THE OREGON BUSINESS PLAN PUBLIC FINANCE INITIATIVE

For Discussion at 7th Annual Leadership Summit

RECOMMENDATIONS

While economic times are hard, Oregon is much better positioned to weather this downturn than most other states. The Governor and Legislature should leverage this advantage to put the state in a strongest competitive position possible when national economic growth returns. With that goal in mind, the Oregon Business Plan calls on the Governor and Legislature to:

- Overhaul the counterproductive personal and corporate kickers; Enact long-term budgeting and the other recommendations of the Revenue Restructuring Taskforce
- Maintain stability of PreK-20 education services by establishing policy for disciplined withdrawals from an expanded Education Stability Fund
- Leverage federal revenue to support critical social services in times of growing need
- Develop a complete and transparent account of the impact of market declines on the state's pension system
- Launch the debate on the replacement of federal timber payments.

Vision for Public Finance and What's at Stake for Oregon

As business and government leaders met at the inaugural Oregon Business Summit in fall 2002, the state was in the grips of a recession that triggered unprecedented budget deficits and painful choices. Leaders responded with competent reserve and pension reforms.

Tough economic times have returned, but thanks to the prudent fiscal policies of the last six years, Oregon is in a much better position to manage the downturn.

First, the state will enter the next biennium with $734 million in two reserve accounts—a remarkable achievement and 180-degree change in focus and priority from just a decade ago.

Second, public resources have held up well relative to other states. At the state level, an expanding export sector have propped up personal incomes and associated tax revenues. At the local level, the decoupling of property taxes from market values, enacted in the 1990s, means that local governments can count on stable revenue as the housing market cools.

ACCOMPLISHMENTS TO DATE

- ✓ The 2007 Legislature created a Rainy Day Fund—adding $340 million to reserves and complementing the Education Stability Fund.
- ✓ The 2003 Legislature enacted comprehensive PERS reform that created a separate retirement system for newly hired employees and limited conditions under which more than the PERS guaranteed rate could be credited to Tier 1 members.
- ✓ Oregon voters created the Education Stability Fund – the state's first sizable reserve fund. Financed by lottery revenues, the fund supports K-12 and higher education. Assuming no economic downturn, it is forecasted to grow to $394 million by June 2009.

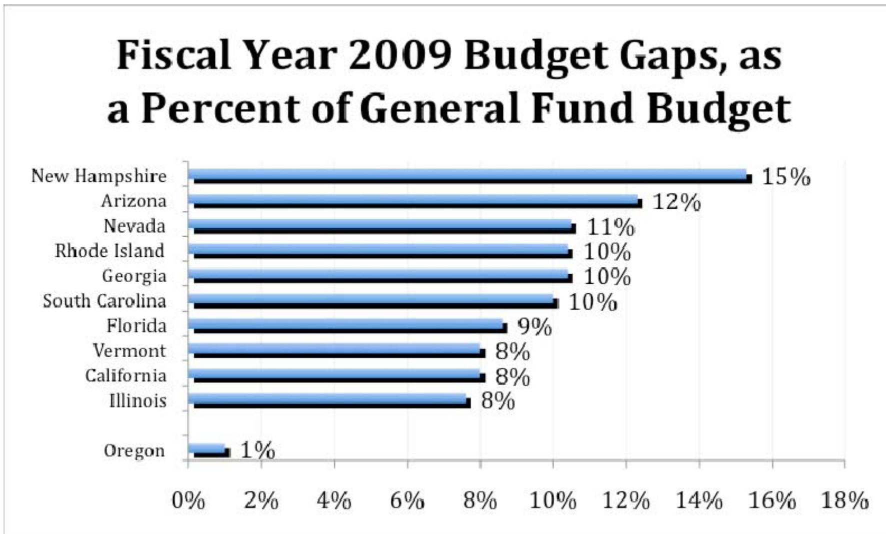
Third, and perhaps most important, the *long-term* fundamentals of the state's fiscal position remain sound. The sizable "baby-boom echo" (that is, children of baby-boomers) is aging out of school and into the workforce, and as they do, population-driven demands on the state's education system will lessen. A slow growing school-age population over the next decade affords Oregon a "demographic breather" and will generate structural budget surpluses during the next economic expansion. Care for aging baby boomers will cut into those surpluses but not eliminate them.

While it may not feel like it to budget managers in Salem or Baker City, Oregon's fiscal position is a key comparative advantage entering this recession. So, the fundamental question facing the state's leaders for 2009 is: How do we manage our finances to make best use of our fiscal advantage?

Agenda for 2009 and Beyond

The Oregon Business Plan calls on the Governor and Legislature to:

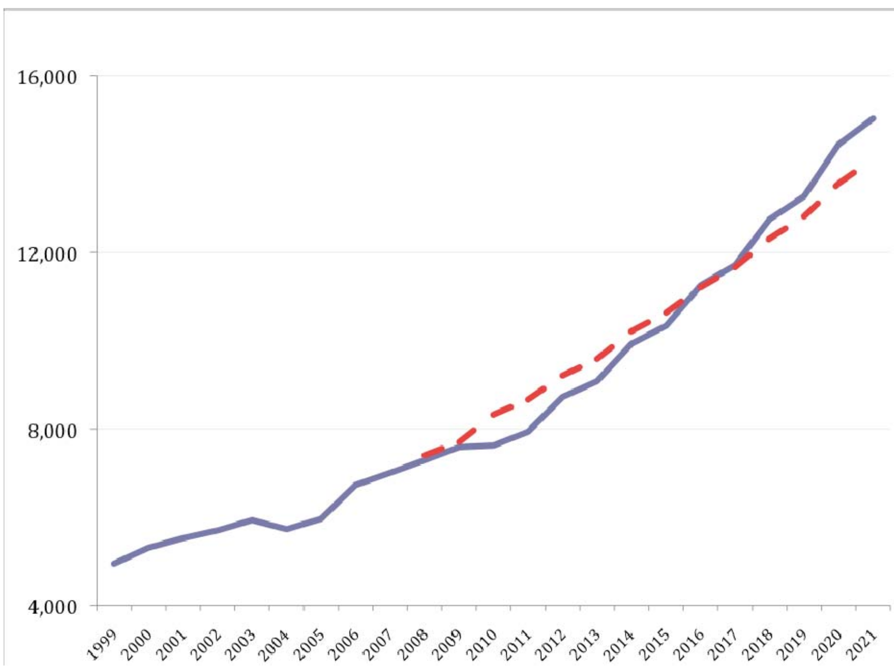
- ***Overhaul the counterproductive personal and corporate kickers; Enact long-term budgeting and the other recommendations of the Revenue Restructuring Taskforce*** The taskforce has advanced five recommendations that would strengthen the state and local fiscal management. Each should be drafted into legislation and enacted.
- **Maintain stability of PreK-20 education services by establishing a policy for disciplined withdrawals from an expanded Education Stability Fund.** In the last recession, Oregon established a reputation for shortened K-12 school years and runaway college tuition. National accounts of Oregon's woes were widespread and toxic. The negative publicity cannot be repeated. In this recession, policymakers should draw on an ESF and continue progress on pre-kindergarten, a new high school diploma, and affordable college tuition.
- ***Leverage federal revenue and support critical social services in times of growing need***. Demands for critical health and human services will be acute in coming months. The state must ensure that safety net services continue for its most vulnerable populations—the elderly, people with disabilities, and children. In doing so, the state should take full advantage of programs matched by federal revenue.
- ***Develop a complete and transparent account of the impact of market declines on the state's pension system***. The recent, sharp fall in market values has significantly affected the PERS asset portfolio. Policymakers and budget mangers lack full description of the market's impact on pension costs in the longer-term.
- ***Launch the debate on the replacement of federal timber payments.*** As Congress extended the federal timber payments this fall, federal policymakers made it abundantly clear that the payments would come to a permanent end in four years. The expiration of the federal timber payments requires a reworking of property tax limitations in the affected counties.



Immediate fiscal shortfalls

A recent survey of state budget officers shows many states face steep challenges in balancing their FY 2009 budgets.

Expressed as a share of its general fund, shortfalls exceed 10 percent in a number of states. Oregon faces an estimated 1 percent shortfall.



Oregon's long-term budget outlook

During next two biennia, Oregon will face budget shortfalls if lawmakers attempt fully fund services at the 2007-09 service levels.

However, over time, a growing workforce and slow growth in school-aged populations should bring the budget into balance.

Overhaul the counterproductive personal and corporate kickers, Enact long-term budgeting and the other recommendations of the Revenue Restructuring Taskforce

During the past year, a broad cross-section of leaders from the business, government, and non-profit sectors convened to study and propose reforms to state and local revenue systems. The 30-member group, led by former state representative Lane Shetterly, developed a pragmatic set of recommendations worthy of quick consideration and adoption by the Legislature.

The taskforce's call for *kicker reform* is long overdue. The policy's counterproductivity has never been more evident than today. The state mailed $1.1 billion in personal kicker refunds precisely as the US entered this recession. Now, policymakers are looking at a biennial budget deficit that exceeds $1 billion, and reserves too small to plug the hole.

Oregon's personal and corporate kickers have been on the books for almost three decades and have never been adopted by another state during that time. That, alone, should tell us something.

The taskforce has proposed a method that would divert the majority of personal and corporate kickers into reserve accounts. Their approach, which builds on a more competent forecasting method, is one way to accomplish kicker reform. Lawmakers should be open to other approaches that accomplish the same goal..

We are especially pleased to see the call for *long-term, performance-based budgeting*. The proposal, which topped the OBP finance agenda for 2008, would require the Governor and Legislature to use 10-year revenue and expenditure forecasts as they develop budgets and consider legislation. The proposal brings a level of rigor and discipline to fiscal planning that Oregon's state government has never had.

The taskforce has also advanced proposals that would apply a *balanced budget rule to ballot initiatives* and *curtail the state's ability to restrict revenue options of local governments*. Both concepts should be refined and adopted in the upcoming session.

Maintain Momentum on PreK-20 Investments Through Prudent Withdrawals From an Expanded Education Stability Fund

The 2007 Legislature made great strides in funding all levels of the PreK-20 education continuum. Lawmakers significantly expanded Oregon's evidence-based pre-kindergarten program, restored K-12 services to the higher levels delivered in the late 1990s, and improved access to postsecondary programs through opportunity grants.

The Legislature and Governor also embarked on an ambitious plan to dramatically increase the educational attainment of Oregonians. The 40/40/20 plan envisions that—going forward—*all* Oregon students will graduate from high school, that 40 percent of high school graduates will earn an associates degree or college credential, and that an additional 40 percent of high school graduates will earn a bachelor's degree or more. Simultaneously, the state unveiled rigorous high school diploma requirements to ensure all graduates will be work or college-ready.

In tight fiscal times, leaders may be tempted to put this important agenda on hold. *But Oregon can't afford to wait two to three years to retrain dislocated workers and prepare a future generation for the fiercely competitive global job market.*

Although the state's fiscal condition is weaker than anticipated just three months ago, Oregon is in a much better position than its neighbors and most other states. The Governor and Legislature must seize the competitive advantage and invest in education just as others cut back.

To do so, the Education Stability Fund (ESF) must live up to its name. Created in the depths of the last recession, the ESF draws 18 percent of state lottery revenues and will have an estimated $393 million ending balance next June. Economic and political triggers govern when and how much lawmakers can withdraw from the fund. But during the fund's short life, lawmakers have yet to develop a policy regarding withdrawals. It is highly likely that the Legislature will be called upon to draw on the fund this upcoming session or at some time during the 2009-11 biennium. It is time to set policy direction.

The Oregon Business Plan calls on lawmakers to adopt a disciplined approach for withdrawing funds from the ESF consistent with Oregon's objective to maintain momentum in education reform, while protecting the integrity of the fund. Below for consideration is *one possible* proposal, developed by the Oregon Business Council:

1. *Establish a PreK-20 instructional funding floor that guarantees enrollment growth.* The state already entitles every K-12 aged resident access to educational services. That entitlement should be extended to public postsecondary institutions for Oregon residents. In short, Oregonians who meet the new, rigorous high school diploma standards should be guaranteed access to the state's postsecondary institutions. The floor should also guarantee access to the Oregon PreKindergarten program to all children living in poverty.

2. *Tie the state's PreK-20 per student contributions at 2008-09 funding levels with reasonable adjustments for inflation.* The state should calculate its 2008-09 contributions per student at each education level. Going forward, per student assistance should be increased by an appropriate measure of inflation. Education is a labor-intensive activity, so a good candidate would be total compensation of professional occupations—as estimated by the US Bureau of Labor Statistics. In recent years, the national index has grown at a yearly rate of between 3.0 and 3.5 percent.

ILLUSTRATIVE ESTIMATES OF AN EDUCATION GUARANTEE
(in Billions)

Baseline Economic Scenario

	2009-11	2011-13	2013-15
General Fund Revenue (Dec. 08 Forecast)	14.75	16.96	19.37
Funding Floor			
State School Fund	6.45	6.96	7.50
School Improvement Fund	0.28	0.30	0.33
PreK and Postsecondary Instruction	1.23	1.38	1.53
Instruction Guarantee ($)	7.97	8.63	9.35
Maintenance of Effort (52% of GF)	7.67	8.82	10.07
Required ESF Withdrawal	**0.30**	**0.00**	**0.00**
ESF Ending Balance After Withdrawal	**0.33**	**0.65**	**0.85**

Weak Economic Scenario

	2009-11	2011-13	2013-15
General Fund Revenue (Dec. 08 Forecast)	14.25	16.46	18.87
Funding Floor			
State School Fund	6.45	6.96	7.50
School Improvement Fund	0.28	0.30	0.33
PreK and Postsecondary Instruction	1.23	1.38	1.53
Instruction Guarantee ($)	7.97	8.63	9.35
Maintenance of Effort (52% of GF)	7.41	8.56	9.81
Required ESF Withdrawal	**0.56**	**0.08**	**0.00**
ESF Ending Balance After Withdrawal	**0.07**	**0.31**	**0.66**

3. *Set a maintenance of effort level in the State General Fund for education instruction.* The Legislature should establish a level of General Fund resources that it is willing to devote to PreK-20 instruction. For illustrative purposes, we'll assume a maintenance level of 52 percent. So, using the December 2008 forecast, the state would commit *up to* $7.67 billion to PreK-20

instruction and instructional support in the 2009-11 biennium (or, 52 percent of the $14.75 billion in General Fund revenue).

4. *Expand the Education Stability Fund.* To ensure the ESF has adequate funds going forward, lawmakers should expand its revenue sources. This illustrative example suggests we can squeak through with the existing fund at the current revenue forecast, but it will be tight. The Baseline Scenario, using the most recent revenue forecast, suggests that $330 million would be available at the end of the 2009-11 biennium. The Weak Scenario, which reduces the revenue forecast by an additional $500 million, shows that the fund would be nearly dry by the biennium's end. Given the current environment, we can envision conditions getting even worse than the Weak Scenario. Future kicker dollars or other sources are needed to help refill the fund and ensure an adequate floor for the years ahead.

5. *Authorize withdrawals from the ESF when the enrollment guarantee and per student allotment growth, together, cause instructional expenditures to exceed the maintenance of effort level.* In biennia when enrollment growth surges, general fund revenues shrink, or both, the Legislature would draw ESF funds to support the enrollment guarantee. Business leaders estimate the 2009-11 guarantee—as described here—would require $7.97 billion (that is, $6.732 billion in K-12 and $1.235 billion in PreK and postsecondary instruction). The General Fund would contribute $7.67 billion. The Education Stability Fund would contribute $0.3 billion.

Leverage Federal Revenue to Support Critical Social Services in Times of Severe Need

The abrupt economic downturn has left many Oregonians jobless. Providing short-term opportunities to retrain and build skills is essential. But they also need assistance in meeting the basic needs of their families.

Lawmakers should be strategic in finding resources to meet these growing demands, and making sure the federal government helps should be a priority. Oregon and the federal government share in the cost of the Medicaid program, which provides health services to children, the disabled, the elderly, and some low-income adults. Every state dollar spent on Medicaid draws about $1.56 in federal assistance. Holding the line on Medicaid programs—or even modest expansions to them—bring two benefits. First, and most important, are the critical health care services, which range from routine checkups for children to intensive nursing care services for the elderly and people with disabilities. But the federal assistance that flows into Oregon also provides an economic boost, supporting jobs of local healthcare workers with tax dollars from elsewhere. For example, a recent study showed that every $1 million dollars in federal Medicaid assistance in the long-term care sector supports 34 direct and indirect jobs.

The Oregon Health Fund Report proposes a broader expansion of Medicaid through a provider tax and matching federal funds. While, the business community understands the rationale of a provider tax as a strategy for drawing federal match, we also recognize that if a tax were levied, it could eventually show up in higher health care premiums. We could support the provider tax only if cost improvement strategies are underway. In the meantime, we support using a cigarette tax to fund short-term Medicaid expansions and public health programs.

The Food Stamp program, which delivers targeted assistance to low-income families, provides another important opportunity to pull the federal government into Oregon's recovery. The state shares in the cost of administering the program, but the federal government funds 100 percent of the benefits. A disciplined outreach effort, funded jointly, would extend critical, federal aid to needy families and provide a modest economic stimulus.

Clearly, the federal government can't and won't answer all our needs. Oregon funds a number of critical programs with its own resources. Lawmakers must take hard look at each, assess the program effectiveness, and protect the state's most vulnerable citizens. Across-the-board 10 percent agency cuts are too blunt a budget-balancing instrument in these difficult fiscal times.

Develop a complete and transparent account of the impact of market declines on the state's pension system.

The state's pension system remains highly volatile despite the comprehensive reforms enacted during the 2003 Legislative session. The system's unique and complex structure requires tight management and constant oversight. PERS's most recent valuation—released just two months ago—is a snapshot of the system's financial condition as December 31, 2007. Based on the system's reasonably solid footing *at that time*, PERS will lower its employer rates—the amount it charges to school districts and state and local government employers.

But a lot has happened since December 2007. PERS' variable account declined 26 percent through September 2008, and it has undoubtedly suffered significant losses thereafter. Especially hard hit are the many governments that "pre-paid" some of their PERS obligations through side accounts. They borrowed money at 5 percent interest, invested it with PERS, and counted on returns in excess of the cost of borrowing. The approach worked well through much of 2007, but those side accounts have taken a beating since then.

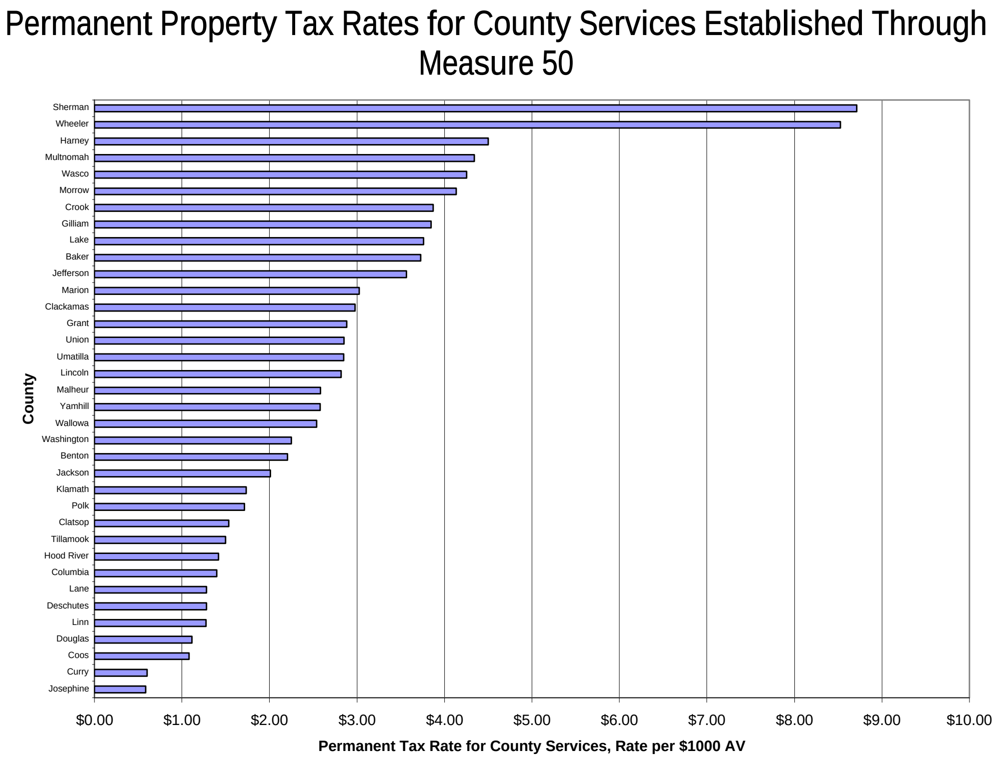
We do not anticipate major changes to the pension system during the 2009 Legislature. However, we do suggest for a comprehensive and transparent update of the impact of recent market conditions on the system. The system's cost to public employers will undoubtedly rise in years to come. The sooner policymakers get a handle on the magnitude of the cost, the better.

Launch the Debate on the Replacement of Federal Timber Payments

In an 11th hour reprieve, the US Congress extended federal timber payments to 33 Oregon counties. The payments, extended in October as part of the $700 billion bailout of the US financial industry, will bring Oregon $254 million in the current budget year. The extension is limited to four years, and few observers anticipate the payments will be reauthorized.

Anticipating a possible termination of payments, Governor Kulongoski convened a *Task force on Federal Forest Payments and County Services* late last year. The task force recommended a wide range of possible responses including renegotiated timber-revenue sharing agreements between the federal and county governments and improved management of federal lands.

Policymakers will also have to reconsider the low permanent property tax rates locked in by Measure 50. Under the M50 limits, Coos County collects only $1.08 per $1,000 of assessed value (AV) to operate county-run services. By contrast, Multnomah County collects $4.34 per $1,000 AV. A new home in Coos County with *real market value* (RMV) of $300,000 has an *assessed value* (AV) of $184,200 and generates only $199 each year for county services including the county sheriff, library, and public health services. In short, the permanent rates created by M50 implicitly assume the continuation of federal payments. When the federal payments end, those permanent rates will have to be reconsidered.



Source: Association of Oregon Counties

Resetting permanent rates in timber counties would require a change to the state Constitution and would inevitability trigger a much broader discussion about Oregon's property tax limitations. That discussion would be a lengthy one. Given the time limit on the federal timber payment, it should start now.

Public Finance Initiative Leader

Maila Wasson, US Bank

Background Resources

"Public Employee Retirement in Oregon: Where Does the System Stand and Where Could Oregon Go From Here?" ECONorthwest, October 2007, Prepared for the Chalkboard

Project and the Oregon Business Council

"Providing Stable and Adequate Funding For Public Services" (PDF) – Oregon Business Plan White Paper (January 2005)

Summit 2003 Discussion Paper: Public Finance) December 2003

"Making Government Work For Oregonians" (PDF) – January 2004 Report by Advisory Committee on Government Performance and Accountability)

“Oregon Budget Principles”–See Governor’s Web Site, www.governor.oregon.gov/Gov/budget/future.shtml

"Grading the States" -- Government Performance Project Website