

RETHINKING COLORADO'S GOVERNMENT

Principles and
Policies for Fiscal
Sustainability

2011 Report of the
**University of Denver
Strategic Issues Panel
on State Government**





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Letter from the Chancellor

Dear Friends,

All of us are living through a time of enormous cultural, political, and economic change. Many of the immediate issues—recession, sovereign debt, joblessness, government gridlock, economic polarization, declining public schools and decaying transportation systems, to name just a few—are entwined with one another, and proposed solutions on one front often seem to exacerbate problems on another. There are no simple answers, and this time history does not seem to inform a clear path forward: the solutions of the past seem to be generally ineffective in the present. One senses that the depth of our problems is such that successful navigation of this time may well entail changes in the overall *fabric* of our society and its reflection in local, state, and federal governments.

This year our Strategic Issues Program focused its work on the many issues facing our Colorado state government, brought on by the broader economic crisis. Rather than attack these issues individually (as many groups have done), our panel concentrated on broad principles and on the *structure* of government, seeking to define changes that would enhance long term fiscal stability and at the same time be applicable to a variety of policy areas. Consequently, the recommendations made in the report do not offer particular solutions, but rather collectively define a roadmap for general progress, a foundation upon which those solutions might be built.

The panel assembled for this task represented once again a very broad spectrum of the state's geography, economics, culture and political opinion. Each of the thoughts and recommendations presented in this report reflects a consensus among the panel members; while there were no votes taken, ideas about which there was significant division are not presented. It is truly remarkable (and refreshing) that when presented with clear information, people of such disparate backgrounds and perspectives can agree.

The University is grateful to the members of this Strategic Issues Panel and to Professor Jim Griesemer, its chairperson, for their diligence and hard work on this project. I hope that you will enjoy reading the report, and that it will give rise to many more constructive conversations on these important matters.

Sincerely,



Robert D. Coombe
Chancellor, University of Denver



Overview from Panel Chair

Colorado and other state governments have been experiencing fiscal upheaval on a scale not seen since the Great Depression. The severity of the financial crisis led the University of Denver to ask its 2010–2011 strategic issues panel to focus on the challenges facing Colorado. The panel's work was funded by the University as part of its ongoing commitment to support the public good.

As with prior panels, the Strategic Issues Panel on State Government was nonpartisan in nature and comprised of accomplished citizens from various segments of the Colorado community. While the panel was nonpartisan, its members brought diverse views to the process. In the course of its year-long effort, panel members received more than 30 presentations from officials, experts and advocates. In addition, they reviewed a wide range of written materials and held extensive discussions on key issues facing Colorado and other states.

The extraordinary breadth of the topic—the entirety of state government—caused the panel to seek broad principles rather than offer detailed policy prescriptions. The goal was to identify a limited number of principles that could enhance fiscal stability and, at the same time, be applicable to a variety of policy areas. As a result, the report's emphasis is on ways to *think about* government as a foundation for deciding what to *do about* specific issues.

In the broadest sense, the panel faced the question “How can Colorado create a strong and sustainable fiscal future?” The responses offered by the panel suggest new approaches to state government: Shift the perspective of government from itself—the institution of government—to citizens; focus intently on creating citizen value; build citizen support by making value visible; change the fiscal structure of state government; and leverage the forces of competition and markets to maximize the effective use of resources.

This report reflects the consensus of the University of Denver Strategic Issues Panel on State Government. It contains the panel's assessment of the issues, along with conclusions and recommendations for Colorado state government. The report is organized into four sections: *Fiscal Fault Lines*, *Principles for Progress*, *Frameworks for Policy* and *Constitutional Impediments*.

The first section, *Fiscal Fault Lines*, briefly examines the fiscal dynamics that exist in Colorado. It concludes that the state's financial difficulties are the result both of cyclical events, such as economic recessions, and structural factors that undermine Colorado's fiscal stability over the long term. While Colorado's budget situation may slowly improve as the economy recovers, it is poised to founder once again at the next economic downturn. Fundamental change is needed to create a sustainable fiscal environment for Colorado.



“The report’s emphasis is on ways to *think about government* as a foundation for deciding what to *do about the issues.*”

Principles for Progress presents new perspectives and identifies principles that could help guide officials as they consider difficult policy questions. These principles do not offer simple solutions or quick fixes. The problems facing Colorado and other states will not be solved in a single stroke. What the principles do provide are ways to think about policy questions. Taken together, these principles suggest the need to:

- **Reframe government;** place citizens, rather than the institution of government, at the center of public discourse and decision making.
- **Focus on value;** shift the focus of government to creating measurable value for citizens instead of thinking in traditional institutional terms.
- **Change the financial structure;** use accountability centers to facilitate value assessment, dampen fiscal imbalance and highlight public subsidies.
- **Foster competition;** focus on outcomes, with the state acting as an enabler, not necessarily the provider, of public services.
- **Leverage market forces;** allocate resources based on citizen demand, focusing primarily on supporting individuals rather than operating institutions.
- **Fully fund programs;** align authority and responsibility in intergovernmental activities, eliminate unfunded mandates and fully fund annual state obligations.

Frameworks for Policy examines several key policy issues through the prism of principles discussed in this report. The result is a series of policy frameworks that illustrate ways in which those principles might apply to various issues. Policy areas discussed include K-12 education, higher education, transportation, Medicaid, PERA and others. The final section of the report, *Constitutional Impediments*, examines the impact of Amendment 23 and TABOR on Colorado’s fiscal stability. The panel concludes that these constitutional amendments have exacerbated the state’s fiscal crisis.

The conclusions and recommendations offered throughout this report imply neither an expanded or lessened role for government nor specific tax rates or funding levels. The panel’s aim was to step back from day-to-day practices, look at state government anew, and consider approaches that might lead to greater fiscal stability and more effective services for citizens. To the degree this report informs the public discourse and offers perspectives that Colorado’s legislature, governor and other policy makers find useful, the panel’s efforts will have been worthwhile.



James Griesemer, chair
University of Denver
Strategic Issues Panel on State Government



Report of the University of Denver Strategic Issues Panel on State Government

FISCAL FAULT LINES

Between fiscal 2008 and fiscal 2010, Colorado's general fund revenue declined by \$1.3 billion, a reduction of 16.6 percent. Those declining revenues, along with rising expenditures, produced extraordinary budget shortfall projections: \$1.2 billion in fiscal 2009, \$1.7 billion in fiscal 2010, \$1 billion in fiscal 2011 and an estimated \$1 billion in fiscal 2012. As required by law, legislators ultimately produced a balanced budget each year.

Balancing the budget in each of these years required significant expenditure reductions. For example, when the fiscal 2012 budget was adopted, spending cuts included closing a state prison, a \$230 million cut to K-12 education, an \$81 million cut to higher education and other reductions. The state eliminated vacant employee positions, implemented salary freezes and furlough days, and increased employee contributions to the state retirement fund to alleviate state expenditures.

The fiscal 2012 reductions described above were *in addition to* budget cuts made in fiscal years 2009, 2010 and 2011. In spite of year-after-year budget reductions, forecasters predicted that the state would continue to be under financial pressure for many years unless major policy changes were implemented. In sum, the financial challenges facing Colorado in both the near and long term

are serious and are not likely to be solved by tinkering at the margins of fiscal policy.

There is little doubt that the fiscal crises experienced by Colorado and other state governments were triggered by the housing and financial collapses that gave rise to what has been called the Great Recession of 2007–2009. The recession was an enormously powerful event, but it was not the only cause of financial turmoil. In many states, fiscal policy decisions made over many years created an environment that allowed a private sector shock wave to become a public sector tsunami.

Revenue Volatility

It is customary to think of government revenue as relatively stable, while business income fluctuates significantly based on the economy. In fact, state revenues can also be highly volatile. Figure 1 shows income and sales and use tax collections for Colorado and all states since 1992, a period that encompassed two recessions. It depicts the volatility of these tax sources that together represent the largest sources of revenue for most state governments. Colorado is even more dependent on these sources than many states, with income, sales and use taxes constituting more than 90 percent of the state's general fund revenue. As a result, Colorado's revenues reflect a pattern similar to that of other states, but with even greater volatility.



Anne Warhover
State Government Panel Member



The volatility of state revenue increases during periods of economic change, as illustrated in Figure 2, which shows the percentage change from year to year. Fluctuations at these times can be dramatic, making state revenues difficult to predict. During each of the last three recessions, average revenue estimates for all states have become progressively less accurate and overestimates have become larger. In 2009, half of all states overestimated revenues by more than 10 percent. As a result, during times of recession states like Colorado can find themselves continually revising income and expenditure estimates downward throughout the budget year.

Expenditure Momentum

Highly volatile revenues, significant as they are to fiscal instability, are only one-half of the financial crisis equation. The other element is expenditure momentum that exists because government expenditures often have characteristics that make them difficult to control. Expenditure momentum may be a result of intentional public policy decisions, economic factors beyond the control of government, fiscal mandates imposed by other governments or constitutional requirements.

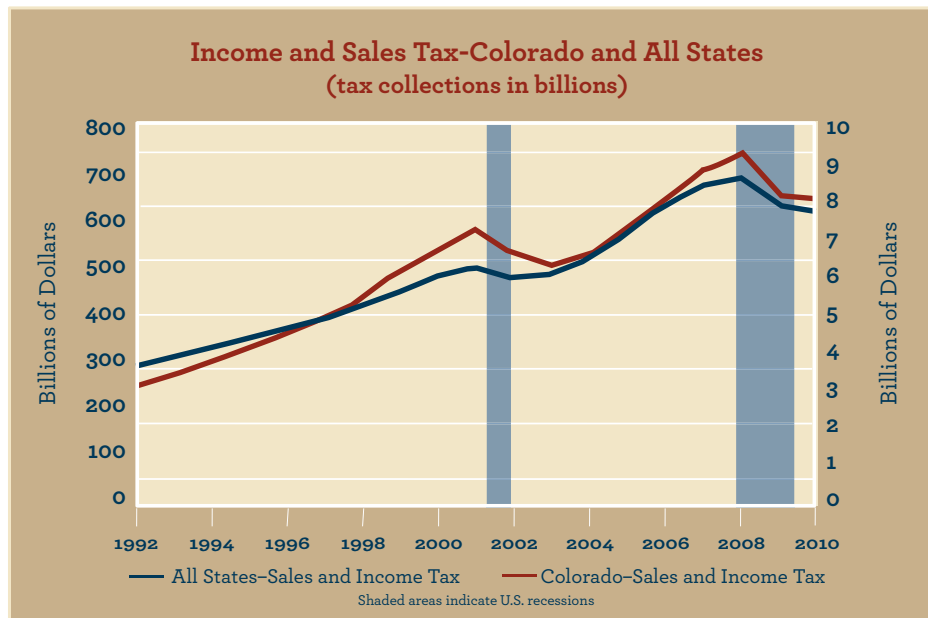


Figure 1 – State Income and Sales Tax Collections

Source: U.S. Census Bureau, State Government Finances

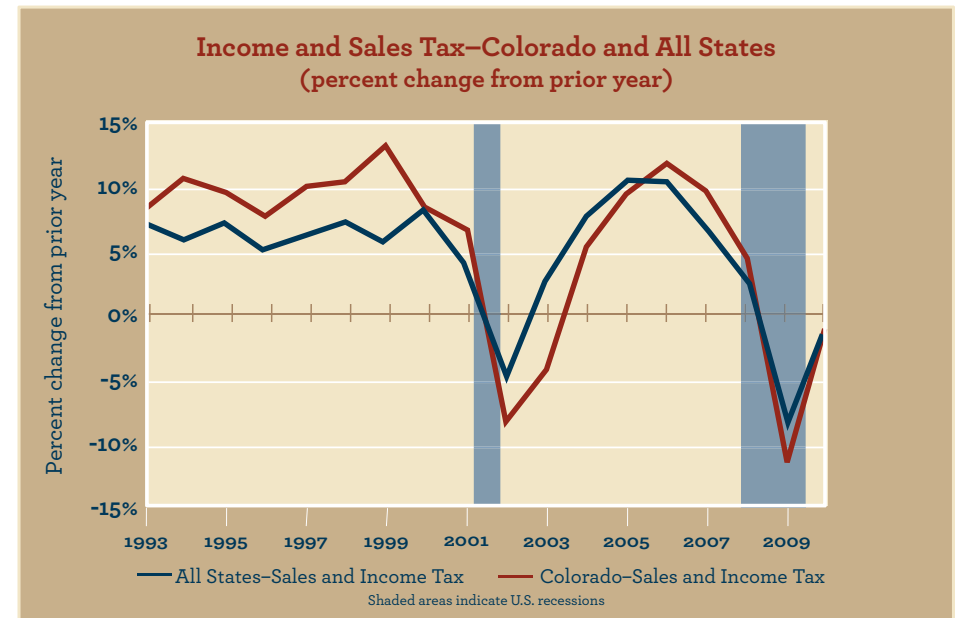


Figure 2 – Percentage Change in Income and Sales Tax Collections

Source: U.S. Census Bureau, State Government Finances

“The fiscal fault line for state government lies at the intersection of revenue volatility and expenditure momentum....a point of fiscal imbalance waiting to be triggered by the next economic downturn.”

Certain types of government expenditures such as unemployment compensation, social services and some higher education programs are countercyclical by nature; that is, demand for the service expands as the economy contracts. Thus, at the very time when volatile revenue sources are declining, countercyclical expenses are increasing. In theory, countercyclical government programs can help soften the impact of economic cycles and pave the way to recovery. However, implementing such deficit-generating programs over any period of time requires either significant fund balances to cover the resulting deficits or the ability to print money. States typically do not maintain large surpluses and they cannot print money.

Expenditure momentum also occurs when costs rise faster than revenues over the long term, notwithstanding economic cycles. For example, health care costs, which are generally beyond the control of states, have risen faster than inflation for many years. Additional contributors to expenditure momentum are long-term expenditure commitments that must be funded annually irrespective of economic conditions. Prime examples here are state pension fund obligations and retiree health benefits. Federal and state mandates also contribute to expenditure momentum by requiring lower-level governments to make expenditures irrespective of whether revenues are available. In addition, constitutional mandates, such as Amendment 23 in Colorado, may require the state to spend money with little regard to economic conditions.

Fiscal Imbalance

The fiscal fault line for state government lies at the intersection of

revenue volatility and expenditure momentum. This is a point of fiscal imbalance waiting to be triggered by the next economic downturn. It is a condition that characterizes Colorado and other states. Figure 3 shows the effects of fiscal imbalance for all states during the 2007–2009 recession. The trend lines show that, as tax revenues declined, spending on entitlement and mandated programs continued to increase. As a result, state discretionary programs—all the other parts of the budget—were either constrained by limited funding, reduced in scope

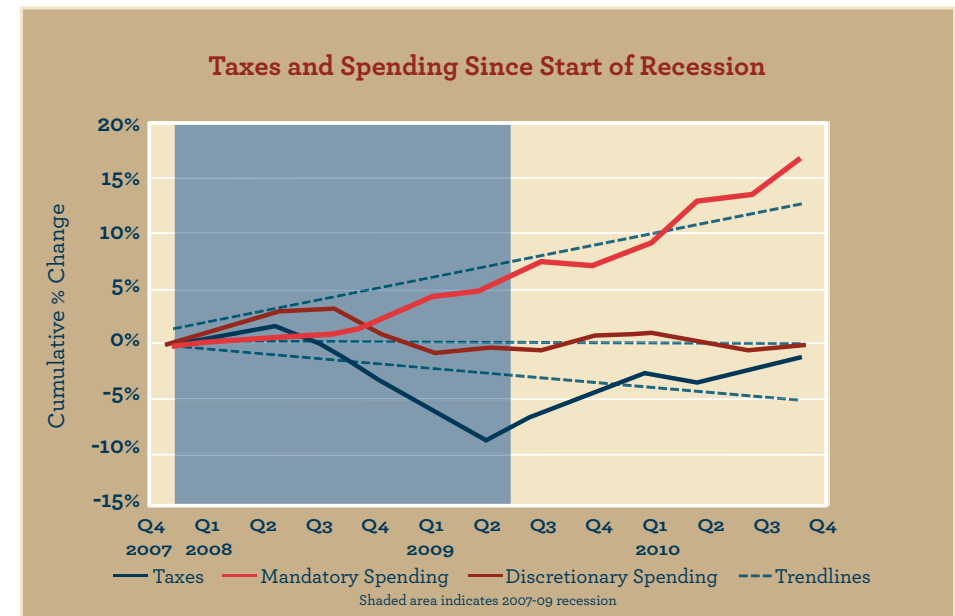


Figure 3 – State and Local Taxes and Spending During 2007-09 Recession

Source: Rockefeller Institute of Government, SUNY Albany



or eliminated. Even as revenues began to recover, mandatory spending increased more rapidly, which continued to restrain other priorities.

Cyclical fiscal imbalance becomes a *structural* problem when the probability exists that revenues may never catch up with constantly growing expenditures. This is currently the case with health care costs and remains a concern with entitlement programs in general. A 2011 Governmental Accountability Office (GAO) report uses long-term economic model simulations to project future state and local government deficits. It offers a grim assessment of the future unless significant policy changes are made. The GAO report looks ahead to the year 2060 and offers the following commentary on the future of state and local government finance:

“The model’s simulations show that the fiscal position ... will steadily decline through 2060 absent any policy changes ... We calculated that closing the fiscal gap would require action to be taken today and maintained for each year equivalent to a 12.5 percent reduction in state and local government current expenditures.”

Figure 4, drawn from the GAO report data, shows how the fiscal situation of state and local government is likely to deteriorate in the absence of fundamental policy changes. The projection is based on estimates for 2010 with data for 2011–2060 drawn from GAO model simulations. Although the projection is illustrative because states cannot run deficits for any extended period of time, it is very important. The chart depicts the increasing pressure that governments will face as they try to bring their budgets into balance each year. A number of other

studies that have examined state and local government finance have come to similar conclusions.

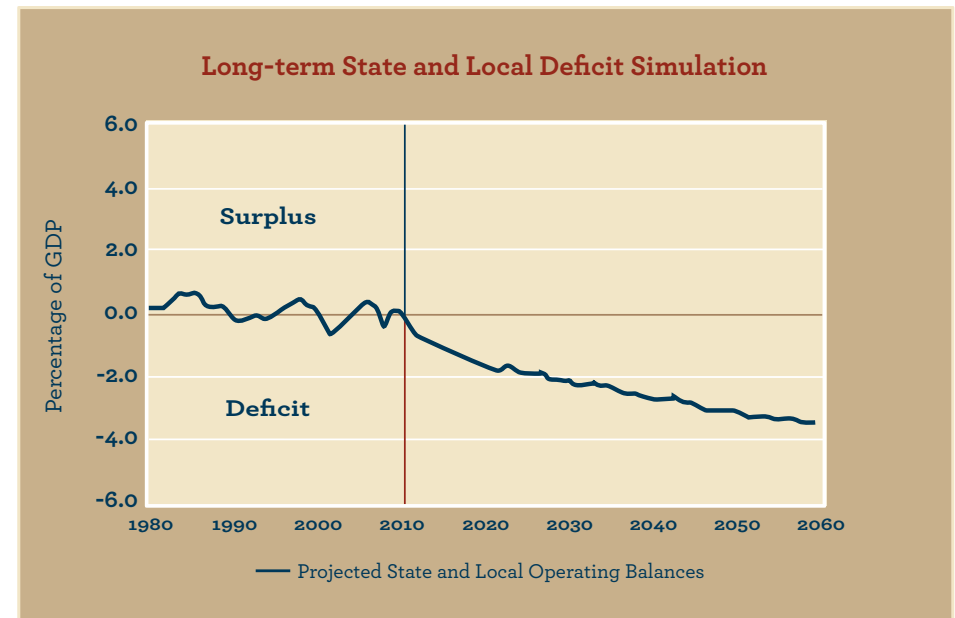


Figure 4 - State and Local Government Projected Operating Balances

Source: Source: Governmental Accountability Office simulations

A new study, *Financing Colorado’s Future*, concludes that a similar situation exists in Colorado. Prepared in 2011 by the Center for Colorado’s Economic Future at the University of Denver, the report presents a comprehensive picture of Colorado’s financial situation. The study indicates that the state is experiencing both cyclical and structural fiscal imbalance and suggests:



“Even a strong recovery and sustained job growth over the next decade and a half will not produce enough income and sales tax revenue to afford Colorado’s share of Medicaid funding and the state’s payment for public schools under current constitutional and statutory provisions. ... the two biggest programs in the state general fund will continue to crowd out higher education and other programs competing for the same tax dollars.”

The implications of the statement are graphically illustrated in Figure 5, which depicts the fiscal squeeze Colorado will face in years to come.

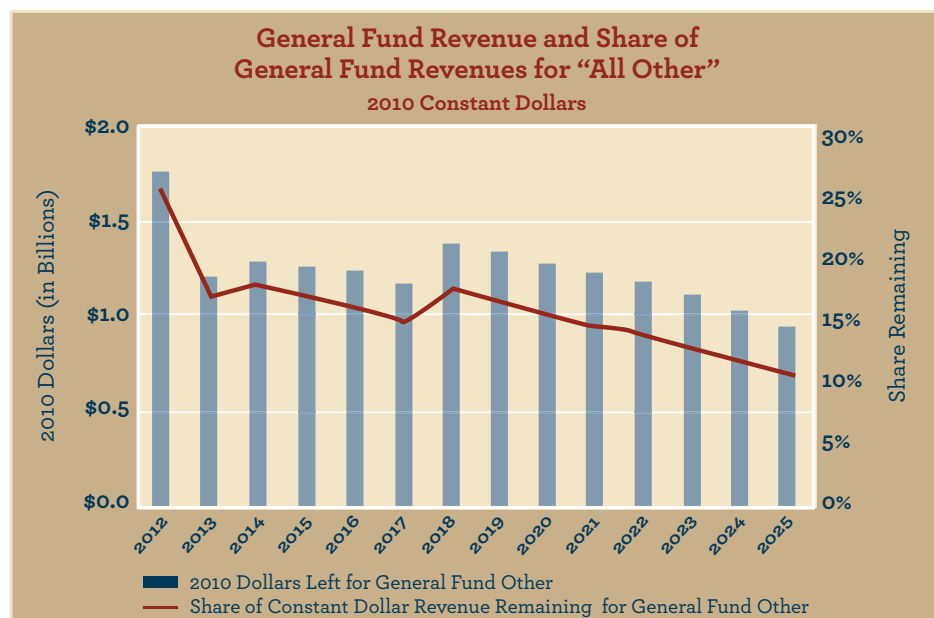


Figure 5 – Colorado General Fund Revenues Available for Programs Other than Medicaid and Mandated Expenses

Source: Center for Colorado’s Economic Future, University of Denver

To summarize, many states rely heavily on income and sales taxes that are highly volatile, especially during periods of economic change. Colorado is more reliant on these sources than most states and experiences greater financial turbulence. While revenues rise and fall with economic cycles, major state expenditures continue to increase, irrespective of economic conditions. This creates a structural imbalance that constrains other budget priorities. Evidence suggests that this imbalance will not cure itself; rather, without basic policy changes, it will become more severe over time.

All of these conditions—volatile revenue sources, uncontrolled expenditures and a crowding out of other priorities—are the result of policies and practices put in place over many years. The state is facing a complex fiscal problem, one that requires new perspectives and structural change. Falling back on past practice is not a viable option if Colorado is to attain fiscal stability. *The panel concludes that achieving a strong and sustainable fiscal environment in Colorado requires rethinking traditional practices and considering new principles to help guide the development of state policies in the twenty-first century.*

“The panel concludes that achieving a strong and sustainable fiscal environment in Colorado requires rethinking traditional practices and considering new principles ...”

PRINCIPLES FOR PROGRESS

As the panel moved from an analysis of Colorado’s financial challenges to a broad discussion of state government, six principles emerged. These principles suggest the need to: reframe government; focus on citizen value; reform the financial structure; encourage competition; leverage market forces; and fully fund governmental programs. The panel believes these principles can help the state become more flexible, adaptable and responsive and support Colorado’s progress toward a strong and sustainable fiscal future.

Reframing Government

Place citizens, rather than the institution of government, at the center of public discourse and decision making.

Reframing Government

States are large, complex organizations that are not easy to control under the best of circumstances. Fiscal conditions in Colorado and other states make the job even more challenging. In recent years, Colorado’s governors and legislators have done a commendable job of making tough decisions to manage an extraordinarily difficult situation. Their actions allowed the state to adopt a balanced budget each year, as required by law.

As difficult as these decisions have been, they have had limited impact on the underlying fiscal environment of the state. While maintaining a balanced budget has been no small feat during such challenging times, the state’s fiscal fragility and structural imbalance remain largely unchanged. After listening to numerous presentations and reviewing extensive materials, the panel believes that the basis for solving the state’s long-term fiscal problems lies beyond immediate questions of tax and spending levels.

Debates over taxes and spending take place within a context that reflects a traditional, institutional perspective of government. This traditional view sees state government primarily as a supplier of public services, as shown on the left side of Figure 6. Through this lens, the salient issues are those relating to production. These include taxes and fees to support the spending necessary to produce and distribute public services. With an orientation toward the production of services, the focus of decision making is on the *institution of government itself*, with success being defined by public officials. None of this, of course, is surprising; it is the way government has long been viewed by officials and the public alike.

While a production orientation is the prevailing perspective at all levels of government, it is not the only lens through which public services may be viewed. Instead of placing the institution of government at the center of the discussion, it is possible to shift the focus and think about public services from a citizen viewpoint, as depicted on the right side of Figure 6. Through this lens, things look quite different. The central issue is no longer absolute levels of taxes or spending as in the production-oriented

“The panel believes that the basis for solving the state’s long-term fiscal problems lies beyond immediate questions of tax and spending levels.”

view. Instead, the focus is on value, the relationship between costs and benefits *from the perspective of the citizen*. Using a value lens, the citizen, not the institution of government, is at the center of the discussion.

Introducing a citizen value perspective opens up new ways to think about state government. It can affect public discourse in important ways. A value perspective allows the discussion to move beyond taxes and spending. Tax and spending debates are often driven either by absolutes or ideology. Absolute arguments focus on the fact that X-level taxes are too high or Y-level funding is too low, or vice versa, from the perspective of the public official. Value-based considerations, by contrast, are *relative* in nature; they focus on the relationship between the price paid and the benefits received as seen through the eyes of the citizen.

In addition to moving beyond absolute tax and spending arguments, shifting the perspective can change the discourse from difficult-to-reconcile philosophical positions to pragmatic judgments about value. Philosophical disagreements are often based on officials’ innate belief

systems and are thus resistant to resolution or compromise. By contrast, in value discussions, the question moves from a philosophical to a practical one: “Is service Z a good value, relative to the price paid?” This is a pragmatic judgment to be made by citizens who can convey their views to public officials.

Government needs to be about more than delivering services at prices driven by costs

of production; it should focus on creating value for citizens. Shifting from a production-oriented perspective to a citizen-demand view is a crucial first step toward stabilizing state finances. It presents an opportunity for

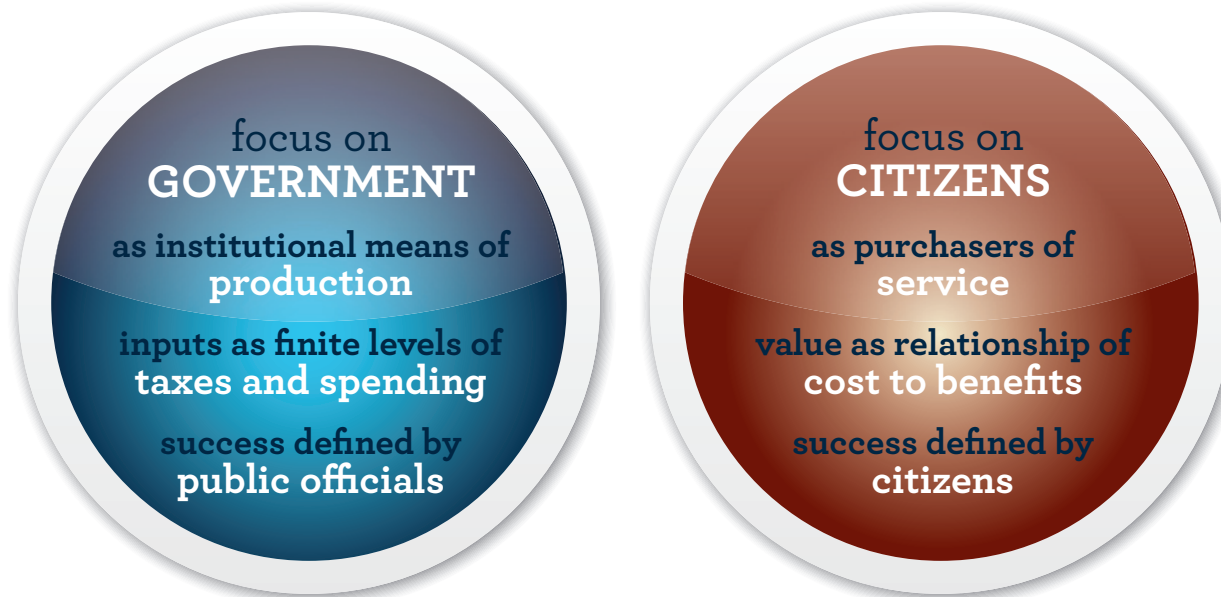


Figure 6 – Institutional and Citizen Perspectives of Government

“Using a value lens, the citizen, not the institution of government, is at the center of the discussion.”



officials to demonstrate, and citizens to recognize, the value of state services. This provides a foundation for building citizen support, without which a sustainable fiscal future is not possible. For these reasons, *the panel recommends the legislature and governor affirm that the purpose of Colorado state government is the creation of measurable value for citizens.*

Citizen Value

Shift the focus of government to creating measurable value for citizens instead of thinking in traditional institutional terms.

Citizen Value

Value—the relationship between perceived cost and perceived benefit—is not a precise mathematical calculation. It is an assessment made by each individual; a judgment that exists in the mind of the purchaser about the balance between the price of something and the benefits it provides. Value is a case where perception is indeed reality.

Unlike the customers of a business, taxpayers have little choice in purchasing public services. Nevertheless, the

process by which individuals determine value is the same for private goods or public services. For both customers and taxpayers the task is to make a judgment about the relationship between costs and benefits. In each case, the critical element required to judge value is accurate information. In the case of an automobile purchase, for example, information about the efficiency, reliability, safety and other aspects of the car is easy to obtain and the cost is apparent. For the taxpayer, the situation is quite different.

In most cases it is difficult, if not impossible, for citizens to make an informed judgment as to the value they are receiving for the tax dollars they pay. States generate huge amounts of data, but little of the information produced is designed to help taxpayers assess value in terms that are understandable or relevant to their own lives. Yet, without such information there is no way to judge the value of state services. With taxpayers having no clear way of assessing the value received for the taxes they pay, it is not surprising that, for many citizens, any tax increase is a bad idea.

In fact, Colorado and other states *do* create significant value in many ways. A transportation system is a prerequisite for commerce and economic growth. Public health services are needed to protect the wellbeing of individual citizens and society as a whole. Public safety is indispensable to society. Education is the basis of a



Don Ament
State Government Panel Member



Donna Lynne
State Government Panel Member

healthy civic life and the essential ingredient for success in a highly competitive global economy. All these activities of state government, and a great many more, are essential to the functioning of modern society.

Unfortunately, the value created by state government is largely hidden from view. The vast majority of state performance assessment systems are designed around a production perspective of government; they are systems built by government, for government. There is nothing inherently undesirable about such systems—they can help improve efficiency and effectiveness—but the information produced has little to do with citizen value.

A small, but useful, step in the right direction is Colorado's Tax Tracks system (www.colorado.gov/taxtracks). This interactive website breaks down the amount of taxes paid by an individual and shows the costs of various state services. While the information provided is not adequate to allow taxpayers to judge the value of state services, the site illustrates the potential for providing information to citizens.

To judge value, citizens need taxpayer-oriented information from an entity that is independent, adequately funded and oriented exclusively toward providing information to the public. To achieve this result, the legislature should establish an independent

Taxpayer Value Council to provide sufficient information so that citizens could assess the value of state services. The Taxpayer Value Council could be led by an unpaid citizen board with appointments coming from all three branches of government. The council would be non-partisan and prohibited from assessing the performance of individual public officials.

The council would assess major state services in terms of cost/capita, cost/taxpayer, satisfaction levels, program outcomes, levels of public subsidy and other measures that would be meaningful to taxpayers. For example, the Taxpayer Value Council could provide information on the per capita cost of highway maintenance or the relationship between K-12 costs per taxpayer and student achievement. The council could analyze the cost per taxpayer of operating correctional facilities, hearing court cases, operating public health programs and other areas of state government. In addition to presenting current information about value, the council would provide data allowing taxpayers to see trends over time and review benchmark information comparing Colorado with other states.

In *no case* would the Taxpayer Value Council itself render opinions as to the value of services. Rather, it would provide unbiased information that allowed *taxpayers themselves* to make informed judgments as to the value

“With taxpayers having no clear way of assessing the value received for the taxes they pay it is not surprising that, for many citizens, any tax increase is a bad idea.”

of state services. Equally important, value information would provide a common basis for citizens and their elected representatives to have informed discussions about the way in which public resources were being used and the benefits being produced. In doing so, the information provided by the Taxpayer Value Council becomes a foundation on which public trust can be built.

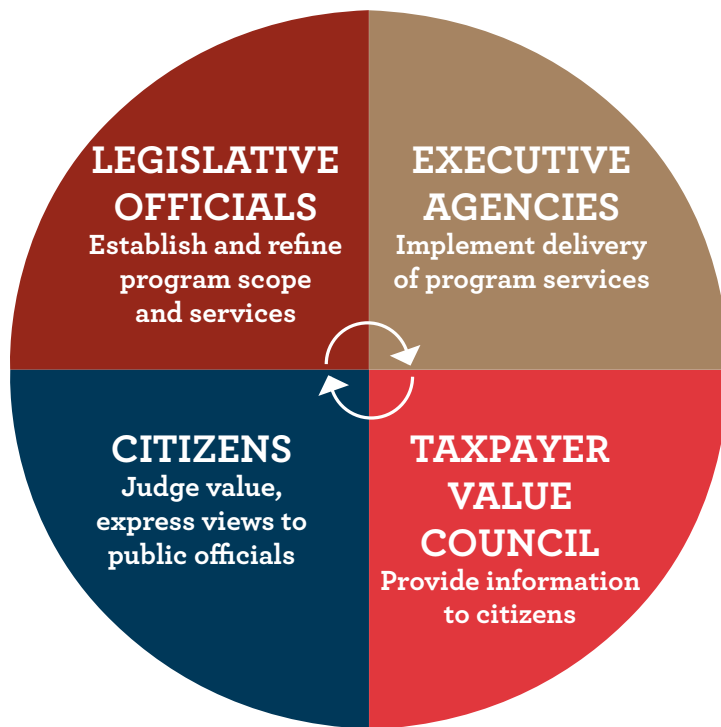


Figure 7 – Taxpayer Value Council

The Taxpayer Value Council would not duplicate the work of other state offices such as the Colorado State Auditor and the Legislative Council. The Office of the State Auditor focuses on managerial and operational issues related to reducing costs, increasing efficiency, ensuring the accuracy of financial information and similar matters. The Colorado Legislative Council provides economic forecasts, fiscal notes on legislation and policy research for the legislature. Unlike these agencies, the Taxpayer Value Council would focus exclusively on providing value information geared specifically to taxpayers.

Creating a Taxpayer Value Council is *the* essential element in implementing a citizen value perspective for state government. While not a panacea, it is a step of great significance. By establishing a Taxpayer Value Council, the legislature and governor would affirm their commitment to citizen value and Colorado would lead the nation in its accountability to taxpayers. With this in mind, *the panel recommends that the legislature and governor establish an independent Taxpayer Value Council to provide information that allows citizens to judge the value of state services.*

“Value information provides a basis for citizens and their elected representatives to have informed discussions about the way in which public resources are being used and the benefits being produced.”

Fiscal Sustainability

Use accountability centers to facilitate value assessment, dampen imbalance and highlight public subsidies.

Fiscal Sustainability

In Colorado and other states, a principle element of the fiscal structure is the general fund. As shown in Figure 8, a general fund can be thought of as an envelope into which various types of revenues flow and are mixed together. These might include receipts from individual and corporate income taxes, sales taxes, excise taxes, estate taxes, etc. Out of the general fund envelope may come funding for services such as elementary and secondary education, public welfare, law enforcement, corrections, courts, health services or other activities.

General funds present several difficulties: they can obscure value, foster fiscal imbalance and disguise subsidies. As the general fund mixes together various types of revenues and expenditures, it becomes difficult, if not impossible, for taxpayers to judge the value of public services. The potential for structural fiscal imbalance exists as revenues with varying levels of volatility are mixed with expenses having differing degrees of expenditure momentum. Finally, programs supported by the general fund have various degrees of public subsidy. Some are subsidized 100 percent while others may rely on user fees to a significant degree. A

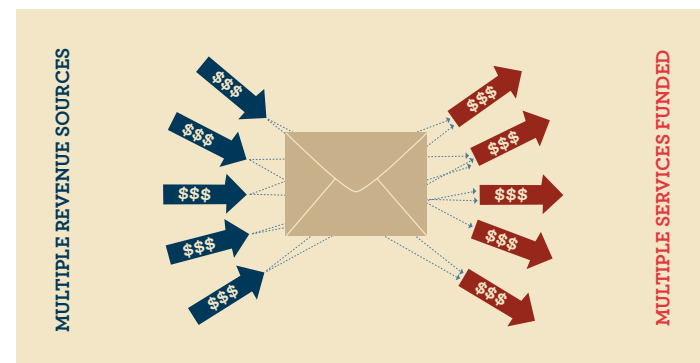


Figure 8 - The General Fund

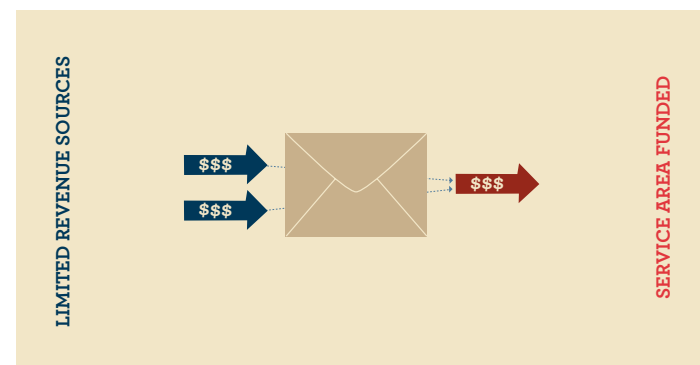


Figure 9 – Special Purpose Funds

“By establishing a Taxpayer Value Council, the legislature and governor would affirm their commitment to citizen value and Colorado would lead the nation in its accountability to taxpayers.”



general fund shrouds the level of public subsidy.

An alternative approach that can facilitate value assessment, dampen imbalance and identify public subsidies is the *accountability center*. Accountability centers are built on the concept of special purpose funds variously called proprietary, enterprise, cash or dedicated funds. Without descending into technicalities, special purpose funds share the characteristic of receiving revenue from one or a limited number of defined sources and using that revenue to support a specific area of service, as depicted in Figure 9. Accountability centers may be separate funds or established as overlays on the general fund, thus keeping the general fund structure intact. In either case, all accountability centers are reestablished annually through the legislative appropriation bill. This allows the legislature to reevaluate the revenue sources used to support various accountability centers each year.

Accountability Centers

Whatever the technical structure, the essential characteristic of an accountability center is that, *by statute, it links all or part of a defined revenue source(s) with a specific area of service* as shown in Figure 10. Accountability centers thus become the basic building blocks of government services. Centers are easy to understand and they facilitate value assessment. This allows them to serve as the organizing framework for

value information provided by the Taxpayer Value Council.

By way of illustration, an accountability center could be established to fund higher education stipends for state residents attending in-state colleges or universities. In this example, the center would be a general fund overlay focusing exclusively on student stipends for higher education. The legislature would identify specific revenue sources, or portions thereof, that would be dedicated to fund the accountability center. This sets the stage for the Taxpayer Value Council to develop

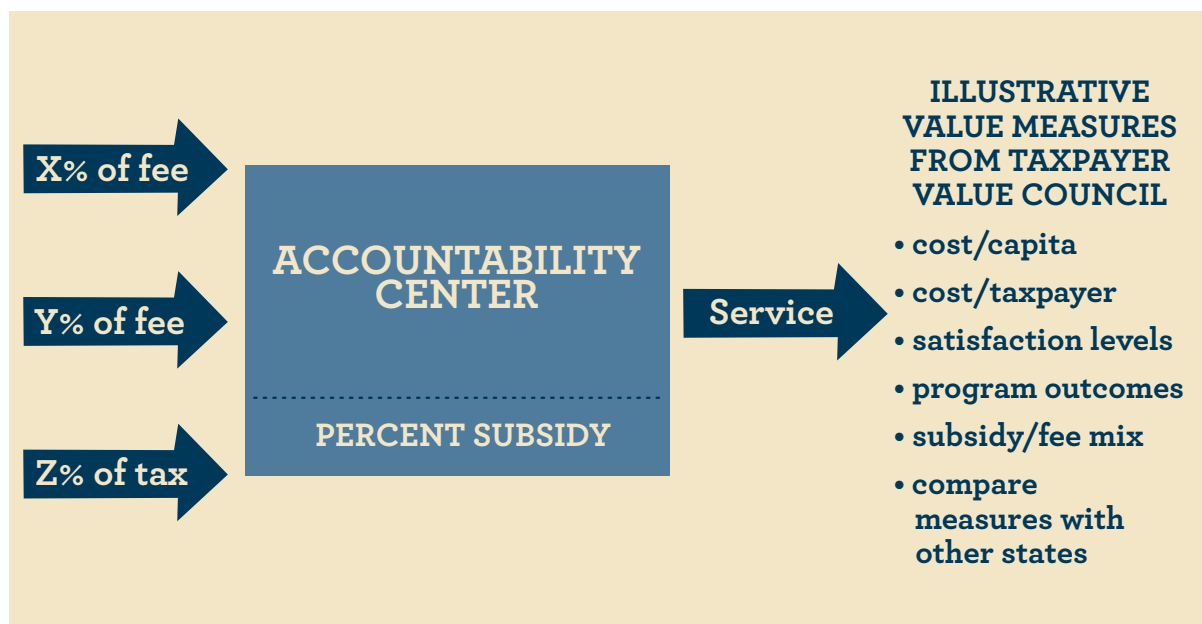


Figure 10 – Accountability Center



Gary Dudley
State Government Panel Member

measures such as cost per student, costs in relation to graduation rates and similar information as well as presenting trend data and comparisons with other states. Because taxpayers know how much they are paying and what results are being achieved, they are in a position to assess the value of the student stipend program.

In Colorado, where state government already makes extensive use of cash funded activities, establishing accountability centers is quite feasible. Cash funded activities can be consolidated or converted directly into accountability centers. Some areas, such as the Colorado Department of Transportation, are already structured in a manner that would facilitate an accountability center approach. For example, a Highway Maintenance Accountability Center might be established and funded by X percent of the state's motor fuel tax revenue, Y percent of toll revenues and Z percent of vehicle registration fees. The Taxpayer Value Council could measure taxpayer costs for highway maintenance, report results from citizen satisfaction surveys, examine trends and benchmark performance with other states.

The ability to link revenues and expenditures in accountability centers offers the potential to mitigate the fiscal imbalance experienced by Colorado and other states. As discussed earlier in this report, fiscal imbalance

occurs when volatile state revenues fall sharply during economic downturns, yet expenditures continue to rise. In establishing accountability centers, attention would be given to aligning the volatility and growth characteristics of revenue sources with those of expenditures supported by the center. While it is unlikely that the fiscal harmonics would ever be identical, careful alignment of revenues and expenditures has the potential to dampen fiscal imbalance.

Accountability centers can be the building blocks of state fiscal reform. Introducing the financial discipline of an accountability center structure is a significant change that will take several years to complete. It represents far more than simply moving boxes around a chart or renaming funds. It will require a fundamental rethinking of revenue sources to determine those that appropriately relate to specific purposes. The panel recognizes that the use of accountability centers is a major structural change but believes it can help introduce badly needed stability into state finances. For that reason, ***the panel recommends that the organizing framework for Colorado state finances be an accountability center structure that links dedicated revenue sources with a specified area of service.***

Public Subsidies

Informed, intentional decisions are a key to fiscal sustainability. Accountability centers facilitate informed

“Accountability centers can be the building blocks of state fiscal reform.”

decision making by creating easy-to-understand financial structures that clearly link revenue sources with a specific service area. Along with establishing such links, it is important to identify the degree to which tax dollars, as opposed to user fees, are being used to support various services.

The use of general tax dollars to support a service is referred to as a subsidy in this report. It is important to note that the term is *not* used in a negative or pejorative sense. Businesses subsidize new products with revenues from existing product lines and governments subsidize organizations and individuals for a variety of reasons. The key point is not that subsidies should be avoided, but that they be clearly visible and undertaken as a matter of intent. Whether a subsidy is too low, too high or just right is a matter for legislators to establish and taxpayers to ultimately judge.

The process of determining the appropriate level of subsidy is aided by organizing

accountability centers into one of three categories. The first category involves what are called pure public goods or public services. These *benefit everyone in society* and the benefit obtained by one person does not diminish the benefit others receive. Examples include clean air and communicable disease prevention, both of which benefit society generally. In cases where it is difficult to identify varying levels of benefit among individuals services can logically be funded by general taxes, in which case the subsidy level would be 100 percent. Public-nature services are shown on the left side of Figure 11.

At the other end of the spectrum, shown on the right side of Figure 11, are services where the individual user is the distinct beneficiary, as in the case of golf courses, recreation classes, hunting licenses, etc. These types of activities can be funded entirely by fees, and no public subsidy is required. In fact, services of this type are sometimes provided by governments as well as private organizations. The use of taxes to fund private-nature services represents an opportunity cost

PUBLIC-NATURE SERVICES	MIXED-NATURE SERVICES	PRIVATE-NATURE SERVICES
Revenue Source: Taxes	Revenue Source: Taxes/Fees	Revenue Source: Fees
Level of Subsidy: Can be 100%	Level of Subsidy: X%	Level of Subsidy: Can be 0%

Figure 11 – Public, Mixed and Private-nature Accountability Centers

“The key point is not that subsidies should be avoided, but that they be clearly visible and undertaken as a matter of intent.”

since funding could come entirely from fees. If the state chooses to subsidize a service of this type, the decision should be overt and the level of subsidy made clear to taxpayers.

While some state activities are clearly public or private in nature, a great many services have both public- and private-nature characteristics. These are mixed-nature services that provide a clear advantage to the general public but also offer significant individual benefit. Examples here include highways where everyone benefits from an effective transportation system but those who drive on the highways receive particular benefit. The same is true with education; all of society benefits from an educated populace, but those receiving the education enjoy significant personal benefit.

In the case of mixed-nature services there is no technical “correct answer” as to the mix of fees and taxes. Initially, the appropriate combination of fees and public subsidy, if any, is determined by public officials. In the longer term, citizens, given the necessary information to judge value, can evaluate the appropriate blend of fees and public subsidy and convey those judgments to elected officials. Given the importance of understanding the level of tax subsidy in public services *the panel recommends that the extent of public subsidy in each state activity be identified through its accountability center and disclosed to citizens through Taxpayer Value Council reports.*

Competition and Markets

Leverage competitive and market forces to improve government operations and effectively allocate public resources.

Competition and Markets

Government as Enabler

Government activities have traditionally enjoyed a monopoly status. While there are areas in which public monopolies are advantageous, such as public health or defense, there are significant disadvantages to monopolies. By their very nature, monopolies, whether public or private, tend to serve their own institutional interests at the expense of others. They establish practices that work to the benefit of the organization rather than other stakeholders because they enjoy singular market power and, in the case of government, compulsory authority as well. As they focus on their own interests, monopolies tend to become inefficient. In the case of private monopolies such as utilities, government can regulate potential abuses and encourage efficiencies. In the case of government monopolies, there is only self-restraint.

The advantages of introducing competition into government services has been recognized for decades and has led, among other things, to the privatization, or contracting out, of public services. The use of private contractors paid by the government to deliver services has become quite common and has the potential to introduce efficiencies into the delivery



process. Private contractors can also provide additional flexibility, allowing governments to expand or reduce services fairly rapidly.

It is important to note, however, that simply privatizing a public service ensures neither lower costs nor better services. Privatization works best when there is a highly competitive marketplace and the government has the capability to actively monitor contractors. The choice between government provision of services and the use of contractors is best determined on a case-by-case basis.

A greater leap on the competitive scale involves a government restraining its own monopoly power to allow private organizations to compete in offering services to citizens. There are, in fact, many areas where governments have chosen *not* to exercise monopoly power, such as the U.S. Postal Service which competes with United Parcel Service and Federal Express. Privately owned golf courses compete with city-owned courses, state parks may compete with private facilities and private schools compete with public schools.

In the panel's view, competition offers the same advantages to government that it does in business: lower costs, better services and innovative approaches. There may be occasions when the state has a legitimate interest in preserving a monopoly status for certain functions. As

a general matter, however, the panel believes competition should be encouraged. Therefore, ***the panel recommends that the role of state government in Colorado be one of enabling public services, using private contractors when appropriate and allowing other organizations to offer public services in competition with the state unless public policy clearly necessitates a monopoly status.***

Market Allocation

For many years, economists have recognized that resources can be allocated through hierarchies (organizations) or through markets. Allocating resources through hierarchies reflects a production perspective that places the organization at the center of control. Allocating resources through markets focuses on demand and places the consumer at the center of the process.

Traditionally, both business and government used organizations as the means to allocate resources. They relied on decisions of leaders in the organizational hierarchy to decide what services to offer, what price or tax level to charge, how to organize operations, etc. When Henry Ford reportedly offered his customers cars of any color "so long as it is black" the organization, not the customer, was making decisions.

Over the years, businesses have increasingly shifted to markets as a means to determine how to allocate



Ed Mueller
State Government Panel Member

“In an age of mass customization, where customers expect a range of choices and value for their money, state governments need to think in terms of markets.”

their resources and what activities to undertake. They have done so in order to compete more effectively for a purchaser's dollars by providing products and services that meet the needs of their customers. The same challenges face government today as they try to build public support for tax resources, user fees or other charges.

In an age of mass customization, where customers expect a range of choices and value for their money, state governments need to think in terms of markets. However, relatively few do so, relying instead on a traditional command and control approach that allocates resources based on the priorities of officials rather than the pull of citizen demand. For example, when a state funds its public universities through grants to institutions, there is the assumption that state officials know best how the public's money should be allocated. By contrast, when a state funds student educational stipends, it is the students, acting through their market choices as to which schools to attend, who allocate public resources.

The panel believes that it is appropriate for Colorado to shift its general approach from a production-oriented view centered on the institution of government to a perspective that focuses on individuals and leverages market forces to allocate resources. With this in mind, *the panel recommends that, when practical, Colorado*

utilize a market approach to allocate public resources, focusing primarily on supporting individuals rather than operating institutions.

Program Funding

Align authority and responsibility in inter-governmental activities, eliminate unfunded mandates and fully-fund annual state obligations.

Program Funding

An important cause of the financial crises facing Colorado and other states is the disconnect that exists between the authority to establish programs and the responsibility to adequately fund them. This disconnect exists in intergovernmental programs such as Medicaid, where the federal government establishes program standards but states are required to pay a portion of the costs resulting from those requirements. The disconnect can also exist within a single government when a program generates long-term obligations that are not fully funded. For example, many states approved public employee pension benefits but failed to fully fund the annual payments required to meet the resulting future obligations.

The principles outlined to this point—reframing



Jerry Groszold
State Government Panel Member



government, focusing on value, creating new financial structures, leveraging competition and market forces—are tools for strengthening financial discipline and building citizen support by creating value. Complementing these principles is the need to balance authority with responsibility by requiring that governments provide full funding for programs they create.

Funding Intergovernmental Programs

Many Americans think of the U.S. federal system as rather like a three-layer cake, with the federal government at the top, state government in the middle and local government below. In reality however, federalism is much more like a marble cake, with responsibilities and programs intermixed among federal, state and local governments.

Multilevel, intergovernmental activities are very common. At the federal level, they include programs such as Medicaid and the No Child Left Behind Act, an array of highway and transportation programs, social service activities and other programs. Multilevel programs are also used at the state level. K-12 education, highway maintenance and other activities all involve joint efforts by state and local government.

Multilevel programs have been useful in a number of respects. They have allowed governments to pool resources in order to tackle difficult problems such as environmental protection. They have also permitted services to be delivered by governments located close to recipients, as in the case of social service programs. However, multilevel programs can, and do, contribute to fiscal instability. Program mandates can force governments to provide services without regard to economic conditions

or the ability to fund activities. The same is true of program inducements where a higher-level government offers partial funding to encourage participation by lower-level governments.

The fiscal difficulties resulting from intergovernmental programs suggest it may be time to rethink the structure of such multilevel programs. The goal is not to hamper intergovernmental cooperation but rather to ensure that authority and responsibility are aligned. The panel believes that an effective means of achieving this goal is by requiring that *each level of government must fully fund all programs it establishes*.

Under this approach, the federal government or a state government would have several choices when initiating a new program. It could design, fund and operate the program using its own staff or contractors, or it could share the effort with another level of government. If it chose an intergovernmental approach, the higher-level, initiating government would have the responsibility to determine the scope of the program, identify the outcomes to be achieved and fully fund the program at a level sufficient to achieve the stated outcomes.

The lower-level, partnering government would be responsible for delivering the program, or obtaining contractors to do so, and achieving specified outcomes. The implementing government should have the flexibility to adapt the program to meet local conditions but it would remain responsible for achieving the desired results without sacrificing quality. The relationship is depicted graphically in the full funding model shown in Figure 12.

“Each level of government must fully fund all programs it establishes.”

In addition to implementing the intergovernmental activity, the lower-level government could enhance the basic program. It would do so by creating a complementary program that offered additional or enhanced services. The complementary program would be operationally coordinated but financially self-contained, funded entirely by the lower-level government.

A fully funded structure for intergovernmental programs offers a

number of advantages. It clarifies governmental roles while leveraging the resources of multiple levels of government. It strengthens fiscal stability by requiring that the initiating government fully fund the cost of delivering the program. If the program creates expenditure momentum, it is the initiating government that must deal with the financial consequences. The approach offers flexibility for the implementing government and responsiveness to local conditions as long as specified outcomes are achieved. The implementing government can further customize the program through a complementary program that it funds.

The requirement that each government pay the full cost of any program it creates is likely to moderate expenditure momentum by encouraging a careful definition of program scope. Federal programs, which would need to embrace a wide variety of conditions and circumstances, would tend to focus on common needs shared by most of the citizens in the country. A state complementary program could be more targeted, focusing on the particular needs of the citizens of that state. Local complementary programs, if established, would be more tightly focused yet designed to meet the conditions of a particular city or county or geographic region. Given these advantages, *the panel recommends that the legislature and governor adopt a full-funding approach for all state/local programs, prohibit unfunded mandates and work to encourage*



Figure 12 – Fully Funded Programs



the federal government to take a similar approach with its intergovernmental programs.

Funding State Programs

The need to fully fund activities and obligations applies *within* state government just as it does in the case of intergovernmental programs. While many operating programs are routinely funded during the budget process, some states have failed to adequately fund longer-term obligations. Examples include the need to realistically schedule and fully fund annual maintenance costs of buildings, highways and other capital facilities. Of equal importance is the requirement that states fully fund the annual contributions necessary to support long-term pension obligations for state employees and retiree health benefits. In recent years, several states have been required to significantly increase funding for pension plans, creating extraordinary financial pressure on those governments.

Scheduling maintenance for capital facilities, calculating unfunded liabilities and future earnings for pension funds and creating a funding schedule for retiree health benefits are all areas where conservative assumptions need to be used in calculating annual funding obligations. Fiscal sustainability requires full funding of both current programs and annual payments necessary to

support long-term obligations. For that reason, *the panel recommends that the legislature fully fund all current programs and annual payments on multiyear obligations, using conservative estimates when calculating Colorado's long-term liabilities.*



Forrest Cason
State Government Panel Member



Linda Clark
State Government Panel Member

FRAMEWORKS FOR POLICY

In examining the challenges facing Colorado, the panel found it useful to consider existing policies that have a significant impact on state finances. The goal was not to provide detailed policy recommendations, an infeasible task given the panel's comprehensive scope. Instead, panel members examined several key policy issues through the prism of principles discussed in this report. The result is a series of policy frameworks that illustrate ways in which those principles may apply to various issues. The panel hopes these frameworks might be useful as the legislature and governor address the challenges facing the state and prepare Colorado to capture the opportunities of the twenty-first century.

K-12 Education

As the largest single appropriation in Colorado's general fund budget, K-12 education accounts for roughly 46 cents of every general fund dollar. In fiscal 1994 the state funded about 55 percent of all K-12 expenses. By fiscal 2011 the state's share had risen to 63 percent and estimates suggest that state funding for K-12 education will reach 70 percent by fiscal 2025. Even as costs continue to rise, the complex school finance formula and the interplay of constitutional provisions make it virtually impossible for citizens to judge the value being created by Colorado's K-12 educational system.

The funding of schools is an intergovernmental function primarily involving the state and local school districts. Consistent with the principles suggested for funding multilevel programs, the panel believes that the role of state government should involve (1) establishing the scope of the state's involvement in K-12 education, (2) determining outcomes to be achieved and assessing results, and (3) providing full funding for K-12 education at a level sufficient to achieve the desired outcomes.

In a number of respects the state is already moving along this path. Colorado currently has a student assessment program in place that defines and measures K-12 student outcomes. The major question in K-12 education in Colorado relates to funding. In Colorado, support for K-12 education is the largest part of the state budget, yet in terms of per-pupil funding Colorado is still far below the national average. While per-pupil funding is a measure of input, not outcomes, the disparity between Colorado and other states suggests the need to reexamine the state's approach.

The state should pay the full cost necessary to achieve the K-12 outcomes it establishes. As a consequence, legislators will wish to carefully consider the outcomes desired by the state. For example, in creating its program, the state may wish to limit its outcomes to proficiency

“The state should pay the full cost necessary to achieve the K-12 outcomes it establishes.”

in traditional academic areas such as reading, writing, mathematics and science. Whatever the scope, the state has the freedom to define the outcomes it wishes to obtain and the responsibility to fully fund implementation of a program to achieve those results. The state’s responsibilities are shown in the top section of Figure 13.

Local school districts are responsible for implementing the state’s K-12 program and should be given considerable freedom in deciding how to best achieve the required results. Beyond the basic program prescribed by the state, local school districts should be free to develop complementary programs that could expand the curriculum to cover additional areas, employ the use of advanced technology, provide support services to students, etc. The costs of such complementary programs would be fully funded by the local school district. Responsibilities of local school districts are shown in the center of Figure 13, and the district’s optional, complementary program is depicted at the bottom of the graphic.

In allocating its resources to local schools, the state should rely on market forces rather than bureaucratic control mechanisms. The state should focus on supporting students,

not institutions. Funding should be allocated in the form of stipends that follow students instead of direct funding to local school districts. Stipends could be used at any public school or public charter school within the student’s home school district or any other district able to accept nonresident students.

Those public schools that are seen as creating value will attract more students and, thus, more state funding. Schools viewed by parents as

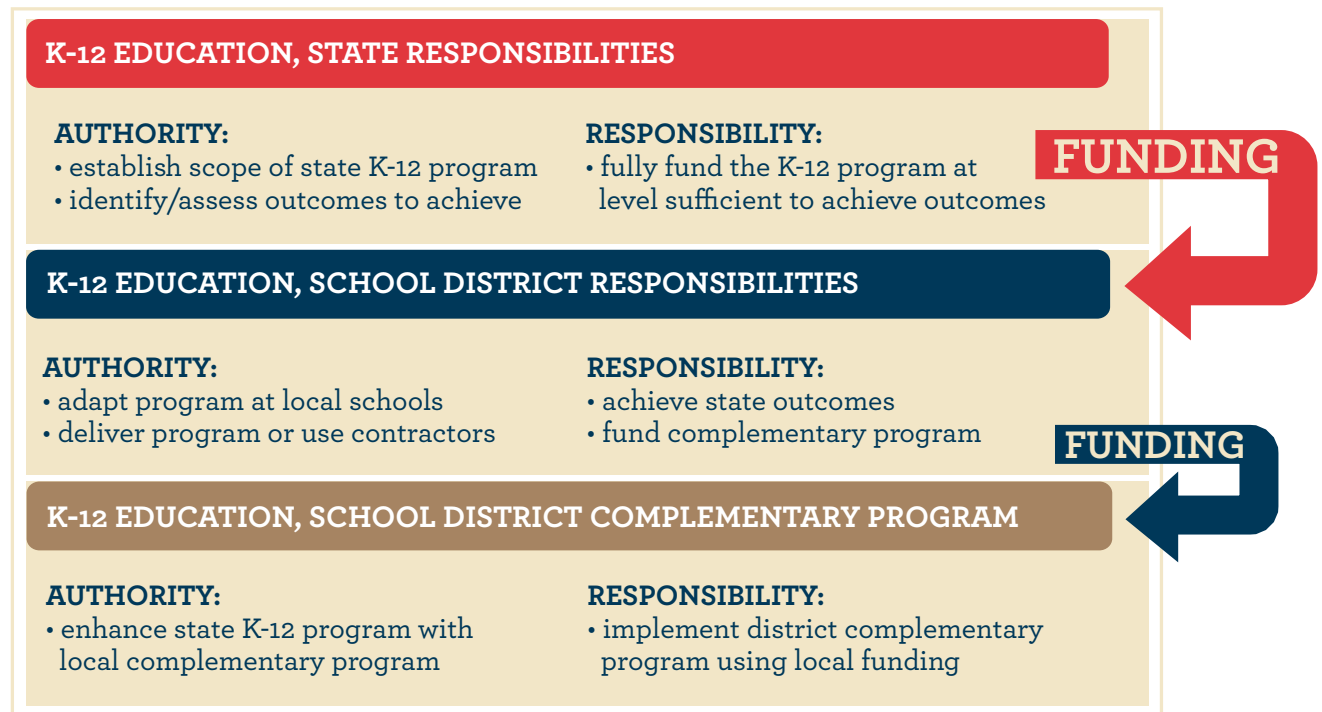


Figure 13 – Structure of Colorado K-12 Education Program

“The panel believes higher education in Colorado suffers from too much reliance on control and too little reliance on market forces.”

inferior will lose state funding as student attendance shifts to other schools or different districts. If a school has insufficient resources because poor outcomes reduce enrollment, the district can either obtain additional funding from local taxpayers or close the school. There should be little need for a state bureaucracy to manage local schools. The state needs only to assess and publicize outcomes and value information so that judgments can be made. Parents, through the educational market, will do the rest.

K-12 education is one of the most important functions the state performs, in partnership with local school districts. As a result, it is essential that citizens be able to judge the value that is being created. In terms of learning outcomes, the state should monitor results and disseminate information, as it does now. The key to building public support, however, lies in providing information that citizens can use to assess value. This is achieved when the Taxpayer Value Council translates technical results data into value information for citizens by relating K-12 learning outcomes to taxpayer costs.

The panel concludes that the principles of full funding for intergovernmental programs, market allocation of resources, competition and citizen value could be beneficially applied to K-12 education in Colorado. The state's role should be limited to defining and assessing outcomes and fully funding the K-12 program. Local school districts should be free to determine how best to achieve outcomes defined by the state. The state should fund students, not school districts, through stipends to students attending public schools. The Taxpayer Value Council should provide information that allows citizens to judge

the value being created by the state's K-12 program and individual school districts.

Higher Education

State support for higher education in Colorado has declined dramatically. Since fiscal 1990, funding has fallen from over 20 percent to 9 percent of the state's general fund budget. It is a tangible example of the consequence of expenditure momentum, where programs such as K-12 education and Medicaid displace funding for higher education in Colorado. The impact of higher education funding cutbacks has been compounded as enrollment continued to climb at community colleges and four-year institutions.

The financial picture facing higher education in Colorado is, frankly, bleak. Yet nothing is more important to Colorado's economy than the quality and accessibility of its institutions of higher education. By 2018, it is estimated that 62 percent of U.S. jobs will require education beyond high school—up from 28 percent in 1973. The way in which Colorado responds to the realities of an education-driven, globally competitive environment will, literally, determine the state's future. These conflicting forces—a declining level of funding and the essential role of higher education in the state's economic future—suggest the need for a thorough reexamination of higher education funding in Colorado.

For a moderately sized state, Colorado has a complex public higher education system. It includes 13 four-year colleges and universities, 13 two-year community colleges, and 2 local district two-year colleges. State organizations designed to oversee or coordinate institutions



include the Department of Higher Education, the Colorado Commission on Higher Education, an elected Board of Regents for the University of Colorado as well as individual boards of one kind or another for each institution. The notion that state government can effectively control, or even coordinate, such far-flung enterprises is open to question. The panel believes higher education in Colorado suffers from too much reliance on control and too little reliance on market forces.

Fortunately, Colorado has a unique vehicle upon which to build. In 2004, Colorado adopted an act creating the College Opportunity Fund (COF), the nation's first attempt to leverage market forces using a system of stipends directed to students. Although the act publicly focused on the use of stipends, it actually had a number of other objectives. Notable among these was the attempt to remove higher education from the grip of TABOR by establishing schools as "enterprises". While the goal of insulating much of higher education from TABOR was achieved, the system of stipends established by the act was accompanied by provisions that essentially protected institutions of higher education from the effects of marketplace competition.

Nevertheless, the College Opportunity Fund legislation created the institutional infrastructure necessary for a market-based resource allocation system. It set up a

means for processing and awarding stipends at the state level and caused universities to consider appropriate changes to their own systems to handle such stipends. The panel believes the state should capitalize on the stipend-processing infrastructure created through the COF and use the program as the exclusive basis for funding the operations of higher education in Colorado.

Using this approach, funding for higher education would be channeled exclusively through a system of stipends to Colorado students qualified for admission. The state would fund students, not institutions, with stipends scaled to reflect the level of student financial need. There would be no direct funding of institutions, however the total state funds available for student stipends should at least equal the total funding level currently supporting Colorado's public colleges and universities. This ensures that, overall, the funding available to all state institutions is not initially diminished, but it does not guarantee a specific funding level for any particular college or university. The success of each individual institution would be determined by its ability to create value and, thereby, attract students and funding.

In addition to funding student stipends, the state could provide capital funding for any institution under whatever terms were approved by the legislature and governor. Cities, counties or other public entities could also



Hal Logan
State Government Panel Member



contribute capital funding to an institution either directly or through regional districts. And, of course, institutions would be encouraged to undertake their own fundraising activities.

The state of Colorado would continue to own the physical property that it had contributed to each entity, but it would not control the institution's operations. The board of each state college, university, two-year community college or technical school would be given full responsibility and authority for the operation of that institution. The board would appoint the CEO, approve strategies for the institution and determine degrees to be offered, while the faculty would establish the curricula. Boards would be free to set tuition at levels that reflected marketplace realities and the quality of education provided. The success of an institution would be determined by the degree to which students perceived they were receiving value. Figure 14 depicts the nature of such a higher-

education funding system.

The panel concludes that the principles of market allocation of resources, competition and a value perspective should be applied to higher education in Colorado. The state should support higher education through a system of stipends, scaled to reflect student financial need, which builds upon the existing College



Lowell Hare
State Government Panel Member

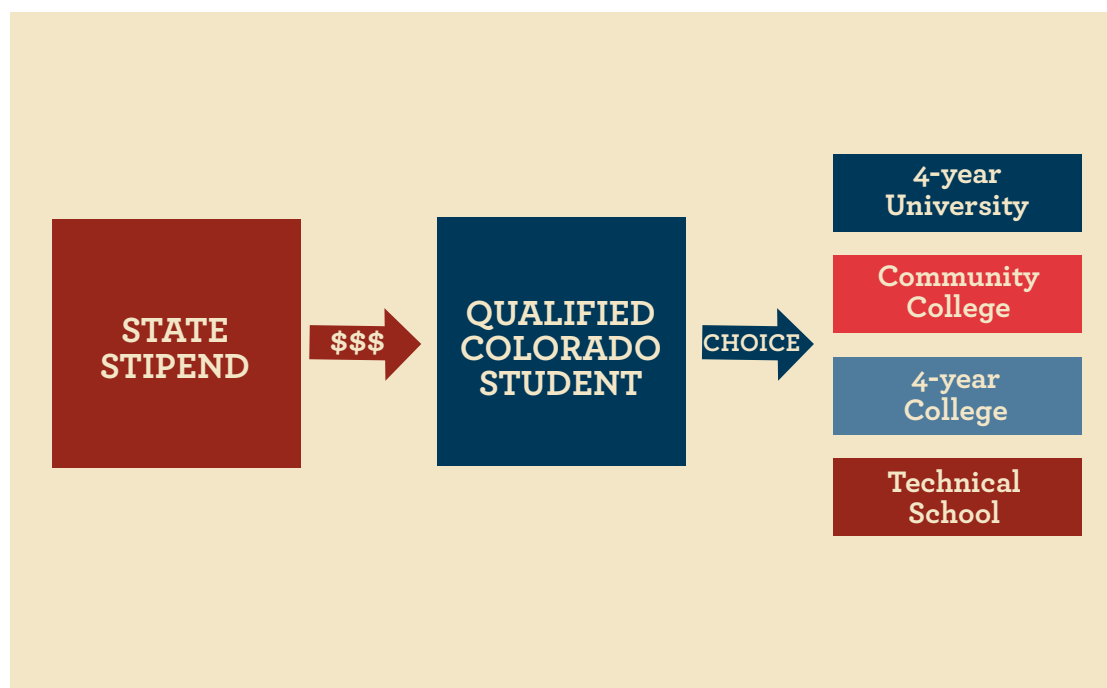


Figure 14 Stipend-based Higher Education System

“CDOT is an ideal candidate for the use of accountability centers.”

Opportunity Fund infrastructure. The boards of Colorado’s universities and colleges should be given the authority to manage each institution with minimal involvement by state agencies. Colorado’s institutions of higher education should be allowed to succeed or fail based upon the value they create for students.

Transportation

The Colorado Department of Transportation (CDOT) maintains 23,000 lane miles of state highways and 3,754 bridges, on which Coloradans and visitors travel more than 28 billion miles per year. In fiscal 2012, CDOT planned to receive some \$1.1 billion dollars in revenue. Colorado’s motor fuel taxes and vehicle registration fees, such as from the state’s recently adopted FASTER program, comprised nearly 60 percent of CDOT’s expected revenue while federal government provided about 35 percent.

Motor fuel taxes, which are levied as a fixed amount per gallon, have long been the principle funding source for highway construction and maintenance. Their utility, however, is being diminished as vehicles with greater fuel efficiency gain market share. As a result, while user fees and charges currently play a relatively minor role in funding, they are increasingly viewed as a potential source of revenue to create and maintain transportation infrastructure. To that end, some state and local governments are looking at mileage-based fees and charges for using crowded highways or entering congested business districts.

The joint federal-state-local nature of Colorado’s transportation program lends itself to the concept of fully funding intergovernmental programs, as described earlier in this report. Indeed, the structure of Federal

Highway Trust Fund (HTF) and related programs already reflect that principle to some degree. Federal and state roles are reasonably well defined. The federal government provides funding for its priorities and the state is responsible for construction and maintenance.

With a limited number of revenue sources dedicated to specific services, CDOT is an ideal candidate for the use of accountability centers. Under its existing structure, the Colorado Department of Transportation already links certain revenues with particular functions. The existing approach can be simplified and refined to be more useful for citizens, but the basics are already in place. The Colorado Department of Transportation can, and should, move to fully utilize an accountability center structure.

In the panel’s view, what CDOT lacks is not so much operational efficiency as a focus on citizen value. In reviewing an array of literature and statistics related to the department, it is difficult to find information that speaks to value in terms that are meaningful to citizens. For the Colorado Department of Transportation, shifting from a production perspective to a focus on citizen value could produce significant benefits. An accountability center structure could set the stage for CDOT to depict the value it creates. A concerted effort by the department to focus on value, along with reports by the Taxpayer Value Council, could enhance trust and support among voters.

The panel concludes that the Colorado Department of Transportation is well suited to apply principles of accountability centers, distinguish between subsidies and fees, and adopt a value perspective. CDOT

“In 2009, about one in every five persons in the U.S. was enrolled in Medicaid for at least one month ...”

should use an accountability center structure linking defined revenue sources to specific service areas and clearly identify the degree to which tax subsidies and fees are used. The department should shift from a technical, production perspective to a focus on citizen value, presenting its public information in those terms.

Medicaid

Although Medicaid and Medicare were both created in 1965, and each focuses on health care, the programs differ in significant ways. Medicare is a program that provides health insurance coverage to all citizens age 65 and older. It is funded and operated by the U.S. government. Medicaid, by contrast, is a means-tested, health care insurance program for individuals and families with low incomes and limited resources. Medicaid is jointly funded by the U.S. government and the states and is administered by state governments.

Although Medicaid is a voluntary program, all states do participate. Depending on wealth, states pay 25 percent to 50 percent of the cost of Medicaid with the federal government paying the balance. Colorado began its participation in Medicaid in 1969 and, as a relatively wealthy state, is required to pay 50 percent of the cost. Colorado also participates in the companion program to Medicaid for low income children and pregnant women, Child Health Plan Plus (CHP+). States operate Medicaid programs under broad federal guidelines although each state has a degree of flexibility in terms of eligibility standards and services offered.

Medicaid represents a great financial challenge for all states, including Colorado. Over the next decade, the cost of Medicaid and CHP+

is predicted to increase faster than any other major component of Colorado's budget. According to the Center for Colorado's Economic Future, Colorado's expenditures for Medicaid will increase dramatically between 2012 and 2025, rising from 18 percent of general fund expenditures to 27 percent. Beyond 2025, costs could rise even more rapidly as Colorado's baby boomers, who use medical services far more than younger adults and children, swell program enrollment. For this aging cohort, Medicaid spending is likely to be up to five times greater per capita than for younger adults and children.

Medicaid expenditures are driven primarily by rising health care costs and growing enrollment. Colorado has virtually no control over national health care costs and limited influence over enrollment. Health care costs are rising much faster than general inflation. In 1970, health care spending accounted for barely more than 7 percent of the U.S. gross domestic product (GDP), the equivalent of \$356 per resident. It is projected that by 2018 health care spending will represent more than 20 percent of GDP, about \$13,100 per resident. Looking ahead, the Congressional Budget Office estimates that the annual rise in Medicaid costs between 2012 and 2020 will be 2.8 to 3.4 percent greater than the general inflation rate.

Enrollment is a major driver of Medicaid spending growth. In 2009, about *one in every five persons* in the U.S. was enrolled in Medicaid for at least one month, and enrollment is projected to increase by an average of 4.5 percent per year over the next ten years. In Colorado, Medicaid enrollment has increased by 121 percent over the last decade. For states like California, where nearly 30 percent of the state's population was



enrolled in Medicaid by 2007, budgetary implications may be particularly profound. There is every reason to believe that enrollment will continue to rise, propelled by slow economic growth, an aging population and the 2010 Patient Protection and Affordable Care Act (PPACA), which expands Medicaid eligibility in 2014.

The panel believes Colorado should approach Medicaid on two levels. At a strategic level, the state should focus on risk. Every indicator suggests that the Medicaid program is a runaway train due to health care costs and growing enrollment. Colorado should cooperate with other states to urge the federal government to restructure Medicaid into a fully funded intergovernmental program based on the principle described earlier in this report. In the near term, Colorado should make maximum use of federal waivers to shape the program in a manner that provides the best outcomes possible for Coloradans while managing financial risk.

The panel concludes that principles relating to fiscal sustainability, value and full funding of intergovernmental programs are useful in connection with Medicaid. The governor and legislature should study the best practices of other states and take full advantage of federal waivers to create an effective program while managing financial risk. Colorado

taxpayers should be provided with value information related to Medicaid by the Taxpayer Value Council. Colorado should join with other states in urging the federal government to rethink Medicaid, redefine outcomes to be achieved and fund 100 percent of the cost of the federal program.

PERA

There is no more powerful example of the hazards of underfunding government obligations than the crisis being faced by state pension funds. Not only are taxpayers ultimately responsible for hundreds of billions of dollars in pension obligations, current public employees who joined pension funds with an expectation of a sound retirement are facing an unknown future. It should be pointed out that not every state has been remiss in funding its pension obligations, but many have.

In 2009, the Pew Center on the States estimated the future cost of state pensions, retiree health care and other retirement benefits to be underfunded by \$1.26 trillion dollars. While there are differing opinions as to the exact level of underfunding, there is little doubt that the problem is serious. In 2009, only 22 states paid their annual pension bills in full and, nationally, state retiree health care liabilities remained 95 percent *unfunded*.

The \$1.26 trillion estimate above is based on what



Judy Giacomini
State Government Panel Member



“Colorado knows firsthand the hazards of underfunding state pension obligations.”

some consider to be an optimistic calculation of future investment earnings by pension funds. This future investment earning capacity is referred to as the discount rate. Small changes in discount rate assumptions have enormous implications for pension funding. If states used the same discount rate required of private corporations, the shortfall would balloon to \$1.8 trillion. If the so-called “riskless rate” based on the 30-year U.S. Treasury bond were used, the funding gap rises to an astronomical \$2.4 trillion. To appreciate the impact of discount rates, when the state of Rhode Island recently considered revising several assumptions, including a reduction of the discount rate from 8.25 percent to a more conservative 7.5 percent, the estimated unfunded liability for the state’s pension fund rose 27 percent.

The failure to fully fund pension obligations is having a spillover effect on state credit ratings as Moody’s now combines both debt levels and pension liabilities as part of an overall process to judge the credit worthiness of state governments. In addition, the Governmental Accounting Standards Board is considering rules that would, among other things, have pension fund information appear directly on state government balance sheets. It is clear that adequate funding of all state obligations, including obligations for pension and retiree health care, is essential if states are to avoid future financial crises.

In Colorado, Public Employees’ Retirement Association (PERA) provides retirement and other benefits to the employees of more than 400 government agencies and public entities, including state employees. With more than 200,000 members PERA is the 21st largest public pension plan in the United States. Colorado knows firsthand the hazards of underfunding state pension obligations. In 2008, the Pew Center for the States rated PERA as a pension fund about which they had “serious concern” given its funding level of less than 70 percent. Subsequent to that report, the Colorado legislature deserves credit for instituting several steps to improve the stability of the system. Although progress has been made, careful monitoring, caution and fiscal conservatism remain the best advice for Colorado.

The panel concludes that the state should apply principles related to full funding of state programs, fiscal sustainability and value to Colorado’s Public Employees’ Retirement Association (PERA). To minimize risk, PERA should use a conservative discount rate when calculating future investment earnings and long-term liabilities. The Colorado legislature should fully fund its annual PERA contribution. Retiree benefits should be expanded only if the plan is 100 percent funded and after careful study of long-term implications. Colorado citizens should be provided with value information on PERA through the Taxpayers Value Council.



Peggy Kerns
State Government Panel Member

Operational Policies

In the course of its work, the panel identified two other areas that relate to Colorado's fiscal sustainability. Although these matters have less visibility than the policy issues discussed above, they are important from an operational perspective.

Internal Services

An often unheralded, but important, aspect of state government is the internal service agencies that provide support for operating departments. They include services such as purchasing, printing, supplies, real estate, maintenance, personnel, technology, law, etc. These functions often enjoy a monopoly status within state government.

Typically, such functions were established on the premise that it was less expensive and/or more convenient to provide the service internally than to use outside contractors. While internal agencies can certainly be efficient, those that are less responsive have the potential to impede the effectiveness of operating departments. This may be a result of inadequate staffing of the internal department, complex state rules or other factors.

Whatever the reason, if internal support units are unable to respond to requests from operating departments on a timely basis, the result can be delays and inefficiencies in delivering public services. The resulting slippage in departmental operations may far outweigh theoretical efficiencies gained through centralized support units. At the same time, there is a balance to be achieved between improving the efficiency of a single department and achieving greater effectiveness across the entire state government, as in the case of an information technology network

affecting all state departments. Nevertheless, introducing competition into the *internal environment* of state government offers the potential to improve state operations and should always receive careful consideration.

The panel concludes that Colorado can benefit from applying the principle of competition to internal state services. State departments and agencies should be allowed to select internal or external suppliers of support services except in cases where interdepartmental consistency requires the use of an internal service agency or designated system.

Employee Compensation

Notwithstanding the use of the term "pay for performance," government compensation systems for managerial employees are not generally built around performance in the sense that businesses use the term. Rather, state systems are often structured around achieving internal goals and/or comparability with similar positions elsewhere. Attempts to make state management compensation systems more effective through the use of performance bonuses have also had limited success. In some cases, public sector bonuses are so small as to be irrelevant. Where bonuses have been more substantial, they have sometimes generated protests from the media and the public who have little information on which to judge whether the bonus was warranted.

In large measure, these conditions exist because it has been extremely difficult to measure managerial performance in government from the perspective of value creation. While government and business are not the same, they share a common interest in customer satisfaction. Yet, most government management compensation systems rely primarily on internal

“Most government management compensation systems rely primarily on internal standards rather than encompassing measures of customer value creation.”

standards rather than encompassing measures of customer value creation.

From a managerial perspective, there are other significant differences between the private and public sectors. Where business usually views senior management as the company's most important asset, public managers are often described as overhead. Where non-performing business executives are quickly removed, dismissing ineffective public employees may be prohibitively time consuming due to civil service or union rules. While top managers in business are often very well paid, public sector executives tend to be compensated at lower, sometimes much lower, levels. These conditions create an invisible, but very real, drag on the effective management and resulting performance of government.

Accountability centers provide a structure for bringing value creation into the employee evaluation and compensation process. Departmental reviews assessing managerial performance in terms of internal goal achievement and other institutional criteria would continue to be important. However, these traditional measures could be supplemented with value information provided to citizens by the independent Taxpayer Value Council. This would provide information on the degree to which the department or agency created value from a citizen perspective. The approach would blend traditional internal, institutional measures with externally focused value-creation information.

The panel believes that such a balanced system could produce a number of positive benefits. The orientation of managers and departmental teams would not simply be internal, but external as well. Departmental personnel would receive useful feedback from a value perspective—the

viewpoint most meaningful to citizens, the department's ultimate customers. Managers would be inclined to focus on the value being created by their departments, a mutually beneficial situation for both citizens and state government.

The Taxpayer Value Council would provide the same information on value creation to managers as it gave to citizens. The council would *not* tell managers how to manage, it would simply give them a window into the perspective citizens use as they judge the success of government programs. The degree to which accountability center managers and their teams were able to create value would become clear over time. When an accountability center created taxpayer value through lower costs or better outcomes, a sound basis would exist for rewarding managers and employees. Conversely, if performance suffered and taxpayer value declined over time, there would be a basis for removing low-performing managers without endless delay.

The panel concludes that applying principles of citizen value and the use of accountability centers can reshape compensation systems for public managers in positive ways. Colorado should create a process that uses independent information on value creation from the Taxpayer Value Council as a significant element in the state's performance review and compensation system for managerial employees and departmental teams.



CONSTITUTIONAL IMPEDIMENTS

Colorado is burdened with conflicting constitutional provisions that impede the state's fiscal stability. The most significant of these are Amendment 23 and the Taxpayer Bill of Rights (TABOR). At the time of their adoption, proponents argued that both of these constitutional amendments would benefit Coloradans. Amendment 23 was meant to ensure that K-12 education would receive adequate funding. TABOR was intended to limit the growth of government and prevent new or increased taxes from being established without a vote of the people. Each amendment was approved through a statewide vote.

Taken together, these constitutional amendments have exacerbated the state's fiscal crisis. In effect, they mandate spending and limit spending at the same time, with little regard to economic conditions or revenue availability. Amendment 23 and TABOR put the state's spending on autopilot, without the ability to alter course when conditions change. Revisiting these constitutional amendments is an important step in restoring Colorado's fiscal sustainability.

Amendment 23

Amendment 23 was adopted by Colorado voters in 2000. Among other things, it generally required that the state increase K-12 funding at the rate of inflation plus 1

percent through 2011. Thereafter, funding is to increase at the rate of inflation. The problem with Amendment 23 is neither the intent of its framers nor the goal of providing quality education. The difficulty lies in the fact that Amendment 23 mandates spending with little regard to economic conditions. It is an example of expenditure momentum that has, and will continue to, exacerbate the state's fiscal crisis and displace other budget priorities.

Proponents of Amendment 23 point out, correctly, that Colorado's per-pupil funding has declined consistently since 1982. As the panel noted in the section on K-12, Colorado has a major responsibility for funding schools to ensure a thorough and uniform system of public education. However, requiring the state to make expenditures without regard to economic conditions is not the solution; it is a serious problem in itself.

The panel concludes that Amendment 23 runs counter to principles of fiscal sustainability by increasing expenditure momentum and mandating expenditures with little regard to the availability of revenue. Amendment 23 should be repealed.

TABOR

Mandates may *require* spending, as with Amendment 23, or they may *limit or prohibit* spending, which is the effect of TABOR, the Taxpayer Bill of Rights. TABOR was



Phil Tamminga
State Government Panel Member



“Amendment 23 and TABOR put the state’s spending on autopilot, without the ability to alter course when conditions change.”

approved by Colorado voters in 1992. It is considered by many to be the most comprehensive tax and expenditure limit in the nation. It is a constitutional amendment that establishes formulas limiting the growth of revenue and, thus, spending. TABOR requires voter approval for new and increased tax rates and outlaws certain types of taxes entirely, irrespective of voter preferences.

TABOR, through its formulas and prohibitions, has greatly reduced the ability of elected officials to enact fiscal policies that respond to changing economic conditions. As Amendment 23 limits officials by forcing expenditures up, TABOR limits officials by constraining revenue. If one were trying to design a state financial system to be as rigid and non-responsive as possible, Colorado might be the model.

While TABOR creates problems, it also produces some important benefits. By prohibiting new taxes or increased tax rates without a vote of the people, TABOR has given citizens a strong measure of control over the level of taxes they pay. This provision may have contributed to Colorado’s status as a relatively low-tax state. TABOR’s formulas limiting revenue growth also tend to restrain the growth of state government during periods of economic expansion, as occurred during the 1990s.

That said, TABOR has impaired Colorado’s fiscal viability by limiting what might be called natural revenue growth; that is, growth *not* resulting from new taxes, higher tax rates or an expanded definition of those covered by a tax. Examples of natural revenue growth include increases in sales and income taxes resulting from a robust economy or new businesses entering the state. While TABOR’s revenue limits have little effect during the depths of a recession, they may constrain the state’s ability to participate in the recovery by capping revenue growth. In the panel’s view, TABOR is neither a complete impediment to progress nor an unmixed blessing for Coloradans.

The panel concludes that TABOR reduces the state’s ability to create a sustainable fiscal environment by substituting formulaic approaches for legislative judgment and prohibiting certain taxes irrespective of voter preferences. The sections in TABOR that require a vote of the people for new or increased taxes should be retained. The remaining provisions of TABOR should be repealed.



Rob Deline
State Government Panel Member

Summary of Conclusions and Recommendations

FISCAL FAULT LINES

Colorado relies heavily on income and sales taxes that are highly volatile. These revenues rise and fall abruptly with economic cycles, while major state expenditures continue to increase irrespective of economic conditions. This creates a structural imbalance and constrains other budget priorities. Evidence suggests that this structural imbalance will not cure itself; rather, it will become more severe over time. These conditions—volatile revenue sources, expenditures that are difficult to control and a crowding out of other priorities—are the result of state policies and practices put in place over many years.

Rethinking State Government

The panel concludes that achieving a strong and sustainable fiscal environment in Colorado requires rethinking traditional practices and considering new principles to help guide the development of state policies in the twenty-first century.

PRINCIPLES FOR PROGRESS

As the panel moved from an analysis of Colorado's financial challenges to a broad discussion of state government, a number of principles emerged. These principles suggest the need to: reframe government; focus on citizen value; reform the financial structure; encourage competition; leverage market forces; and fully fund governmental programs. The panel believes these principles can help the state become more flexible, adaptable and responsive and support Colorado's progress toward a strong and sustainable fiscal future.

Taxpayer Value

The panel recommends the legislature and governor affirm that the purpose of Colorado state government is the creation of measurable value for citizens.

Taxpayer Value Council

The panel recommends that the legislature and governor establish an independent Taxpayer Value Council to provide information that allows citizens to judge the value of state services.



Summary of Conclusions and Recommendations, continued

Accountability Centers

The panel recommends that the organizing framework for Colorado state finances be an accountability center structure that links dedicated revenue sources with a specified area of service.

Public Subsidies

The panel recommends that the extent of public subsidy in each state activity be identified through its accountability center and disclosed to citizens through Taxpayer Value Council reports.

Government as Enabler

The panel recommends that the role of state government in Colorado be one of enabling public services, using private contractors when appropriate and allowing other organizations to offer public services in competition with the state unless public policy clearly necessitates a monopoly status.

Using Markets to Allocate Resources

The panel recommends that, when practical, Colorado utilize a market approach to allocate public resources, focusing primarily on supporting individuals rather than operating institutions.

Funding Intergovernmental Programs

The panel recommends that the legislature and governor adopt a full-funding approach for all state/local programs, prohibit unfunded mandates and work to encourage the federal government to take a similar approach with its intergovernmental programs.

Funding State Programs

The panel recommends that the legislature fully fund all current programs and annual payments on multiyear obligations, using conservative estimates when calculating Colorado's long-term liabilities.



George Simon
State Government Panel Member



FRAMEWORKS FOR POLICY

If Colorado is to address its financial challenges and create a fiscally sustainable future, it should reconsider several major policies. The panel's goal was not to provide detailed policy recommendations, an infeasible task given the broad scope of this report. Instead, panel members examined several key policy issues in light of the principles discussed herein. The result is a series of policy commentaries that illustrate ways in which those principles might be applied to various issues. These commentaries serve as principle-based frameworks around which sustainable policies may be developed.

K-12 Education

The panel concludes that the principles of full funding for intergovernmental programs, market allocation of resources, competition and citizen value could be beneficially applied to K-12 education in Colorado. The state's role should be limited to defining and assessing outcomes and fully funding the K-12 program. Local school districts should be free to determine how best to achieve outcomes defined by the state. The state should fund students, not school districts, through stipends to students attending public schools. The Taxpayer Value Council should provide information that allows citizens to judge the value being created by the state's K-12 program and individual school districts.

Higher Education

The panel concludes that the principles of market allocation of resources, competition and a value perspective should be applied to higher education in Colorado. The state should support higher education through a system of stipends, scaled to reflect student financial need, which builds upon the existing College Opportunity Fund infrastructure. The boards of Colorado's universities and colleges should be given the authority to manage each institution with minimal involvement by state agencies. Colorado's institutions of higher education should be allowed to succeed or fail based upon the value they create for students.



Mary Lou Makepeace
State Government Panel Member

Summary of Conclusions and Recommendations, continued

Transportation

The panel concludes that the Colorado Department of Transportation is well suited to apply principles of accountability centers, distinguish between subsidies and fees, and adopt a value perspective. CDOT should use an accountability center structure linking defined revenue sources to specific service areas and clearly identify the degree to which tax subsidies and fees are used. The department should shift from a technical, production perspective to a focus on citizen value, presenting its public information in those terms.

Medicaid

The panel concludes that principles relating to fiscal sustainability, value and full funding of intergovernmental programs are useful in connection with Medicaid. The governor and legislature should study the best practices of other states and take full advantage of federal waivers to create an effective program while managing financial risk. Colorado taxpayers should be provided with value information related to Medicaid by the Taxpayer Value Council. Colorado should join with other states in urging the federal government to rethink Medicaid, redefine outcomes to be achieved and fund 100 percent of the cost of the federal program.

PERA

The panel concludes that the state should apply principles related to full funding of state programs, fiscal sustainability and value to Colorado's Public Employees' Retirement Association (PERA). To minimize risk, PERA should use a conservative discount rate when calculating future investment earnings and long-term liabilities. The Colorado legislature should fully fund its annual PERA contribution. Retiree benefits should be expanded only if the plan is 100 percent funded and after careful study of long-term implications. Colorado citizens should be provided with value information on PERA through the Taxpayers Value Council.

Internal Services

The panel concludes that Colorado can benefit from applying the principle of competition to internal state services. State departments and agencies should be allowed to select internal or external suppliers of support services except in cases where interdepartmental consistency requires the use of an internal service agency or designated system.



Jon Zeschin
State Government Panel Member



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Acknowledgments

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This report was authored by James Griesemer, Chair of the Panel and Dean Emeritus of the Daniels College of Business at the University of Denver. Portions previously copyrighted by Dr. Griesemer are used with permission. Appreciation is extended to Jennifer Dennis for editing and production of the report and Rebecca Swanson for research assistance throughout the project.



