Task Force on Comprehensive Revenue Restructuring

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CHAPTER 2
LONG TERM FISCAL BASELINE PROJECTIONS

Introduction

The purpose of this chapter is to project Oregon's current state and local revenue system forward over the next decade the most likely revenue trends for counties and cities and the state government. The revenue projections are combined with projections for spending on current services. Current service projections are based on expected inflation, overall population growth and changing demographic patterns. The Task Force spent considerable time examining these trends based on information presented by the Budget and Management Division, the Office of Economic Analysis, the League of Oregon Cities, the Association of Oregon Counties and the Legislative Revenue Office.

State Government

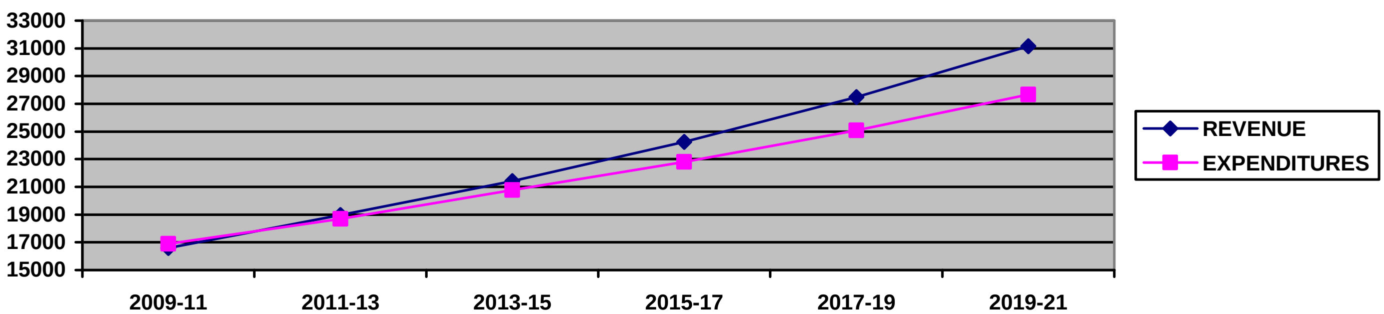
The Office of Economic Analysis issues quarterly projections for General Fund and Lottery revenue. This report uses the forecast released in September 2008. The revenue projections go through the 2013-15 biennium. The Office of Economic Analysis prepared trend projections for the Task Force beyond the forecast horizon through the 2019-21 biennium. Those trend growth rates have been applied to the updated September 2008 revenue forecast to complete the long-term state revenue projections. For current service projections the essential budget level for the 2009-11 biennium as calculated by the Legislative Fiscal Office, serves as the base. Projected growth rates for the major program areas developed by the Budget and Management Division are then applied to the 2009-11 base through the 2019-21 biennium. Table 2.1 and Chart 2.1 show the projections for General Fund/Lottery revenue along with the current service projections.

Table 2.1: LONG-TERM STATE DISCRETIONARY REVENUE AND CURRENT SERVICE PROJECTIONS (in millions of $)

BIENNIUM	2009-11	2011-13	2013-15	2015-17	2017-19	2019-21
REVENUE						
GENERAL FUND	$15,467.8	17,768	20,056.1	22,743.6	25,791.3	29,247.3
LOTTERY*	1,119.9	1,207.6	1,352.0	1,515.6	1,699.0	1,904.6
TOTAL	16,587.7	18,975.6	21,408.1	24,259.2	27,490.2	31,151.8
EXPENDITURES						
EDUCATION	8,700.3	9,393.5	10,149.7	10,972.0	11,864.1	12,834.9
HUMAN SERVICES	4,252.5	4,985.7	5,937.9	6,783.8	7,797.9	8,996.3
PUBLIC SAFETY	2,190.7	2,440.4	2,682.8	2,924.4	3,155.6	3,413.3
OTHER**	1,752.1	1,881.8	2,005.1	2,123.4	2,268.3	2,419.6
TOTAL	16,895.6	18,701.2	20,775.5	22,803.6	25,085.9	27,664.1
NET FISCAL POSITION***	-307.9	274.4	632.6	1,455.6	2,404.3	3,487.7

*Excludes dedications for the Education Stability Fund, county economic development and county fairs.
**Other includes natural resources, economic development and administration.
***Net fiscal position does not include a projected ending balance. For the 2009-11 biennium the projected ending balance is $215 million leaving a projected net fiscal position of -$522.9 million when the ending balance is included.

Chart 2.1
LONG-TERM STATE FISCAL POSITION UNDER TREND PROJECTIONS (in millions of $)



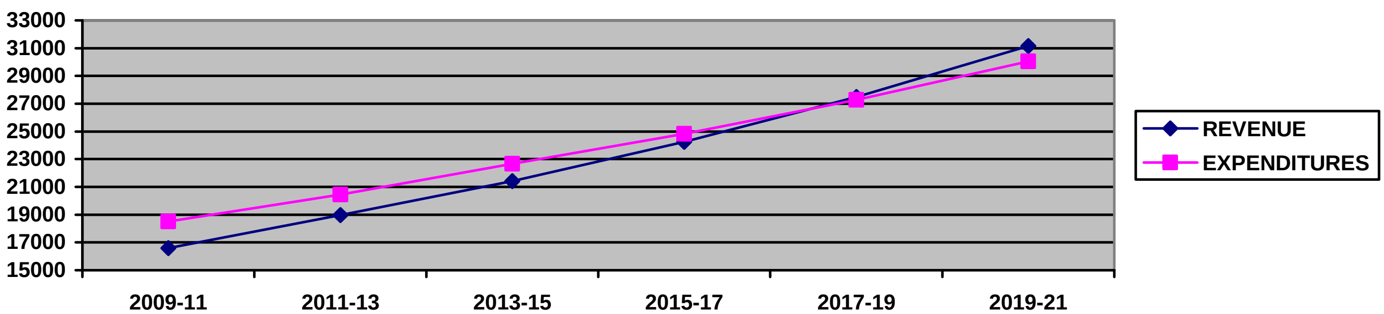
The trend projections indicate that state discretionary revenue will outpace the growth in the cost of providing current services over the long-term. This result is primarily due to the responsiveness of the personal income tax to economic growth. Long-term economic projections show Oregon and the western states in general growing faster than the country as a whole. Personal income tax revenue tends to grow slightly faster than overall personal income over time due to its progressive rate structure. Although this is a significant result it is important to keep in mind the limitations of this type of analysis:

- The analysis includes only discretionary state spending i.e. the General Fund/Lottery budget. This leaves out large portions of the state All Funds budget. In some cases such as the public employment retirement accounts, there is little link to service provision, but in other cases such as use of federal funds or the Highway Fund, there is a direct link to the service provided by state government. Federal funds are particularly important because they make up roughly 20% of total state revenue and are a major factor in critical areas such as education, transportation and human services. The long-term fiscal position of the federal government is cause for concern.

- The projections are for operating revenue and expenses. They ignore capital expenditures beyond the costs of servicing current debt. This means that the costs of maintaining the existing stock and increases in physical capital are not adequately captured in the analysis. This is particularly important for public safety (new prisons), transportation and education.
- This analysis is based on long-term trends or averages over time. It does not reflect cyclical ups and downs that are inevitable for the national and state economy. This highlights the strength of a personal income tax dominated revenue system but does not show the inherent biennium-to-biennium volatility of the state system.
- Current service projections imply that the current level of service provision is the desired long-term level. This is very unlikely to be the case. In the view of many, the current budget level based on existing resources is inadequate. It is also likely that over time as citizens become more prosperous they desire a higher quality of public services such as education and public safety.

To show how the state's fiscal position is affected by changes in the desired service level an alternative projection based on full funding of the Quality Education Model for K-12 is considered. The Quality Education Model, developed in 1999, is designed to show the resources required to achieve the state's education goals. The Quality Education Commission estimated that the Legislature would need to appropriate $7.7 billion in 2007-09 to achieve the standards set forth in the model. The 2007-09 Legislature allocated $6.248 billion to K-12 through the State School Fund and the School Improvement Fund. Taking this gap and adjusting for expected cost increases would add an additional $1.6 billion to the 2009-11 essential budget level shown in Table 1. Chart 2.2 shows how the state's long-term net fiscal position would be affected by the inclusion of full funding for the Quality Education Model.

Chart 2.2
LONG-TERM STATE FISCAL POSITION WITH FULL FUNDING OF QUALITY EDUCATION MODEL (in millions of $)



Fully funding the Quality Education Model pushes the state's net fiscal position to -$1.9 billion in the 2009-11 biennium. The gap remains greater than $500 million through the 2015-17 biennium but eventually is eliminated through the long-term growth of the personal income tax. This scenario demonstrates how an increase in the desired service level can dramatically affect the long-term outlook. Although K-12 education is the largest single component of the state's discretionary budget, major General Fund program expansion in areas such as health care, higher education or corrections would also have a significant impact on the state's long-term fiscal outlook. In the past a number of these mandates, such as the state school spending requirement implied by Measure 5 or the increased prison population resulting from Measure 11 (1995) have been triggered by voter initiatives.

Local Governments

This analysis will focus on city and county governments but much of the analysis applies to the special districts as well. Using audited data from all 36 counties and the cities accounting for 88% of total city population, the Association of Oregon Counties and the League of Oregon Cities tabulated revenue and expenditure data for the most recent period available. These data served as the base year (2005-06 for counties and 2006-07 for cities). Projections for revenue and expenditures were then developed by the Legislative Revenue Office. These data are extrapolated forward using known inflation rates and estimated revenue to the 2007-08 base year. Table 2.2 shows the base year estimates for counties and cities combined.

Table 2.2: BASE YEAR REVENUE AND EXPENDITURE ESTIMATES FOR CITIES & COUNTIES

	2007-08 FISCAL YEAR ($ IN MILLIONS)
REVENUE	
PROPERTY TAX	$1,740.5
HOTEL/MOTEL	54.3
OTHER TAXES & ASSESSMENTS	427.4
LICENSE, PERMITS & FINES	407.0
CHARGES FOR SERVICES	595.0
SYSTEM DEVELOPMENT CHARGES	85.5
FRANCHISE FEES	172.7
INTERGOVERNMENTAL REVENUE	1,685.3
FEDERAL FOREST PAYMENTS	203.1
INTEREST EARNINGS	130.3
MISCELLANEOUS	324.7
BOND PROCEEDS	368.4
TOTAL REVENUE	6,190.3
EXPENDITURES	
GENERAL GOVERNMENT	859.9
PUBLIC SAFETY	1,849.1
TRANSPORTATION	752.6
HEALTH	942.2
COMMUNITY DEVLOPMENT	420.8
CULTURAL & EDUCATION SERVICES	236.2
PARKS & NATURAL RESOURCES	180.4
CAPITAL OUTLAY	589.9
DEBT SERVICE	409.5
MISCELLANEOUS	55
TOTAL EXPENDITURES	6,295.7
NET FISCAL POSITION	-100.7

The baseline data shows that property taxes and intergovernmental revenue (primarily from the state), are the two major sources of revenue for cities and counties. On the expenditure side public safety and health are the largest categories. The extrapolations show that the cities and counties have a -$100.7 million fiscal position in the 2007-08 base year. This means that cities and counties as a whole were required to go into reserves or cut expenditures in order to balance their budgets for the base year. The primary reason for the current fiscal pressure is a price level that is rising faster than local government revenues. The state and local government deflator, designed to measure inflation for the market basket of goods and services purchased by governments, increased 5.1% in 2007 and a projected 6.4% in 2008.

In order to develop long-term fiscal projections for city and county governments as a whole, each of the revenue and expenditure categories in Table 2.2 is projected forward using variables from the state economic and demographic forecast (September 2008). The projections rely heavily on inflation forecasts using various deflators for specific GDP components from the national economic forecast upon which the state forecast is based. The most common inflation measure used is the state and local government deflator. Overall state population projections are also used extensively to estimate growth in demand for services and growth of the revenue base. For a complete list of the variables used to project each of the categories see Appendix C.

Two key revenue categories are largely unaffected by the assumptions about inflation and economic growth: property taxes and federal timber payments. Property tax revenue growth is restricted by Measure 50 while federal timber payments are a political decision made by Congress. Property taxes are assumed to grow 4.5% annually over the long-term. This includes the 3% limit on value growth for existing property under Measure 50 and an additional 1.5% for new construction. It is important to note that new construction comes on the property rolls at the property change ratio (average assessment ratio for that class of property in the county) and not at market value. This means that over time, assessed value will fall further behind market value as the economy grows. Property taxes are currently about $9 per $1,000 of market value. By 2019-20 they are expected to fall to $6.50 per $1,000 of market value. The estimates for federal timber payments have been updated to reflect the 4-year extension of the program approved by Congress as part of the financial rescue package in early October, 2008. Title 1 timber payments (from both Forest Service Lands and O & C Lands) are projected to drop from $203.8 million in 2007-08 to $182.1 million in 08-09, $163.8 million in 09-10, $147.7 million in 11-12 and $81.5 million in 12-13 before dropping off to the residual level of $24.5 million through the remainder of the forecast horizon. In effect, the extension moves the county fiscal crisis out into the future but does not avoid it.

Table 2.3 shows the projected revenue and expenditure categories for the 2019-20 fiscal year. The projections show that current service expenditures, largely driven by population growth and inflation, are expected to grow faster than revenue growth. By 2019-20 current service expenditures are expected to exceed current law revenue by $702.2 million.

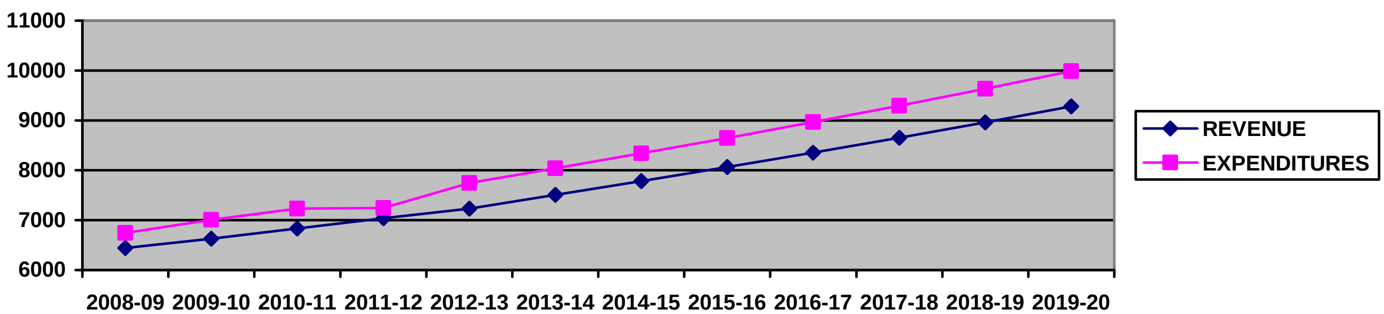
Table 2.3: PROJECTED REVENUE AND EXPENDITURES FOR CITY AND COUNTY GOVERNMENTS

	2019-20 FISCAL YEAR ($ IN MILLIONS)
REVENUE	
PROPERTY TAX	$2,951.7
HOTEL/MOTEL	81.3
OTHER TAXES & ASSESSMENTS	640.5
LICENSE, PERMITS & FINES	588.1
CHARGES FOR SERVICES	891.7
SYSTEM DEVELOPMENT CHARGES	128.1
FRANCHISE FEES	216.8
INTERGOVERNMENTAL REVENUE	2,525.6
FEDERAL FOREST PAYMENTS	24.5
INTEREST EARNINGS	195.3
MISCELLANEOUS	486.7
BOND PROCEEDS	552.1

TOTAL REVENUE	9,281.8
EXPENDITURES	
GENERAL GOVERNMENT	1,361.6
PUBLIC SAFETY	3,021.5
TRANSPORTATION	1,149.2
HEALTH	1,567.4
COMMUNITY DEVLOPMENT	666.4
CULTURAL & EDUCATION SERVICES	374
PARKS & NATURAL RESOURCES	285.6
CAPITAL OUTLAY	934.1
DEBT SERVICE	537.5
MISCELLANEOUS	87.1
TOTAL EXPENDITURES	9,984.5
NET FISCAL POSITION	-702.2

Chart 2.3 shows that the fiscal position of cities and counties as a whole, slowly deteriorates as property taxes fail to keep up with costs and timber payments are phased out.

Chart 2.3: LONG-TERM CITY AND COUNTY FISCAL POSITION UNDER TREND PROJECTIONS (in millions of $)



It is important to note that the future fiscal position for cities and counties is highly dependent on the assumed inflation rate. The baseline forecast assumes that the recent resurgence of inflation is temporary and overall inflation is expected to return to the 2 to 2.5% range. The baseline forecast for the state and local government deflator (used extensively in the projections) is forecast to drop from 6.4% in 2008 to 2.7% in 2009 and average between 2 and 2.5% annually through the remainder of the forecast. This would tend to keep property tax revenue growth relatively close to the increasing cost of services. To see the importance of this assumption, the Task Force examined an alternative scenario in which inflation, as measured by the state and local government deflator drops backs to 5.1% (the rate for both 2006 and 2007) and remains there through 2019-20.

Chart 2.4 compares the city and county net fiscal position for the baseline projections with the alternative scenario based on the higher 5.1% inflation assumption. Under this scenario current service expenditures continually outpace revenue. The net fiscal position of the county-city system deteriorates annually reaching -$2.8 billion by the 2019-20 fiscal year. This is because assessed property values do not respond to the higher inflation environment—property tax revenue growth remains locked in at 4.5% per year regardless of the inflation rate. This scenario shows the risk that higher inflation poses for the relatively inflexible county and city revenue system.

Chart 2.4: LONG-TERM CITY AND COUNTY FISCAL POSITION UNDER HIGHER INFLATION ASSUMPTIONS (in millions of $)

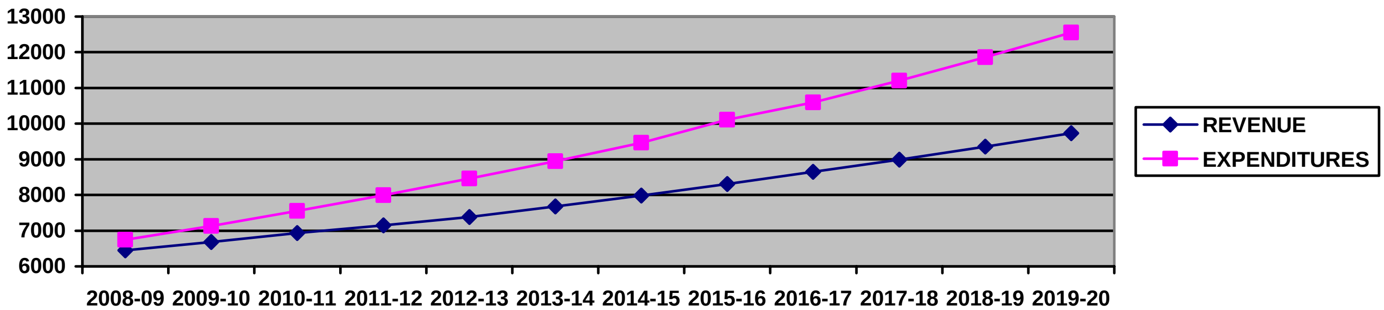
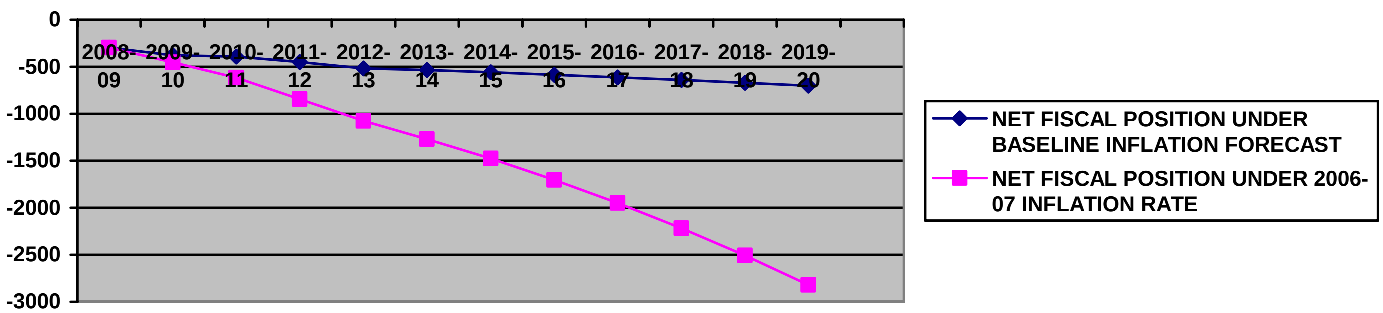


Chart 2.5 compares the fiscal gap estimates under the two inflation scenarios.

Chart 2.5: FISCAL GAP ESTIMATES UNDER THE BASELINE INFLATION ASSUMPTIONS AND THE HIGHER 2006-07 INFLATION LEVELS (in millions of $)



As is the case for the state analysis, it is important to note the limitations of this type of trend analysis. First, the projections are for the system as a whole—counties and cities vary widely in their overall size and the services they provide to their constituents. Secondly, these projections are not predictions. Local policy-makers are required to respond to budget imbalances—fiscal imbalances would not accumulate year after year. Finally, the forecasts for the individual categories are crude even in the aggregate. A more sophisticated approach would include more refined variables to project the different revenue and spending categories. Despite these limitations, the trend analysis provides state and local government policy-makers with a broad overview of where fundamental forces are driving the local revenue system.

Conclusions

- State government's discretionary budget, where the personal income tax is the dominant revenue source, is expected to generate sufficient revenue to offset the growth in costs of providing the current service budget level over the long term.
- Despite the expected trend for state discretionary revenue and spending, a number of factors are likely to create fiscal pressure for the state in the future. Most prominent of these factors are:
    - The volatile nature of the personal income tax means revenue growth is likely to be erratic and hard to predict. Interaction with the 2% surplus kicker revenue limit means the state discretionary revenue situation will vary greatly from biennium to biennium.
    - Federal revenue accounts for about 20% of the state's All Funds budget. Federal revenue is particularly important in service areas such as health and transportation where costs are expected to continue rising rapidly. Retrenchment at the federal level could significantly affect the state's fiscal situation.
    - Demands for new programs or major program upgrades could change the state's fiscal position dramatically. For example, adoption of a fully funded Quality Education Model would quickly turn the state's fiscal position negative for an extended period of time without a major offsetting revenue stream. Similar concerns would apply to health care, higher education and corrections spending.
    - In the past, a number of the demands for new programs or reduced revenue have originated from voter initiatives. Passage of voter initiative such as Measure 5 (1990) or Measure 11 (1995) can change the state's fiscal situation significantly.
    - Although the state's discretionary revenue stream is responsive to economic growth over time its transportation funding stream is not. Fuel tax and vehicle registration revenue is expected to remain flat at best unless rates or fees are increased by the Legislature.
    - Capital expenditures for new or replacement infrastructure are not accounted for. The analysis includes debt repayment for existing bonds but does not include any new funding for infrastructure spending.
    - Increased proportion of costs for shared service provision with counties and cities. County and city revenue streams are likely to lag behind both costs and the state revenue stream putting additional fiscal pressure on the state to pick up a larger share.
- In contrast to the state, the local city and county revenue system is stable and predictable but it is not very responsive to economic growth. This means that counties and cities are expected to see a continuous decline in their fiscal position over time under the current revenue structure. Under a benign long-term inflation forecast contained in the baseline projection, the city and county fiscal system continually lags behind the cost of providing services as property revenue grows slowly under Measure 50 limitations and federal timber payments are phased out.
- A major risk for the county and city revenue system as it currently exists is the continuation of higher inflation. The state and local government purchase price index has risen by more than 5% annually over the past three years. If the 5.1% inflation rate experienced in both 2006 and 2007 were to continue through 2019-20 the county and city fiscal system would come under enormous pressure. The net fiscal position for counties and cities as a whole would decline sharply reaching -$2.8 billion by the 2019-20 fiscal year.