

Issue Brief



January 2009

Balancing the State Budget

Summary

Colorado's second recession this decade is now expected to lead to a 6.8 percent decline in state General Fund revenue and a shortfall of more than \$600 million to support spending plans in the current state fiscal year, which ends June 30, 2009. The Colorado Constitution requires that the state budget be balanced each year, so policymakers in the legislative and executive branches are wrestling with ways to plug the massive gap between revenue and spending. *But while many are focused on the current year, whatever is done to balance the \$7.5 billion General Fund budget this year can have profound implications for future years.* Options to balance the budget include the use of the reserve (*page 1*), borrowing from cash fund balances (*page 2*), reducing appropriations (*page 2*), and other steps (*page 4*). No doubt a combination of these approaches will be used, but like a recipe, the proportion of each ingredient is critical – and in the case of the state's current fiscal dilemma, the proportion of each option used should be measured with a view to the longer-term implications for a sustainable state budget. This article discusses each of the options currently under consideration and examines the “pay now or pay later” implications of a budget plan (*page 3*).

Using the General Fund Reserve

The state has an emergency reserve to use in the event of revenue shortfalls. The General Fund reserve is set at 4 percent of appropriations in most years. However, the legislature has reduced the reserve requirement when it needed to tap into the reserve. For instance, the reserve requirement was completely eliminated during an economic downturn in FY 2001-02. Rather than setting a particular percentage requirement in FY 2002-03, the reserve was established at \$131.3 million, or 2.4 percent of total appropriations for that year.

Based on the budgeted appropriation amount for the current year, the General Fund reserve requirement is \$301.6 million. Exhausting the reserve

would make up nearly one half of the projected \$625 million shortfall. Use of the reserve fund in mid-year is appropriate as it creates additional time to formulate a long-term plan for budget reductions. Use of the reserve can temporarily alleviate across-the-board reductions that could reduce program benefits for people who are particularly impacted by an economic downturn, such as Medicaid recipients.

Forty-seven states have a rainy day fund or other reserves intended for use when revenue shortfalls occur. Colorado's fund is low compared with most states – only five require less than Colorado's 4 percent. The highest cap on a reserve requirement is 15 percent in Nevada and Massachusetts. The *Center for Colorado's Economic Future* will

examine rainy day funds in greater depth in a future Issue Brief.

Using Transfers From Other Funds

Transferring money from other state funds is another stopgap way to help balance the budget. About \$300 million is available for transfer, according to the governor's office.

That amount is substantially less than what was transferred during previous budget shortfalls in FY 2001-02 and FY 2002-03. More than \$1.2 billion was moved to the General Fund in those two years, but only a small percentage has been repaid to the cash funds. This has resulted in the relatively smaller amounts available in cash fund balances today. As with

the reserve, use of transfers from cash fund balances may be appropriate in a mid-year shortfall to allow the state to formulate a more thoughtful budget reduction plan.

The state should develop a plan to rebuild the balances in its cash funds, which include the major medical fund, the workers' compensation fund and the subsequent injury fund. This is a sound idea, not just to make more money available for future transfers to the General Fund but to preserve the original intent in maintaining cash fund balances. Legislators should keep in mind that the state faces some risk in building balances by increasing cash fund fees. The risk occurs because increasing fees in cash funds may trigger a TABOR refund from the General Fund. The best way to restore cash fund balances would be to pay back the transfers from the General Fund.

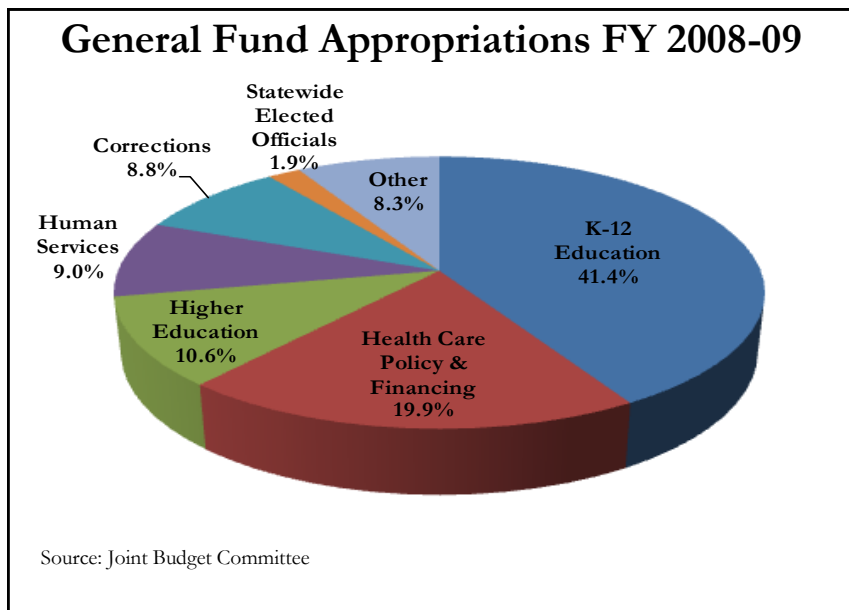
However, this is easier said than done, again illustrating the many constraints on the General Fund.

Reducing Appropriations

Using the rainy day fund and cash fund transfers are not permanent solutions. These infusions to the General Fund are "one-time" money. A reduction in appropriations must eventually be considered.

Reducing appropriations is the most difficult option for the General Assembly given that half of the budget year has already passed. The experience of the decade's earlier recession illustrates the difficulty. General Fund revenue declined 15 percent in FY 2001-02, but appropriations still increased by

5.7 percent because mid-year reductions were only minimal. The timing of the revenue decline during the fiscal year was similar to the current situation. Faced with other available options at the time to balance the budget, the General Assembly chose to leave FY 2001-02



appropriations largely untouched. This time, appropriations reductions might be inevitable if the recession and weak revenue picture are prolonged and other options are initially chosen to balance the budget. Any reductions must be focused on a narrow part of the budget given constitutional and caseload mandates for many programs.

The pre-school through 12th grade (P-12) portion of the budget is protected by the constitutional mandates of Amendment 23. Weaker-than-typical assessed value projections will place some additional pressure on General Fund support for schools.

Legislative economists recently estimated assessed value growth at 4.5 percent for FY 2009-10 and -1.8 percent for FY 2010-11. This was significantly weaker than what was predicted a year ago. Lower estimates for inflation and enrollment growth will somewhat offset the weakness in assessed value growth. P-12 education accounts for 41.4 percent of FY 2008-09 appropriations.

A significant portion of the rest of the budget is caseload driven (Corrections, Health Care Policy and Financing and Human Services), and therefore it would be difficult to extract significant immediate reductions. These portions of the budget ac-

reached by reducing appropriations by \$625 million. This assumes that the 4 percent reserve is maintained and no transfers of cash funds are made to the General Fund. It would allow appropriations to increase by 0.4 percent in FY 2009-10.

The chart below shows what must happen to appropriations to balance the budget with various combinations of transfers and reserve changes in the current year. We assume that transfers will not occur in FY 2009-10 and the 4 percent reserve requirement is maintained for that year. The amount for FY 2008-09 is in dollars, while the amount for FY 2009-10 is shown as a percentage change from

Paths to a Balanced Budget (dollars in millions)						
Transfer of Cash Funds in FY 2008-09		Percentage-Point Reduction in the Reserve				
		0	1	2	3	4
The Budget Implications Are:						
\$100	\$ change in FY 2009	-\$529	-\$461	-\$391	-\$320	-\$248
	% change in FY 2010	-0.1%	-2.8%	-4.7%	-6.5%	-8.4%
\$200	\$ change in FY 2009	-\$433	-\$364	-\$293	-\$221	-\$148
	% change in FY 2010	-2.2%	-4.1%	-5.9%	-7.8%	-9.7%
\$300	\$ change in FY 2009	-\$336	-\$266	-\$195	-\$122	-\$48
	% change in FY 2010	-3.4%	-5.3%	-7.1%	-9.0%	-10.9%

Source: CCEF analysis of Colorado Legislative Council data

count for 37.7 percent of appropriations.

Pay Now or Pay Later

As mentioned earlier, the use of the rainy day fund and cash fund transfers are not permanent ways to balance the budget. They help in the initial year of a downturn, but a prolonged revenue squeeze will necessitate actual budget reductions in the following year. This is illustrated by what happened earlier in the decade. Despite the transfer of more than \$1.2 billion in cash funds to the General Fund and the use of the reserve over two years, General Fund appropriations were reduced by 4.3 percent in the second year of the budget crisis.

A balanced budget for the current year could be

the adjusted appropriations for the previous year. A budget for FY 2009-10 has not been passed yet, so a dollar change is not applicable.

For example, by transferring \$200 million and reducing the statutory reserve by 2 percentage points, appropriations would need to be reduced by \$293 million in the current year. By not reducing appropriations to the fullest extent to balance the budget this year, next year's appropriations must be reduced by 5.9 percent from the reduced base for this year. If the reserve is reduced by an additional 1 percentage point, next year's budget must be reduced by 7.8 percent. To eventually reach a balanced budget, the governor and legisla-

ture must pay now or pay later.

Other Budget Solutions

Some legislators have mentioned the sale of state property to balance the budget. This is a one-time source of funds and actual budget reductions still would be necessary eventually. Securitizing tobacco settlement proceeds was seriously considered during the last revenue downturn. This alternative would bring upfront money to the state at the expense of future proceeds from the tobacco settlement. Again, this is a one-time infusion. Money budgeted for construction projects also is available for use. Additionally, eliminating the homestead exemption for seniors and disabled veterans, estimated at \$91.4 million, is under consideration for FY 2009-10.

Increasing fees is only a partial solution, given that relatively small amounts of fees are deposited into the General Fund. Court fees were raised during the last budget downturn, and the legislature temporarily reduced the 3½ percent vendor discount that retailers retain for collecting the state sales tax. These actions would provide a minimal amount relative to the size of the revenue shortfall.

Some have suggested voter-approved tax increases as a long-term solution. Given the timing of a tax-increase election, it would be relatively late in the process to achieve a balanced budget. Raising taxes would allow the restoration of some program cuts in the long run if the 6 percent cap on increases in General Fund appropriations was lifted. However, the next economic downturn would once again ratchet down appropriations.

The only long-run solution to avoiding these difficult choices in future downturns may be to increase the rainy day fund. However, given that every dollar of state revenue is spent on some program, it would necessitate short-term pain for long

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-term gain.

Conclusion

While Referendum C provided relief from potential deficits three years ago, the state was still at risk from economic downturns. State government will face chronic structural deficits in the future. The *Center for Colorado's Economic Future* will examine how the state might avoid budget problems in a post-Referendum C environment in future releases examining school finance, revenue and spending limits, and a rainy day fund.

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The Center for Colorado's Economic Future at the University of Denver is an independent, nonpartisan organization that conducts research on matters related to Colorado's fiscal health, trends affecting the state's economy and proposed legislation relating to taxation and public spending.