independence institute

Citizens' Budget

Road Map for Sustainable Government in Colorado

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Letter from the President

Nearly every Colorado citizen has been affected by the downturn in the economy and its current slow recovery. Governments at all levels also have had to adjust. Just as the private sector is unlikely to see a big rebound in wages and salaries, or businesses find their coffers suddenly full of robust profits, our public servants face similar troubles ahead. Fiscal circumstances will be made worse in the coming years as the federal government expects to curtail its level of subsidies to the states. Colorado's budgeters won't be able to find any more accounting gimmicks. Programs cannot continue to expand.

Is the only answer to raid family savings accounts and businesses' incomes with new taxes and fees? If so, what will that do to the desirability of living and working in Colorado? Will we be able to provide an improved standard of living for Colorado's residents? What do we do to keep appropriate government services at an adequate level?

The Independence Institute brought together a strong team of people who have the insights and the experience to suggest different ways of doing business. My thanks to the many writers and volunteers who made this report possible. They have provided citizens with many ideas and offered elected leaders solutions to difficult policy questions.

Let me be clear. There is no easy answer to Colorado's budget challenge. It will take political courage. People who care very deeply about the public storm ahead are willing to do the right thing, but must protect their defense of spending limits from retribution by powerful interests; therefore, they are understandably reluctant to be publicly associated with this ground-breaking and wide-reaching work. Allow the content alone be the full measure of the credibility of the report. The ideas contained herein are worthy of discussion and stand as their own defense.

The General Assembly over the course of the next several years must make difficult decisions and will dramatically shape our state's economy. Its debates will echo the important question about the nature of government that is being carried out in Washington, D.C. Will we as a People expect only those public goods that allow for a vibrant, growing private sector, or will we demand an ever-larger, more intrusive government on which we depend for our every need and decision?

Let us engage the debate.

Yours for a better Colorado,

Jon Caldara

Road Map for Sustainable Government

Colorado can close the upcoming billion-dollar budget problem, and establish a sustainable trend line for balanced budgets into the future, by undertaking a package of realistic spending revisions with no increases in taxes or fees.

Colorado faces a systemic problem that has been building for years, a problem that has been exacerbated, accelerated, and brought to the surface by two recessions in the past decade. Process, policy, and structural changes, some of which likely will require voter approval, will be necessary for Colorado to regain sustainable government.

Over the past decade, steadily increasing budget shortfalls have been managed through stopgap financial manipulations, including shifting payrolls into future budget cycles, raiding cash funds, and raising fees. This past year, fiscal pressures became too large for further short-term manipulations. However, real corrective action was deferred yet again because the federal government stepped in to subsidize the state with "stimulus funds." Next year, it is highly improbable those funds will be authorized. Colorado must implement policy changes that address the structural nature of the problem.

Underlying Causes

The demand for government services is nearly infinite. There is always a handy explanation for someone who must be helped by expanding a current program or instituting a new one. Our elected leaders and Colorado citizens have not demanded that difficult decisions be made, choosing instead to expand State services in a futile effort to satiate the insatiable.

When one-time or short-term funds became available, the legislature applied them to fill holes for budgeted government services without looking ahead to meeting the demand for the services in out-year budgets.

We cannot place the health and well-being of government above the health and well-being of citizens. Coloradans watched as the recession removed 171,400 jobs in the economy. Citizens' personal income shrank 3.3 percent over two years, while combined state and local government grew. Families dependent on the private sector for income tightened their budgets, saw colleagues furloughed from businesses, yet watched as an increasingly unresponsive government sector continued growing. The burden of public spending at the federal and state level is becoming too great for the productive sector to support.

At the center of the problem lies an unwillingness to address how, and how much, the State spends. Colorado state government has lived too close to the limit, creating a structure and a process that cannot be sustained. It is not prudent to design future budgets based on an unsupported hope that times once again will be economically robust.

Proposed Solutions

A range of potential solutions was considered. No strategy was ruled out based simply on political ideology. Solutions were assessed on their potential for placing the State on the road to regain long-term, sustainable government.

Elected officials gladly will tell you they have cut all the fat out of programs and if we cut back any more, we will be cutting out sinew and bone. We did not look to close the $1 billion shortfall through focusing on "waste, fraud and abuse," for that would have been beyond our means to investigate each division and each branch office, as the new governor should do. Further, focusing on trimming the fat fails to address Colorado's systemic budgetary problems.

The answer given so far by the majority of the General Assembly and the executive branch is that taxes and fees are simply inadequate to support necessary State services. The structural changes they seek are potential new taxes and increases in existing taxes, coupled with higher fees.

While potentially solving the near-term budget shortfall, increasing revenue fails to address the true systemic problem regarding how and how much the State spends. Adopting this approach will place Colorado on the same path as California, New York and New Jersey—states that have repeatedly addressed budget shortfalls through increased taxes and fees. Each of these states now faces a budget crisis significantly greater than that faced by Colorado. We have the opportunity to learn from their mistakes and follow a different, sustainable path.

Colorado must budget within anticipated revenues, an approach that will require structural and policy changes. This report recognizes a few broad spending categories and confronts how we spend our funds there. Not only can we meet the challenges for next year, but the legislature could prepare during the next session for further changes to be voted on in the 2012 election.

Proposal Highlights

The report provides an overview of the structure, timing and size of the State budget. We speak to how the problems originated and how things have gone wrong, emphasizing that too much focus is on the costs that make up the spending total, such as number of leased vehicles, number of employees, office supplies and imputed value of leased space. Almost no emphasis is placed on outcomes for the spending. We urge greater attention to measuring and managing the services provided in terms of benefits received. We take a strong position in favor of a new legislative process to place government services into a priority list.

Pension benefits

PERA's problems were reduced but not fixed with recent legislation. End the guaranteed pension to new hires in favor of defined contribution plans and separate the $23.4 billion liability for benefits owed to retirees and current workers from the cost of providing benefits to newly-hired workers who didn't contribute to that deficit. Raise the minimum age to receive benefits to the same as Social Security. Replace the taxpayer's unlimited exposure for investment results with a responsibility by the beneficiaries.

Implement a defined contribution plan for retirement benefits provided to both the State government and local governments for the Health Care Trust Fund. Next year's savings to the State would be $10.1 million. More importantly, it would save local districts (including schools) $43.6 million and would close a gargantuan unfunded liability of $1 billion.

Holding onto a state-based social security system is indefensible, since a qualifying beneficiary may never have contributed a single cent to qualify. Other elderly direct assistance programs cover basic needs. Ours is the last state with a system left over from before the federal Social Security program began its distributions. Repeal of this program could be done in two to three years, freeing up about $105 million per year.

K-12 Education

The largest single area of State spending is Kindergarten through 12th grade education. Taxpayers would be able to fulfill the constitutional mandate while taking pressure off the budget by encouraging families to seek alternatives outside of current government offerings. Using a national think-tank's education financing model, we see that tax credits to encourage new switchers would save $21.3 million for the State in its first three years and would take an additional $53.8 million off local school districts' burdens during the same span. Ten-year savings are projected to be even greater on an annual basis. A bigger annual savings to restrain teacher salary increases by eliminating the ineffective "masters degree bump" would save $137.6 million every year. A study would likely illuminate why Colorado is far outside other states' expenditures for "other business services." Adjustment just halfway towards the norm would save another $112.3 million per year.

Higher Education

Colorado is one of the states to rely on tuition increases to grow higher education spending. Better outcomes will result from expansion of the stipend program, phased in over five years, to end direct funding of state colleges and universities. Requiring average yet realistic productivity improvements will make $50 million available. Freeing all state higher education institutions to operate as government enterprises under TABOR will introduce market changes.

Corrections

Reduce incarcerations, but only for non-violent offenders. Corrections' portion of 9 percent of the budget would drop modestly back in the direction of the historical level of 3 percent. A one percent savings would be $78 million per year. Parole violations that do not involve committing another crime cost the State $40.1 million. If we could cut that in half, even if other types of costs were imposed, Colorado might save about $20 million per year.

Health Spending within the Department of Health Care Policy and Financing

Taxpayer supported health coverage has undergone vigorous expansion and enormous spending increases that are unsustainable. Returning Medicaid eligibility levels to those prevailing in FY 2006-07 could produce savings on the order of $218 million. Reversing another change in eligibility, this for adults qualifying under the Children's Basic Health Plan, will save another $140.5 million by 2012-13. Correcting Children's Benefit Health Plan enrollment fees for inflation and bringing them up to the levels charged in states like New Hampshire would bring in an extra $18 million a year. A system-wide change from third-party payer to a program that resembles health savings account spending will save about 5 percent, or $28 million.

Conclusion

Citizens must have a government that has pulled back from the edge. No more growing as large as possible and then surviving on accounting tricks and raiding cash funds. The servant of the people must address problems with difficult, adult discussions, fully aware of potential problems. If the federal government's unfunded liabilities will squeeze the economy a decade before predicted, if the federal government's massive borrowing dries up, if we get a double-dip recession, or unforeseen problems arise, we need the flexibility to respond, not to be so close to the fiscal edge that further adjustment becomes implausible.

The U.S. Constitution demands self-governance by the states. Just as families successfully budget so that they are not living on the edge or perennially dependent on bailouts, our state government must, as well.

The legislature must be prompted by the people to end Colorado's habitual over-spending.

Our Road Map can place us on a path to sustainable government.

Legislative Changes for Sustainable Government		
Action	Savings (millions)	Department
Conform half way towards normal admin services cost	112.3	School Finance Act
Tuition tax credits	21.3	K-12
Eliminate teachers' master's degree "bump"	137.6	School Finance Act
Return to 2007 eligibility requirements	218.0	Medicaid
Return to 2007 spending levels	25.0	Medicaid mental health
Repeal expansions for population that already can afford private insurance	15.0	CHBP
Raise enrollment fees for inflation	18.0	CHBP
Reverse Executive Director's Office increases	21.0	DHCPF
Modify 3rd party payer to health savings account – like spending (take care not to double count)	28.0	Medicaid, CHBP
Reduce incarceration of non-violent offenders	78.0	Corrections
Cut in half technical parole revocations	20.0	Corrections
Institute defined contribution plan for retirement health benefits	10.1	Other Retirement Benefits
Faculty productivity	50.0 to 67.0	Higher Education
Miscellaneous savings	4.0	various

Policy changes that the Legislature should offer to the people, who must approve in changes to the constitution:		
Action	Savings (millions)	Department
Roll the State's own Social Security System into welfare	105.0	Off-budget
Redirect COGO funds to the General Fund	137.0	Off-budget
Permit managed competition for internal operations that mimic private business		System wide
Repeal Amendment 23		School Finance Act

Policy changes that would have long term effects:		
Action	Savings (millions)	Department
Copy other states' commissions to consider opting out of Medicaid; let federal health care program pick it up; about 60% is future cost avoidance	1,000.0	Medicaid
Institute defined contribution plan would allow the State to fully fund the Health Care Trust Plan, closing a $1 Billion unfunded liability		Other Retirement Benefits

Policy changes that avoid future costs:		
Action	Savings (millions)	Department
Reverse eligibility for adults under the Children's Benefit	140.5	Medicaid

Policy changes that have important budgetary impacts, although not quantified in this report:	
Action	Department
Change PERA for new hires to a defined contribution plan	PERA
Separate PERA fund balances into new and old	PERA
Conform retirement ages for all PERA enrollees to match Social Security guidelines (these three moves could contribute as much as $300 million per year to plug the $23.4 billion unfunded liability)	PERA
Sunset the AED and SAED payments to make PERA accountable for reaching fully-funded status.	PERA
Relieve taxpayers from the responsibility of future bailouts	PERA
Move to higher education subsidies through only student stipends; ending direct subsidies to state colleges and universities	Higher Education
Reform the power of higher education institutions to operate as independent entities with new and flexible funds generating activities	Higher Education
Enhance the budget process by adhering to Priority-Based methods	System-wide
Enhance the budget process by focusing on outcomes rather than only inputs	System-wide
Prevent further damage to the economy by corporate welfare (This will immediately save between $4 million and $18 million per year)	Governor's Office of Economic Development; others
Reverse the Bridge Enterprise Fund power to incur debt without a vote of the people	Department of Revenue
Develop goals for expansion of tolled traffic lanes; consider how to develop separate tolled lanes for trucking	Transportation
Fund only mass transit that relieves congestion; re-balance the Denver-metro split between highways and mass transit	Transportation
Reform the make-up of the Colorado Transportation Commission	Transportation
Enhance how highways are funded, through greater privatization	Transportation
Deregulate transportation of people to introduce market reforms	Public Utilities Commission
Consolidate the Governor's Energy Office into executive agencies	GEO

Policy changes that would affect local governments:		
Action	Savings (millions)	Department
Institute defined contribution plan	43.6	Other Retirement Benefits

Introduction & Overview: The State's Budget

Colorado's state government faces a serious budget shortfall somewhere between $700 million and $1 billion in the coming fiscal year of 2011-12. The problem has been building for years, but has been deferred through various accounting manipulations, relatively minor budget adjustments to discretionary items, and more recently by enhanced federal aid. At the center of the problem lies an unwillingness to address spending, as well as a process and a structure that build greater pressure every year and add to the demand for more and more expensive services. With the prospect diminishing of continued federal budgetary support and the exhaustion of accounting devices, Colorado finally must face hard reality. The appetite of proponents for government action to create new state programs or to expand them now exceeds the will of the people to fund the programs. It is imperative to see all elected leaders make genuine efforts that will change services the State delivers and the manner in which it performs its duties. The legislature must be prompted by the people to end Colorado's habitual over-spending.

The appetite of proponents for government action to create new state programs or to expand them now exceeds the will of the people to fund the programs.

The problem stems from a budgeting structure in which demand for more money each year is greater than expected revenues. The impending spending crisis provides the opportunity to consider whether the numerous programs are redundant or outmoded and if they meet real needs and reflect rational operations. Legislators repeatedly have applied short-term, windfall funding to establish or continue multi-year programs, deferring solutions to out-year budgets.

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The current administration, many legislators, and reporters looking for sensationalized stories painted a picture: years of drastic budget cuts and nothing left to cut, state service collapsing, and the painful alternative of raising taxes as the only remaining option. Now citizens must collaborate with leaders to overcome short-sighted thinking to uncover the systemic improvements. Worse, the proposed solution of raising taxes and fees only advances and reinforces the tax-and-spend mentality that created and continues to feed the current situation. While increased taxes and fees might provide a near-term reprieve, state government consistently and repeatedly has demonstrated a propensity to increase spending beyond any level of increased revenues, and Colorado once again will face a situation of severe budget shortfalls.

For any proposed actions to be long-lasting, the systemic nature of the current situation must be exposed. Permanent fixes only can be realized through a detailed examination of the current budget structure, identification of redundant and ineffective programs, and discovery of opportunities for redefinition and reprioritization to bring state spending in line with current and future revenues.
It is to the first of these steps, an examination of the current budget's structure, that we now turn our attention. Let's deal with the facts. How much does the state government collect and spend in a year?

To proffer effective and substantial recommendations, we must begin with an understanding of the size and magnitude of the State's budget. Next, we need to examine the three categories of state moneys: the General Fund, Cash Funds, and Federal Funding. The flexibility of elected officials to change the direction and amount of funding of any program is enhanced or hampered depending on the way moneys are received and restricted.

Size

Most people think of how much they earn, and spend, in one year and they generally start counting on January 1 and end at the termination of the calendar year on December 31. Governments are generally unlike families in that they have a different fiscal year. To understand how revenues and expenditures are timed, the reader must know the new budget starts for Colorado on July 1, and straddles the end of the calendar year in order to wrap up its12-month budget on June 30.[1]

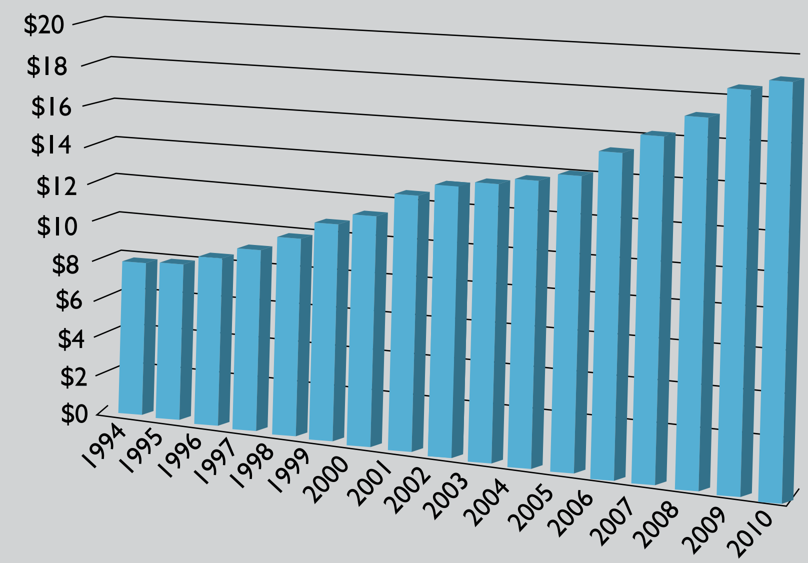
For the current fiscal year that started on July 1, 2010, the State will spend a total of $19.8 billion. Contrary to reports from the media and certain legislators, total spending has not declined in at least the past 15 years. This truth is most exemplified by the 2010-11 budget. Despite being in the midst of a recession, and amid claims of massive budget shortfalls, the newly approved budget is scheduled to increase by about $399 million, or 6 percent from the previous year.

The increase in total revenues received and spent annually over the past 15 years has been 187 percent. This increase has spanned both economic expansions and two recessions, including the most recent Great Recession. The average annual increase has been 7.4 percent.[2]

Put in *per capita* terms, the State's total fiscal year 2011 budget places a demand of $3,830 on every man, woman and child living in Colorado.[3] But there are many people who do not pay taxes, mostly children and spouses working only inside the home. Adult full-time students, elderly people on exempt incomes, some indigent people below a certain threshold and institutionalized persons also may contribute little or no taxes. Therefore, it is wiser to look at the burden on those people who earn the income and pay the taxes. The State's fiscal 2011 budget places a demand of $9,078 on every working Colorado family.[4]

The Colorado Constitution prohibits the State from deficit spending.[5] Although the U.S. Congress habitually spends more than the tax revenues generated for the federal government and borrows to fund its deficit, Colorado may not. In fact, the State has been prohibited from borrowing for any reason without prior voter approval. However, recent liberal interpretations by the Colorado Supreme Court have weakened this direct prohibition. As a result, within the past five years, state government borrowed in order to build a medical facility and a prison, and skirted the voter require-

Colorado State Total Budget (in billions)



Source: Colorado Joint Budget Committee, appropriations history: http://www.state.co.us/gov_dir/leg_dir/jbc/apphist.pdf

ment in doing so.[6] Otherwise, the State has been in general conformance with the requirement to spend no more day-to-day, operational funds than the taxes collected.

Three Broad Categories

To understand the State's budget, one must understand that its revenues are obtained from different sources.

Colorado government moneys are collected, allocated and managed within three broad categories. Each category has distinct sources of funding and specific programs or purposes to which funds are committed.

General Fund

The most sensitive category is the General Fund, which accounts for 39 percent of the total budget and generates the most debate and disagreement. In the year just ended on June 30, 2010, General Fund spending amounted to $7.06 billion. For the current fiscal year that started on July 1, 2010, General Fund spending will increase to $7.48 billion (a 6 percent increase), and the outlook for the following fiscal year anticipates further growth to at least $7.5 billion.[7] General Fund moneys can be spent for any legitimate governmental purpose that the legislature determines.

On the revenue side, the General Fund receives all your personal income taxes,[8] the income taxes you pay indirectly through corporate earnings, the State's portion of sales taxes on purchases,[9] excise taxes and other taxes on assets[10] and income.[11]

It is important to note that revenues from taxes are significantly influenced by the health of the Colorado, national and global economies. In both the 2001-02 recession and the most recent recession, revenue generation and spending in this category did not rise every year. Four of those years saw declines, although only two years experienced a reduction greater than 2 percent.

Cash Funds

The second budget category is Cash Funds, which are intended to be fees that individuals have some discretion in paying. An easily understood example is the fee you pay at the entrance to a State Park. If you choose to go elsewhere or to forego the opportunity to hike or camp that day, you pay nothing to the government. You make the decision whether to add to the stream of funds.

The largest cash funds, however, are not what you might think. All the tuitions college and university students pay to state institutions are part of this category. So too is the 22 cents gas tax[12] you pay on every gallon of gasoline you put in your vehicle.[13] People who use the services pay for them; a student (or his benefactor) must pay some tuition and a driver must pay to travel. Other fees include professional registration and licensing, co-payments collected at State health clinics, and tire disposal fees. The legislature has almost no flexibility to allocate revenues that are directed to the Highway Users Trust Fund or to college and university campuses.

As proposed and enacted, moneys in the Cash Funds segment of the State's budget are intended to pay for direct services related to the source of funding. For example, gasoline taxes are intended to help fund road maintenance, State Park fees support the construction and maintenance of park facilities, while hunting and fishing license fees are intended to help fund the Colorado Division of Wildlife.

As proposed and enacted, moneys in the Cash Funds segment of the State's budget are intended to pay for direct services related to the source of funding. For example, gasoline taxes are intended to help fund road maintenance, State Park fees support the construction and maintenance of park facilities, while hunting and fishing license fees are intended to help fund the Colorado Division of Wildlife. However, over the past several years, the Legislature has diverted some of these cash charges by raiding the balances in funds meant to cover direct services, and moving them to the General Fund. When individual cash fund balances are lowered too far, increases in those fees are triggered. This policy has been a source of controversy because many people perceive the diversion as an illegitimate way to prop up spending by taking funds intended and promised for direct services. The structural changes proposed within this report are anticipated to address General Fund shortfalls adequately to avoid further raids on fee balance accounts. Ultimately, it will be up to the legislature to halt this questionable practice.

Many people acknowledge that the Ritter administration advocated for, and obtained, tax rate increases. Using the subterfuge of calling increases in tax rates (which require advance approval by voters) increases in fees (which do not require such votes), the current administration successfully pushed through a "dirty dozen" of fee increases this year. The prior year, the highly controversial "FASTER"[14] revenues became the biggest example of such increases, in which increased taxes on car registrations were defined as "fees" and implemented without a TABOR election.

Federal Funding

The final major state budget category is federal funding. It probably surprises no one that the Air National Guard and the Army National Guard, which operate within the State's Department of Military Affairs, are funded mostly by the federal government. Other programs require the State to contribute some portion while the federal government funds the rest. Programs that originated in the national

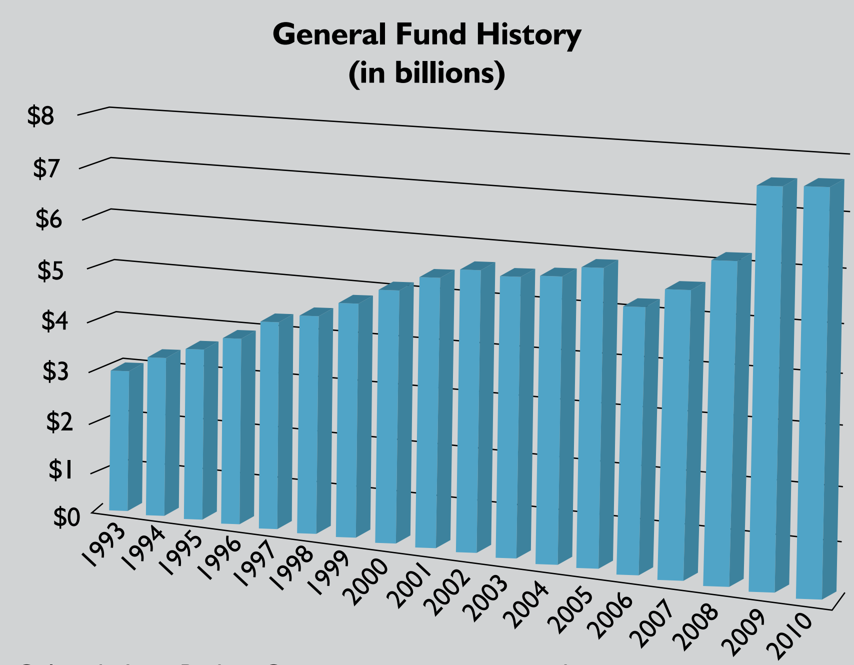
Congress provide enough support and incentive that the State enthusiastically administers them. As an example, projects funded by the federal gas tax are identified and approved in Washington, D.C., but the Colorado Department of Transportation manages the implementation of the new construction.

Federal funds commonly have been used to pay for specific programs and not as broad subsidies. This practice changed with the fiscal year ended June 30, 2010, when states, including Colorado, used federal moneys to plug budget holes. The Obama administration has responded to the economic slowdown by sending funds to states' governors under a program called the "American Recovery and Reinvestment Act" (ARRA). Within wide measures of discretion, these ARRA funds were used as the governors saw fit in order to fill budget gaps, bypassing the general assemblies.[15]

As an example, Colorado historically has received around 50 percent reimbursement for Medicaid payments. However, the recession prompted the federal government to apportion a larger percentage of state Medicaid funds through the ARRA stimulus. As a result of increased federal subsidies, for the fiscal year ended June 30, 2010, Colorado paid only 38.4 percent of Medicaid expenditures, while the federal government paid 61.6 percent. Translated into actual dollars, in FY 2009-10, total Medicaid expenditures were $3.9 billion of which the federal government paid $2.3 billion. In FY 2010-11, it is projected that total Medicaid expenditures will be $4.6 billion, of which $2.8 billion will come from Washington.[16] This projection assumes federal reimbursement for Medicaid expenditures will remain over 60 percent. If the federal moneys are not available, the State will have to backfill the difference.

Matching funding occurs extensively in education, as well. Thirteen percent of Colorado's K-12 education is subsidized with federal money, with higher education receiving 6.1 percent in federal funds.[17] Here again, ARRA stimulus money has been directed to plug shortfalls in Colorado's education budget. According to the Colorado Department of Education, the State received $621.9 million in education state grants through the "State Fiscal Stabilization Fund."[18]

It is far from certain whether these broad subsidies will continue next year, but according to most analysts, the ARRA should be considered a one-time remedy.



Source: Colorado Joint Budget Committee, appropriations history: http://www.state.co.us/gov_dir/leg_dir/jbc/apphist.pdf

The Approaching Storm

Total state spending continues to climb. General Fund spending is forecasted to begin another expansion. What then is the problem that necessitates this report? Why, if things are improving, do we find ourselves struggling with a large problem for the coming new General Assembly to resolve? Anticipated revenue streams for both the General Fund and Federal Funding segments of the State Budget are critical sources for concern.

An official internal forecast is generated quarterly at the Capitol by a non-political, non-partisan team of economists employed by the Colorado General Assembly. The team is part of a larger group of employees collectively known as the Legislative Council staff.[19] We utilize the recent forecast here to understand that the General Assembly does not expect the economy to grow robustly, or great numbers of new jobs to materialize, in the next year. Therefore, the prediction is for slow growth in tax revenues and fees generated in the State.[20] Even though inflation is quiescent and population growth is modest, the forecast does not anticipate that taxes will grow even to the low limit allowed this coming year under the State Constitution.[21] Further, there are any number of scenarios under which the economy does not continue in recovery:

> *Economic conditions are expected to be difficult throughout 2011. Although recovery is officially underway, it is slow and weak with real risks that business conditions will worsen.*

- Renowned economist Arthur Laffer recently observed[22] that the Bush tax cuts, which are anticipated to expire at the end of the year, are causing people to accelerate income into this cheaper tax year, to be followed by a deep second recession after January 1, 2011.
- The President of the Kansas City Federal Reserve Bank ("our" Federal Reserve District Bank) now has called publicly for monetary policy to take a dramatic change in direction.[23] When the "federal funds"[24] rate is close to zero, as it has been since it dipped below 1.0 percent on December 16, 2008,[25] there is no room for monetary policy to become more "accommodative," and fears of inflation now appear greater than earlier fears of deflation. The St. Louis Federal Reserve Bank tracking the monetary base reports it has ***more than doubled*** within the past two years, soaring from $900 billion to $2.4 trillion.[26]
- The nation had hoped for several years of payroll tax funds to exceed collections, thereby providing a buffer to the budget of the federal government. However, revenues were off and entitlement spending jumped this year, so higher deficits caused by old age pension benefits eating into program spending may arrive sooner than later. In the first half of 2010, tax benefit payments for Social Security exceeded tax revenues,[27] a situation not expected for another five years or so. Although an expanding economy should reverse that situation until approximately 2016, it shows that the FICA surplus used to prop up federal spending may not be as readily available as prognosticators had hoped.

General Fund revenues are highly susceptible to fluctuations in the health of the Colorado, national and global economies. Colorado's economic retrenching resulted in an early decline in tax-based funds, but then subsequent flat revenues during the current downturn. During the recession, every state government across the nation has felt the pinch. That circumstance was repeated in almost every other state, and it should be noted that Colorado's reduction was rather modest in comparison with states that have governments in real crisis, such as New York, New Jersey, Michigan and California. But to what extent are tax-based revenues expected to recover?

It is important to observe that citizens in fiscal crisis states, such as Michigan and California, do not enjoy the constitutional protections against governments growing too fast in good times and then needing to retrench severely in troubled times. Colorado is protected from excessive growth by our own constitutional tax-and-spending limitation, the Taxpayer's Bill of Rights (TABOR). That being the case, it is timely to note that TABOR has had nothing to do with restricting revenues received now. It functions to curtail government from growing faster than citizens' abilities to support higher budgets, but has no immediate effect during a downturn. The only way our protection against too-rapid growth in government could apply is that legislators cannot increase tax rates or institute new taxes without going to a vote of the people. Even the ardent proponent of Keynesian economics who justifies and urges high government spending, however, knows that governments should not raise taxes in the middle of a recession for fear of killing off any nascent recovery.

Even the ardent proponent of Keynesian economics who justifies and urges high government spending, however, knows that governments should not raise taxes in the middle of a recession for fear of killing off any nascent recovery.

Citizens across the nation are expressing more and more unease about the size of the national deficit and the totals accumulated in both debt and unfunded liabilities. U.S. Senators and Congressmen are growing increasingly leery of running up the national debt at record paces.[28] The sources of those funds have come from borrowing and not from new tax receipts. Many people see huge negative implications in the Federal Reserve System[29] buying up U.S. Treasury bonds directly, after lenders did not subscribe to the full issuance.

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Since federal funds have been borrowed to prop up state budgets, it is far from certain that federal subsidies will continue at the levels seen over the past two years. The moneys allowed the State to delay some hard decisions that likely will be forced during the next legislative session. The Legislative Council economists' forecast noted:

> *If you incorporate the losses of all of the one-time sources of money …. into the shortfall for FY 2011-12, the FY 2011-12 shortfall increases from $61.4 million to $678 million. If you also assume that the state legislature chooses to fund $300 million in budgetary pressures from inflation and caseload growth,* ***the shortfall increases to just under $1 billion.*** *[emphasis added]*[30]

The Systemic Problem

Colorado's state budget must be in balance at the end of each fiscal year—a requirement imposed from the citizens by a constitutional provision. If upon examination, the current budget and each subsequent budget face a deficit that must be closed, then one can conclude the structure has been established to grow spending faster than revenues. A systemic problem exists. This has been the case in Colorado, during good years and bad, for most of the past decades.

The State's budget problems arise not just from recent difficult economic times, but originate from structural spending problems that allow reoccurring crises.

It is impossible for the private sector to gain ground on public spending if the system is rigged for increases that will always be larger on the side that demands services than the side that pays for them.

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That reality goes a great distance in explaining the antipathy towards TABOR manifested by supporters of bigger government and tax consumers. We emphasize this point while at the same time recognizing the unusual degree of pressure to which the State's budget is being subjected by current economic conditions. The present and future budget pressures come from both the aforementioned structure and a temporary economic malaise. As acknowledged throughout this report, the national economy and the state economy is limping out of a severe recession, from which the majority of forecasters expect will take many more months, perhaps years, to recover fully. The recession has been accompanied by a sharp revenue shortfall in General Fund receipts to the State. We do not presume to minimize the temporal problems resulting from this economic downturn. The point not to be overlooked, however, is that even with a strong surge in revenues to the government, the more dominant factor of structure remains.

For a more complete understanding of the budget process, see that section, (page 23). Here it is enough to observe that budgets from one year to the next are meant to be funded by streams of income that are repeated year-over-year, reasonably predictable and relatively stable. For example, the tax on communications that nearly every citizen pays with every phone bill most certainly qualifies as a recurring source of income. By way of comparison, however, anyone can see that using money to build the base from a one-time occurrence—say the sale of an excess government building—is not repeatable or stable. Therefore, readers are urged to see that a mistake has been made by the legislature in this fashion. Dr. Barry Poulson's presentation to the Long-Term Stability Commission in 2009[31] warned:

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

For several years, the Colorado Legislature has used one-time, windfall moneys to establish long-term programs, thereby systemically and structurally creating an unsustainable burden on state resources and upon Colorado taxpayers.

For several years, the Colorado Legislature has used one-time, windfall moneys to establish long-term programs, thereby systemically and structurally creating an unsustainable burden on state resources and upon Colorado taxpayers. Solutions have been deferred year after year. As recently as the beginning of the decade, relatively small budget shortfalls were handled by shifting money around between various funding buckets. To deal with perennial budget shortfalls, such short-term financial manipulations were made as shifting a payroll into the next budget cycle, deferring state building maintenance, raiding cash funds and raising fees.

Colorado finds itself at a crossroads. The first path, favored by the current administration and the current class of legislators, addresses only the revenue side of the equation by promoting higher fees and increased taxes. In fact, as noted above, several actions aligned with this perspective already have been implemented. Continued tax rate increases will promise short-term solutions in order to quiet budgetary concerns, although even those steps may backfire if increased rates drive such disincentives that the changes lead to lower actual revenues. Certainly the long-term impact of any tax increase is likely to drive high-income earners out of the state, as has happened in California, New York, New Jersey and other high-tax states. Further, higher taxes will not permanently resolve the internal conflicts for ever-more public services and higher costs. States with higher tax rates uniformly have seen them turned into disproportionate salaries for government workers, creating further disparities between government professionals and the citizens who pay their wages.

Colorado finds itself at a crossroads. The first path, favored by the current administration and the current class of legislators, addresses only the revenue side of the equation by promoting higher fees and increased taxes.

The answer to the dilemma is to pursue the specific policy concepts offered in this paper – to address the systemic problem of agencies established with short-term funds that carry long-term liabilities. Together, the newly-elected General Assembly and newly-elected governor must make the hard choices that will restore Colorado to fiscal sanity. They will create a budget that does not flow year-to-year from one crisis to another. Citizens may still obtain the basic services that few argue should be central to the properly defined role of government. The situation cannot be delayed for another administration or even by another year because as Dr. Poulson presciently observed:

> *This problem of annualization is about to get much worse because of federal bailout money. Much of this one-time money is earmarked for ongoing programs, such as Medicaid. When the federal bailout dollars disappear two years from now [2011], it will be difficult to finance these ongoing programs.*[32]

Acknowledgements

Penn R. Pfiffner was the primary author of this section. See his biography in the authors section.

The Honorable John K. Andrews, Jr. reviewed the section for clarity and factual interpretation. Mr. Andrews was President of the Colorado Senate, 2003-2005. He is currently director of the Centennial Institute at Colorado Christian University, a regular commentator for Colorado Public Television and KNUS Radio, and a *Denver Post* columnist. He founded the Independence Institute in 1985, helped establish the State Policy Network in 1991, and headed the Texas Public Policy Foundation 1993-94. He was educated at Principia College.

The Honorable Mark Hillman reviewed this section for accuracy and factual interpretation. See his biography in the authors section.

The Honorable Greg Kaza provided perspective and reviewed the section for accuracy. Mr. Kaza has served as Executive Director

of the Arkansas Policy Foundation in Little Rock since 2001. He served six years (1993-98) in the Michigan House of Representatives where he chaired the Urban Policy Committee. He holds an M.S.F. in International Finance from Walsh College. His academic research has been published in peer-reviewed journals in North America, Europe and Asia.

The Honorable Kent Lambert added perspective and insights about current operations of the legislature. He serves in the Colorado House of Representatives from El Paso County and was a member of the Joint Budget Committee for one budget cycle. Mr. Lambert retired as a Colonel from the Air Force, where he had a career as a pilot, operations research analyst, and military diplomat. A graduate of the Air Force Academy, he also holds masters degrees from the University of Southern California in International Relations, and the Air Force Institute of Technology in Operations Research.

Barry Poulson reviewed this section for accuracy and factual interpretation. See his biography in the authors section.

We extend our appreciation to **Thomas Ryan**, who spent a great deal of time editing and amending this section. Mr. Ryan is the Chief Research Officer and co-owner of Analyst Strategy Group, a consulting firm providing marketing consulting services to high-tech companies. Concurrently, earlier this year he founded Reclaiming Moral Government, a company providing educational programs focused on civic responsibility for churches, schools, and clubs. His earlier career included working as the Chief Information Officer for EchoStar, and as a strategic consultant at KPMG Consulting. He holds an MBA and a Bachelor of Science in Business/Economics from Regis University.

We acknowledge the time generously given by **Jason Schrock**, Economist with the Legislative Council Staff, who professionally addressed direct questions regarding the estimate of potential budget shortfalls if federal funding is curtailed, that backfills the current budget.

Greg Schroeder clarified where in the state constitution the prohibition of a state property tax exists. Mr. Schroeder is a Property Tax Specialist with the Division of Property Taxation, an office within the Department of Local Affairs.

We thank **Jonathan Williams** for his review of this section. Mr. Williams is the Director of the Tax and Fiscal Policy Task Force for the American Legislative Exchange Council, headquartered in Washington, D.C. He is the author, along with Dr. Arthur Laffer and the ***Wall Street Journal's*** Stephen Moore, of the book ***Rich States, Poor States***, which is now in its third annual edition. Mr. Williams graduated ***magna cum laude*** from Northwood University in Midland, Michigan, majoring in economics, banking/finance, and business management.

We must acknowledge the time generously given by **John Ziegler**, the Staff Director of the Joint Budget Committee, who patiently answered direct questions regarding the magnitudes and timing of expected changes in federal funds going into the State's budget.

APPENDIX

Colorado State Total Budget (in billions)	
1994	7.56
1995	7.73
1996	8.27
1997	8.82
1998	9.63
1999	10.48
2000	11.15
2001	12.35
2002	12.96
2003	13.27
2004	13.62
2005	14.03
2006	15.29
2007	16.3
2008	17.21
2009	18.68
2010	19.17
Source: Colorado Joint Budget Committee, appropriations history: http://www.state.co.us/gov_dir/leg_dir/jbc/apphist.pdf	

General Fund History (in billions)	
1992-93	3.02
1993-94	3.35
1994-95	3.62
1995-96	3.91
1996-97	4.25
1997-98	4.49
1998-99	4.79
1999-00	5.10
2000-01	5.40
2001-02	5.61
2002-03	5.55
2003-04	5.64
2004-05	5.84
2005-06	5.19
2006-07	5.52
2007-08	6.11
2008-09	7.45
2009-10	7.48
Source: Colorado Joint Budget Committee, appropriations history: http://www.state.co.us/gov_dir/leg_dir/jbc/apphist.pdf	

ENDNOTES

[1] The federal government's fiscal year runs from October 1 to September 30 of the next year. Its next budget year will start on October 1, 2010, and will end on September 30, 2011.

[2] This figure is not adjusted for inflation. Over the same period, from 1994 to 2009, inflation averaged 2.51% per year (http://inflationdata.com/Inflation/Inflation_Rate/HistoricalInflation.aspx).

[3] There are approximately 5,170,000 residents of Colorado. See https://www.dola.state.co.us/dlg/demog/pop_colo_forecasts.html.

[4] There are approximately 2,181,287 families living in Colorado. See https://www.dola.state.co.us/dig/demog/housing_muni_estimates.html.

[5] Article X, Section 16.

[6] At the time of this publication, an initiated constitutional amendment was on the November 2010 ballot. Governments currently issue "certificates of participation" (COPs) to get around the existing restriction. Pending its passage of the measure, Amendment 61, the Constitution might return to the existing restriction so that citizens once again get a final review and approval before government burdens them further with debts.

[7] All from "Focus Colorado: Economic and Revenue Forecast." Colorado Legislative Council Staff, Economics Section, June 21, 2010, Table 1, page 4. It is imperative to note that the funds diverted by Amendment 23 into the State Education Fund are used to fund K-12 education directly, and therefore must be included in annual spending calculations.

[8] The rate for Colorado is based on the "adjusted gross income" from the income tax return that you file with the federal government. After deductions and exemptions, a flat rate of 4.63 cents is paid on every dollar earned.

[9] Although purchases of some items such as food and medicine are not taxed, a flat rate of 2.9 cents is paid on every dollar of most goods bought in Colorado.

[10] There is an estate tax (death tax), taxes on insurance premiums, gambling and more. Property taxes are local. At the time the TABOR amendment passed, there were no state-wide property taxes in place, and the TABOR Amendment (paragraph 8) clearly inserts a constitutional prohibition that "No new state real property tax .... shall be imposed."

[11] Income from dividends, interest, some capital gains, royalties and net rental income is rolled up in the income tax form reported to the Internal Revenue Service, and Colorado depends on the Form 1040 report.

[12] In addition, the federal government collects another 18 cents gas tax on every gallon.

[13] Gas put into vehicles that do not travel on local or state roads, such as farm tractors, is exempted from the gas tax.

[14] Senate Bill 09-108.

[15] We are indebted to the Honorable Kent Lambert for this information. From his position as a member of the Joint Budget Committee, he observed that the ARRA funds were sent directly to the Executive Branch so that the Legislative Branch, which is supposed to hold the power of the purse, did not determine how the funds were to be appropriated.

[16] Colorado Department of Health Care Policy and Financing, http://www.colorado.gov/cs/Satellite/HCPF/HCPF/1197969486224.

[17] 2009-10 education funding: K-12 education was 24.6% of the total budget ($4.48B). Higher education was 14.7% of the total budget ($2.67B).

[18] Congress designed the State Fiscal Stabilization Fund to prevent reductions in critical education and other services. Colorado received a $760,242,539 State Fiscal Stabilization Fund state allocation, which includes $621.9 million for its Education State Grant and $138.3 million for its Government Services Grant. See http://www.cde.state.co.us/scripts/federalstimulus/detail.asp?itemid=432776.

[19] The group should not be confused with the similarly-named committee of state legislators, elected as leaders from among all the legislators, who make the final executive decisions about how the Legislative Branch is run.

[20] "Focus Colorado: Economic and Revenue Forecast." Colorado Legislative Council Staff, Economics Section, June 21, 2010.

[21] Article X, Section 20 (TABOR) allows spending based on the current budget to be increased automatically by the percentage growth in inflation plus another percentage increase to reflect changes in population.

[22] Arthur Laffer, "Tax Hikes and the 2011 Economic Collapse," *The Wall Street Journal*, June 6, 2010, www.WSJ.com/taxes.

[23] Thomas M. Hoenig, "The High Cost of Exceptionally Low Rates., http://www.bis.org/review/r100625f.pdf.

[24] The interest rate that banks charge for short-term loans to each other.

[25] Open Market Operations. Intended federal funds rate, Change (basis points) and Level." Board of Directors of the Federal Reserve System. August 2010. http://www.federalreserve.gov/monetarypolicy/openmarket.htm.

[26] Federal Reserve Economic Data, Federal Reserve Bank of St. Louis: *Adjusted Monetary Base* http://research.stlouisfed.org/fred2/graph/?s[1][id]=AMBNS, accessed July 2010.

[27] Michael Barone, "Social Security cash flow suddenly negative," *Washington Examiner*, June 12, 2010, http://www.washingtonexaminer.com/opinion/blogs/beltway-confidential/Social-Security-cash-flow-suddenly-negative-96223259.html.

[28] For a more complete look at the problem, see "We Think You're Already Bankrupt" on the Independence Institute's Fiscal Policy web page, http://www.tax.i2i.org.

[29] The nation's central bank, which creates the money supply.

[30] "Focus Colorado: Economic and Revenue Forecast," idem, page 3.

[31] Barry W. Poulson, Ph.D. "A Fiscal Roadmap for Colorado: Remarks prepared for the Long-Term Fiscal Stability Commission, July 9, 2009," reprinted in July 2009 as Independence Institute Paper IP-8-2009 and available in full on our web site at http://old.i2i.org/articles/IP_8_2009_a.pdf.

[32] "Long-term Fiscal Stability commission," idem., page 3.

State Budget Process

The State of Colorado's budget is developed annually by the legislature. The process culminates in one piece of legislation that funds the executive and judicial branches for the year, known as the Long Bill. The Long Bill is organized by department. It includes authorization for each division and program for the number of state employees it may have, and covers the expected overhead costs such as imputed value of building space, cost of leased vehicles allowed and payroll burdens, such as PERA contributions and health insurance costs.[1]

The State of Colorado's budget is developed annually by the legislature. The process culminates in one piece of legislation that funds the executive and judicial branches for the year, known as the Long Bill.

Budget limits are established by quarterly forecasts[2] generated by economists working in Legislative Council staff, the research arm of the legislature. There are also quarterly forecasts developed by the Governor's Office of State Planning and Budgeting (OSPB). Each forecast includes anticipated economic conditions at the national and state levels, which in turn are used to create specific forecasts of State revenues. During years with strong revenue increases, TABOR restrains the total budget limit for state revenues.[3]

Other states depend on their governors' budget submittals to a far greater extent than Colorado, which uses legislators and legislative staff to create an initial budget. The governor is required to submit a budget by November 1 of each year.[4] That budget may be the starting point, but often is not the guiding document. Instead, the budget is generated by the Joint Budget Committee (JBC) of the legislature. Historically, the governor's input has been more influential when the majority party in both houses of the General Assembly has been the same as the governor's party. If the legislature is controlled by the party other than the governor's, however, the executive branch's influence tends to be less.

Three representatives and three senators comprise the JBC. The majority party in each house appoints two and the minority party one. Senate Committee members are selected by a vote of each party's caucus, and Representatives are appointed by their respective leaders within the parties' caucuses. The JBC staff director runs the nonpartisan JBC staff of 13 policy analysts. They develop proposed budgets for state agencies using data obtained in presentations before the JBC, past funding figures and State Auditor reports.

The JBC usually convenes in November immediately following the election and two months prior to the legislature convening its regular session in January. The Committee establishes "common policies" for departments such as salary increase percentage, motor vehicle lease rates from the state motor pool, building lease rates, equipment depreciation and information technology costs. During the early budget process, the Committee meets in order to hear department heads present their program requests and funding needs. At that point, the JBC raises questions and concerns about requests, but provides time to department directors for research and analysis. Answers are compiled in an overall briefing document from which the JBC and its staff build each department's budget. Often the JBC asks for full investigations and intricate reviews by the departments, which occasionally have taken as much as a year to resolve.

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Executive branch input is provided through the OSPB, which assembles the initial funding requests. The Schedule 3 form submitted by OSPB presents funding in great detail by type of expenditure. Each kind of expense is summarized as a line item, intended to become a final spending authority. Its five columns of data compare the request with the past two year's expenditures, current appropriations and current year adjustments.

The JBC relies on detailed annual lists for major maintenance, upgrades and new construction of State buildings and for facilities at state colleges and universities. These lists are created by the Capital Development Committee, a standing legislative committee with its own, smaller staff. The JBC's statewide budget recommends a certain level of spending for buildings, which then is applied as far down the capital development list as funds allow.

Certain programs are established as permanently revolving funds, such as construction and maintenance of county, municipal and local water supplies. A local government borrows from this source, which is "continuously appropriated," and will pay back the loans through user charges. The moneys return to the fund and are made available for the next approved application. The legislature has the opportunity to review the projects, which are listed in a separate bill[5] each year. In other respects, those funds are outside the budget debate.

The Committee takes responsibility to prepare a state budget that conforms to revenue limitations, reserve requirements caps and provisions of the Taxpayer's Bill of Rights, paring as necessary.

Federal funds are "appropriated" in the Long Bill, allowing for specific spending through the State for programs directed from Washington, D.C. Unlike appropriations of state revenues, the JBC has no control over how federal program spending is disbursed.

JBC staff includes responses to the inquiries to bring a revised proposal to the JBC, which further adjusts the budgets at the most detailed level. The Committee takes responsibility to prepare a state budget that conforms to revenue limitations, reserve requirements caps and provisions of the Taxpayer's Bill of Rights, paring as necessary. The JBC aims for consensus to close out each department and to vote out the entire budget.

The JBC typically advocates for the Long Bill in floor action. Over the years the JBC mostly demonstrates a strong desire to operate by an internal agreement, adopted before the convening of each budget writing session, to function with a unanimous front, defending each line item as initially recommended. The other 94 legislators may of course amend the Long Bill, but rarely succeed in making more than minimal alterations. Many legislators have objected to this process, but it has been the common practice.

Over the years the JBC mostly demonstrates a strong desire to operate by an internal agreement, adopted before the convening of each budget writing session, to function with a unanimous front, defending each line item as initially recommended.

Unforeseen circumstances and exigencies force departments to come back midyear for changes. "Supplemental funding "can be increases or decreases to line items within the budget, as the agencies discover changes in program demands throughout the year. Greater or lesser receipts also mean the State will adjust its budget to spend more or less, unless during strong business expansions certain limits have already been reached. Supplementals must by law be submitted by the first day of January,[6] and are habitually the first budget actions voted on in each legislative session.

Problems

We started our Citizen's Budget stating that the structure of the State budget must be challenged and altered. A critical observation is that the process starts from the prior year's spending. By law, the JBC had the authority to request a zero-based budget,[7] but rarely had the time and resources to make more than a modest attempt. That authority was repealed in this year's House Bill 1119.

We recommend a different way of identifying spending priorities. It is such an important discussion that we give its own separate section, below.

Focus on results, not inputs

In addition to tackling priorities, we identify as a significant weakness that budgets are put together by compiling the quantity of ***inputs*** that agencies believe are necessary. A better formulation would be to start with metrics about ***outcomes***. Rarely does the legislature argue over outcomes, just the inputs. Some executive branch agencies have performance metrics written into their strategic plans, but the process for the legislature has not been results-oriented. For example, "How many people are removed from the homeless rolls?" would be a better question than "How many employees need to drive what number of leased vehicles?" to address the problem.

Greater accountability can be demanded if Colorado is able to compare outcomes with other states' results.

Greater accountability can be demanded if Colorado is able to compare outcomes with other states' results. If our Human Services is handling only 90 percent of welfare cases for the same money as another state, that situation would suggest an immediate opportunity for greater efficiency. If reading programs are 50 percent more expensive than in similar neighboring school districts, likewise a change may be indicated.

In order to resolve structural problems in the budget, the legislature must alter the process by which it decides the budget. It must understand what product or service is being purchased, since there will never be more than a few people who can know definitively the right number of inputs to solve a problem. Accountability will entail forcing agencies to set realistic but rigorous goals for government programs, and then clearly demonstrating they are organized and managed to succeed. Once elected officials figure out what is a proper taxpayer-funded service, citizens have the right to know that what is purchased is designed to tackle and hopefully improve or solve a societal problem. Should the program fail to meet its objectives, a resolute decision must be made to end the failure and demand a new approach.

Once elected officials figure out what is a proper taxpayer-funded service, citizens have the right to know that what is purchased is designed to tackle and hopefully improve or solve a societal problem.

As things stand now, we have it backwards. Failure is offered as reason for the legislature to pour more money into a failed project. Although the legislature has yet to implement a performance-based system, it appeared to take a large step in that direction by passing new legislation in 2010[8] that builds on output-based concepts. Leaders should not retreat from the new process, but rather should embrace it enthusiastically.

Restore the Arveschoug-Bird spending limitation

A limitation on how quickly General Fund spending may increase predates TABOR. In 1991 the legislature imposed a statutory measure to ensure appropriations for operations would not expend more than 6 percent over the prior year.[9] (It is known by its sponsors' names: Representative Steve Arveschoug and Senator Mike Bird.) Proponents of TABOR intended to protect the rule from subsequent relaxation by stating, "Other limits on … spending … may be weakened only by future voter approval." The legislature was convinced to ignore that constitutional phrase and recently[10] removed the restriction by itself.

Exempted from the Arveschoug-Bird limitation are the state's expenditures for building maintenance and new capital projects. This spending is known as "capital development funding."

Most years there has been money left over after the Arveschoug-Bird limitation was applied, money that could be spent under the more generous TABOR limitation. Those funds have been used for "one-time" expenditures. Capital development moneys are used to catch up on deferred maintenance, to fund highway maintenance or construction, or to erect or remodel new state buildings and college facilities.

The 2010-2011 Budget Instructions[11] state, "The amount of resources left unexpended .... is considered a reversion." We want to reverse any incentives for waste. The instructions motivate agencies, however, to spend up to the allocated amount designated for each line item of a department's budget. The alternative for the agency is to suffer a budget reversion. The reversion also provides a disincentive to spend below the amount allocated in order to avoid a continued lower level of spending in succeeding years.

Continuing without Arveschoug-Bird will mean that day-to-day operations can, and likely will, consume all the General Fund revenues.

Continuing without Arveschoug-Bird will mean that day-to-day operations can, and likely will, consume all the General Fund revenues. Money for capital outlays has dried up, so building upkeep, remodeling and new construction will continue to be deferred. The new system has already provided incentive to spend any unused funds in whatever fashion will max out the annual appropriation, however inefficacious that expenditure may be.

Endnotes

[1] The objective descriptions of JBC operations and organization are derived substantially from "Role of the JBC," Joint Budget Committee at http://www.state.co.us/gov_dir/leg_dir/jbc/jbcrole.htm.

[2] Forecasts are expected to be released on March 20, June 20, September 20 and December 20.

[3] Federal funds do not count in computing the TABOR limit, nor do funds going towards Amendment 23's State Education Fund or for the national tobacco settlement. Other funds exempted from TABOR include gifts and other lawsuit settlements and awards, but these last are not significant revenue factors.

[4] Colo. Rev. Stat. § 24-37-304(b).

[5] The Water Conservation Board may give loans under $10 million directly to entities without action by the legislature. For projects over $10 million, the Board either may loan funds if authorized by legislation or the Board may instead grant money to the entity that does not need to be repaid, but that too must be authorized in a bill.

[6] Colo. Rev. Stat. § 24-37-304(b.5).

[7] Colo. Rev. Stat. § 2-3-207.

[8] House Bill 1119.

[9] The limitation also must conform to a growth limit of a change in personal income over 5 percent, but this economic measure of the entire economy will rarely come into play.

[10] Senate Bill 2009-228 by Senator Morse and Representatives Marostica and Court, "Concerning an Increase in the Flexibility of the General Assembly to Determine the Appropriate Use of State Revenues."

[11] Page 6-3.

Priority-Based Budgeting

We recommend that legislature move to a "priority-based budgeting" system. It is crucial that the structure for setting a State budget more closely conform to the reality of expected income, not only for the ensuing year but well into the future. Washington State adopted this type of budget reform, and is now being employed in New Jersey to deal with a budget crisis.

The process of creating a budget also might be modified to evolve the current system to one that works somewhat differently. The role of 94 legislators should expand while the process provides more direct input to the Joint Budget Committee (JBC).

The move to performance-based budgeting is not a partisan issue. For years the Democrat Leadership Council actively has lobbied its members to embrace outcome-based budgeting:

> *That citizens want value for their money is no mystery. We all want as much value as we can get from each dollar we spend—including what we spent on government. The price and value of government are up against the price and value of housing, food, clothing, health care and countless other goods and services that meet people's needs. The price of government is limited, therefore, by the value that citizens want—and get—from government, compared with the value they want and get elsewhere.*
>
> *Government can compete—and stay relevant—only by delivering more value per dollar. But the only way to accomplish this is to reinvent the way we do the public's business. Our public institutions must learn to work harder, but more important, they must learn to work smarter.*[1]

In 2010, conditions of several states are objectively worse than the balance of the states: California, New York, New Jersey and Michigan are among those most frequently identified. In his first year in office, Governor Chris Christie has forcefully led the charge to fix the perceived problem in New Jersey rather than follow the poor examples being set elsewhere. While California is issuing I.O.U.s due to running out of funds[2], New Jersey is addressing the problem with priority based budgeting. It should be noted that the four worse-case examples are states that have respectively the 6th, 2nd, 1st and 27th highest state and local combined tax burdens.[3] Collecting more taxes does not shield a state from budgetary woes, and counter-intuitively, even appears to exacerbate them.

Regardless of the mechanism through which priority-based budgeting is implemented, this change will require a new way of thinking that breaks the traditional mold of business-as-usual budgeting.

Regardless of the mechanism through which priority-based budgeting is implemented, this change will require a new way of thinking that breaks the traditional mold of business-as-usual budgeting.

a. Each program currently begins on a relatively equal footing simply because it was funded in the previous year. A small program that helps few people, or might be nearly incapable of reaching its goals, is afforded the same time and focus as one of the programs that make up the largest and most central of government responsibilities. A new system would deal first and foremost with the core functions.
b. Programs would have to change from defending their costs, expenses or inputs, and would instead be defended by the extent to which stated outcomes are fulfilled. The JBC holds hearings with the cabinet officers for each department, and

detailed discussions can focus on specific line items within a program budget. The process is long and involved, but frequently misses the bigger picture. This important description of the current process is addressed in detail on page 23.

c. Many more clear choices and trade-offs would be available to legislators, who then would be able to concentrate on how their decisions impact taxes and spending. They will be able to address such questions as: "Is it better to perform a program with lackluster support in order to add another program, or is it better to finance the more-highly desired program at the full level, even if it means ending or not starting another program?" There undoubtedly will be different conclusions reached at different times on trade-offs such as these, but the recommended system likely would give focus to the real costs of legislative choices.

d. The present system lacks priorities. The recommended system would provide them.

Colorado's legislative branch, with support, cooperation and collaboration of the executive branch, would need to answer questions based on Washington's model:

Question #1. What is the forecasted revenue for the next budget cycle?

The expected revenues, as limited by the Constitution, establish the outer bounds of what can be spent. A small reserve to handle fluctuations must exist, too.

Question #2. What are the essential services the state must deliver to citizens?

All existing programs should fit within one of the core functions, or they should be abolished.

What should state government do, and in what priority? Colorado's elected leaders should develop a meaningful set of core government principles. All existing programs should fit within one of the core functions, or they should be abolished. For each core function measurable outcomes should be identified and agency activities prioritized.

After core functions are identified, legislators prioritize activities within these functions to deliver the expected outcomes. Otherwise, state budgets resemble an iceberg, with decades worth of spending unseen and unexamined under the water, while the debate rages year after year over the small part that sticks out of the water. The longer state lawmakers continue to use the cost-plus model, the more "hardwired" their funding problems will become.

Taxpayers understand priority-based budgeting is the better way of doing business, but elected officials who urge its acceptance must explain the process in simple, compelling terms: If Colorado families and businesses must set priorities and live within their means, then state government can be expected to do the same.

Taxpayers understand priority-based budgeting is the better way of doing business, but elected officials who urge its acceptance must explain the process in simple, compelling terms: If Colorado families and businesses must set priorities and live within their means, then state government can be expected to do the same. This new type of budgeting protects the programs deemed most important from budget cuts. It holds agency directors responsible for spending taxpayers' dollars in the best way possible to deliver the best services possible. It protects vulnerable programs from election-year rhetoric. The worst solution is to absorb ever-more taxpayer dollars but not to deliver proportional improvements.

Question #3. How will the state measure its progress in accomplishing those goals?

As priorities are established, elected leaders develop measureable outcomes for each of the identified core functions. Then, agency programs can be prioritized further, based on how effectively and efficiently each will help meet the goals. A priority-based system must include these indicators of success; and delivery of desired services *must* be measurable.

Question #4. What is the most effective way to accomplish the state's goals with the funds available?

The first three questions in performance-based budgeting are about developing meaningful and measurable goals. This question, by contrast, is about using market forces and competition to deliver those goals effectively and efficiently without compromising cost and quality.

Each activity should be categorized as high, medium, or low priority, and performance indicators should be identified. The agency's budget request should reflect those priorities and guidelines.

To make this process functional, each state agency should develop what it believes to be its mission as established by law. Once its mission is defined, the agency must outline the goals and objectives necessary to accomplish it. Each activity should be categorized as high, medium, or low priority, and performance indicators should be identified. The agency's budget request should reflect those priorities and guidelines. At the point where agencies complete an analysis of mission and goals, the legislature steps into action. It is the role of the legislature to review, and ultimately determine, the proper mission, objectives, and performance indicators for all agencies under their jurisdiction in order to determine whether or not they comply with the core functions of government adopted in the joint resolution.

By following this budget process, a government "buy list" is created, directing the discussion away from "cuts" to instead what outcomes are being purchased.

This step leads directly to legislators debating the "make or buy" issue. By following this budget process, a government "buy list" is created, directing the discussion away from "cuts" to instead what outcomes are being purchased. Performance-based budgeting provides a logical process for measuring the activities of government against desired performance outcomes and using that as a tool to make decisions accordingly. This budget process also greatly increases spending efficiency and economy.

As described by a 1995 Evergreen Freedom Foundation report, Washington State instituted the process in 1981 when the Department of Social and Health Services was faced with the necessity of recommending real cuts:

> *Top managers decided to highlight 40% of the SDHS budget in a 'visible bank' of potential cuts. They used a three-point prioritization program to determine where the cuts should be made.*
>
> *Managers defined the mission for each program, prioritizing major components. These priorities established the guidelines and criteria for budget-cutting decisions. Cuts in 'priority three' services were generally acceptable. 'Priority two' cuts would reduce the department's effectiveness and 'priority one' cuts would destroy its purpose.*[4]

At the margin, government leaders will be able to show they have been able to fund the most important functions. If those leaders wish to implore citizens to buy more public goods rather than keep the funds in the hands of families, it will be clear what the trade-offs are. It is important that the structure reinforces the selection of the most important functions.

Washington State

The original full development and implementation of priority-based budgeting occurred in Washington State in response to the need to close a large budget hole in 2002. Democratic Governor Gary Locke did not believe his administration or the legislature could or should figure a way to raise enough taxes to eliminate the deficit. The figure stood at $2.8 billion in a state only a little larger than Colorado. By utilizing the new method, Governor Locke was able to close the budget hole without raising taxes.

Washington's Priorities of Government approach goes beyond conventional budgeting, which often ignores the efficiency and effectiveness of existing state programs.

Washington's Priorities of Government approach goes beyond conventional budgeting, which often ignores the efficiency and effectiveness of existing state programs. Rarely is the question asked about how to improve existing programs or how to maximize the return on tax dollars that are collected.

Washington's legislature determined that its core functions are:

1. Improve student achievement in elementary, middle, and high schools.
2. Improve the value of post-secondary learning.
3. Improve the health of Washingtonians.
4. Improve the security of Washington's vulnerable children and adults.
5. Improve economic vitality of businesses and individuals.
6. Improve statewide mobility of people, goods, and services.
7. Improve the safety of people and property.
8. Improve the quality of Washington's natural resources.
9. Improve the cultural and recreational opportunities throughout the state.
10. Strengthen government's ability to achieve results efficiently and effectively.

As a result of following this performance-based budgeting, Washington salvaged a budget without making across-the-board cuts— a less responsible method than the more enduring step of establishing priorities. The reductions in spending were not haphazard or routine. They came from determining the most important things to buy in order to deliver the most important services. The Governor directed agencies to provide more details on the specific services they delivered, who benefited, how much the services cost, and what results the agencies expected to achieve. Agencies further were required to designate all their activities as high, medium, or low priority, with at least one-third of the agency's expenditures in the low priority category. By focusing on specific activities—not programs or agencies—the governor's budget staff created lists across the entire government for each of the core functions and proposed to fund those activities which contributed most directly to each core function.

As a result of following this performance-based budgeting, Washington salvaged a budget without making across-the-board cuts— a less responsible method than the more enduring step of establishing priorities.

The results generated from this process surprised nearly everyone, especially those who initially believed it was just another public relations program. Its success scared agency directors, unions, many lobbyists, and lots of lazy legislators who suddenly realized they had to pay attention and say "No" to special interests that could not prove high value for a dollar spent.

Colorado can achieve similar favorable results by following the steps that Washington took:

Step #1. Establish a forecast of state revenue for the next budget cycle. The legislature already has in place an annual resolution in which they agree to accept a certain level of expected funding. The non-political staff at the Capitol generate quarterly economic studies and projections. For decades these studies have been accurate to an impressive degree, especially in light of the vicissitudes of taxable income from one year to the next. There is already a "statutory reserve" that must be funded every year at 4 percent of the general fund budget to ensure unexpected conditions do not run the state government out of operating dollars.

Step #2. Reach a conclusion of what the essential services are that the state must deliver to citizens. The budget components should be presented by goal topic. Each program, no matter in which agency it is housed, should appear to make its case for funding. This new process will bring to the fore the opportunity to identify duplication and overlap, and point out positive opportunities for program consolidation and cooperation.

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A priority-based budgeting system would not reach its final form within one year. Rather, it will be an evolutionary process of improvement. It will take strong, visionary leadership to push this reform forward and to keep it progressing. Implementation might look like:

A. In the first, transitional year the budget already will have been prepared using the current methodology. Near the beginning of the 2011 legislative session, the General Assembly would have to come to a decision to modify the structure.
B. Beyond arriving at a decision to alter the system, the only new action the legislature need accomplish would be to delineate core government functions and to place them in priority. The creation of a rather simple list would be immensely difficult and require scheduling by legislative leadership. The process likely would mean each body would caucus for one or two days before beginning the debate on the Resolution, which itself would probably absorb two or three days in each chamber.
C. Establishing broad priorities reasonably early in the session should assist in defining the acceptable changes in the 2011-12 budget that must be approved before the end of the session in May. It also will set up the process for the next year.
D. In the case where a downturn reduces the budget from one year to the next, a possible evolution would involve the 10 Committees of Reference, or standing committees. These committees are each tasked with oversight of one or more executive branch departments. Within the limits laid down in the Resolution, each committee could propose cuts for the JBC to consider and compile. The emphasis would change from a question of "How do we fund everything?" to "How do we fund the most important mix of government services?"

Step #3. Establish outcome measures to track achieving the State's objectives. In the "Budget Process" section, page 23, we have tackled in great detail the need to move from focusing only on the cost inputs (how many employees, leased space, vehicles, etc.) to focusing on the outcomes of expenditures. Nowhere does the need become more clear than in a priority-based system. It also highlights that the incoming gubernatorial administration must accept the idea of change, since legislators do not have the staff, time or constitutional position that would allow them to determine outcomes independently. One weakness in the transition is that a Governor whose positions about spending reform are antithetical to the recommended change could drag out the process, or even thwart it.

Step #4. Create the "Buy" list of those actions that will most effectively reach the State's goals with the funds available. The elected officials who report back to their constituencies must take responsibility for how taxpayer funds are used. More than occurs with a simple up-or-down vote on the annual Long Bill, a priority budget will delineate the choices to be made by the people's representatives.

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Penn R. Pfiffner was one of the authors of this section. See his biography in the authors section.

Brett Davis is due equal credit for authoring this section. Mr. Davis is an Economic Policy analyst at the Evergreen Freedom Foundation in Olympia, Washington. Before coming to the Freedom Foundation, he worked as a writer for a major humanitarian organization based in Federal Way, Washington, and also served as an editor and reporter for various community newspapers and business/legal publications in Washington state. Mr. Davis earned a Bachelor's degree in journalism from Western Washington University.

The Honorable Mark Hillman provided a great deal of perspective and understanding and rewrote a large portion to reflect his better interpretation of the proposed implementation. See his biography in the authors section.

The Honorable Kent Lambert added perspective and insights about current operations of the legislature. He serves in the Colorado House of Representatives from El Paso County and was a member of the Joint Budget Committee for one budget cycle. Mr. Lambert retired as a Colonel from the Air Force, where he had a career as a pilot, operations research analyst, and military diplomat. A graduate of the Air Force Academy, he also holds masters degrees from the University of Southern California in International Relations, and the Air Force Institute of Technology in Operations Research.

ENDNOTES

[1] David Osborne and Peter Hutchinson, "Budgeting For Outcomes: How government can deliver more value for the tax dollars citizens spend," *Blueprint Magazine*, May 7, 2004. http://www.dlc.org/ndol_ci.cfm?contentid=252574&kaid=125&subid=162.

[2] http://cbs5.com/local/california.budget.IOU.2.924701.html.

[3] National Tax Foundation.

[4] "The Washington State Budget, A Herd of Sacred Cows," Evergreen Freedom Foundation, 1995.

Policy Changes to Make a Difference

Higher Education

To formulate policy on higher education, we must get past the jumble of assertions made about the state of funding and the access to education past high school enjoyed by the citizens. We will find that, contrary to much-discussed allegations, citizens of all incomes and ethnicities are presented with the chance to attend a state college or university.

To formulate policy on higher education, we must get past the jumble of assertions made about the state of funding and the access to education past high school enjoyed by the citizens.

The State has cut total spending to higher education for the last two fiscal years. We will find that the outlook is grim for that circumstance to be reversed soon. That means that the structure of how state institutions collect revenue must fundamentally change to meet sufficient levels.

The revenue problem in this category is also exacerbated by the same problems discussed elsewhere in this report; that a recent dependency on federal direct support payments will be tested when those federal funds are curtailed.

We find that the College Opportunity Fund program should be retained because it forms an excellent base on which to build changes. It must be expanded and modified to conform to the real needs.

After a review of how state colleges and universities are operated as independent government enterprises, we conclude the situation should be extended and made permanent. We address what the real reform would entail and urge reform that does not involve changing ownership to a form of private holdings.

The term "full time equivalent" (FTE) is used throughout this section to designate a student. For example, two half-time students or one full-time student would in each case equal one FTE. The term is used ubiquitously in the state budget to mean a full-time equivalent state employee, so the two concepts must not be confused.

We urge the institutions to reform themselves by initiating audits regarding teaching productivity, and thereby lead the nation in reducing low priority publication in favor of more direct instruction. The standings of highly-rated institutions, dependent on research dollars, should not be called into question.

As elected officials grapple with the determination of the best set of priorities for citizens, they must address a fundamental understanding about higher education. Is the system primarily for society's benefit? If so, then ever higher amounts of support will be justified and students should understand that completing their educations implies they owe some return to the government. If on the other hand, furthering one's education is primarily so that an individual can improve his understanding of the world and his professional production, then subsidy can be justified only for those for whom higher education is otherwise unattainable. The general justification for college subsidies is that successful pursuit of a degree can lift an individual out of perpetual poverty. Is higher education primarily for society's benefit or the individual's benefit?

Funding Adequacy

Critics will argue that higher education is underfunded, especially in Colorado, and that the state should allocate more subsidies to higher education.[1] The argument that higher education is underfunded has been challenged in the economics literature. Barry Poulson explores this argument in a forthcoming Independence Institute publication "The Funding Crisis in Colorado's Higher Education System."

Table 1. State Expenditures for Higher Education ($ millions)					
Fiscal Year	General Fund	Other State Funds	Total State Funds	Federal Funds	Total Funds
2007	729	2,365	3,094	250	3,344
2008	846	2,311	3,157	347	3,504
2009	777	1,123	1,900	540	2,440
2010	716	1,123	1,839	282	2,121

Source: 2007-2009 actual data from the National Association of State Budget Officers (NASBO) State Expenditures Report, fall 2009; 2010 authors estimate.

Table 2. Higher Education Expenditures as a Share of Total State Expenditures (percent)		
Fiscal Year	Colorado	All States
2007	14.1	10.2
2008	13.9	10.2
2009	9.1	9.8

Source: National Association of State Budget Officers, State Expenditures Report, fall 2009.

State funding for higher education in Colorado, as well as other states, is heavily impacted by the business cycle. Spending cuts made since 2007 by necessity targeted higher education, because it is discretionary, while other components of the state budget are mandated by state and federal regulations and court orders.

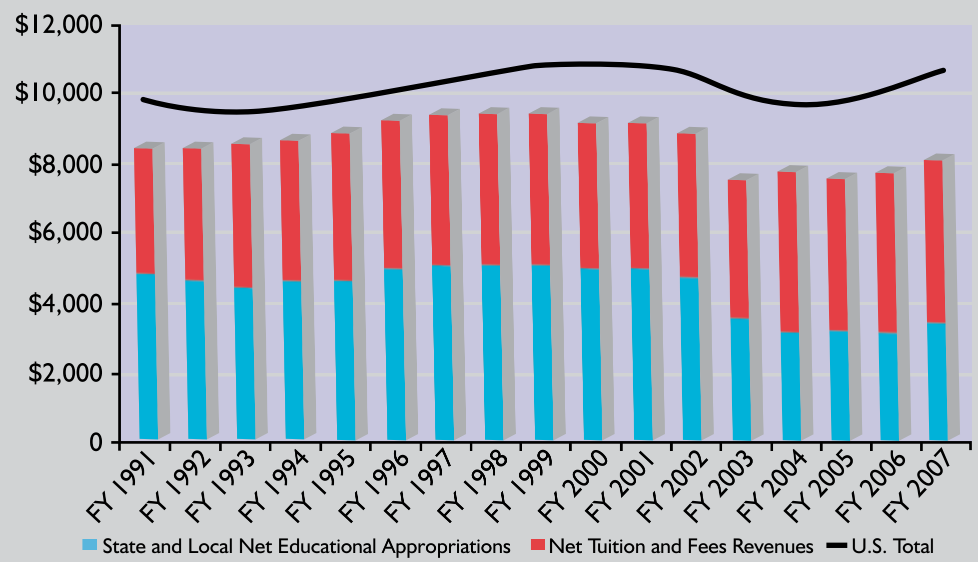
Some cuts were offset with federal funds; however, the use of one-time stimulus dollars to finance ongoing programs has created a structural deficit in higher education budgets. General Fund revenues are not projected to recover to pre-recession levels for several years.[2] When the federal stimulus money ends in FY 2011, higher education budgets will face further significant challenges.

The demand for higher education is increasing. During the recession more people continue their education, rather than enter the workforce. Also, families that might have chosen private institutions are sending their children to public colleges and universities to save money.

Colorado's legislators have allowed colleges and universities to increase tuition to offset the budget cuts in periods of recession. In periods of growth legislators have provided more generous funding for higher education.

As figure 1 shows, prior to the recession in the early part of this decade, total funding for higher education was relatively stable. From 1991 to 2002 total funding

Figure 1
State Appropriations and Tuition Revenue per FTE for Colorado Institutions



Source: SHEEOSHEF with adjustments for inflation (HECA), cost of living, and enrollment mix.

Source: Western Interstate Commission on Higher Education, (2008).

per undergraduate full time equivalent student (FTE) exceeded $8,000. This sum included both state appropriations and tuition. The availability of state funding was allowed to force tuition levels to adjust. During the earlier recession of the early 90's when state funding fell, tuition charges also increased to offset the funding shortfall. When the economy recovered and state funding to higher education could increase, tuition increases were limited. As a result, total funding per FTE plateaued.

The recession in the early 21st century brought a sharp revenue shortfall, and a sharp decrease in state funding per FTE. While tuition charges were increased, the increases did not make up for the shortfall in state funding. Total funding per FTE fell below $8,000, which was well below average funding per FTE in the nation.

In fiscal 2008 the state was able to increase total funding for higher education by increasing General Fund expenditures as well as federal funds. However, in fiscal 2009 state funding for higher education fell sharply, only partially offset by increased federal funds. Prior to 2009 higher education expenditures as a share of total state expenditures in Colorado exceeded that in other states; in 2009 the share fell below that in other states. Colorado's increased dependence on federal funding for higher education began with the College Opportunity and Affordability Act of 2007. That dependence increased dramatically with the federal stimulus money created in the American Recovery and Reinvestment Act (ARRA) in 2009. ARRA was designed to stabilize support for higher education funding by supplementing state funding for higher education. The state expects to receive $7.1 billion in federal funds from the ARRA.[3]

Higher education received $621.8 million in federal stimulus moneys that supplemented state funds. On an annual basis the federal stimulus money has boosted total funding by 25 percent, to about $800 million. When the federal stimulus money disappears in the next fiscal year, the state will ***lose $207 million annually in federal funds*** allocated to higher education. Table 3 shows the allocation of these funds by institution.

Table 3. Allocation of ARRA Funds by Institution

Institution	FY 2008-2009	FY 2009-2010	FY 2010-2011
Adams State College	$2,459,127	$7,207,904	$1,413,343
Mesa State College	$4,117,215	$11,700,892	$2,387,079
Metropolitan State College of Denver	$9,934,344	$24,765,859	$4,665,091
Western State College	$2,280,870	$6,196,492	$1,412,354
Colorado State University System	$33,271,434	$80,088,438	$19,566,800
Fort Lewis College	$3,978,508	$7,752,908	$2,843,580
University of Colorado System	$49,995,467	$119,390,747	$35,003,398
Colorado School of Mines	$4,443,761	$12,463,207	$2,845,658
University of Northern Colorado	$8,909,433	$23,222,224	$5,793,766
Community College System	$25,300,005	$69,953,805	$14,959,668
Local District Junior Colleges	$3,288,325	$8,414,708	$2,154,256
Area Vocational Schools	$2,697,018	$5,351,059	$1,649,106
TOTAL	$150,676,055	$376,508,243	$94,694,099

Source: State of Colorado, Governor's Office of State Planning and Budget (2010).

Colorado chose to spend most of the ARRA money in FY 2008 and FY2009. Colorado's dependence on ARRA money is reflected in the changes in higher education expenditures over the past two years. Federal funding for higher education in Colorado increased 38.8 percent in FY2008, and 55.6 percent in FY 2009. As a share of total funding for higher education in Colorado the federal share increased from 7.5 percent in 2007 to 22.1 percent in 2009. No other state has become as dependent as Colorado on federal funding for higher education over this period.

Federal funding for higher education in Colorado increased 38.8 percent in FY2008, and 55.6 percent in FY 2009. As a share of total funding for higher education in Colorado the federal share increased from 7.5 percent in 2007 to 22.1 percent in 2009. No other state has become as dependent as Colorado on federal funding for higher education over this period.

The impact of the ARRA money is captured in table 5. In FY 2009, in the absence of ARRA money total expenditures for higher education in Colorado would have fallen 11.5 percent. With ARRA money total expenditures for higher education increased 8.7 percent. The percentage point difference in funding for higher education with and without ARRA money in Colorado was 20.2 percent. The average percentage point difference for the nation as a whole was 1.9 percent. There is only one other state that comes even close to Colorado in dependence on ARRA money in that year: Arizona, at 14.2 percent.

The structural deficit in higher education budgets reflects more than the use of one-time ARRA money for ongoing programs. Federal funding has come with strings attached that have imposed an unfunded mandate on state expenditures for higher education. Included in this federal legislation impacting higher education spending are Maintenance of Effort (MOE) provisions. This provision was included in the College Opportunity Act of 2007, as well as the ARRA of 2009. Especially pernicious was the MOE provision originally incorporated in the former legislation. The penalty for a state failing to meet that provision would have been loss of the Federal Leveraging Educational Assistance Partnership money, funds that go directly to helping low-income students. The federal government coerces states into funding higher education by threatening to withhold federal funds for the neediest students in higher education.

As a condition of receiving ARRA moneys, the State must provide higher education funding at not less than 2006 levels. Governor Ritter has submitted a request for a waiver from this ARRA MOE requirement.[4] One proposal is to transfer $80 million from the K-12 budget to the higher education budget.[5]

The unfunded mandates imposed by the federal government on state spending for higher education set a dangerous precedent for several reasons. Not only do these federal mandates dictate minimum levels of state spending for higher education, they also restrict how the federal money can be used. The federal stimulus money mandates that federal funding for higher education must be used for non-instructional

Table 4. Annual Percentage Change in Higher Education Expenditures (percent)

Fiscal Year	State Funds	Federal Funds	All Funds
2007 to 2008	2.0	38.8	4.8
2008 to 2009	-39.8	55.6	-30.4

Source: National Association of State Budget Officers, State Expenditures Report, fall 2009.

Table 5. Percentage Change in Higher Education Spending With and Without ARRA Funds, Fiscal Year 2009 (percent)			
	Without ARRA Funds	With ARRA Funds	Percentage Point Difference
Colorado	-11.5	8.7	20.2
U.S. Average	-3.4	-1.5	1.9
Source: National Association of State Budget Officers, State Expenditures Report, fall 2009.			

programs. This mandate is at odds with state priorities to spend more dollars on classroom instruction, but federal priorities override state priorities.

Dependence on federal funding actually could decrease state funding for higher education in the long run. Historically, during economic growth the State has been more generous in allocating state funds to higher education. If state legislators perceive that more generous state expenditures could set a higher standard in meeting federal mandates, they may choose to be less generous to higher education in periods of prosperity.

Finally, citizens are increasingly leery of policy direction from Washington. Both federal spending for higher education and the unfunded mandates that accompany these expenditures, fall outside the powers enumerated in the U.S. Constitution.

Finally, citizens are increasingly leery of policy direction from Washington. Both federal spending for higher education and the unfunded mandates that accompany these expenditures, fall outside the powers enumerated in the U.S. Constitution. The 10th Amendment reserves such powers to the states and the people. Citizens concerned with these constitutional issues want to reduce the federal government's influence and return powers to the State and to citizens, restoring state sovereignty and enhancing individual freedom.

There have been unsuccessful efforts to raise taxes earmarked for higher education. In 2008, the legislature considered Initiative 119, which would have earmarked severance tax revenues for higher education; but the initiative was withdrawn by the sponsor prior to hearing. Amendment 58, which also earmarked severance tax revenue for higher education, made it to the ballot box, but was rejected by the voters. Amendment 59 would have earmarked TABOR surplus revenue for higher education, and was also defeated at the ballot box. Voters passed a citizen initiative, Amendment 50, earmarking gaming tax revenue for community colleges. House Bill 09-1272 passed in the most recent session to implement Amendment 50, allocates a modest amount of gaming revenues to the community college system.[6] In August 2010 Governor Ritter proposed to make up a revenue shortfall by diverting back to the General Fund $9.4 million from a fund for higher education financed by federal mineral lease money.[7]

Solving a structural deficit requires fundamental reforms to stabilize higher education funding and to balance the state budget without federal handouts and federal unfunded mandates.

College Opportunity Fund: Already Begun

As the funding crisis in Colorado's higher education system emerged in the early part of this decade elected officials began to search for alternative ways to fund higher education.[8] In 2004 the legislature enacted the College Opportunity Fund (COF). This Fund created a voucher system to replace some direct funding to public higher education institutions. The vouchers, referred to as stipends, were set at $2,400 per year per full-time student

In 2004 the legislature enacted the College Opportunity Fund (COF). This Fund created a voucher system to replace some direct funding to public higher education institutions.

to be used to offset tuition. Vouchers were to be portable among Colorado's public higher education institutions and some private institutions.[9]

Block grants in the form of direct funding contracts for specific purposes were provided to each institution reflecting their different mission statements. These included graduate-level education, specialized education services, and professional degrees. Performance contracts are negotiated between the administrations in higher education institutions and the Department of Higher Education (DHE).[10]

Because the vouchers replaced some direct funding to institutions of higher education, the share of state general funds allocated to some institutions fell below 10 percent of their total funding. This change allowed these institutions to acquire enterprise status, which made them exempt from Taxpayer's Bill of Rights (TABOR) restrictions. Most importantly, ***these institutions could raise tuition without triggering the TABOR limit on state revenue and spending.*** Thus, higher education institutions could raise tuition without requiring cuts in other state programs. The institutions with enterprise status also had greater flexibility in issuing debt. The quid pro quo of enterprise status is what motivated administrators in higher education to support the COF plan.

The state is criticized for having low levels of state funding in higher education compared to other states. When the focus shifts to outcomes however, the higher education system in Colorado compares more favorably to other states.

Some observers criticized vouchers as failing to improve access to higher education because enrollment did not increase, especially among in-state students and underrepresented populations.[11] The report also concluded that vouchers had failed to create incentives for higher education institutions to become more innovative and efficient in the delivery of education services. Much of the criticism improperly focuses on inputs into higher education system rather than outcomes. The state is criticized for having low levels of state funding in higher education compared to other states. When the focus shifts to outcomes however, the higher education system in Colorado compares more favorably to other states.

Measures of Access to Higher Education

The empirical evidence comes from the National Comparison Data compiled by the National Center for Higher Education Management Systems (NCHEMS). When comparing access information, we look at several similar western states and California. The percentage of 18-24 year olds enrolled in Colorado colleges, at 34.9 percent, is above the national average of 33.9 percent. Only California ranks above Colorado, reflecting a much lower undergraduate tuition charged by California compared to Colorado.

Over the period 1992-2007 the number of undergraduate degrees awarded relative to the number of students enrolled increased from 14 percent to 18 percent.

Measures of Progress and Completion of Higher Education

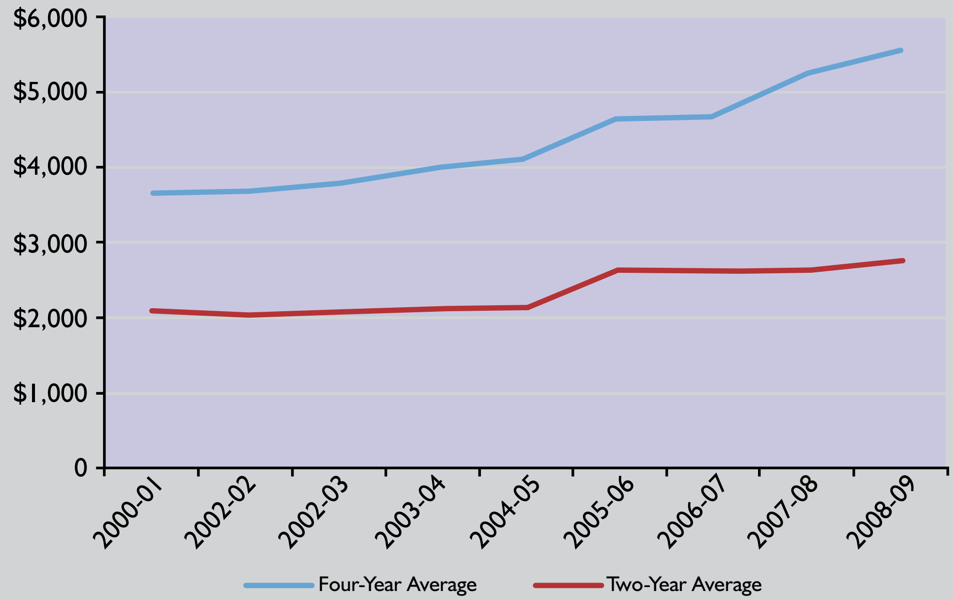
Colorado has made significant progress in the completion rates for higher education. Over the period 1992-2007 the number of undergraduate degrees awarded relative to the number of students enrolled increased from 14 percent to 18 percent. That ratio still falls below the national average, however, and the six-year graduation rate of bachelors students also falls below that for most states in the region.

Measures of Affordability of Higher Education

Some states place the burden of going to college on the individual by holding tuitions high. Other states rely on the taxpayer instead to provide the largest proportion of college funding. Colorado clearly falls into the first category.

Tuition revenue per student in Colorado, at $5,353, is significantly above the national average of $3,845. It is also higher than in regional states, which range from California's minimal $1,424 to Oregon's $4,664. Colorado higher education counts on tuition for 58.4 percent of its revenue, compared to the 36.2 percent for a national average.

Figure 2
Average Published Tuition and Fees at COF-Eligible Public Institution by Sector, 2000-01 to 2008-09



Note: Data reflect the student share of published in-state tuition after applying the COF stipend.

Source: Western Interstate Commission on Higher Education, 2008b.

Colorado exceeds the national average of 27.8 percent, and most other states in the region, in the percentage of family income needed to pay for college at four- year colleges and universities, at 30.3 percent. By contrast, the percentage of family income needed to pay for two-year colleges is slightly below the national average and below that in most other states in the region. However, even after financial aid, the share of family income needed to pay for college has risen substantially in Colorado over the past decade.

However, even after financial aid, the share of family income needed to pay for college has risen substantially in Colorado over the past decade.

As in most states, Colorado tuitions have increased rapidly in recent years (see figure 2). The COF legislation included specific language that vouchers were designed to make college more affordable to low-income students. In this regard COF has not fulfilled expectations. In the same year that COF became effective, 2005-06, institutions raised tuition significantly. Average tuition for full-time students, after deducting the value of the COF voucher, increased $507 (23.5 percent) at community colleges, and $545 (13.3 percent) at four-year institutions. Much of the benefit of COF has been captured by institutions rather than students.[12] Across the nation, public subsidies to higher education have increased very rapidly in recent years; and, recent research suggests that much of this public subsidy has been captured by professors, administrators and other stakeholders in higher education.[13] There has been a virtual explosion of recent studies critical of the rising cost and diminished quality of public higher education.[14]

With few exceptions, financial aid has not kept pace with published tuition in most states, and that is true for Colorado. As a result, net tuition has been increasing more rapidly than published tuition.

The Level of Public Support for Higher Education

Much of the criticism of Colorado's higher education system is the low level of state and local government support. Colorado ranks well below the national average, and below other states in the region in several measures of public support. In state and local public support the State provides $3,807 per FTE, which is 4.1 percent of the State budget. Compare that with the national average of $6,673 and 6.5 percent of the average state's budget. When comparing regional states, outcomes vary from Oregon's $4,948 to Nevada's $8,589 and percentage of state budget range from Oregon's 5.6 percent to Idaho's 8.3 percent.

There is an important qualification to this evidence regarding state and local funding for higher education in Colorado. The above data is based on General Fund appropriations to higher education. The money for COF vouchers and direct funding contracts for special purposes is reported separately from state appropriations to higher education. Adding that money to state appropriations to higher education, Colorado compares more favorably with other states. Further, economists measuring the efficiency of higher education have found that Colorado ranks significantly above the national average, and above other states in the region.[15]

A measure of efficiency takes a ratio of the index for graduation rates divided by an index for total higher education revenues per FTE. This measure is comprehensive because it compares graduation rates with total education resources per FTE. While higher education efficiency in Colorado is about equal to that for the nation using this measure, it is below that for three other states in the region.

Why Has the COF Plan Not Fulfilled Expectations?

Our analysis suggests that while Colorado has a relatively efficient higher education system, there is certainly room for improvement in other measures of performance. Particularly troubling is the evidence of deterioration over the past two decades in measures of access and affordability. The voucher plan has not fulfilled many of the expectations of the higher education system when the plan was enacted. The question is why the voucher plan has not been successful in fulfilling these expectations?

The WICHE report explains that vouchers were combined with service contract funding so as to protect the revenue and budgets of higher education institutions.[16] Service contract funding undermines incentive effects of the voucher plan. DHE provides estimates of enrollments that then are used to determine voucher funding each year. When these projections underestimate the use of vouchers, the state covers any shortfall from fee-for-service fund. Money is redistributed from service contract funding to voucher funding so as to leave total state funding to that institution unchanged. Thus, enrollment growth is not actually funded by the state, and institutions have no incentive to increase enrollment. There is no incentive in this funding policy to induce institutions to compete for any students, let alone in-state students or underrepresented populations.

WICHE found that even though the state designed performance contracts for each institution, there were no penalties or rewards for performance.

WICHE found that even though the state designed performance contracts for each institution, there were no penalties or rewards for performance. There were no rewards for attracting more students, or for attracting in-state students, or for targeting underrepresented populations. There were no penalties if students failed to progress or graduate in a timely manner. The performance contracts became another bureaucratic requirement, without impacting decision making; the result was business as usual in higher education institutions. Universities also correctly anticipated that service contract combined with the voucher plan would leave their revenues and budgets unharmed. Community colleges that attracted more students did not receive the additional voucher money that was promised. Some universities that failed to attract the projected number of voucher students, nonetheless received the voucher funding for those missing students.

The amount of voucher revenue received by private higher education institutions was a little over $1 million, equal to a miniscule 0.3 percent of total voucher funds. It is not surprising voucher funding to private institutions has created little competition for public college and universities.

Eligibility limitations on where vouchers can be cashed are too restricted. The legal monopoly held by public colleges and universities will not be broken by the small numbers of students and limited funding impacted by vouchers at two private universities.

Eligibility limitations on where vouchers can be cashed are too restricted. The legal monopoly held by public colleges and universities will not be broken by the small numbers of students and limited funding impacted by vouchers at two private universities. As long as these constraints are imposed we should not expect much incentive effect from vouchers through increased competition in the higher education system.

A New Stipend Plan

Funds currently allocated to higher education from the General Fund, and service contract funding, would be used to fund the stipend plan. Stipends would be extended to students attending all qualified postsecondary institutions, including for-profit as well as nonprofit institutions. The stipend plan would be phased in over five years to give higher education institutions time to adjust to the new system.

A goal of the stipend plan is to create competition among all qualified postsecondary institutions. This stipend-based higher education system would create incentives for these institutions to deliver quality education at lower cost.

A goal of the stipend plan is to create competition among all qualified postsecondary institutions. This stipend-based higher education system would create incentives for these institutions to deliver quality education at lower cost. Replacing the current system of direct state funding to higher education institutions with a stipend plan funding students and families will generate public support, and reverse the downward trend in state support for higher education.

Reservations regarding state funding for higher education are not new. Half a century ago Milton Friedman challenged the rationale for government subsidies to higher education based on 'social benefits.'[17] Friedman pointed to potential negative social impacts from public subsidies to higher education. One of those impacts is certainly evident in current government subsidies to higher education, increased government regulation and intervention in higher education.

As Friedman observed, many of the presumed benefits of higher education to a democratic society are difficult to measure, and controversial.[18] To the extent that college graduates capture the benefits of higher education in higher earnings, this represents a transfer of wealth from taxpayers to college graduates.

Friedman argued that if the state does subsidize higher education the funding should be in the form of student vouchers rather than direct state funding to colleges and universities. The vouchers should be extended to students attending all higher education institutions, private and public. Friedman and others have argued, a voucher system should create a more competitive higher education system in which institutions have an incentive to deliver quality education at a low cost.

A wealth of economic analysis now supports Friedman's proposed system for higher education.[19] Some studies provide empirical support that such a system can increase efficiency and equity in higher education. Barry Poulson has reviewed empirical literature on the impact of a voucher system in an earlier study,[20] and also explored the rationale for voucher system including all qualified postsecondary institutions in Colorado.[21]

A wealth of economic analysis now supports Friedman's proposed system for higher education.

Should Every Colorado Resident Student Be Guaranteed a Stipend?

A very difficult public policy issue will emerge. Does the State further control costs by imposing a means test so that wealthy families are not eligible for a stipend, but lower-income families are? Does the State limit the number of credit hours that stipends will cover, or can a student enroll for many hours in addition to the minimum to earn a degree? Two strong, opposing arguments present themselves:

1. Citizens already have paid the taxes used to fund stipends. To argue that some families who are eligible should receive smaller stipends in order to subsidize other students with higher stipends is an implicit tax. Stipends should be set at the same level for all students eligible for the stipends. The stipend plan should not be used to redistribute income from one Colorado family to another.

2. Our nation is at risk now due to unsustainable entitlement spending. A universal college stipend would entitle a resident to government funds merely by being a resident. To avoid creating yet another broad entitlement program, stipends should be means-tested. Experience shows entitlements tend to grow over time, and are very difficult to cut during periods of budget pressure. Therefore, the legislature will lose even more control over the budget. Finally, some people choose never to pursue a college degree; universal stipends would redistribute income from these people to other people.

For the time being, it is not necessary to resolve this debate in order to start improving Colorado's stipend system.

A New Stipend Plan for Higher Education

As this chapter has detailed, the flaw is not in stipends per se, but rather in the way in which the COF plan was designed and implemented. We propose a new stipend plan to replace the COF plan, to be implemented over a five year period. There are several provisions in the proposed stipend plan that would correct flaws in the COF plan.

Stipends Replace All Direct State Funding to Higher Education

Stipends would replace all direct funding to public higher education institutions. Funds currently allocated directly from the General Fund to these institutions would be allocated to the stipend plan. The forthcoming Independence Institute paper by Barry Poulson, "A New Stipend Plan for Higher Education in Colorado," details how to manage a five-year transition period.

The goal should be a stipend voucher system to create competition among all institutions of higher education. Students should be eligible to apply stipends toward tuition at all postsecondary institutions in the state, including public, private for-profit, and nonprofit private institutions. We then should expect improved outcomes from wider incentives as COF is fully enacted.

Stipends and the Flagship Institutions

The University of Colorado and Colorado State Systems would no longer receive direct funding from the state; their students would continue to receive funding in the form of stipends.

The flagship institutions will criticize the proposed stipends system because of the loss of direct revenue. These two institutions received $204 million in direct funding in FY 2007-08.

Under COF, direct state funding has fallen below 10 percent of the total funding for CU and CSU, enabling them to receive enterprise status. With enterprise status they have had greater flexibility in raising tuition. They have also had more flexibility in issuing debt, using certificates of participation (COPs). They have had greater freedom to design academic programs in response to market forces. These institutions can offset the loss of direct state funding by improving efficiency. While the evidence suggests they have not always taken advantage of this freedom, a stipend system will create more incentives for them to implement these reforms.

Under COF, direct state funding has fallen below 10 percent of the total funding for CU and CSU, enabling them to receive enterprise status.

The economics literature suggests that in a more competitive environment in which funding is provided through stipends rather than through direct funding, the flagship institutions of higher education will be the most competitive.[22] We can predict that these institutions will increase tuition more rapidly than other public institutions. Further, the tuition of the flagship institutions will tend to converge with that at private colleges and universities, which in turn will create greater calls for merit and need-based scholarships. The flagship institutions will continue to attract students even with higher tuitions, because of the higher quality of their undergraduate programs. The higher tuition revenues will enable the flagship institutions to provide better quality undergraduate education, using tuition revenues to offset the loss in direct funding.

The flagship institutions already have adjusted tuitions to target disadvantaged students. Colorado State University recently announced that families with incomes below the poverty line would pay half tuition; and students eligible for PELL grants would pay no tuition. Expect these institutions to continue to target disadvantaged students, even without direct funding from the state.

The higher tuition revenues will enable these flagship institutions to provide better quality undergraduate education, using tuition revenues to offset the loss in direct funding.

While the flagship institutions would have five years to adapt to a full stipend system, some of their programs could adjust immediately. Because COF voucher funding is not available to fund graduate programs, the graduate programs in Medicine, Law, Engineering, and Business should immediately begin funding themselves entirely from tuition, and, of course, from donations from alumni, corporations and foundations. Students in the graduate programs capture the benefits of their graduate degree in higher lifetime earnings. Tuition charges for these graduate programs already have been adjusted to reflect their greater cost, but graduate program rates likely would increase to an amount closer to the full cost of the programs. This adjustment would not preclude graduate students from continuing to receive financial support from sources other than state funding.

At the other end of the spectrum are undergraduate programs at these institutions, such as Arts and Sciences, which depend heavily on public subsidy. Some have argued that CU and CUS shortchange undergraduate programs in order to fund expensive graduate programs and to pursue other agendas. To the extent this argument is true, it will be more difficult for the undergraduate programs to compete in a stipend system, and they will likely need more time to adjust.

Some other public higher education institutions could adapt quickly to a stipend system. The Colorado School of Mines already has received enterprise status with a great deal of autonomy from state regulations. It shares some of the characteristics of the flagship institutions, such as a reputation for quality undergraduate programs that attract students. The School of Mines also could raise tuition and continue to attract students.

The economics literature suggests the non-flagship public higher education institutions will find it more difficult to adjust to a competitive environment.[23] These institutions have been more dependent on public support. In the most recent report on COF for FY 2007-08, the total amount of direct funding was $298.8 million. Of that total, $204 million was received by the University of Colorado and Colorado State Universities, and the smaller total of $94.8 million was received by all other public higher education institutions.

The other public higher education institutions undoubtedly will protest loss of direct funding. All undergraduate programs should link revenue to stipends.

State support has enabled other public higher education institutions to set tuition levels below that at flagship institutions, and well below tuitions levels at private institutions.

State support has enabled other public higher education institutions to set tuition levels below that at flagship institutions, and well below tuitions levels at private institutions. Students are attracted to these other public institutions by the low cost, even when they receive an inferior quality of education. The other institutions may raise tuition, but not to the extent of flagship institutions. It is more difficult for the other public institutions to raise tuition to offset the loss of direct funding. They are more likely to expand enrollments to sustain revenues.

A stipend system may change the composition of enrollments within the public higher education system. If flagship institutions increase tuition more rapidly than other public higher education institutions, it could result in an expansion of enrollments at community colleges and other public institutions relative to enrollments at flagship institutions. Such a shift would not be a bad option from an economic standpoint, because the cost of educating students at the other public higher education institutions tends to be significantly lower than at flagship institutions.[24]

Other public higher education institutions also should have greater freedom to design academic programs in response to market forces.

Other public higher education institutions also should have greater freedom to design academic programs in response to market forces. These institutions also can offset the loss of direct state funding by improving efficiency.

The stipend plan would be extended to all Colorado students attending qualified postsecondary institutions, including private for-profit schools and private nonprofit schools. Of the $716 million transferred from the General Fund to the stipend plan a significant share of these funds likely will end up as stipend used by students attending private post-secondary institutions.

The economics literature suggests the impact of this stipend system would be to significantly reduce tuition charges at private colleges, and significantly increase tuition charges at public colleges. The most significant reduction in tuition would be at private two-year colleges. The current differential in tuition between private and public colleges and universities would decline.[25]

In a study for the Independence Institute, Poulson found that for-profit postsecondary institutions compare favorably with their public sector counterparts in terms of the performance measures cited earlier in this chapter.[26] In fact, these for-profit institutions are more successful in the progress of students and completion of degrees compared to their public sector counterparts. For-profit schools also educate postsecondary students at a lower cost.

If private for-profit postsecondary institutions are able to attract students in the current system without stipends, we would expect them to be even more competitive if their students are eligible for stipends. We would expect a significant increase in the numbers of students attending private postsecondary institutions relative to those attending public institutions.

The economics literature suggests that with this stipend plan a larger number of students would choose to enroll in inexpensive two-year colleges rather than more expensive four-year colleges. While both public and private two-year institutions would experience increased enrollments, the increased enrollment in private two-year colleges would be significantly greater.[27]

The response of low-income students to the tuition changes under a stipend system is predicted to be far greater than that for middle- and higher-income students. Thus, an important result of this stipend system would be to expand postsecondary education to a broader group of students, including low-income students.[28]

With expansion of the stipend system to all postsecondary institutions the incentive effects of stipends will lead to more efficient delivery of education services. Students will be able to make more rational choices in postsecondary education based on the quality of education relative to price. Those decisions will not be biased by the ability to capture subsidy at public institutions but not private institutions. In order to attract students all postsecondary institutions will need to enact reforms to deliver better quality education at lower cost.

Thus, an important result of this stipend system would be to expand postsecondary education to a broader group of students, including low-income students.

Building the Higher Education Trust Fund

A Higher Education Trust Fund (Trust) would be created to accumulate funds that already have been earmarked for higher education. Amendment 50 gaming proceeds for community colleges would be administered by the Trust, as directed by that Amendment.

A second current source of funding for the Trust is federal mineral lease earnings that have been earmarked for higher education. Governor Ritter has proposed that this money be diverted to fund other General Fund expenditures. Mineral lease money deposited into the Trust could only support the stipend system.

Any land, buildings, and capital equipment not claimed by a public higher education institution with enterprise status would become part of the assets administered by the Trust. The Legislature could also earmark other assets to be deposited there and charge the Trust with administering assets so as to maximize the revenues. The Trust would be allowed to buy, sell, rent or lease facilities. In this sense the role of the Higher Education Trust Fund would become parallel to the responsibilities of the Colorado State Land Board, which administers state Trust Lands to support K-12 education.

The assets in the Trust would be used to stabilize the stipend plan during periods of recession and revenue shortfall. The assets also would be used to fund the transition to a stipend-based postsecondary system in which stipends could be used at both private and public higher education institutions.

The Trust would maintain a minimum level of stipend support by adjusting yearly for inflation. The legislature should be limited to transfers from the Trust to the stipend program only in periods of revenue shortfall. The Trust would become a true budget stabilization fund earmarked for higher education.

Finally, the stipends will be available to all students attending postsecondary institutions, including private for-profit and private nonprofit postsecondary institutions. Sufficient assets should be accumulated in the Trust to finance this expansion of the stipend plan.

The legislature always should have the discretion to increase contributions to the Trust each year more than the minimum amount specified above. It also should have the discretion to increase the dollar amount of the stipend above the minimum amount.

The new system of postsecondary education will drive public institutions that have depended on direct subsidies as well as stipends to enact reforms to compete with their private counterparts.

Reforming Public Higher Education

The new system of postsecondary education will drive public institutions that have depended on direct subsidies as well as stipends to enact reforms to compete with their private counterparts. It should be up to each public institution to design these reforms; the last thing the state should do is prescribe reforms. However, a number of reforms have proven to be successful when public higher education institutions are subject to greater competition. The following is not a prescription, but rather a menu of potential reforms these institutions should consider. Some of these reforms already have been enacted in Colorado public higher education institutions, but the imperative for reform will be greater with a full stipend system.

Improve productivity

Almost all college and university teachers are hired with the explicit expectation to do more work than just give lectures. As used in this section, "teacher" is a generic term that is meant to include all tenured and tenure-track faculty at all levels. Professors, associate professors, lecturers and some instructors all fall within this definition.

If the experience on only one campus is correct, a formal change at all the state institutions of higher education would improve productivity by 15 to 20 percent and would save between $50 million and $67 million per year in faculty salaries.

If the experience on only one campus is correct, a formal change at all the state institutions of higher education would improve productivity by 15 to 20 percent and would save between $50 million and $67 million per year in faculty salaries. The steps to accomplish this change are likely to be different for each level of institution. The Board of Regents, for example, could alter the University of Colorado system, while statutory change might be necessary for state colleges.

For many decades, expectations placed upon college teachers were stable. The former rule of thumb was that professors taught 15 credit-hours per semester. Since most courses are three credit-hours, each professor taught five classes in the fall semester and five classes in the winter semester. The standard class would meet for three hours per week, so the professor would spend 15 hours in direct contact with all the students enrolled for his courses during 30 weeks of the year. But more recently, the accepted guidelines for faculty employment have been eroded. It also must be noted that there are other time expectations directly related to the classes, in holding office hours to assist students individually, to prepare and update lesson plans, to create and grade tests and to handle administrative details.

The current expectation could be summed up in this fashion: The rule of thumb for time distribution is that 40 percent goes to instruction, 30 percent for service (which is usually poorly defined or not defined at all), and 30 percent (internally-funded) research.

Research is an integral and central aspect of an academic career, and nothing in this section would suggest otherwise.

Research is an integral and central aspect of an academic career, and nothing in this section would suggest otherwise. It becomes more central to the job description, the closer a teacher moves from the community college system to the flagship research universities. An important distinction emerges while looking closer at the way research is initiated and paid for. "Internally-funded" research is part and parcel of the salary paid to have a teacher on campus. It manifests itself as staying current on developments within the individual's field of study, and writing, and in collaborating and reviewing others' works. The second type is the externally-funded research. In that circumstance, the contract brings in new funding to finance the many resources that might be required. Beyond covering materials and research assistants, it includes a salary for the teacher which is meant to fund the portion of the time the professor otherwise would be engaged in instruction and internal research. We urge the legislature and the Department of Higher Education to do nothing to interfere or impact externally-funded research performed by those faculty members. Compute the productivity measures after removing the externally funded research from the equation.

If the responses to our research requests were any indication, state colleges and universities will make it difficult to pursue this line of investigation. We could not locate any central repository of information on faculty productivity, and searching institutions' web sites proved fruitless. We tried the direct approach of asking. Only one of five provosts' offices would take or return the call. Metro State College graciously provided the exact data we sought. Yet although the information was readily available, it took some time to obtain permission from the campus administration of Metro State College for its release. The lack of responsiveness and transparency within the entire system would lead us to expect the system to resist mightily.

It is possible that Metro State is not representative of all state colleges and universities. We offer a quick analysis of this one campus and hypothesize that the results could be extended for all public higher education entities. We have created a spreadsheet, available at our web site, that permits the user to enter the productivity goal and the current number of hours taught for each level of teacher. A productivity improvement percentage is created and then is multiplied by the total salaries at that teaching level. Metro State, like other state colleges, has no research responsibilities or objectives. It sets the annual goal of 30 hours teaching. The normal maximum load might include 15 hours in the fall and spring semesters and six hours in the summer. Using data from the College:

Table 6. Faculty Productivity at Metro State College

	Actual hours	Goal	Possible improvement
Professor	25.55	30	17%
Associate	26.81	33	23%
Assistant	26.7	33	24%
Instructor	27.28	36	32%

When the potential improvement was applied to the $29.3 million in faculty salaries, we project a savings of $6.4 million for this institution alone. The average savings is 19 percent.

Freedom to Set Tuition Rates

All postsecondary institutions should have the freedom to set their own tuitions. Economic research predicts a convergence of tuitions when all public funding is provided to students through stipends rather than allocated directly to public institutions. Tuition at public institutions will tend to rise, while that at private institutions will tend to fall.

All postsecondary institutions, including public institutions, should set tuitions to reflect supply and demand. Thus programs in business and engineering, which are more costly, should have higher tuition charges than other programs such as Arts and Sciences. The net effect will be for students to use their stipends more efficiently.

As noted earlier in this study some public institutions have adjusted tuition levels to reflect family income, and they should have the freedom to do so in a privatized system. Privatizing postsecondary education will open up more opportunities for low-income families to have access to vouchers they can use at private as well as public institutions. These students will continue to be eligible for other means-tested support, such as the PELL program.

Create Incentives for Higher Education to Provided High Quality Education at Lower Cost

Reform will create incentives for institutions to engage in entrepreneurial activities to generate other sources of revenue including research grants, private donations, and ancillary activities. Given the limited resources that likely will be available from the state for the foreseeable future, higher education institutions must look for other sources of revenue. Some of the institutions with less than 10 percent funding from the state are already well on their way toward privatization. With enterprise status these institutions should be free to aggressively pursue these other sources of revenue, without constraints or interference from the state.

1. Promote market incentives for a more efficient utilization of facilities. Public higher education institutions with enterprise status now have wide discretion to accumulate and utilize assets. In a stipend-driven higher education system they would have the power to buy, sell, rent or lease facilities just like a private institution. The expectation is that in this more competitive postsecondary system public higher education institutions would have more incentive to utilize assets efficiently.

There is ample evidence that public higher education institutions are poor managers of assets.

There is ample evidence that public higher education institutions are poor managers of assets. The University of Colorado is very inefficient in managing dormitory facilities, such as Williams Village.[29] Dormitory space often is not rented because the University does not adjust rents to reflect supply and demand for student housing in Boulder. A good solution in this case might be for the University to sell the dormitory facilities, use the funds for other investments, and allow the private sector to utilize the facilities more efficiently.

There is evidence that universities do not utilize classroom space efficiently. One study estimates that classrooms seldom operate at more than 25 percent capacity during the summer months, or vacation periods. Classroom facilities are underutilized in the early mornings, evenings and Fridays.[30]

One way for public higher education institutions to create incentives for better utilization of facilities would be to charge rent to the different units utilizing the facilities.

One way for public higher education institutions to create incentives for better utilization of facilities would be to charge rent to the different units utilizing the facilities. Each unit within the university could be given a budget to rent space. The administration then could charge differential rents depending on the demand for that space at different times of the day or days of the week. It then would be up to each unit to decide to pay higher rents for peak time use of the space, or to reduce spending and use the funds for other purposes.

2. Reform will provide incentives to reallocate resources to academic activities. Non-academic activities, such as sports, recreation, food, housing, etc., likely will be turned over to entities outside the university administration. The "yellow pages" criteria should apply: If there is a private option for these services, a high probability exists the private sector can deliver better quality service at a lower price. This understanding should result in contracting out and increased reliance on the private sector.

3. Higher education institutions should reconsider tenure. They should reexamine tenure contracts to determine if such long-term contracts are viable. If these institutions continue granting tenure, Professors should be subject to performance evaluations at all stages of their career.

Higher education institutions should reconsider tenure. They should reexamine tenure contracts to determine if such long term contracts are viable.

4. Make better use of new technologies in teaching and administration. Distance learning and computerized instruction have the potential to deliver better education at lower cost to a broader population. New technologies should be introduced in other areas, such as replacing library resources with digitized access to publications. Public colleges and universities could move to the cutting edge in utilizing these technologies.

5. Increase the ease with which students can transfer between institutions. The most critical factor will be reaching agreement on a common core curriculum of courses that can be easily transferred from one institution to another.

6. Create incentives for students to complete a degree in a timely manner. Currently, Colorado uses performance contracts to reward institutions when students complete their degree on time. The poor performance of public institutions in this regard suggests the use of these contracts has not provided much incentive to institutions. Eliminating fee-for-service contracts will preclude this option. A stipend system of higher education should create adequate incentives for institutions to pursue this objective. The stipend plan can be designed to create incentive by limiting the total number of credit hours that a student can fund from stipend. Limiting stipends to a four-year period is more controversial, but could also create the right incentives.

7. Improve the preparation of students for postsecondary education. Not every student should be preparing for a college degree. With stipends extended to all postsecondary institutions, financial support will be available to a broader group of students, including vocational programs such as business, nursing, computer science, etc. Such an extension should create more incentive for students to prepare for these careers. High schools must do a better job in counseling and preparing students for all postsecondary education.

8. In colleges and universities stipends should not be available to fund tuition costs of remedial courses.

9. High school students should have more opportunities to take an accelerated college preparation program. More opportunities should be made available to take college courses, advanced placement courses, and to receive exemptions from require courses by passing a placement exam. Students should be able to complete their high school education and make the transition to college based on their own progress, and not be tied to the standard four-year college preparation program.

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Penn Pfiffner contributed the discussion of faculty productivity. See his biographical material in the authors section.

Much of the primary research of the facts and the salary figures on faculty productivity was conducted by **Jacob Zax**. He also helped to develop the productivity model. Mr. Zax is a political science major with sophomore credits at Washington University in St. Louis. He worked as an intern at the Independence Institute during the summer 2010. He is contemplating a graduate degree in business after his anticipated graduation in May 2013.

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K-12 Tuition Tax Credits

The section on K-12 education is perhaps the best example of our earlier discussions for the need to recognize common principles and to come to understand which fundamentals cause the split in citizens' views on education funding.

Colorado's constitution calls for a state guarantee that children be educated. No reasoned debate starts with the thought that some children don't need or should not have an education. Once we recognize that basic point of agreement, then we need to ask some very fundamental questions about the delivery of education.

The first consideration is whether the State has fulfilled its constitutional requirement to fund education. Consider as you read through this section whether adequate resources are spent each year.

We know funding has been going up substantially and taking a larger portion of state taxes. Reality must force a limit at some point. An extreme example makes the point that no one wants to spend resources to teach children if it means the State can no longer protect them or that families have too little to feed and clothe a child. If you reach the conclusion that education funding is inadequate, what spending would you delete in the public or private sectors?

There was once a goal of schooling all children in the government schools so as to inculcate certain common values. Yet we perceive broad failure of the system to even impart basic scholastic knowledge. Many parents are opting out to home-school, and people inside and outside of the system are seeking alternatives. If one size does not fit all and citizens are increasingly bitter about the values taught, would greater harmony be found by giving parents more options, even if children are not schooled in an official government program?

If one size does not fit all and citizens are increasingly bitter about the values taught, would greater harmony be found by giving parents more options, even if children are not schooled in an official government program?

We must recognize moneys cannot be directed to other parts of the budget while a constitutional requirement remains to mandate that citizens add to the system every year. If our collective will is to sacrifice other important programs always in favor of K-12 education, the best these suggestions could accomplish would be to take the pressure off local district budgets.

Overview

For the current fiscal year of 2010-11, appropriations to K-12 education comprise the largest share of the state's general fund (45.6%). In all, the state is slated to appropriate $4.339 billion for K-12 education, down from $4.726 billion in 2009-10. The reduction returns Colorado K-12 state-appropriated funding to real 2007-08 dollars levels. Two-thirds of the decline is accounted for in a $257 million rollback in state-appropriated federal dollars from a record-high 2009-10 appropriation of $827 million.[1] The decline will be partially offset by nearly $160 million in federal funds to hire or rehire employees through the Education Jobs Fund.

The recent reduction represents a small offset to the long-term trend. In the past quarter century, state funding of Colorado K-12 education has grown both in real terms and as a share of total education funding. The annual amount of real state-appropriated dollars per pupil rose by 72.6 percent from 1984-85 to 2009-10.[2] Over time the state has assumed an ever-increasing share of the elementary and secondary education funding burden.

Rising expenditures for public schools are mandated in the state constitution. In 2000 Colorado voters narrowly approved Amendment 23. The law mandates annual increases to School Finance Act and categorical funding of 1 percent above inflation through 2010-11, and at the rate of inflation in years thereafter. Amendment 23 also created the State Education Fund through a designated marginal increase in the state income tax. Additionally, Amendment 23 enacted a "maintenance of effort" provision that requires a 5 percent annual increase in General Fund contributions to K-12 education—except when the state economy slows and personal income growth fails to reach 4.5 percent.

Meanwhile, with the rapid rise in federal funds and Amendment 23's creation of a separate State Education Fund, the General Fund now only provides 68.6 percent of state-appropriated K-12 education dollars as opposed to 87 percent two decades earlier.

During the 1990s—before Amendment 23 was enacted—the General Fund contribution to education grew every year in real dollars while decreasing as a share of General Fund contributions from 40.8 percent to 37.8 percent. In the nine years since Amendment 23, K-12 education has taken greater shares of General Fund moneys, increasing to 43.3 percent in 2009-10 and a projected 45.6 percent in 2010-11. Meanwhile, with the rapid rise in federal funds and Amendment 23's creation of a separate State Education Fund, the General Fund now only provides 68.6 percent of state-appropriated K-12 education dollars as opposed to 87 percent two decades earlier.[3]

Amendment 23 has greatly increased the State's share of the burden to fund K-12 education. In particular, the provisions requiring automatic, annual inflation-based increases and General Fund "maintenance of effort" have limited legislative flexibility. They also have obligated the state to underwrite unending increases regardless of revenues with no incentive to enhance learning productivity. These provisions, the heart of Amendment 23, need to be revisited.

K-12 Funding and Recent Colorado Policy Debates

The public is woefully uninformed about how much money is spent in public K-12 education. A 2007 Education Next-PEPG survey of nearly 2,000 American adults found more than 90 percent of respondents underestimated their school district's per-pupil expenditure. The median response of $2,000 was more than 80 percent below the actual figure[4] of roughly $10,000. It is unclear whether the Colorado voting population provides an exception to the rule.

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The accelerated increases in Colorado's K-12 per-pupil spending during the recent decade largely can be attributed to voter approval of the statewide ballot measure Amendment 23 in 2000. The constitutional change has guaranteed spending increases above the rate of inflation for the School Finance Act and categorical programs, representing the core of public school budgets.

Several subsequent state-level tax-hike efforts have been predicated on increasing revenues "for the children." Some proponents of 2005's narrowly-approved Referendum C promised one-third of new dollars would be furnished for K-12 education. The 2007 property tax mill levy rate freeze enacted by the General Assembly without a popular vote, despite a strong case that it violated the Taxpayer's Bill of Rights, was presented as a way to free extra funds to spend on preschool, full-day kindergarten and other education programs.[5]

In 2008 Amendment 59 sought to dismantle the Taxpayer's Bill of Rights by taking dollars available for TABOR refunds and dedicating them to fill requests for funding increases to K-12 education. Fifty-five percent of Colorado voters rejected the measure. More recently, a coalition called DECIDE moved during the 2010 legislative session to repeal voter approval of future tax increases for education. The resolution failed to receive the necessary two-thirds vote from either chamber. But some lawmakers who supported Senate Bill 191, the recently-adopted tenure reform legislation, stipulated during debate that its passage would enlist greater business interest backing of future education tax increase proposals.

SCHOOL FINANCE ACT

The Colorado state constitution guarantees the provision of "a thorough and uniform system of free public schools."[6] The lion's share of funding for public schools comes in the form of tax revenue collected by state and local governments. Most funding to the state's 178 local school districts—and to the Charter School Institute, a special authorizer created in 2004—is administered through the School Finance Act. The Act's basic existing framework was adopted in 1994, though it has been amended regularly in subsequent years.

The core funding each district receives through the School Finance Act is known as its ***total program***. The total program amount is derived from a statutory formula that factors in a funded pupil count (an average of up to five years of actual October pupil counts to protect districts with declining student enrollments), a base funding amount and various factors that attempt to reflect the cost of providing education services in different parts of the state:

- A factor that expresses the difference in cost of living between a metropolitan Denver suburb, a rural farm community and an upscale mountain resort town
- A factor that accounts for local and regional personnel costs, as employee salary and benefits make up the dominant share of local education budgets
- A factor that compensates for a school district's size, recognizing especially the constraints on purchasing power and the greater demands for transportation in a geographically large rural district

Additional considerations that drive the formula and determine a district's total program amount include:

- The number of at-risk students (i.e., students eligible for the federal free and reduced lunch program due to limited family income) increases the amount of funds received; and
- Students enrolled in an online education program that operates across district lines are funded at a standard rate lower than statewide average per-pupil funding.

Individual district receipts range from $6,358 in per pupil revenue (PPR) for Branson School District Re-82 in Las Animas County (because most students are enrolled statewide through a special online program) to $14,749 in PPR for Silverton School District 1 in southwestern Colorado's San Miguel County.

Total program funding for 2010-11 originally was estimated at $5.807 billion, but a "stabilization factor" enacted to address state budget shortages reduced the amount to $5.441 billion. Individual district receipts range from $6,358 in per pupil revenue (PPR) for Branson School District Re-82 in Las Animas County (because most students are enrolled statewide through a special online program) to $14,749 in PPR for Silverton School District 1 in southwestern Colorado's San Miguel County. Larger districts like Jefferson County Public Schools and Denver Public Schools receive PPR of $6,652 and $7,239, respectively.[7]

Earmarked Revenue

As currently amended, the School Finance Act only has one statutory obligation on local districts for the use of total program funding. At least three-fourths of the dollars received to provide at-risk student funding must be designated "to school or district-wide instructional programs for at-risk pupils or to staff development associated with teaching at-risk pupils in each district."[8] Before 2009-10 the School Finance Act required specified minimum amounts of total program funding to be allocated to instructional supplies (including textbooks), as well as to reserve funds for capital and insurance purposes. The General Assembly concluded in 2009 that local education agencies needed fewer earmarked revenues and greater discretion over the use of general education dollars.

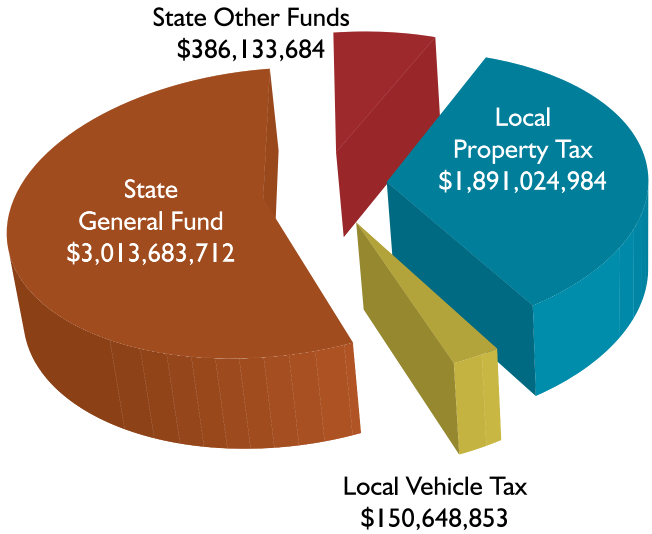
Public charter schools are entitled to receive 100 percent of PPR based on October 1 enrollment count. Authorizing districts with more than 500 students may charge up to 5 percent of PPR for administrative services. Authorizing districts with fewer than 500 students may charge up to 15 percent of PPR.[9]

State vs. Local Share

Funds generated locally through property taxes on homes and businesses furnish $1.891 billion toward the School Finance Act. Total program mill levy rates vary by district—from 1.68 mills in rural southern Colorado's Primero School District to 27 mills, the maximum allowed by statute. The remaining $150 million comes from locally-collected vehicle ownership taxes. These two revenue sources provide the foundation of a district's School Finance Act funding.

In most districts, the combined property and vehicle ownership tax revenue falls short of the total program formula amount defined in statute. The remaining funds are backfilled through

Colorado School Finance Act Funding: Local vs. State Revenue (FY 2010-11)



income taxes and other funds collected at the state level. In 2010-11 nearly nine out of every 10 state dollars used to pay for the School Finance Act comes directly from the general fund, more than $3 billion.[10] The remainder is appropriated from the State Education Fund (created by Amendment 23) and the State Public School Fund.

As shown in figure 1 above, the state's share of total program funding for the current budget year (2010-11) is projected to be 62.5 percent, or $3.4 billion. Primarily due to higher local property values compared to student enrollment, seven districts are slated to receive no state total program aid: Aspen, Clear Creek Re-1, Estes Park R-3, Gunnison Watershed Re-1J, Park County Re-2, Summit Re-1 and West Grand 1-Jt. At the opposite end of the spectrum, Edison School District 54 Jt in rural El Paso County is slated to receive the greatest share of state aid at 96.5 percent.[11] (Interestingly, Edison is heavily dependent on state funding despite having the highest total program mill levy allowed under state law.)

From 2001-02 to 2009-10 Colorado statewide per-pupil spending through the School Finance Act's total program grew by 15 percent in real dollars.[12] During the same time span, the state's share of total program grew from 56.5 percent ($2.23 billion) to 63.8 percent ($3.65 billion).[13]

Additional Funding Sources

Other major sources of public revenue are available to school districts beyond the total program in the School Finance Act. In 2009-10, state lawmakers designated more than $230 million in categorical funds to serve disabled students, gifted students, students with limited English proficiency, and expelled and at-risk students, as well as to provide extra aid for rural transportation, vocational training, comprehensive health services and small attendance centers. This amount represents an appropriations increase of 34.7 percent above inflation since 2000-01, compared with 14.9 percent growth in student enrollment over the same time.[14]

State statute also authorizes local districts to seek voter approval for *mill levy overrides*. The amount of override a district can receive generally is capped according to the size of its total program funding.[15] As with the total program mill levy, override revenues are determined by multiplying the mill levy rate to the property's assessed valuation: 7.96 percent for homes and 29 percent for commercial properties. For 2009-10, school districts generated a total of $591.2 million in override revenues.[16]

Example: *A school district has a voter-approved override of 10 mills (.010), with total assessed residential property value of $100 million and total assessed commercial property value of $100 million. The assessed valuation for homes is **$7.96 million** (7.96 percent of $100 million), and the assessed business valuation is **$29 million** (29 percent of $100 million), for a total valuation of **$36.96 million**. At 10 mills, the school district each year would collect 1 percent of $36.96 million, or **$369,600**.*

Federal money includes the Title I program for low-income schools and a wide range of other U.S. Department of Education funds. These comprise a significant share of Colorado K-12 funding. In 2008-09, the state's public schools received nearly $600 million in federal funds administered through state and local education agencies, or about 7 percent of total revenues.[17] Counting only federal funds appropriated through the state agency, the stream of dollars grew from $70 million in 1982-83 to a whopping $827 million in 2009-10—representing a compound annual growth rate of nearly 13 percent.[18]

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One particular case shows why additional revenue sources beyond the School Finance Act must be included in school funding calculations. Colorado public charter schools by law receive the same PPR as district schools, in most cases minus 5 percent for district administrative overhead (as explained previously). Yet a 2010 study from Ball State University shows that charter schools in 2006-07 on average received 15 percent fewer dollars per student than their traditional public school counterparts. The discrepancy is explained primarily by two factors: 1) The state's charter schools receive significantly less funding from the U.S. Department of Education's Title I program for low-income schools, and 2) Before 2009 charter schools were not eligible to receive a share of local mill levy overrides .[19]

Capital Construction Funding

To finance the cost of building new schools local Colorado districts frequently issue voter-approved bonds, or may also create a local mill levy-backed Special Building and Technology Fund. For districts growing in student population, the state treasurer may provide capital construction loans—provided voters have approved the debt, payment method and length of repayment period beyond one year.[20]

The State of Colorado also makes funds available to local schools (including district and charter schools) through the Building Excellent Schools Today (BEST) program, enacted by the General Assembly in 2008. Through BEST, a combination of income generated from state trust lands and matching funds at the local level finances qualifying capital construction projects throughout the state. In 2009 a total of 11 projects were awarded at a total cost to the state of $76.5 million.[21] In August 2010 the State Board of Education approved awards for construction, renovation and repair in the amount of $252 million—about $177 million in state funds tied to $75 million in local matching requirements.[22]

The Big Picture: Funding Rankings and Facts

Traditional media outlets, elected officials and other public figures typically cite *current* expenditures per pupil in drawing comparisons between states and local school agencies in the area of K-12 education finance. Current expenditures exclude money allotted for capital projects and for financing bonded debt. Yet using different assumptions, competing sources yield diverse numbers and rankings, allowing for selective manipulation of statistics.

For example, the U.S. Department of Education, the U.S. Census Bureau and the National Education Association offer substantially different information on Colorado's current expenditures per pupil for 2007-08 (the most recent school year with comparable data):

- US Dept of Ed: $9,152 per pupil, ranked 35th in the nation[23]
- Census Bureau: $9,079 per pupil, ranked 36th in the nation[24]
- NEA: $9,335 per pupil, ranked 29th in the nation[25]

Regardless of the source, the long-term trend remains clear. According to the U.S. Department of Education, real current per-pupil expenditures at the state level and nationwide roughly doubled between 1970 and 2000, and have grown by about 20 percent since the turn of the millennium. Colorado's spending growth outpaced most states during the 1970s but lagged them during the 1980s and 1990s. Yet as it did in 1970, Colorado currently spends about 90 percent of the national average on each enrolled public school student.[26]

Total Per-Pupil Expenditures

The U.S. Department of Education also measures total expenditures per pupil—including capital construction and debt financing costs. On a statewide basis, comparisons using these statistics provider a fairer and fuller picture of the full financial resources available to public schools. Recently released data show Colorado spent nearly $8.93 billion on K-12 education in the 2007-08 school year, or $11,133 per pupil. Colorado ranks 32nd in total per-pupil spending, about a thousand dollars below the national average of $12,121.[27]

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Measuring the growth of dollars spent is more meaningful than comparing rankings, as states almost universally have increased expenditures beyond student enrollment for years and decades. Starting in the 1988-89 school year, the U.S. Department of Education began reporting consistent yearly information on total K-12 expenditures. Within nearly two decades Colorado's total spending grew by 31 percent in real dollars per student, a substantial increase but smaller than the national increase of more than 45 percent.[28]

A commonly-used misleading chart displays the red line of Colorado's per-pupil spending going down—an effect that only works by making the fast-rising national spending average into a flat line.

Some interest and advocacy groups frequently seize on this disparity to make comparisons showing Colorado lagging national spending averages. A commonly-used misleading chart displays the red line of Colorado's per-pupil spending going down—an effect that only works by making the fast-rising national spending average into a flat line.[29] If Colorado had matched the nation's inflation-adjusted K-12 spending increases since 1988-89, the state would have spent $12,362 per student in 2007-08—ranking the state at 18th and above the national average. An additional $985 million in funding from state revenue or other sources would have been required for that year alone.

In Context: Comparing with Other States

Colorado's 2007-08 total per-pupil spending is comparable to or greater than most neighboring and other regional states. Colorado's student-level expenditure ranks slightly higher than Kansas, Montana, New Mexico and Texas, places the state significantly ahead of Nevada and Arizona, and is more than two thousand dollars greater than Idaho, Oklahoma and Utah. Only Nebraska (which spends just above the national average) and rural Wyoming (which has no income tax but funds its schools largely through oil and gas revenues) regionally outspend Colorado on a per-student basis.[30]

Nationally, no state spends more than the District of Columbia's $20,269 per student. Closely following are New Jersey ($19,154), New York ($18,801), Wyoming ($17,572) and Alaska ($17,360). By most measures on the National Assessment of Educational Progress (NAEP), these high-spending states and D.C. perform roughly the same or worse than Colorado.[31]

There is no clear correlation between significantly greater amounts of money spent per student and academic results. According to a comprehensive analysis performed in the late 1990s, two-thirds of 163 academic studies showed insignificant correlations and a handful showed a negative relationship. Only 27 percent demonstrated "a statistically significant relationship between increased per-pupil spending and student performance."[32]

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49th in Funding?

Some advocates of increased spending claim Colorado ranks 49th in K-12 education funding, but few explain the context. The reference is to the amount of dollars spent as a share of residents' personal income. Because Colorado is a wealthier state, the income denominator is high. More dollars need to be spent per student than in poorer states to achieve a comparable ranking. Those who say Colorado ranks near the bottom in education funding use a statistical comparison that implies the more money you make, the more you should spend on education programs—no matter how well those programs work.[33]

U.S. Census Bureau data for 2006-07 ranks Colorado 49th in public school revenues and expenditures as a share of $1,000 in personal income. When measured against personal income, Colo-

Table 1. K-12 Spending Categories, Colorado vs. U.S. Average (2007-08)		
Category	Colorado	US Average
Instructional (Classroom Teachers, Textbooks)	57.9%	60.8%
General Administration (Boards, Executive, Legal)	1.9%	2.0%
School Administration (Principals and Office Staff)	7.0%	5.6%
Student Support (Guidance, Health, Intervention)	4.7%	5.4%
Instructional Support (Libraries, Teacher Training)	5.4%	5.0%
Student Transportation	3.1%	4.2%
Operation / Maintenance / Food Service	13.2%	13.7%
Other Support (Business, Research, Personnel)	6.8%	3.2%
TOTAL	100.0%	100.0%

rado's spending on school administration and general administration rank 32nd and 38th, respectively.[34] Measuring data from the same year, the National Education Association ranks Colorado 41st in spending as a share of personal income. About 3.5 percent of all earnings in the state are spent on K-12 public school current operating expenditures, compared to the national average of about 4 percent.[35]

How Dollars Are Spent

For ease of comparison among states, the U.S. Department of Education has defined categories of spending. Table 1 provides an overview comparison that breaks down Colorado's reported current operational spending versus the national average for the 2007-08 school year, the most recent for which data are available[36]:

As shown in table 1, nearly 58 percent of Colorado's K-12 operating budgets reach the classroom level. From 2000-01 to 2008-09, the state's ratio of enrolled students to full-time equivalent (FTE) teachers declined slightly from 17.4 to 17.0.[37] The NEA reports Colorado's student-teacher ratio at 16.8 for 2008-09, placing the state 10th highest and above the national average of 15.2.[38] (It must be noted that student-teacher ratio is not the same as average class size, which in grades K-3 typically exceeds the ratio by 9 or 10. Therefore, the average early elementary class size in Colorado stands at about 26, compared to 24 or 25 nationwide.[39])

While 58 percent of Colorado K-12 operational spending is directed toward the classroom, only 48 percent of K-12 personnel are classroom teachers.[40] The ratio of fewer than one classroom teacher for every non-teacher K-12 employee is even lower than the national average of 51 percent. For a variety of reasons the nationwide ratio has changed dramatically over the past half-century. In 1960 the national ratio of teachers to non-teacher K-12 employees was 2 to 1.[41]

State-Level Administration and Miscellaneous Appropriations

K-12 management and administration through the Colorado Department of Education (CDE) is budgeted to take in $49 million for 2010-11 to fulfill the functions of governance, oversight, professional licensure, CSAP assessment administration, the Charter School Institute and information management. Other smaller appropriations have been made for the Colorado School for the Deaf and Blind ($14.4 million) and library-related programs ($5.7 million).[42]

Personnel Salaries and Benefits

The U.S. Department of Education also breaks down spending by object. In

2006-07, 78 percent of reported current operational expenditures of Colorado K-12 public schools paid employee salaries and benefits.[43] Thus, Colorado's increased K-12 spending during the recent decade largely can be attributed to personnel hiring rates. Between 2000 and 2009 Colorado's public school enrollment grew by nearly 15 percent—from 724,508 to 832,368. During the same time the number of public school employees increased by almost 21 percent, from roughly 108,700 to 131,400.[44]

In 2008-09, Colorado spent nearly $5.7 billion on K-12 employee salaries and benefits—nearly two-thirds to compensate teachers and about 8 percent to compensate administrators, with all other employees making up a quarter of the payroll.[45] The average teacher's base salary was $48,485, with an additional 23 percent typically received in benefits. Average teacher salaries ranged from $27,250 in rural Campo Re-6 to $59,177 in Cherry Creek Schools.[46] According to the National Education Association, Colorado ranks 28th in average public school teacher salary.[47]

The average teacher's base salary was $48,485, with an additional 23 percent typically received in benefits.

The average principal's base salary was $79,759 in 2008-09, while the average base salary for superintendents (including assistant superintendents) was $109,442—with administrators typically receiving an additional 21 percent in benefits.[48] In addition to the salary and benefits documented here is the high value of deferred compensation in pension guarantees for government employees who become vested through extended years of service.[49]

For most Colorado public school teachers, compensation is subject to the political pressures of budget negotiations and the rigid formulae of service years on one hand and graduate-level credits and degrees on the other. Except in rare circumstances of budget austerity and true salary freezes, as many districts have experienced in 2009 and 2010, a teacher's earning and purchasing power tends to rise steadily and significantly. Education Sector analyst Forrest Hinton notes that since 2005 K-12 employee earnings on average have outperformed their private sector counterparts.[50]

As a seventh-year teacher in 2009-10 she earned $46,780 plus benefits with a B.A., a 37.2 percent rise in real earnings, or an average annual increase of 5.4 percent.

A teacher with a bachelor's degree in Aurora Public Schools—the median district for teacher pay in the Denver metropolitan area—started at $30,631 in base salary for the 2003-04 school year. As a seventh-year teacher in 2009-10 she earned $46,780 plus benefits with a B.A., a 37.2 percent rise in real earnings, or an average annual increase of 5.4 percent. If the same teacher has completed a master's degree the increase would be 50.2 percent in real earnings, or an average annual increase of 7 percent. Aurora teachers in their 20th year of service make $51,243 in base pay with a bachelor's degree, $58,214 with a master's degree, or $65,479 with a doctorate.[51]

Costs of Collective Compensation

Research shows no correlation between a teacher earning a master's degree credential and effectiveness at improving student learning outcomes. Yet a 2009 report by the Center on Reinventing Public Education notes that Colorado spends 1.76 percent of its current K-12 expenditures on "master's bumps"—rewarding teachers with automatic bonuses for the degree achievement.[52] Similarly, pay raises for seniority ignore the fact that most studies find teacher quality plateaus after the fourth or fifth year and in some cases even may decline as an instructor approaches retirement age.

Since negotiated bargaining agreements and salary schedules determine that teachers are compensated collectively, determining whether individual teachers are adequately paid is a highly difficult proposition. Using Bureau of Labor Statistics reports of annual salaries and hours worked, however, a 2007 Manhattan Institute study determined that the "average public school teacher was paid 36 percent more per hour than the average non-sales white-collar worker and 11 percent more than the average professional specialty and technical worker."[53]

The average teacher works far fewer days per year than other white-collar professionals. Some teachers complete many hours of additional take-home work, such as grading papers, but no known effective comparison has been made to other professionals' amount of take-home work. Due to the nature of the subjects they teach or to other factors, other instructors complete all their work within the contract hours at school. Undifferentiated collective compensation obscures both the value of teacher inputs and outputs that affect student learning.

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Achievement Results

The U.S. Department of Education's National Assessment of Educational Progress (NAEP) remains the gold standard of testing. Math and reading tests have been administered to statistically representative samples of fourth- and eighth-grade students in states every other year since 2003, and at less frequent intervals before then. In each of the four grade-subject combinations Colorado ranks slightly ahead of the national average in performance, with the state's progress closely tracking its peers nationwide.[54]

The Colorado State Assessment Program (CSAP) is administered statewide to public school students in four subject areas:[55]

- **Reading** proficiency (tested grades 3 through 10) since 2002 has shown modest gains in most grades and has been flat in the rest
- **Writing** proficiency (tested grades 3 through 10) since 2002 has been flat in some grades and shown modest gains in others
- **Mathematics** proficiency (tested grades 3 through 10) since 2005 has shown a mix of significant improvement, modest gains and flat results
- **Science** proficiency (tested in three grades only) since 2006 has shown significant improvement at the fifth grade level and flat results in eighth and 10th grade

Official calculations for Colorado's high school completion rate have changed, making valid long-term comparisons extremely difficult. In recent years the state's graduation rate has remained steady at about 75 percent.

Proposed Reforms

A wide range of reforms that promote more efficient and effective use of K-12 education resources should be contemplated:

1. Repeal Amendment 23. The effect on the State budget could not be felt until after voters passed the repeal measure, so the next fiscal year would experience no flexibility from this reform. The earliest the legislature could place this measure on the ballot would likely be the general election in November 2012. Some might argue persuasively that the proffered change could be designated as a TABOR issue and therefore could go on the ballot in 2011, but that might not stand the inevitable court challenge. If delayed as expected, the next budget for 2011-12 would have

no relief from this quarter and other cuts would have to be found.

Proponents couched the need for Amendment 23 as being "for the children," and indeed it has resulted in more funds being added to the education budget each year, even when revenues are dropping. Most people understand that political decisions are about making trade-offs. More for education means less for something else. In a political context, we must deal with something approaching a zero-sum game, where the net benefit to society as trade-offs are made is a wash. The government has no money of its own and must take it from some productive activity. That circumstance is unlike the private sector in which people first create value and then trade it for something of even higher value, benefiting both parties and raising the standard of living. Amendment 23 locks in the rest of the budget as losers to the largest and more powerful entities and lobbying organizations.

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California in the 1980s had a provision to restrict government from growing too rapidly, the GANN Amendment. It was effectively eviscerated by a later measure that was sold as being "for the children" and "to fund education." The proponents of Colorado's Amendment 23 were not, and are not today, either stupid or naïve. They undoubtedly hope that bloating the budget in this fashion will make the case to overturn the citizens' protection against very rapid government increases, the constitutional provision of the Taxpayer's Bill of Rights. One of the fundamental questions to be answered if Amendment 23 is not eliminated is whether citizens therefore want to give up the check-and-balance they enjoy by having a veto on new or increased taxes so that education funding increases can stay on autopilot forever. Do they continue to see the benefit of having a say in such an important decision as having less in the family budgets in order to have higher teachers' salaries and more spending, or do they want to turn control back over to the monopoly providers?

2. Tuition tax credits provide offsetting tax benefits to individuals and/or corporations that provide funds to help enable a student attend non-public school. Setting the value of the credit scholarship below a student's per-pupil revenue share ensures marginal cost savings while empowering more families to afford a private education. With sufficient demand expressed by education consumers, the state will realize both short-term and long-term savings while ensuring students have access to a wider range of quality education options.

The Cato Institute in Washington, D.C., has developed a formula to measure the fiscal impact of education tax credits, based on current financial and enrollment data and the specific design of the program.

The Cato Institute in Washington, D.C., has developed a formula to measure the fiscal impact of education tax credits, based on current financial and enrollment data and the specific design of the program. For the purpose of the Citizens' Budget, we postulate the creation of a tax credit program with the following features, largely drawn from Cato's Public Education Tax Credit model:

- **Private tuition coverage.** Scholarships through the tax credit program could be used to offset the cost for non-public school tuition for students in grades K-12.
- **Corporate and personal income taxes.** Tax burden will be reduced for any business or individual that helps to pay for an eligible student to attend non-public school. Contributions made directly by parents or guardians on behalf of a student or donations to qualifying organizations that provide scholarship aid all receive the tax credit.

Table 2. Colorado Public Education Tax Credit, Projected Migration and Savings

			SAVINGS: 10 YEARS		
Tax Credit	**Migration**	**State Savings: 3 Yrs**	**State**	**District**	**Total**
10%	40,406	$28,036,079	$348,661,331	$510,509,839	$859,171,170
20%	43,337	$26,735,511	$315,048,938	$547,443,714	$862,492,652
25%	44,961	$26,007,160	$296,288,166	$567,894,481	$864,182,647
33%	47,816	$24,714,232	$263,080,632	$603,840,764	$866,921,396
40%	50,615	$23,433,102	$230,280,716	$639,064,487	$869,345,203
50%	**55,205**	**$21,306,738**	**$176,030,887**	**$696,798,073**	**$872,828,960**
60%	60,668	$18,741,195	$110,828,620	$765,462,672	$876,291,292
67%	65,153	$16,611,402	$56,864,427	$821,795,158	$878,659,585
75%	71,131	$13,746,657	-$15,543,274	$896,791,069	$881,247,795
80%	75,436	$11,667,871	-$67,987,703	$950,748,405	$882,760,702
90%	85,767	$6,640,358	-$194,496,835	$1,079,992,057	$885,495,222
100%	99,339	$0	-$360,799,952	$1,248,914,424	$888,114,472

- **Not means-tested.** Students qualify for tuition assistance regardless of family income.
- **Phased in.** During the first three years of the program, only previously enrolled public school students (known as "switchers"), along with 5-year-olds and newly enrolled 6-year-olds, would be eligible to receive tuition tax credit assistance. In Year 4, at least 90 percent of tax credit scholarship recipients would be new non-public school students. The figure would decrease to 80 percent in Year 5 before leveling off at 70 percent in Year 6 and thereafter.

The credit only would impact the payment of state taxes. As explained earlier, the school finance funding formula is made up of dollars collected through taxes at both the state and local level. Further, school districts derive revenues through other programs and from other sources. To identify the total savings therefore requires a reasonable estimate of the *marginal cost* for Colorado public schools, defined as "the additional spending required to serve one additional student, and also the savings from having to serve one fewer student."[56] As a result, the school district or other local education agency from which the student transfers would receive large marginal cost benefits regardless of the tax-funded scholarship amount.

In table 2, specific examples of stipulated tax credit scholarship values stated as a percentage of state-funded per-pupil revenue (roughly $4,400 in fiscal year 2009-10) are listed to show a change in the effect. At 50 percent, a public school student could use about $2,200 in tax-credited family savings or a tax-funded scholarship to supplement tuition for his new enrollment at a non-public school. The model predicts more than 55,000 students would choose this incentive over time to leave a public school in order to pursue private education. During the first three years, when only public school "switchers" receive the benefit, the state would realize $21.3 million in savings by having fewer students to fund. In intermediate years the growth of state savings would slow, but would continue to accumulate over time. Most financial benefit would be achieved at the local school district level, as combined in the 10-year savings calculation. A larger scholarship size decreases the state's savings but necessarily increases the number of students expected to choose a non-public school.

Implementing a tax credit scholarship for public school switchers, worth the value of 50 percent state per-pupil revenue is projected to save ***$21.3 million*** at the state level during the first three years of the program. Over 10 years state savings would reach $176 million, with nearly $697 million in savings realized at the district level. (See Appendix for more details on calculations, including regional breakdowns of student migrations from public to non-public schools.)

In addition to the fiscal benefits, recent research has shown that the competitive effects of Florida's private school tuition tax credit program significantly increased the academic performance of public school students.

Although a strict calculation cannot be projected, it should be noted that further long-term savings also may be realized by a reduced need for new school construction. The potential savings in the area of capital costs presents an additional opportunity to lower the financial burden on the state of Colorado in coming decades.

In addition to the fiscal benefits, recent research has shown that the competitive effects of Florida's private school tuition tax credit program significantly increased the academic performance of public school students.[57]

Unlike the savings proposed through a tuition tax credit program, the State could not immediately realize the savings estimated from the following two proposals. As explained above, Amendment 23 constitutionally mandates minimum amounts for the School Finance Act—the core piece of K-12 funding. Any efficiencies achieved therefore would result in local agencies using the funds for other purposes. The State's total bill would be unchanged. The two proposals provide salient examples of how local schools and districts could achieve real, significant efficiencies with modest reductions in state funding for K-12 education.

3. Colorado's local school boards retain the authority to dictate employee pay scales and policies. Still, the General Assembly should consider using its prerogatives to impose an effective statewide cap on salary increases. A formal recognition that educators should not be compensated for earned master's degrees, which show no connection to improved student learning, is one crucial strategy. This observation could be due to the fact that about 90 percent of teacher master's degrees are awarded from schools of education.[58] An exception to the phase-out could be considered for master's degrees in subject content areas relevant to the teaching assignment. The phased-out elimination of ineffective "master's bumps" would save the State as much as ***$137.6 million*** per year.[59]

4. As indicated previously, Colorado spends about 3 percentage points less of its current expenditures on classroom instruction than the national average: 57.9 compared to 60.8 percent. The only spending category where Colorado is more out of line with national trends is in the area of other support services, defined by the U.S. Department of Education as follows:

> *Expenditures for business support services (activities concerned with the fiscal operation of the [Local Education Agency]), central support services (activities, other than general administration, which support each of the other instructional and support services programs, including planning, research, development, evaluation, information, and data processing services), and other support services expenditures not reported elsewhere.*[60]

In 2007-08, Colorado spent 6.8 percent of its current operating budget, or $620 per student, on “other support services”—as compared with 3.2 percent, or $331 per student, nationwide. Only the District of Columbia and Delaware spend more on this category on a per-pupil basis than Colorado does.[61] A study to determine why Colorado spends 87 percent more on “other support services” than the average state should be able to yield significant efficiencies, and what exactly is included in the spending. To reduce the per-student “other support services” spending to $480 (less than half the difference with the national average) in terms of the 2007-08 budget would have yielded annual savings of $112.3 million. By this act alone, the state would move the share of its current expenditures in the classroom from 57.9 to 58.8 percent.

Appendix: Notes on Colorado Public Education Tax Calculator

The Colorado version of the Public Education Tax Calculator (PETC) was closely adapted from the original version created by The Cato Institute in Washington, D.C., and with assistance from staff members from Cato’s Center for Educational Freedom: Andrew Coulson and Adam B. Schaeffer. A copy of the full spreadsheet calculator can be found online at: http://bit.ly/dp12W3.

Inputs include the following hard financial and enrollment data (data sources in parentheses):

- Total expenditures (Colorado Department of Education)
- Total expenditures less federal revenues (CDE)
- Share of state expenditures tied to enrollment (CDE, Colorado Joint Budget Committee)
- Per-pupil funding by state, local and federal sources: statewide and by region (CDE)
- Public school enrollment: statewide and by region (CDE)
- Non-public school enrollment: statewide and by region (CDE)

In addition, the calculator’s key, carefully-developed proxies and assumptions are accounted for as follows:

1. Private school tuition: In lieu of attempting to collect tuition data from individual private schools within the state, the Colorado PETC adopted the method used by Coulson in his 2009 PETC analysis for Nevada. The U.S. Department of Education’s most recent edition of the Digest of Education Statistics (2009) provides the average private school tuition for 2003-2004 and 2007-08. Between these school years, in real 2009 dollars, tuition increased about $420 a year. Median private school tuition is used because the average, or mean, is skewed by expensive, elite schools. The National Center for Education Statistics (NCES) reports that the national median highest tuition paid in private schools was $3,500.[62] Adjusted to 2009 dollars, the national median tuition is $3,970.[63] Median tuition is allowed to rise at the same rate as average tuition ($420/year) for a national median of $6,490. The tuition figure then is inflated by the U.S. Bureau of Economic Analysis ratio of Colorado-to-national per capita income.[64]

2. Marginal cost: In order to determine the cost savings made available to public school districts and other local education agencies, a calculation is needed to determine the marginal cost—the amount of extra spending needed to serve one extra Colorado K-12 student, or conversely the amount of spending saved by not having to serve one fewer student. As explained in Coulson’s Nevada report, determining a precise estimate of marginal cost within a 95 percent confidence interval requires formal statistical regression analysis.[65] In lieu of a full analysis, the Colorado PETC’s marginal cost estimate was taken as a percentage of the total per pupil expenditure, based conservatively on the lowest percentage from previous regression analyses performed to determine PETC savings in Nevada and South Carolina: 81.24 percent of $11,101. A next important step would be to pursue a full regression analysis to refine the marginal cost estimate.

3. Elasticity of demand: An elasticity coefficient of -1.1 was adopted to identify parental demand for non-public education and by extension to estimate the number of students who would choose to migrate from public schools. As in previous PETC analyses, elasticity was derived from an average of estimates available in the academic literature.[66]

Acknowledgements

Ben DeGrow was primarily responsible for the content of this section. See his biographical material in the Authors section.

Among the professionals reviewing this section was **Pamela Benigno**, the Director of the Education Policy Center at the Independence Institute since 1997. Ms. Benigno initiates, coordinates and supervises projects, writes, and speaks about K-12 education issues. Her professional emphasis has been on public and private school choice, working with education organizations, policymakers, and community leaders to expand school choice opportunities. She has served on various committees, including the State Board of Education's implementation advisory committee for Colorado's school voucher program (later struck down by the court), and is currently a board member of an online charter school. Ms. Benigno was formerly an elementary school teacher. She holds a degree in Elementary Education from the University of Northern Colorado.

We recognize the significant contribution by the **Cato Institute** by making available its proprietary software model for tuition tax credits. The Cato Institute has offered public policy solutions for 30 years and is now one of the dominant influences on members of Congress and their professional staffs. Cato produces the quarterly academic journal ***Cato Review***, an online ***Cato Weekly Digest*** and ***Regulation Magazine***, and frequently publishes books on various public policy problems. Its policy staff is commonly invited for interviews on network television, radio and blogs.

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dom, traditional American values, and a strong national defense. Her published works include one book and numerous papers and articles. She holds a degree in History from the University of Colorado at Denver.

Matthew Ladner graciously reviewed the material presented in this section for accuracy and factual interpretation. Dr. Ladner has been the Vice President for Research for five years at the Goldwater Institute, a public policy organization in Phoenix. Before that he served as the Director of State Projects at the Alliance for School Choice. He has published numerous articles and is the coauthor of the book ***Report Card on American Education*** published by the American Legislative Exchange Council. He holds a doctorate in Political Science from the University of Houston.

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The Department of Health Care Policy and Financing (HCPF)

Passed in 1965, Medicaid was designed to help finance medical services for people unable to care for themselves due to poverty or disability. In 1993, the Colorado Department of Health Care Policy and Financing (HCPF) was created to oversee the operation of the Colorado Medicaid program and provide a central point of contact with federal Medicaid authorities.

Originally designed to collect and disburse the moneys allocated to the Medicaid program and to ensure that Colorado Medicaid abides by federal law, the Department's expanded mission now states that it will create "a novel model of public insurance and to promote health, function and self-sufficiency as its core goals."

Originally designed to collect and disburse the moneys allocated to the Medicaid program and to ensure that Colorado Medicaid abides by federal law, the Department's expanded mission now states that it will create "a novel model of public insurance and to promote health, function and self-sufficiency as its core goals." The public insurance will "reach beyond the clinical setting and into community settings where healthy behaviors are shaped."[1]

The Department proudly asserts that it "covers over 550,000 clients, over 10 percent of the state's population, and spends over 20 percent of the state's budget to administer its health insurance programs."[2] The Joint Budget Committee (JBC) report shows that it requested $4.58 billion in state and federal funding for FY 2010-11. It expects slightly more than 60 percent of its budget to come from the federal government.

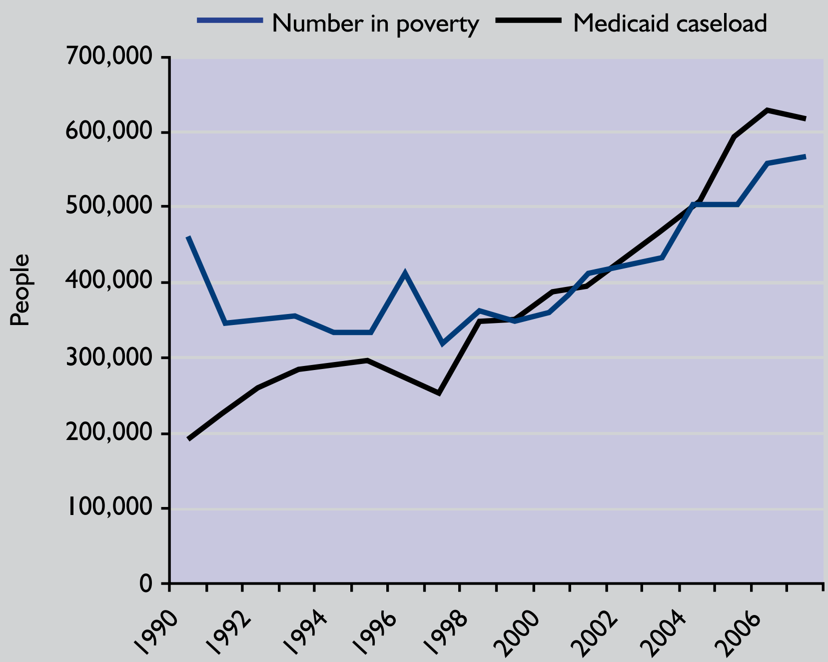
Department publications state HCPF is "responsible for the provision of all health care" for people enrolled in federal matching fund programs. Despite significant evidence suggesting government entities of all kinds do a poor job of providing health care when they control it, the Department apparently believes that it can manage its novel health care system well enough to provide care that is "medically necessary, appropriate to the population, and cost-effective." It fails to address the fact that health care appropriate to "the population" is not necessarily the same as curing or ameliorating the ills of a specific individual.

In recent years state officials have supported the Department in its drive to develop a state-run medical system. Programs have been shaped to favor certain kinds of health care providers and delivery systems. Rather than treat all physicians, hospitals and medical practices equally, officials have begun to pick winners and losers. They have supported new taxes levied only on those who pay for their own health care, and directed government funds to favored private groups. Officials have even supported a foundation plan to force physicians to report individuals' most private health information to a state-run data base. Information from that database will be used to control the type and amount of treatment that people can receive. State employees also have cooperated with private foundations interested in using Colorado citizens to promote their health care agendas.

Rather than treat all physicians, hospitals and medical practices equally, officials have begun to pick winners and losers.

The end of federal stimulus funding likely will open an annual shortfall of $252 million in the HCPF budget that will have to be backfilled by state funds. Reversing expensive decisions made within the past three years could save over $200 million per year. The Department plans future increases in eligibility for state programs that could increase annual costs by another $490 million per year. Its capitated mental health programs are expensive and their

Figure 1
Colorado: Number of People in Poverty Versus Medicaid Caseload



efficacy is unknown. They should be subjected to critical review.

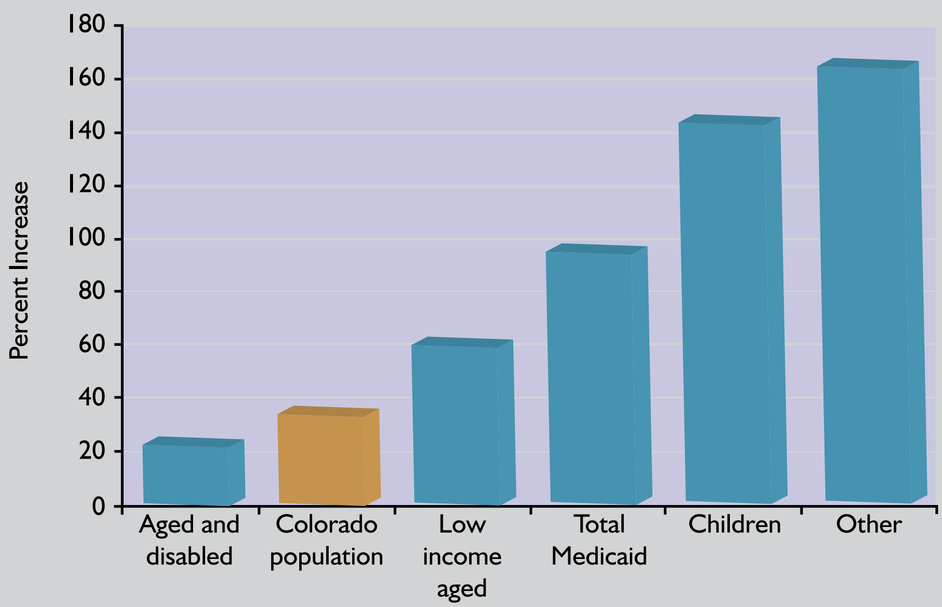
Major HCPF Programs and Spending: Medicaid

Medicaid was initially designed to pay for health care for impoverished families, the disabled and the impoverished elderly. On paper, Medicaid offers more benefits than the most generous corporate plan in America. It covers all medical costs. Co-pays, when they are collected, are generally capped at $5 per visit. Medical transportation, drugs, durable medical equipment, rehabilitative therapies, some over-the-counter medications and long-term care are covered.

States that choose to participate in Medicaid must develop medical assistance programs that pay for certain mandatory services for specifically defined groups of people. States have the option to add certain services and groups of people to their Medicaid programs. The federal government matches each dollar that a state spends on eligible programs and populations with a dollar of its own. State medical assistance for people who are not eligible for the Medicaid program does not qualify for federal matching funds.

Medicaid eligibility depends on income, usually expressed as a percentage of the income defined as the federal poverty level (FPL). Unless the percentage of

Figure 2
Medicaid Caseload Increase
FY 1995 to FY 2009-10 (projected)



people at or below the federal poverty level declines, one would expect Medicaid caseloads to expand along with the state's population. In Colorado, the Medicaid caseload has expanded faster than the state's population, and faster than the proportion of the state's population in poverty because the state has continuously expanded Medicaid eligibility.

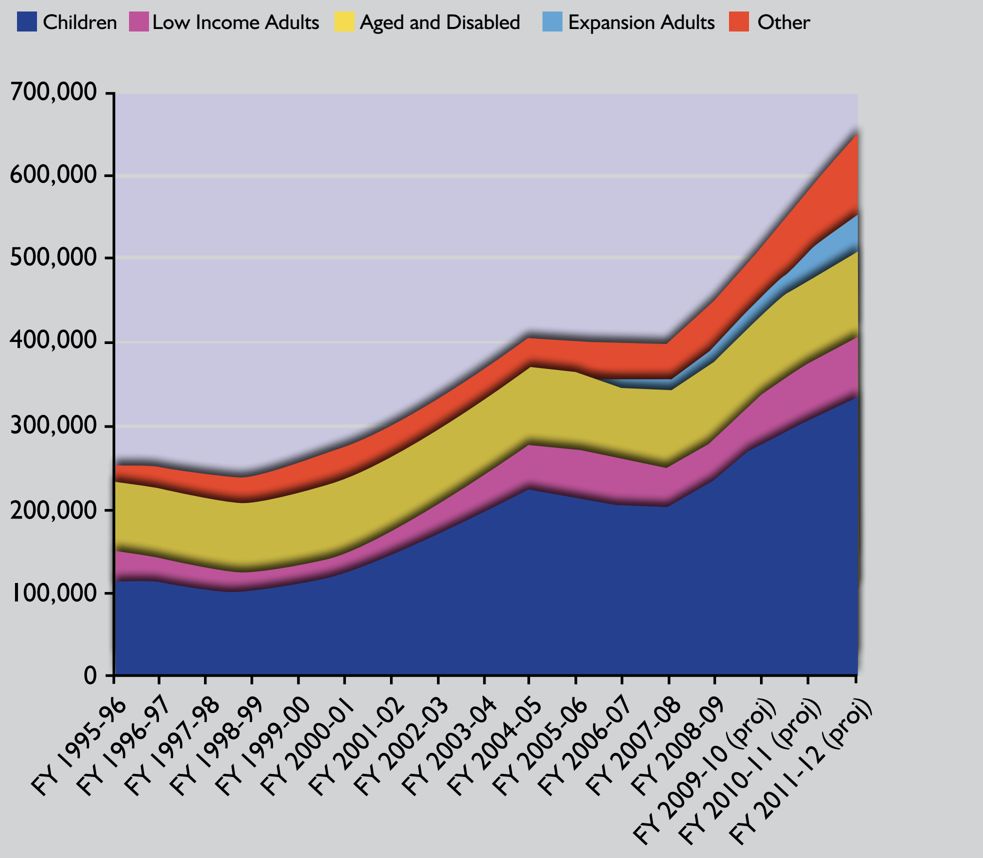
As figure 3 shows, children's eligibility began to expand in FY 1999-2000. Overall enrollment increased sharply in FY 2008-09, as eligibility for adults was expanded. Childless adults in good health historically have been ineligible for Medicaid except at very low levels of income. The assumption is that single adults in good health can work to pay for their own care. If they become seriously ill, their income would fall and they would automatically become eligible for Medicaid.

In the 2009 expansion, the legislature expanded Medicaid eligibility for parents of eligible children from 60 percent of the federal poverty level ($8,742 for two people) to 100 percent of the federal poverty level ($14,570 for two people). This increased caseloads by 11.4 percent in 2009. Cases are expected to increase by an additional 11.1 percent in 2010-11. In FY 2009-10 the state appropriated $4.3 billion dollars for Medicaid. The state share was $1.77 billion.

Between 1995 and 2009-10, the increase in the people who used to be the primary focus of Medicaid, the aged and disabled, has been smaller than the state's population increase. One would expect the percentage of low-income aged to grow faster than the population as the Baby Boom ages. In fact, the growth in the Medicaid caseload has been much more rapid than that of the population, and it has been led by the number of children and "others" enrolled.

Public statements by officials tend to ignore the role that eligibility expansions have played in Medicaid growth. They suggest that caseloads grow only as a result of greater "need." As figure 4 suggests, the Department's own research shows that caseload growth has not been well correlated with the state's business cycle. Caseloads grew throughout the 1990s both as unemployment rose and as unemployment fell. Caseloads fell both in Colorado and

Figure 3
Colorado Medicaid Caseload Composition



across the country after July 2006, likely a result of a new federal law requiring that states verify U.S. citizenship before allowing Medicaid enrollment.

The FY 2010-11 Medicaid budget passed at the end of the regular 2010 legislative session was $4.6 billion. The state share of that spending will be $1.86 billion.[3]

Colorado Medicaid is growing faster than private sector health spending. Figure 5 compares state Medicaid expenditures in FY 2006-07 with what they would have been had that year's totals been increased by the private sector medical cost trend. As the chart shows, maintaining the FY 2006-07 caseload in FY 2008-09 would have reduced state spending by $218 million after allowing for medical cost inflation.

Since 1995 Colorado's Medicaid program has provided mental health services via a separate Medicaid mental health program. It operates under a waiver from the federal government. The state contracts with "Behavioral Health Organizations." They provide all mental health care for eligible Medicaid clients living in their geographic areas. In exchange, the state pays the monopoly Behavioral Health Organization a set monthly fee (the "capitated cost") for each eligible Medicaid client in that area. The fee is determined through negotiation. It is paid whether or eligible people actually use the services.

Although the number of people eligible for the Medicaid mental health program fell, expenditures rose. The FY 2010-11 appropriation for the program is $247.6 million.[4] The Department does not appear to have published studies on the cost-effectiveness of its mental health arrangements.

Rather than take a hard look at the state fiscally unsustainable Medicaid growth, the state used funds from the American Recovery and Reinvestment Act (ARRA) of 2009 to maintain existing program expansions. ARRA has been extended to June 2011. According to a JBC staff analysis, once the ARRA funding expires the worst case scenario is that the state will have to find an additional $252 million in order to continue funding Colorado Medicaid at FY 2009-10 levels.[5] This estimate includes money from the Health Care Expansion Fund. It is funded by new taxes on hospital bills. This year the tax proceeds were diverted to fund

Figure 4

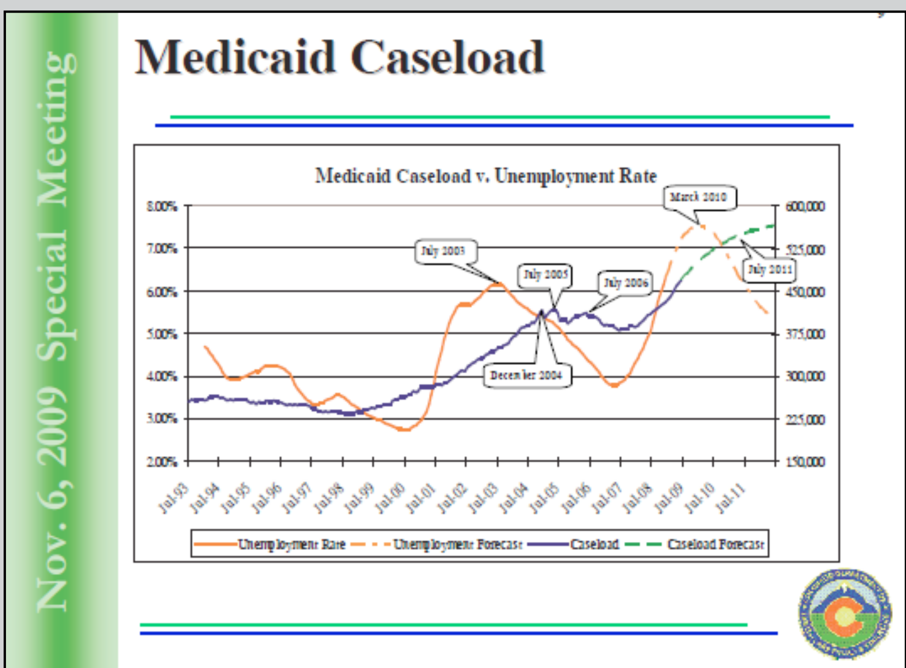


Figure 5
The $218 Million Dollar Difference: Actual Medicaid Spending Versus 2006/07 Spending Increased by the Milliman Medical Cost Trend

existing Medicaid programs rather than the planned eligibility expansions

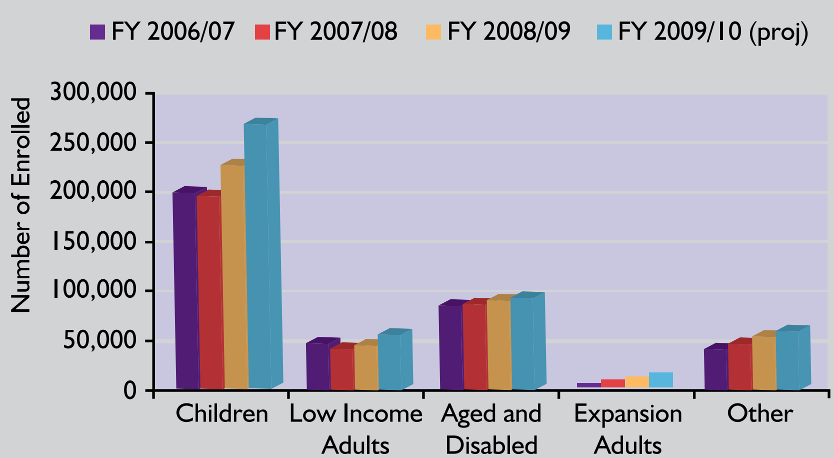
Despite its budget problems, state officials are in the process of further expanding Medicaid eligibility:

- The legislature voted to allow continuous 12-month eligibility *for children regardless of household income after enrollment.* This is a caseload expansion because low-income adults currently spend an average of 8.8 months on the program, while eligible children are enrolled for an average of 8.6 months.[6]
- Continuous 12-month eligibility *for adults* is estimated to be $75.9 million in FY 2012-13.
- Adults whose children are eligible either for Medicaid or CBHP, will be eligible as long as their household income is less than the federal poverty level. Costs for this expansion are estimated to be $140.5 million in FY 2012-13.
- Adding childless adults, or adults without a child in the home, will be eligible for Medicaid if they "earn" less than 100 percent of the federal poverty level at an estimated state cost of $197.3 million in 2012-13. Officials ignored the fact that many retirees "earn" less than poverty income because they collect reasonable incomes from Social Security, pensions and investments.
- Disabled adults and children with earned incomes up to 450 percent of the federal poverty level (household income of $65,565 for two) will be eligible. The estimated cost to state taxpayers will be $75.8 million per year.

Major Programs and Spending: The Children's Basic Health Plan (CBHP)

Although it began as a small state program funded by "gifts, grants,

Figure 6
Medicaid Caseload: Four Years of Expansion



and donations" in 1990, the Colorado Children's Basic Health Plan (CBHP), now costs state taxpayers $63 million a year. Under the federal State Children's Health Insurance Program (SCHIP), and the federal government matches every state dollar spent in the CBHP with two federal dollars. As one would expect, the large federal match has encouraged state spending. Officials aggressively expanded CHBP eligibility by raising the income limit for the means-tested program's eligibility. Caseloads increased by 6.5 percent in FY 2006-07 jumped by 23 percent in FY 2007-08, rose 6.6 percent in FY 2008-09, and rose again by 14 percent in FY 2009-10.[7]

From June 2005 to June 2006, enrollment in Colorado's children's health insurance program rose 32.4 percent, the largest percentage increase in the country.

The vigorous enrollment expansion in CBHP has added to Colorado's budget woes. From June 2005 to June 2006, enrollment in Colorado's children's health insurance program rose 32.4 percent, the largest percentage increase in the country. State officials expanded eligibility from 185 percent of the federal poverty level to 200 percent of the federal poverty level.

In FY 2009-10, the Department initially appropriated $164.4 million for the CBHP. The state spending share was $57.8 million. The appropriation underestimated actual expenditures by almost 10 percent. A JBC analysis notes that although the Department initially estimated the hospital tax-funded Health Care Expansion Fund balance would be "$78.2 million at the end of FY 2009-10, it is instead anticipated to be insolvent by FY 2011-12."[8]

The program fixes proposed by the Department suggest the state's managed care network needs better management.[9] The Department remains committed to managed care even though it told the JBC in December 2006 that managed care did not save money. Specifically, it wrote:

> Although managed care organizations should experience savings over fee-for-service due to their improved ability to reduce unnecessary hospitalizations, emergency room visits, and other overutilization, there are also extensive administrative costs for care management, utilization management, providing networking to ensure access, and other processes such as bill paying and risk management.[10]

Families pay just $35 a year to enroll two or more children in CBHP, $25 for one child. Co-pays for office visits range from $2 to $5. Emergency room and hospital visits have maximum co-pays of $15. There are no co-pays for check-ups or prenatal care visits.

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Enrollment is good for 12 months. According to the HCPF website, in FY 2010-11 a pregnant woman with an annual income of up to $35,432 after childcare costs, medical expenses, dental expenses, and child support would have been eligible for CBHP. Families of four with residual incomes of up to $55,128 also qualified.[11]

Determination of eligibility is generally based on the previous month's income, supported by a pay stub. The state cannot vet reported income. People may hold multiple jobs and receive various forms of unreported income. Officials plan to check reported income against tax records, but tax records do not contain information on people who are paid in cash or do not file.

The income definition used for CBHP

eligibility is generous. It ignores most types of government aid. Child care costs are subtracted from gross income as are medical expenses, dental expenses, health insurance premiums, and child support and alimony payments. Income-augmenting subsidies like the earned income tax credit, housing subsidies, food stamps or energy assistance are not added. In all, eligibility standards disregard income supplements such as food stamps and housing that can add more than $20,000 a year to consumption income.[12]

In 2010, 225 percent of the federal poverty level was equivalent to an annual income of $49,613 a year (about $21 an hour) for a family of four. The Census Bureau estimates that median household income in Colorado in 2006-08 was $56,574, that average family size was 3.14 people, and that average household size was 2.54 people. At the current 225 percent of FPL means-tested limits, an eligibility limit reduced from the previous 250 percent level due to the state budget shortfall, CBHP has reached the point where ***half of the households in the state are expected to bear all the medical expenses for the other half's children.***

...CBHP has reached the point where half of the households in the state are expected to bear all the medical expenses for the other half's children.

In a widely-cited study of the effect of SCHIP on private coverage, Gruber and Simon used federal longitudinal surveys to estimate that six out of 10 new SCHIP enrollees previously had private insurance and that the rate at which SCHIP "crowds-out" private coverage rises as income eligibility levels has expanded."[13]

As the income level for eligibility is raised, parents are more likely to drop private coverage to enroll their children in CBHP simply because families with higher incomes are more likely already to have private health insurance coverage. With 60 percent crowd-out, the CBHP does an exceptionally poor job of targeting people who really need help.

Though state officials claim that health insurance is unaffordable, Bundorf and Pauly used various definitions of affordability to conclude that "while 36 percent of individuals in families with income of two times poverty level or less are uninsured, 44 percent have coverage." With incomes at or above 175 percent of the poverty line, 51 percent of the uninsured could have afforded coverage."[14]

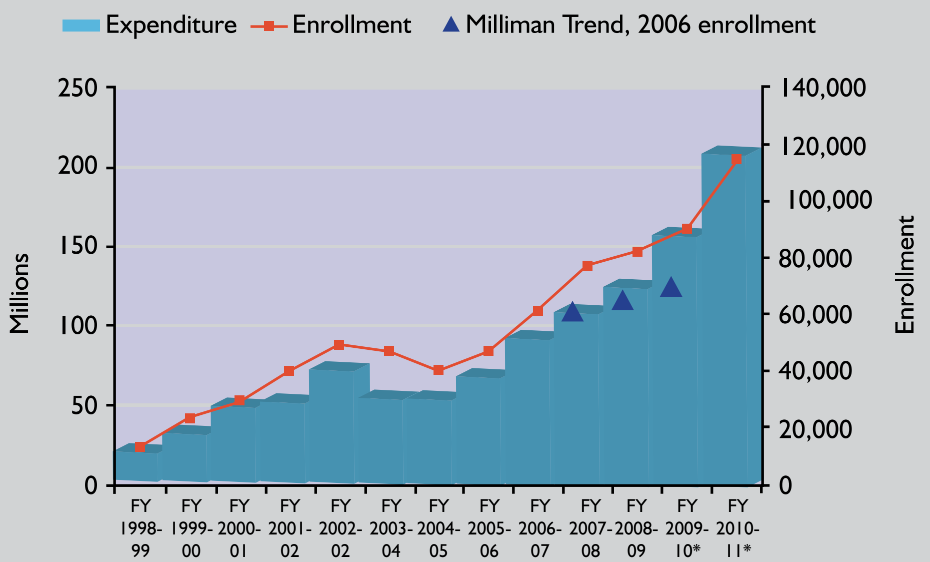
State officials could prevent at least some crowd-out by making the $35 CBHP enrollment fee more realistic.

State officials could prevent at least some crowd-out by making the $35 CBHP enrollment fee more realistic. In 2009, the average employee cost for a family policy in an employer-based group health plan was $3,515. The average annual employee cost for health insurance without dependent coverage was $779.[15] The annual premium for a family health insurance policy in Colorado's individual market was $5,939. The average annual premium for coverage of a single adult was $2,777.[16]

One way to estimate the cost of CBHP caseload expansion since 2006 is to apply standard trend estimates for increases in medical costs to 2006 CBHP caseloads. This analysis produces conservative estimates of the effect of caseload increases for two reasons: The population covered by the CBHP is relatively healthy, and the state claims to control provider reimbursement increases.

If state CBHP expenditures in 2006 had followed overall medical cost trend increases, the state share of expenditures would have risen from roughly $40 million to $46 million as shown by the triangles. Instead, the state expanded eligibility and expenditures rose from $40 million to $57.8 million. If national estimates of crowd-

Figure 7
Colorado Children's Plan Expenditures and Enrollment (*projected)



What the report does not say is that any migration that occurred caused both the Medicaid caseload and the CBHP caseload to continue to expand.[18] It also neglects to mention that the Department was worried about a caseload decrease. When budget cuts reduced its $2,700,000 FY 2007-08 CBHP advertising budget to $500,000 in FY 2010-11, the Department decided the remaining $500,000 was not "sufficient to drive large increases in caseload," and therefore the funding should be redirected "toward retention of existing eligible clients."[19]

out apply to Colorado, they suggest that between 2007 and 2009 Colorado spent about $6 million in state funds to provide CBHP health coverage for people who already had it.

Undeterred by the expense, the Department's FY 2010-11 Strategic Plan has made future enrollment increases in the CBHP part of its performance goals. Past and future targets are shown below in table 1.

The Department believes it did not reach its FY 2008-09 enrollment goals because "a higher number of children migrated to Medicaid who were previously eligible for the CBHP. This migration was the result of a drop in the incomes of families who initially qualified for the Plan, thus making their children eligible for Medicaid." It believes "The increased enrollment numbers in Medicaid support this trend."[17]

The obvious question, of course, is whether it is in the best interest of the taxpayer to spend millions of dollars to market programs designed to encourage people that are paying for their own health care to depend instead on state taxpayers.

Table 1. CBHP Enrollment Increase Goals

	FY 2007-08	FY 2008-09	FY 2009-10	FY 2010-11
Targeted Increase	9,000	10,000	7,000	12,839
Actual	11,299	4,039	--	--

Source: State of Colorado, Department of Health Care Policy and Financing Strategic Plan FY 2010-11 Budget Request, November 6, 2009, page C-24.

Table 2. CBHP and Medicaid caseloads expand, 2006-2009

Caseload (Children)	FY 2006-07	FY 2007-08	FY 2008-09
Medicaid	206,170	204,022 (-2.0%)	235,129 (15.2%)
CBHP (increase from previous year)	47,047 (6.5%)	57,795 (22.8%)	61,582 (6.6%)

Table 3. SCHIP Health Insurance Enrollment Fees, 2006				
	Colorado	Kansas	Iowa	New Hampshire
Annual Income of 151-200%FPL: ($21,856-$29,140 for a 2 person family in 2010)	$25-35 dollars per family per year	$20-$30 per family per month	$20 per family per month	$25 per child per month, family maximum of $100 per month
Source: Vernon Smith and Jason Cooke. May 2007. SCHIP Turns 10: An Update on Enrollment and the Outlook on Reauthorization from the Program's Directors. Kaiser Commission on Medicaid and the Uninsured.				

Though state control over Medicaid co-pays is limited, the state has considerable control over the enrollment fees and co-pays for the CBHP. As table 3 shows, CBHP enrollment fees are much lower than those in some other states.

With a FY 2008-09 CBHP caseload of roughly 61,582 children, simply collecting an additional $35 per child per year would increase state revenues by $2.1 million. Switching to the New Hampshire formula of $25 per child per month would generate more than $18 million a year—a net gain of more than $16 million assuming that every CBHP enrollee already pays $25 a year. CBHP enrollment fees also should be indexed for inflation. Adjusted for inflation, a $35 fee in 1999 would be worth almost $46 in 2010.

One of the major problems with medical assistance programs is that state officials have steadfastly refused to seriously consider programs designed to make the people aided by them feel as if they are spending their own money. For example, increases in co-pays have been shown to significantly reduce health service use without any effect on health. This is especially true of charges for emergency room use. Yet CBHP co-pays remain absurdly low relative to the program's income eligibility limits and the real cost of medical care.

According to its web page, in August 2010 the CBHP program charged $2 to $5 per visit for medical care and prescriptions, $3 to $15 per visit for emergency services, and $5 for most dental services. When Medicaid was authorized it was designed to provide coverage for the poor. Congress set the maximum co-pay at $5. In inflation-adjusted terms, a $5 co-pay in 1965 would be $34.60 in 2010.

Although state officials and private sector interest groups maintain that further CBHP expansion is required in order to take care of children who are not receiving proper medical care, officials have yet to show that any CHBP spending has improved the actual health of children. Measures published by the Department generally monitor service utilization rather than actual health.

Although state officials and private sector interest groups maintain that further CBHP expansion is required in order to take care of children who are not receiving proper medical care, officials have yet to show that any CHBP spending has improved the actual health of children.

Also of concern is the state's routine underestimation of CBHP cost. When eligibility was expanded from 200 percent to 205 percent of the federal poverty level in 2008, expenditure growth was "significantly higher" than estimated in the fiscal note that accompanied the enacting legislation. Growth in expenditures for the supplemental expansion children in FY 2009-10 was also "much higher than the Department's November 2009 forecast."

There is little evidence that the state provides coverage at a lower price than companies that offer private health insurance on the individual market. The Department reported that the FY 2009-10 per capita expenditure for the CBHP was $1,929. This amount includes the cost of the insurance paid by the state to insure itself against extremely expensive illnesses.[20] It does not include managerial resources covered in other sections of the state budget, things like auditing, detecting and prosecuting fraud, or the cost of maintaining the tax system that collects the money used to underwrite the CBHP.

There is little evidence that the state provides coverage at a lower price than companies that offer private health insurance on the individual market.

In mid-2010 the cost of insuring a 10-year-old Denver child by purchasing individual health insurance was $2,094 for a Kaiser-Permanente plan with a $35 co-pay. A Humana plan that qualified for a health savings account (HAS) and included childhood vaccinations and regular checkups cost $1,124 a year for with a $3,000 deductible. This means that after well child care and immunizations, the parents would pay the first $3,000 and the plan would pay everything after that.

If the CBHP were modeled after HSA qualified plans, the state could purchase the Humana plan and put $805 into a health savings account for the child. At most, parents would be liable for the $3,000 deductible minus the $805 that could be used to help pay for expenses, or $2,195 in the first year. The CBHP limits total family expenditure to 5 percent of family income in a year. At 185 to 200 percent of the federal poverty level, annual family health expenditures are therefore capped at 5 percent of income. This is between $1,347 and $1,457 a year.

Under the HSA plan, a worst case scenario would have families paying $542 to $652 more in their first year with the HSA. But if the state allowed balances to build up in the HSA account, families would have less financial exposure than with CBHP in less than three years even if parents spent $400 a year on dental visits, drugs and acute care visits. In addition to allowing parents to accumulate funds for their children's future health expenses, a HSA-type plan would allow people to see whatever physician they found most convenient.

People spend their own money more carefully than they spend other people's money, and mounting evidence indicates that plans structured around HSAs substantially reduce expenditures on health care without harming health. In May 2009, The American Academy of Actuaries estimates consumer-directed plans reduced expenditures 4 to 15 percent in their first year, and the expenditure growth rate by 3 to 5 percent in the years thereafter.[21] A 5 percent reduction in the state share of spending on the CBHP would reduce expenditures by about $5 million a year. A 5 percent reduction in the state share of Medicaid spending would save almost $90 million a year.

People spend their own money more carefully than they spend other people's money, and mounting evidence indicates that plans structured around HSAs substantially reduce expenditures on health care without harming health.

Despite the demonstrated savings, the Department has shown a surprising reluctance to consider this type of plan design. It may believe the federal government is unlikely to approve such plans. This is unfortunate. Because they properly align incentives, it is clear consumer-directed health plans save money by reducing unnecessary service use. As the Robert Wood Johnson Cash & Counseling experiments have shown, consumer-directed plans also improve health and reduce long-term expenditure by allowing people dependent on state programs to spend their money on the health care they know they need rather than on the health care bureaucrats think they should have.

Without remodeling the program for savings, it is clear that in FY 2010-11 Colorado will spend $76.1 million in state funds on the $216.4 million CBHP. Though Arizona has more people under 18 years old than Colorado has, it spends much less on its SCHIP program. Arizona was spending $22.9 million a year before it canceled its SCHIP program on June 15, 2010, to help fill its $2.6 billion budget deficit.[22] Colorado could save up to $76.1 million by doing the same thing.

There is some question whether the Obama Care "maintenance of effort" requirement gives the federal government the power to prevent Colorado from dropping out of the SCHIP program in even the most dire fiscal emergency. But if Obama Care works as advertised, all people will have health insurance and all health insurance that covers parents will automatically cover their children. The CBHP should not be needed any longer.

The Indigent Care Program (CICP) program enrolls people with incomes up to 250 percent of the federal poverty level.

Major Programs and Spending: The Indigent Care Program (CICP)

The Indigent Care Program (CICP) program enrolls people with incomes up to 250 percent of the federal poverty level. They are assigned a co-payment amount that depends on income and family size, and is very low compared to private insurance. CICP co-payments are capped at 10 percent of income in a 12-month period.[23] The co-payment fee structure strongly favors emergency room and outpatient clinic care. Adults in CICP are charged far higher co-pays than adults with similar incomes who are eligible for CBHP or Medicaid.

In practice, the Department directs CICP payments to hospitals and clinics that agree to cooperate with other state coverage programs.

In theory, CICP compensates hospitals and clinics for providing care to people who do not pay for it. In practice, the Department directs CICP payments to hospitals and clinics that agree to cooperate with other state coverage programs. Publicly- and locally-owned hospitals receive preferential funding, as do pediatric teaching hospitals, hospitals that treat more Medicaid patients, community health clinics, rural hospitals, and the Denver Health Medical Center. This politically-directed favoritism has little to do with the efficiency with which a hospital or clinic operates, the quality of its care, or whether people in the program like using it.

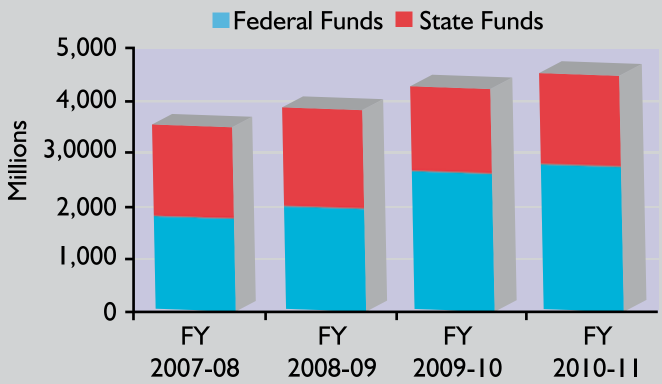
Overall expenditures rose from $308.7 million in FY 2006-07 to $325.8 million in FY 2009-10, or $15.1 million in four years. This is an increase of just 6 percent, an amount far below medical inflation or the increases in spending on relatively healthy children and adults in the same period.

Major Programs and Spending: The Comprehensive Primary Care Program

The Comprehensive Primary Care Program (PCP) was created when Amendment 35 passed in 2004. Amendment 35 increased taxes on tobacco products with the goal of expanding certain kinds of health programs. Implementation gave additional funding only to those providers in which adding the number of uninsured or indigent patients to the number enrolled in Medicaid or the CBHP exceeded 50 percent of total patient caseload. In essence, the General Assembly used the money to increase support for institutions that cooperated in its healthcare programs.

The Amendment language allowed the funds to be diverted to other uses upon a two-thirds majority vote of the General Assembly, the case in the past two years.

Figure 8
The Federal and State Share of HCPF
HCPF Appropriations



Does the HCPF Work for the Federal Government or Colorado Citizen?

As figure 8 shows, the Department ambitiously pursues federal funding. Over the last two decades, this pursuit has shifted Medicaid from its traditional focus on the care of the acutely and chronically ill poor to funding programs that provide state-run health care for basically healthy people at higher levels of income. The programs the Department designs are copies of those in other states. In those states they have produced much higher than expected costs, retarded medical innovation, and degraded service quality with no measurable gains in health.

Although state officials are fond of claiming that federal matching funds allow them to "leverage" state dollars, they ignore the fact that Colorado taxpayers must pay federal taxes—taxes that fund increased federal matching dollars. In order to create sensible health care policy, it is crucial to understand that any increase in the receipt of federal matching funds always requires an increase in spending by the State, that federal funds often come with expensive federal strings attached, and that the programs popular in Congress may not be the same as those that would provide needed help to the sick and disabled in Colorado.

Despite Departmental claims of poverty, figure 9 shows the state share of expenditures on Medicaid have continued to increase in good times and bad. Simply rolling expenditures back to the FY 2006-07 level would save about $500 million in state funds each year.

In 2009, the legislature imposed a tax on every hospital bill in the state. Because new taxes without a public vote are unconstitutional under TABOR provisions, both the Department and the legislature took care to call the new tax a "fee" in the legislation and in public communications. The Act hid the cost increase from patients by making it illegal for hospitals to list the extra charge on their bills.

The pretense came to a halt when the Department sought the required federal approval for the new tax. In a letter[24] the Department states: "The non-federal share of the proposed Medicaid inpatient hospital and DSH payments will be funded solely with fees assessed on hospital pro-

Figure 9
Medicaid Total Spending
Colorado Medicaid Expenditure

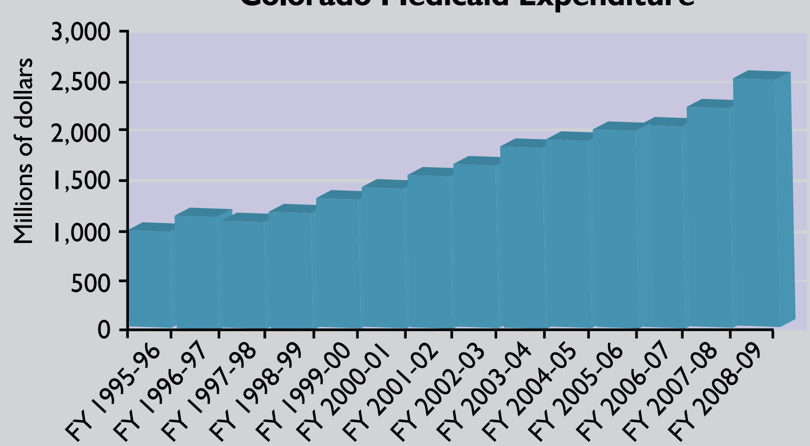
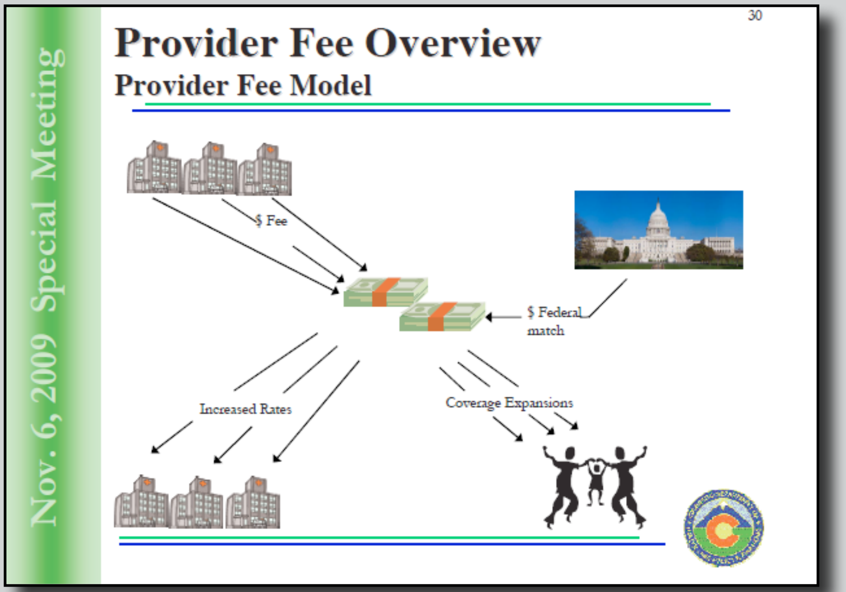


Figure 10



viders, which is designated as a provider tax under 42 CFR §433.68."[25]

The "fee" increase was done to gain more federal funding along with private taxes. People who pay for their own health care end up paying the state an additional $20 "fee" for the privilege of being sick enough to need hospitalization in Colorado.

Figure 10 comes from the November 6, 2009, Special Provider Meeting for the Colorado Indigent Care Program held by the Department of Health Care Policy & Financing. It provides insight into how Department employees view the new tax and the funds it raises. The only people in the figure jump for joy at the prospect of receiving coverage under a state health care expansion. Taxpayers are nowhere to be seen. According to the diagram, actual people do not have to give up anything because the money used to fund the Department's programmatic expansions will come only from hospital and U.S. government buildings.

The Department does not provide cost-benefit analyses of its expansion proposals or any data showing that past expansions have actually improved either the health of individual citizens or general population health. There is little evidence from other sources supporting the notion that the proposed coverage expansions make health care better or more affordable, and no evidence showing that taxing hospital care purchased by private payers improves health. The only thing clear is that the institutional behaviors required to maximize federal funding are not necessarily consistent with those required to maximize the welfare of the people of Colorado.

Obama Care and Colorado Medicaid Spending: Should Colorado Drop Out?

If the recent federal health care legislation remains as it currently exists, citizens and states might be better off exiting Medicaid and letting the federal government pay for health insurance for eligible Colorado citizens.

In FY 2013-14, the federal healthcare law forces states to expand Medicaid eligibility to people with incomes up to 133 percent of the federal poverty level (equivalent to an annual income of $19,378 for two people in 2010). The Department estimates the mandate will increase Colorado caseloads by 130,000 people at a cost of $625 million per year. The federal government will subsidize the state for the increased Medicaid spending in the first years of the program. After that, the Department estimates Obama Care will increase state Medicaid expenditures by $31.0 million in 2017, $39.1 million in 2018, $48.2 million in 2019, and $72.3 million in 2020. The total spending increase in those four years alone would be $190.6 million.

Although the Department's estimates of future state Medicaid spending under Obama Care are somewhat lower than the estimates of independent experts, all agree that Obama Care will significantly increase state Medicaid costs.

Edmund Haislmaier of the Heritage Foundation estimates that Obama Care will increase Colorado's Medicaid spending by $637.3 million between 2014 and 2020.[26] At the historic match rate of 50 percent, this analysis means the state share of Medicaid spending will rise by $318.6 million in six years. At a match rate of 57.4 percent, the state share of Medicaid spending will rise by $271.5 million.

Estimates produced by John Holahan and Irene Headen for the Kaiser Family Commission on Medicaid and the Uninsured, long a strong advocate for the program expansions embodied in the Obama Care law, also suggest the Department has underestimated future Medicaid spending. They conclude that spending on low-income adults will by itself increase by a minimum of $286 million between 2014 and 2019, an estimate close to the one produced by the Heritage Foundation analysts.[27] Under different assumptions, the Kaiser Family Foundation estimates spending will balloon by $470 million.

The looming spending increases are so large that Haislmaier and Smith make a persuasive case that states could make almost all of their citizens better off simply by pulling out of Medicaid.

The looming spending increases are so large that Haislmaier and Smith make a persuasive case that states could make almost all of their citizens better off simply by pulling out of Medicaid. They argue that exiting Medicaid likely would benefit the low-income people currently dependent upon it because Obama Care provides direct federal subsidies of up to $20,000 a year for the purchase of health insurance for a family of four provided that family is not enrolled in a state Medicaid program. If a state maintains such a program, Obama Care forces the state to enroll the family in Medicaid rather than in a private insurance plan. Numerous studies suggest the privately insured receive better and more convenient health care. If Colorado were to exit Medicaid, everyone on the state program would be eligible for federal health insurance subsidies. They could replace often spotty and inconvenient Medicaid coverage with private health insurance.

Assuming that Colorado uses roughly $2 billion of the money saved by pulling out of Medicaid in 2013 to continue paying for long-term care for people currently getting it under Medicaid, Haislmaier and Smith estimate state government could save $7.4 billion from 2013 to 2019.[28] Their estimate assumes the state also drops out of the SCHIP, as the CHBP would be no longer necessary with the subsidies provided for purchasing medical insurance.

Fiscal prudence and a sincere concern for the well-being of citizens dictate that both the state leaders and the Department give serious consideration to withdrawing from Medicaid.

HEALTH POLICY CHANGES DIRECTED BY LOBBIES

For the last 20 years, the executive branch of Colorado government actively has cooperated with private foundations intent on reshaping health care.[29] In 1992, Governor Roy Romer received a $566,999 grant from the Robert Wood Johnson Foundation's State Initiatives in Health Care Financing Reform Program.

In return for the grant, the governor's office agreed to champion ColoradoCare, a state-run, single-payer health care program. The Colorado Trust coordinated its efforts with those of the Robert Wood Johnson Foundation, adding an additional $100,000 to the ColoradoCare project and using its resources to produce favorable publicity and build a statewide coalition. In 1993, project director Alan Weil helped create the Department of Health Care Policy and Financing. He demonstrated how long-term government policy could be changed by using grant funds to hire people dedicated to passing legislation, and, once the legislation was passed, rewarding them with state jobs. Mr. Weil moved from the grant-funded CoverColorado project to the state payroll and became the first Executive Director of the Department.

The history of CBHP shows how small receipts of private grant money can be used to create new tax-funded programs that take on a life of their own.

The history of CBHP shows how small receipts of private grant money can be used to create new tax-funded programs that take on a life of their own. Along with grants, the Robert Wood Johnson Foundation aided friendly state officials[30] by hosting meetings, providing experts to testify in favor of its legislative agenda, conducting retreats, and offering help in producing favorable publications. Its efforts are detailed on its State Coverage Initiatives web page.[31]

To understand the extent to which private foundations have influenced Colorado's state health policy with grant-funded staffing and legislative support, consider that although Colorado's Center for Improving Value in Health Care Steering Committee (CIVHC) ostensibly was established by Governor Ritter by Executive Order,[32] it is listed as one of AcademyHealth's programs on the AcademyHealth website.[33] The Robert Wood Johnson Foundation is a major supporter of AcademyHealth.

As it did when the Robert Wood Johnson Foundation funded ColoradoCare, the Colorado Trust immediately "leveraged" the AcademyHealth CIVHC program by providing the money that HCPF used to plan, create, and staff CIVHC steering committee meetings. Eight members of the steering committee (the "Chicago eight") were then sent to a meeting hosted by The Commonwealth Fund and Academy Health. After the meeting they "assisted [HCPF] Department staff in creating a draft action plan for the Chicago team to use as a working document during the kick-off meeting."[34]

As of April 10, 2010, state documents suggest the CIVHC team planned to formulate new plans to control how physicians are paid, to expand palliative and hospice care in Medicaid and private care, to collect data on every health care encounter for every individual in the state, and to mount a public relations campaign to market its work.

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It is unlikely the "Chicago eight" effectively represented viewpoints uncongenial to the Department or to the Robert Wood Johnson Foundation ideas about health care, ideas that have remained essentially unchanged since its support for single payer in the early 1990s. Of the nine members of the State Quality Improvement Institute Team listed by AcademyHealth, three are from HCPF and the rest come from entities that either receive substantial state funding or have an interest in expanding government control of health care.

The narrow viewpoint that grant-funded staffing has created within the Department has important implications for the state budget. The passage of Obama Care made large amounts of federal funding available for various initiatives. The federal money comes with strings attached, and most of the programs are designed to expand government control of health care. They will expand state spending on health care projects of questionable utility, and may endanger both state government fiscal stability and the stability of its private medical care system.

Minnesota Governor Tim Pawlenty recognizes the danger that federal control of health care poses to state treasuries. On August 31, 2010, he signed an Executive Order directing Minnesota state agencies to decline all discretionary participation in Obama Care pilots and demonstration programs. The Order notes that Obama Care contains a "multitude of programs and demonstration projects intended to speed the transition to federally-controlled health care." It states that "no application shall be submitted to the federal government in connection with requests for grant funding for programs and demonstration projects deriving from the Patient Protection and Affordable Care Act ... unless otherwise required by law, or approved by the office of the Governor."[36]

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Poor Management, Crony Capitalism, and Excessive Spending at the Executive Director's Office

The Executive Director's Office directs Departmental programs. Its appropriations have grown from a FY 2006-2007 appropriation of $38.8 million for a staff of 231.8 full-time equivalent employees (FTEs) to $52.9 million for a staff of 294.8 FTEs in FY 2010-11.[37] In just five years, the Executive Director's Office budget grew by more than a third and the amount spent per full-time employee increased from $167,385 to $179,444. These increases occurred at a time when state tax revenues fell from $8,936 million in FY 2006-07 to $8,231 million in FY 2008-09.[38]

Although the Department plans to create its "novel model of public insurance and to promote health, function and self-sufficiency as its core goals" to "reach beyond the clinical setting and into community settings where healthy behaviors are shaped,"[39] it is having trouble managing its existing programs.

In 2008, the State Auditor reviewed 52 of 852,400 claims made under the CBHP. Errors were found in 52 percent of the claims. Overpayments equaled $54,800. Underpayments equaled $20. One of the claims was for abortion services in spite of both federal regulations and the Colorado Constitutional prohibitions on taxpayer abortion funding.[40] A separate 2008 audit of 203 applications for the CBHP found that 10 percent of those enrolled lacked adequate documentation, and that 16 people who were enrolled were ineligible. The errors cost taxpayers $48,300. The Department "lacked adequate controls to ensure that all enrollment fees are collected," exhibited an "overall lack of effective management and oversight," and did not ensure that its marketing and outreach for the program was "cost-effective, as required by statute."[41]

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As Colorado does not publish regular Medicaid performance audits, it is impossible for taxpayers to ascertain whether Department management practices have improved. The Department also appears to have difficulties determining appropriate

Table 4. Comparison of Private and Medicaid Reimbursement Rates

	Wheelchair	Pediatrician	Chest X-ray	Ambulance
Private	$532.60	$115.94	$53.61	$700.05
Medicaid	$571.23	$86.21	$30.21	$131.91

payments for services provided under its medical assistance programs. Although it has determined that managed care is more costly, it remains committed to it despite the fact that capitated rates are determined by actuaries and negotiations, rather than by the actual fees paid for actual people for actual medical care.

The problem is that actuarial estimates are not necessarily accurate estimates. In 1995, the Department neglected to include care for foster care children in its mental health capitation estimates. The Department recognized its error in 1998. Between April 2001 and November 2004 the Department unilaterally increased payments to the managed care mental health providers by about $24 million. In November 2004, the federal government directed the Department to stop making those supplemental payments.[42]

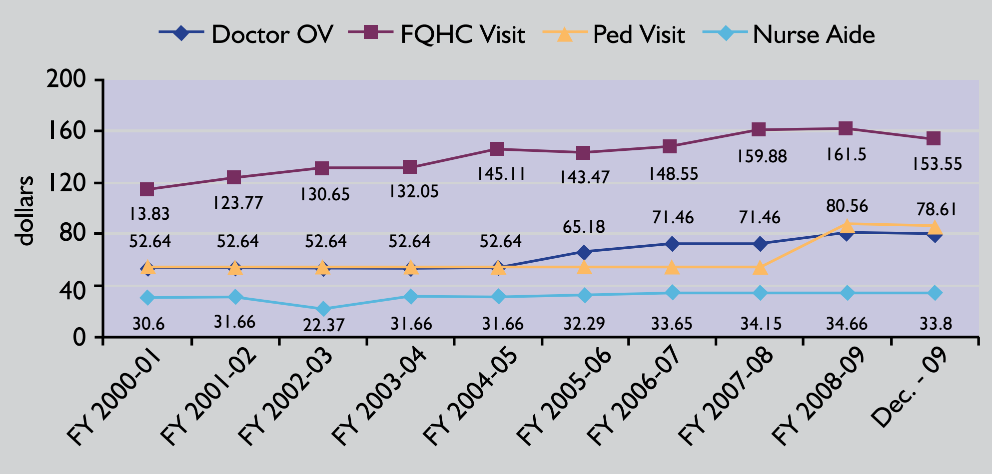
In a December 21, 2009, response to questions from the JBC, the Department provided some information about its Medicaid reimbursement rates. Table 4 compares standard commercial reimbursement rates provided by United Health Care and Ingenix.

Although the data in this table suggest Medicaid pays less for medical care than private insurers, they do not tell the whole story. In recent years the Department has made extensive use of Federally Qualified Health Centers (FQHC) and FQHC look-alikes in its managed care network. Denver Health's family health centers are FQHCs. The Colorado Community Managed Care Network consists of 12 FQHCs. It is a corporate member of Colorado Access. Colorado Access is one of the entities favored in the Department's efforts to enroll Medicaid and CBHP members in managed care.[43] As of 2009, an estimated 30 percent of Colorado's Medicaid population receives care in FQHCs.[44]

The FQHCs are very well paid compared to the reimbursements offered private physicians because federal law requires that Medicaid and Medicare reimburse all FQHCs for "reasonable costs." By steering patients to the more expensive FQHC clinics, the Department ensures taxpayers pay top dollar for primary care visits in its medical assistance programs, and it discriminates against Colorado's private physicians and hospitals. This discrimination makes both Medicaid clients and taxpayers worse off.

Since federal law requires payment of reasonable costs, only private physicians are harmed when the Department cuts reimbursement

Figure 11. Selected Medicaid Payments



rates. State law does not trump federal law and the bottom lines of Department contractors are protected.

The Department also discriminates against private health care by paying for FQHC equipment, buildings, offices and staff through its Comprehensive Primary and Preventive Care Grant Program.[45] Physicians and nurses practicing at the FQHCs enjoy special malpractice protections, and the nonprofit clinics enjoy favorable tax treatment. When all subsidies are included, and adjustments are made for the possibility that the clinics' mid-level practitioners see fewer patients per unit of time than private physicians do, it is possible the Department pays more for medical care than it would if it depended less on FQHCs and more on reasonable reimbursements rates for private physicians.

Determining the adequacy of the Department's capitated payments is also a problem. As required, the Department relies on actuarial calculations to determine the rates it will pay for capitated care. But without adequate competition in medical markets and arrangements that allow Medicaid patients to choose between fee-for-service and managed care, it is impossible to determine what health care really costs and whether capitated providers are actually providing the care for which they are being paid.

Access to care is a particular concern in capitated health care systems, particularly in view of evidence that Medicare clients with chronic illnesses are more likely to switch to Medicare's fee-for-service system in order to access care. The Department says it protects the quality of care with its measurement programs. It relies on its Healthcare Effectiveness Data and Information Set (HEDIS) measures of program quality. Unfortunately, most HEDIS measures monitor medical processes rather than medical care. HEDIS counts child immunizations, routine baby care visits, annual dental visits, asthma medication use, procedure frequency, hospital days and average use of antibiotics. Its composite measures, such as "Children's Access to Care" or "Adult Access to Care," are based on whether adults and children had various elective well-care visits or were continuously enrolled (thereby generating continuous capitation payments) with a particular provider.

HEDIS does not measure the time from seeking care to diagnosis to adequate treatment. It does not measure how long someone has to wait for an appointment, which is an important driver in emergency room overuse. It does not measure how difficult it is to access specialty care within the state's managed care plans.

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Despite its 2006 finding that managed care does not save money, the Department's 2010-11 performance measures require increasing the number of high-need clients in managed care. The new Colorado Regional Integrated Care Collaborative plans to put people into untested "medical homes" and "focal point of care" arrangements. These are HMOs by another name, and as one would expect, managed care giant Kaiser-Permanente has been extremely influential in the creation and design of the Collaborative.

Despite evidence to the contrary, the Department describes the "fee-for-service" health care system as difficult to manage and claims, without evidentiary support, that the 24 percent of clients in the fee-for-service system would be better served by managed care.

A number of programs of dubious provenance that benefit specific providers are included in the Department's Appropriations Highlights for FY 2010-11. These include:

- An additional $1.3 million for the administrative costs of instituting "evidence guided" utilization controls on hospital stays and to monitor emergency room visits. Evidence-based utilization controls are favored by large HMOs and some private insurers. In government-controlled systems like the United Kingdom's National Health Service, they provide a "cover" for denying care that others might consider necessary and reasonable.

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- A spending increase of $772,095 to fund the Accountable Care Collaboration project managed care pilot program. Of that, $635,097 is for administrative costs, including money to develop pay-for-performance indicators. Pay-for-performance indicators provide a tool that government officials can use to reduce health spending by forcing physicians to provide only the care that is approved by government utilization guidelines.

- A spending increase of $257,183 and 0.9 FTE for the administrative costs associated with implementing "payment reform," which increases overall spending by $3.6 million. Payment reform seeks to get rid of fee-for-service medicine in favor of capitated care provided by managed care organizations that use pay-for-performance and utilization controls.

The general strategy for fueling future expansions in the Department's fiscally unsustainable government-run healthcare empire has three parts. The first requires coverage expansions whether or not the state can afford them. The idea is that people will be nominally covered even though the state may cut provider reimbursements, impose utilization controls, or otherwise make medical care difficult to access.

Proponents calculate that taxpayers can be goaded into approving tax increases as long as officials and their rent-seeking allies mount extensive publicity campaigns claiming that a refusal to increase taxes denies medical care to the poor and the sick. To expand their share of state revenues, favored non-profits that provide Medicaid services also have been successful in lobbying for provider taxes and other programs that increase the state funds flowing to them at the expense of those who pay for their own care.[46]

Rather than focusing on reducing the cost of running a healthcare business, the Department has helped increase the number of people who demand services by supporting taxes on privately-provided care and promoting regulations that are expensive, ill-conceived, and without evidentiary support.

State programs already provide poorly targeted subsidies to large numbers of people who either can pay for their own health care or can afford to contribute much more than they do. Rather than focusing on reducing the cost of running a healthcare business, the Department has helped increase the number of people who demand services by supporting taxes on privately-provided care and promoting regulations that are expensive, ill-conceived and without evidentiary support.

The second part of the strategy requires controlling the public message about how well existing state programs work compared to the system they are supposed to replace. At present, the Department ignores its own findings on managed care, preferring instead to repeat the mantra that managed care reduces cost. It depends on allied foundations to fund extensive "technical support" programs and to create various small institutions that can be relied on for friendly staffing of proliferating committees, commissions and boards that make it increasingly difficult to pinpoint who is actually making policy within the Department. The small foundation-supported institutions also can be relied upon to join coalitions that provide political cover for state officials intent on transferring more money and power from private sector health programs to public ones.

Life in the cozy foundation cocoon has tended to blind Department officials to evidence and results that are not in accord with foundation claims.

Life in the cozy foundation cocoon has tended to blind Department officials to evidence and results that are not in accord with foundation claims.[47] The sheer number of rent-seeking special interests also makes it difficult for state officials to properly consider whether the suggestions being made are well thought out and well supported by actual evidence. The Department webpage on "Boards and Committees" lists 20 different groups of people who determine health policy for Colorado. Many of them represent the very same special interests that have done so much to design, develop, finance and expand the state's current collection of fiscally unsustainable, poorly managed and poorly conceived health programs.

The third part of the strategy is to cooperate with federal officials in making the citizens of Colorado submit to the requirements of Obama Care. When the federal government offered increased funding, Governor Ritter and the Department immediately began developing an insurance plan to cover uninsured residents with pre-existing medical conditions.

They elected to spend scarce State resources developing the transitional high-risk pool program even though Colorado already has a state plan to cover people with pre-existing conditions. Cover Colorado is funded by the unclaimed property fund and taxes on health insurers. The actuary for the Centers for Medicare and Medicaid Services predicted the $5 billion the federal government allocated nationally for the new state plans will run out as early as next year, so accepting the federal funds will likely increase future state spending. In addition, all of these efforts and all of this tax money will be wasted. The new insurance plan will, by law, be dismantled in 2014.

Responsible governors in other states refused to participate. They knew the relatively few people who need such insurance could join the federal insurance pool that will be operated by the federal government for people living in states that do not offer such insurance. The governors noted that designing such pools is an "enormously complicated undertaking," that there were few people who were uninsured, and that the lack of funding put their taxpayers at risk.[48]

In New York, Massachusetts, Kentucky and Tennessee, ill-considered expansions of poorly managed foundation-designed medical assistance programs have brought state government to the brink of bankruptcy.

In New York, Massachusetts, Kentucky and Tennessee, ill-considered expansions of poorly managed foundation-designed medical assistance programs have brought state government to the brink of bankruptcy. Colorado appears to be only a few years behind. Prudent management requires an immediate reconsideration of the state's medical assistance arrangements. In an era in which Obama Care essentially allows the federal government to control state medical assistance budgets, state healthcare access, and the type of medical treatment that may be offered, citizens would be better served by a Department that is skeptical of federal claims than by one that is eager to swallow them.

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Merrill Matthews offered insights, improvements and corrections to the work. He is a resident scholar at the Institute for Policy Innovation and specializes in health policy. Dr. Matthews served for 10 years as the medical ethicist for the University of Texas Southwestern Medical Center's Institutional Review Board for Human Experimentation, has contributed chapters to several books and has been published in numerous journals and newspapers. He writes the Right Directions column for Forbes.com, was an award-winning political analyst for the USA Radio Network, and provided a daily commentary on Sirius-XM for several years. He received his Ph.D. in Humanities from the University of Texas at Dallas.

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COLORADO'S PENSION LIABILITY

The Public Employees Retirement Association (PERA), created in 1931, is the state's largest pension plan with more than 441,000 members in 2009. Although PERA boasts assets with market value of $32.9 billion,[1] its total liabilities were nearly twice that amount – $56.3 billion – even after the legislature adopted the latest PERA bailout: Senate Bill 1 (2010). That legislation reduced PERA's long-term liabilities and increased contributions from both taxpayers and employees by as much as $160 million annually.[2]

Although PERA boasts assets with market value of $32.9 billion, its total liabilities were nearly twice that amount – $56.3 billion – even after the legislature adopted the latest PERA bailout: Senate Bill 1 (2010).

A pension plan's "funding ratio" is an estimate of the actuarial value of a plan's assets versus its liabilities. At one extreme, a ratio of 0 percent would mean a plan has promised a benefit and has no assets to pay for it. A ratio of 100 percent would mean a plan is on track to have the actual assets needed to pay out the benefits when they come due. From 1970 to 2000, PERA's funding ratio steadily climbed from 55 percent to a high of 105 percent. As PERA's funding improved, state lawmakers and the PERA Board of Directors backed various policy changes that increased benefits, allowed members to purchase additional years of service at below cost, and reduced the employer contribution rate from 12.15 percent to 10.15 percent.

The market retrenchment of the early 2000s cost PERA an estimated $6.8 billion in investment assets through 2004. In the wake of the 2008 credit crisis, PERA lost another $12.3 billion in market assets. In just eight years, the market value of PERA's assets had fallen to less than 52 percent of its liabilities — a shortfall of $27.5 billion. The steady fiscal improvement that the plan had made over a 30-year period was wiped out in just eight years. Now, the costs of the extra benefits that were added during a time when the plan was just becoming fully funded are exacerbating the problem.

Even PERA began to acknowledge drastic changes were needed: "The combination of the dramatic losses due to the financial markets along with the cumulative effect of contribution shortfalls in the last five years and benefit enhancements in the 1990s, bring into question the long-term sustainability of the (fund)."[3]

Even PERA began to acknowledge drastic changes were needed: "The combination of the dramatic losses due to the financial markets along with the cumulative effect of contribution shortfalls in the last five years and benefit enhancements in the 1990s, bring into question the long-term sustainability of the (fund)."

Prior to 2008, PERA officials routinely brushed off assertions that its ability to pay members' benefits was in jeopardy, although independent actuaries had told PERA, "If there is not a sufficient recovery in the investment markets in the near future, the long-term ability of (PERA) to support the benefits will be challenged . . . ."[4] As late as October 2009, PERA spokeswoman Katie Kaufmanis told the Associated Press that PERA has $32 billion in assets and will still be able to pay benefits for many years.

Within three months, however, PERA was singing a different tune. Sponsors of the PERA-supported Senate Bill 1 (2010) warned that without significant changes, including immediate benefit reductions, the fund could go broke within 20 years.[5]

Senate Bill 1 made some long overdue changes:

- For the first time, PERA's legal staff abandoned the contention that certain benefit enhancements, like cost of living adjustments (COLAs), were irreversible and could never be scaled back for current retirees or for members who are "fully vested" (i.e., who have more than five years' experience). Retirees' annual COLA was capped at the lesser of 2 percent or the annual rate of inflation.

- PERA retirees were required to continue to contribute the employees' share to the fund if, while "retired," they work for a PERA-covered employer. Previously, PERA retirees could collect their retirement benefits while working at their former job "part-time" and not contributing to the fund. This provision exacerbated PERA's funding shortfall because the "retired" worker was collecting benefits but likely displacing a younger worker who would have contributed to PERA's trust fund.

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- Members seeking to maximize their highest average salary to increase their monthly retirement benefit were limited in their salary "spiking" ability. Retirement benefits had been calculated based on highest average salary over the members' last 36 months of employment. Senate Bill 1 spread the calculation over 60 months and capped year-to-year salary increases during that period at no more than 8 percent.

However, the bill stopped short on several important measures that would protect taxpayers and promote equity between workers in the public and private sectors:

- Even under Senate Bill 1, current PERA members can retire at age 55, and those hired after Jan. 1, 2011, can retire at age 58. By contrast, private sector workers who were born in 1960 or later, must wait until age 67 to retire with full benefits under Social Security.

Increasing the retirement age is necessary to promote a sense of fairness between taxpayers whose tax dollars pay the overwhelming share of employer contributions to PERA. Asking private sector workers to work longer so that public sector workers can retire earlier simply does not wash. Moreover, increasing the retirement age would decrease PERA's actuarial liability in the same way that increasing the deductible on an auto or health insurance policy reduces the premium.

In reality, pension plans like PERA or Social Security provide "retirement insurance" to their members. Actuaries necessarily account for their members' average life expectancy after retirement, and calculate the funds necessary to pay benefits for that period.

A PERA member's average age at retirement is 58.[6] According to the U.S. Department of Health and Human Services, a 58-year-old male can expect to live another 20.4 years and a 58-year-old female can expect to live another 24.6 years — an approximate average of 22.5 years, or to age 81. By contrast, a 67-year-old male can expect to live another 14.8 years and a female another 18.4 years — an approximate average of 16.6 years.[7]

By linking PERA's retirement age to that of Social Security (at least for current PERA members under age 35 and for all new hires), PERA could reduce the duration of its retirement benefits from an expected average of 22.5 years per affected retiree to 16.6 years – a reduction of 5.9 years; or approximately 26 percent. Raising the retirement age also would have the benefit of deferring the expected payout period by nine years if the retirement age were raised from 58 to the private sector's age of 67 years. If combined, both of these factors could reduce the costs for the affected portion of the plan by 20 percent to 35 percent.

Although the complexity of PERA's benefit structure and actuarial assumptions eschew back-of-the-envelope calculations, any change that would reduce by one-fourth the cost of benefits to future retirees would be a significant step toward making PERA sustainable and reducing the burden on young workers to pay both the cost of their own retirement and that of current retirees.

A key policy question for lawmakers to consider is whether PERA should be a plan that supports workers in retirement or an investment plan that provides supplemental income to able-bodied workers before they actually retire.

Incidentally, a favorite retort of those who oppose retirement equity goes something like this, "You don't want a 64-year-old teacher in the classroom." In reality, raising the PERA retirement age would not force anyone but the most highly-paid public workers to work longer. Many PERA members, who retire in their late 50s, either work part-time for their former employer or take a job that is not covered by PERA, thereby allowing them to collect both a salary and retirement. A key policy question for lawmakers to consider is whether PERA should be a plan that supports workers in retirement or an investment plan that provides supplemental income to able-bodied workers before they actually retire.

- When fully implemented, Senate Bill 1 and previous PERA bailouts will increase the total contribution to PERA on behalf of its members to 28.15 percent of payroll — of which, 8 percent is paid directly by employees, 10.15 percent by employers, and another 10 percent paid by employers in the form of amortization equalization disbursements (AEDs) and supplemental AEDs (SAEDs). According to law, the SAEDs are to be paid from wage increases withheld from employees. However, for the past two years, SAED payments by employers increased despite the fact that no salary increases were provided to state workers; thus the SAED came at the expense of other budget priorities.[8]

The long-term impact of these bailouts is costly, not just to the state, school districts and other PERA employers, but also to PERA members. Employers must pay PERA an annual contribution equal to 20.15 percent of each employee's salary. Because government budgets are limited, this bailout burden inevitably suppresses wages of public employees, resulting in younger workers paying both the cost of their own retirement and that of current retirees. Compounding the inequity is the decreasing ratio of current workers to current retirees. Thirty years ago, working PERA members outnumbered retirees by 5.6-to-1. Today, the ratio is just over 2-to-1. In 25 years, the ratio will be closer to 1.2.-to-1. As life expectancies increase, many PERA members may spend as much time collecting benefits as working in a PERA-covered job. Unless the retirement age is increased to reflect this increased longevity, PERA's demographic spiral will continue downward.

As life expectancies increase, many PERA members may spend as much time collecting benefits as working in a PERA-covered job.

- Despite contributing more than $1.2 billion a year for PERA to be invested at the direction of PERA's Board of Directors, Colorado taxpayers still may remain contractually obligated to further attempts to rescue PERA from future market downturns and a costly benefit structure. Taxpayers need to know that, at a specific point, they have fulfilled their obligation to provide for public employees' retirements and that thereafter the responsibility rests with the employees and their elected Board of Trustees.

Although the performance of PERA's investments generally has exceeded their benchmarks, its cash flow needs demand that it beat the market year after year — a task that eventually baffles even the best mutual fund managers. "The most important long-run driver of a pension plan is investment income, which can contribute as much as 80 percent or more of the total inflows into a pension plan over its life," PERA states in its 2008 annual report.

Although the performance of PERA's investments generally has exceeded their benchmarks, its cash flow needs demand that it beat the market year after year — a task that eventually baffles even the best mutual fund managers.

As a result of these cash flow pressures, PERA's Board of Trustees has adopted an investment strategy that assumes an 8 percent return on investment (ROI) — revised from 8.5 percent as recently as 2008. Ironically, this small nod to prudence adversely affected PERA's funding ratio. Without the compounding power of that additional one-half percent, PERA's ability to meet its projected liabilities fell by $3.5 billion and reduced the funded status of its state division by 3.9 percent.

While the current reported average rate of return assumption is 8.0 percent, it could easily be argued that this is still too high. This 8.0 percent is based upon projections for "Real Rate of Return," "Inflation" and "Expenses." A brief review of these assumptions could lead one to believe that a Return on Investment assumption of 8.0 percent, though reduced by 0.50 percent from the prior year, is still too optimistic.

While the chief actuary for the Social Security OASDI plan chose an assumption of 2.8 percent for inflation, in 2008 the PERA valuation used 3.75 percent, which is at the high end of its own stated "reasonable range" of 2.0 percent-4.0 percent. This higher estimate for inflation pushes the overall investment assumption up to 4.56% + 3.75% - 0.40% = 7.91%, which was rounded up to 8.0 percent. If PERA were to use the same inflation assumption as Social Security, the investment assumption would only be 7.0 percent. Apparently, such an adjustment would be too much bad news for the PERA board to bear, since it would reduce PERA's ability to meet its projected liabilities by another $7 billion, and reduce the funded status of its state division by another 8 percent. PERA's investment staff is under constant pressure to invest aggressively because a more conservative strategy will rarely achieve the necessary ROI. PERA's investment strategy allocates its funds as follows:

- Domestic equity: 43 percent
- Fixed income: 25 percent
- International equity: 15 percent
- Alternative investments: 7 percent
- Real estate: 7 percent
- Opportunity fund: 3 percent

So long as lawmakers are willing to bail out PERA—at the expense of other state budget priorities—when its investments fall short, PERA would be foolish to invest more conservatively.

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In 2009, PERA paid out $3.24 billion in benefits and received $2.22 billion in contributions from members and employers. The difference, $1.02 billion, must come from return on investment (ROI), or else PERA is forced to dip into its trust fund to pay benefits. Withdrawals from the trust fund are gone forever; they cannot be reinvested and cannot generate interest or dividends in the future. Put another way, PERA needs approximately 4 percent ROI just for cash flow; only returns exceeding that rate can be reinvested.

Cost to State and other PERA Employers

The cost to PERA employers—state government, school districts and many county or municipal governments—of rescuing PERA is significant and comes at the expense of other budget priorities.

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Accurately estimating this cost is difficult. As of 2009, employees working in PERA-covered jobs accounted for more than $7.0 billion in total payroll.[9] A one percent increase or decrease in contribution rates would vary spending by $70 million.

However, only a portion of PERA-covered workers are dependent upon salaries paid directly or indirectly through the state budget. A litany of quasi-government entities and associations of governmental entities have also been added to PERA, at their request, over the years. These ancillary PERA employers include, among many others: CollegeInvest, Colorado Association of School Boards, the Colorado High School Activities Association, Pinnacol Assurance, and the Special District Association of Colorado.

Moreover, even the legislature's Joint Budget Committee doesn't have direct access to the direct cost of PERA employment for state workers. Governor Bill Ritter's administration recently changed the format of the payroll information transmitted to the legislature with its budget requests, aggregating the amount for salaries and benefits and eliminating the specific line item for each subcategory. The best available information available for estimating the PERA's payroll costs to state government—not including schools—comes from Senate Bill 146 (2010), in which the legislature shifted 2.5 percent of the PERA contributions from employers to employees for the 2010-11 fiscal year.[10] (That bill estimates the savings to state government at $37.2 million for one year; thus, one percent of payroll for state workers under PERA can be estimated at approximately $14.9 million.) Although it won't be fully implemented until 2017, the current cost of PERA's bailout plan, were it to be fully if implemented in 2011, would be $149 million, just for state government.

Although it won't be fully implemented until 2017, the current cost of PERA's bailout plan, were it to be fully if implemented in 2011, would be $149 million, just for state government.

To put that amount in context, $149 million exceeds the cost of all tax increases ($102.9 million) approved by the legislature as part of its 2010-11 budget-balancing package. It also exceeds the combined general fund expenditures for the departments of Agriculture, Law, Local Affairs, Military Affairs, Natural Resources, Personnel, Public Health and Environment, Regulatory Agencies and Treasury, as well as the Governor's Office and the Legislature, all of which combine to total $141.3 million.

The impact on school finance is larger still. Most recent available data (from 2008) place the total annual payroll in the school division at $3.8 billion, so the bailout cost (10 percent of payroll) for the school division will ultimately rise to more than $380 million annually. Although this cost is paid by local school districts, those districts receive more than 60 percent of their funding from the state legislature and most of the balance from local property taxes. Each district's PERA contribution detracts from its ability to put more resources into the classroom, increase stated salaries for quality teachers or both.

The tradeoff between rescuing PERA and funding public education is clear. To balance the 2010-11 state budget, the legislature reduced total K-12 public education funding by $382 million —

almost exactly the amount that the PERA bailout will require of employers in the School Division when fully implemented.

For 2011, the bailout cost just for public schools comes to an estimated $174 million. For comparison, the cost of Governor Ritter's 2007 property tax increase, which forced most school districts to collect more tax revenue locally is $160 million.[11] Subtract the cost of the PERA bailout and more money would be available for local school districts even without higher property taxes.

These costs will escalate as the number of teachers and state employees increase and as salaries grow — until such time as PERA exceeds a 103 percent funding ratio, which has happened only once in the fund's 79-year history. Worse still, ample evidence suggests that Senate Bill 1, combined with previous "rescue" plans, is unlikely to achieve the professed goal of helping PERA reach fully-funded status—as government accounting rules require of pension plans in the private sector.

PERA's 2009 Certified Annual Financial Report confirms that the Board of Trustees' assumed future rate of return (ROR) greatly affects the funding ratio. Of course, the assumed rate of return is an attempt to estimate future returns, not something beneficiaries or taxpayers can take to the bank. When the Board of Trustees reduced the ROR assumption from 8.5 percent to 8.0 percent in 2008, PERA's unfunded liability, on paper, increased by $3.5 billion. If trustees were to assume a conservative return of 4 percent—which might seem optimistic in the current environment—the cost on paper likely would approach $40 billion.

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Of course, more important than the Trustees' assumption is the actual rate of return. The state has a contractual obligation under the Colorado constitution to ensure PERA members receive the benefits they have earned. Whether that applies to perpetual cost-of-living increases or bans the reconsideration of retroactive benefit increases is a legal question likely to be resolved through the courts in the wake of Senate Bill 1. However, PERA members are, at a minimum, entitled to a benefit calculated based on their years of employment and average salary.

Policy Proposals

1. ***Require PERA to create separate pension fund for "new hires."*** Under PERA's current funding structure, young workers and those hired in the next three decades will pay a large share of the cost of providing pension benefits for today's retirees and workers nearing retirement age. This structure penalizes younger workers in two ways: First, younger workers will be paid less. Secondly, as younger workers later near retirement, their salaries will remain suppressed until such time as PERA's funding ratio reaches 103 percent, which has happened only once in 79 years.

   The contributions of new hires should be segregated into a new trust fund, from which their benefits alone—not the benefits of older retirees—should be paid. This fund's model must be based on a benefit structure that is sustainable, including many of the cost-control features included in Senate Bill 1 (2010), and retirement age must be linked to that of Social Security.

   Current PERA members who are at least 20 years from retirement should be given the opportunity to join the new hires fund, too.

2. *Specifically identify "bailout" costs.* PERA uses the complexity of its current pension system, which relies on contributions from today's workers to ensure benefits of today's retirees, to conflate the costs of bailing out PERA's financial losses with the cost of current benefits with the cost of paying benefits for today's younger workers when they reach retirement age.

Creating a new hires fund will enable lawmakers to identify the specific costs of a new system that includes adequate cost controls, the costs of providing benefits to current retirees, and the cost of subsidizing PERA's recent financial losses.

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By isolating these costs, lawmakers can be sure that they aren't simply digging a deeper hole and transferring the cost to future workers and future legislatures.

3. *Sunset the AED and SAED payments to make PERA accountable for reaching fully-funded status.* Under current law, PERA expects the state and local school districts to continue making bailout payments (AED and SAED contributions) for at least 24 years in the State Division and 23 years in the School Division. By that time, each seat in the State Senate and State House will change hands at least four times, and most of PERA's current officials will be retired, as well. As a result, there is virtually no accountability built into the current system to ensure the current bailout plan does not extend for an additional two, six or 10 years, taking billions more away from other priorities, like education, transportation and public safety.

4. *Relieve taxpayers from the responsibility of future bailouts.* In the past decade, lawmakers have passed three bills designed to rescue PERA from investment losses and costly benefits. Only the last bill took significant steps to reduce the future cost of benefits, but all three obligated employers or employees to pay still more to help PERA attain solvency. Even after the latest "fix," Senate Bill 1 (2010), PERA does not expect to fully amortize its liabilities for 16 to 65 years. To reach that goal, PERA needs an average return on investment of 8.0 percent per year.

Under current law, if PERA's investments fail to realize those lofty projections taxpayers are still on the hook to make PERA whole, even though taxpayers have no control over PERA's investment choices. It's time to end this "heads we win, tails you lose" racket. Taxpayers cannot afford it, and neither can young employees whose earnings are reduced in order to fully fund the retirement of current and pending beneficiaries.

It's time to end this "heads we win, tails you lose" racket. Taxpayers cannot afford it, and neither can young employees whose earnings are reduced in order to fully fund the retirement of current and pending beneficiaries.

If PERA's investments fail to achieve returns necessary to pay benefits, then lawmakers should require PERA's Board of Trustees to equitably reduce the cost of benefits to all members—not simply increase the burden on younger workers.

The state, public schools and young public employees can scarcely afford the current schedule of bailout payments, which take funds from other budget priorities. Additional bailout payments must be off the table, and PERA must be required to return to funding its pension plan from contributions which are affordable and sustainable both to employers and employees.

5. ***Link the retirement age to Social Security.*** Linking the retirement age for PERA members to that of Social Security would restore equity between taxpayers and the government employees whose salaries and retirement benefits taxpayers help finance. It's simply unfair to expect ordinary Coloradans to work longer to bail out a pension plan that allows state workers to retire as early as age 50 or 55. Just as importantly, this policy change could significantly reduce future benefit costs.

FIRE & POLICE PENSION ASSOCIATION (FPPA)

In 1978, the state legislature and local municipal officials created the Fire and Police Pension Association (FPPA) to provide uniform adequate funding for local fire and police pension funds—all of which had been managed locally and accrued a combined unfunded liability of more than $500 million.

To address the unfunded liability for existing fire and police pensioners and ensure proper funding of pensions in the future, the state separated FPPA into two funds: 1) the "old hires" fund, covering those police officers and firefighters hired prior to April 8, 1978, and 2) a "new hires" fund for those hired on or after that date.

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The state and each of 110 local governments responsible for pension benefits under the old hires plan agreed to a schedule of payments to eliminate the unfunded liability in 30 years (2009-10) or when the plan became fully funded, whichever came first. Since 1980, the state has paid nearly $538 million toward its share of the agreement, and local governments have paid just over $540 million. During three periods of budget shortfalls, the state has suspended its payments for a total of seven years (1987, 2003, 2004, 2005, 2009, 2010 and 2011), although those omissions have been subsequently replaced or scheduled as additional years. Currently, the state's remaining obligations total some $160 million to be paid by 2015.

Learning from those mistakes, the state created a new hires plan that has been fully funded since its inception, according to FPPA's annual report for 2009. Even after the stock market collapse in 2008, FPPA remained funded at 101 percent of future liabilities, in part because it had increased its assets to as much as 122.5 percent of liabilities as recently as 2007.

FPPA's structure includes many safeguards created to avert future unfunded liabilities:

- ***No guaranteed COLA.*** FPPA's Board of Directors determine each year whether sufficient funds exist to pay for a COLA of 3 percent or less.

- ***Retirement age flexibility.*** Although the standard retirement age under FPPA is age 55 with 25 years of service, members who have 30 years of service by age 50 may retire early but receive reduced benefits. Further, the Board of Directors may raise the retirement age to 60 if actuarially necessary. (Incidentally, the rationale for allowing retirement at age 55 or 60 for employees in high risk fields, such as police and fire protection, is far more sound than allowing retirement at those ages for government employees in jobs that don't regularly require significant strength and stamina.)

- ***Stabilization Reserve Account (SRA)***. When FPPA's defined benefit plan is fully funded, excess contributions (i.e., those in excess of the amount needed to pay benefits) are deposited into a Stabilization Reserve Account that includes separate accounts for reach member. According to FPPA's 2009 Annual Update, in any year in which employer and member contributions are insufficient to fund benefits, the shortfall "must be taken out of the SRA accounts" before contribution rates may be increased. This contingency has never happened but remains an important safeguard of the plan.

- ***Actuarial necessity.*** When a funding shortfall occurs, state law requires funds to be withdrawn from the SRA to make up the difference. If an actuarial shortfall remains, then benefit formulas must be reduced and the retirement age increased.

- ***Contribution stability and equity.*** Both member and employer contribution rates have remained at 8.0 percent of payroll since the plan's inception in 1980. State law requires that members' and employers' contributions be equal.

- ***Governance and conflicts of interest.*** FPPA's Board is divided into nine members, all appointed by the Governor and confirmed by the Colorado Senate. Three board members represent the plan's beneficiaries; three represent employers; and three are private citizens with a specific area of expertise. Moreover, FPPA staff does not participate in the defined benefit plan.

(Resources: Annual Update to the Pension Reform Commission, August 7, 2009, Fire and Police Pension Association of Colorado; FY 2010-11 Staff Budget Briefing, Department of Treasury, prepared by David Meng, Joint Budget Committee Staff, November 12, 2009; Funding of Fire and Police Pensions: 1903-2009, Colorado Municipal League, August 14, 2009.)

Acknowledgements

The Honorable Mark Hillman wrote this section. See his biographical material in the authors section.

We wish to thank **Richard Bratten** for conducting actuarial research for much of this section; the portion that was not drawn from PERA's research. Mr. Bratten is Partner of Bank Financial Services Group, a national firm specializing in non-qualified benefit plan design and funding. He holds designations as a Fellow, Society of Actuaries (FSA) and as a Chartered Financial Analyst (CFA Charter). He has 21 years of experience in the field after a first career teaching math and physics in high school. He is also the volunteer executive director of the Republican Study Committee of Colorado. He earned a degree in Education from the University of Cincinnati.

Notes

[1] PERA Certified Annual Financial Report (CAFR), December 31, 2009.

[2] "Final Fiscal Note" for Senate Bill 1, Colorado Legislative Council Staff, May 13, 2010.

[3] PERA Certified Annual Financial Report, December 31, 2008, pg. 18.

[4] PERA Update, February 28, 2006.

[5] "Colorado state pension changes given initial nod," 9NEWs.com, http://www.9news.com/rss/article.aspx?storyid=131557, Jan. 27, 2010, accessed

June 8, 2010
[6] CAFR, Dec. 31, 2008, pg. 122.
[7] Life Expectancy Tables, Department of Health and Human Services, 1996; http://www.efmoody.com/estate/lifeexpectancy.html.
[8] "Final Fiscal Note" for Senate Bill 1, Legislative Council Staff, May 13, 2010.
[9] PERA CAFR, Dec. 31, 2009.
[10] "Final Fiscal Note" for Senate Bill 146, Legislative Council Staff, May 13, 2010.
[11] "Revised Impact of Mill Levy Freeze," Legislative Council memorandum, June 18, 2009.

Post Employment Benefit Costs of the Defined Benefits Retiree Health Plan

The Colorado Public Employees' Retirement Association (PERA) administers a retiree health plan. The PERA Health Care Program is a cost sharing multiple-employer plan. The "employers" in this context are the various governments that hire most public employees, such as public school teachers, fire fighters, police officers and state employees. Under this program, PERA subsidizes a portion of the premium for health care coverage, and the retiree pays any remaining amount of that premium.

The State government continues to promise public employees that the retiree health care benefit will be part of their total remuneration. As the predicted shortfall in funding for the retiree health plan materializes, taxpayers will be on the hook to make up the funding deficiency.

As the predicted shortfall in funding for the retiree health plan materializes, taxpayers will be on the hook to make up the funding deficiency.

More than $1 billion in unfunded liabilities have been incurred in the PERA retiree health plan. An additional $79 million in unfunded liabilities was incurred in 2008, reflecting a rapid growth in retiree benefits, and losses in the assets held in the Health Care Trust Fund. Prospects are for continued volatility and deterioration in the funding status of PERA's retiree health plan.

Colorado should replace PERA's retiree health plan with a defined contribution plan, similar to that enacted in Idaho. We estimate that in the short run this reform would reduce the employer annual required contribution to the plan from $72.6 million to $29.0 million. In addition, the annual subsidy from the State to the PERA Trust Fund would be reduced from $24.6 million to $14.5 million, a savings of $10.1 million per year. More importantly, an Idaho-style reform would reduce the accrued actuarial liabilities in the plan, and enable the state to pay off the $1 billion in unfunded liabilities over a 30-year period.

The Budgetary Impact of a Defined Contribution Retiree Health Plan

With the defined contribution retiree health plan in place, the state contribution to the plan could also be significantly reduced. Currently the state contributes 1.02 percent of gross covered wages to the Health Care Trust. In fiscal year 2008-09 the state contributed $24.6 million to the plan. The State's savings rise if it shares proportionately with employers, thereby achieving the 59 percent reduction.

More important than the immediate budgetary impact is the long-run savings that would result from the proposed defined contribution retiree health plan.

More important than the immediate budgetary impact is the long-run savings that would result from the proposed defined contribution retiree health plan. It is difficult to estimate long-term savings because of the dynamic response of employees and employers to the new incentives created by this reform. For example, when employees assume responsibility for costs we expect them to purchase less costly health insurance plans.

The proposed reform would significantly reduce the long-term cost of the retiree health plan to the government. The savings estimate above would be captured over the actuarial life of the plan. Note the dramatic reduction in actuarial accrued liabilities in the Idaho plan following a similar reform. We would expect a similar reduction in actuarial accrued liabilities in the proposed defined contribution

Table 1. Health Care Trust Fund Schedule of Funding Progress (dollars in millions)

	2008	2007	2006	2005	2004	2003
Actuarial value of assets	255.6	258.8	214.8	191.3	166.6	160.4
Actuarial accrued liability	1368.6	1303.6	1248.0	1116.6	1102.6	897.5
Total unfunded actuarial						
Accrued liability	1112.7	1044.8	1033.1	925.4	936.0	737.0
Funded ratio (percent)	18.7	19.9	17.2	17.1	15.1	17.9

retiree health proposed for Colorado. Most importantly, Colorado would be able to pay of these liabilities over the 30-year amortization period required by GASB standards. Colorado could eliminate $1 billion in actuarial accrued liabilities in the current retiree health plan.

PERA's Retiree Health Plan

Like most states, Colorado only recently has begun to report liabilities in Other Post-Employment Benefit (OPEB) plans, in response to Government Accounting Board Standards Board (GASB) Statement NO. 45. Before the change in accounting standards, States could ignore the unfunded liabilities and recognize only the annual ongoing expenditures. The change forced governments to copy pension reporting standards in the private sector and essentially changed the accounting from a cash basis to a more honest and complete accrual picture of these large costs.

The 2009 Comprehensive Annual Financial Report (CAFR) provides the following schedule of funding progress in the Health Care Trust Fund. Total unfunded actuarial accrued liabilities have increased to more than $1 billion.

For the most recent fiscal year, 2008, additions to the Health Care Trust Fund fell below payments by more than $79 million. This shortfall was in part due to the rapid growth in benefit payments. Over the past four years benefit payments have increased more than 50 percent.

The shortfall was also the result of an investment loss for the Trust Fund equal to $72 million. As a result of this decrease

Table 2. Health Care Trust Fund Additions and Deductions (dollars in millions)

	2008	2007	2006	2005	2004	2003
Additions						
Employer contributions	72.6	68.5	64.5	61.2	60.5	64.4
Employee contributions	102.6	96.3	85.7	62.9	59.5	55.7
Medicare retire						
drug subsidy	13.7	12.4	12.5			
Investment income (loss)	-72.4	23.9	30.9	17.7	23.1	33.4
Other	12.8	12.5	13.0	13.6	16.1	2.1
Total additions	129.4	213.6	206.6	155.3	159.2	155.7
Deductions						
Benefit payments	196.8	159.9	164.8	135.6	130.9	120.8
Administrative expenses	11.8	11.1	8.1	8.2	6.6	6.2
Total deductions	208.6	171	172.9	143.8	137.6	127
Changes in net assets	-79.2	42.6	33.7	11.6	21.6	28.7
Net assets	190.2	269.4	226.9	193.1	181.6	160

Note: The changes in net assets are equal to total additions less total deductions.
Source: 2009 Comprehensive Annual Financial Report

in the value of assets in the Fund, net assets fell 42 percent, from $269 million to $190 million. Even with recovery in the stock market, the prospects are for continued volatility and deterioration in the funding status of the Health Care Trust Fund.

At this point the retiree health plan is not meeting GASB standards. The GASB guidelines require that employers amortize unfunded liabilities in the plan over a 30-year actuarial time period. The estimated amortization for the Colorado plan is 39 years.

The $1 billion in unfunded liabilities in the Health Care Trust Fund would not appear to be a crisis if there was some prospect that the liabilities could be paid off within 30 years to meet GASB standards.

The $1 billion in unfunded liabilities in the Health Care Trust Fund would not appear to be a crisis if there were some prospect the liabilities could be paid off within 30 years to meet GASB standards. Unfortunately, there are a number of reasons why the funding status in the plan is likely to deteriorate for the foreseeable future.

The current funding status in the Health Care Trust Fund is actually worse than that reported in the CAFR because the actuarial assumptions used by PERA in administering the Health Care Trust Fund are similar to those used in administering pension funds. A four-year smoothing technique is used to estimate the actuarial value of assets in the plan. Thus some, but not all, of the decrease in the market value of assets in 2008 is reflected in the actuarial value of assets for that year. The loss in the market values of assets in more recent years is, of course, not reflected in the actuarial value of assets in 2008. These losses in the market values of assets in the plan will be reflected in the actuarial value of assets over the next four years. As a result, even with recovery in the stock market we are likely to see an increase in unfunded liabilities in the plan over the next four years.

There is a fatal flaw in PERA's administration of the Health Care Trust Fund, as well as its administration of pension funds.

A fatal flaw in PERA's administration of the Health Care Trust Fund, as well as its administration of pension funds, is the assumed 8.0 percent rate of return on assets in these plans. The actual rate of return has been zero or negative over the past decade. The best economic analysis of public sector pension and health plans, such as PERA, suggests a more realistic rate of return on assets that is about half or less than that assumed by PERA.[1]

Because PERA assumes an unrealistically high rate of return on assets, it engages in a risky investment strategy, with 70 percent or more of assets in equities. The best economic analysis projects that such pension and retiree health plans will continue to experience volatility and deterioration in funding status in future years. A recent study projects many of these funds will exhaust their assets and go bankrupt over the next two decades.[2]

The Case for a Defined Contribution Retiree Health Plan

Most private sector employers now either have eliminated defined benefit retiree health plans, or replaced them with defined contribution plans.[3] While most state and local governments have not eliminated health plans for their retirees, they have enacted a number of reforms to reduce the cost of those plans, including replacing defined benefit plans with defined contribution plans.

A defined benefit plan specifies the amount of benefits provided either as a dollar amount, or as a percentage of health insurance premiums paid by the government.

Abstracting from the complex health insurance plans offered to retirees, we can identify plans in which the employer contracts to cover most of the cost of the health insurance premium as defined-benefit plans. In a defined-benefit plan the state is exposed to the risk of high and volatile levels of health care costs. This exposure makes it difficult for the state to project the unfunded liabilities that will be incurred by the plans, and to fund those liabilities.

There are several flaws in the design of defined benefit plans in the public sector. One flaw relates to assumptions regarding health care costs. These government plans continue to assume a rate of inflation in the cost of health service far below the actual rate of inflation. Health care costs have been increasing at double-digit rates in recent years, and there is no reason to assume they will increase less rapidly in future years. This forecast is especially true with the new federal health legislation that will significantly increase demand for health care services, while restricting the supply.

Politicians have promised retiree health benefits they can't pay for. They offer public sector retirees generous health benefits as an alternative to better compensation because the cost of retiree health benefits is deferred to future generations.

A second flaw in defined benefit plans in the public sector was discussed above: the unrealistic assumptions regarding the rate of return on assets accumulated in these plans.

The fatal flaw in defined benefit retiree health plans in the public sector is moral hazard. Politicians have promised retiree health benefits they cannot pay for. They offer public sector retirees generous health benefits as an alternative to better compensation because the cost of retiree health benefits is deferred to future generations. Public sector employee unions encourage this activity because it is less likely to generate taxpayer resistance than higher compensation, which must be funded from current revenue. Only with the transparency created by GASB rules are taxpayers more aware of the magnitude of unfunded liabilities accumulating in these plans. It is increasingly clear that defined benefit retiree health plans in many states are not sustainable in the long run.[4]

A recent federal Government Accounting Office (GAO) study reports that some governments have shifted from defined benefit retiree health plans to defined contribution plans.[5] The basic principle of a defined contribution health plan is similar to that for a defined contribution pension plan. Instead of a promise to cover all or most of the cost of health insurance, the state contracts to make a contribution toward that cost. The contribution may take different forms. Most often it is a contract to pay a dollar amount toward the health care premium. That dollar amount may be specified in absolute dollars, or relative to the years of service. In some cases the dollar amount is linked to funds the employee has accumulated in sick leave, disability or other accounts.

The GAO study reports that some governments have reduced the amount or percentage of health insurance premium paid for by the government. In effect, this reform can convert the retiree health plan into a defined contribution plan to the extent that employees are expected to pay for most of the cost of health insurance.

The rationale for a defined contribution health plan for retirees is clear. The employer limits unfunded liabilities by minimizing the risk of high and volatile health care cost inflation.

The rationale for a defined contribution health plan for retirees is clear. The employer limits unfunded liabilities by minimizing the risk of high and volatile health care cost inflation. The State is then better able to project unfunded liabilities and fund liabilities to meet GASB standards, while motivating beneficiaries to economize. In states with defined contribution health plans for retirees, the premium cost is generally less than \$500 per month.[6]

This fact suggests that when employees must cover more of the cost of those health insurance premiums, they tend to choose lower cost plans.

Learning from Idaho's experience

Among the most successful public sector retiree health benefit reforms is the one enacted in Idaho. In 2009 the Idaho legislature faced unfunded liabilities of $353 million, with skyrocketing numbers forecast for out-years. Like many states Idaho was not meeting the promises made to retirees in their health plan.

Among the most successful public sector retiree health benefit reforms is that enacted in Idaho.

Faced with revenue and budgets problems much like Colorado, Idaho enacted a successful reform we have followed in our recommendations for this report (see "How to Save a Billion Dollars in Other Post-Employment Benefit Costs: A Case for Shifting to a Defined Contribution Retiree Health Plan"[7] for full details). The State of Idaho, with about one-fifth the population of Colorado, shed over $300 million in unfunded liabilities and reduced the annual cost to the State.

To follow Idaho's example, Colorado would replace the current retiree health plan with a defined contribution plan. The change would reduce the dollar amount employers are required to contribute to the retiree health plan. Currently, PERA subsidizes a portion of the monthly premium for health insurance. The subsidy is $230 per month for benefit recipients under the age of 65 who are not eligible for Medicare. Setting the maximum amount of the subsidy per benefit recipient at $155 per month would reduce employer's cost for that health insurance by almost half.[8]

Colorado also must restrict eligibility. Currently, retirees who are eligible for Medicare are also covered by PERA's retiree health plan. The subsidy is $115 per month for Medicare-eligible retirees. Limiting eligibility in the defined contribution plan to retirees under the age of 65 who are not eligible for Medicare would eliminate this cost to employers.[9]

Colorado could restrict eligibility for the defined contribution retiree health plan to employees with a minimum of 10 years of service. The maximum contribution could be limited to employees with 20 years of service, subject to a 10 percent reduction for each year of service less than 20 years. Currently, the maximum subsidy is paid to employees with 20 years of service, and is subject to a reduction of 5 percent for each year less than 20 years.[10]

Eligibility for the defined contribution retiree health plan could be limited to employees who retire directly from government service. If employees are rehired, they would have to have 10 years of prior service and accumulate an additional three years of service after they are rehired to be eligible. The retiree health plan would be closed to new employees.

Acknowledgements

Dr. Barry Poulson was primarily responsible for the content of this section. See his biographical material in the Authors section.

The Independence Institute appreciates and acknowledges the reviews and comments from the following people:

The **Honorable Mark Hillman**. See his biographical material in the Authors section.

Dick Murphy has made a career as an institutional money manager and financial advisor, operating his own firm since 1991. He earned a Ph.D. in Economics from Iowa State University and taught at various colleges and universities before coming to Colo-

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The **Honorable Penn R. Pfiffner**. See his biographical material in the Authors section.

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TRANSPORTATION AND HIGHWAY USERS TRUST FUND

If a full-blown budget crisis leads to true reform by the General Assembly, in cooperation with a new Governor, there is no better place to start than at the Colorado Department of Transportation (CDOT).

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The effect on the budget will be indirect, however. Funding for state highways comes from a "Highway Users Trust Fund" separate from the General Fund. Most of its revenues come from the State's portion of the tax assessed every time a gallon of gasoline is purchase at the pump, or from the moneys appropriated by Congress to the states. Deferred maintenance and long-deferred road expansion cry out for funding and cause officials to demand money from new taxes and other sources. If instead of more funding for a broken system, however, the Governor would be able to operate this vast bureaucracy in ways that materially improve the productivity and organization, fewer new dollars would have to be generated. More intelligent use of the current stream of funds should be the objective.

Consumers of transportation may appear inconsistent. On one hand they regularly refuse to entrust more funds to government administration. Yet they are willing to pay more for mobility, speed and trip-time certainty. Although these two actions make consumers appear inconsistent, is the opposite possible? Might consumers be consistent? Do taxpayers know that more funds to government are not likely to yield benefits? Do they know an alternative paradigm is possible? Do mere citizens know what leaders have yet to recognize: A new paradigm is possible, one that can yield more benefits at less expense?

Once again, many opportunities exist for improvement, but first the State must be willing to change its thinking and approach. Bold leadership geared towards a willingness to use modern ideas will be necessary to get Colorado out of the mire of long obsolete procedures. Significant changes need to be made.

ACTION RECOMMENDATIONS

Establish a New System of Performance Measurements

1. Mandate that CDOT employ industry-wide measures of performance for all operational, maintenance, and construction activities. Insist that managers and workers use the information to improve effectiveness. Make the information available for public scrutiny. Report annually to the Senate and House Transportation Committees with comparative outcomes of other states.
2. Implement GAAP accounting.

Mandate that CDOT employ industry-wide measures of performance for all operational, maintenance, and construction activities.

Choose Projects Differently

3. Alter the make-up of the Colorado Transportation Commission with a goal to redefine its role and the process it uses to put next projects into the best priorities. To depoliticize the Commission's decisions, the legislature should establish a minimum level of benefit-cost that must be satisfied for a transportation project to go forward. Further, capital projects can be prioritized by benefit-cost to ensure maximum benefits.

Competition Improves Quality and Reduces Costs

4. Divest or outsource maintenance and operations.
5. Establish a committee of non-CDOT staff to review and approve proposals from CDOT work groups who wish to continue to perform their same work duties at a lower cost to CDOT as independent contractors.
6. Reward CDOT employees who provide efficiency-creating ideas.

Transit Contribution

7. Pass a statute requiring only transit projects that enhance mobility may be funded.
8. It is now known voters were misinformed by RTD about FASTRACKS. Because RTD cannot deliver what was promised, the legislature should prohibit RTD from incurring additional expenses until a new, more truthful FASTRACKS proposal is approved by voters.
9. Convene a grand jury or similar independent body to investigate objectively and to review the facts and conclusions presented to the public about mass transit. Hold officials accountable for purposely mischaracterizing opportunities and facts.
10. Allow RTD to compete for revenues from a Mobility Fund based on the contribution to mobility the outlay will provide. Establish the Mobility Fund using taxes currently going to RTD.

Implement Market Reforms

11. Direct CDOT to present a proposal to the legislature in one year to implement a network of HOT lanes throughout the Denver metro area to eliminate traffic congestion. The HOT lane network will be self-funding, should be implemented in no more than 10 years and may necessitate the use of a PPP to access capital and expertise external to CDOT. The new T-REX lane should be converted to a HOT lane as the first portion of a network, dedicating its revenues to conversion costs, expansion and to enhancing corridor capacity.

Direct CDOT to present a proposal to the legislature in one year to implement a network of HOT lanes throughout the Denver metro area to eliminate traffic congestion.

12. A network of dedicated lanes may be one in the same with a HOT lane network, as well as a revised Fastracks proposal. Fastracks implemented as Bus Rapid Transit (BRT) would cost less than half of the light rail / heavy rail plan and, operated jointly with HOT lanes, would offer a revenue source and economic benefits Fastracks cannot offer. The I-25 HOT lane should be converted to dynamic pricing. Dedicate its revenues first to cover conversion costs and second to corridor enhancements. Although small, it may be a potential PPP project.
13. Direct CDOT to report on the practicality of improving mobility on U.S. 287 to Texas by establishing new truck-fee-financed, truck-only lanes. Truckers must be consulted to know the feasibility and limits of multi-trailer rigs and whether the new economies would be sufficient to merit the expense.
14. Establish a trial program using transportation vouchers to grow the number of transit providers. A statute is needed to lift regulations that prohibit entry into this market. Direct CDOT's Transit Division (or State Auditor) to commission a study and report on the feasibility of implementing the Miami

Establish a trial program using transportation vouchers to grow the number of transit providers.

decentralized transit approach in Colorado.

15. Regulations that prohibit transit competition should be loosened or eliminated. CDOT managers incapable or unwilling to implement market systems should be replaced.

Change the Way the State Finances Transportation

Direct CDOT to develop a plan by 2012 to transition all Colorado Interstate Highways to IHE by 2020.

16. Establish the Interstate Highway Enterprise in 2011. Direct CDOT to develop a plan by 2012 to transition all Colorado Interstate Highways to IHE by 2020. Direct CDOT and the Colorado Department of Revenue to work with the E-470 Authority to come up with a method to refund gas tax to E-470 users.
17. To help CDOT become more open to PPPs and to learn how to capture the benefits of PPPs for Colorado, establish a goal (requirement) that CDOT accept one PPP per year be for each of the next five years.
18. Require CDOT to rewrite its PPI guidelines incorporating best practices creating a friendlier, inviting tone by mid-2011; announce the opening of the PPP process in Colorado on the CDOT website and elsewhere.
19. The ideas of an SIB and other mechanisms of advanced financing to access billions of dollars in private capital are premature and should not be introduced to citizens until the State can demonstrate good faith efforts to improve Colorado's infrastructure by making changes to those things that impose enormous unnecessary costs.

Establish a New System of Performance Measurements

1. Performance measurements. Governments' incentives are wrong. "In government all of the incentive is in the direction of not making mistakes."[1] Costs, accounting, accountability, efficiency and effectiveness are empty terms. "At all levels of government, accounting records almost entirely ignore what assets are owned, their state of repair, and their value. These systems imply that it costs nothing to use existing assets."[2] Operated similarly, any business or family would fail. "Most governments have no idea how much it costs to deliver the services they offer."[3] Infrastructure envy impacts the reason, judgment and priorities of both elected officials and government managers, and "Public accounting reinforces the politician's natural preference for building impressive new structures."[4] Operation and maintenance (OAM) of existing facilities lack political glamour and are off the radar.

With the book ***Reinventing Government*** in hand, President Clinton and Vice President Gore declared that the "era of big government is over." Evidently, no one told the government. The book astutely called for a reformation in government. "What we need most if this revolution is to succeed, is a new framework for understanding government—a new paradigm."[5]

The call for revolution in government—for a new paradigm—was not new to the 1990s. Throughout the 1980s the National Council on Public Works Improvement[6] probed the issue thoroughly, releasing its final report (titled ***Fragile Foundations***) to Congress in 1988. Under the pressure of special interest groups' claims that the nation's infrastructure was in dire condition, immediately requiring unfathomable amounts of funding, Congress commissioned the Council. Because the Council drew a larger perspective than simply allocating the dollars suggested, those same special interest groups undertook to challenge and discredit the Council's work.

For example, the Council answered the question, "Who should pay for infrastructure?" with the simple and politically moderate reply, "… users could finance a greater share of many public works facilities."[7] The Council went on to suggest "dedicated taxes," wherein a tax is designated for a particular service (as the gas tax originally was dedicated to fund highways) and greater use of "user fees," whereby those who benefit directly from a particular service are charged a related fee.[8]

Council recommendations were as follows:[9]

- Clarification of the respective roles of the federal, state and local governments in the construction and management of infrastructure to focus responsibility and increase accountability;
- Steps to improve the performance and efficiency of existing facilities;
- A rational capital budgeting process at all levels of government;
- Strong incentives to ensure adequate maintenance and, where appropriate, adopt new technologies;
- More rigorous and widespread use of low capital techniques for delivering services and meeting service needs, such as demand management, coordinated land-use planning, and waste reduction and recycling.

Fragile Foundations continued with the following suggestions:

- Timely repairs reduce long-term operating costs and ensure the full life expectancy of existing facilities and equipment;[10]
- Public works investments should be guided by clearly stated performance objectives;[11]
- Governments should inventory the facilities they own;[12]
- Infrastructure innovation must be accelerated with more R&D;[13] and
- The nation has a shortage of technically competent personnel to meet future requirements of the public works profession.[14]

These suggestions could have been written yesterday; government reform has not progressed in at least three decades. Periodically, a clamor demands more attention and more dollars. Subsequent studies advocate market-related reforms. Special interests seeking to protect their funding object to the change. The cycle repeats with very little change in how elected officials and government managers view and perform their work. The cry for more funds will persist, and no amount of new funds is ever sufficient— until a new paradigm is envisioned and implemented. New funds (e.g., FASTER[15]) instantly are devoured with little improvement to service.

Alternatively, when the new paradigm is implemented, the costs of infrastructure services will plummet with a resultant boom to the economy lifting the wealth and lifestyle of all.

Alternatively, when the new paradigm is implemented, the costs of infrastructure services will plummet with a resultant boom to the economy lifting the wealth and lifestyle of all.

The lack of readily available performance information and cost data suggests the need for far more performance information and transparency by CDOT. We know, for example, that during the 2009 fiscal year, CDOT maintenance employees tended more than 23,000 lane miles by repairing and maintaining more than 2.7 million square yards of roadway surface and utilized 175,106 tons of asphalt and 906,663 gallons of liquid asphalt in asphalt preservation activities. Absent from these records is the perspective of productivity.[16] Are Colorado's metrics reasonably comparable with other Western region states? How much improvement should be expected?

In cost-benefit terms, Colorado citizens paid almost a billion dollars and received the above list of services. Was it worth it? Hard to say. Cost-effective? Can't tell. Can some things be done more cost-effectively? Maybe, but there is no way to tell without better information. Numerous contacts to CDOT resulted in no more detailed performance data than is shown above. It is unknown whether detailed CDOT data exists. The fact that data could not be found raises transparency, as well as management, questions. The old way of doing things is the root of the problem. Once the political and bureaucratic worlds get out of the way, traffic congestion, transportation finance and deteriorating infrastructure will all improve.

Because government accounting does not provide useful cost information to government managers, governments are hobbled in their mission to provide the best service to the public at the lowest cost.

2. Accounting. Reliable cost information improves good management. Because government accounting does not provide useful cost information to government managers, governments are hobbled in their mission to provide the best service to the public at the lowest cost. Bureaucracies benefit from the proliferation of poor information; good management is hamstrung. When true costs are unknown, alternative methods of achieving the task are difficult to consider. Aware of the difficulty, accounting professionals established the Government Accounting Standards Board[17] (GASB) to reform government accounting. GASB generates directives that guide audits, but generally issues only one or two per year. At GASB's glacial pace of reform, a more expedient solution is needed. Government accounting should be abandoned and replaced with normal GAAP accounting (generally accepted accounting practices). Armed with better cost information, dedicated government managers not only will be empowered to become better managers but also will find and implement alternative service delivery methodologies that will bring previously unimagined efficiency to public service.

The present method for placing a dedicated tax into the Highway Users Trust Fund (HUTF) is strongly supported. Building projects and handling maintenance out of the HUTF maintains a little distance from parochial considerations or from competing with non-transportation programs, so transportation financing decisions can be isolated. Colorado should not backslide further from the dedicated tax model of the HUTF, as has occurred in recent years. Infrastructure managers observe parallel experiences in cities and counties. Those with dedicated revenues sources for transportation have better street maintenance and transportation programs with higher levels of service.

True user fees that cover direct services bring costs and benefits of service closer together and closer to consumers and at the same time further remove politics from the provision of services.

Because dedicated taxes are more effective than general taxes, it follows that user fees would further increase effectiveness. True user fees that cover direct services bring costs and benefits of service closer together and closer to consumers and at the same time further remove politics from the provision of services. That is a large figurative distance from the imposition of fees that are meant instead to relieve General Fund pressures.

As if CDOT's lack of performance measurements and transparency is not enough cause for concern, the maintenance and general budgeting process merits examination. CDOT appears to use prior year costs as a base to develop the budget for the succeeding year. Because CDOT's six regions seek funds from the same pot, each region sends a team of inspectors to another district to inspect 0.3 miles of reach road to determine the amount of work needed to bring roads to the required minimum level of service. Results are multiplied to account for the full 9,144 mile (23,000 lane-mile) CDOT responsibility. The Colorado Transportation Commission (CTC) then decides how funds are allocated among the regions. When billions of dollars in backlogged needs are claimed, it is fair to question the factual basis for the number.

The science of building prediction models for road deterioration (Pavement Management) has been around for more than 30 years. It appears much of this science has not been discovered by CDOT. Prediction models empower managers to minimize costs by knowing when less expensive maintenance can be performed to avoid more expensive maintenance later.

Choose Projects Differently

3. Modernize the way projects are selected. The Colorado Transportation Commission (CTC) was created in 1910 to remove the influence of politics from transportation decision-making. The goal was worthy, and the insight of leaders to understand the deleterious effect of politics on the efficient use of limited tax dollars was astute. The CTC consists of 11 individuals geographically distributed throughout the state who oversee the operation of CDOT, diminishing the oversight role of the General Assembly. It is time that CTC be critically reexamined and potentially restructured. CTC is inherently political; its members are appointed by the Governor. Commissioners often are former legislators, and in their selection pains are taken to sustain partisan balance implying that lack of balance would permit policy to swing. Thus, CTC may not be as apolitical as was hoped during its inception. Fair geographic distribution of limited transportation funds is important. It is even more important that full value is received for expenditures. Policy strategies should benefit the public generally, maximize mobility, and facilitate economic growth. Less political influence can be achieved by applying a minimum benefit over costs to each project assessment: simply don't fund projects with ratios below the required minimum. Colorado taxpayers have been underserved by the failure to establish rational transportation policy priorities. Irrational transportation funding priorities infer the influence of special interests politics in the process, the very thing from which the CTC was created to protect Colorado. RTD will have more internal checks and balances and greater accountability when the method of electing RTD Directors is changed. The change might be something as simple as choosing Directors in partisan elections.

It is time that CTC be critically reexamined and potentially restructured. CTC is inherently political; its members are appointed by the Governor.

RTD will have more internal checks and balances and greater accountability when the method of electing RTD Directors is changed.

Competition Improves Quality and Reduces Costs

4. Divest or outsource. Is "privatization" a bad word? The word "privatization" is confrontational, inferring that one is not doing his job efficiently, eliciting predictably defensive reactions. Yet responsible infrastructure managers have a moral obligation to search for and implement efficiencies whenever possible. Wasting (or not using funds efficiently) taxpayer dollars should be a crime. Responsible managers have open and inquiring minds in search of alternative service delivery mechanisms. Some of the many barriers to better management are government accounting and lack of performance information, both discussed in other sections.

Two privatization tools that can bring efficiency to services are divestiture and outsourcing.[18] Each merits brief discussion.

Divestiture is best illustrated by the "yellow page" test. When the same service can be purchased by consumers from a private supplier in the phone book, government involvement in the service cannot be rationalized as a cure for market failure (as market failure has not yet occurred). Instead, government competition (meaning tax subsidized and under-regulated) threatens to perpetrate a market failure. Similarly, when governments provide yellow page services to themselves or other governments, efficiency should be doubted. The presence of politics, bureaucratic management and lack of accountability almost always makes efficiency impossible. Martin L. Gross, the famed author and government critic, claims anything governments do costs twice as much. Although empirical evidence of the half-price claim is lacking because the nature of government accounting makes it impossible to prove or disprove, Gross is probably not far off the mark. Thus, most things that fall under the yellow page subheading can likely be done for about half the price externally, even when done by the same government employees after they leave government.

HOW EXTREME IS TOO EXTREME?

Effective July 1, 2010, the City of Maywood, California, terminated every city employee, including police officers. Had leaders acted sooner, might a less extreme alternative have been possible?

Outsourcing is like divestiture, but government retains control (ownership, management and guiding parameters). As a general rule, the savings that can be captured by outsourcing are about half of divestiture savings. An excellent Colorado example of documented outsourcing benefits is RTD bus routes. In 1988 the General Assembly mandated that RTD outsource 20 percent of its bus routes. RTD dictated routes, schedule, stops, and equipment. The initial result was a cost savings of 45 percent.[19]

The fact that RTD produced indisputable dollar savings for the waste and did nothing more until additional mandates were imposed by the legislature years later reveals some of the psychology of bureaucracies and the need for elected leaders to direct change.

Table 1. RTD Outsourcing Results[20]

	Internal	Outsourced
	1979-1988	1988-1997
Bus Expenditures*	Increased 8.7%	Increased 4.3%
Bus Service	Decreased 12.6%	Increased 34.3%
*inflation adjusted		

5. Managed competition. Some governments have experimented with "managed competition," wherein work groups are allowed to bid to continue providing services. The City of Phoenix[21] was the first in 1978 to experiment with managed competition. Applied to city trash collection services, it resulted in cost reductions and newfound efficiencies.

6. Empower government workers. In addition to benefiting CDOT, management and the public, transparent performance information would benefit workers by informing them of their effectiveness and help motivate them to come forth with efficiency-generating ideas. "Government cannot achieve the same market efficiencies as business."[22] Those most familiar with government waste and in the best position to root it out are government workers. Programs should be devised that invite and reward innovative cost-saving reforms by government workers. Innumerable untapped ideas and innovations are being suffocated by the lack of a mechanism to receive, evaluate and implement them. The traditional "suggestion box" yields control and judgment to higher-ups who might be threatened by change or improvement.

Beyond simply making suggestions, a second system should be devised whereby government workers may extricate themselves.

Both government and individual workers can benefit when the individual (or work group) is allowed to remove the job function from bureaucracy and politics, establishing it as a privately-owned, taxpaying business and providing the same services to their former government employer for less cost. The main reason not to establish this system is it might threaten the bureaucratic status quo. The legislature should direct CDOT and RTD to employ systems that allow employees to offer their same services at a reduced cost.

Both government and individual workers can benefit when the individual (or work group) is allowed to remove the job function from bureaucracy and politics, establishing it as a privately-owned, taxpaying business and providing the same services to their former government employer for less cost.

Transit Contribution

As expressed in CDOT's budget for fiscal year 2011, ***"The mission of the Colorado Department of Transportation is to provide the best multi-modal transportation system for Colorado that most effectively moves people, goods and information."***[23] As the population in Colorado has increased and subsequently the vehicle miles traveled (VMT) have risen, CDOT has been challenged to maintain service levels while keeping congestion levels low, roads open and safe, and a general level of mobility that "most effectively moves people, goods and information." Use of the term "multi-modal" creates a perverse anti-mobility incentive within CDOT to apply funds not necessarily to their most effective use. Offering consumers an alternative to the automobile, when rarely used, is hardly defensible when far greater mobility can be offered to far more citizens for far less money. The politicization of Colorado's transportation policy has resulted in disproportionate and wasteful outlays for transit.

Transit has an important role to play in transportation. Transit should enhance overall mobility at a minimum expense to taxpayers. Colorado's current approach to transit directs disproportionate outlays in exchange for small mobility enhancement. Serious re-evaluation and reconsideration is in order.

7. Decentralize transit. A new statute is needed to limit new transit projects only to those that will enhance mobility. Other concerns of directing where new development or redevelopment is to occur, or of reducing carbon emissions, should not be funded from the transportation pots. Mobility and traffic congestion are decentralized problems. It is impossible to solve a decentralized problem with a centralized approach. Over the years bus transit subsidies have grown from zero to 80 percent of trip costs. It is an absurdity to believe that even more centralization (light rail) will change this trend.

Do transit advocates truly care about transit? If they favor mobility by transit they would support a new vision and reform. What they advocate—the re-population of central cities–cannot work. A century ago transit was an effective mode of mobility. Americans in large numbers lived in tenements and worked in factories. As Americans grew wealthier, dependence on transit declined. As market share fell, covering costs became impossible for private transit companies. Governments stepped in to preserve the failing industry with subsidies. As the trend continued, the subsidies grew to be exorbitant. Similar to declaring that water shall run uphill, lawmakers implemented statutes declaring that subsidies were not to exceed a stated level. When they inevitably did, the limit was simply raised and raised again. Currently, most bus trips receive about 80 percent taxpayer subsidy, and rail trips are subsi-

Currently, most bus trips receive about 80 percent taxpayer subsidy, and rail trips are subsidized closer to 95 percent when capital costs are counted.

dized closer to 95 percent when capital costs are counted. Because traditional transit grew out of a time when cities were more centralized, transit remains centralized in its approach. A new vision with a decentralized design is needed.

Colorado's anti-transportation policy. Taxpayers and consumers want and deserve more mobility. Colorado's transportation policy has been so politically influenced by special interests that it might be considered outright "anti-transportation" and anti-mobility. The Denver Regional Council of Governments (DRCOG) reports for the Denver metro area between 2008 and 2011, of the $1.8 billion state and federal transportation funds for transportation "two-thirds is for transit."[24] It is now common knowledge that RTD's Fastracks 67 percent tax increase, approved in 2004, cannot construct light rail anywhere near the promised cost or deliver the promised reductions in traffic congestion. RTD is in blatant violation of its agreement, commitment and trust with voters. Normally, such violation voids a contract.

Colorado's transportation policy has been so politically influenced by special interests that it might be considered outright "anti-transportation" and anti-mobility.

8. Revisit FASTRACKS. The General Assembly should require that Fastracks be put on hold until voters re-approve the light rail expansion tax with more accurate and complete information regarding costs and realistic expectations of impact on traffic congestion disclosed to the public. RTD is a questionable steward of the public trust, and a new oversight entity will likely be needed.

With such a large share of tax dollars going to transit, one might expect transit to account for a reasonable share of mobility. Buses and light rail combined account for only 2 percent of all miles traveled, yet use 55 percent of the budget.[25] Within the transit segment, buses do the bulk of the lifting, with rail consuming the bulk of the funding and contributing a fraction of mobility.

Cost-effectiveness of transit

	Cost	Benefit = Mobility	Cost: Benefit	Cost: Benefit
Transit	55%	2%	55 to 2	27.5 to 1
All other modes	45%	98%	45 to 98	0.45 to 1

In cost-effectiveness terms, transit costs taxpayers 60 times[26] more per unit of benefit than other forms of transportation.

9. Ensure truthful claims. Citizens have come to expect less and less information and more hyperbole from campaigns, even those that deal only with ballot issues and not candidates. Elected officials have gone terribly wrong in allowing transit zealotry to cloud objective trade-offs in developing new projects. Accountability should be the watchword here. Where elected officials have intentionally misled the public, there should be remedies in place. Transit exaggerations are not limited to Colorado, as can be learned from the mistakes of others.

In May 1999 an Orange County California Grand Jury released its report investigating the decision process to build light rail, including the following findings:[27]

- Benefits were overstated;
- Of the 12 LRT systems built in various parts of the country over the prior two decades, "none can be called a success;"
- The national experience with urban LRT systems' ability to solve traffic congestion, air pollution, and related urban problems has been poor;
- The transportation authority had done "more promoting than studying;" and
- There would be a "negligible impact on traffic congestion, less effectiveness than predicted, more expense than predicted, an inflexible system, and no improvement in

commuter travel times, energy conservation, or safety."

The Grand Jury suggested that:[28]

- Measurable goals be established and published;
- Disinterested national experts be consulted for historical perspective; and
- Full disclosure be made to the public of all perceived benefits, drawbacks, costs and impacts before final approval.

In short, the Grand Jury asked the Orange County Transportation Authority to stop misleading voters. Colorado should convene a Grand Jury (or equivalent) investigation of RTD.

10. Establish a mobility fund. Voters have approved taxes for RTD to improve mobility. Mobility is defined as reducing or minimizing travel times, and as such is associated with greater economic growth, job creation and poverty alleviation. Because RTD has undertaken extravagantly expensive policies that do little for mobility, a new approach is in order. Why not do what voters were led to believe? Put the tax revenues into a mobility fund. All cities and counties, as well as RTD and CDOT, can apply to receive mobility funds. Allocation of funds would be to the projects and programs that most significantly enhance mobility.

Implement Market Solutions

Traffic congestion wastes time and money, and injures both the environment and the economy. Generally, congested traffic generates 2.5 times[29] the air emissions as free-flowing traffic.[30] The Texas Transportation Institute[31] reports annually on traffic congestion throughout the U.S. that the annual cost of traffic congestion nearly equals the amount of money needed to eliminate it. Traffic congestion in Colorado costs drivers $1.35 billion per year.[32] In the Denver metropolitan area, the annual average cost of traffic congestion is $913 per person.[33] A plan to capture these benefits and eliminate traffic congestion more fairly should assess the costs to those who benefit directly rather than taxpayers generally. HOT (high occupancy toll) lanes should be expanded strategically throughout the metro area.

11. Expand HOT lanes. Beyond the metropolitan area, additional HOT lanes are possible along I-25 to Colorado Springs and north to Fort Collins. T-REX can be converted quickly and the revenue stream capitalized to fund a HOT lane connection with the current I-25-North HOT lane. A complete network of HOT lanes eliminating all traffic congestion in the metropolitan area can be achieved before 2020.

T-REX is the I-25 widening project accomplished between 2000 and 2006. It added one traffic lane (from 3 to 4 lanes throughout) in each direction that is freely available to all motorists. The new lane should have been a HOT lane. HOT lanes are HOV (high occupancy vehicle) lanes that sell unused capacity. HOT lanes also provide a lane that is never congested. HOT lanes are never congested because the fee to travel them varies with demand. When demand is high the price goes up. Never-congested lanes provide many benefits. High occupancy vehicles can move large numbers of people. Emergency vehicles can readily reach emergencies, saving both lives and property. HOT lanes generate revenue. Had the new T-REX lane been a HOT lane, one estimate capitalizes the potential revenue stream after operating expenses ***at a value of $600 million.***[34] Not exercising this option precluded CDOT's ability to apply funds elsewhere in the system. Even though Colorado decided against securing these benefits during construction, the conversion opportunity still exists.

Had the new T-REX lane been a HOT lane, one estimate capitalizes the potential revenue stream after operating expenses at a value of $600 million.

Federal government prohibitions on innovation at the state level may be loosened when the next reauthorization passes, possibly in 2011, giving Colorado some time to prepare.

The current HOT lanes on I-25 north of Denver will be able to generate more revenue and serve more customers by installing dynamic pricing. Current pricing varies by the clock, and thus overpricing is needed as insurance against traffic congestion. This, in turn, results in under use. Dynamic pricing would allow the price to vary with demand, resulting in more use and more revenue. Net revenue ($2.5 million revenue and $1.5 million expenses)[35] after operating expenses to CDOT of $1,000,000 in 2009 would likely double.

Dynamic pricing would allow the price to vary with demand, resulting in more use and more revenue.

12. Dedicated lanes. There are many types of dedicated lanes: HOV (high occupancy vehicle), HOT (high occupancy toll) and BRT (bus rapid transit). BRT costs about half as much as light rail and can move more people more quickly. BRT is nearly 10 times more cost-effective than light rail, depending on respective ridership. Fortunately HOV, HOT and BRT are compatible. That is, all three may share a dedicated lane, increasing benefits and distributing costs. A network of dedicated lanes should be planned and implemented immediately as a key element to eliminating traffic congestion in the metro area.

13. Truck-only lanes. Trucks and automobiles are not particularly compatible. Their use of the same facilities drives up operation and maintenance costs, as well as construction costs, while reducing safety and carrying capacity. Truck traffic counts comprise about 10 percent of vehicles but consume nearly 30 percent of highway capacity. Thus, removing trucks from some highways effectively would increase capacity by 30 percent for automobiles. Trucks pay a lot in taxes and fees which, if isolated for exclusive use of trucks, might be enough revenue to construct their own truck-only lanes.[36] If current taxes and fees are not sufficient, new efficiencies could allow truckers to pay more to move more goods more quickly to market. Engineering design standards for separate automobile and truck facilities would allow both to become more cost-effective and safe. Truck-only lanes could allow major innovative changes to truck traffic management. For example, truckers capture greater economic efficiency when they pull multiple trailers. What should be the trailer-limit on the truck-only system (2, 3, 4 or more)? This question can be addressed when the new engineering standards are developed. Obviously, multi-trailer rigs will not move off their truck-only system, meaning there will be truck stops or hubs where they may break down to single trailers to go on to their final destinations. Weight limits, axle configurations and tire pressures can be changed to allow heavier loads in accordance with the new engineering standards. What economies might be captured using GPS guidance systems? The likely first candidate for this experiment in Colorado would be U.S. 287, which carries significant truck traffic to Texas.

Truck traffic counts comprise about 10 percent of vehicles but consume nearly 30 percent of highway capacity. Thus, removing trucks from some highways effectively would increase capacity by 30 percent for automobiles.

14. Transportation vouchers. Subsidies always should be used sparingly and with ongoing scrutiny, review and reconsideration. The economic rule that applies is, "Anything that is subsidized grows; anything taxed shrinks." The current model provides tax subsidies to transit bureaucracies such as RTD. The result is RTD grows to be bigger and more bureaucratic. As if the subsidies were not enough to exclude competition, RTD enjoys regulatory protections that make it illegal to compete directly. RTD subsidies (as well as regulatory protections) result in a closed market (a monopoly), erroneously called a "market failure." Taxpayer subsidies and regulatory protections have caused the transit market to fail. Rational public policy can restore the transit-mobility market.

Transit vouchers would increase the number of suppliers and increase competition, both of which always lead to better service at lower cost.

With deregulation, the problem can be remedied via transit vouchers. Rather than subsidize bureaucracy, subsidize mobility. More mobility is better than more bureaucracy. Those who need transit subsidies would get vouchers to spend like cash on any form of transportation available. Obviously, regulatory protections would need to be lifted to allow a private transit market to grow and compete. Transit vouchers would increase the number of suppliers and increase competition, both of which always lead to better service at lower cost.

15. Open transit to entrepreneurs. Deregulation is the process of allowing free entry to markets with service and price decisions but subject to appropriate safety regulations. Some regulations legitimately protect consumers. Other regulations serve to protect some businesses from competition. Regulatory protectionism benefits special interests who advocate for such regulation at the expenses of consumers. The notion that some industries are "natural monopolies" and can operate more efficiently as monopolies has been brought into question. Some natural monopolies recently deregulated include "airlines (1977), trucking (1980), railroads (1980), natural gas (1984), and long distance telephone (1984)."[37] The benefits of these deregulations, documented by the Brookings Institution, are not trivial. "The cost of service in inflation-adjusted-dollars declined 13 percent after two years, 22 percent after five years, and 40 percent after ten years."[38] Benefits to the U.S. economy are estimated at "$53.1 billion[39] per year or $200 per person."[40] A point to be taken from this example: these were private businesses and the profit motive without competition proved insufficient to motivate efficiency. When government monopoly services similarly are opened to competition, consumers reasonably should expect similar or larger magnitudes of benefits.

The General Assembly must update statutes to obtain unrealized gains from allowing the private sector to end the restrictions that prevent competition with RTD. Companies that move people are regulated by the Public Utilities Commission under the same general theory of monopoly that governs electric and gas service—an unnecessary restraint on free trade. Only safety need be ensured, and not the number of companies, number and types of vehicles, or the price structure.

The General Assembly must update statutes to obtain unrealized gains from allowing the private sector to end the restrictions that prevent competition with RTD.

The potential of decentralized transit was experienced in Miami, Florida, in 1989. Regulations that prohibited competition with government-owned buses were lifted accidentally by the Florida legislature. Within a few months 20 new firms using mini-buses existed, providing faster trip times, shorter wait times, flexibility in boarding locations and drop-off points, and availability of service in late evening. The $1.00 fare included no government subsidy. By the end of the year ridership was 25 percent of the bus system, at nearly 50,000 trips per week. Even though the mini-bus riders were primarily new transit users, the accidental legislative loophole was "corrected," putting dozens of entrepreneurs out of business and depriving a share of the transit market the use of more viable, more efficient, decentralized transit.[41]
The Miami experience occurred before GPS and current common use of cell phones, computers and the internet. Incorporation of new technologies with the

Miami experience would certainly yield a decentralized transit approach that would be inexpensive and viable to consumers.

Change the Way the State Finances Transportation

CDOT has responsibility for 9,144 miles of Colorado's 88,259 center-line miles of road. Interstate highways account for 956 miles (10.5 percent). Interstate highways generally account for one percent of center-line miles but carry about 20 percent of all traffic.

16. Establish an Interstate Highway Enterprise. The 2011 Federal reauthorization may allow more tolling of interstate highways. Colorado should create a new Interstate Highway Enterprise (IHE) that is financially self-supported via tolling. Revenue generated within a corridor must not be transferred to another corridor.

Colorado should create a new Interstate Highway Enterprise (IHE) that is financially self-supported via tolling.

Toll road authorities might achieve similar benefits at the local level. Rather than limit change to a statewide entity, this idea would create another mechanism for diminishing politics by allowing costs of services to be closer to those who benefit. Similar local government entities already have proven effective in Florida and Texas. The independent agencies are empowered by state statute to sell bonds, build roads and repay bonds out of new toll revenues.

Because the Colorado Constitution[42] requires gas tax revenue to be used for "public roads," other uses of gasoline are not subject to the HUTF (highway user trust fund) tax. The Colorado Department of Revenue has systems in place to refund tax to farmers, boaters, and manufacturers. The Colorado Constitution makes it illegal to collect gas tax from vehicles that pay a fee for use of a road. At 22 cents per gallon the gas tax is approximately equal on average to $0.01 per mile. Because IHE will use electronic toll collection, the $0.01 per mile can be refunded to users at the time of use.

The creation of IHE would reduce HUTF revenue by about 20 percent, requiring the fund sharing formula to be revised to keep city, county and CDOT revenues the same. HUTF is currently shared among CDOT, Colorado's 64 counties and 271 cities and towns by a sharing formula specified in state statute (62% state / 23% counties / 15% cities)[43]. The after-transition HUTF formula that would keep all entities whole is 52 / 29 / 19.

Colorado should set the goal of transferring all 956 miles of Interstate highways to IHE by 2020.

Colorado should set the goal of transferring all 956 miles of Interstate highways to IHE by 2020. IHE could be removed from direct oversight of CTC; instead, CDOT managers would lead the transition. Alternatively, IHE could function as a utility under the oversight of the PUC or similar new entity, to improve chances that IHE acts in the best interest of citizens. The phase-in sequence would look something like the following:

Year	Miles Transferred to IHE	Cumulative Miles
1	30	30
2	50	80
3	100	180
4	200	380
5	300	680
6	276	956

17. Public-Private Partnerships. Colorado's name for public-private partnerships (PPPs) is Public Private Initiatives. PPPs introduce opportunities to bring external talent, expertise, and resources to the table. Resources are virtually unlimited and may range from capital (as with the construction of E-470) to design-build (as with T-REX) that can shave both dollars and years from a project to operation and/or maintenance of facilities to anything or to any combination. Various other states have experimented with PPPs, but CDOT experience has been limited.

18. Open up institutional attitude. After passage of Colorado's PPI statute in 1995, CDOT authored facilitating guidelines. Unfortunately, the original guidelines were merely tolerant, and even could have been perceived as hostile or threatening. For example, CDOT can assess a "review fee" of any amount, unilaterally imposed on anyone bold enough to make a suggestion. Because many people are able to offer worthy ideas, CDOT's PPI guidelines should be simple, inviting, accessible, readily known, and rewarding to idea-generating people. The process should be easily understood and widely publicized. CDOT commissioned a study of best practices in 2001,[44] but there is no evidence that any of the study's pro-active PPI recommendations were considered and implemented or that the PPI guidelines were made friendlier. Over the years, "several unsolicited proposals have been received but none have moved forward."[45] "At times, proponents have felt CDOT to be adversarial."[46]

Because many people are able to offer worthy ideas, CDOT's PPI guidelines should be simple, inviting, accessible, readily known, and rewarding to idea-generating people.

19. Private Capital. One key finding from CDOT's 2001 best practices study[47] was that states such as Florida, Texas and Virginia were able to access billions of dollars in new private capital via transportation concessions.

The notion of an infrastructure bank exists in most states and in Colorado statute, but is non-functioning in Colorado. Functioning State Infrastructure Banks (SIBs) have proven effective in Texas, South Carolina and Missouri. Generally, they operate as any bank does, issuing loans that are repaid. SIBs pose a problem in that they can be a target for politicization of funds. Politicization, including converting loans into grants, must be avoided.

Because the Federal income tax code discriminates against privately-owned infrastructure, a SIB could be empowered with tax-exempt revenue bonds in order to level the playing field. That is, taxed bonds cost more than non-taxed government bonds by the amount of the tax rate. Thus, the cost-premium of private capital is about 30 percent higher. An infrastructure bank could provide to qualifying PPPs tax-exempt revenue bonds to finance PPP projects. A functioning infrastructure bank empowered with revenue bonds should be created as one of the pieces of a plan to invite and facilitate innovation and leadership to improve Colorado infrastructure.

Functioning State Infrastructure Banks (SIBs) have proven effective in Texas, South Carolina and Missouri.

DEVOLVE THE FEDERAL GAS TAX

People are usually shocked to learn the Federal government does not own any highways, airports, trains, harbors or transit facilities. Centralized collection of gas tax made sense to expedite the construction of the interstate highway system, which began in 1956 and finished in 1982. Coincidently, 1982 was the genesis of the explosion of Federal earmarks using transportation funds. The Federal gas tax of 18.4 cents per gallon generates about $40 billion per year. Some of the money is used to fund other programs such as mass transit, but much of it eventually finds its way to the states two years later with expensive conditions imposed on the states.

A Colorado dollar that cycles through Washington, D.C., is worth about 70 cents[48] when it gets home. Colorado is a donor state, meaning it gets less money back than it sends to Washington. At least 33 states[49] are donor states. Devolution of the gas tax to the states would equal 4.82 cent per gallon[50] revenue windfall to Colorado, equating to about $100 million per year in money paid by Colorado taxpayers. In 2003 the Colorado General Assembly passed Senate Joint Resolution 42 by a vote of 97 to 3, asking that the Federal gas tax be devolved to the states. Arizona passed a similar resolution. Congress ignored both. If Colorado passed the same resolution every year, other states will follow Colorado's lead. With resolutions from many states, Congress eventually will be forced to act.

Colorado is a donor state, meaning it gets less money back than it sends to Washington.

In short, Colorado would benefit not only from the additional $100 million per year but also from the 30 percent (equaling nearly $150 million per year) no longer donated to other states. Greater effectiveness of the remaining $500 million per year would be gained, due to the elimination of federal mandates, time delays and diversions to earmarks and to other programs, as well as gaining the benefit of setting priorities independent of federal coercion.

PARTIAL DEVOLUTION OF THE FEDERAL GAS TAX

Partial or gradual devolution may be more likely in the short term, phasing in the devolution over a few years. There are value-creating functions that merit consolidation at the Federal level such as research and safety standard conformity (public goods, in effect, that can be done once by a federal entity rather than many times by several of the individual states).

ACKNOWLEDGEMENTS

Dennis Polhill was primarily responsible for the content of this section. See his biographical material in the Authors section.

Wendell Cox reviewed this section for completeness and accuracy. Mr. Cox has been a visiting professor at a French national university and provided consulting assistance to the U.S. Department of Transportation and public transit authorities in Canada, Australia and New Zealand. He served as a certified expert for the Urban Mass Transportation Administration during its Public-Private Transportation Network program, the Amtrak Reform Council and three terms on the Los Angeles County Transportation Commission. He was elected chairman of both the American Public Transit Association's Planning and Policy Committee and the Governing Boards Committee. Mr. Cox is the author of scores of monographs and book chapters addressing urban sprawl and smart growth, transportation, mass transit, congestion, and demographic trends. He holds an MBA from Pepperdine University.

We extend our thanks to **Dobbs Hogoboom**. He contributed the initial research and wrote about managerial issues. Mr. Hogoboom is a 2008 graduate of Brown University with a Bachelor of Arts degree in American Civilization. He was a summer 2010 Intern at the Independence Institute, before accepting a position with the Clinton Foundation in Eastern Highlands Province, Papua New Guinea.

Randall O'Toole reviewed this section for accuracy and factual interpretation. He is a Cato Institute Senior Fellow working on urban growth, public land, and transportation issues and Director of the Independence Institute's Center for the American Dream. Among the many books he has authored is his latest, ***Gridlock: Why We're Stuck in Traffic*** and What to do about It, in which he presents a wide range of innovative ideas and policy recommendations for creating an effective transportation system. Mr. O'Toole has written numerous papers and articles, and speaks frequently about free-market environmental issues. He holds a degree in

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Bob Poole reviewed this section for content and accuracy. Mr. Poole is Director of Transportation Policy at the Reason Foundation. He produces Reason's monthly e-newsletter, Surface Transportation Innovations, and writes a monthly column on transportation policy for ***Public Works Financing***. He has advised the U.S. Department of Transportation and half a dozen state transportation departments on policy. Over the past 20 years, he has helped introduce a number of policy ideas, including long-term toll concessions, HOT lanes, and truck-only toll lanes. His research directly inspired the first state PPP law, enacted in California in 1989, that led directly to the first all-electronic toll road and the first U.S. long-term toll concession project. Mr. Poole received his B.S. and M.S. in mechanical engineering at the Massachusetts Institute of Technology.

We appreciate the tireless work of **Charles F. Riebe**. He expended extensive effort in the pursuit of performance measurement information and budgeting process of CDOT. His career included serving as a Regional Maintenance Engineer for the National Park Service and as an Assistant Superintendent for Interstate Highway Construction. Mr. Riebe is a licensed professional engineer who also owned and operated 6R Corporation, a private engineering consulting business. He holds a Bachelor of Science in Civil Engineering from Montana State University and completed graduate studies in business administration and economics at the University of Maryland.

Endnotes

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Appendix

Table 1. CDOT Highway Responsibility[51, 52]

Year	Highway Miles	Lane-Miles	VMT (billion)	Budget	Population
1970	9,007	20,190	8.6	Not found	2,209,596
1985	9,201	22,491	16.1	$437,819.000	3,092,065
1987	9,198	22,440	26.4	$367,166,000	3,185,747
1990	9,169	22,751	27.6	$405,840,000	3,294,394
1996	9,137	22,543	36.0	$601,472,000	3,957,160
2010	9,144*	23,000*	40.0*	$973,515,000	4,831,554*
2035	9,200*	24,000*	46.7*	Not available	6,371,593*

*estimated

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CDOT Debt

The Colorado Department of Transportation (CDOT) currently budgets $168 million annually to service debt on Tax Revenue Anticipation Notes (TRANS) issued during the Owens administration. This level of debt service will continue until 2016. These bonds were issued in order to build the I-25 Southeast Corridor through Denver (known as "T-REX"), including the light rail line running parallel to I-25. The same bonds also financed new transportation construction throughout other areas of the state. In 2017, payments drop to $130 million, the year in which this outstanding debt will be retired.

Funds for annual payments come from the State's gas tax and federal transportation revenues remitted to Colorado. The payments are mandated to be made before any money can be spent for operations, maintenance or construction. All this debt is contractual in nature. Investment banks will monitor the current outstanding debt and suggest refinancing if it is economically feasible to do so.

While this level of debt service is large, it is not the major concern with CDOT debt.

While this level of debt service is large, it is not the major concern with CDOT debt. All the current outstanding debt was voted on by the people. In 2009, new legislation[1] reconstituted the Colorado Tolling Authority as the High Performance Transportation Enterprise and created a second enterprise called the Statewide Bridge Enterprise. Enterprise status enables the state to move significant categories of expenditures off the books of state government operations, and thereby enables borrowing without a vote of the people.[2]

The Statewide Bridge Enterprise forecasts that revenues will exceed $100 million annually after a three-year phase-in period. Elected officials raise these revenues from a surcharge, the Bridge Safety Fee, levied as part of the new vehicle registration fees. The enabling legislation is wrong in several ways. It is really a tax, not a fee. The charge is based on the weight of each truck and not on the frequency that any particular truck uses a Colorado bridge. As a tax, it required prior voter approval, which was never requested.

Nor is the so-called "Bridge Enterprise" really an independent enterprise under the constitutional definition. According to the state constitution, an "Enterprise" is a "government business … .. receiving under 10% of annual revenue in grants from all Colorado state and local governments combined."[3] Examples of an Enterprise envisioned in TABOR would be a government-owned parking garage or a university dormitory, each functioning independently, and the cost of building and operating each facility funded directly by those who use it. The Bridge Enterprise is based on the erroneous concept that a surcharge collected as part of a general vehicle registration is somehow not government revenue collected at large and granted to the enterprise.

The Bridge Enterprise is based on the erroneous concept that a surcharge collected as part of a general vehicle registration is somehow not government revenue collected at large and granted to the enterprise.

A hundred million dollars of annual revenue would allow the Bridge Enterprise to service an enormous amount of debt. One rule of thumb would place the estimate at 15 times the funds available to service the debt, or about $1.5 billion. The state has transferred title to many bridges into the name of the Enterprise at this point. While the debt incurred by the Enterprise is "technically" not debt of the State of Colorado, if economic issues cause a potential default or cause other problems with the repayment process, the State of Colorado will be implicated.

Perhaps the most disturbing aspect of this entire discussion of CDOT debt is the fact that major portions of the function of the agency are being moved "off budget" for the state. These enterprises are required to report to the state each year, but technically are not constrained by the legislature. If substantial debt is issued by either or both of these entities, the result simply will be a further reduction in trust in government.

Acknowledgements

We appreciate the substantial leadership and work contributed by **Dick Murphy,** who researched and authored this section. He has made a career as an institutional money manager and financial advisor, operating his own firm since 1991. He earned a Ph.D. in Economics from Iowa State University and taught at various colleges and universities before coming to Colorado in 1974. Dr. Murphy provided expertise in Colorado in public school finance, and under the tenure of different Colorado State Treasurers, managed the State Treasury from 1976 to 1980 and again in 2003-2004. Dr. Murphy managed institutional taxable sales and trading operations for regional brokerages before starting his own firm.

Endnotes

[1] Senate Bill 09-108.

[2] Defined in the Taxpayer's Bill of Rights, Article X, Section 20 of the State Constitution (paragraph 2(d)), an enterprise is a government entity that receives less than 10 percent of its income from tax subsidies, and has the power to bond. It is meant to operate as a business. The 10 percent limit on tax subsidies is a total from all sources.

[3] Taxpayer's Bill of Rights, Article X, Section 20, paragraph 2(d).

Old Age Pension Plan

Citizens are rightly concerned about the future stability of the Social Security Administration in Washington. They know the promised benefits are higher than the expected income from FICA taxes.

Even so, Colorado has maintained the Old Age Pension Plan since its inception in 1937. A recipient may qualify even if he or she has never paid any taxes in Colorado. Out of the sales taxes collected for the State, the Colorado Constitution requires that 85 percent be diverted to this program. Only after the program is fully funded may the rest of the diverted funds be returned to the General Fund. The funding is automatic and off-budget, as far as the legislature's ability to adjust either the flow of funding or the amount spent each year. The total cost of the program in fiscal year 2008-09 was $100.1 million. According to the preliminary figures for the year just ended and the projections for the current budget, the amounts each year generally should be about the same. The program is an entitlement, so that anyone who qualifies may obtain the distribution. Funds are continually appropriated based on program demands, and not budgeted by the legislature. This program cost $5.7 million in 2008 to administer, equal to 5.6 percent of the program.

...Colorado has maintained the Old Age Pension Plan since its inception in 1937. A recipient may qualify even if he or she has never paid any taxes in Colorado.

Back in the depths of the Great Depression, 38 (of the then-48) states operated old-age assistance plans, and Colorado's was the most generous.[1] The pension plan was passed in the 1936 general election as Article XXIV of the State constitution. The structure was modified in the 1956 general election to its current status. With the establishment of the federal Social Security System, most other states quickly dropped their programs. Colorado today is the only state with its own old age pension plan.[2]

To qualify one must be a resident of Colorado over age 60 and meet the need-based standard for eligibility. On the first day a person declares himself a Colorado resident, he becomes eligible to receive a free pension from taxpayers. A requirement that the beneficiary needed to reside in Colorado for 35 years was overturned by the Colorado Supreme Court in 1979.[3] Based on the federal "Personal Responsibility and Work Opportunity Reconciliation Act of 1996,"[4] a person does not even need to be a U.S. citizen. A legal immigrant may receive these benefits, as long as the sponsor rules have been met.[5] The Old Age Pension provides financial benefits up to $699 per month to nearly 24,000 beneficiaries.

On the first day a person declares himself a Colorado resident, he becomes eligible to receive a free pension from taxpayers.

Many forms of income—such as wages, social security benefits, disability benefits, pension or Veteran's Assistance—can reduce the amount paid by the Old Age Pension. Some applicants are required to apply for federal Supplemental Security Income benefits as a condition of receiving the Old Age Pension and the SSI benefits reduce the amount of the Old Age Pension. However, owning a residence does not disqualify a Colorado resident from receiving the pension and there is no limit to the size and value of that property. If someone can maintain a large estate and pay its taxes, that person still may qualify. The presence of relatives who may be able to contribute to the pensioner's upkeep is no condition for disqualification by law. Beneficiaries never need to pay back the moneys, even if they come into an extraordinary amount of new income or assets.

Plenty of existing state and federally funded programs assist the elderly with their living expenses, including energy rebates, Meals on Wheels, Medicaid and Medicare. Colorado allows income tax filers to shelter a portion of pension earnings from the state income tax. In strong revenue years for the State, many elderly residents do not pay property taxes on the first $200,000 of their homes' values. The Old Age Pension Plan is the only program to offer direct income assistance through stipend payments.

The Plan is even more generous than Social Security in the sense that, unlike the federal program, beneficiaries do not need to show they have ever earned income, lived in the state before applying for benefits, nor ever paid any taxes of any nature to Colorado. Social Security must be earned with 40 quarters of employment at a minimum wage (today it is $1,220 per quarter of employment), although supplemental security income (SSI) for the disabled does not have that requirement. The Colorado Supplement program fills in the amounts of SSI benefits that are not fully paid by the federal government, and the Old Age Pension covers those not covered by Social Security or SSI.

The Plan is even more generous than Social Security in the sense that, unlike the federal program, beneficiaries do not need to show they have ever earned income, lived in the state before applying for benefits, nor ever paid any taxes of any nature to Colorado.

Colorado at some point may be forced to cancel the program, if it becomes a magnet state to draw in the elderly poor. According to the Social Security Reform Center, Social Security will run into an inevitable funding problem as it begins to pay out more in benefits than it receives in taxes. If benefits are curtailed, people may find the incentive to move to Colorado in order to replace the lower federal Social Security benefits.

A modest attempt at reforming the Old Age Pension Plan, Colorado House Bill 1384, was passed and signed by the Governor in the past legislative session. It requires a five-year waiting period for legal immigrants to the U.S., and requires that a sponsor's resources be counted for eligibility except in unusual circumstances. The legislation follows an earlier attempt by State Representative Jack Pommer (D-Boulder), who withdrew HB 1353 before its first vote in the chamber of origin, citing citizen backlash.[6] Although the earlier bill's Fiscal Note showed annual savings would be $24.5 million[7] from all sources, the later bill saved about half that amount.[8]

The assumption of incapacity at old age has greatly diminished over the years. Most people now do not make a living in menial tasks that become ever more difficult as we age. The person exhausted at age 60 by physically demanding work to the point of being forced into retirement is a rare occurrence. Most 60 year olds are rather hale, and physical decline to the point of being invalided is rare. For those so disabled for any of a host of reasons, there are other Human Services programs.

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When the Old Age Pension was put into place in 1936, the earliest age to qualify was 65 years old. At that time, an individual attaining that age could expect on average an additional 12.6 years of life. When the age was lowered to 60 years in 1956, the average person at that age could expect to live 17.5 more years, and a person 65 years old could expect another 14.2 years of life. Today, the average person who reaches 60 years old has an expected actuarial lifespan of 21.8 more years. In order to return to the assumptions of the initial deal, the qualifying age should be raised to 73 years old. To assume the longer lifespan expected of a 65-year-old person in 1956, the qualifying age only would need to go up to 70.[9]

All parsing of actuarial lifespan aside, the larger question of the Old Age Pension's validity remains. The program provides a direct and unapologetic redistribution of income from the younger segment of society to an older group. No one need pay into the fund at any point during his or her working life. Indeed, people from outside the country are eligible for these benefits (with the correct sponsor requirements), although they may now be subject to a five-year waiting period. There are a host of other funded assistance programs for the elderly. The Old Age Pension is a redundancy and an anachronism.

The program provides a direct and unapologetic redistribution of income from the younger segment of society to an older group.

A repeal of the program would require some minor reorganization. Spending on the Old Age Pension program is used by the Department of Human Services as matching funds with the Social Security Administration in a formal agreement known as a Maintenance of Effort (MOE). A 2008 document produced by the state legislature's Joint Budget Committee explains:

> The MOE agreement specifies that the State must maintain expenditures at the same level as the highest previous calendar year. If the Maintenance of Effort agreement amount is not met, the State risks the loss of over one billion dollars of Federal matching funds in the Medicaid program.[10]

The Department of Human Services already uses other assistance programs for the elderly to support the matching funds. Other states use general assistance program funding to the same purpose, since those states lack such a general pension plan. Colorado can repeal the Old Age Pension without jeopardizing matching federal program funds if the Department of Human Services includes a step in the transition to modify the MOE through the identification of other supporting programs dollars to insert into the MOE.

To repeal the Old Age Pension Plan would take a vote of the people, and one that could not be scheduled before the next general election in 2012. If it were to pass, some modest transition time would likely be built into the measure, so the reduction in spending would likely impact the 2012-13 budget year.

ACKNOWLEDGEMENTS

Penn R. Pfiffner was primarily responsible for the content of this section. See his biographical material in the Authors section.

We extend our thanks to **Don Bammes**. He contributed to the basic documentation of the program and researched the requirements to qualify and the application procedures. Mr. Bammes is a retired regional sales and marketing executive in the construction industry, and currently operates a private consulting practice. He serves on the Board of Directors of the TABOR Foundation and is active in local politics in Douglas County. He earned a Masters degree in Marketing from Webster University and an MBA from the University of Phoenix.

A substantial portion of the research of the facts and figures in this section was conducted by **Sam Beck**. Mr. Beck is an economics major with Senior credits at the University of Colorado at Boulder. Mr. Beck is working as an intern at the Independence Institute in the summer and fall of 2010. He will pursue a career in government after his anticipated graduation in May, 2011.

We want to thank Budget Analyst **Amanda Bickel** at the Joint Budget Committee for clarifying information on budget expenditures for this program.

We extend our thanks to **Richard Bratten**. He contributed the research on the actuarial figures within this section. Mr. Bratten is Partner of Bank Financial Services Group, a national firm specializing in non-qualified benefit plan design and funding. He holds designations as a Fellow, Society of Actuaries (FSA) and as a Chartered Financial Analyst (CFA Charter). He has 21 years of experience in the field after a first career teaching math and physics in high school. He is also the volunteer executive director of the Republican Study Committee of Colorado. He earned a degree in Education from the University of Cincinnati.

We want to thank Financial Officer **Cheryl Duncan** in the Division of Aging and Adult Services for confirming information regarding the use of Old Age Pension Plan funds in the Maintenance of Effort agreement for Medicaid.

We extend our thanks to **Justine Fink** of the American Legislative Exchange Council. When no current research could be located on the history of other states' terminations of similar programs, she conducted a census of all the states (not a survey of some select states), using direct interviews and web-based research. Ms. Fink is a research assistant at ALEC and a business major at James Madison University studying Marketing and Economics.

The **Honorable Phil L. Pankey** graciously reviewed the material presented in this section for factual interpretation. He served in the Colorado House of Representatives from 1983 to 1998, during which he sponsored legislation dealing directly with this issue. In his private life, Mr. Pankey started and built a large medical accounting firm. He earned a master's degree in Marketing from the University of Colorado at Boulder.

Endnotes

[1] As reported by the Colorado Welfare Director, Earl M. Kouns, Colorado paid $30 on top of the $15 sent by the Social Security Administration, the highest average in the nation. "Discord Between Various Factions Are Smoothed Out; Question of Raising Huge Sum is Big Problem for the Legislature," Gene Cervl, *Denver Post*, November 5, 1936, pg. 6.

[2] Justine Fink, Tax and Fiscal Policy Task Force of the American Legislative Exchange Council. "Census of States' Pension Plans." Unpublished paper, July 2010.

[3] *Jeffrey v. Colorado Department of Social Services*, 198 Colo. 265, 599 P.2d 874 (1979).

[4] Public Law 104-193.

[5] Colorado Revised Statutes § 26-2-137(2).

[6] Tim Hoover, "Bill to Close Old Age Pension Loophole Withdrawn" *Denver Post*, March 18, 2010, http://www.denverpost.com/politics/ci_14696624 (accessed July 23, 2010).

[7] *Actuarial Study No. 120*, Felicitie C. Bell and Michael L. Miller; found at www.socialsecurity.gov/OACT/NOTES/actstud.html; 2001 CSO Table (as a cross-reference for the information from Actuarial Study 120 as well as for use in some interpolation) which can be found at http://www.actuary.org/life/cso_0702.asp.

[8] Cost of Living Adjustment decision item, 2010 Schedule 13 Change Application, October 15, 2008, pg. DI-21-4.

[9] HB10-1353 State Fiscal Impact, February 22, 2010, http://www.leg.state.co.us/clics/clics2010a/csl.nsf/fsbillcont3/3EDCB43A4CCACD2E872576AA00696A8F?Open&file=HB1353_f1.pdf.

[10] HB10-1353 State Fiscal Impact, April 1, 2010, at http://www.leg.state.co.us/clics/clics2010a/csl.nsf/fsbillcont3/22B43CC0B2DB612B872576F10065FD4D?Open&file=HB1384_r1.pdf.

Corporate Welfare

We use the inflammatory term "corporate welfare" to draw attention to a proposal for a significant rethinking of policy executed at the State level. It is likely to bring together liberals and progressives doubtful about direct subsidies to business with fiscal conservatives and libertarians.

Many elected leaders have pushed for government to contribute tax dollars to private businesses. The newest vision is that of Governor Ritter to create a "green energy" industry in Colorado. The intent of such redistribution programs is for government to intervene in the economy so that new jobs are created where otherwise none would be. These jobs then supposedly will multiply through the economy as wages from the jobs and purchases of materials and other inputs provide new income to supporting businesses. It is the dream, vision and expressed intent behind the Obama administration's American Recovery and Reinvestment Act (ARRA) stimulus funding, and the hope of governments at all levels. Yet it is increasingly understood that such programs actually result in a lower general standard of living.

Policy makers often overlook that resources given to a business must come from somewhere else where they could have been better used in alternate ways. Economists observe that "the real cost of something is what you have to give up to get it." The real costs of the Ritter administration's green energy jobs are all the lost opportunities to use the labor, resources and capital for other, more productive things in the economy. Misunderstanding this crucial point is the fallacy of the broken window writ large. [1]

A person will decide what to purchase based on an opinion of what will make him or her better off. When government steps in with a prohibition, a regulation or an incentive, it adversely changes the decision and prevents the actor from taking that best step. If a state-provided incentive is used, the cost is lowered for the decision-maker by forcing someone else to pay the difference.

The cost of competing with other states to win the favor of firms wastes resources. Studies going back decades call the practice into question. A comprehensive paper on the practice found:

> Some evidence exists that incentives have the potential to move jobs from one state to another intraregionally; but no evidence exists that incentives actually create new jobs. This intraregional job heist has been dubbed 'begger (*sic*) thy neighbor' strategy by Timothy Schellhardt of the Wall Street Journal (1983).
>
> The fact that states continue to compete among themselves through business inducements despite the evidence that the competition is generally counterproductive is an obvious anomaly for students of state government and policy. Furthermore, this competition is more than a theoretical concern since these inducements

The "broken window fallacy" is an allegory of a young hoodlum breaking a baker's window. The townspeople are happy that the glass maker is now employed and that the moneys will invariably filter into the local economy. The young hoodlum is viewed as a benefactor to the town's economy. The fallacy is in "what is not seen." The baker would have used the money on something that would make him happier, such as buying a new suit. The tailor in turn is deprived of an income, the baker is worse off for buying something he already possessed, and the townspeople are deprived of a tangible good in their economy. The "young hoodlum" can serve as a metaphor for governmental manipulation of the economy.

> represent a substantial investment of state resources.[2]

Others' research has led to a call for terminating the programs:

> Some economists claim that so long as incentives are directing firms to areas with high unemployment, these policies are wonderful. In fact, the free market already does this, directing resources to where they are in greatest demand and cheapest to employ. State financial packages can only distort prices and resource allocation.
>
> The whole institution of the state development agency needs to be scrapped as a futile and frequently corrupt effort in economic planning that only ends up redistributing other people's money. What we need is a free market within the states and economic competition among states, not a war among state government agencies.[3]

The progressive Economic Policy Institute has come to similar conclusions, based on the research of Robert Lynch of Washington College, who has studied the issue of corporate welfare for 20 years. Lynch argues that these incentive packages "rarely cause firms to expand in geographic areas that they would not have otherwise expanded to without state incentives."[4]

The whole institution of the state development agency needs to be scrapped as a futile and frequently corrupt effort in economic planning that only ends up redistributing other people's money.

There are instances when a state can buy the favor of a firm with a large incentive package. Milwaukee bought 200 Frontier Airline maintenance jobs, wooing them from Colorado by offering $27 million in incentives compared to the $16.5 million Colorado offered.[5] Milwaukee now has 200 jobs it may have gained in any case, but arguably it is not 200 jobs richer. Paying $135,000 for each new job is likely to have caused net damage to the City's economy.[6]

In the words of economist Russ Roberts, "it's like taking a bucket of water from the deep end of a pool and dumping it into the shallow end. Funny thing—the water in the shallow end doesn't get any deeper." [7] To make things even worse, there are economic "leakages" that take place—the inefficiencies, false starts and mistakes that occur when someone in charge does not have his own money at risk. It is like moving swimming pool water with a bucket that has holes poked in it. The faster you try to move the water, the faster resources are depleted and wasted, and the more our standard of living declines.

Local and state economic development agencies have been too silent about failures. Projects and businesses financed with tax dollars occasionally fail or do not permanently relocate to Colorado.

Local and state economic development agencies have been too silent about failures. Projects and businesses financed with tax dollars occasionally fail or do not permanently relocate to Colorado. The Intel plant in Colorado Springs was a high priority for people looking to secure a "basic industry" for the state and generous tax incentives were used to lure the company. When the market for computer chips changed soon thereafter, Intel closed the plant and moved its operations out of state. First Data Corporation moved its headquarters from Greenwood Village to Atlanta in 2009; economic incentives did not matter when the new C.E.O. decided that Atlanta was closer to the company's customers.[8]

The central justification for making the incentive decisions is that the elected officials and the government employees who serve them are expert, knowledgeable people who know better than the citizen or individual investor about what business is best suited to be wooed. The economist Hayek calls this justification the "fatal conceit" that hands over unwarranted power to people who cannot possibly have all the information that resides in the millions of actors who make up a market.

We believe the entire "green energy" effort is slowing economic recovery and very likely does not represent the strongest investment. The state legislature[9] has mandated that fossil fuel-based energy sources be curtailed and that 30 percent of the energy consumed in Colorado by 2020 be generated from solar and wind power.[10] Direct costs paid by energy consumers to a utility provider act as a new tax, but the focus here is only on the economic development part of the equation.

We believe the entire "green energy" effort is slowing economic recovery and very likely does not represent the strongest investment.

From 2005 to 2009 the legislatively-created and politically-appointed Economic Development Commission and local governments spent just under $13 million in direct subsidies. Matching funds from local agencies and governments more than double the cost to $27 million. Tax credits undoubtedly were a far larger part of subsidizing businesses. The Economic Development function, housed within the Governor's budget, will spend $3.4 million of General Fund moneys in the current fiscal year, and an additional $2.7 million for job training.[11] Money over the past four years went to directly support about 57 companies. About half of them are large, publicly-traded international and national companies. Seven are dedicated to "green" activities such as wind and solar power.[12]

Colorado has paid for bioscience grants.[13] The theoretical justification for the state's funding of bioscience is the alleged existence of a "market failure" and the inability to serve the public good at optimal levels without the state's intervention. The cost to the taxpayer was also that the free market would have employed researchers to pursue alternatives with higher potential. By contrast, computer technology also benefits society, but the state was not central in the development of the computer industry. Even without state intervention, rapid advancement of technological efficiency continues as computers become faster and cost less.

Another unstated assumption has to be that the target company does not know and cannot accurately predict the extent of its contribution. If a company understands the cost-benefit analysis for each community under consideration, it can continue to negotiate increasingly higher subsidies. A rational economic development agency will stop only when the analysis shows the additional costs of bringing in the new company begin to exceed the benefits.[14] At that point, there is no net gain to the town or state that attracted the new company. Instead, the agency must hope the target company has inept negotiators or is unable to quantify on its own how much net value a subsidy is worth—usually not a good bet. Where negotiations are successful for the agency, look to the strong possibility that the investing private firm had already decided to move into the community, but was looking for a hand-out to sweeten the deal.

When it comes to economic development, citizens should demand that governments at all levels enforce contracts, protect property rights and curtail "externalities." Individuals should be left to function unimpeded by bureaucrats, undirected by politicians and left to enjoy their work rather than have it spread around by agents who neither started the enterprises nor contributed to the value the enterprises created. In 1680 the powerful French finance minister Jean-Baptiste Colbert asked a delegation of merchants and other men of commerce what the state could do to help them. Their answer was simple and resonates today: "Leave us alone."[15]

When it comes to economic development, citizens should demand that governments at all levels enforce contracts, protect property rights and curtail "externalities."

Colorado benefits from the reminder that the state constitution strictly prohibits taking on public debt for companies and very explicitly prohibits any appropriation to be made "for charitable, industrial, educational or benevolent purposes to any person, corporation or community not under absolute control of the state … ."[16] "Corporate welfare" on its face is a violation of the state constitution.

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Sam Beck assisted in the research. Mr. Beck is an economics major with Senior credits at the University of Colorado at Boulder. He is working as an intern at the Independence Institute in the summer and fall of 2010. He will pursue a career in government after his anticipated graduation in May 2011.

Fred Holden graciously reviewed this section for accuracy and completeness. He is a Senior Fellow with the Independence Institute and a public policy specialist, speaker and author of two books, ***TOTAL Power of ONE in America*** and ***The Phoenix Phenomenon***. Mr. Holden's career included working for Adolph Coors Company sequentially as a Facilities Engineering Manager and then Director of Economic Affairs. He later served as Jefferson County Deputy Treasurer. He earned an engineering degree from the University of Colorado at Boulder and an MBA from the University of Colorado at Denver.

Sean Paige provided historical insights for economic development failures. He is a City Councilman in Colorado Springs and the Director of Local Liberty Action. He also is the Executive Director of the Limited Government Forum. His career included work as the editorial page editor of the ***Colorado Springs Gazette.*** He received his education at Arizona State University.

We appreciate the review of this material by **Paul Prentice**, a Senior Fellow in at the Independence Institute and an Adjunct Scholar at the Ludwig von Mises Institute. Dr. Prentice owns a consulting practice, Farm Sector Economics, Inc., which analyzes macroeconomic developments and their implications for agriculture. He also teaches at The Vanguard School in Colorado Springs. Dr. Prentice's career included work as the Chief Macroeconomist at the Department of Agriculture's Economics Research Service under both the Carter and Reagan administrations, and as a Visiting Scholar at the U.S. Department of Treasury under the Clinton Administration. He obtained his doctorate in agricultural economics from the University of Connecticut.

Eric Wilson performed a great deal of the research in this section. He is a 2010 graduate of the University of Colorado at Denver, with a degree in history. Mr. Wilson worked as an intern at the Independence Institute during the summer 2010. He is preparing for a graduate degree in economic policy at the London School of Economics external studies program.

ENDNOTES

1 See Henry Hazlitt, *Economics In One Lesson* (New York: Arlington House Publishers, 1979), pgs. 23-24.

2 Dennis O. Grady, "State Economic Development Incentives: Why Do States Compete?" *State & Local Government Review* 19, no.3 (Autumn 1987), pg. 87.

3 Peter T. Calcagno, "Can States Buy Businesses?" *The Free Market: Mises Institute Monthly* 17, no. 4 (April 1999), http://mises.org/freemarket_detail.aspx?control=30.

4 Robert G. Lynch, *Rethinking Growth Strategies:*

How State and Local Taxes and Services Affect Economic Development (Washington D.C.: Economic Policy Institute, 2004).

[5] Renee McGraw and Ed Sealover, "Can Colorado Do More To Keep Company Headquarters?" *Denver Business Journal*, April 30, 2010.

[6] Stacey Vogel Davis, "People Speak Poll," *The Business Journal Serving Great Milwaukee*, June 25, 2010.

[7] Russell Roberts, "Presidential Economics: What Leaders Can And Cannot Do About The State of the Economy," Library Of Economics And Liberty, http://www.econlib.org/library/Columns/y2004/Robertsleaders.html.

[8] McGraw and Sealover.

[9] Before the legislative mandate, a plebiscite started the trend. In 2004, then-Speaker of the House Lola Spradley led an initiative that demanded 10 percent of alternative forms of energy constitute citizens' energy consumption on or before 2015. Amendment 37 passed by 52-48.

[10] Other options include nuclear-generated steam, hydroelectric plants, or geothermal plants. These options suffer from one or more impossibly large regulatory burdens, and/or rare few workable locations, or other deficiencies that drive per unit costs into stratospheric heights.

[11] Appropriations legislation for 2010 budget, House Bill 1376.

[12] Colorado Office of Economic Development and International Trade, *Annual Reports*, 2006 through 2009.

[13] Colorado Office of Economic Development and International Trade, *Bioscience Discovery Evaluation Grant Program*, http://www.colorado.gov/cs/Satellite/OEDIT/OEDIT/1167928017742.

[14] Although, as discussed above, the economic development agency first must ignore the information created by the producers and consumers in the polity who have found through the trial and error of the market what the best investment would be.

[15] "*Laissez-nous faire*," from which the term "laissez-faire capitalism" is derived. Compare with the interventionist policies of public-private partnerships and other government direction of the economy. The French economist and statesman Anne-Robert-Jacques Turgot writes of this episode in *Eloge de Vincent de Gournay* (1759). Quoted in Murray N. Rothbard, "Biography of A.R.J. Turgot," http://www.Mises.org/resources/3244.

[16] Article XI, Section 1. "Pledging credit of state, county, city, town or school district forbidden," and Article XI, Section 2. "No aid to corporations - no joint ownership by state, county, city, town, or school district," and Article V, Section 34. "Appropriations to private institutions forbidden."

Revenues from Tobacco "Master Settlement Agreement" of 1998

Since 2000, Colorado has received $1.05 billion in payments from the multi-state lawsuits against cigarette manufacturers, lawsuits that resulted in the 1998 Master Settlement Agreement (MSA) between 45 states and the nation's four largest cigarette manufacturers.

Since 2000, Colorado has received $1.05 billion in payments from the multi-state lawsuits against cigarette manufacturers, lawsuits that resulted in the 1998 Master Settlement Agreement (MSA) between 45 states and the nation's four largest cigarette manufacturers.

In 2009, annual payments to Colorado reached a peak of $112.8 million, but fell to $94.6 million for 2010. In addition, beginning in 2006, some participating manufacturers began to withhold a portion of their scheduled payments, contending that Colorado was not adequately enforcing portions of the MSA that called for certain annual payments to the state from smaller tobacco manufacturers which were not party to the original settlement.

MSA revenues are allocated according to a complicated formula set forth in law.[1] Primary beneficiaries (aka "Tier 1") of these revenues are:

- Children's Basic Health Plan, 24 percent of MSA revenues, not to exceed $30 million and not less than $17.5 million.
- Nurse Home Visitor Program, 13 percent in FY 2009-10, rising 1 percent per year to 19 percent by FY 2015-16, and not to exceed $19 million.
- Fitzsimons lease purchase, 8 percent, not to exceed $8 million.
- Read-to-Achieve and related education grants, 5 percent, not to exceed $8 million.
- Tony Grampsas Youth Services Program, 4 percent, not to exceed $5 million.
- HIV/AIDS drug assistance program, 3.5 percent, not to exceed $5 million.
- Comprehensive primary and preventive care grants, 2 percent, not to exceed $2 million.
- HIV/AIDS prevention grants, 2 percent, not to exceed $2 million.
- State veterans, 1 percent, not to exceed $1 million.
- Autism treatment fund, $1 million annually.
- Child Mental Health Transplant Act, $300,000 annually.
- Dental Loan Repayment Program, $200,000 annually.

Any funds remaining after the above allocations have been met are then distributed as follows:

- University of Colorado Health Sciences Center, 49 percent.
- Children's Basic Health Plan, 13.5 percent
- Mental health services for juvenile and adult offenders, 12 percent.
- Local public health services, 7 percent.
- Short-term grants for innovative health programs, 6 percent.
- Supplemental state contribution for group benefit plans, 4.5 percent.
- Colorado Immunization Program, 4 percent.
- Alcohol and drug abuse treatment programs, 3 percent.
- Children's Hospital Medicaid shortfall, 1 percent.

In many cases, MSA revenues pay for programs that otherwise would be funded by general fund tax revenues. In other instances, MSA funds were used to fuel new programs.

While anti-tobacco advocates argue that MSA revenues should be earmarked for anti-tobacco education and cessation and to pay for state health care costs related to tobacco use, the MSA does not stipulate how the funds must be spent. Moreover, the state lawsuits argued that cigarette manufacturers should pay states for money they had previously spent on tobacco-related illnesses – i.e., money that otherwise would have been spent on other budget priorities not related to health care.

Thus, lawmakers have flexibility to spend this money on a wide variety of budget priorities determined annually. Expenditures should be re-examined annually to specifically determine whether funded programs are resolving the problems they purport to address or merely are adding to the perpetual, caseload-driven spending bureaucracy.

Acknowledgements

Mark Hillman wrote this section. Please see his complete biography in the Author's section.

Additional Resources

Office of the State Treasurer, Tobacco Revenues table, 2000-2010 (June 2010).
Joint Budget Committee, FY 2010-11 Appropriations Report, Appendix G.
Congressional Research Service, ***Tobacco Master Settlement Agreement (1998): Overview, Implementation by States, and Congressional Issues***, Nov. 5, 1999.

Endnotes

[1] Colo. Rev. Stat. § 24-75-1104.5.

THE CASE FOR FURTHER SENTENCING REFORM IN COLORADO

"We have acted under a belief that no price is too high to pay for protecting the public from crime and have generated incarceration costs that now consume huge proportions of corrections budgets, all to the detriment of programs that corrections professionals know to be crucial to any hope of converting offenders into law-abiding citizens."
Robert G. Lawson, University of Kentucky Professor of Law, "Difficult Times in Kentucky Corrections—Aftershocks Of A 'Tough On Crime' Philosophy"

"It is a far better policy to provide for a marginally earlier release for select offenders than it is to perpetuate a business-as-usual system that simply is not sustainable."
Ari Zavaras, Executive Director, Colorado Department of Corrections, and
Pete Weir, Executive Director, Colorado Department of Public Safety, ***Denver Post***, August 30, 2009

The first and most basic duty of Colorado's criminal justice system is to protect the innocent from force and fraud.

The first and most basic duty of Colorado's criminal justice system is to protect the innocent from force and fraud. And as a government service, the roughly $32,000 (average cost)[1] taxpayers spend annually per state prisoner is a good bargain for the separation of violent and predatory criminals from the public.

While this extreme prison spending spree has been bipartisan in nature, the participation over the years of lawmakers who consider themselves "fiscal conservatives" is particularly troubling. As such a dramatic increase in the questionable use of incarceration as a crime control strategy, and the attendant runaway prison spending violates many of the principles generally associated with a "fiscally conservative" political philosophy.

But over the last several decades Colorado has embarked on a massive incarceration campaign. This campaign has in turn required an extreme and unprecedented state spending spree that has pushed corrections spending in Colorado from less than 3 percent to almost 9 percent of Colorado's General Fund appropriation, with an often less-than-clear public safety benefit.

While this extreme prison spending spree has been bipartisan in nature, the participation over the years of lawmakers who consider themselves "fiscal conservatives" is particularly troubling. As such a dramatic increase in the questionable use of incarceration as a crime control strategy, and the attendant runaway prison spending violates many of the principles generally associated with a "fiscally conservative" political philosophy. These principles have traditionally included:

- A commitment to limited and constitutional government;
- A desire to reduce the influence of government in people's lives;
- Keeping the burden of taxation as low as possible;
- A healthy skepticism towards the creation of new state agencies, laws and programs, and the expansion of existing state agencies and programs;
- A critical view towards tax dollars and public policy as a tool of social engineering; and
- A fiscally conservative general attitude towards state government spending.

State spending does not drive the prison population. Rather, just like an entitlement, the prison population drives state spending. The legislature's ability to affect the prison caseload, and thus the corrections budget, rests in its prerogative to write, and when necessary, re-write the state's criminal sentencing and parole laws and policies.

On May 25, 2010, Governor Bill Ritter signed into law a significant package of sentencing and other criminal justice-related reform bills.[2] Many of these bills were generated from the work of the Colorado Commission on Criminal and Juvenile Justice (CCJJ).[3] As the Governor, a former prosecutor, correctly noted at the signing, "There is no easier place to get it wrong" than when it comes to issues of crime and punishment.

With that in mind, our purpose here is not to make any specific sentencing, criminal law or parole reform recommendations, but rather to make the case for legislators to support ongoing examination of Colorado's criminal justice system. We also support evidence-based recommendations, specifically in the areas of drug policy and recidivism, in an effort to avoid any further prison capacity expansion in Colorado and to maximize the best use of the state's existing prison capacity and criminal justice resources.

Prison Spending in Colorado: Anatomy of a Fiscal Train Wreck

In 1985 the Colorado General Assembly passed House Bill 1320, the "Mielke-Arnold" bill. The legislation not only increased the minimum sentences for crimes of violence, but also doubled the maximum penalties for all levels of felony crimes, regardless of the nature of the crime, in Colorado's presumptive sentencing range. Within three years, the average length of prison sentences in Colorado increased by two-thirds, and the average length of stay increased by 40 percent.[4] Colorado's inmate population more than doubled in the next five years. Since 1990 it has more than doubled again to around 23,000 inmates.[5] In comparison, Colorado's overall population has increased by roughly 65 percent over the last 20 years.

Within three years, the average length of prison sentences in Colorado increased by two-thirds, and the average length of stay increased by 40 percent.

To keep pace with the capacity demands of such unprecedented growth in the prison population, successive legislatures and governors have pushed corrections spending from less than 3 percent in 1990 to more than 9 percent of General Fund appropriations today, or from around $115 million to $675 million per year. Prison spending over the two decades from FY 1989-90 to FY 2009-10 grew at a compound annual rate of more than 9 percent.[6]

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In a direct tradeoff, a dramatic increase in spending for one item as a percentage of the state's General Fund (prisons) necessarily means that other items have had to decrease.

In 2003, unable to build more prisons out of the General Fund, the General Assembly enacted House Bill 1256. The legislation authorized the Colorado Department of Corrections to finance construction of a new 948-bed prison (Colorado State Penitentiary II) through the issuance of "certificates of participation," or COPs. COPs are structured and marketed like government bonds, a form of debt financing. Investors purchase the COPs, and the state makes annual "lease payments" to service the outstanding debt. When the COPs are paid off, the state (through taxpayers) will own the facility.

The legislation originally capped the cost of the COPs at $102.8 million, but according to Joint Budget Committee staff, the COPs actually will cost the state $167.3 million, including $18.6 million in capital interest that has accrued to date.[7]

The Diminishing Return of Increasing Prison Populations

From 1985 to 2007, Colorado's total crime rates (violent and property crimes combined) dropped by almost half (48 percent).[8] Over that same time period, Colorado's incarceration rate increased by more than 230 percent.[9]

To be sure, there is a relationship between incarceration of criminals and crime rates. At its simplest, a criminal removed from general society is incapable of re-offending outside the walls of prison for as long as he is incarcerated. At the same time every convict not sentenced to life without parole (nor those who die in prison) is eventually released. The broader question is whether an offender's time in prison prepares him to continue committing crimes, or prepares him to pursue a lawful post-incarceration existence.

It is widely accepted that putting certain classes of criminals in prison for longer periods of time often does, temporarily, reduce crime. Yet the large-scale expansion of Colorado's prison population has not resulted in a proportional reduction in either violent or property crime.

It is widely accepted that putting certain classes of criminals in prison for longer periods of time often does, temporarily, reduce crime. Yet the large-scale expansion of Colorado's prison population has not resulted in a proportional reduction in either violent or property crime. For instance, if doubling the prison population resulted in even a corresponding halving of these crimes, then a dramatic increase in both the prison population and corrections spending would be more easily justified. But no one claims that quadrupling Colorado's prison population over 20 years has by itself cut crime rates in half.

As Roger Przybylski notes in *What Works* (prepared for the Colorado Division of Criminal Justice):

> From a policy perspective, it is important to recognize that the increased use of imprisonment eventually results in diminishing returns. The reason for this is simple; locking up more and more people eventually leads to the incarceration of less serious offenders. When that happens, costs increase without a commensurate increase in public safety.[10]

For instance, both property and violent crime rates in Colorado already were trending down in the years before the 1985 doubling of sentences with Mielke-Arnold.[11]

From 1987 to 1993, Colorado's incarceration rate (the number of people incarcerated per 100,000 in population) roughly doubled to over 257.

From 1987 to 1993, Colorado's incarceration rate (the number of people incarcerated per 100,000 in population) roughly doubled to over 257. Yet over that same time period, violent crime rates (or the number of reported offenses per 100,000 in population) in Colorado also increased, from 467.5 to 567.3, before beginning to trend downward again.

Similarly, after dropping steadily for more than a decade, property crime rates in Colorado increased between 2000 and 2005[12] before dropping off again. Over that same time period, Colorado's incarceration rate grew from 357 to more than 428 per 100,000 of population.

As Przybylski continues in *What Works*:

> Incarceration has a far greater impact and return on investment when it is used for violent and high-rate

> offenders. Prisons are expensive, but violent and career criminals impose tremendous financial and social costs on society. The empirical evidence is increasingly clear, however, that the increased use of incarceration for low-rate, non-violent offenders prevents and deters fewer crimes.[13]

Przybylski quantifies the cost of expanding the prison population, noting that "increasing the incarceration rate by 10 percent to achieve a 4 percent reduction in the crime rate is far more expensive today than it was years ago. In 1990, increasing Colorado's prison population by 10 percent meant adding about 750 prisoners. Today, it means adding about 2,250."

In a 2005 study by the Sentencing Project, researchers similarly found that:

> Expanding the use of imprisonment inevitably results in diminishing return in crime control. This is because high rate and serious offenders or violent offenders will generally be incarcerated even at modest levels of imprisonment, but as prison systems expand, new admissions will increasingly draw in lower-rate offenders. This growth in lower-rate and lower-level offenders shifts the cost-to-benefit ratio, as an equal amount of resources are spent per offender, but the state receives less return on its investment in terms of declining crime rates.[14]

Another Sentencing Project report from 2000 found that during the national decline in crime between 1991 and 1998 (a trend that included Colorado), states with the largest increases in incarceration actually experienced smaller declines in crime than states with smaller increases in incarceration.[15]

None of these observations are to say that incarceration does not have an impact on crime; clearly it does. Yet mass incarceration alone has not led to a reduction in crime over the last several decades.

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Drug Policy: A Case Study in Failed Policy

In 1992 Colorado lawmakers surrendered their prerogative to write the state's criminal law and enacted the Uniform Controlled Substances Act,[16] written by drug war judicial agents in Washington, D.C., and designed to turn state drug laws into copies of federal law (the federal Controlled Substances Act). The Uniform Controlled Substances Act created numerous new drug offenses in Colorado, and sentencing enhancements for those offenses.

In the last 20 years, the percentage of inmates whose most serious offense is a drug offense has quadrupled. Drug offenders now constitute the single largest category of people admitted to prison in Colorado, 23 percent of total admissions in 2009 (more than 1,500 admissions).[17] In 1982, drug offenders made up only 6 percent of total prison admissions in Colorado.[18]

Drug offenders now constitute the single largest category of people admitted to prison in Colorado, 23 percent of total admissions in 2009 (more than 1,500 admissions).

A snapshot of Colorado's adult inmate population as of June 30, 2009, showed roughly 18 percent (more than 4,000 inmates) of Colorado's prison population had a controlled substance offense as their "most serious offense."[19]

While there is little available data to parse out the criminal histories of the offenders referenced in this statistic, prosecutors will say that few offenders receive an actual prison sentence for such offenses as a first-time conviction of possessing a controlled substance. It is often the case that incarcerated drug offenders have a significant criminal record and/or have pled guilty to a drug offense and had other offenses dismissed (e.g., possessing a weapon while dealing, assault, burglary, etc.). But it does not change the fact that the conviction leading to their prison sentence was a drug offense. Nor does it change the fact that there are more people convicted of drug offenses in Colorado prisons today than the entire state prison population 25 years ago, when the total inmate population was around 3,500.

Given the tremendous increase in incarceration of drug offenders over the last several decades, one might assume that a drug-free Colorado is close at hand. However, this is not the case.

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According to the U.S. Drug Enforcement Administration's (DEA) 2008 State Fact Sheet for Colorado, heroin is not only "available in the major metropolitan areas of Colorado," but "various law enforcement and treatment indicators suggest that heroin use and availability may be on the rise in Colorado." As for cocaine, "Enforcement activities reflect a steady supply of cocaine coming into and through Colorado." Crack cocaine is "available in the larger metropolitan areas of Colorado, generally in street level amounts." And marijuana, according to DEA, "is available throughout Colorado."[20]

One of the main goals driving the interdiction and incarceration drug control strategy, and thus the mass incarceration of drug offenders in Colorado, has simply failed.

The problem is not that the Colorado legislature failed to try hard enough; indeed, the legislature and the Department of Corrections undertook one of the most costly and ambitious expansions in state history. The core problem is that putting non-violent drug felonies in the same presumptive sentencing categories as violent and property crimes is irrational. It consumes the criminal justice system's most valuable tool: prison beds, distracting prisons from their primary mission of incapacitating violent and predatory criminals. One rationale for the mass incarceration of drug offenders is that drug sales or use are inherently violent and constitute a threat to public safety—despite the fact that the Colorado Department of Corrections lists drug offenses as "non-violent". Many drug offenses in Colorado are labeled as "extraordinary risk of harm to society" crimes, which automatically increase sentences in Colorado's presumptive sentencing range.

Much of the violence related to illegal drug use and sales is due mostly to the drug laws themselves. Violence from disputes between dealers (turf wars) is engendered by prohibition, just as alcohol prohibition caused violence in another era. Robberies and other crimes committed by drug users to support a drug habit are caused in part by the "risk premium" charged by drug dealers as part of their risk of going to prison.[21]

Trying to incarcerate away drug use and sales simply has not worked. The imprisonment of one drug dealer (or even an entire network of dealers) only temporarily disrupts the flow of illegal drugs.

Trying to incarcerate away drug use and sales simply has not worked. The imprisonment of one drug dealer (or even an entire network of dealers) only temporarily disrupts the flow of illegal drugs. As soon as one supplier is gone, another quickly moves in to take his place. As long as there is a demand for a product, a market will make that product available.

Using incarceration to try to halt the availability of drugs can only be achieved by imprisoning every illicit drug user and addict, who constitute the majority of the small-time dealers, and everyone willing to break the law in return for potential financial rewards (i.e., dealers in the upper levels of the drug world). A far more cost-effective policy for dealing with illegal drug use, and the criminal activity committed by drug-addicted offenders, is coerced treatment instead of incarceration.

Using incarceration to try to halt the availability of drugs can only be achieved by imprisoning every illicit drug user and addict, who constitute the majority of the small-time dealers, and everyone willing to break the law in return for potential financial rewards (i.e., dealers in the upper levels of the drug world).

A RAND Corp. national study, "Controlling Cocaine: Supply Versus Demand Programs,"[22] concludes each dollar spent on treatment reduces the cost of crime and lost productivity by $7.46. By contrast, domestic enforcement (arrest, seizure and incarceration) returns just 52 cents. In the American Enterprise Institute book, ***An Analytical Assessment of U.S. Drug Policy***, authors David Boyum and Peter Reuter note that even if the RAND study is off by a wide margin, the conclusion is unchanged: "Treatment of heavy users is a far more cost-effective policy at the margin than any kind of enforcement."[23]

Focusing resources and the coercive power of the state on hardcore drug addicts who also commit other crimes makes more economic sense than simply punishing all drug offenders since, as the AEI authors note, "most who start using illicit drugs desist of their own volition, without treatment or incarceration, within five years of initiation."[24]

In May 2010, Governor Ritter signed into law House Bill 1352, which was generated out of recommendations from the CCJJ, and which passed out of the legislature with broad bipartisan support. (The House vote was 58-5 and the Senate vote was 30-5.) The bill was sponsored in the Senate by Democrat Pat Steadman and Republican Shawn Mitchell, and in the House by Mark Waller, a Republican and a voting member of the CCJJ. HB 1352 makes modest but much-needed changes to drug offenses contained in the Uniform Controlled Substances Act.[25] The changes it brings, among others, include:

- Creates a separate statute for the crime of possession of drugs, thereby separating it from the crime of manufacturing, dispensing, selling, distributing or possessing with the intent to manufacture, sell or distribute;
- Reduces the crime of drug use from a class 6 felony to a class 2 misdemeanor;
- Redefines the quantity of drugs that is considered "simple possession" from one gram or less to four grams or less of a schedule I or II drug and two grams or less of methamphetamine ("simple possession" would be a class 6 felony);
- Standardizes crimes so that possession for personal use of amounts greater than "simple possession" quantities is a class 4 felony;
- Reduces possession of schedule III-V drugs (i.e., prescription drugs) to a misdemeanor;
- Reduces the penalty for fraud and deceit in connection with controlled substances from a class 5 to a class 6 felony; and
- Requires cost savings from the bill to be evaluated annually by the Division of Criminal Justice and reported to the legislature, and requires that some of the cost savings will be allocated to expand

and enhance substance abuse treatment.

While HB 1352 lowered penalties for certain drug offenses, the bill also increased penalties for crimes such as selling illicit drugs to minors and clarified provisions of Colorado's Special Offender statute.

The Fiscal Note for HB 1352 estimates ***more than $56 million in prison bed cost-savings over five years to state taxpayers.***[26] These cost savings may be partially offset by increased jail costs at the county level.[27]

The broad bipartisan support of HB 1352 should put to rest any fear that taking up sentencing reform, and specifically drug law reform, is a career killer for politicians. A careful and thorough vetting process and working with groups such as CCJJ provides an excellent opportunity for the General Assembly to further pursue drug offense sentencing reforms. Long-term corrections cost savings are available through the expansion of mandatory treatment options over incarceration for drug offenders. Community savings arise from reducing the number of crimes through which drug-addicted offenders fund their habits.

Long-term corrections cost savings are available through the expansion of mandatory treatment options over incarceration for both drug offenders.

Parole Revocation: Fiscal Conservatives Should Want Parolees to Succeed

In Colorado, recidivism is defined as a return to prison "for either new criminal activity or a technical violation of parole, probation or non-departmental community placement within 3 years of release."[28] Colorado's recidivism rate is fairly high compared to other states, at around 53 percent.[29]

To be sure, when offenders released to parole then re-offend (commit crimes), a revocation of parole (or a new prosecution) and a return to prison is a necessary part of the price we pay in order to separate criminals from the public. But with technical parole revocation (where there is not a new crime, but rather some violation of the terms of parole) the frequent resort to re-incarceration is an available area for lawmakers to seek out reforms for cost savings and more efficient use of existing criminal justice resources.

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According to the Joint Budget Committee (JBC) staff, "Technical parole revocations (without a new crime) account for almost 30 percent of admission to Department of Corrections." These admissions cost the state at least $42.1 million during FY 2008-09. JBC Staff continues, "Although the cost associated with these technical parole violators is high, there are few guidelines provided to parole officers to determining when an individual's parole should be revoked for a technical violation."[30]

"In addition, staff was unable to find any administrative regulations that attempted to limit the use of prison for technical parole violations," concludes JBC staff.[31] In other words, members of the parole board and individual parole officers have significant, and mostly unchecked, power to drive costs and expenditure of state funds.

In 2010 the General Assembly passed House Bill 1360, which is intended to reduce revocations for technical violations of parole. According to an analysis of HB 1360:

> In lieu of revocation for a technical violation, the parole board may modify the conditions of parole and require the parolee to participate in a residential or outpatient

treatment program. If parolee is revoked for a technical violation, the maximum time of re-incarceration in prison is 90 days if the parolee was assessed as a lower than high risk and the parolees underlying conviction was not for a crime of violence, menacing or stalking. A parolee can be re-incarcerated up to 180 days if s/he is assessed as high risk or is revoked to a community return to custody facility or community corrections facility and the underlying conviction was not for a crime of violence, menacing or stalking.[32]

The 2010 legislature also unanimously passed House Bill 1023, an attempt to start removing barriers to parolees and those with criminal backgrounds to obtain and keep employment as key elements both to successful completion of parole, and to avoiding re-incarceration for technical revocations due to unemployment. This law includes limits on the admissibility of evidence of an employee's criminal history in a civil action against an employer where "the criminal history did not have a direct relationship to the underlying cause of action in the civil case."[33]

The legislature should take advantage of these steps, and again take advantage of the expertise and vetting process of the CCJJ, to continue pursuing reforms designed to both increase the ability of parolees to get and keep employment, and to decrease technical parole revocations to prison.

With HB 1360 and HB 1023, Colorado lawmakers made very careful steps towards both slowing admissions to prison for technical revocations and lowering barriers to employment for parolees. The legislature also allowed broader authority to use coerced treatment instead of incarceration when appropriate in an effort to avoid using valuable and scarce prison beds unnecessarily.

The legislature should take advantage of these steps, and again take advantage of the expertise and vetting process of the CCJJ, to continue pursuing reforms designed to both increase the ability of parolees to get and keep employment, and to decrease technical parole revocations to prison.

Conclusion

No rational person should expect the legislature to try to balance the Colorado state budget on the back of public safety. Cost savings generated out of sentencing reform are partially dependent on the individual decisions and actions of offenders and parolees—forces outside the control of either the legislature, or the criminal justice system. But for several decades in Colorado, fiscal conservatives have been willing participants in one of the most extreme spending sprees in state history.

The lesson that should be taken away from the successful, mostly bipartisan, passage of numerous criminal justice reform related bills in 2010 is that prison spending, and the sentencing laws and policies that drive that spending, can and should be placed under the same kind of regular scrutiny as any other state spending item.

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Acknowledgements

We appreciate the substantial leadership and work contributed by **Mike Krause**, who researched and authored this section. He currently serves as a Senior Fellow in Criminal Justice and as the Independence Institute's Operations Manager. Mr. Krause is a veteran of the U.S. Coast Guard, where he participated in numerous joint agency drug-interdiction operations. He is a graduate of the University of Nebraska.

Christie Donner graciously reviewed the material presented in this section for accuracy and factual interpretation and offered substantive amendments. Ms. Donner is the Executive Director of the Colorado Criminal Justice Reform Commission, a state-wide, 15 year old public policy organization. Ms. Donner is also the co-author of ***Parenting from Prison: A Resource Guide for Incarcerated Parents in Colorado*** and ***Getting On After Getting Out, A Re-Entry Guide for Colorado.*** She holds a degree in political science from the University of Colorado at Boulder.

Peter Weir gave generously of his time to review this material for public policy content and for factual interpretation. He currently is the Senior Chief Deputy District Attorney for the First Judicial District (Jefferson & Gilpin Counties). Until July 2010, Mr. Weir was the Executive Director of the Colorado Department of Public Safety, a cabinet officer position working directly with the Governor. He served previously as a District Judge, deputy District Attorney and worked in private law practice. Mr. Weir earned his law degree from the University of Denver.

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[16] Colorado Revised Statutes, Title18, Article 18.
[17] Colorado Department of Corrections, "Statistical Report, Fiscal Year 2009," pg. 17, table 13.
[18] Colorado Department of Corrections, "Statistical Report, 1983-1987," (January 1988), pg. 22.
[19] Colorado Department of Corrections, "Statistical Report, Fiscal Year 2009," pg. 36, table 29.
[20] U.S. Drug Enforcement Administration, "Fact Sheets, Colorado, 2008." http://www.usdoj.gov/dea/pubs/state_factsheets/colorado.html.
[21] Illicit drugs cost more than they otherwise would because of a) the high cost of illegal smuggling and b) some amount of drugs are going to be seized by police, requiring a higher profit on the drugs which make it to market. Drug dealers also charge customers a "risk premium" based on the chance they might be caught and go to prison. Risk premiums for cocaine and heroin can cause these drugs' prices to be much as 20 to 40 times what they otherwise would cost.
[22] C. Peter Rydell and Susan S. Everingham, *Controlling Cocaine, Supply Versus Demand Programs*, Rand Corporation, 1994.
[23] David Boyum and Peter Rueter, *An analytical Assessment of U.S. Drug Policy*, American Enterprise Institute, 2005, pg. 87.
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LOTTERY PROCEEDS

Lottery games run by Colorado state government began operating in 1983. Net proceeds are allocated by formula 40 percent to the Conservation Trust Fund for distribution to local governments, 10 percent to State Parks for specific projects and the remaining 50 percent to Great Outdoors Colorado (GOCO).

About $138 million per year flows into this revenue stream.[1] It is time that citizens and the legislature revisit how the money is spent. Are automatic disbursements for governments to purchase and hold more undeveloped property, and for parks and recreation, the highest and best use for budget funds?

Only today's difficult circumstances could lead to reconsideration. When voters first created the lottery, most expected it would fund what are now current priorities. But at the time the legislature directed at least half of the money into maintaining existing buildings and developing new ones (capital construction). With the GOCO Amendment, voters approved the clause that prohibits substitution of such projects for open space purchases, parks and recreation.

GOCO was enacted in the November 1992 general election for the disbursement of Colorado's lottery proceeds.[2] The stated purpose of the fund is to "preserve, protect, enhance and manage Colorado's wildlife, park, river, trail and open space heritage."[3] Of the half that goes to GOCO, the proceeds are dispersed equally among different categories:

- Wildlife;
- Parks and outdoor recreation;
- Competitive grants for open space; and
- Competitive matching grants to local government for open lands and parks.

The GOCO fund was capped at $54.3 million for 2009 with the upper limit being adjusted for inflation each year.[4] The remaining moneys are given to the School Capital Construction Assistance Fund for school facility improvements. In 2009, $59.6 million was disbursed from lottery revenues, $5.5 million of which paid for school facility improvements.

UNIQUE IS NOT BETTER IN THIS CASE

Colorado differs notably in where it places its lottery proceeds. Almost all of the 43 other states that conduct lotteries do so for the explicit purpose of generating K-12 education revenues and providing higher education scholarships. The only two states not to use lottery revenues for education are Pennsylvania and Kansas: Pennsylvania assists senior citizens[5] and Kansas subsidizes businesses and constructs prisons.[6] Several states fund programs in addition to education. For example, Arizona also spends lottery proceeds on state parks and recreation, county assistance and several other programs.[7] Minnesota also distributes its funds to environmental protection, natural resources and the state's fish and game agency.[8] Other states simply reduce their citizens' property tax burden with lottery proceeds.[9]

COGO Trust Fund revenues are collected in addition to the budget for the Depart-

The organization is not run by employees of the Department of Natural Resources reporting up a chain of command to the Governor. Instead it is run by a 17-member Board appointed by the Governor and confirmed by the Senate. Two members are selected from each Congressional district; the representatives from each district must have different political affiliations. Places on the Board are reserved for the Executive Director of the Department of Natural Resources, a representative from the Colorado Board of Parks and Outdoor Recreation, and a representative from the Wildlife Commission.

ment of Natural Resources. For the current fiscal year, the Department is authorized to spend $224.7 million,[10] including $39.5 million from the operational account of the Severance Tax Trust Fund.[11] The strict separation of COGO proceeds and operational funding of the Department is mandated in the constitutional language that created the program.[12]

Alternate uses

That Colorado's lottery provides revenue for the state from a source other than taxation does not make the revenue any less valuable. Concerns over open space in 1992 when GOCO was started may be surpassed today by more pressing needs. We urge the legislature to offer for public approval the permanent redirection of lottery proceeds to the General Fund. A less desirable, but perhaps more politically palatable, change would allow the legislature to divert funds for other uses only for a certain number of years. Any change would have to amend the state constitution; legislators could only put the question to voters on the 2012 general election ballot. If approved, implementation only could occur after the budget crisis of the 2011-12 fiscal year.

The current allocation of resources is difficult to justify in an environment of budgetary shortfalls. Grants during 2010 were made for a skate park in Northglenn, a dog park in El Paso and an ice rink in Fraser. COGO even funded $83,900 for renewable energy education for children in Boulder. A total of $9.3 million was spent for these as well as for more tennis courts, parks and trails.[13]

When COGO purchases subsidized land with lottery moneys, a trade-off is being made. When $647,000 was spent to purchase KOK ranch in Chaffee for the Trust of Public Land, as happened this year, the State is placing a higher priority during difficult times on maintaining undeveloped spaces than on purchase of school books, human services or public health.[14] While investigating how to improve the structure of the State budget, elected officials and citizens should weigh what investments we put first.

Acknowledgements

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The primary research of the facts and figures in this section was conducted by **Eric Wilson**, who also wrote a great deal of the paper. He is a 2010 graduate of the University of Colorado at Denver, with a degree in history. Mr. Wilson worked as an intern at the Independence Institute during the summer 2010. He is preparing for a graduate degree in economic policy at the London School of Economics external studies program.

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9 South Dakota and Wisconsin are leading examples.
10 House Bill 10-1376.
11 Colorado Department of Natural Resources, FY 2009-10 Joint Budget Committee Hearing, pg. 1, http://dnr.state.co.us/NR/rdonlyres/48A8D5E5-6599-4271-B436-C79827D2111A/0/DNRHearingAgenda1011DNR.pdf.
12 Colorado Constitution, Article XXVII, Section 8.
13 Great Outdoors Colorado, "Spring 2010 Grant Awards," http://goco.org.s57353.gridserver.com/wp-content/uploads/2010/06/June-2010-Grant-Summary-List.pdf.
14 Ibid.

GOVERNOR'S ENERGY OFFICE

What is known today as the Governor's Energy Office (GEO) has existed since 1977, when it was first designated the Governor's Office of Energy Conservation. In 1999, under the Owens administration, the name was changed to the Governor's Office of Energy Management and Conservation. It took its current name soon after Bill Ritter became governor in 2007.

Every state (and territory) has a similar organization, generically known as its State Energy Office (SEO). Just like every other government operation where two or more bureaucrats are doing the same job in different states, an organization called the National Association of State Energy Officials (NASEO) is devoted to representing state energy offices.[1]

The GEO's stated mission goes back to the days of the Carter administration, reflecting the former president's stated goal of "lessening our dependence on foreign crude oil."

The GEO's stated mission goes back to the days of the Carter administration, reflecting the former president's stated goal of "lessening our dependence on foreign crude oil." Among SEOs something akin to an orthodoxy presumes that lessening our dependence on foreign crude oil means increasing reliance on alternative energy and energy efficiency. Alternative energy in this case means electrical generation from wind turbines and solar cells, fuel from biomass, and hydro-electric generation without the use of large dams. NASEO and its staff are powerful, effective advocates and lobbyists for these programs.

Some smaller degree of attention is given to fuel cells and other forms of generation. SEOs generally do not expend effort on nuclear power or other forms of energy that do not comport with a generally accepted "environmentalist" view of the world. Paradoxically, the SEOs' intent to reduce dependence on foreign crude oil does not lead to a determination to increase domestic oil production. Outside-the-box thinking is discouraged and seldom rewarded with the mother's milk from Washington: grant money. Most SEO directors and much of their staff are well-schooled (or are expected to become so) on issues relating to the power grid, its workings and its problems.

Outside-the-box thinking is discouraged and seldom rewarded with the mother's milk from Washington: grant money.

In 1983 SEOs nationwide received a huge financial infusion when significant funds were distributed to the states as a result of alleged oil company violations of the federal oil price controls in place from 1973 to 1981.[2] These funds are known as Petroleum Violation Escrow (PVE) funds, or oil-overcharge funds. An expanded history of this program can be found in the 1999 document, ***State Energy Program Operations Manual***:

> The PVE funds or oil-overcharge funds ... support a variety of energy-related programs in the States. Each State determines how it wishes to allocate the funds across eligible programs. The States may use these funds and the interest earned to finance SEP (State Energy Plan) activities. In that case, PVE funds allocated to SEP are treated as appropriated funds and are subject to program requirements. PVE funds are not subject to the matching requirement or the 20% limitation on equipment purchases under the program.[3]

Although historical records of the final disbursement to each state are difficult to obtain, Colorado's initial allocation was likely around $37 million plus significant "dividend and interest checks" that continued to roll into the office later to support operational costs. In total, Colorado received $70.5 million.[4] All 50 states and the territories received proportional shares of the largesse based on a formula understood only by a few, but one which resulted in huge piles of cash to California and other populous states.

The significance of this fund and the ensuing cash stream to Colorado was that the money came into the state without passing through the state legislature, much less the Joint Budget Committee. Oversight came from federal bureaucrats, who looked for key words and expressed goals that supported the original intent of the program. Generally, if projects contained the words "energy efficiency" or "renewable energy," they were approved. The original fund was drawn down over the years for the various projects supported by the office and to run the office administration. When federal grants were offered (including the SEP, which was the overall base grant for operating the office) that required matching grants from the states, the states were allowed to use PVE funds as their stake in the grant. Only about $2.5 million remains of Colorado's original fund balance.[5] In the future, therefore, the GEO will need to approach the state legislature for any significant federal requirement of matching funds. Colorado was a reasonable steward of those funds, being one of the last states to (nearly) exhaust their PVE funds. Other states long ago sought other sources for energy office funding.

Generally, if projects contained the words "energy efficiency" or "renewable energy," they were approved.

The GEO is not connected to any State Department and operates off-budget. The legislature has little say in the flow of dollars into the Office's programs, nor any say in how the funds are disbursed. The system is led, during normal economic circumstances, to contribute matching funds in order to obtain large amounts of federal funding for "green" initiatives. The Office is headed by an appointee of the Governor who, along with his entire staff, can be dismissed by the Governor under the same rules that hold for other non-classified agency directors appointed at the policy level.[6] The appointee generally has been a person with significant political experience and connections; the current Division Head is former state representative and former Joint Budget Committee member Thomas Plant.

Budget and Finance

In order to achieve some degree of transparency and accountability, the legislature should direct the Office's books and budget be open and available. There is a paucity of information on the finances associated with the GEO's operations. The overall budget request is buried under "OIT, GEO, and Other Gov. Offices."[7] Expenditures are difficult, if not impossible, to monitor.

In order to achieve some degree of transparency and accountability, the legislature should direct the Office's books and budget be open and available.

Now that PVE funds are no longer available as State matching funds for new grants, support of this office may require the Colorado legislature to find sources from the General Fund. Excerpts from a presentation to the Joint Budget Committee, titled ***Energy Efficiency and Renewable Energy Resource Development Initiatives,*** covered the considerations for funding:

> A number of programs administered by the GEO are now funded from sources that have the potential to vary considerably from year to year, including limited gaming revenue, severance tax earnings, and onetime federal funds.
>
> The Clean Energy Fund receives the remaining portion of moneys from the Limited Gaming Fund after all other transfers are completed. The ongoing recession, job losses, and other economic factors have caused gaming revenue to see

its worst decline since Colorado limited gaming began in 1991 …. decreasing (16.5) percent (over) FY 2007-(09). Furthermore, in instances where General Fund revenue is found to be insufficient to meet appropriations, the General Fund receives an additional amount of gaming revenue that would otherwise be transferred to programs supported by the Limited Gaming Fund. When this occurs, as it did in FY 2009-10, no moneys are transferred to the Clean Energy Fund for programs administered by the GEO.[8]

Moneys from the Operational Account of the Severance Tax Trust Fund are …. continuously appropriated to the GEO to provide home energy efficiency improvements for low-income households ….*[Editor's note: In 2010, the legislature eliminated the transfer for both FY 2010-11 and FY 2011-12 budget years with the passage of House Bill 1319]*.

The Public School Energy Efficiency Fund, used to support energy efficiency projects in public schools across the State, receives moneys generated from interest earned on the accelerated collection of oil and gas severance taxes. In FY 2009-10, total severance tax revenue is projected to drop to $54.9 million, a decrease of 83.7 percent from FY 2008-09.

The GEO received $143.7 million in one-time revenue via the American Recovery and Reinvestment Act of 2009 (ARRA) for investment in weatherization, energy efficiency and conservation, and other state energy programs."[9]

The total, then, for matching funds during the current budget year will be about $50,000. The State must contribute a 10 percent match for the SEP grant for weatherization retrofits. The State will appropriate funds from the PVE account balance to cover this amount.

The legislature should revisit the need to continue operating this Office as an independent agency. It is an excellent candidate to free up state matching funds for other uses, or to use funds for administration to support other, on-budget Departments. If the federal government regulations regarding SEOs require a separate agency, Colorado could seek a waiver to allow distribution of programs to other, existing executive branch agencies. Poverty assistance funds might be handled directly by the Department of Human Services and any remaining energy programs transferred to the Department of Local Affairs. Weatherization programs initially were run from the latter Department. Consolidation will not eliminate the disbursement of all the funds now paying for staff at the Governor's Energy Office, because state employees still would administer the projects. It likely would help, however, to cover some of the overhead positions such as accounting, purchasing and the Department Heads' staffs, freeing up General Fund money for direct program expenditures. Terminating this office would also improve governance, as programs will once again be brought into the normal budgeting oversight by the legislature, rather than leave $140 million off-budget.

The legislature should revisit the need to continue operating this Office as an independent agency. It is an excellent candidate to free up state matching funds for other uses, or to use funds for administration to support other, on-budget Departments.

Acknowledgements

Rick Grice was the author of this section. He served as the Executive Director of what was then the Governor's Office of Energy Management & Conservation from December 1998 until the summer of 2004.

Clark M. Bolser assisted by identifying the type of personnel position that the Executive Director is designated. Mr. Bolser is the Legislative Liaison with the Department of Personnel and Administration.

Kevin Neimond of the Joint Budget Committee staff answered questions about the amount of annual matching funds and the amount of PVE funds left.

Endnotes

[1] Information on the organization can be found at its web site, http://www.NASEO.org.

[2] In response to oil supply restrictions implemented by foreign suppliers, specifically the Organization of Petroleum Exporting Countries (OPEC), the federal government regulated oil prices from 1973-1981 to prevent "price gouging" by domestic crude oil producers and to ensure "fair" allocation of oil resources. The U.S. Department of Energy was charged with identifying violations, recovering overcharges and obtaining restitution for states and other parties for alleged overcharges. Oil overcharge funds, also known as Petroleum Violation Escrow (PVE) funds, came from fines paid by oil companies that were found to have violated federal oil price caps in place from 1973-1981. To date, more than $4 billion in PVE funds have been made available to states.

[3] A current version can be found at http://www.nrel.gov/docs/fy03osti/32982.pdf.

[4] FY 2010-11 Staff Budget Briefing for the Office of the Governor. Prepared by Kevin Neimond, Joint Budget Committee Staff, November 19, 2009.

[5] We recognize the assistance of Kevin Neimond in locating this information.

[6] Classified senior executives fall under the procedures of the Personnel System that convey property rights to the job, and mandate an appeals process within the system. Merit system employees are protected by strict rules which prevent hiring and firing for political purposes.

[7] The budget request can be found in Table Attachments to Governor Ritter's November 6, 2009 Letter. http://www.colorado.gov/cs/Satellite?blobcol=urldata&blobheader=application%2Fpdf&blobkey=id&blobtable=MungoBlobs&blobwhere=1251602243662&ssbinary=true.

[8] Future transfer of limited gaming moneys to the Clean Energy Fund was subsequently eliminated for use in the FY 2010-11 budget with the passage of House Bill 1339 in the 2010 session.

[9] FY 2010-11 Staff Budget Briefing for the Office of the Governor. Prepared by Kevin Neimond, Joint Budget Committee Staff, November 19, 2009.

Topics Needing Further Study

A. **The Denver Regional Council of Governments** (DRCOG) is a regional planning entity. It is federally mandated and designated officially as a Metropolitan Planning Organization. Representatives from local governments and a paid staff run its operations. Its mission is to plan and shape the future infrastructure, development and living environment of the greater Denver metropolitan area. Its decisions are far-reaching and can lead to very costly action. It also has the designation of Area Agency for Aging, disbursing federal funds for Title III and Title VII programs.

This very influential and little-known agency should undergo a substantial audit to disclose its costs of operation.

This very influential and little-known agency should undergo a substantial audit to disclose its costs of operation. Legislation is needed to make more transparent both its mission and its objectives. The same audit should review the policy control (or lack thereof) exercised over it by state and local officials.

B. Did the number of state employees grow during the recession? Should the State return to pre-recession numbers? The downturn in the economy officially started in December 2007[1], when Bill Ritter had been Governor for less than a year. Allegations arose of the total employed climbing throughout his administration, but verification and justifications fall outside this study's resources.

C. Should we prohibit businesses from providing contract services to the State, in favor of exempting state divisions from any competition? Governors going back to John Love have noted that citizens must change the personnel system. The system must be updated to shed antiquated work rules and anti-competitive regulation. Currently provisions stifle improvements, protect mediocre performers and prevent cost efficiencies. The system is written into the Constitution to favor centralized, bureaucratized and unionized structures. Reforms proposed in the 1980s by then-Personnel Director Gail Schoettler, in the 1990s by Representative Penn Pfiffner, and in the 2000s by Governor Bill Owens should finally be implemented. Referring constitutional amendments to the ballot alone will be inadequate; a full campaign to overcome union resistance must be shaped and prepared.

Should we prohibit businesses from providing contract services to the State, in favor of exempting state divisions from any competition?

D. A little-known, but large, off-budget state organization, the Colorado Housing & Finance Authority (CHFA), runs programs that likely duplicate agency missions. It is a good candidate for reduced state aid, or instead for consolidation into the executive branch.

The Colorado Division of Housing in the Department of Local Affairs appears to duplicate much of the work of CHFA. The agency finances construction of new housing and rehabilitation of existing housing for medium and low income persons. It serves housing authorities, private developers, nonprofit corporations and cities and counties. Its current budget is over $2 million. The federal government funds $45 million more for housing construction grants and loans.

Private, nonprofit organizations also work to create and to upgrade existing low-income housing. Habitat for Humanity and Community Resources Housing Development Corporation are examples of entities that assist low or moderate income people into homeownership.

How should CHFA fit into this picture, since its mission is to assist homeowners with down payments and closing costs? When established in 1973, its only goal was expansion of "affordable housing." In 1982 it expanded into loans to small and medium-sized businesses.

Do these similar programs collaborate? How does CHFA compare in size to the Division of Housing? What opportunities exist to consolidate? How would continued federal subsidies be administered? Should state programs continue to compete with private ones, rather than simply support them?

E. Allegations have surfaced over the years that wage and salary levels of state employees are higher than for similar jobs in the private sector.[2] Critics of those studies justly observed that the studies did not thoroughly compare the types of work, ignoring for instance, that averages include low-paying retail and menial labor, for which state government employment is small. More recent studies, however, reach conclusions of overpay by making job-to-job comparisons.

Allegations have surfaced over the years that wage and salary levels of state employees are higher than for similar jobs in the private sector.

If the legislature addresses whether state workers are overpaid, it should reconsider a policy that "similar work must receive similar pay." No matter where the employee is in the state, he or she receives the same remuneration as the employee in Denver, the state's most expensive locale. This concept is based on the "labor theory of value," that a service's worth is best valued by taking the hours that go into it. It ignores the role of the market in setting rates and leads to a true inequality of pay among employees. The person based in Denver is attracted to work there only if the pay is sufficient enough to compare with other opportunities. Those alternate costs include a relatively high cost of living in housing and other living expenses. Non-dollar costs that the downtown worker endures can be a long and often difficult commute, and the stress of a higher-crime environment. Yet, in the interest of fairness, the state policy violates fairness by paying an employee in the San Luis Valley the identical amount, even though the San Luis employee enjoys lower costs of living and a less-stressed lifestyle. How many state workers reside and work in rural areas? What should a cost of living adjustment be, and should it mirror the State's formula for schools? What politically palatable step would phase in the policy gradually so as to smooth the transition?

Setting the base wages and salaries is done annually by use of surveys of comparable positions. How then do we end up with the average pay exceeding comparable private sector jobs?

Setting the base wages and salaries is done annually by use of surveys of comparable positions. How then do we end up with the average pay exceeding comparable private sector jobs? Do surveys of other government positions really identify market comparables? Do surveys capture the value of the security of a government job? How can a measure of turnover be used to assess pay level? Are the level of health care and other benefits truly reflected in total remuneration figures?

F. *Does the Department of Agriculture operate with significant inefficiencies?* In the private sector, non-governmental organizations that seek donations are careful to control their overhead and developmental costs. Supporters are far more likely to contribute to organizations that keep the costs of generating revenue and of doing business to less than 15 percent, leaving 85 percent of revenue to be spent in the programs that aid the intended beneficiaries. Government departments do not spend any money to generate revenue, since programs are either run through tax subsidies or by fees for service. Therefore, we would hope that governments should be able to show the overhead burden at between 5 and 10 percent. When we measure the cost of the Commissioner's office and add the allocated indirect costs of each division, however, we find that the administration, operations and overhead represent about 28 percent of the cost.

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Department of Agriculture Administrative, Operating and Overhead Costs by Division

	Total	Ops Exp + Indirect	% Overhead
Central Office	7,954,634	7,954,634	
Brand Board	3,921,832	137,241	3.50%
Colo. State Fair	9,009,242		
Markets	1,099,653	86,465	7.86%
Services Division	12,320,521	2,021,020	16.40%
Special Purpose	735,752	11,663	1.59%
Conservatio Board	1,998,522	64,109	3.21%
TOTALS	37,040,156	10,275,132	27.74%

There appears to be a great deal of cost in the central administration, and two divisions, Markets and Services, also run a high overhead burden. If the administration of those divisions were reduced to five percent, then the Department might save as much as $154,000.

ENDNOTES

[1] "Percent Change From Preceding Period in Real Gross Domestic Product," found in "National Economic Accounts," Bureau of Economic Analysis, US Department of Commerce. http://www.bea.gov/National/nipaweb/TableView.asp?SelectedTable=1&ViewSeries=NO&Java=no&Request3Place=N&3Place=N&FromView=YES&Freq=Qtr&FirstYear=2007&LastYear=2010&3Place=N&Update=Update&JavaBox=no.

[2] Protected Class, Wendell Cox. Protected Class II, Wendell Cox.


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SAVINGS
AHEAD

Other Operational Savings

The budget problem will not be solved by addressing only "waste, fraud and abuse," the all-too-common political football. We do not want to dismiss the opportunity to save a couple hundred thousand or a few million dollars, however. That's real money that must come from citizens, who certainly expect continued efforts by government to locate efficiencies.

A. The Division of Housing must certify "all factory/ manufactured structures built in or shipped to Colorado and approve(s) multifamily construction in counties with no construction codes."[1] In order to provide this service, Division employees travel across the country to manufacturing plants at taxpayer expense. Although the Division has the option of using third party inspectors,[2] it does not do so. There is little justification for using the Colorado government to inspect manufactured-housing plants in other states, rather than relying on ratings from private insurance policies. It is even more puzzling why our government sends people from Colorado to inspect these plants when the job could easily be done by contracting with local inspectors in the several states where factories operate.

It is even more puzzling why our government sends people from Colorado to inspect these plants when the job could easily be done by contracting with local inspectors in the several states where factories operate.

B. The Department of Local Affairs (DOLA) provides training classes to improve operations of town, county and special governments. It is difficult to quantify how much is spent each year on training because itemized costs are not accounted for. Four organizations could perform the training function: Colorado Municipal League, Colorado Counties, Special Districts Association and Colorado Association of School Boards are membership organizations that represent local communities in Colorado. They coordinate with DOLA to ensure classes are not redundant with their own training. Turning training over to professional groups would save the State money not only for the classes themselves but also reduce the number of employees and overhead required by each division.

C. Tony Grampsas Youth Services Program. Although it is protected by a well-respected name, there was a time when "midnight basketball" spending was not considered a serious crime prevention activity. Well over a decade after this experiment began, Colorado's program still exists, and spends an even $1,000,000 from general funds in 2008-09. The goals of this program are noble, "to provide funding to community-based organizations that serve children, youth and their families with programs designed to reduce youth crime and violence and prevent child abuse and neglect."[3] The operation could be turned back to the private sector, which likely would take great care in disbursing money raised by charity. Generally, central planners do not consistently put moneys to the highest and best use. For example, funded programs include a 26-week cultural enrichment course at a cost of $588 per child served. Should tax payers be forced to pay $90 per month, per student, for art classes?

Should tax payers be forced to pay $90 per month, per student, for art classes?

D. The State Fair is part of a separate political Authority within the Department of Agriculture. The State Auditor issued negative findings of the State Fair over the course of several years.[4]

Operations have consistently relied on significant General Fund subsidies to make up hefty deficits. In addition, the capital construction budget has provided millions more into the facilities in Pueblo.

The State Fair was begun at a time when agriculture played a major portion of the Colorado economy and has run for 125 years. Large agri-businesses should now provide the operations and subsidies, as the Colorado economy has diversified beyond its first industries. It has continued value in exposing families whose lives are centered around the city to rural life, activities and values. An operational audit shows the Authority had a net operating loss of $2.4 million in the year ending June 2008. It has lost money every year for a very long time, and in the prior five years losses total $8 million.[5] Some of the current subsidy is going to pay off a capital loan. After that debt is discharged and the new business plan is in effect, current plans call for subsidies of $800,000 per year for all future years. The Auditor's Office projects that the Authority will incur losses above that figure.[6]

Large agri-businesses should now provide the operations and subsidies, as the Colorado economy has diversified beyond its first industries.

ENDNOTES

1 Strategic Plan for FY 2010-11, pg. 19.

2 Telephone interviews by Todd Hollenbeck with Department of Local Affairs Deputy Director Bruce Eisenhauer and that Department's Public Information Officer, Linda S. Rice, July 2010.

3 Tony Grampsas Youth Services Program 2008-09 Annual Report, http://www.cdphe.state.co.us/ps/tgys/2008-2009%20TGYS%20Annual%20Report%20FINAL.pdf P.2.

4 "Financial and Compliance Audit, Fiscal Years ended June 30, 2008 and 2007." Colorado State Auditor.

5 Ibid.

6 Ibid.

Authors

Penn R. Pfiffner

Penn is a former state representative, having served in the Colorado legislature from 1993 through 2000.

His major bills included the enhanced sentences for dangerous pedophiles, the state's first full-restitution policy and the ground-breaking performance-based pay for state employees. His legislation created the Privatization Committee, which he chaired, and the findings and suggestions received national attention. He authored the repeal of the capital gains tax, wrote the major deregulation bill of the decade (trucking) and rewrote the state employee compensation statutes.

He was an early leader and proponent of the Taxpayer's Bill of Rights, serving as a Regional Coordinator in the 1986 effort, and serving on the TABOR Committee in subsequent years.

His business is financial and managerial consulting to architects, engineers and contractors. He also conducts economic analyses such as forecasting and valuing closely-held stock. He opened his practice, Construction Economics, LLC in 1983.

He taught college Economics at night school, at both the graduate and undergraduate level, for thirteen years.

Penn earned his Masters in Finance from the University of Colorado at Denver and his undergraduate degrees in Economics and Political Science from CU-Boulder.

He is the former President of the Denver Association of Business Economists. In the 1980's, he was a member of the national ASTM's (Association of Standards, Testing and Materials) Building Economics Subcommittee, which established standards for life-cycle costing and the use of net present value analysis. He was one of 300 economists polled nationally by the National Association of Business Economists for quarterly forecasts of the economy.

He is currently a Senior Fellow at the Independence Institute and the Director of the Fiscal Policy Center. Penn hosted the Institute's weekly talk radio show on KNRC for its five-month run. He served six years as the President of the Colorado Union of Taxpayers and still sits on that organization's Board of Directors. He is currently Chairman of the TABOR Committee, which grew out of the Strike a Better Balance issue committee that defeated Amendment 59 in 2008.

Penn and Karen are the parents of three adult children. He helps out as an Assistant Scoutmaster and merit badge counselor for Lakewood's Troop 748 and is a member of the Timberline Executive Committee.

He is a veteran, having served as an officer in the Navy, assigned to U.S.S. Oklahoma City (CG5), based out of Yokosuka ("Yo'- koos – ka"), Japan from 1977 to the end of 1979.

Ben DeGrow

Ben DeGrow is a Colorado-based public policy analyst with a focus on education labor issues. Since joining the Independence Institute in 2003, Ben has advanced its research in the areas of collective bargaining, teacher unionism, teacher employment, and school finance. He oversees the Education Policy Center's informational Web site for teachers and coordinates the Institute's outreach to teachers.

Ben has authored seven Issue Papers, 17 Issue Backgrounders, and numerous opinion-editorials for the Independence Institute. His writings have appeared in such Colorado publications as the ***Rocky Mountain News, Denver Post, Pueblo Chieftain, Colorado Springs Gazette, Greeley Tribune, Longmont Times-Call, Colorado Statesman, Colorado Daily, HeadFirst Colorado, Grand County Daily Tribune, Denver Daily News*** and ***Vail Mountaineer***. He is a contributing editor for the national monthly ***School Reform News***, and serves as the regular free market blogger voice on Education News Colorado.

Ben has made many guest appearances on Colorado radio and television programs to discuss policy issues. He has testified before legislative committees and has given presentations to community groups, legislators, candidates, and national conferences.
Ben was born in Pontiac, Michigan, in 1977, and grew up in the greater Detroit metropolitan area. He graduated summa cum laude from Hillsdale College in 1999 with a B.A. in History (Political Science minor) and received an M.A. in History in 2001 from The Pennsylvania State University.

Ben's experiences in the classroom include leading recitations and discussions as a university graduate assistant and a term as a substitute teacher in public elementary and middle schools in Michigan. He also spent nearly a year on the editorial staff of the ***Hillsdale Daily News***, where he earned Associated Press honors for local sports writing.

Linda Gorman

Linda Gorman is a Senior Fellow and Director of the Health Care Policy Center at the Independence Institute.

A former academic economist, she has written extensively about the problems created by government interference in health care decisions and the promise of consumer directed health care. Her articles on minimum wages, education, and discrimination appear in the ***Concise Encyclopedia of Economics***.

A frequent contributor to John Goodman's Health Policy blog, she is also a member of the Galen Institute's Health Policy Consensus Group and was appointed to the Colorado Blue Ribbon Commission for Healthcare Reform where she co-authored one of the Commission's minority reports. She holds a Ph.D. in economics.

Mark Hillman

Mark Hillman is a Colorado native, farmer, and a "recovering journalist." He was elected two terms in the Colorado State Senate and served as Majority Leader, as well as Colorado State Treasurer. In 2008, Mark elected to represent Colorado on the Republican National Committee.

In the Colorado Senate, Mark has been a leader in the fight to protecting the rights of private property owners against government takings, halting frivolous lawsuits and demanding personal responsibility, promoting economic opportunity in rural communities, and empowering parents through educational choice and accountability.

His dynamic, common sense leadership earned recognition as National Legislator of the Year, Champion of the Taxpayer, and Guardian of Small Business.

His commentaries have appeared in the ***Wall Street Journal***, ***Rocky Mountain News***, ***Denver Post***, Townhall.com and numerous other publications. He frequently comments as a guest or host on The Mike Rosen Show on Denver's 850 KOA.

Mark raises hard red winter wheat on his family's farm near Burlington, where he also grazes cattle and breeds quarter horses and thoroughbreds.

DENNIS POLHILL, P.E., PLS

Dennis received degrees in Mathematics and General Engineering from the University of Illinois in 1970. In 1978 Dennis received degrees from the University of Pittsburgh in Transportation Engineering (MSCE) and Public Works Management (MPA) after being awarded a fellowship in 1975 from the U.S. Department of Transportation to pursue graduate study.

He spent a decade in local government with the cities of Urbana, Illinois; Cumberland, Maryland; and Lakewood, Colorado, quickly ascending from construction inspector to City Engineer and Director of Public Works supervising a staff of over 200 people before the age of 30.

In 1981 Dennis found an outlet for his creative talent by leaving government to establish his consulting engineering and management firm Pavement Management Systems, Inc. and help to develop the new field of engineering: pavement management. Pavement management integrated materials science, computer data management, operations research, and financial analysis to help governments manage their pavements dollars more effectively.
Soon recognized internationally as a pavement expert, Dennis taught numerous workshops and seminars all over the U.S. and in 1984 taught graduate level Pavement Design for the University of Colorado as an Adjunct Professor.
Dennis became a Registered Professional Engineer in 12 states and a Registered Professional Land Surveyor in two states.
He was active in a multitude of professional organizations authoring numerous articles and serving in various leadership roles, including Transportation Research Board, American Society of Civil Engineers, National Society of Professional Engineers, American Public Works Association, and Institute of Transportation Engineers, to name a few.

As President of APWA in 1984, he led Colorado to receive a myriad of awards both nationally and internationally, including Most Outstanding State Chapter, and he was recognized for "Meritorious Service." He also served 4 years as President of the Graduate Public Works Alumni Association.

In 1993 Dennis became a Senior Fellow in Public Infrastructure at the Independence Institute. In addition to infrastructure and transportation, Dennis also writes about economic, role-of-government, and democracy issues. Several research papers are posted at www.i2i.org.

BARRY POULSON

Barry W. Poulson is Professor of Economics at the University of Colorado. He has been a Visiting Professor at several Universities including, Universidad Autonomo De Guadalajara, Mexico; University of North Carolina; Cambridge University; Konan University, Kobe Japan; and Universidad Carlos Tercera, Madrid, Spain.

He is the author of numerous books and articles in the fields of economic development and economic history. His current research focuses on fiscal policies and fiscal constitutions.

Professor Poulson is currently Americans for Prosperity Foundation's Distinguished Scholar. He has written several studies and articles for AFPF including Colorado's TABOR Amendment: Recent Trends and Future Projects and A Taxpayer's Bill of Rights for Wisconsin.

He has served on the Colorado Tax Commission and as Vice Chair of the State Treasurer's Advisory Group on Constitutional Amendments in Colorado.

Professor Poulson is Past President of the North American Economics and Finance Association. He is an Adjunct Scholar oatthe Heritage Foundation, and Senior Fellow at the Independence Institute.

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