Joint Budget Committee Staff

Memorandum

To: Interested Parties
From: Craig Harper, JBC Staff director (303-866-3481)
Date: Friday, February 14, 2025
Subject: Corrections to the Attached Shortfall Analysis Memo

The attached memorandum was originally published and presented to the Joint Budget Committee on February 12, 2025. However, staff has revised the attached version to correct an error associated with assumed costs for Health, Life, and Dental insurance for state employees in FY 2025-26. That correction reduced the projected shortfall under the "JBC Staff Scenario" from $1.3 billion in the February 12 version to $1.04 billion now.

In addition, legislative staff has corrected the slides accompanying the memorandum – and added some additional detail to the assumptions shown under the Governor's Request scenario.

Joint Budget Committee Staff

Memorandum

To:	Joint Budget Committee Members
From:	Craig Harper, JBC Staff Director
	Greg Sobetski, Legislative Council Staff Chief Economist
Date:	Wednesday, February 12, 2025 (re-published Friday, February 14, 2025)
Subject:	Near- and Medium-term Fiscal Projections

This memorandum, a joint effort between JBC Staff and Legislative Council Staff (LCS), responds to questions from the Committee and other members of the General Assembly. The memo and the accompanying visuals seek to capture the magnitude of the projected shortfall for FY 2025-26 and the impact of the "structural deficit" on the State's budget in FY 2025-26 and beyond. To that end, it includes two sections: (1) a look at the near-term challenges for the FY 2025-26 budget (with visual aids from built by LCS); and (2) a medium-term assessment of the strains on the budget through FY 2029-30 using a "Budget Stress Test."

Near-term: The shortfall for FY 2025-26

Barring additional action to either reduce obligations and/or make additional General Fund available, sustaining current (FY 2024-25) appropriations in FY 2025-26 leaves little room for General Fund increases. JBC Staff and LCS collaborated to produce three scenarios to illustrate the challenges for FY 2025-26.

JBC Staff Scenario A: Current Law

Scenario A holds General Fund appropriations constant at FY 2024-25 levels (including the supplemental package) and then adds $587.2 million to reverse the "Big Swap" of personal services funds in Corrections, Human Services, and Judicial. The scenario then overlays the December 2024 LCS forecast assumptions for revenues and other General Fund obligations (transfers under current law, TABOR refund obligations, etc.).

This scenario leaves about $303.6 million available for potential increases in FY 2025-26 (see JBC Staff Scenario A in the accompanying slides).

- The scenario starts with an "excess reserve" of $1.161 billion based on the December 2024 LCS forecast. The supplemental package adds $84.6 million in General Fund appropriations for FY 2024-25 (reducing the excess reserve by that amount) – and then continues that impact in FY 2025-26. So, after accounting for the impact of the supplemental package, the excess reserve falls to $1.0 billion.

- Reversing the Big Swap of personal services funding (shown as "ARPA Rolloff") requires another $587.2 million.
- The adjustments for the FY 2024-25 supplemental package and the reversal of the Big Swap also increases the reserve requirement by $100.8 million (15.0 percent of the increase), reducing the excess reserve to $303.6 million.
- As discussed in Scenario B below, that is not enough to fund the current projection for Medicaid caseload alone (an increase of $334.7 million General Fund), much less caseload across all departments, employee compensation, provider rates, etc.

JBC Staff Scenario: Adding the Big Buckets

JBC Staff Scenario A leaves $303.6 million available for additional General Fund obligations <u>before accounting for any increases necessary for caseload or other purposes in FY 2025-26</u>. This is well short of projected obligations for FY 2025-26 for caseload alone.

Adding in projected costs for caseload, higher education, state employee salary and benefits, private provider rates, and controlled maintenance would take the reserve $1.04 billion below the 15.0 percent requirement (see JBC Staff Scenario in the accompanying slides). This visual starts with the $303.6 million left from Scenario A and then builds in assumptions constructed by JBC Staff. The "big buckets" of additional costs for FY 2025-26 include:

- $334.7 million General Fund currently requested for Medicaid in FY 2025-26. This amount may increase with the February 2025 request – but even the current estimate exceeds the *total* excess reserve for FY 2025-26 under Scenario A.
- $30.7 million for projected Health, Life, and Dental costs plus an additional $54.1 million for salary increases to align with the Colorado WINS agreement.
- $125.6 million for school finance and the Department of Education.
- $80.4 million for an estimated 2.0 percent provider rate increase (similar to the policy adopted for FY 2024-25).
- $62.5 million for higher education (a revised estimate of the institution's minimum costs model).

These amounts do not include the $78.3 million increase requested by the Judicial Branch for FY 2025-26. But it is already clear that there is not sufficient revenue available to support these needs and sustain the General Fund reserve. The listed items would increase General Fund appropriations by $688.1 million above JBC Staff Scenario A, increasing the reserve requirement by 15.0 percent of that amount, or $103.2 million

Additionally, JBC Staff Scenario B includes the following transfers from the General Fund (also not included in Scenario A):

- $202.6 million for controlled maintenance, based on the recommended metric of 1.0 percent of replacement value.
- $350.0 million transferred to the Peace Officer Training and Support Fund under Proposition 130.

Governor's Request

The final scenario for FY 2025-26 illustrates the Governor's request.[1] Facing the dynamics illustrated in scenarios A and B, the Governor's request includes a number of proposals to reduce General Fund obligations *and* to make additional General Fund available. As shown in the Governor's Request slide, those changes have taken a number of forms:

- The request includes more than $130 million in additional *transfers into* the General Fund in FY 2024-25 and at least $200.8 million in FY 2025-26 (staff expects this number to continue to increase through reconciliation with OSPB).
- The request assumes a $100.0 million benefit from the Pinnacol conversion in FY 2025-26.
- The request includes a tax credit package that would phase out a number of tax credits (increasing General Fund revenues as well as the TABOR refund obligation by an estimated $83.3 million in FY 2025-26).
- However, the request offsets that increase in the TABOR refund with a number of adjustments to TABOR enterprises and cash fund revenue reductions that would reduce TABOR revenues (and thus the refund obligation) by an estimated $151.7 million.
- If the request stopped there then it would balance under the December LCS forecast, ending about $21.9 million above the reserve requirement.
- However, the Governor's January 2 submittal letter also includes a legislative placeholder to transfer $350.0 million out of the General Fund in response to the passage of Proposition 130. Combined with an additional transfer of $5.0 million proposed for "State Protection Funding," those transfers would take the General Fund an estimated $333.1 million below the 15.0 percent reserve requirement for FY 2025-26.

Uncertainty and Points to Consider

Staff notes significant uncertainty about the impact of some of these balancing proposals. Staff does not know whether the Pinnacol conversion would generate a $100 million General Fund benefit in FY 2025-26. Some of the other proposals also include significant complications. The severance tax restructure is complicated and the benefit is entirely dependent on anticipated severance tax revenues. Finally, the TABOR-related proposals (enterprises and cash fund revenues) only benefit the General Fund if the State is above the TABOR cap. Should a recession drive revenues below the cap, those proposals would provide no General Fund help.

Medium-term: Budget Stress Test through FY 2029-30

JBC Staff is also working with LCS to look at longer-term projections. For this purpose, the staff agencies are using a "Stress Test" originally created by a consulting firm in Colorado and built to

[1] JBC Staff and OSPB are still working to ensure alignment with the many moving parts in the Governor's request. Staff expects additional minor adjustments – but they would not change the dynamic portrayed here.

capture the unique circumstances of Colorado's budget.[2] Stress tests are designed to assess the fiscal health and stability of state budgets over a multi-year period and under multiple economic scenarios. This is a tool to visualize the budget under a variety of scenarios; it does not replace the detailed revenue forecasts and General Fund overviews used for detailed balancing decisions in a given year.

The Colorado test includes projections for five years (through FY 2029-30), allowing analysis beyond the standard three-year forecast window. Obviously, uncertainty increases significantly in the outyears. Again, it is an illustrative tool and not a prediction.

The test allows for visualizations under three scenarios:

- A *baseline* scenario that extends beyond the revenue forecast window *without a recession.*
- A *moderate recession* scenario with a 6.6 percent decrease in General Fund revenues hitting in FY 2025-26. The moderate recession scenario reflects roughly half the impact of the severe recession scenario (below).
- A *severe recession* scenario with a 13.2 percent decline in General Fund revenues in FY 2025-26. The severe recession scenario mirrors the revenue contractions and inflationary pressure experienced following the 2001 recession.

JBC Staff has updated the stress test to incorporate the December 2024 LCS revenue forecast, the impact of the FY 2024-25 supplemental package, and the impacts of the Governor's request for FY 2025-26 (including changes to revenues, appropriations, transfers in and out of the General Fund, and adjustments impacting the TABOR refund).[3]

Take-home Message: The budget appears to be on an unsustainable path. Without significant *ongoing* actions to reduce obligations and/or make additional revenues available, the State would exhaust the 15.0 percent General Fund reserve before FY 2029-30, even without a recession. The recession scenarios only accelerate the depletion of the reserve. Sustaining a viable reserve will require structural change to revenues and/or obligations.

For the purposes of this document, staff is only showing the "baseline" and "moderate recession" scenarios, as those illustrate the challenges facing the State – and the severe recession is just worse.

General Fund Obligation Assumptions

Assumptions for FY 2024-25 and FY 2025-26 align with current law as adjusted by the supplemental package and the Governor's request. For the outyear projections, all scenarios

[2] Pew Charitable Trusts has funded the creation of stress tests in a number of states. They contracted with Bright Fox Analytics to create the test for Colorado.

[3] Staff continues to reconcile with OSPB and expects ongoing refinements to the General Fund Overview and to the stress test.

assume the following expenditure increases. While the assumptions are rough, JBC Staff agrees that these are reasonable assumptions based on historic trends.

- *Medicaid/Health Care Policy and Financing:* General Fund obligations grow by inflation plus population plus 2.0 percent.
- *K12 Education:* Appropriations for the baseline scenario align with the phased implementation of H.B. 24-1448 *as proposed by the Governor through FY 2025-26 R1/BA1* (including the changes to enrollment averaging) and modeled by LCS and JBC Staff. Under the recession scenarios, the new formula under H.B. 24-1448 "turns off" and school finance appropriations go back to the previous formula.
- *Higher Education:* Appropriations grow by inflation plus 1.0 percent.
- *Human Services:* Appropriations grow by inflation plus population plus 1.0 percent.
- *Corrections:* Appropriations grow by inflation each year.
- *Judicial:* Appropriations grow by inflation plus population.
- *All Other Departments:* Appropriations grow by inflation plus population.

Baseline Scenario

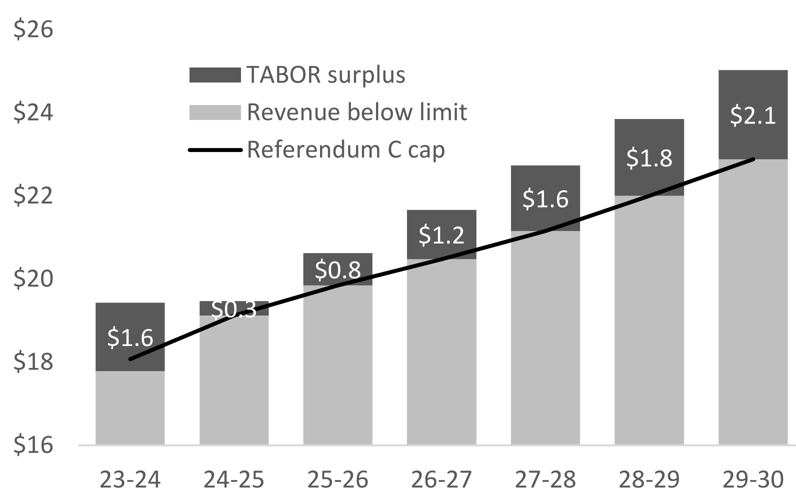
This scenario assumes a 5.0 percent annual increase in General Fund revenues and a 3.0 percent rate of inflation beyond the forecast period (FY 2027-28 through FY 2029-30).

General Fund revenues exceed the TABOR/Referendum C cap throughout the forecast period, with significant TABOR refunds anticipated each year (see Figure 1).

However, as shown in Figure 2 on the following page, projected General Fund appropriations and obligations (under the expenditure assumptions outlined above) would require the use of the General Fund reserve each year. The reserve would be exhausted entirely before the end of the projection window.

As a percentage of appropriations, the reserve would fall to 8.0 percent by the end of FY 2027-28, to 3.2 percent in FY 2028-29, and would

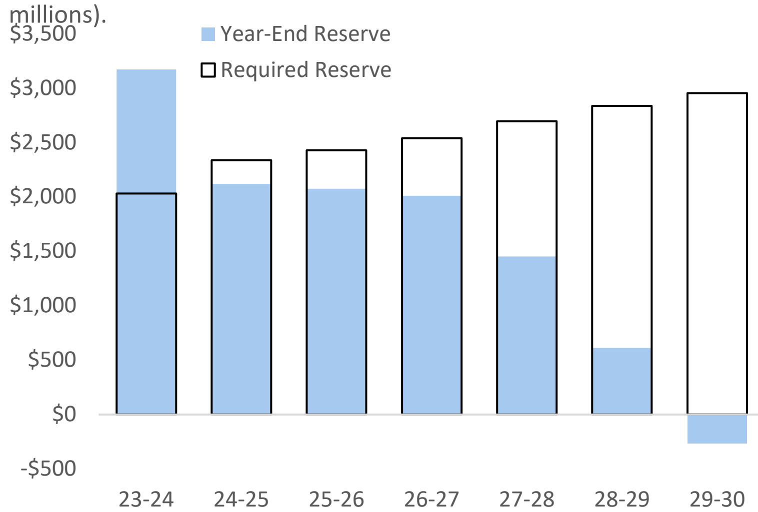
Figure 1: Under the baseline scenario, revenues would exceed the TABOR cap each year ($ in billions).



be gone in FY 2029-30. The State would be unable to accommodate projected General Fund obligations that year.

In short, the State cannot sustain "business as usual" under the assumptions outlined above, even in the absence of a recession. Clearly, sustaining a General Fund reserve will require ongoing, structural change to either make additional revenues available or "bend the cost curves" assumed for General Fund obligations.

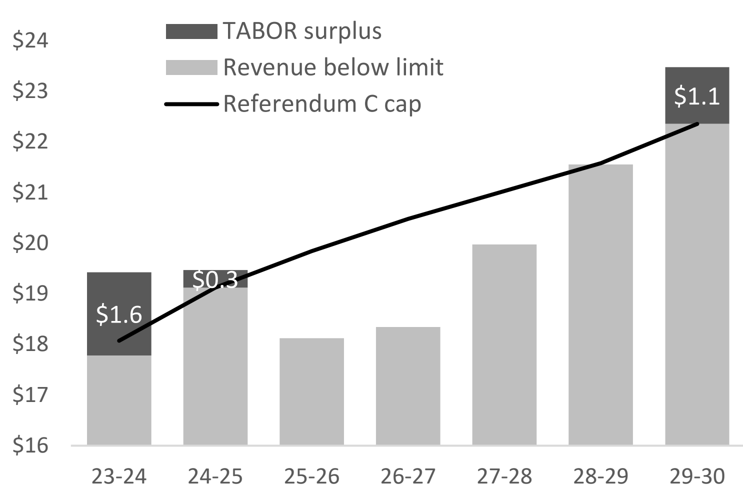
Figure 2: Projected General Fund obligations would exhaust the reserve even without a recession ($ in millions).



Moderate Recession Scenario

The moderate recession scenario reduces General Fund revenues by 6.6 percent in FY 2025-26, with a further reduction of 1.4 percent in FY 2026-27, before rebounding with 9.0 percent growth in FY 2028-29. Inflation also decreases each year relative to the baseline scenario, staying below 2.0 percent for FY 2026-27 through FY 2028-29 before returning to the baseline assumption of 3.0 percent in FY 2029-30. As a result, both General Fund revenues and the TABOR cap decrease relative to the baseline scenario (see figure 3).

Figure 3: Under a moderate recession, revenues fall well below the (decreased) TABOR cap ($ in billions).

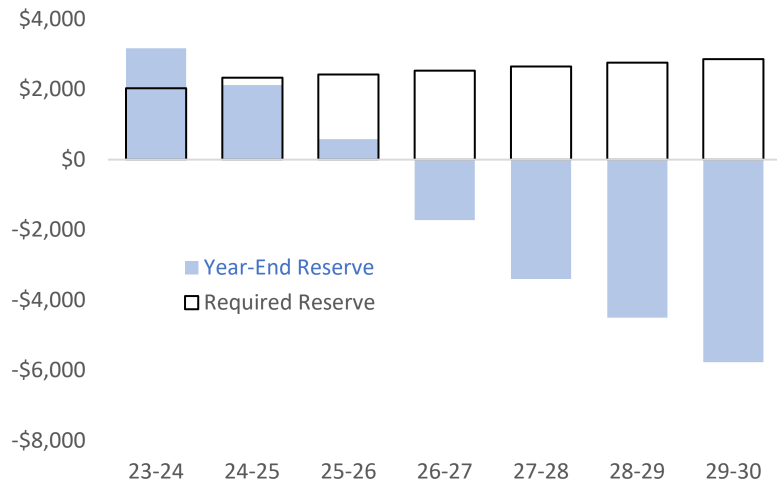


Under the recession scenario, K12 education obligations for school finance fall below the baseline scenario for several reasons. Most importantly, the test "turns off" the new school finance formula created in H.B. 24-1448. In addition, the lower inflation rate decreases pressure on school finance associated with Amendment 23 (which requires statewide base per pupil funding to increase by at least the rate of inflation each year).

However, not surprisingly, even with those adjustments the decrease in revenue under this scenario places increased strain on the General Fund. As shown in figure 4, these projections anticipate that the General Fund reserve would fall to 3.6 percent of appropriations in FY 2025-26 and be exhausted completely in FY 2026-27.

It is worth noting that the reserve cannot "go negative." Both figure 2 and figure 4 show the reserve falling below $0 as an indication of what would be necessary to sustain appropriations. That is not actually possible. However, the figures do provide a useful visual indication of the strain on the General Fund.

Figure 4: A moderate recession would exhaust the reserve entirely in FY 2026-27 ($in millions).



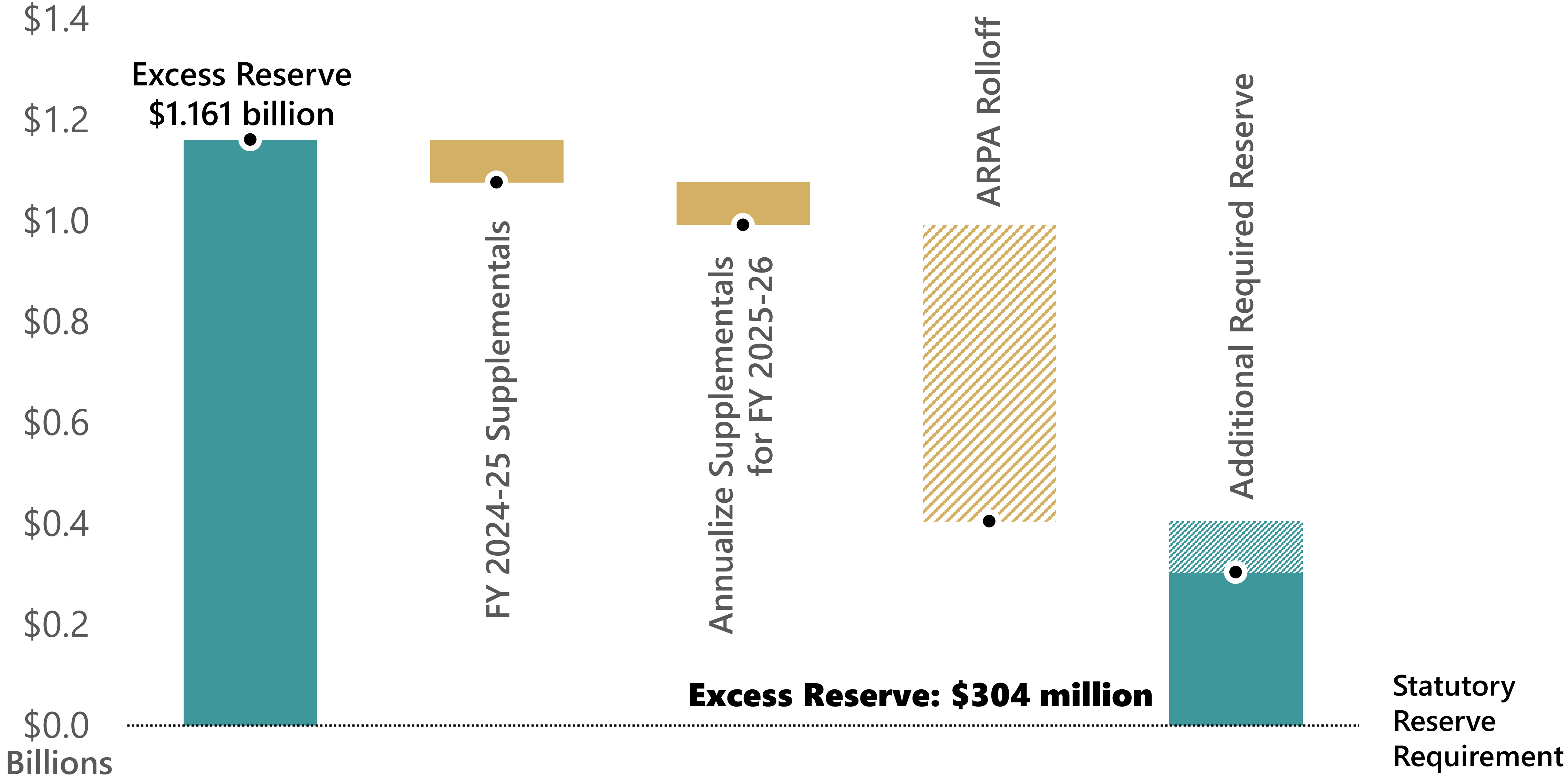
Conclusions

Staff hopes that this memorandum provides some additional context for the challenges facing the Committee and the General Assembly in planning for the budget for FY 2025-26 and beyond.

- The General Assembly faces near-term challenges for FY 2025-26. Sustaining the reserve in FY 2025-26 will require significant reductions in obligations and/or the availability of additional revenues. The stress test scenarios make clear that those changes need to be structural and ongoing; reasonable projections of "business as usual" obligations would exhaust the reserve even outside of a recessionary scenario.
- Based on that, maintaining a General Fund reserve going forward will require ongoing structural change. One-time changes can help with the "soft landing" discussed by the Committee – but they will need to be part of longer-term plan.
- The strains on the budget also highlight the difficulty of "refilling" the reserve, especially if the reserve is depleted outside of a recession. The state is clearly facing a long-term/structural challenge and would have to reduce obligations *well below* annual revenues in order to refill the reserve. This is unlikely to happen.
- Staff hopes that the stress test facilitate longer-term planning that has always been difficult without a clear tool to visualize potential scenarios.

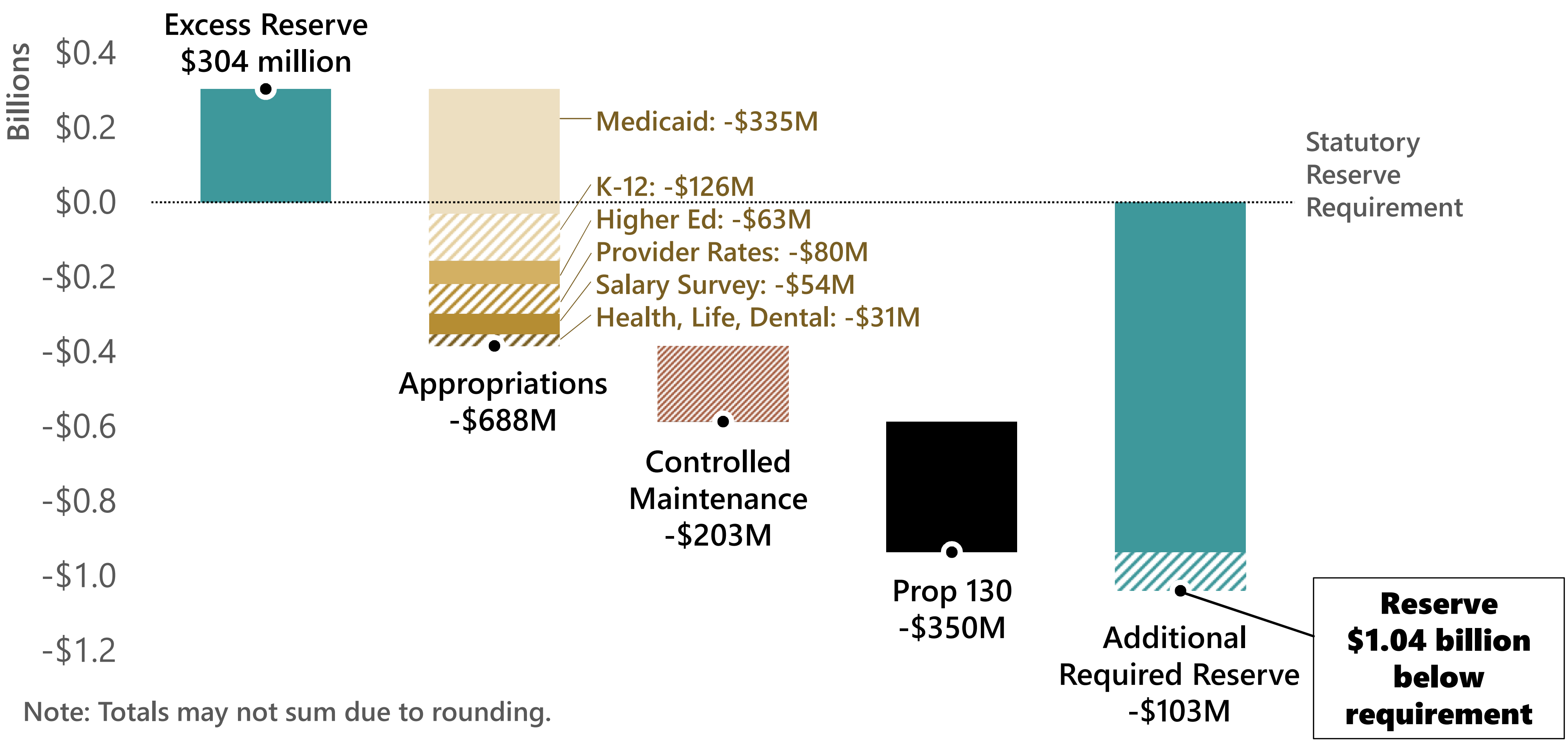
JBC Staff Scenario A

Incorporates Supplemental Package, ARPA Rolloff, Capital Transfer Placeholders



JBC Staff Scenario

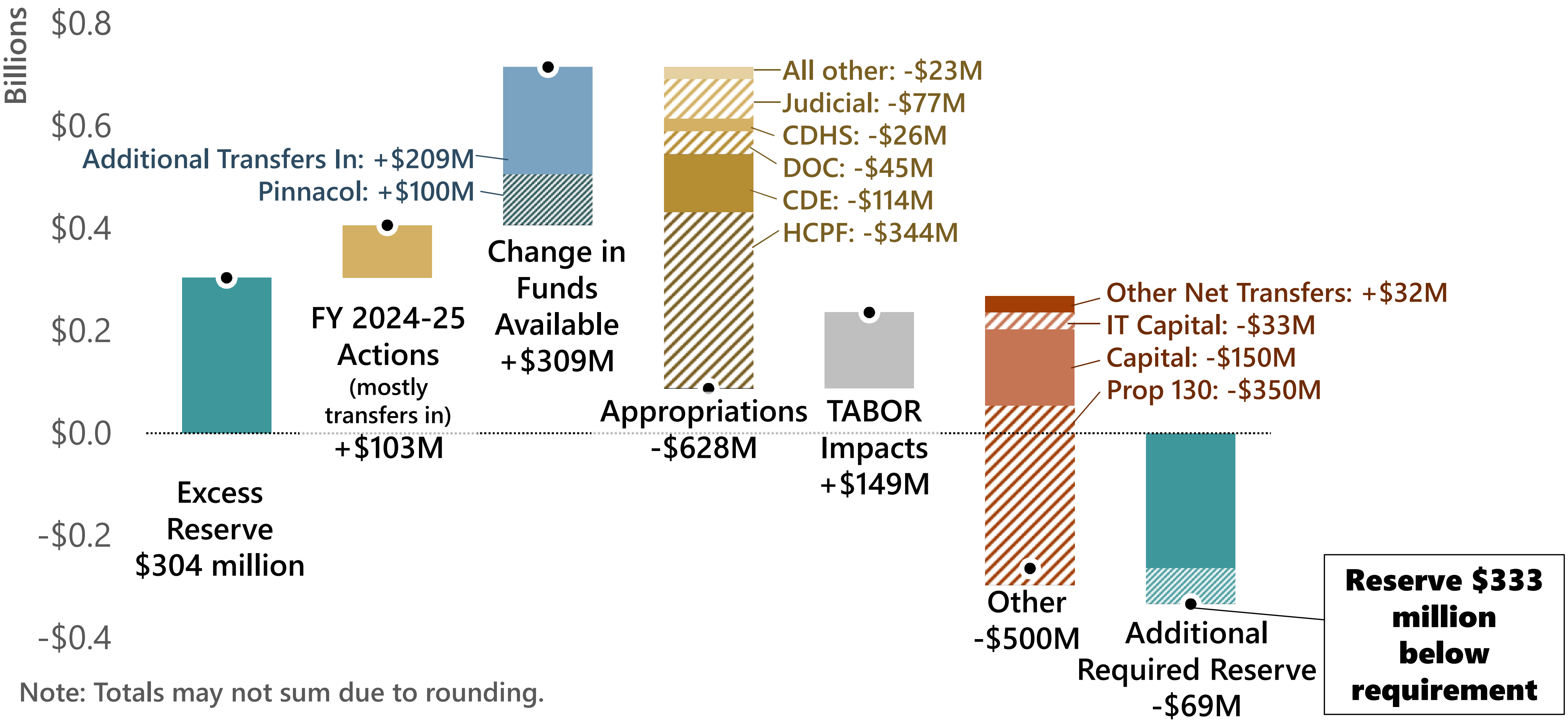
Incorporates FY 2025-26 Budget Drivers, Controlled Maintenance, and Prop 130



Note: Totals may not sum due to rounding.

Governor's Request

Incorporates All Placeholders in Governor's Request and Prop 130



Note: Totals may not sum due to rounding.