Introduction & Overview: The State's Budget

Perhaps you expect America to continue to improve its economic circumstances. If Colorado tax receipts will increase unimpeded, you will find this Citizen's Budget report useful. Everyone agrees that government should be managed as well as possible, so you can use the report to address about $1 billion in less-than-optimal spending. No one should pretend that government can have it all, so policy decisions come down to important trade-offs. Is it wise to continue to promise impossibly generous public pensions? To degrade delivery of health care, or to reduce welfare payments to the disabled in order to put strong, able-bodied people on the dole? Follow the ideas in the *Citizen's Budget for 2013* to obtain better outcomes for your taxes.

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If on the other hand you expect the economy to slow again, you still will find this report useful. In that situation, you may follow it as a road map to matching taxes obtained by the government with the services that citizens demand of their government. Rather than become terrified by revenue shortfalls, use the *Citizen's Budget for 2013* to adjust to it.

The report is written with the assumption of continuing business stability, slow improvement in employment opportunities, and modest annual growth in income and taxes. That assumption is the post-Keynesian consensus that stock markets, government forecasters, and office holders are using. Many people point out that annual $1 trillion federal government deficits cannot go on forever, and they are right. Many also point out that fulfilling unrealistic promises of federal entitlement programs like Medicare, Medicaid, and Social Security, plus interest on the $16 trillion debt, eventually will consume government budgets, and they are right.

But few pretend to know when those crises will overwhelm the private, productive sector. We assume here that problems can be pushed off for at least a year or two, and that too few citizens or elected officials will act to prevent any massive deterioration. Such problems will be tackled after the crisis is upon us.

Economist Herbert Stein famously said, *"If something cannot go on forever, it will stop."* Whether you love the idea of the current course of government overspending and high taxation, or loathe the direction America has chosen, our individual likes and desires are immaterial. Reality cares nothing about our political preferences. The course the voting public has put us on is unsustainable, so eventually we all will have to confront the need for significant change. Please think to call us then; we already have ideas to address more dire situations.

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The State is not ready for a crisis, but would be somewhat better off if the concepts in this report were used.

For now, the State's budget is growing. It will have between $789 million[1] and $865 million[2] more to spend in the current 2012-13 fiscal year than last. The Governor thinks the additional funds should go for K-12 education, Medicaid, and higher salaries for state employees.[3]

The fundamental structure of overspending at the State level went unaddressed during the economic downturn. Instead, the legislature used various accounting manipulations, relatively minor budget adjustments to discretionary items, and enhanced federal aid.

An ongoing and ignored problem is the budgeting structure in which demand for more money each year is greater than expected revenues. In spite of increased tax receipts, citizens should demand that their legislators 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.

The current administration, many legislators, and reporters looking for sensationalized stories paint a consistent picture: years of drastic budget cuts and nothing left to cut, state services collapsing, and the painful alternative of raising taxes as the only remaining option. Citizens instead ought to collaborate with leaders to overcome short-sighted thinking to uncover the systemic improvements. Worse, any proposal to raise 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 can be realized only through a detailed examination of the current budget structure, identification of redundant and ineffective programs, and discovery of opportunities to redefine and reprioritize in order to bring state spending in line with current and future revenues.

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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, generally unlike families, have a different fiscal year. To understand how revenues and expenditures are timed, the reader must know that the new budget starts for Colorado on July 1, and straddles the end of the calendar year in order to wrap up its 12-month budget on June 30.[4]

For the current fiscal year that started on July 1, 2012, the State will spend a total of $20.6 billion. Contrary to overwrought reports from the media and certain legislators, total spending has continued an upward trajectory for several decades. Every year was higher than the previous, with the single exception of fiscal year 2011-12, when the federal stimulus subsidy ended, dropping federal funds by more than $400 million in one year. The current approved budget is scheduled to increase by about $850 million, or 4 percent from the previous year.

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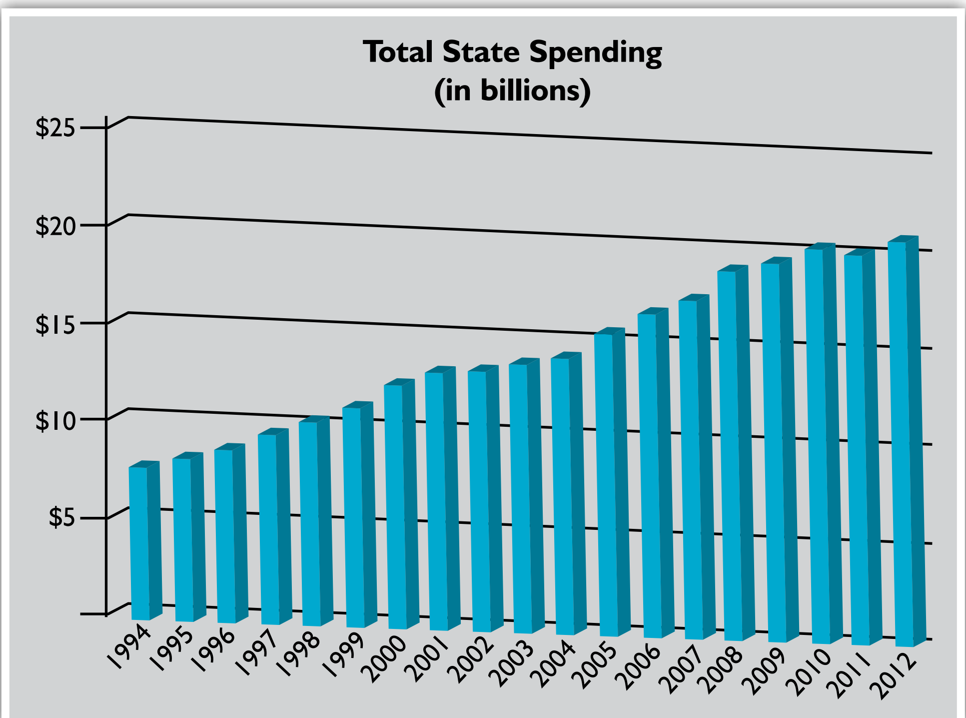
The increase in total revenues received and spent annually over the past 15 years



has more than doubled. The numerical increase spans both economic expansions and two recessions, including this most recent Great Recession. The average annual increase over that period has been roughly 4.2 percent.[5]

Put in *per capita* terms, the State's total fiscal year 2013 budget places a demand of $3,970 on every man, woman, and child living in Colorado.[6] 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 $10,051 on every working Colorado family.[7]

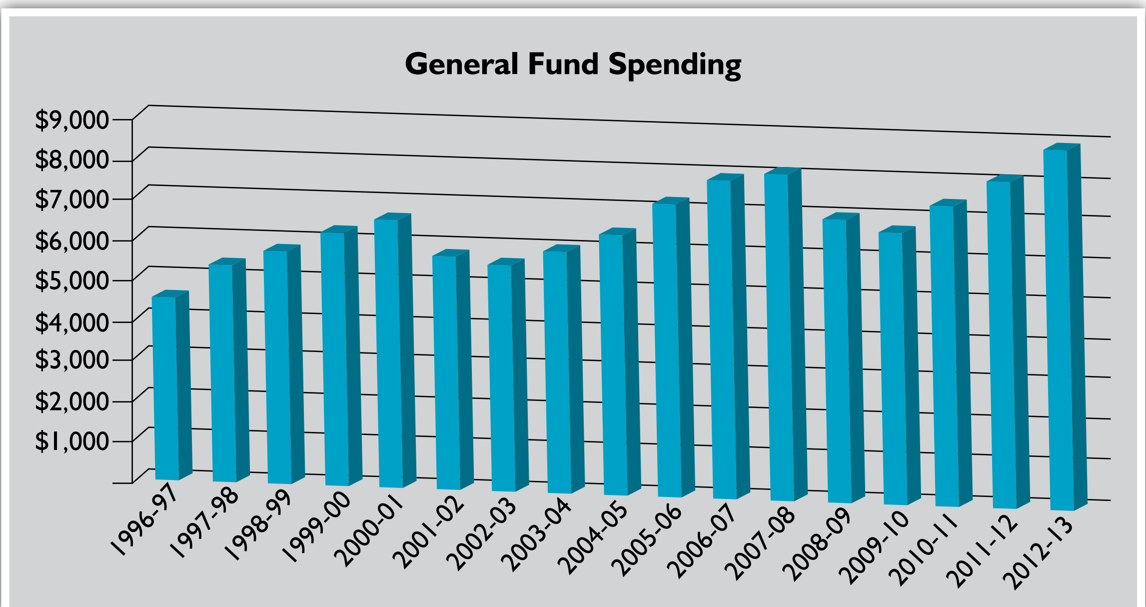
The Colorado Constitution prohibits the State from deficit spending.[8] Although Congress habitually spends more than the tax revenues generated for the federal government and borrows to fund its deficit, Colorado may not. In fact, the State has been prohibited from borrowing for any reason without prior voter approval. However, recent liberal interpretations by the Colorado Supreme Court have weakened this direct prohibition. As a result, within the past seven years, state government borrowed in order to build a medical facility and a prison, and skirted the voter requirement in doing so.[9] Otherwise, the State generally has conformed 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, you 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 40 percent of the total budget and generates the most debate and disagreement. In the year just ended on June 30, 2012, General Fund spending amounted to $8.14 billion.[10] For the current fiscal year that started on July 1, 2012, General Fund spending will increase to $8.45 billion,[11] and the outlook for the following fiscal year anticipates further growth to at least $8.9 billion. 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,[12] the income taxes you pay indirectly through corporate earnings, the State's portion of sales taxes on purchases,[13] excise taxes, and other taxes on assets[14] and income.[15]

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 most recent recession and the 2001-02 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 4 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 parking 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 that college and university students pay to state institutions are part of this category. So too is the 22-cent gas tax[16] you pay on every gallon of gasoline you put in your vehicle.[17] 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 supposed 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, in past years of lower General Fund receipts, the Legislature 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 controversial 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 reduce demands on the General Fund and thus avoid further raids on fee balance accounts. Ultimately, it will be up to the legislature to halt this questionable practice.

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Many people acknowledge that during the Ritter administration, the legislative and executive branches obtained tax rate increases. Using the subterfuge of calling increases in tax rates (which require advance approval by voters) an increase in fees (which do not require such votes), in 2010 the previous administration successfully pushed through a "dirty dozen" of fee increases. The prior year, the highly controversial "FASTER"[18] 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.

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 American Recovery and Reinvestment Act (stimulus) program. The federal government promises to pay almost all of the costs of the new health care programs. If the federal moneys are not available, the State will have to backfill the difference.

The occurrence of matching funding in education has followed two different paths. More than 14 percent of Colorado's legislative appropriations for K-12 education are made up of federal money. Federal funds appropriated by the legislature for higher education have declined significantly to 0.63 percent, although there is more direct federal funding for colleges and universities that does not appear in the State budget.[19]

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Outlook

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.[20] We utilize the recent forecast here to understand that the General Assembly expects the economy to grow slowly in the next year. 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]

Facing the State and the private sector, and not resolved before this report went to print, were several major Congressional actions. Updated federal legislation was needed to address the automatic sequestration of spending and a new, higher federal government debt limit. Pundits and observers called for delicate handling of the situation so as to avoid pushing the nation back into recession.

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 during the recession. 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.

Although the Federal Reserve Bank has *more than tripled* the monetary base since the recession started, soaring from $900 billion to $2.7 trillion,[22] it is still pursuing a program of quantitative easing. The "federal funds"[23] rate is close to zero, as it has been since it dipped below 1.0 percent on October 16, 2008.[24] As a result, there is little room for monetary policy to become more "accommodative," and inflation is a strong possibility in some out-year.
General Fund revenues are highly susceptible to fluctuations in the health of the Colorado, national, and global economies. Colorado's economic retrenching during the recent recession and subsequent slow economic recovery mirrored the experience across the nation. That circumstance was repeated in almost every other state. 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? The sources of those federal funds have come from borrowing and not from new tax receipts. Many people see huge negative implications in the Federal Reserve System[25] buying up U.S. Treasury bonds directly, after lenders did not subscribe to the full issuance.

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 we can conclude the structure has been established to grow spending faster than revenues. A systemic problem has existed in Colorado, during good years and bad, for most of the past decades. It is impossible for the private sector to gain ground on public spending if the system is rigged for increases that always will be larger on the side that demands services than the side that pays for them. That reality goes a great distance in explaining the antipathy towards TABOR manifested by supporters of bigger government and tax consumers.

For a more complete understanding of the budget process, see that section, page 19. 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 government 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, you 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[26] 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 state taxpayers. Solutions have been deferred year after year. In the previous 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.

The current administration and the current class of legislators favors only increasing the revenue side of the equation by promoting higher fees and increased taxes. Continued tax rate increases will promise short-term solutions in order to quiet budgetary concerns. Even those steps may backfire, though, 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.

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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 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 still may obtain the basic services that few argue should be central to the properly defined role of government.

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 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.

We extend our thanks to **Natalie Mullis**, Chief Economist for Legislative Council, who patiently compared our budget facts and figures to the information reported by her office and other government entities. Our understanding and statistical statements were improved by her comments, and any remaining mistakes in figures are our own.

We extend our appreciation to **Thomas Ryan**, who helped to write the original introductory chapter, on which a great deal of this year's updated chapter is based. 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. 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, both from Regis University.

Endnotes

1 Colorado Legislative Council Staff, "Focus Colorado: Economic and Revenue Forecast," Economics Section, December 20, 2012, Table 1, line 6, p. 4. http://www.colorado.gov/legcouncil/Forecast/12decemberforecast.pdf.

2 Governor's Office of State Planning and Budget, "The Colorado Outlook. Economic and Fiscal Review," December 20, 2012, p.2,http://www.colorado.gov/cs/Satellite?blobcol=urldata&blobheader=application%2Fpdf&blobkey=id&blobtable=MungoBlobs&blobwhere=1251843184456&ssbinary=true.

3 Ivan Moreno, Associated Press, "CO budget plan focuses on investments, not cuts," Reported in the *Denver Post*, November 1, 2012, http://www.denverpost.com/ci_21902754/hickenlooper-unveil-next-colo-budget?IADID=Search-www.denverpost.com-www.denverpost.com.

4 The federal government's fiscal year runs from October 1 to September 30 of the next year. Its current budget year started on October 1, 2012, and will end on September 30, 2013.

5 This figure is not adjusted for inflation. Over the same period, from 1999 to 2013, inflation averaged 2.4 percent per year. See http://inflationdata.com/Inflation/Inflation_Rate/HistoricalInflation.aspx.

6 There are approximately 5,189,000 residents of Colorado. See http://www.colorado.gov/cs/Satellite?c=Page&childpagename=DOLA-Main%2FCBONLayout&cid=1251593346834&pagename=CBONWrapper

7 There are approximately 2,049,600 families living in Colorado. See https://dola.colorado.gov/households/forecastsParameters.jsf. Choose statewide, 2012, all households, total (age groups)

8 Article X, Section 16.

9 Governments issue "certificates of participation" (COPs) to get around the existing restriction. That type of security instrument is amortized like a bond, pays interest and returns principal like a bond, but is not called a bond because the legislative body that authorizes it must re-authorize it every year. By taking that *pro forma* vote once a year, the debt is officially not a multi-year obligation and therefore legally exempt from prior voter approval.

10 Revenue Summary Report, Fiscal Year 2011-12, http://www.colorado.gov/dpa/dfp/sco/rs.htm. The amount comes from "Total General Fund Revenues" in the column "Year-to-Date Accrual Basis Actual." Using the number that most closely represents the total taxes paid into the General Fund every year was confirmed through an interview with State Controller David J. McDermott CPA, on November 23, 2012, and refined in a telephone call on February 18, 2013.

11 "Focus Colorado," ibid. See Table 1, p. 4, "General Fund Overview," column FY2012-13, line 16, "Amount Available for Expenditure." 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 are not included in line 16. They therefore must be included in annual spending calculations by adding line 26, "Amount Directed… by Amendment 23."

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

13 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.

[14] There is an estate tax (death tax), taxes on insurance premiums, gambling and more. Property taxes are local. At the time that the TABOR amendment passed, there was not a significant statewide property tax in place and the TABOR Amendment (paragraph 8) clearly inserts a constitutional prohibition that "No new state real property tax ……. shall be imposed."

[15] 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.

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

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

[18] Senate Bill 09-108.

[19] http://www.state.co.us/gov_dir/leg_dir/jbc/FY12-13apprept.pdf, Part II, Summary Tables, p. 14.

[20] 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.

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

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

[24] http://research.stlouisfed.org/fred2/data/FEDFUNDS.txt.

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

[26] 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 Issue Paper 8-2009, http://old.i2i.org/articles/IP_8_2009_a.pdf.