Editorial
Ignoring the Obvious

In announcing he was "backing away" from consideration of tax reform, Gov. Ted Kulongoski noted that he believed Oregon's current tax structure appeared to be sufficient to provide all of the tax revenues necessary for the future. That certainly was not Kulongoski's, nor Gov. John Kitzhaber's, point of view during the last Oregon recession which began in 2001.

During that recession, income tax and capital gains tax revenues plummeted and the legislature was forced to meet in five consecutive special sessions to deal with a state budget that was shredded to tatters by the declining tax revenue picture. That is likely to occur again with the new economic downturn facing Oregon.

When Kulongoski made his pronouncement in the latter part of October 2007, things looked pretty rosy and the giddiness from assuming that the tax largesse would continue forever once again overtook the governor. His ability or willingness to look forward to the inevitable economic downturn dissolved. Kulongoski and his colleagues were fresh from a jubilant 23 percent increase in the state biennial budget and were looking forward to doing even more in the scheduled special session and the following 2009-10 regular session.

Whether Kulongoski simply didn't want to hear the words of caution already beginning to surface about Oregon's economic future, or that having heard it in detail, he simply lacked the requisite education or real life experience to understand it is unclear.

We are reminded that the governor reacted strongly and negatively to a *BrainstormnNW* article in June 2007 in which members of his economic advisory council warned that all was not well for Oregon's economic future.

Those admonitions have proven to be prescient. The first revenue forecast from Oregon's Legislative Revenue Office (LRO) for 2008 has projected a shortfall for the 2007-08 biennium of $180 million. That may not seem like much for a state with a budget in excess of $14 billion per biennium. However, the methodology for projecting revenues used by the LRO assumes that revenues will increase from whatever point they recalibrate. It does not project declining revenues.

For instance, because the LRO budget methodology always projects increasing revenues, we can assume that the $14 billion revenue projection for the 2007-08 biennium was actually more like $6.75 billion for 2007 and $7.25 billion for 2008 — a $500 million increase. (These figures and the figures hereafter are for illustrative purposes only.) When the new budget forecast was issued noting a reduction of $180 million, it meant that revenues for 2007 were $180 million less than projected but they would still increase by $500 million for 2008. When the next revenue forecast comes out this spring showing a further reduction of, say, $200 million, the budget model simply reduces the base by $200 million and continues to forecast the pro rata portion of the $500 million increase

for the remainder of the biennium. In doing so, each succeeding revenue forecast in a declining economy is, by definition, wrong.

During the beginning of the last recession, this problem was compounded by Kitzhaber's refusal to order a reduction in spending commensurate with the growing problem. Kitzhaber continued spending as if the revenue shortfall did not exist, and by doing so he pushed the majority of the impact of the downturn into the final two quarters of the biennium and thus multiplied the impact fourfold.

Here's how: Assume the state has a biennial budget of $12 billion — that is roughly $500 million per month for 24 months. Now assume there is a 10 percent, or $1.2 billion, revenue shortfall for the biennium. In theory, that means there is $10.8 billion for the biennium, or roughly $450 million per month (approximately $50 million per month less), to spend. However, if government continues spending at $500 million per month for the first 18 months it means that it will have spent $9 billion of the $10.8 billion available, and there will be only $1.8 billion remaining for the final six months — that is $300 million or $200 million per month less than budgeted. In order to absorb such a loss in that final six months, there must be cuts in programs of 40 percent instead of 10 percent. Were a CEO of any publicly held corporation to act in such a manner, the shareholders would demand his immediate ouster.

Mismanagement has created a crisis, and those who favor increased spending and increased taxes as a solution will likely predict a parade of horrible outcomes if additional funds (taxes) are not made available.

Oregon is poised to repeat the exact same pattern of self-destructive behavior if immediate steps are not taken to resolve the situation. A prudent funds manager, whether they manage shareholder investments or taxpayer assessments, would undertake at least the following steps:

1. **Fix the revenue forecasting model.** Because the model currently uses an increase based on multi-year averages, it will forecast accurately over the long run. However, the budget is set for a biennium and not for the "long run." The result is that the current method underforecasts revenues during a boom period (this is what happened in the last biennium and resulted in the massive "kicker" recently paid out) and overforecasts revenues in a declining economy (this is what happened during the last recession and is about to happen again). If the model cannot be fixed in a short period of time, the LRO should at least assume that revenues will be flat, not increasing.

   In the example above where the revenue shortfall of $180 million is experienced in the first year of the biennium, instead of assuming that revenues will still increase by $500 million, the LRO would be better served by assuming the revenues will not grow at all. In such an instance, the real revenue shortfall for the biennium will look more like $180 million for the first year and $680 million for the second year. If revenue collections exceed that projection during the year, the

assumed revenue shortfall can be adjusted accordingly and spending (see number two below) can be adjusted upward anew.

2. **Implement spending cuts now to account for the current known shortfall.** By doing so, the impact on services delivered will be minimal. State government is a master at padding its budget process.

   About 80-plus percent of the state budget is spent on salaries and benefits for public employees. The method most commonly used by state agencies to pad their budgets is overstating the needed full-time equivalent (FTE) personnel. Routinely, a significant number of authorized positions go unfilled, and the budget for those positions are either used for other purposes or held for contingency planning. The governor could order a reduction in spending by eliminating the authorized but unfilled FTE positions with virtually no impact on service delivered.

   Any delay in implementing the reductions increases the size of the problem going forward. On the other hand, if the reductions are implemented immediately and the revenue picture improves, the increased spending can be reauthorized.

3. **Begin planning for additional reductions.** The recent history of the last economic downturn demonstrates that, for at least the remainder of the biennium, the situation will not get better and will probably get much worse. By planning now, state government can make proactive decisions to defer or eliminate new spending. It can capture the benefits of future retirements, terminations and resignations. In other words, it can get ahead of a growing problem rather than scrambling to keep up.

4. **Obtain authorization to utilize interagency transfers.** This way, in the event of a strong downturn, the critical services (law enforcement, public health and safety, etc.) can be maintained.

While we know the economy is cyclical, Oregon's lack of a robust industrial base makes it more vulnerable to economic downturns than other states. Its primary reliance on the vulnerable income tax ensures that vulnerability is felt immediately. Both impose a greater duty on the governor and the legislature to act prudently at the first sign of an economic downturn. We have little confidence that this governor and legislature will do so.

***BrainstormNW* March 2008**