MY VIEW

By Charlie Brown, University of Denver Center for Colorado's Economic Future director

THE BUDGET:

STRUCTURAL PROBLEMS REQUIRE structural solutions. That, in a phrase terse enough to fit on a bumper sticker, is the bottom-line recommendation of the University of Denver's Center for Colorado's Economic Future ("the Center") in its study of state government finances, requested by the Colorado General Assembly in early 2010. You might recall that a previous article (see "Stong Leadership: A Requirement to Pull out of Colorado's Fiscal Problems" by Dr. Phyllis Resnick in the June 2011 issue of *Colorado Municipalities*) on the first part of this analysis described a persistent, long-term structural imbalance underlying the General Fund, the main operating fund of Colorado's government. A forecast by the study's economists shows that the combined growth rate of the General Fund's three largest programs (K-12 education, Medicaid, and prisons) will far outpace the growth rate of revenues through FY 2024-25 — and even a strong economic recovery will not avert that inevitability.

The second phase of this study weighed the trajectory of all General Fund spending against that of revenues, which primarily consist of the sales and income taxes collected by the state. Our models show that, absent policy changes, total expenditures will exceed

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tax collections by 20 percent — or $3.5 billion — in FY 2024-25. Revenues will fall 2 percent short of funding schools, health care and corrections, and there will be no money for other core services such as higher education, the court system, public safety, and child protection.

The reality is that Colorado lawmakers must balance the General Fund budget every year. But doing so will require significant cuts, additional revenue, or a combination of cuts and tax increases. Ideally, such changes would be made strategically, with an eye on the long-term horizon. The Center's analysis suggests that policymakers embrace a hybrid approach of taxes and cuts aimed at aligning the growth patterns of projected revenues and expenditures.

To demonstrate the enormity of the problem facing state government finances, the Center developed two illustrative scenarios: one that addresses the revenue/expenditure gap entirely with cuts and one that addresses it entirely with tax increases. Each scenario requires a set of assumptions.

A "cuts only" scenario

There are infinite combinations elected officials might employ in an attempt to cut their way to fiscal sustainability. For our illustration, we first assumed that the legislature and governor would maintain programs that leverage the receipt of federal dollars. That means protecting the Department of Human Services and the Department of Health Care Policy and Financing, the agency through which Colorado's Medicaid dollars flow. (There are, of course, other reasons to protect these safety-net agencies.) We also assumed that policymakers would protect functions of state government required by the Colorado Constitution – the governor, legislature, court system, attorney general and treasury – as well as the prison system.

With these assumed protections, cuts of the magnitude needed to address a $3.5 billion gap require looking to the largest part of the General Fund budget. That would be K-12 education, which makes up 40 percent of the total. The legislature and governor already have cut public schools, even though Amendment 23 requires annual funding increases. Their rationale is that Amendment 23 protects the per-pupil base but not additional factors in the funding formula that adjust for variances among school districts in enrollment size, cost of living, and proportion of at-risk students. These factors add about 25 percent overall, but our analysis indicates that school funding can be reduced by only about 20 percent statewide without cutting into the per-pupil base in some districts.

Under this scenario, policymakers would reduce K-12 funding as much as needed to balance the budget from now until FY 2024-25 without violating Amendment 23. In years when schools have taken the maximum 20 percent cut, additional cuts would come from the 10 departments in the General Fund that remain unprotected: higher education, public safety, revenue, public health, natural resources, local affairs, military and veterans affairs, personnel, regulatory agencies, and agriculture.

Here is how this cut scenario plays out: Public schools would lose at least 19 percent of their state funding in 13 of 14 years. The 10 unprotected departments would be affected slightly through FY 2017-18 as schools absorb the bulk of cuts, then suffer drastic cuts from FY 2018-19 on. By FY 2024-25, the end of our forecast horizon, funding for the 10 departments would be reduced by more than 90 percent to match total appropriations with revenues. General Fund support for state colleges and universities would virtually be eliminated, as it would for a host of programs such as youth corrections and state enforcement of disease control and clean water regulations.

A "taxes/revenue" scenario

In developing a second scenario that bridges the revenue/expenditure gap with taxes, we assumed that a package of new revenue sources should: 1) be sufficient to address the problem; 2) grow in step with future spending; 3) reflect the structure of Colorado's economy; 4) balance volatility against stability; 5) maintain or enhance the fairness of the tax system; 6) address inefficiencies and inequalities in the local share of public school funding; and 7) allow Colorado to remain competitive with other states. Our examination of several tax possibilities led to only two with significantly steeper growth curves than that of current revenues — extending the sales tax to personal services and reinstituting a graduated individual income tax, which Colorado abandoned for a flat tax in 1987. We included a phased-in uniform mill levy in all school districts, regardless of wealth, to help reduce the state's share of K-12 funding, which has risen to 63 percent from 55 percent in FY 1993-94.

Here is what the tax scenario looks like:

- A sales tax on personal services (everything from pet grooming to haircuts but not health services) would help state revenues grow more in step with today's modern, service-based economy. At the current rate of 2.9 percent, it would raise an additional $918.3 million in FY 2024-25.
- A graduated individual income tax would help ensure that income tax collections grow as fast as service demands. There would be four brackets indexed so that taxpayers would not be pushed into higher brackets solely due to inflation. The first $50,000 of income would be taxed at 4 percent, the next $50,000 at 4.7 percent, the next $100,000 at

5.4 percent, and income greater than $200,000 at 6.1 percent. Those with taxable incomes below $136,400 would pay less than they currently pay. This would produce an extra $1.6 billion in FY 2024-25.

- A phased-in uniform levy of about 23 mills would amount to a property tax increase in some of the state's 178 school districts and a property tax decrease in others. The goal would be to reduce the state's share of K-12 education costs to 60 percent and lessen the General Fund's responsibility for funding schools by $1 billion in FY 2024-25.

We realize that neither the tax-increase scenario nor the cuts scenario would be easy pills to swallow. A hybrid scenario is probably just as hard a sell — "pay more and get less" is not exactly a politically popular message. But Colorado's long-term fiscal challenges demand that policymakers and citizens step up and do something. The demographic forces driving Medicaid costs, in particular, will not magically disappear until the aging baby boom generation is gone, well beyond 2025. Until then, expect the state's share of Medicaid long-term care costs to skyrocket.

Municipal ramifications

So, what does all this mean for municipal governments? While the Senate resolution that called for this study asked our research team to assess the long-term fiscal stability of all units of government in Colorado, to date we have only had the time and funding to complete an in-depth analysis of the state's General Fund. The results of that study, however, offer both cautionary tales and potential opportunities for municipal government leaders.

First, the logical nexus between the state's General Fund and local government finance is the sales tax. The multiple forces rendering the state sales tax less productive — the aging population, the continuing decline in prices of electronics and certain other goods, and the shift in the consumption patterns of Americans toward services — will affect local governments more than the state because local governments in Colorado are more reliant on the sales tax. Should the state choose to extend the sales tax to additional services, this would provide an opportunity for local government to do the same. While it is difficult for any local government to enact this sort of tax reform alone, a coordinated state–local effort would improve the productivity of the sales tax for all units of government.

Also related to the sales tax, the most common question we have received while presenting our findings to civic groups involves the impact of Internet sales on the current and future productivity of the sales tax. Our forecasts implicitly assume a continued and gradual shift to remote sales, one commensurate with the rate at which sales have been migrating over the past decade. However, to date we have not fully quantified the total dollar impact of Internet sales leakage on any unit of government in Colorado. Additionally, we have not yet explored the full impact of an acceleration of the switch, a phenomena we are likely to see in the next decade.

Although currently less significant, the property tax poses another revenue issue for Colorado municipal governments. While the property tax is not the significant source of revenue for municipalities, over time more and more of them have begun to utilize it. Our study of state fiscal sustainability identified a structural problem with school finance, particularly related to the continued degradation of the share of K-12 education program costs borne by local property taxes. Currently, 19 school districts levy fewer than 10 mills. Of these, 14 receive support for more than half of their total program funding from the state General Fund. Should school finance reform include increases in the mill levies of these extremely low levy school districts, municipalities in these districts could find access to the property tax extremely limited. Conversely, for districts with high mill levies and a low state share of total funding, mill levy decreases might be considered. If so, access to the property tax could be improved for municipalities in these districts.

Our study identified issues that will impact local governments in other ways. State demographic trends, particularly aging, will affect the demand for local government services in the future. While Medicaid does not place a fiscal demand on local governments, other services for aging residents do. It has been long recognized that the elderly are among the heaviest users of emergency medical services, so any local government whose fire department responds to medical calls should expect to experience an increase in these calls as Coloradans age. In addition, our state's aging baby boomers tend to be active, and thus will want additional recreation and other senior services. The aging of the baby boomers will place demands on some local government services at levels we have yet to experience.

In addition, our state forecasts show virtually no General Fund support for the state's transportation infrastructure. Frequently in the past, the General Fund has supplemented the motor fuel tax, the main funding source for transportation and one that faces declining productivity. With reduced state support for Colorado's roads, bridges and other transportation infrastructure, local governments in the future may be called on to dedicate additional local sources to transportation infrastructure in order to maintain a functional system.

Although many believe that the state and local governments in Colorado are largely autonomous, there are significant interdependencies. Trends and phenomena that affect the state's fiscal sustainability also have impacts locally. While we have identified some of the major impacts, further study is needed to examine how the structural imbalances we found at the state level affect Colorado's municipal governments and the extent to which local governments in Colorado face their own persistent structural imbalances in the future. The Center for Colorado's Economic Future at the University of Denver stands ready to partner with Colorado municipalities and other stakeholders in order to conduct this important research.

To read a summary or view a narrated presentation on these findings, visit the Center's website at *www.du.edu/economicfuture*. Build your own scenarios for generating additional state tax revenue at *www.du.edu/economicfuture/bridgethegap.html.*