

How Big an Umbrella Does Oregon Need? Reserves of at Least 15 Percent Were Needed in Two of the Last Three Recessions

by Michael Leachman

It is going to rain, and when it does Oregon will wish it had a bigger umbrella. At present, Oregon's reserve fund system is not up to the task of protecting public structures from the wrath of a fiscal storm similar in impact to those that struck in the early 1980s and the early part of the current decade.

Oregon has two reserve funds, the Education Stability Fund and the Oregon Rainy Day Fund. The Education Stability Fund, dedicated solely to public education, is allowed to grow up to 5 percent of General Fund revenue in the prior biennium. The Oregon Rainy Day Fund, a general purpose reserve fund, is capped at 7.5 percent of General Fund revenue in the prior biennium, although the legislature can spend only two-thirds of the available funds (or 5 percent of General Fund revenue). Thus, the maximum funding available from both of Oregon's reserve funds would be 10 percent of General Fund revenue in the prior biennium.¹

OCPP's report *It Better Only Drizzle* examined the status of Oregon's reserve funds. It found that at the present rate of funding for both the Rainy Day Fund and the Education Stability Fund, total available reserves will grow to just 6.8 percent of General Fund revenue by the end of the 2013-15 budget cycle. By comparison, the 2001 recession caused General Fund revenue to decline by 15.2 percent.

This issue brief presents additional evidence that reserves totaling 15 percent of current revenue is an appropriate and reasonable level for protecting public structures during a recession.

Reserves of at least 15 percent were needed in two of the three last recessions

Ideally, Oregon's reserves would protect existing state services during a recession without significant service cuts, tax increases, or borrowing. During two of the last three economic downturns to hit Oregon, avoiding such measures would have required reserves totaling at least 15 percent of current General Fund revenue.

The back to back recessions of the early 1980s exceeded 15 percent

In the early 1980s, two recessions struck the state in rapid succession, rocking its job and income base. Relative to the General Fund revenue legislators expected at the beginning of the 1979-81 biennium, actual revenue came in 6 percent below projections in that budget period (see figure).²

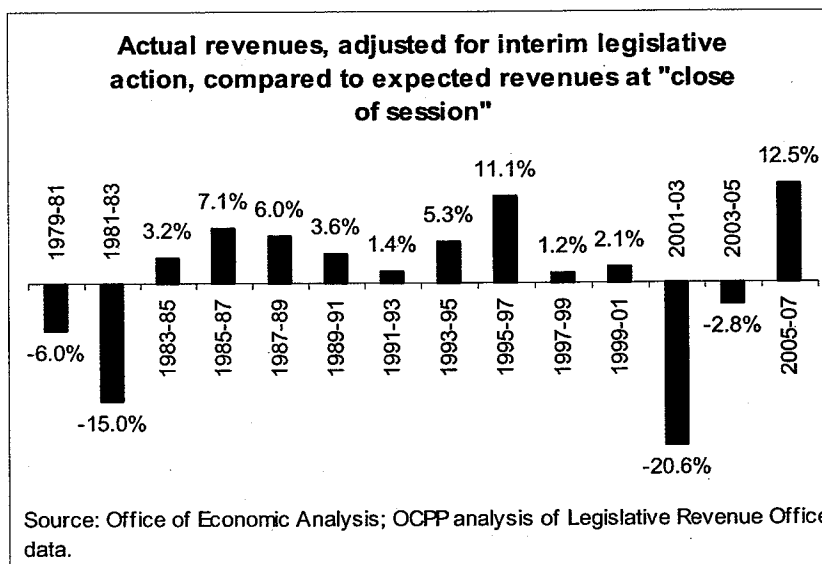
Revenue continued to decline relative to expectations in the 1981-83 biennium that followed. To lessen the revenue shortfall, the Legislative Assembly enacted a temporary three-year income tax rate increase during the second of four special sessions in 1982.³ Had legislators not raised taxes and taken other measures to improve revenue during the 1981-83 budget cycle, General

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Fund revenue would have declined 15 percent relative to what legislators expected going into the 1981-83 cycle (see figure).⁴

The 1990s recession was mild

The next recession to strike, in the early 1990s, was relatively mild, in part thanks to rapid population growth in Oregon at the time. Legislators met in special session once in 1992 but rejected the Governor's tax proposals.⁵ They did, however, suspend the personal income tax kicker in 1991 and the corporate income tax kicker in 1993. Revenue did not decline in 1989-91 or 1991-93 relative to expectations at the beginning of these budget cycles (see figure).



The 2001 recession caused declines well over 15 percent

The 2001 recession, by contrast, again pummeled the state's revenue base. High-technology stocks crashed, causing capital gains losses, layoffs that reduced personal income tax revenue, and sharp corporate profit declines. The Legislative Assembly met in five special sessions during 2002. Unlike in the early 1980s, legislative efforts to raise significant taxes failed after voters rejected two income tax hikes.⁶ As a result, the state slashed funding for schools, the Oregon Health Plan, and other important public services.

With the rejection of significant tax increases, legislators borrowed money and took other action to soften the 2001-03 budget cuts.⁷ Excluding these actions, General Fund revenue declined by 20.6 percent in 2001-03 relative to what legislators expected going into the biennium (see figure).⁸ In the subsequent budget cycle, 2003-05, revenue again fell short of expectations, this time by 2.8 percent (see figure).⁹

Hence, just as in the recessions of the early 1980s, reserves totaling 15 percent of current revenue would have mitigated much, but not all, of the damage of the 2001 recession. Some budget cuts, revenue increases, or budget gimmicks would still have been needed, but the state would have escaped the worst of the fiscal storm.

The 2001 recession, while significant, was not an outlier

The recession that struck during the 2001-03 budget cycle caused General Fund revenue to fall by 7.5 percent compared to the prior biennium. That was the steepest decline since the Great Depression.¹⁰

This does not mean, however, that the 2001-03 downturn was so much of an outlier that it should be ignored when determining the appropriate size of Oregon's reserves. The 2001-03 downturn looks similar to the one that happened in the early 1980s, once the effects of inflation

and tax increases imposed during prior recessions are taken into account and once the revenue declines in 1979-81 and 1981-83 are combined, as they should be.

Inflation masks comparisons

The revenue decline in 2001-03, relative to the prior biennium, reached historic proportions in part because inflation in 2001-03, at just 3.2 percent, was low compared to past recessions. Relatively high inflation during past recessions masks the depth of the revenue problems that occurred during these downturns. During the 1979-81 biennium, for example, General Fund revenues increased by 21 percent above the prior biennium. That might seem good, except that inflation shot up by a whopping 25 percent — even faster than the revenue gain.¹¹ This is part of the reason why the state faced a revenue crisis.

Tax increases mask comparisons

The 2001-03 revenue decline was also steep compared to downturns in the past because legislators were unable to raise taxes significantly during the downturn. In the early 1980s the revenue decline was offset somewhat by the tax increases described above.

When examined in its full context, the magnitude of the revenue decline caused by the 2001 recession was not so unusual. That decline was not much larger than the decline in the early 1980s, when adjusted for inflation and tax increases enacted during the interim, and once the declines in 1979-81 and 1981-83 are appropriately combined.

Conclusion

Just as it is sure to rain in western Oregon, the business cycle will take a downturn. An adequate rainy day fund is critical for protecting our schools, the health of our residents, and the safety of our communities when the downturn happens. Based on Oregon's experience during two of the last three economic downturns, a 15 percent rainy day fund is the minimum necessary to protect our public structures from the wrath of fiscal storms that Oregon may be forced to endure in the future.

Endnotes:

- ¹ Two-thirds of the 7.5 percent that could accumulate in the Oregon Rainy Day Fund is 5 percent. When added to the 5 percent maximum limit in the Education Stability Fund, the maximum available resources would be 10 percent.
- ² OCPP analysis of data from the Legislative Revenue Office.
- ³ Prior to the temporary rate increase, Oregon income tax rates ranged from 4 percent to 10 percent. In the second special session of 1982, the Legislative Assembly increased these rates to a range of 4.2 percent to 10.8 percent for the 1982-84 period. In 1985, rates returned to the 4-10 percent rate structure. See Legislative Fiscal Office, *History of Oregon Special Legislative Sessions*, Budget Information Brief 2006-4. Available at www.leg.state.or.us/comm/lfo/2006_4Special_Sessions_Update.pdf. See also Legislative Revenue Office, *2007 Oregon Public Finance: Basic Facts*, Research Report 1-07, p. C-3. Available at www.leg.state.or.us/comm/lro/2007_final_basic_facts.pdf.
- ⁴ According to an analysis by the Office of Economic Analysis.
- ⁵ See Legislative Fiscal Office, *History of Oregon Special Legislative Sessions*.
- ⁶ During the fifth special session of 2002, the legislature referred to voters Measure 28, which would have temporarily raised personal and corporate income tax rates. Measure 28 was defeated in a January 2003 special election. Subsequently, during the 2003 regular session, the legislature enacted a package of tax increases including a personal income tax surcharge. This package was subsequently placed before voters through a referendum petition as Measure 30. Measure 30 was defeated in a February 2004 special election.
- ⁷ Under Senate Bill 856, the legislature authorized the State Treasurer to issue \$450 million in appropriation credit bonds, the proceeds of which were deposited in the General Fund. In addition, legislators deferred the implementation of Measure 88, which increased the amount of federal income taxes Oregonians can deduct from their state income taxes, shifted money into the General Fund from other accounts, and placed half the proceeds of a property sale in Boardman into the General Fund.
- ⁸ According to an analysis by the Office of Economic Analysis.
- ⁹ Ibid.
- ¹⁰ Based on data from the Legislative Revenue Office. See also testimony of Paul Warner, Legislative Revenue Officer, before the Senate Finance and Revenue Committee, October 19, 2007. Specifically, Warner said, "First of all, keep in mind that the 01-03 period was the biggest decline in revenue we've had since '31-33 in percentage terms." Audio available at www.leg.state.or.us/listn/.
- ¹¹ U.S. CPI-U used to measure inflation from June 1979 to June 1981.

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