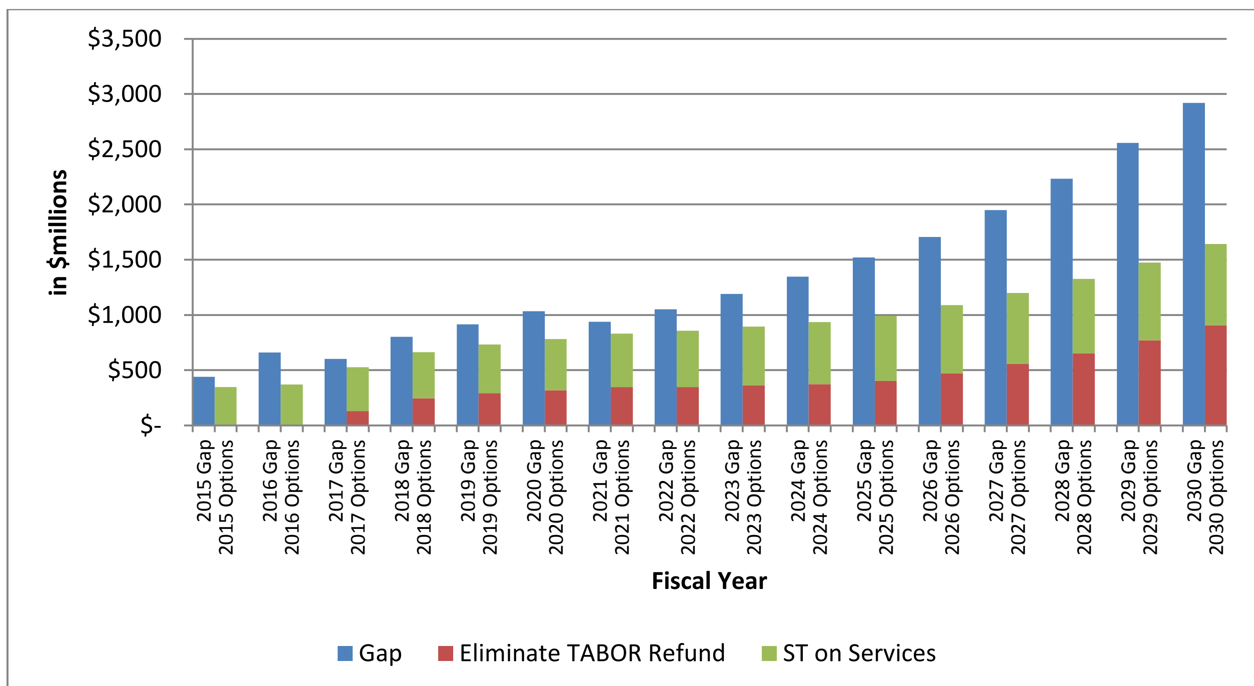
In step with long-term national trends, an increasing proportion of Coloradans' personal consumption expenditures is shifting from the purchase of goods, which are subject to the state sales tax, to services, which are exempt from sales taxes. In 1959, 46 percent of personal consumption spending nationally was spent on services, while 54 percent was spent on retail goods. By 2013, 64 percent of personal consumption spending went to services and 34 percent to goods. These trends are expected to continue throughout the forecast horizon with 71 percent of personal consumption projected to be spent on services and only 29 percent spent on retail goods in 2030.

In order to update the state sales tax to better reflect current economic reality, the state sales tax base could be expanded to include personal services. Personal services exclude business-to-business services such as legal services and accountancy. In addition, we have not included health care services in our modeling. Extending the state sales tax to personal services would raise $736 million in 2030 and would narrow the gap of $2.92 billion in that year by just over 25 percent, if implemented.

Another major contributor to the long-term structural gap is the TABOR refund, which returns in FY 2017. By removing the Hospital Provider Fee from the TABOR limit, TABOR refunds that are taken from the state General Fund would be eliminated. This action would reduce the gap by $906 million in FY 2030, reducing the gap by 31 percent.

The combination of these two actions would reduce the gap by 88 percent in FY 2017, falling to about 56 percent in FY 2030, reducing the need for deeper budget cuts throughout the period.

Figure 5. Closing the Gap by Eliminating the TABOR Refund and Extending the Sales Tax to Personal Services



Conclusion

Coloradans have an opportunity. Economic and demographic factors that have emerged in the wake of the recession have served to relieve some of the structural pressure on the state budget, rendering the remaining problem more manageable. Discrete actions, as outlined above, would close a majority of the structural gap through the end of this decade, giving policymakers a little breathing room.

Even if those steps are taken, the structural problem would require additional structural solutions during the decade of the 2020s. Simple across-the-board budget cuts and tax rate increases will not resolve the problem. The structurally broken state and local partnership for K-12 education funding remains a prime candidate for reform. A close examination of Colorado's property tax system, which hasn't been undertaken for over 30 years, may need to be a part of the state/local school funding equation.

Inaction, of course, would bring about a strictly budget-cutting solution. The cuts would be extreme. For example, closing the gap with cuts alone, while maintaining full funding for K-12, Medicaid and Corrections, would result in cuts of nearly 75 percent to all of the other 17 General Fund departments by 2030.