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Memo

To: Oklahoma candidates and elected officials

From: David Blatt, Director, Oklahoma Policy Institute

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Subject: The State Budget – Outlook and Recommendations

The state budget crisis of the past two years has put great strains on the public structures and institutions that Oklahoma families, businesses, and communities count on to help us meet our common goals as a state. Whoever wins the elections in November will face difficult choices in filling large budget holes and balancing the budget over the next two to three years. Yet even as short-term challenges demand immediate attention, policymakers must also be aware of a longer-term horizon marked by a growing misalignment, or fiscal gap, between the cost of providing core public services and the revenues generated by our tax system.

This memo is intended to provide candidates and policymakers a concise summary of Oklahoma Policy Institute's analysis of the state's fiscal situation, and to suggest some guiding principles and policy recommendations for both the short- and long-term that will lead to fiscally responsible and fair policy choices. OK Policy is an independent non-profit organization whose mission is to provide timely and credible information, analysis and ideas on state policy issues. You can find a full set of resources, including presentations, issue briefs and fact sheets on the budget and our comprehensive Online Budget Guide from our website at: <http://www.okpolicy.org>

WHERE WE ARE NOW: Over the past two years, Oklahoma has experienced its steepest drop in state revenue collections in decades. Revenues fell sharply over the final half of Fiscal Year 2009 (January – June 2009), and then plummeted even further in the first half of FY '10. Even though collections began to rebound in the second half of FY '10 (January – June 2010), General Revenue collections for all of FY '10 were down 22.7 percent from pre-downturn heights and remained below their levels of six years ago. Even assuming that the state's economy continues to gain steam, it will take a good deal of time until revenues return to pre-downturn levels. The official projections are for GR collections this year (FY '11) to grow by 6.3 percent compared to last year, and we anticipate that revenues will not return to nominal pre-downturn levels for another two years (see our accompanying 2-page fact sheet).

While declining tax collections have made the task of crafting a state budget extremely difficult over the past two years, the budget impact of the downturn has been greatly mitigated by the availability of other revenues. In particular, the last two budgets (FY '10 and FY '11) have included almost \$1.4 billion

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from the federal Recovery Act, which was expressly intended to help states avert massive budget cuts and layoffs, and nearly \$600 million from Oklahoma's Rainy Day Fund.

Even with these funds, and some additional revenue-generating measures proposed by Governor Henry and approved by the Legislature, this year's appropriations of \$6.714 billion represent an overall cut of 7.2 percent from FY '09. Over half of all appropriated state agencies have absorbed funding cuts of at least 15 percent, and some cuts have been multiplied by the loss of matching federal dollars. These cuts have weakened the ability of state agencies and schools to fulfill their core missions and have contributed to a corrosion of the public structures and institutions that Oklahoma rely on to promote our well-being and invest in our future. Across state government, shortfalls have forced agencies to serve fewer Oklahomans in need, eliminate programs, reduce hours of operation to the public, cut payments to private providers, and lay off or furlough employees. Some agencies, such as the Department of Corrections, may be facing additional major cuts during the current budget year in the absence of a supplemental appropriation.

SHORT-TERM OUTLOOK: The use of revenues from the federal Recovery Act, state Rainy Day Fund, and other sources averted genuinely devastating cuts to essential education, health, and public safety services, and bought some time for an economic recovery to kick in. However, it created a situation where some \$1.1 billion, or 17 percent, of this year's state appropriated budget consists of non-recurring revenues. This amounts to a major hole in the budget for the coming years and virtually ensures that a serious budget crunch will continue into FY '12 and likely FY '13, even assuming healthy growth in the state economy. Some of the FY '12 budget hole can be filled with additional federal assistance for education and Medicaid approved by Congress this summer, along with a portion of the Rainy Day Fund (\$100 million) that was set aside this past session and cash balances that will grow if revenue collections meet and surpass expectations. At the same time, several other factors will lead to *less revenue* to maintain and restore services for upcoming budgets:

- The top income tax rate is scheduled to fall from 5.5 percent to 5.25 percent in 2012, if, as expected, FY '12 revenues are projected to grow by more than 4 percent over FY '11;
- Appropriations to the ROADS Fund for highway and bridge maintenance are set to increase automatically by \$35 million each year; and
- The Legislature this past session voted to defer payment of an anticipated \$85 million of tax credits to the oil and gas industry until FY '13.

While each of these policy choices will be defended by some, their impact in complicating the short-term budget outlook is certain.

Of course, if the voters approve SQ 744 – the ballot measure to peg education funding to the regional average of per pupil expenditures in surrounding states - in November, the budget outlook over the coming years becomes exponentially more difficult. We estimate that if SQ 744 passes, the state would be obliged to increase funding for Common Education by \$392 million in FY '12, an additional \$415 million in FY '13, and an additional \$889 million once the three-year phase-in to the regional average is complete in FY '14 (see the accompanying materials on SQ 744).

SHORT-TERM RECOMMENDATIONS: Our analysis leads us to expect that revenue collections will fall considerably below what is needed to maintain state services at existing levels and that our elected leaders will again be facing the challenge of managing substantial budget shortfalls. After two years of successive and significant budget cuts, most agencies have already pared services and programs to the marrow. Additional deep cuts put at risk the security, health and well-being of many of our families, businesses and communities. We therefore urge you to consider a balanced approach to bridging the budget gap. Some of our specific recommendations include:

- **Defer additional tax cuts until revenues recover.** Under legislation passed in the mid-2000's, well before the current fiscal crisis, the cut in the top income tax rate will take effect once revenues are projected to grow by 4 percent, even if revenues and funding levels remain well below pre-downturn levels. This tax cut, which would have a \$115 -\$175 million fiscal impact in FY '12 and FY '13, should at least be deferred until we have fully recovered and we can evaluate our ongoing fiscal situation.
- **Seriously review tax credits, deductions and exemptions.** This past year saw some progress made in getting a handle on the state's multi-billion dollar system of tax expenditures, effectively a form of spending through the tax code. We need to go further in scrutinizing and evaluating which tax preferences serve a worthwhile economic purpose and which are mostly subsidies or giveaways that are not the most efficient allocation of scarce resources. The review should include business tax incentives, itemized deductions from the personal income tax, exemptions from the sales tax, and other tax preferences.
- **Consider new revenue streams for the Medicaid program.** Between rising health care costs and the use of substantial non-recurring stimulus dollars over the past two years, keeping the Medicaid program adequately funded will pose especially daunting challenges. Funding mechanisms such as the proposed hospital assessment can generate federal matching funds and avert serious harm to Medicaid beneficiaries and our health care infrastructure alike.
- **Consolidate agencies and functions where duplicative or unnecessary.** The Legislature has taken important steps in examining how state government can be structured and operate more efficiently. Consolidation should be pursued where it can save money and produce better outcomes.
- **Prioritize prevention, diversion and surveillance over detention.** Tough budget times are leading many states to experiment with alternatives to incarceration for non-violent offenders. Oklahoma, which has among the highest incarceration rates in the nation, has various opportunities to send and keep fewer people in prison without endangering public safety.

Overall, a **balanced approach** of targeted cuts of direct expenditures and tax breaks, selected new revenues, and more efficient use of public dollars will be needed to navigate the perilous fiscal straits over the next few years.

LONG-TERM RECOMMENDATIONS: While we grapple with immediate budget needs, we must acknowledge that our state fiscal system faces serious **long-term challenges** that will persist and become increasingly acute over time, regardless of the ups and downs of the economic cycle. This fiscal gap, often referred

to by experts as a *structural deficit*, has many causes, including: an aging population that will require growing expenditures for health care services; an outdated tax system that is increasingly ill-suited to the modern, service-based economy; an underfunded public pension system that must address its large liabilities; and a decaying public infrastructure, including roads, bridges, and buildings, that has suffered from decades of underinvestment.

There is no single or simple answer to our long-term budget challenges. But we must at least begin to engage in serious and honest thinking about how to align our revenue system with our funding commitments not just for next year or the year after, but for ten and twenty years down the road. This thinking should involve:

- A serious review of our tax system with the goal of proposing reforms that would improve our revenue capacities, make the system fairer, and provide effective economic incentives;
- Expanded use of budget and revenue forecasting to help policymakers evaluate policy choices;
- Mechanisms along the line of federal pay-go rules to ensure that both spending and revenue decisions are paid for and budget neutral;
- A plan to shore up our pension system in a way that respects our commitments to current employees and allows for sustainable funding of benefits;
- Greater emphasis on mechanisms that allow for programs to be scrutinized, evaluated, and prioritized;
- Restoring full authority and accountability for making decisions about revenue and spending to our elected representatives.

OK Policy looks forward to working with you to confront these crucial challenges in the months and years ahead. Please do not hesitate to contact me at (918) 794-3944 or by e-mail at dblatt@okpolicy.org if you have any questions or ideas, or wish to discuss any of these matters further.