OREGON
BUSINESS PLAN

TIME TO ACT

It's time for cost and revenue reforms to put Oregon's fiscal house in order so we can make vital public investments

FOR OUR KIDS · TIME TO ACT ·

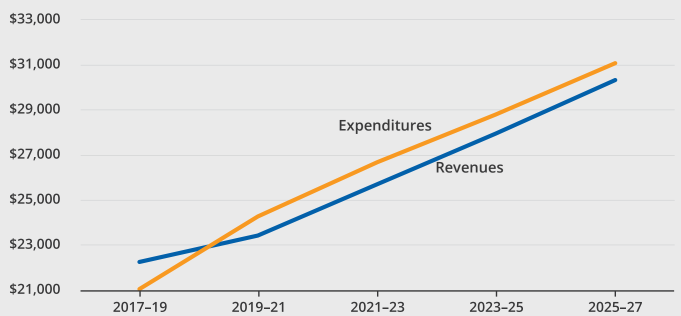
Oregon Business Plan | December 3, 2018

TIME TO ACT: OUR CHILDREN'S FUTURE DEPENDS ON PUTTING OUR FISCAL HOUSE IN ORDER

OUR FISCAL SYSTEM FALLS SHORT OF MEETING OUR NEEDS

Oregon is caught in a growing fiscal bind that threatens to rob current and future generations of quality public services while damaging our economic resilience. Even in this strong economic expansion, the costs of state and local services are increasing faster than record revenues. This is creating a "structural deficit", a fiscal gap that will plague us for years. As illustrated below, projected baseline revenues won't be sufficient to maintain services even at current levels well into the next decade, *assuming no recession.* When a recession hits, as happens periodically, we won't have enough reserves to see us through it, or to avoid painful choices about what services to cut.

We Keep Spending More Than We Take In
Projected General/Lottery Fund Expenditures and Revenues (in millions)



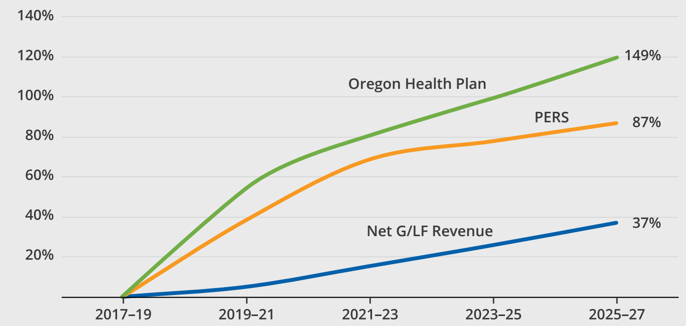
Note: Expenditures include higher assumed CSLs for K12, community colleges, and public universities.
Source: OBC/OBP Analysis of State Revenue and Expenditure Data

NOT FINDING AN ANSWER TO THIS PROBLEM ISN'T AN OPTION

Failure to meet this challenge will come at a high cost to our citizens and economy. If we do nothing to change the fiscal structure of our state, problems already rooted will damage the prospects for generations of our youth:

- Too many of our students won't attain the learning and credentials they need for success in life. Students will suffer shortened school days and larger class sizes because our schools won't have sufficient funds to maintain full teaching staffs, and to compete for and keep the best teaching talent.
- Tuition hikes in our universities will drive out students at the very time an affordable education is critical.
- We'll miss opportunities to support young children and families that would help break the cycle of intergenerational poverty.

Cost Growth Runs Ahead of Revenue Growth
Main Sources of Oregon's Budget Imbalance, 2017-19 values = 0%



Source: OBC/OBP Analysis of State Revenue and Expenditure Data

THE CAUSES ARE CLEAR

There are two significant public sector cost drivers creating Oregon's fiscal imbalance. One is the ever-rising cost of Oregon's Public Employees Retirement System (PERS). Its unfunded liability, now at $22 billion, will continue to claim larger shares of public budgets. Revenue from a robust, growing economy is increasingly diverted to pay for PERS rather than to boost services at the state and local level. The other cost driver is Medicaid, also known as the Oregon Health Plan. The Business Plan has steadfastly supported expansion of this health care coverage for low-income Oregonians, but the state must pick up an increasing share of the coverage cost for 350,000 Oregonians as federal support declines.

OREGON NEEDS A LONG-TERM, BALANCED SOLUTION

Solving this crisis calls for a long-term fiscal plan based on a vision of opportunity. In this vision, every Oregonian has access to education; health care; safe, affordable communities; and a life rich with possibilities.

Achieving this vision, we believe, calls for a broad three-part strategy:

- Grow the economy (the best source of new dollars for public sector revenue).

- Constrain the growth of runaway costs.
- Add new revenues, targeted to critical education investments and other vital services.

The Oregon Business Plan has been focused broadly on the first component of this strategy for years. Addressing the latter two is the focus of this paper. It is important to note at the onset that cost control and revenue reform are not fungible components of this strategy. Without curbing the unsustainable cost of certain government programs, it makes no sense to just raise revenues. New dollars alone will only prop up a broken system rather than improve outcomes for Oregonians. We must achieve cost control *and* look at our opportunities to improve our revenue system.

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THERE ARE THREE KEY ELEMENTS TO A FISCAL SOLUTION

PERS. Fixing PERS is Job 1, and it's doable. There are fair and legal steps available to significantly reduce the system's unfunded liability. These measures are long overdue.

Public Employee Health Care Benefits. Oregon pays too much for public employee health insurance. Better plan designs would yield more value at a lower cost, freeing up dollars for needed public services and competitive salaries to attract and keep talented public employees.

Revenue. The current revenue system, so dependent on the personal income tax, is unstable, rising and falling wildly with economic cycles. This harms vital services, such as education, through budget cuts during downturns. In addition, our high tax rates for income and capital gains repel entrepreneurs as well as businesses with high-salary payrolls, impeding economic growth. Kicker reform and changes to our tax structure, *coupled with cost-containment,* would stabilize revenues and generate more resources for education, health care, and other vital public services.

THE FUNDS MADE AVAILABLE BY REFORMS WILL PAY FOR VITAL INVESTMENTS

Funding for Medicaid. Oregon's Medicaid expansion has brought health coverage to 350,000 Oregonians, and is improving health through innovations in service delivery. It's an investment we need to maintain.

Early Childhood Education. Greater preschool access and support for parents with young children can make an extraordinary difference in the life prospects for young Oregonians.

Pathways to Careers. Oregon schools at all levels are ramping up career and technical education opportunities that lead directly to promising careers. Investments in these pathways in K12, community college, and universities will raise incomes of Oregonians and bolster our economy.

College Access. Too many Oregonians who need support are not receiving assistance through Oregon's student grant program. Additional dollars will put higher education in reach.

Institutional Support. All of our public education institutions would benefit from the ability to hire more teaching and support staff, to pay them better, and to invest in new programs. Such support would improve our prospects for raising student attainment.

IT'S TIME TO ACT

Oregon has an opportunity to change its fiscal course in a way that will lead to healthier, better educated Oregonians and a stronger economy that meets our goals for higher incomes and lower levels of poverty. The key is to put all these pieces together. One element without the others will not work. We need to pursue a comprehensive plan, implemented over a decade or more, to fully put Oregon's fiscal house in order. As the deficit grows and time passes, the problem gets harder to solve. It's time to act.

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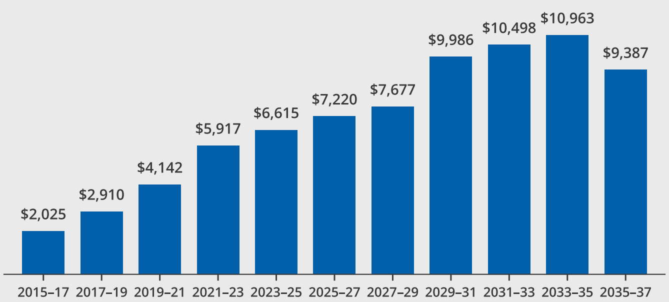
PERS: OREGON'S $22 BILLION PERS DEBT HITS TAXPAYERS AND REDUCES SERVICES

RUNAWAY PERS COSTS BURDEN BOTH GOVERNMENT BUDGETS AND OREGON HOUSEHOLDS

Oregon's Public Employees Retirement System is in the red. It's $22 billion short of funds needed to pay for pensions owed to government employees and retirees. This unfunded liability is covered by government employers and ultimately taxpayers. PERS costs are rising each budget cycle, taking an ever-bigger bite out of budgets for education, police, health care, housing, and other services state and local governments provide.

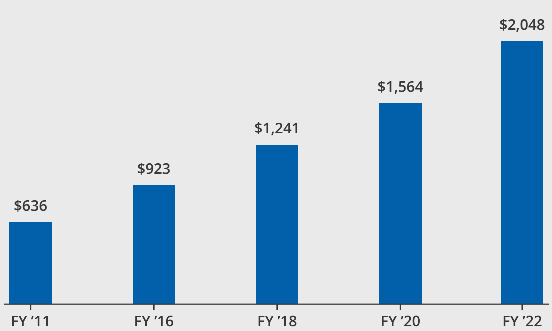
This PERS burden will essentially double over four years. It's going from almost $3 billion in the 2017–19 cycle to nearly $6 billion in 2021–23. It will be heading for $10 billion by 2029–31, and still rising.

PERS Costs Will Surge for a Decade and a Half
Projected Systemwide Net Contributions to PERS (in millions)



Source: 2017 PERS UAL Task Force Report

PERS Burden Per Oregon Household Will Triple
Projected PERS Growth Per Oregon Household



Source: OBC/OBP Analysis of PERS and Office of Economic Analysis Data

Oregon taxpayers foot this bill to the tune of more than $1,200 per year per household. By 2022, the cost will pass $2,000 per year — and keep climbing.

This shortchanges public services. Every dollar spent on rising PERS costs is a dollar that can't be spent to employ more teachers, firefighters, or other public service providers. Or can't be used to reduce class sizes or offer more career and technical education programs.

Projected K12 Impact of PERS Cost Increases Equivalent to Teaching Positions or School Days
For PERS Costs Accumulating from 2015–17 through 2021–23

Source: Oregon Business Council/Oregon Business Plan analysis of PERS and Quality Education Model data

THERE ARE LEGAL REFORMS THAT CAN BE MADE

Benefits not yet earned can be modified. In the most recent PERS decision, *Moro v. Oregon,* the state Supreme Court said that benefits can be modified for work that has not yet been performed (all future service of current employees).

Employee contributions can be required. The court has long allowed for changes to the share of the benefits paid for by employees and the share paid for by employers (i.e., taxpayers).

THESE ARE THE LEADING REFORM OPTIONS

Reinstate employee contributions. Employee contributions are a simple way of asking employees to pitch in for a portion of their retirement benefits without changing those benefits.

- Employees could be asked to contribute up to 6 percent of their salary to pay for their defined-benefit pension, as they do in most other states and as they did in Oregon prior to 2003.

- Employee contributions could be for all employees, just for Tier 1 and 2 employees (those hired before 2003), or for a greater amount for Tier 1 and 2 and a lesser amount for Oregon Public Service Retirement Plan (OPSRP) participants (those hired after 2003).

Extend benefit reforms to pre-2003 employees. Tier 1 and 2 PERS members continue to earn benefits that are much more generous and almost twice as expensive as those earned by employees hired after 2003. As a result, younger employees are bearing higher payroll costs to pay for the benefits of those who preceded them.

- Benefits for all current employees can be adjusted on a going-forward basis, provided all benefits earned to date are protected.
- Adjusting benefits for Tier 1 and 2 employees, to align them with benefits in effect for younger employees, would be more equitable for the public employee workforce and more affordable for Oregon taxpayers.

Expand post-retirement employment options. Some public employees may wish to continue working even after retirement.

- Rehiring retirees back into government service should be an option for employers and employees, provided employees contribute 6 percent of salary into the PERS fund to reduce the unfunded liability.
- Employees would benefit from additional salary along with a pension.
- Employers would benefit from ability to hire hiring a quality employee while addressing lowering their organization's pension liability.

Shift all new employees to a generous defined contribution plan. Employees and employers alike would benefit from a defined contribution model where the state provides regular payments into a 401(k)-style retirement account for each employee.

- Employees would have the flexibility to take their dollars with them upon taking a new job, which provides greater retirement protection in an uncertain labor market.
- Employers (and taxpayers) will be reassured to know that they will not be burdened with liabilities in the future to pay for commitments from the past.

Refinance the liability. With these legal benefit and cost-sharing reforms in place, Oregon can then look at refinancing the remaining liability associated with public employees already retired.

- This could include using more of the state's bonding capacity, extending the period over which the PERS debt must be paid off, or looking for creative ways, as the Governor has done, to incent employers to make additional contributions.
- However, without exhausting the legal and equitable reforms that are available, simply refinancing the liability would be unaffordable for Oregon taxpayers and detrimental to generations of Oregonians to come.

HISTORY: PERS IS A CRISIS LONG IN THE MAKING

The plan has far exceeded its original, reasonable intent. *Oregon's original pension plan goal was to provide public employees a retirement income worth 50 percent of final salary for 30 years of service, on top of 25 to 30 percent from Social Security. However, poor policy and management decisions greatly increased pension benefits for many employees. PERS retirees between 1990 and 2017 exceeded this target with pensions averaging 78 percent of their final average salary at 30 years. Thousands of other PERS members retired with annual benefits higher than their final salary. Taxpayers are on the hook for funding these excessive pension benefits.*

Only a part of the problem has been solved. *In 2003 the Legislature reformed the system for new hires but left in place many of the generous pension benefits for employees hired prior to 2003. This effectively created two different benefit plans, with 34 percent of the current workforce continuing to accrue benefits at the higher pre-2003 levels.*

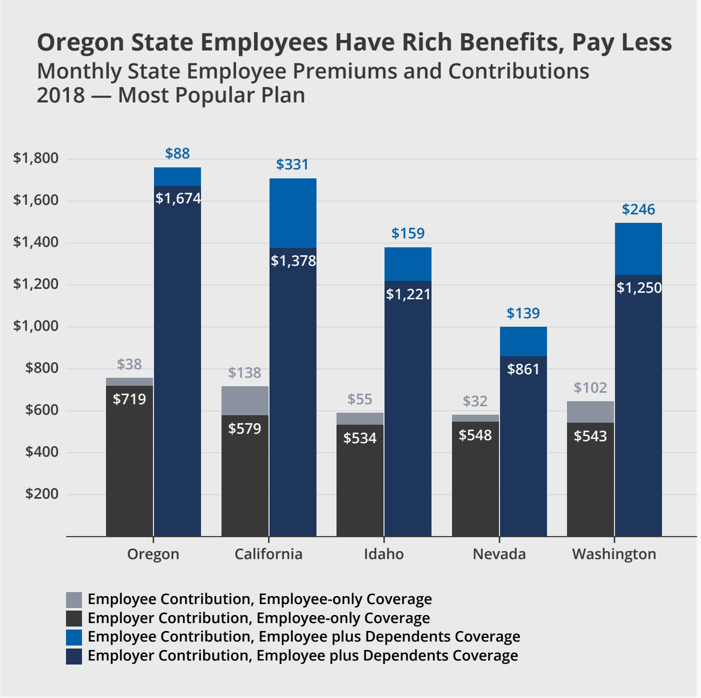
The Oregon pension system limps along unfixed. *When the stock market crashed in 2008, public and private retirement plans throughout the U.S. were forced to adjust to a more challenging investment environment to sustain their benefits. Most plans adjusted by slowing the accrual of new benefits and by requiring higher contributions from both employers and employees to replenish their assets. Oregon has yet to respond to this challenge, except by shifting the problem entirely to taxpayers. Since the market crash, PERS investment returns have rebounded and been exemplary, but the system's unfunded liability has still climbed to $22 billion — a stunning $13,000 for every Oregon household.*

In Oregon, public employees don't contribute anything to their PERS pensions. *Most pension systems are supported in part by employee contributions. That's the case with nearly every public pension system in the nation. Yet Oregon law requires schools, cities, counties and the state — meaning taxpayers — to pick up the full tab for PERS pensions. Employee contributions to the pension fund were eliminated in 2003. Since then, no employees (except some judges) contribute to their PERS pensions. Some employees contribute to a separate 401(k)-style account, but that does not pay for the PERS pension system or lower its long-term debt.*

PEBB AND OEBB: OREGON COULD SAVE SIGNIFICANT COSTS IN PUBLIC EMPLOYEE HEALTH INSURANCE

WE PAY MORE THAN WE SHOULD FOR PUBLIC EMPLOYEE COVERAGE

Adjustments to health insurance benefits for public employees offer a ready opportunity for cost savings that would make additional funds available for public services — or for more competitive pay to attract and keep talented public employees. Public leaders are in a position to act on this opportunity because many public employees in Oregon have health coverage through either of two main providers. The Public Employee Benefit Board (PEBB) covers state agency staff and university employees. Most Oregon school districts (except some large districts) and a number of local governments are members of the Oregon Educators Benefit Board (OEBB).



Source: Comparison of Health Benefits Offered to State Employees and Teachers: California, Idaho, Nevada, Oregon, and Washington. Milliman draft report, Dec. 2018.

A new study by actuarial firm Milliman (to be published December, 2018) notes that Oregon state employees have rich benefits and pay less for their coverage than employees in the four states adjoining Oregon. While cost comparisons are more difficult to make for teachers, Milliman found a slightly different story there: coverage costs relatively less, but as with state employee coverage, public employers, i.e. taxpayers, bear more of the cost.

The potential for cost savings is greater for coverage provided through the Public Employee Benefit Board (PEBB), but there are also potential cost improvements that could be made for school districts and some local government employees covered through the Oregon Educators Benefit Board (OEBB) system.

PEBB COSTS MORE THAN OTHER STATE PLANS

Several factors drive higher costs for PEBB:

- **Plans are richer and more expensive for Oregon state employees.** The plans for state employees are more generous and expensive than coverage offered in other states.
- **Employees pay much less of the premium costs than in other states so they have little incentive to choose more efficient plans.** In Oregon, the average contribution toward premiums is 3 percent for employees and employees with dependents. Other states require a 10 to 20 percent contribution for employee-only coverage and a 12 to 20 percent contribution for employees with dependents. While California employees enjoy rich benefits, they also make a more significant contribution to their plan costs. Indeed, the share that Oregon employees contribute for both employee-only and dependent-coverage plans is the lowest of the five states in the Milliman study by a significant margin.
- PEBB's consultant, Mercer recently reported that **Oregon provider reimbursements are average or higher compared to the rest of the nation (i.e. the cost of health care is higher in Oregon).** Another study, the 2018 Health Care Cost Institute Healthy Market Index, found that health care prices in Portland are 7 percent above the national average when comparing 112 U.S. cities. This ranks Portland tenth highest of the cities included.

THERE ARE THINGS WE CAN DO TO REDUCE THESE COSTS

A concerted, thoughtful effort to reform health benefits could help address Oregon's budget shortfall and lead to a better total compensation package for public employees. This work needs to be conducted in concert with a total compensation study that benchmarks total compensation for state employees to ensure the state can recruit and retain talent. (The Oregon Business Plan has provided recommendations for how such a total compensation study should be carried out.)

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To help control health care costs for state and school employees, the following measures should be considered.

Controlling the Cost of Payments to Health Care Providers

- Continue to hold the PEBB and OEBB boards accountable for limiting growth in per member health care costs to 3.4 percent.
- Hold school districts outside of OEBB to the same target.
- Have the boards and school districts establish contracting requirements of their carriers for hospitals and providers to move from billing fee-for-service to value-based, global payments for the overall care of patients by 2023.
- Increase efforts to manage complex, high-cost patients; provide customized service to help them get the right care they need.

Reforming Employer/Employee Contributions

- Over time, move to a fixed dollar contribution for health benefits that increases by CPI. This creates incentives for employees to select a lower cost plan that meets their needs.
- Set a target for the fixed dollar contribution that brings Oregon's costs closer in line with other public-sector and large Oregon purchasers, with more room for salary increases.
- Increase in 5 percent increments the percentage paid by employees until it is comparable to other public and large Oregon employers.
- Create shared savings models with employees.

Offering More Choice in Plans and Options

- For PEBB, offer additional benefit plans, with different price points including a Consumer Directed Health Plan, that allow employees to select the right amount of coverage they need while not over insuring.

OEBB PREMIUMS ARE LOWER COMPARED TO PEBB AND OTHER STATES

While comparing school teacher health benefits across states is more difficult, the Milliman study found that in general, premiums in OEBB are lower than those for school teachers in Washington and California. However, teachers in other states pay a greater share of the premium when compared to Oregon. In Oregon, the average contribution for employee coverage is paid in full for districts paying on a 4-tiered rating structure, and 7 percent for those who have one composite rate. For employees with dependents, they pay on average 6 percent for plans on a tiered basis, and 7 percent for composite rates. As with PEBB in Oregon, Washington and California only offer benefits with premiums on a tiered rating structure. On average, the contributions for employee-only coverage in Washington and California ranges from 0 to 23 percent and 31 to 45 percent for employees with dependents. The school districts in all three states offer a range of comparable benefit plan options.

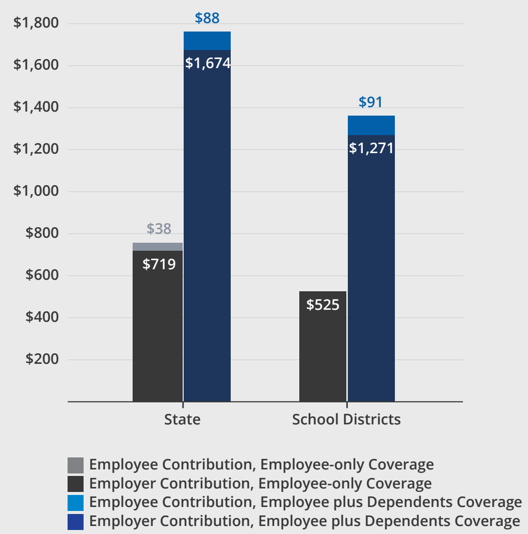
Although OEBB costs are lower than PEBB, there is still room for improvement in some jurisdictions.

For example:

- The decisions on the plans offered, the employer contribution, and the rating structure used in offering benefits are made at the district level and vary considerably across the state. Districts and labor leaders may not have the tools to know how to best structure their plan offerings and contribution approaches to create savings.
- Some districts take advantage of the OEBB model and support choice of offerings with contribution approaches that create the right incentives; other districts don't. These decisions impact the district costs; sometimes resulting in district costs above 3.4 percent.

Oregon State and School Employees Pay a Small Share into Their Plans

Monthly Premiums and Contributions
2018 — Most Popular Plan



Source: Comparison of Health Benefits Offered to State Employees and Teachers: California, Idaho, Nevada, Oregon, and Washington. Milliman draft report, Dec. 2018.

OEBB SHOULD CONSIDER THESE REFORMS

- Require districts to offer plans on a 4-tiered premium rating structure, like PEBB and other school districts. This could allow more savings to apply to salary adjustments for starting teachers.
- Create a labor-management team including OEBB staff to help districts optimize the elements of the OEBB model to offer choice of plans, control district costs, create shared savings models with employees, and help employees make better decisions.
- Encourage more cities and counties to move to OEBB or the same model.

REFORMS SHOULD AVOID POTENTIAL COST SHIFTING

While these changes will help allow for savings for the state for other investments, there is concern that the changes may shift costs to other Oregonians. Steps to avoid this include the following.

- As with the 3.4 percent growth target for PEBB and OEBB, create a statewide, all-payer health care spending target to ensure that health care costs do not outpace growth in the economy and wages, with mechanisms for ensuring that health systems operate within the target.
- Build on existing state data sources to create a system for transparent reporting on health care cost drivers.
- Leverage and align contracts across all payers, including the regulated markets, to require hospitals and providers to move from billing fee-for-service to value-based, global payments for the overall care of patients by 2023.

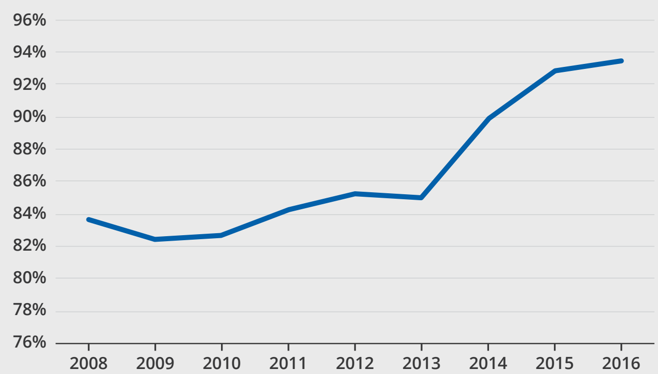
MEDICAID: OREGON MUST FIND A WAY TO KEEP AND FUND THE MEDICAID COVERAGE EXPANSION

THE MEDICAID FUNDING GAP THIS BIENNIUM COULD REACH $830 MILLION

Funding Medicaid — the Oregon Health Plan — is a key part of Oregon's fiscal challenge. Under Medicaid expansion in the Affordable Care Act, the state is required to pick up a larger share of Medicaid costs in the upcoming biennium, increasing the size of its projected budget deficit. About $230 million of one-time taxes to cover Medicaid will expire, increasing the budget gap even more. Assuming none of the anticipated General Fund revenue growth is directed to Medicaid, the expected deficit is $830 million for the 2019–21 biennium.

The Oregon Business Plan supports continued funding of Medicaid because it improves health outcomes that are beneficial to Oregonians, as well as Oregon's economy and community life. A sustainable Medicaid program can be achieved through holding down costs, improving health, and addressing the biennial revenue challenge in the larger state budget context.

Oregon Health Insurance Coverage Up Dramatically
Percent of Oregonians with Coverage, 2008–2016



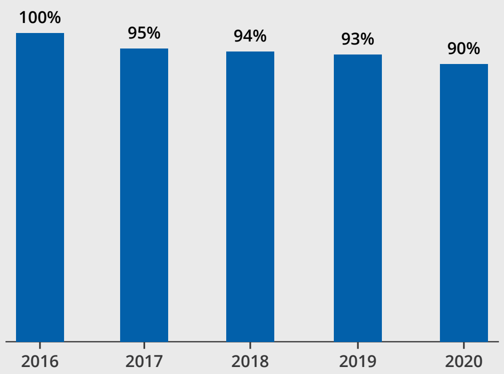
Source: OBC/OBP Analysis of ACS IPUMS

FUNDING MEDICAID IS A DECADES-OLD CHALLENGE

Taxpayers overwhelmingly supported Measure 101 to uphold temporary funding to maintain Medicaid coverage. The Oregon Business Plan supported the 2014 expansion of Medicaid to more low-income Oregonians. It's a key way to ensure at least 95 percent of all Oregonians have health insurance coverage.

Even before the expansion, funding Medicaid was a challenge going back at least two decades. The state coped with it either by reducing eligibility and services or by imposing temporary assessments on the health care industry. Neither are sustainable approaches.

Oregon Will Soon Pick up 10 Percent of Medicaid
Scheduled drop in federal share of ACA expansion costs



The implementation of the Coordinated Care Organizations (CCOs) and the annual 3.4 percent limit on expenditure growth has created a promising pay-for-performance platform for improving how Medicaid funds are invested, balanced with our future state budget liability. The CCOs have made notable strides on quality metrics. These include reductions in emergency department visits, increases in depression screening, and greater enrollment in patient-centered primary care homes, while maintaining spending growth under the 3.4 percent limit.

However, a sustainable approach to funding the program, which is essential to ensuring the continuum of health coverage for Oregonians, has not been found after decades of discussions. Oregon has relied on health care specific taxes to fund the Medicaid program one biennium at a time, two at most. And we are faced with a growing state share of the costs in the upcoming biennium, increasing the financing burden on the state budget.

WE NEED A SUSTAINABLE SOLUTION

The Oregon Business Plan supports funding the Oregon Health Plan in a way that 1) controls health care costs, 2) improves the social determinants of health that bear on demand for services under Medicaid, and 3) aligns with the overall revenue demands of the state.

There should be three key components to any strategy to make the Oregon Health Plan sustainable:

Continue to hold CCO per capita cost growth to no more than 3.4 percent annually. As part of that, we should continue to drive value-based purchasing practices within the program. Moreover, we need to collaboratively examine the drivers of health care cost and set overall cost growth targets for the state's entire health care system much like the 3.4 percent target. This includes establishing clear system wide goals and targets for aligned implementation of value-based payment approaches to improve health outcomes and reduce cost.

Invest in upstream and social determinants of health that improve health outcomes and reduce the need for medical care. In the long term, Medicaid dollars can be saved through upstream investments such as family planning, prenatal care, and early intervention, and these investments should be aligned. We must enhance communication about the value of upstream investments as well as create new partnerships and a shared health agenda among stakeholders in business, health care, education, and other sectors. Additionally, we must continue to support community level innovation and the implementation of localized solutions that improve health outcomes.

Sustainably fund Medicaid as part of a broader solution to Oregon's long-term fiscal challenge. We are open to options about how to pay for Oregon Health Plan coverage. However, it's important that conversations about revenue for education and revenue for Medicaid funding take place in connection with one another so we can understand the cumulative revenue burdens and the way revenue increases will come together. For example, the companies and consumers most burdened by health care-related taxes might also be most burdened by taxes that the Legislature raises to pay for education. The only way to avoid excessive or double taxation is to tie these conversations together.

For example, the Governor's Medicaid Financing Work Group reviewed many health care-related tax increases to pay for the Oregon Health Plan. They recommended a package of increases in insurance premium taxes, cigarette taxes, hospital taxes, and a new tax on employers who don't provide health insurance. It's too soon to evaluate the merits of this package without knowing what other taxes will be advanced to pay for education and other budget priorities.

It's important that conversations about revenue for education and revenue for Medicaid funding take place in connection with one another so we can understand the cumulative revenue burdens and the way revenue increases will come together.

REVENUE: TO FUND INVESTMENTS IN PUBLIC SERVICES WE MUST ADDRESS REVENUE AS WELL AS COSTS

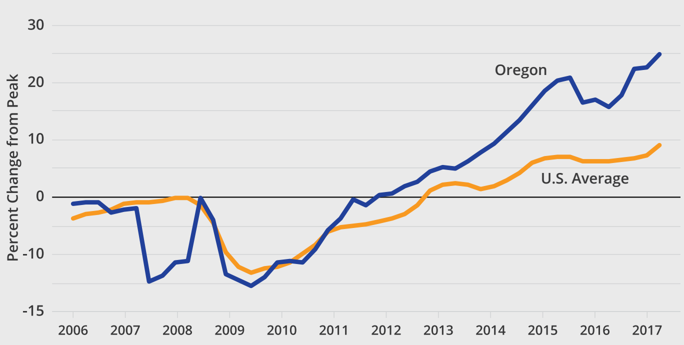
OUR REVENUE STRUCTURE ILL SERVES BOTH PUBLIC SERVICES AND OUR ECONOMY

Oregon's revenue is booming (see below). Yet, our revenue system fails us in a number of glaring ways. Because it's so reliant on personal income and capital gains taxes, it's hostage to swings in the economy and it's highly volatile. It swells revenues during economic growth but starves funding for public services during recessions. At the same time, our unique "kicker" law blocks our ability to smooth out revenue volatility. The kicker rebates tax dollars when revenue forecasts exceed expectations, rather than placing that revenue in a reserve fund to weather down cycles.

Moreover, our high income and capital gains taxes are a disincentive for high-income earners and entrepreneurs who would otherwise locate here and help drive economic growth and job creation.

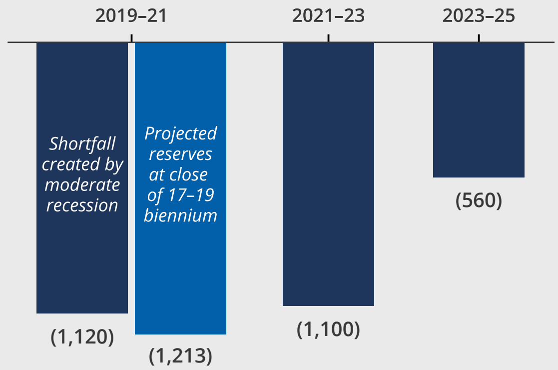
Along with these fundamental problems — which have persisted for decades — there is an additional challenge. Oregon faces a fiscal shortfall. Increases in taxes will be required along with cost containment in order to close the gap and to enable new investments in education. More revenue could be generated with changes to the existing tax code, but this is a good opportunity to explore fresh alternatives rather than just cobbling together a tax package based on existing revenue sources.

Oregon Has Strong Revenue Growth
Oregon vs. 50-State Average Change in Tax Revenue from Peak Quarter, Adjusted for Inflation



Source: Pew Charitable Trusts, Fiscal 50: State Trends and Analysis

Oregon's Reserves Aren't Adequate to Sustain Us Through a Full Recession
Potential Revenue Losses from Moderate Recession vs. Projected Reserves



Note: Reserve balance includes ORDF and ESF; does not include 2017–19 ending balance.
Source: Office of Economic Analysis, December 2018 Forecast; OBC/OBP Analysis of State Revenues

HOW OREGON'S REVENUE SYSTEM STACKS UP AGAINST OTHERS

This year, the Oregon Business Plan contracted the State Tax Research Institute (STRI) to conduct analysis on how Oregon's tax system stacks up to other states, and to provide us with options for reform. Not surprisingly, STRI found that Oregon's lack of a general sales tax makes it vastly more reliant on personal income taxes than other states. The lack of a sales tax not only impacts Oregon's overall tax make-up, but also its business tax make-up. The tables on the next page show the percentage composition of all Oregon state and local taxes by type and also the percentage composition of state and local **business** taxes by type, FY2016.

Sales taxes are more stable than income taxes, but they are also more regressive. And Oregonians have said time and again that they don't support them. So, what are our options? First, we start with our principles.

REFORM MUST BE PAIRED WITH COST CONTAINMENT; MUST ADDRESS FAIRNESS, ADEQUACY, AND STABILITY

Below are criteria that we consider necessary within the options for restructuring revenue.

- Revenue reforms must be adopted commensurate with expenditure reforms. In particular, it would be futile to raise taxes without PERS reform. Without it, new revenue would mostly be poured into the PERS system, yielding little improvement in public services. Tax increases without PERS reform should be a non-starter.
- Any new business taxes must be broad based (no favorites among industries).
- The playing field must be level, with similar impacts among competitors.
- The needs of businesses with low margins must be considered.
- A new tax structure must support job and wage growth.
- The choices made must reduce volatility and promote stability in state revenues over budget cycles, for example, by applying reserves in conjunction with fiscal discipline.

With No Sales Tax, Oregon Relies Heavily on Personal Income Taxes
Percentage composition of all state and local taxes by type, FY2016

Type of state and local tax	Oregon	U.S.
Property taxes	31%	31%
Sales taxes	0%	22%
Excise taxes	11%	11%
Corporate income taxes	3%	4%
Unemployment insurance taxes	5%	3%
Individual income taxes	40%	23%
Licenses and other taxes	10%	7%
Total state and local taxes	100%	100%

Source: State Tax Research Institute. EY/COST Total State and Local Business Taxes: State-by-State Estimates for FY2016, August 2017

Lack of a Sales Tax Leaves Oregon with a Higher Reliance on Other Business Taxes
Percentage composition of all state and local **business** taxes by type, FY2016

Type of business tax	Oregon	U.S.
Property taxes on business property	38%	38%
Sales taxes on business purchases	0%	21%
Excise taxes, incl. public utilities and insurance	14%	12%
Corporate income taxes	9%	9%
Unemployment insurance taxes	14%	6%
Individual income taxes on business income	11% (9%)	6%
Licenses and other taxes	14%	8%
Total business taxes	100%	100%

Source: State Tax Research Institute. EY/COST Total State and Local Business Taxes: State-by-State Estimates for FY2016, August 2017

- If new taxes are regressive, they should be paired with offsets to income, property and/or other taxes to ensure that low-income Oregonians aren't left holding the bag.
- New revenues should be directed at high priority investments like the Medicaid and education investments described in other parts of this document.

TWO OPTIONS LOOK MOST PROMISING

Given the long-standing challenges with Oregon's tax code, research findings from STRI, and our tax reform principles, we believe that two approaches are worthy of further exploration by the business community, lawmakers, and other stakeholders.

- **Reform our kicker law** so we can build up our reserves to ensure adequate funding during economic downturns. Polling in 2017 from DHM Research on behalf of the Oregon School Boards Association showed that 61 percent of Oregonians favor putting the kicker into a reserve funder for K12 schools. Kicker reform is a progressive change because kicker rebates are paid out in proportion to income tax liability. Tight controls on how and when reserve funds could be tapped are critical. This is not a change we would recommend if the money was not going into a reserve fund.
- **Adopt a business activities tax** (revenues minus purchases from other firms) coupled with significant reductions in personal income taxes and other business taxes. On a revenue-neutral basis, such a tax could reduce Oregon's reliance on income taxes, improve revenue stability, and make Oregon's tax code more like other states. For any such tax to meet the above principles, it would need to be at a low rate, be coupled with reductions in other business and personal taxes, apply equally to all forms of business (C corporations and pass-through businesses), and — like Oregon's current income tax apportionment — be destination based (taxes only on in-state sales). Paired with commensurate spending reforms (i.e. PERS and health care costs), this tax could be used to generate additional revenue. However, like any tax, the more revenue that it raises the more likely it is to yield negative economic effects.

Lawmakers have also discussed gross receipts taxes. While more analysis needs to be done, we believe that the Business Activities Tax could be fairer and less economically damaging than a gross receipts tax. A gross receipts tax is a tax on all of a company's revenues. It applies to the full value of a sale at every step in the supply chain. Companies with longer supply chains are disadvantaged, as are low-margin businesses. The tax has a pyramid effect, adding to the cost of the product at each step, raising the price ultimately borne by consumers.

By contrast, a business activities tax applies to revenues minus all purchases from other firms. This is a critical distinction. The tax only applies to the value being added by the company paying the tax, rather than all of the activity that happened earlier in the supply chain. This should result in less pain for both businesses and consumers.

Lawmakers have also discussed increasing taxes within the current tax structure rather than making structural reforms. Options are limited. A group convened by the Governor's office earlier this year developed a suite of health care and sin taxes to pay for Medicaid. Likely targets for an education funding package would be increasing rates and broadening the base of corporate and/or personal income taxes. While this approach warrants continued exploration, a downside is that it could amplify the volatility of our current tax code rather than fixing its underlying problems. It also poses an excessive number of tax votes for legislators to take.

Oregonians should not experience rising taxes and prices simply to pay for added PERS costs. Any increases in taxes must be part of a larger fiscal overhaul and must be devoted to spending that leads to measurable improvements in education and health.

Regardless of which approach is taken, Oregonians should not experience rising taxes and prices simply to pay for added PERS costs. Any increases in taxes must be part of a larger fiscal overhaul and must be devoted to spending that leads to measurable improvements in education and health.

WE'RE PREPARED TO ENGAGE WITH PUBLIC LEADERS ON THE ISSUE

Oregon Business Plan partners are vetting these revenue options widely and plan to engage actively in discussions during the 2019 legislative session. It's important to us that conversations about revenue for education and revenue for Medicaid funding take place in connection with one another so we can understand the cumulative revenue burdens and the way revenue increases will come together. For example, the companies and consumers most burdened by health care-related taxes might also be most burdened by taxes that the Legislature raises to pay for education. The only way to avoid unreasonable or double taxation is to tie these conversations together in some fashion.

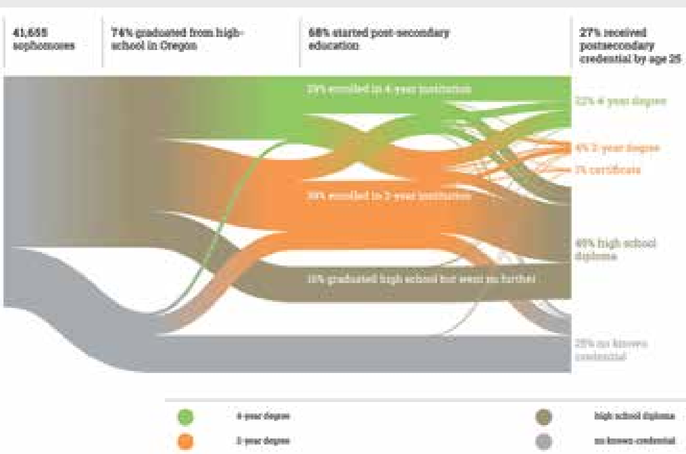
EDUCATION INVESTMENTS: FUNDING PRODUCED FROM FISCAL REFORM WILL ENABLE LEARNER SUCCESS

IT'S TIME TO SHORE UP OUR INVESTMENTS IN EDUCATION

For years, Oregon's unreliable fiscal structure has shortchanged education, a vital foundation for the success and well-being of Oregonians and the Oregon economy. A key purpose of the fiscal reforms envisioned by the Oregon Business Plan is to generate ample and stable funding so Oregon students can achieve success. PERS reforms and other cost-containment measures, along with revenue reforms, could be designed to provide new increments of funding starting in 2019–21, and growing over the decade ahead.

We need to invest boldly. Oregon has set a goal that 40 percent of Oregon students will attain a four-year degree or more, that another 40 percent will attain an associate degree or meaningful certificate, and that every Oregonian will attain a high school diploma or equivalent. The Business Plan has long supported this goal, recognizing that acquisition of knowledge and skills is essential for all or our citizens to succeed in work and life.

Not Enough of Our Students Complete Postsecondary Studies
Oregon Class of 2006 Education Pathway Through 2015



Source: ECONorthwest Analysis Based on Oregon and U.S. Data Sources

As illustrated above, we are not close to achieving this goal. To get on track, we need not only new investments, but also new approaches to education and learning at systemwide scale. For example, we should:

- Build stronger wraparound support systems for learners from preschool to postsecondary education.
- Adopt student-centered learning practices that encourage students not only to develop academic knowledge and cognitive skills, but also occupational awareness and aspirations, collaborative capability, and greater agency and adaptability.
- Commit to policies and practices to advance equity, diversity and inclusion, and to culturally specific practices that reflect the needs of all students.
- Build learning pathways for students in preparation for high-wage, high-demand jobs, especially those related to Career and Technical Education (CTE) and Science Technology Engineering and Mathematics (STEM) education.

WE SHOULD STAGE OUR INVESTMENTS WITH LONG-TERM GOALS IN MIND

The key to achieving our goals is to make strategic investments across the education continuum, sequenced to gain the greatest impact at each stage of investment. At the same time, it is vitally important to provide stable funding, so we avoid losing gains and momentum from prior investments — as we have so often over the past three decades.

This is how we believe Oregon should proceed.

To begin with, establish funding levels that ensure schools can continue the services they are currently providing (and in the case of postsecondary education, without punitive levels of tuition increases). This means establishing current service levels (CSLs) that recognize the added costs of PERS, health care, and other expenses beyond the control of school leaders. Accurate CSL funding should be the starting point for consideration of additional investment.

Then we need to make sure we have sufficient reserves so we don't backslide on education funding during the next recession. We have learned the hard way that investments made in good times that can't be sustained in downturns are not productive.

Next, map out a 10-year investment plan with an aim to accomplish the following:

- Transform the fragmented, siloed systems of early learning into a fully developed network of family supports and early childhood programs from birth to age 5, with a variety of choices available to families.
- Enrich the student experience in K12 education with more hands-on learning and greater personalization of curriculum to respond to diverse interests.
- Create clear pathways from high school to postsecondary degrees that guide learners to chosen career and

- life interests. In doing that, make sure that every high school graduate can afford to pursue his or her chosen pathway, regardless of income.
- Provide Oregonians with additional education and training throughout their adult years, so they are better able to move up the economic ladder and adjust to workplace changes and disruptions.

Finally, with these aims in mind, start with the investments that are most likely to have the highest payoffs for students in securing well-paying jobs and living stable, rewarding lives. In the long run, the impact of these and subsequent investments over the next decade will be a more successful economy, healthier communities, more revenue for public services and facilities, and reduced costs of government through reduced need for remedial education, the social safety net, and corrections.

INITIAL INVESTMENTS SHOULD PRIORITIZE EARLY CHILDHOOD AND POSTSECONDARY PATHWAYS

Based on additional funding that we envision from cost controls and revenue reform — however those efforts unfold — we recommend the following education investment priorities for 2019–21. These recommendations are compatible with the Governor's education priorities and the Legislature's Joint Committee on Student Success.

Early Childhood Development. It is time to step up on early childhood education. Oregon should increase the share of young children who begin their lives with a cohesive and supportive family environment and pre-school learning that nurture their development. This is especially pertinent to children in low-income families and historically marginalized communities.

The dividends of this investment include fewer health care and developmental problems that impede learning, greater learning success in later grades, reduced need for remedial education, and a stronger launch into life and career. This also eases demand on the social safety net while increasing public revenue and the availability of public funds for other needs.

We recommend that these investments include 1) increased access to health services for pregnant low-income women with high risk factors, 2) additional innovative and culturally specific community-based models of early childhood development and parenting, 3) expanded access to high quality early education, 4) extension of childcare subsidies, and 5) investments in early learning infrastructure.

Kindergarten through Grade 12. K12 education receives by far the biggest allocation along the education continuum and is critically important. There is a case to be made for significant additional funding, with the following priorities.

- Fully fund the High School Success (Measure 98) mandate. That would constitute a baseline for M98 current service levels going forward, and it would enhance efforts to improve high school completion through college-level opportunities, dropout prevention strategies, and enhanced CTE curriculum offerings.
- Provide additional funding to meet the social and emotional needs of children and to build their resiliency. This includes development of services and practices that are culturally responsive.
- In addition to fully funding M98, provide funding for CTE pathways and STEM education, which engage and inspire students and prepare them for high-wage jobs and promising careers.

Strategic investments envisioned in the coming biennium would give priority to early childhood development and the transition of learners from high school to postsecondary schooling.

The dividends from these investments will be more students with a high school diploma who are ready to pursue productive, meaningful careers and lives.

Secondary/Postsecondary Pathways to a Prosperous Future. In postsecondary education we recommend three investment priorities.

First, we should fund a comprehensive strategy for K12, community colleges, and universities to partner in guiding students along chosen pathways to degrees and certificates associated with CTE and STEM education. These investments include:

- Investments in CTE and STEM programs, grants, STEM hubs, and curriculum development in math and computer science
- Investments in postsecondary pathways for community college technical degrees and certificates, apprenticeships, and university science and engineering program degrees that meet talent needs of Oregon employers.

With these investments, we are poised to dramatically increase the number of Oregonians on pathways to well-paying jobs — especially for those historically left out of these opportunities. These investments are key for breaking the cycle of poverty and increasing earnings of young adult Oregonians.

Second, we recommend increased funding for Oregon Opportunity Grants, the state scholarship program for low-income students. Pairing these grants with postsecondary institutional funding to keep tuition affordable offers the best strategy to assist students who have financial challenges. These dollars should be coupled with funds for programs that encourage high school students to pursue postsecondary studies as well as funds to support student completion at the postsecondary level.

Third, we need more investment to support adult training. This is especially important for the approximately 450,000 Oregonians 25 and older, without postsecondary credentials, who are either unemployed or are working and making less than $15 per hour. It's vitally important for these adults, especially those from underrepresented populations, to acquire additional employment skills and earn meaningful credentials. Beyond this target group, we can expect many adults to need additional education and training in the years ahead to advance in careers and adjust to changing work place requirements.

To get started in this area, we recommend a competitive grant program for community colleges and universities to test and measure individualized and adult-friendly strategies with the aim to scale up promising practices.

ADDITIONAL INVESTMENTS SHOULD SUPPORT THE VISION FOR EDUCATION ATTAINMENT

We recognize that there are many other opportunities for investments in education. Given limited resources we need to be focused and strategic. Useful guidelines would include the following.

- Start with evidence-based investments that will have the biggest impact on learning, looking across the entire continuum.
- Prioritize those investments that enhance equitable outcomes for students of color and economically disadvantaged Oregonians.
- Measure and assess all investments to check whether intended results are being achieved.
- Adjust approaches as we learn about what does and does not work.

THIS PAPER GROWS FROM A YEAR OF RESEARCH AND ANALYSIS, PLUS DIALOGUE WITH A WIDE RANGE OF OREGON LEADERS

The Oregon Business Plan began the Fiscal Policy Initiative and the analysis contained in this paper at the beginning of 2018. This work represents the perspective of business leaders and our community partners on 1) the fiscal crisis that Oregon faces now and in the coming decade, 2) measures policymakers should consider to realign government expenditures and revenues, and 3) targeted investments policymakers should consider in education and other vital services to assure Oregon's future prosperity.

This work has two principal aims. One is to achieve legislation that restores Oregon's fiscal balance and long-range stability. The other is to enable fiscal choices that will help break our damaging cycle of intergenerational poverty, raise education attainment, and improve the lives of Oregonians.

The Fiscal Policy Initiative is managed by the Oregon Business Plan's principal partners: the Oregon Business Council, Oregon Business and Industry, and the Portland Business Alliance. However, the project involves leaders across business groups, industries, regions, and political affiliations. In spring 2018, in an effort continuing through the balance of the year, Oregon Business Plan representatives visited communities and industry groups across the state, along with elected leaders and candidates, editorial boards, and others, to help develop, refine, and seek support for policy proposals to reorder Oregon's fiscal house. Ideas here were assembled to present at the December 2018 Oregon Leadership Summit and to offer our elected leaders for consideration in the 2019 Legislature.

Note: *There is a substantial body of research and analysis behind the briefs in this document. We are happy to provide additional detail on this policy work on request.*

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