

Discussion Paper for Leadership Summit 2003

PROVIDING STABLE AND ADEQUATE FUNDING FOR PUBLIC SERVICES

Initiative Summary

Last year, the Oregon Business Plan white paper on public finance called for revamping our state budget and finance system to stabilize funding for critical public services and to strengthen incentives for economic growth. The Plan identified two major problems. First, the tax system is too narrowly based and volatile. Personal income taxes comprise 76 percent of state revenue collections, and income taxes, especially corporate and capital gains, are highly sensitive to economic cycles. Second, in three categories of spending – corrections, health care, and retirement funding for public employees – runaway cost increases have threatened our ability to provide other services.

The depth of these problems was aggravated by the recession and exposed in repeated revenue forecasts which showed tax receipts dropping below budget allocations, triggering, in turn, an unprecedented series of special legislative sessions to rebalance the budget. The public finance white paper offered suggestions on how to address the immediate crisis, but it focused mainly on the need to repair fundamental flaws in Oregon public finance in order to avoid future crises. The white paper recommended four steps:

- **Fix the Public Employee Retirement System** to avoid crippling increases and to rebuild confidence in public services.
- **Develop an “essentials only” budget for 2003-05** at the \$12.2 billion general fund revenue level then forecast for the biennium. Apply a “zero-based” budget process to determine priorities.¹
- **Establish a long-term fiscal vision.** Identify critical goals for Oregon and aim the state budget towards those goals. Establish a preferred budget for years 2005-07 and 2007-09 and beyond based on assumptions of strong economic growth and breakthroughs in service quality. Develop “re-engineering teams” to identify steps to make the preferred budget a reality.
- **Revamp the revenue system** to provide greater stability and to increase incentives for economic growth.

Important pieces of this agenda were accomplished in 2003, providing a strong base for even further work in 2004 and beyond.

PERS. By far, the biggest success in public finance the past year was legislation to transform PERS. In a strong bipartisan effort, the Legislature steered the state away from a near-term fiscal calamity and made system changes that will save taxpayers more than \$9 billion in the decades ahead. The reforms corrected the worst features of the current system and created a simpler, less costly plan for new employees.

¹ Zero-based budgeting requires that programs and expenditures be justified from the ground up each budget cycle, rather than assuming that programs will be continued and that current funding will be the beginning basis for setting new expenditure levels.

The 2003-05 Budget. Both the Governor and the Legislature set out to balance the budget within existing resources, as proposed in the white paper. The Governor announced a salary freeze before he took office. About 1,000 vacant positions were eliminated, and 750 employees were laid off. In addition, the Ways and Means Committee conducted a prioritization process at the outset of the session to help guide budget deliberations. Rather than make blanket cuts, the Ways and Means process was more selective than usual, although time constraints made a full zero-based budgeting process impractical.

In the end, the Legislature did balance the budget at a level roughly equal to the white paper recommendation last December. However, early in the session, the revenue forecast declined by roughly another \$1 billion. As a result, the session balanced the 2003-05 budget through a combination of budget cuts and tax increases that pleased no one. The revenue package (HB 2152) includes an extension of the cigarette tax increase, a temporary income tax surcharge, and increased corporate taxes.

Develop a long-term fiscal vision. Our public finance system is too focused on short-term budgets, which are balanced to meet immediate rather than long-term objectives. The past year many state leaders adopted this perspective and took significant steps to improve the budget process. At the beginning of the year both the Governor and the Legislature declared "current-services" budgeting dead. As part of that break with tradition, the Legislature went through a priority setting process. The Governor created the Advisory Committee on Government Performance and Accountability, which includes an excellent mix of business leaders, to review management practices, streamline regulations, and evaluate the status of the performance measurement process. The timing is right to build on these efforts

Revamp the revenue system. The Legislature conducted ten days of hearings on revenue reform, airing a wide variety of proposals. As the 2003 session wound down, it created a committee to develop tax reform recommendations for a special session in May 2004

Despite these promising efforts, the hardest work lies ahead. There is widespread consensus among political leaders and the voters that an overhaul is needed, but there is far less consensus on what specifically should be done. This will be a contentious debate but one vitally important to Oregon's future. It will be important for business leaders to engage in this issue. This paper serves as a framework for that engagement.

The Case for Change

At the 2002 Leadership Summit, fixing Oregon's broken public finance system was ranked as the most pressing priority facing Oregon. It is not hard to understand why. A healthy economy and an efficient system for providing and financing essential public services are vitally interdependent. A high-wage, high-skill economy enables us to finance needed public services with relatively low tax rates. Good public services, including education, infrastructure, public safety, and transportation, are critical needs for a growing and prosperous economy. As our population grows and changes, we need to make sure that we are keeping up with these needs.

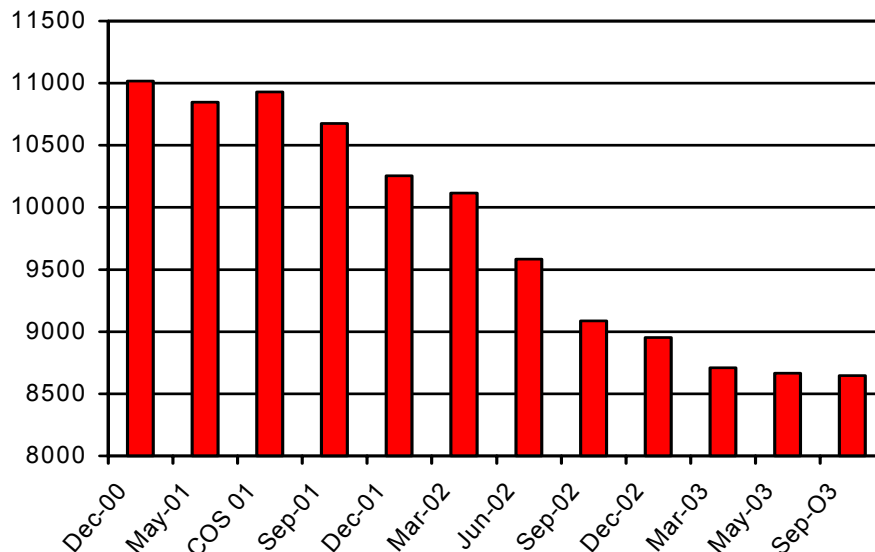
Against this vision, the Business Plan identified opportunities for improvement. First, the tax system, so heavily dependent on personal and corporate income, is unstable. During a recession, income tax receipts drop, making it difficult to maintain critical public services such as schools, courts, and public safety. Second, the tax structure itself does not line up well with our economic strategy because of relatively high rates for many traded-sector firms.

And, finally, we found that the budget process itself could be improved to better assist policy-makers to establish priorities, to ensure that budgets track long-term demographic trends relating to populations served by public programs and to identify major categories that need special attention.

The magnitude of Oregon's recent revenue problems is illustrated in the chart below, which shows repeated declines in revenue forecasts². These declines placed extraordinary demands on the Governor and Legislature to rebalance the budget.

The revenue revisions that forced the special sessions intruded in various ways into the 2003 legislative session. The following points, which characterize that intrusion, are summarized in snapshot form in the chart below, and detailed more fully in the table that follows.

Declining 2001-03 General Fund Forecasts
(Millions of Dollars)
Excluding Special Session Revenue Enhancements



Sessions to Rebalance the Budget

- 1** February 8 to 11, 2002 (Special)
- 2** Feb 25 to March 2, 2002 (Special)
- 3** June 12 to 30, 2002 (Special)
- 4** August 16 to 20, 2002 (Special)
- 5** September 1 to 18, 2002 (Special)
- 6** iMarch 2003 (Regular)

² The chart was provided by the Legislative Revenue Office. The forecast data were provided by State Economists Office.

- General Fund for the 2001-03 biennium was approximately \$2.360 billion below the level forecast at the close of the 2001 legislative session.³
- As declining forecasts necessitated budget adjustments, the Legislature, in a succession of special sessions bridged the revenue gap by using one-time revenue sources (\$1.6 billion)⁴ and raising the tobacco tax (\$.2 billion).
- The \$792 million revenue package for 2003-05 enables expenditures slightly higher than budgets ultimately approved for 2001-03 (after the six special sessions). Without the tax increase, the funds available for 2003-05 would be lower than the budget approved in 2001-03.

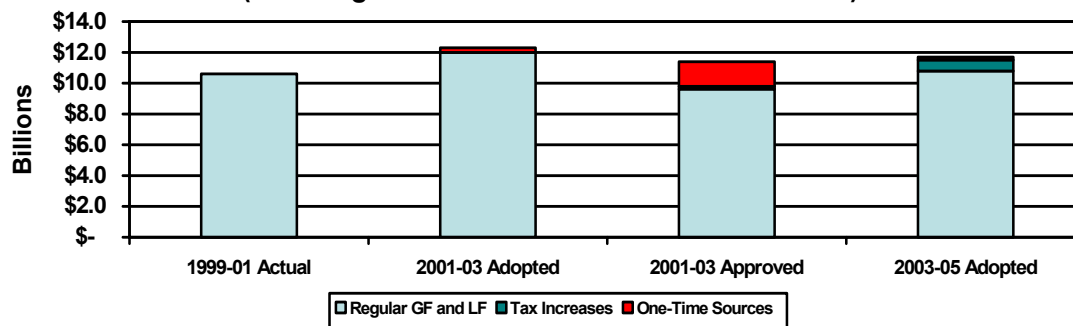
Table 1 presents the relative budget levels for various services across three biennia.

Table 1. 2003-05 Legislatively Adopted Budget - Historical Comparison

	1999-01 Actual	2001-03 Adopted	2001-03 Actual	2003-05 Adopted	2003-05 No New Revenue*
Education					
K-12	4,568	5,179	4,870	5,190	4,905
Higher Education	872	923	848	771	763
Community Colleges	436	475	438	423	416
All Other Education	287	377	342	351	351
Total Education	6,163	6,954	6,498	6,729	6,430
Human Services	2,287	2,805	2,665	2,533	2,345
Public Safety	1,189	1,351	1,244	1,247	1,189
Natural Resources	216	279	265	227	227
All Other Programs	716	955	727	849	849
Total Expenditures	10,571	12,344	11,399	11,591	11,046

*This dis-appropriation reflects a reduction of \$544 million, which is only the income tax surcharge portion of the tax package. An additional \$250 million would be lost if the package does not go into effect. The Governor would need to make the additional \$250 million in cuts independently or call a special legislative session.

Summary of State Spending (Including one-time funds used for General Fund)



³ Revenue Measures Passed by the 2003 Legislature, Research Report #4-03, October 1, 2003, p. 10, Table 2. 2001-03 General Fund Resources (in millions) minus legislative actions were \$9,107.5, this was \$2,360 less than the 2001 close of session forecast.

⁴ One-time sources used to backfill were: \$335 million MUPL, \$335.2 Master Tobacco Settlement revenue, \$262 million Education Stability Fund transfer, \$450 million Tobacco Master Settlement bond proceeds, \$37 million transfers from various Other Funds. (Budget Highlights 2003-05 Legislatively Adopted Budget, LFO, September 2003). In addition, the fund shift generated \$200 million.

The final column in the Table 1 includes the dis-appropriations that are scheduled to occur should the tax increases be referred to voters and rejected early in 2004. Whether these reductions would stand is uncertain. A special session of the Legislature could adopt a different approach to balancing the budget. The numbers do show the scale of the challenge if voters reject the enhancement revenue package that came out of the 2003 session.

Whether voters choose to accept or reject the revenue package, the recent budget crisis and the continuing tension over revenue and spending suggest several lessons that we should heed.

First, Oregon has a highly volatile tax system that does not match our need for *stable* public services. We need good schools, prisons, and social services through lows as well as the highs of economic cycles. The current system makes such provisions very difficult. On the other hand, during good economic times, revenues accelerate at unsustainable rates, tempting public leaders to build in program costs that can't be maintained through a complete economic cycle.

Second, we have learned how hard it is to set priorities among budget categories. Both the Governor and the Legislature went to extraordinary efforts to re-examine priorities in order to balance the current budget. Better budgeting tools and a consistent and ongoing budget prioritization process would make such work easier.

Third, it would be very helpful to have a long –term budget plan in mind in order to help guide policy decisions being made today. For example, the cost growth in corrections and health care mentioned earlier should not be dealt with only when they reach a crisis stage. A long-term budget could highlight such trends, and decide what actions can be taken to either slow the growth or find a way to pay for the services. A long-term budget can spot the key policy issues that need to be tackled to keep Oregon's budget in balance over time. Having a long-term budget will also be critical as Oregon overhauls its tax structure. Otherwise, we will not know what revenue targets to establish as part of the plan.

Fourth, as part of the budget process, Oregon needs to better assess the performance of its public programs, and to compare its performance and expenditures with other states. The state has made considerable progress in building performance measures that are tied to Oregon Benchmarks. The Governor's Advisory Committee on Government Performance and Accountability is working with the Department of Administrative Services to accelerate this work. This effort will help to improve program effectiveness and efficiency.

None of these budget tools are panaceas. Hard choices are always required and policy disagreements are inevitable. However, with better budget tools, Oregon will be more capable of ensuring quality services year in and year out at affordable costs to Oregonians. The business community has the opportunity to bring its experience and resources to this endeavor.

Recommendations

Our recommendations build on the substantial, commendable work by the Governor and the Legislature in 2003 to put Oregon's fiscal house in order.

1. Support the PERS reforms. The PERS reforms are being challenged. The business community should support the team defending the reforms to explain why they are fair and why, without them Oregon will face a fiscal calamity.

2. Improve the budget process. Both the Legislature and the Governor have made meaningful progress in improving the budget process. This interim, the business community should join in to help. Now is the time to implement reform; it should not be put off for another biennium. The reform effort should establish a budget process that identifies essential government services, ties explicit desired results to expenditure decisions, measures results to ensure performance accountability, and addresses costs drivers (programs whose spiraling costs threaten adequate funding for other needs). While not all this can happen at once, here are the features that should be considered. Both the Governor and the Legislature's budget staff, already overworked, will need additional resources to make this happen.

- ***Identify explicit desired results (explicit results) for program expenditures and craft benchmarks to define and measure their attainment.*** In K-12 education, for example, a key result should be specific levels of academic achievement. In public safety, a key result should be specific levels of crime reduction.
- ***Organize programs and expenditures by explicit results.***
- ***For each explicit result desired, review budget trends over the previous 10 years and forecast trends over the next 10 years.*** The Governor and Legislature should establish a preferred budget for the years 2007-09 and 2009-11 that is based on strong economic growth and the assumption that we will achieve breakthroughs in service quality and efficiency in major spending categories.
- ***Evaluate performance by explicit results.*** Using benchmarks, examine program performance in terms of explicit results to determine whether the state is getting the desired benefit from its expenditures. Each program should participate in identifying and defining explicit results for which it will be held accountable.
- ***For each explicit result desired, compare budget investments and performance with other states.***
- ***Prioritize expenditures for all explicit results (perhaps model after the State of Washington's "Priorities in Government" initiative).*** The Governor and Legislature should identify all of the programs responsible for explicit results and prioritize expenditures according to explicit results.
- ***Re-engineer selected programs that consume large portions of the budget and that have the greatest influence on Oregon's future.*** Re-engineering teams composed of business and public sector leaders should be charged to investigate ways to improve effectiveness and reduce cost of services. Re-engineering efforts should be directed in particular at cost drivers (programs or activities such as corrections, which are growing faster than the budget as a whole) based on data that shows what is most effective to achieve desired outcomes.

3. Develop a tax reform plan that can win the endorsement of voters. The discussion that shapes this plan, in which the business community should participate, should be guided by three major goals.

- *Goal 1:* Any tax overhaul should be considered in light of achieving the fundamental goals in the Oregon Business Plan: *creating well paying jobs for Oregonians through the*

growth of leading-edge traded-sector firms. With this in mind, state tax policy should carefully consider the needs and circumstances of traded-sector firms and industries.

For example, traded-sector businesses have a limited capacity to absorb tax increases. In particular, it is difficult for them to pass tax increases on to customers, because the price for their products is often set by global market competition. Increased tax burdens passed on to product prices can hurt a company in its marketplace and threaten its competitive survival. Similarly, companies also have limited room to make up tax increases by reducing margins, payrolls, or R&D investment without damaging their prospects and the benefits they bring to the Oregon economy. In sum, Oregon's business tax policy should strive to avoid doing harm and to promote a climate that encourages traded-sector companies to locate and grow here.

As we look at Oregon's tax system against this vision, we note the following:

- Oregon's dependence on the income tax as a primary source of public revenue hurts the traded sector economy in two ways. First, S-corporations are an important part of our trade sector economy and Oregon is not a tax-friendly state for them. Because S-Corp income is treated as personal, it is taxed at personal income tax rates – rates that are among the highest in nation. Second, high-income individuals who work in traded-sector firms find Oregon's tax system unattractive. For both reasons, the high income tax makes it difficult for Oregon to attract and keep S-Corps and talented, high-income individuals.
- Oregon could do much more to encourage capital investment, which is key for strong, high-income growth. Oregon's capital gains taxes are unusually high and Oregon would benefit from credits on capital investment.
- Oregon relies very little on consumption taxes. Consumption taxes, properly designed, can provide more stable resources and allow reductions in personal income and capital gains taxes and tax credits that will stimulate traded-sector growth.
- A gross receipts tax and value-added tax would be highly detrimental to traded-sector firms. Taxing each step of production, which is what these taxes do, adds costs that firms cannot pass on in the price of goods sold outside Oregon. Europe, which has a value added tax, exempts the tax on exports for just this reason. Applying this tax at the state level (where exemptions for sales to other states would be very difficult) is probably not workable.
- *Goal 2:* Revenue stability is critical for providing high quality services during all stages of the economic cycle.
 - Three-fourths of state tax revenue collections come from the personal income tax. Personal and corporate income taxes make up 94 percent of the state's General Fund. This means that state revenue, especially the General Fund, is highly sensitive to changes in the economy.⁵ Oregon has several options for stabilizing public revenue: (a) adopt less volatile taxes (e.g. sales tax), (b) adopt a diversified portfolio of taxes that behave differently during economic cycles, or (c) create an adequate reserve fund. Whatever option is selected, the change should create a system that allows Oregon to continue essential services during all economic cycles.

⁵ Governor's Tax Review, Phase II Policy Recommendations, January 1999, p. 4

- We also need to guard against runaway expenditure growth in good times. Historically Oregon has had higher expenditures when revenue was higher. Under a new system, spending should not automatically increase to whatever revenue is provided. If Oregonians want to increase the size of government, they should do it consciously (not by default during periods of higher public revenue).
- *Goal 3:* Tax reform needs to be connected with expenditure policy described in the previous section. First, as a practical matter, it is doubtful that voters will consider a major tax overhaul proposal unless they have confidence that their tax dollars are being spent wisely. The recommendations on performance budgeting and setting budget priorities address that concern. Second, without a long-term revenue and budget forecast, the state will not have a means to assess the level of revenue needed to pay for the public services needed in the future. The budget process should include a review of the biggest cost drivers and a plan to investigate ways to improve effectiveness and reduce the cost of services.