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STATE BUDGET SHORTFALLS: FY '10 AND BEYOND How CAN OKLAHOMA WEATHER THE CRISIS?

SPECIAL POINTS OF INTEREST

- The severe recession has contributed to nearly a 30 percent drop in state revenues and has compromised the state's ability to provide effective public services.
- OK Policy forecasts indicate that FY '10 revenues may be 14 percent below the budgeted amount.
- Improved forecasting, Rainy Day Fund appropriations, and using new resources to balance the budget can ease the damage in FY '10.
- It likely will be FY '13 before state revenues rebound to pre-downturn levels.
- The state should improve forecasting, plan for the fiscal impacts of major decisions, and create better reserve policies to improve long-term fiscal stability.

The current national economic recession is the longest and deepest in at least 50 years. While Oklahoma has not been affected as drastically as many other states, families and businesses are facing significant hardships. The state's unemployment rate has reached its highest level since 1988 and food stamp caseloads shatter new records each month. Bankruptcies and foreclosures are up, construction and other investments are down.

State government is not immune to the effects of the downturn. Beginning at the start of 2009, revenue began to fall dramatically. Revenue in the first nine months of calendar year 2009 was down 21 percent from the previous year. The state has responded to shortfalls by cutting agency budgets across the board for four straight months.

While there are signs that the national economy is beginning to rebound, state revenues may continue falling or remain stagnant for some time. The

coming recovery is likely to be slow and weak. It will be impossible to endure this recession without significant hardship in the form of service reductions, tax increases, or both. At the same time, however, the state needs a strong fiscal plan to mitigate the recession's worst effects and to better prepare for the recovery and for future economic cycles.



This brief describes the revenue shortfall, including its causes, depth, length, and the state's response. It then reports on OK Policy revenue forecasts for the remainder of this fiscal year and for the next three years. It recommends a program for the state to better understand and prepare for the remain-

der of this budgetary downturn. Finally, it recommends long-term improvements in Oklahoma's financial processes that can help us better anticipate, plan for, and manage future downturns.

I. Oklahoma's Revenue Performance

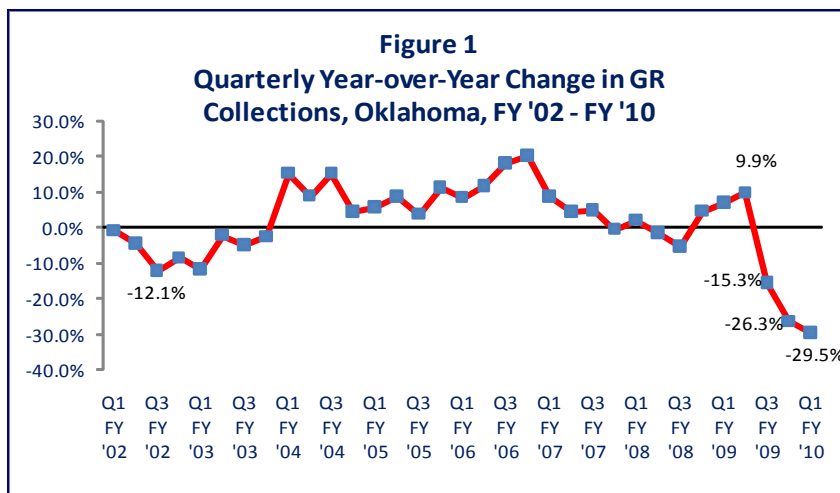
The growth in Oklahoma's economy and state budget of the 1990s ended in FY '02, when the state and nation entered a sharp economic downturn. In FY '02, state revenues fell 12 percent below the previous year. Revenue did not return to pre-downturn levels for over three years. Beginning in FY '04, revenue grew 29 percent in four years.¹

Early in 2009, however, revenue began to plummet, reflecting the downturn in the state's economy. Overall, FY '09 revenue was seven percent

below both FY '08 actual revenue and the original FY '09 estimate.²

The severity of the downturn is illustrated by Figure 1. Revenues have fallen progressively more steeply in each of the last three quarters. Revenues for the first quarter of FY '10 were 29.5 percent below the previous year. The graph also indicates how much worse this shortfall is than the last one. The worst quarterly revenue decline during the FY '02-'04 recession was 12.1 percent, less than half the decline of the most recent quarter.

As the recession hit, it became clear that revenues available for FY '10 would fall far below prior year levels. Legislators faced a limit on state appropriations of \$6.46 billion, which was \$612 million less than the previous year's appropriations. The federal stimulus (officially the American Recovery and Reinvestment Act, or ARRA) provided an additional \$641 million and minor revenue enhancements added \$160 million. These resources helped support some state services, notably education and health care. As a result, the total budget from both



state appropriations and ARRA, \$7.23 billion, actually exceeded the FY '09 budget by \$106 million. It is important to note, however, that most agencies that did not receive ARRA support received lower budgets for FY '10 than for FY '09.³ Figure 2 shows how ARRA helped make up for falling state revenue.

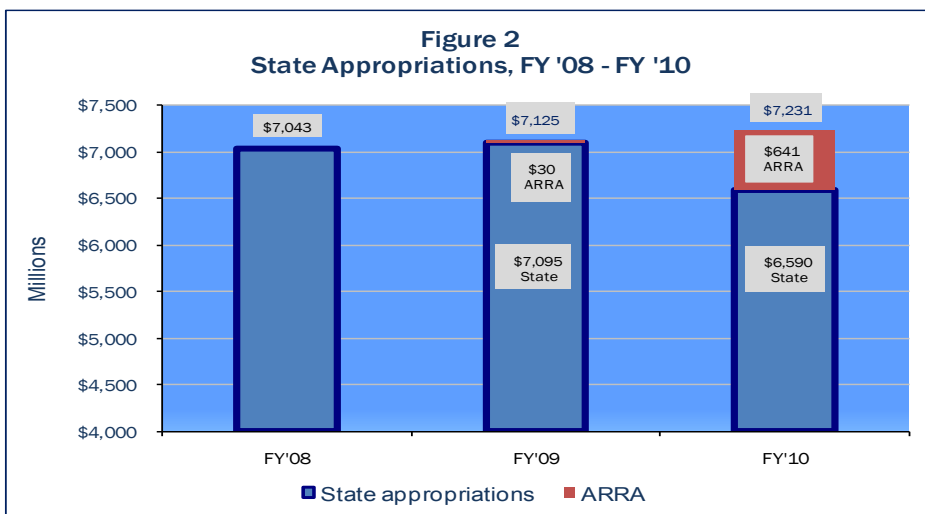
Most state agencies entered the current downturn under considerable financial stress. For many agencies and public school districts, rising costs combined with flat funding had already led to hiring freezes, unfilled vacancies, and reductions in

service before the FY '10 budget was in place.

Even in the best of times, spending for many services was not adequate to meet Oklahoma's needs. The state lags behind most states in several key measures of government effectiveness, including educational outcomes, road condition, and overall health of the population. The revenue shortfall and resulting budget reductions could only make these shortcomings greater.

Once the current fiscal year began, it became clear that revenues would not support the \$7.23 billion spending level adopted by the Legislature. For the first quarter of FY '10, General Revenue Fund (GRF) revenues were \$388 million, or 26 percent less than the original estimate.⁴

The state's response to shortfalls so far can best be characterized as reactive and un-



even. GRF allocations were cut by five percent in each of the first three months of FY '10. Many agencies have announced hiring freezes and reduced their workforce through voluntary retirement, which may hurt agencies' ability to perform their core missions. Several agencies, including the departments of Human Services, Health, Mental Health and Corrections and several public school districts, have indicated they will need to make significant reductions if monthly allocation cuts continue. The resulting cuts in public services are now having real impacts on businesses and families, including low-income seniors and other vulnerable populations.⁵

In late October, Governor Brad Henry and legislative leaders warned state agencies to expect allocation cuts of at least five percent for the remainder of the fiscal year. Governor Henry suggested it may be necessary to appropriate from the Rainy Day Fund but offered no schedule or proposal.⁶ Agencies and their constituencies are left uncertain as to how they should plan for the rest of the fiscal year.

II. Oklahoma's Revenue Outlook

Dramatically falling revenue and the continuing damage to state services raise two obvious questions: First, where are we going, and, second, what can we do about it? This section addresses the first question. The remainder

of the brief addresses the second question.

Oklahoma's Board of Equalization, composed of elected and appointed state leaders, updates revenue estimates twice a year, in December and February. This means that the current year's revenue forecast is not reviewed until five months are completed and that the only additional review comes just two months later. The review does not require any adjustments or action. The Board also prepares forecasts for the coming fiscal year at this time; the Constitution establishes the ceiling on state appropriations at 95 percent of the Board's February estimate.

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Decisions about agency budgets and state services should not be based on incomplete information. It is possible and advisable to prepare new revenue estimates for FY '10 based on the results of the first quarter and on expert opinions about the near-term outlook for the economy. It is equally possible and advisable to forecast revenues for future years. This helps make budget decisions today that are sustainable for the long period of recovery.

OK Policy has developed several state revenue forecasts in hopes of expanding and informing the discussion of budget options. All forecasts require using what is known to try to predict what is unknown. Because a single forecast is rarely correct, our estimates are based on six different forecasts using four different methods of forecasting.⁷

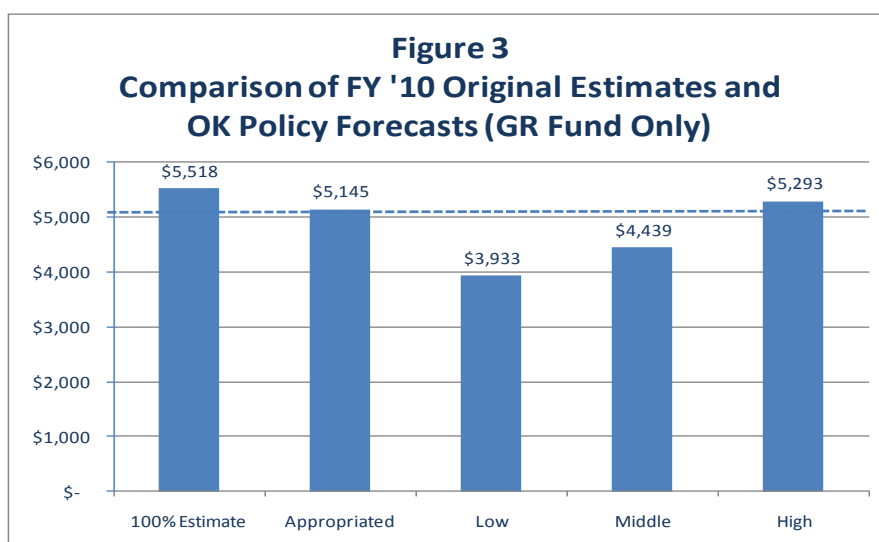
This brief reports the range of results from these six forecasts.

- Two of the forecasts use trend analysis, examining recent revenue trends and estimating a likely future path. One of these forecasts assumes the current quarter is the deepest in the revenue downturn, while another assumes there is one more quarter of downturn before revenues start to rebound.
- One forecast assumes the current downturn will look just like the previous downturn, only deeper.
- One forecast projects this year's revenue based on the revenue collected in the first quarter of the year.
- Two forecasts are based on regression analysis, which seeks relationships between state revenues and underlying economic indicators. In this case, the forecasts determine how past revenues have been affected by natural gas prices and the gross domestic product. Both then predict revenue based on

expert predictions of future gas prices and GDP.

Figure 3 shows how revenues for FY '10 vary under these six forecasts. For simplicity's sake, only the highest and lowest forecasts are shown, along with a "middle scenario" that represents the mid-point of the six forecasts. All data are for the General Revenue Fund only, which comprises approximately 78 percent of state appropriations, excluding federal stimulus funds.

The left-hand bar in Figure 3 shows the final Board of Equalization estimate of \$5.518 billion. The next bar shows the amount that was appropriated to state agencies, \$5.143 billion, which represents 95 percent of the estimate available for appropriation. The dashed line extends this level across the graph because revenue must reach this amount to avoid budget shortfalls for the year as a whole. The low forecast suggests that revenue could fall over \$1.2 billion short of that point, while the high forecast suggests it is still possible for reve-



nue to recover enough to fund all state services for the year as a whole. *The middle scenario suggests a shortfall of approximately \$700 million, or 14 percent of appropriations.*

The Rainy Day Fund (RDF) was created to address revenue shortfalls like the one the state faces today. The RDF now has approximately \$600 million (the constitutional maximum of 10 percent of the General Revenue Fund). Up to 3/8ths of the Fund (approximately \$225 million) may be appropriated when revenues for the forthcoming year are projected to be

less than the current year. Up to 3/8ths may be appropriated when revenue falls short of the year's original estimate. An additional 1/4th (approximately \$150 million) may be appropriated upon declaration of an emergency. According to an advisory letter issued in November by the Attorney General's Office, the conditions are in place allowing all portions of the Rainy Day Fund to be used in FY '10.⁸

Table 1 shows the budget shortfalls resulting from the three different forecasts, depending on how the RDF is employed.

Table 1							
FY '10 Forecast Shortfalls and Rainy Day Fund Impacts (\$ in millions)							
Forecast	FY '10 Forecast Revenue	General Revenue (GR) Shortfall	% GR Shortfall with no Rainy Day Fund	% GR Shortfall with 3/8ths of RDF (\$224M)	% GR Shortfall with 5/8ths of RDF (\$373M)	% GR Shortfall with 3/4 of RDF (\$448M)	% GR Shortfall with all of RDF (\$597M)
Appropriated Amount (GR)	\$5,143	-	-	-	-	-	-
Low	\$3,933	\$1,210	23.5%	19.2%	16.3%	14.8%	11.9%
Middle	\$4,439	\$704	13.7%	9.4%	6.4%	5.0%	2.1%
High	\$5,293	-0-	-0-	-0-	-0-	-0-	-0-

The table shows that the low forecast would have devastating effects on budgets. Even using the maximum allowable RDF would result still in 16 percent budget shortfalls. At the other end of the scale, the high forecast would not result in shortfalls at all and would leave the RDF intact. The middle scenario would create a significant shortfall that would require considerably more action than the state has taken to date.

This scenario suggests a shortfall of nearly 14 percent if none of the Rainy Day Fund is used. Appropriating 3/8th of the RDF would still leave a significant 9 percent gap. Even using 3/4 of the Rainy Day Fund would result in shortfalls of 5 percent. State leaders should give serious consideration to applying a plan that assumes the middle scenario as the likely outcome for the year. Such a plan would logically include appropriating at least 3/8ths of the RDF.

Fortunately, budget cuts are not the only tool available to address

the shortfalls. Other state resources could be created by sweeping cash from non-appropriated funds or by delaying tax cuts or revenue diversions. ARRA should provide at least \$700 million more than the state has used so far. While it may be tempting and in some cases advisable to apply some ARRA money to the current shortfall, this should be done only if leaders are convinced it will not result in a greater shortfall in FY '11.

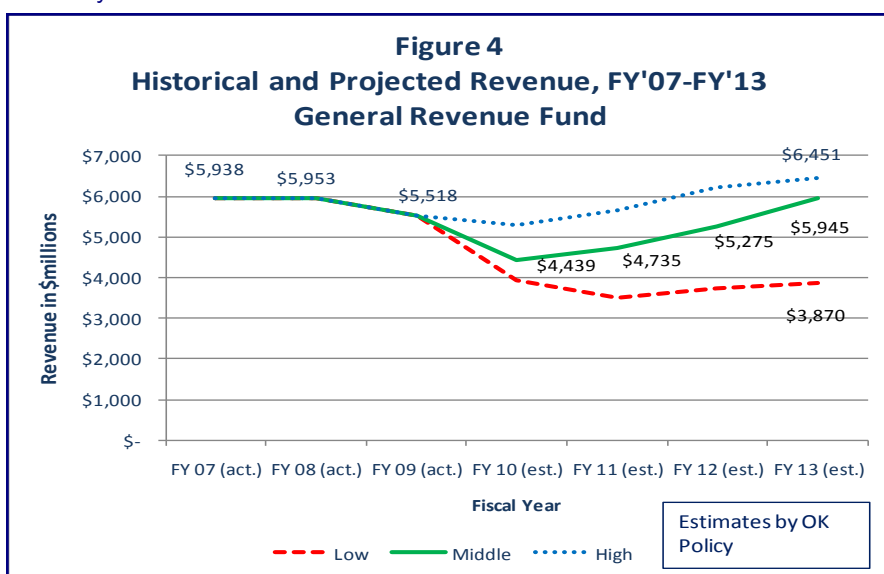
Extending these forecasts out for three more years indicates that it may be several years before we return to pre-recession revenue levels. Figure 4 shows the forecasted range of revenues over the next three years, along with the actual revenues for three prior years.

The high forecast shows a relatively brief downturn with a robust recovery. In this scenario, revenue would return to pre-downturn levels in FY '12 and reach a relatively

healthy \$6.45 billion in FY '13. The low forecast shows a considerably different picture, indicating FY '13 revenue of \$3.87 billion that would still be well below pre-recession levels. The low forecast assumes a considerable delay between economic recovery and revenue upturns; that assumption is based on Oklahoma's recent revenue history. The middle scenario is a composite of all five forecasts, so it offers the best picture of the most likely path. It shows revenue beginning to rebound in FY '11 and yearly growth rates of more than 10 percent in FY '12 and FY '13. Even with this strong recovery, however, revenue in FY '13 would recover only to FY '08 levels. This scenario makes a strong case that the revenue downturn is a long-term issue that should be met with long-term planning.

Several factors make the long-range forecasts more sobering.

- Under present law, ARRA spending will be completed during FY '11. That means that over \$600 million in state education and health spending presently supported by ARRA either must be paid from state revenue or cut from the budget. Under the middle scenario, FY '12 revenue growth of about \$540 million would not make up for all of the lost ARRA funding, let alone meet other state obligations.



- Revenue growth will continue to be hampered by policy changes already in statute, as described below.

- ◆ FY '11 is the final year of the increase in the income tax standard deduction.
- ◆ FY '12 is the last year of revenue for the estate tax, which is being phased out.
- ◆ Once revenues are certified to be four percent higher than the previous year's estimate, likely in FY '12, the top income tax rate falls from 5.5 to 5.25 percent.
- ◆ Current law also requires that an additional \$30 million per year be placed in the ROADS fund.

Assuming the top tax rate cut is triggered in FY '12, tax cuts and revenue diversions will cost the GRF \$140 million in FY '11, an additional \$88 million in FY '12, \$90 million more in FY '13.

At best, Oklahoma's FY '13 budget will be only slightly larger than FY '08 spending. At worst, it will be \$2 billion lower. In any scenario, the FY '13 budget would not support the same level of services the state provided in FY '08. Inflation during that five-year time frame would reduce the value of FY '13 dollars by 15-20 percent compared to FY '08.

In a state that has already fallen behind its peers in supporting edu-

cation, health care, infrastructure, and economic growth, this revenue downturn sets the stage for a long and difficult climb back. We can, however, create some tools to better understand that climb and to make it a more even one.

III. A Fiscal Plan for FY '10

Oklahoma's response to the current downturn has been a series of disconnected short-term reactions to monthly revenue shortfalls. The state's unannounced but apparent plan is to continue to cut monthly allocations on an across-the-board basis, borrowing as necessary to limit the cuts to five percent, and "getting through" to February, so the Legislature can develop a plan to complete the fiscal year.

There are several drawbacks to the state's current approach, which are discussed below.

- Many agencies can absorb a few monthly cuts by using reserves, eliminating travel and freezing hiring, but few can save five or more percent of the entire year's budget through these measures.
- Budget cuts to date are considerably less than revenue shortfalls. Each month where that trend continues "digs a deeper hole" by borrowing from other funds. The borrowing must be repaid this year, adding to the obligations that must be paid from under-performing revenues.
- If revenues continue falling short, deeper budget cuts may be required as the year goes on. The more of the year that is finished,

however, the less flexibility agencies have to cut.

There are several steps the state can take to develop a genuine plan of action that minimizes these disadvantages of the current approach.

The state should develop and publicize revenue forecasts for the remainder of the current fiscal year. The forecasts described earlier offer a glimpse into the uncertain revenue outlook. The view could be improved if the state develops and shares official revenue forecasts. Those forecasts should be reviewed and updated quarterly, so leaders can identify and allocate unanticipated revenues, and so that budget cuts, if necessary, can be made openly and coherently.

The Legislature should hold hearings to determine the impact of shortfalls on each agency budget and the impact on services and citizens. Cuts of five percent or more will probably be necessary for the rest of this fiscal year. After forecasts are released, agencies should have the opportunity to describe how such cuts will affect services and employees the rest of the fiscal year.

State leadership should develop and advance a plan for use of the Rainy Day Fund and consideration of other revenues and resources. Unless revenues turn around quickly, the state will have to appropriate RDF monies to limit budget cuts to acceptable levels.

We also need to explore other revenues. The sooner such a plan is complete, the better we can manage the shortfall and its impacts.

IV. A Fiscal Plan for the Long Term

The revenue downturn and resultant service impact can best be managed as a long-term problem. This section discusses potential elements of a long-term plan for surviving the recession and recovery and for improving our response to the next downturn.

Oklahoma should develop a broad-based and transparent process for forecasting state revenues. The state should estimate revenues for several years in advance to facilitate taxing and service-level decisions that make sense for the long run, not just the current year. State agencies and citizens need this information so they know how to plan and what to expect in the coming years. Oklahoma has a statutory requirement for long-term forecasting. The forecast prepared under this requirement is a good start; it incorporates economic modeling and considers several different trends for future growth. Unfortunately, it is not sufficiently documented, widely circulated, or used in budget planning. Oklahoma should improve its forecasting process by executing this law in a way that includes these key elements:

- The Board of Equalization may be the appropriate body to oversee this expanded revenue forecasting capability, but it needs

more technical support. Its current, short-term forecasts rely nearly exclusively on revenue estimates from the Oklahoma Tax Commission. Forecasts are usually technically improved and better understood when more experts are involved. Oklahoma should support the Board by creating a forecasting body that includes the Office of State Finance, legislative staff, and academic and private economists as well as the Tax Commission.

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- The annual certification of revenue should include revenue estimates for at least two years beyond the coming year. The “out year” estimates need not be binding on future budgets, but they should be used by the Governor and Legislature and by state agencies in adopting tax and service levels.
- The Legislature should adopt scoring and pay-as-you-go procedures similar to those used successfully at times by the federal government. These procedures should prevent changes in financial policies, including tax rates and exemptions, creation of new special funds, and changes in service lev-

els, until the long-term fiscal impact is estimated. These procedures should require that significant service expansions and tax cuts be offset by other revenues or other cost reductions.

The state should improve its policies for reserve funds. Voters approved changes in the Rainy Day Fund rules after the 2002 recession to help the state through future downturns. Recent events suggest further improvements are needed. The Fund’s cap—ten percent of one year’s GRF revenues—is not sufficient to endure steep revenue downturns. The restrictions on the Fund’s use are too great. The RDF should be restructured so it may be appropriated at any time until revenues return to pre-downturn levels.

In addition to improving the RDF, it’s time for Oklahoma to examine the role of volatile revenues like taxes on oil and natural gas and consider removing at least a portion of these taxes from the stream of recurring revenues. Among the options to explore include placing a cap on the amount of oil and gas gross productions that can go to the GRF and other operating funds, and using some or all gross production taxes to fund long-term obligations and one-time spending such as improvements to state facilities and infrastructure.

The state should thoroughly examine its tax system. Oklahoma's tax base is threatened by the shift to a service economy and by the ease at which state taxes can be avoided in a global economy. The state has further eroded its funding capacity by granting an ever-expanding array of uncapped and poorly-evaluated tax exemptions and incentives. The state will need to modernize its tax system in order to fund the level of services that will help Oklahoma families and communities prosper.

V. Conclusion

Oklahoma's current revenue shortfall and service squeeze is harsh and will continue for several more years. State services will continue to deteriorate, causing harm to families and restraining economic growth in Oklahoma. It will be years before services are restored and even longer before we can invest in the public structures that will support greater prosperity.

The downturn is largely uncontrollable and so is its impact on state revenues and services. These impacts, however, can be better forecasted, understood, and managed. The state should take steps to do so by improving forecasting, planning, and readiness and by working harder to create the resources that will fund public services Oklahoma needs in order to recover and prosper.

ENDNOTES

¹Oklahoma Policy Institute, "FY '10 Budget Review: Federal Dollars Soften the Blow, but Funding Gaps and Hard Choices Remain," June 2009; available at http://www.okpolicy.org/files/FY10review_brief.pdf.

²Oklahoma State Treasurer, "Recession Hits Oklahoma's Revenue Collection: Meacham Says Shortfall is Probable during New Fiscal Year," July 14, 2009; available at <http://www.ok.gov/treasurer/documents/June%20Revenue%20PR%207-14-09.pdf>.

³Oklahoma Policy Institute, "FY '10 Budget Brief," available at: <http://okpolicy.org/fy-10-budget-information>

⁴Oklahoma State Treasurer, "September Revenue Collections Sufficient To Cover Reduced Monthly Spending Obligations," October 13, 2009; available at <http://www.ok.gov/treasurer/documents/September%20Revenue%20PR%2010-13-09-r.pdf>. Note that these figures represent only the General Revenue Fund, not the total state appropriations discussed earlier.

⁵Oklahoma Policy Institute, "Cutting into the bone: Impact of falling revenues

starting to be felt," September 17, 2009; available at <http://okpolicy.org/blog/budget/cutting-into-the-bone-impact-of-falling-revenues-starting-to-be-felt/>.

⁶Office of Governor Brad Henry, "Governor, legislative leaders warn agencies of continued cuts," October 27, 2009; available at http://www.ok.gov/governor/display_article.php?article_id=1303&article_type=1.

⁷ A detailed memorandum explaining our forecasting methods is available on our website at: <http://okpolicy.org/fy10-budget-info>

⁸ Letter from Tom Gruber, First Assistant Attorney General to Treasurer Scott Meacham, November 2, 2009. **Note that the original version of this brief treated the 3/8ths of the Rainy Day Fund that may be used for shortfalls in the forthcoming fiscal year as no longer available for use in FY '10. The Attorney General's letter states that "there is no requirement under the constitutional provision that once the triggering event occurs, that the funds available for appropriation be appropriated during a regular legislative session. Thus the first three-eighths (3/8) of the Reserve Fund remain available for appropriation for fiscal year 2010.

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