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## Oklahoma Policy Institute

### SPECIAL POINTS OF INTEREST

- Oklahoma will face prolonged constraints on the state budget, even as the economy and state revenues recover;
- Our forecasts suggest that even by FY '14, it is unlikely that revenues and spending will return to pre-downturn levels under current policies;
- The FY '12 budget shortfall looks to be nearly \$400 million compared to FY '11 ;
- Agencies have already enacted deep cuts and facing growing costs and needs.
- Faced with a new fiscal reality, the state needs to create a revenue structure that better supports public services, make smarter expenditure decisions, and create a budget process that supports sound and responsible fiscal management and planning.

## A NEW FISCAL REALITY FOR OKLAHOMA:

# THE STATE BUDGET OUTLOOK, 2011-2014

### I. Introduction

As Oklahoma enters the third year of a deep and prolonged fiscal downturn, it has become increasingly clear that our budget system is not up to the challenge. As revenue has fallen, the state has been unable to develop a long-term, coherent response that protects essential public services, uses our resources wisely, and sets the stage for capitalizing on the eventual economic recovery. Instead, we have failed to anticipate the severity and the length of the revenue loss, made repeated budget cuts without fully considering impacts on services and staffing, and plugged holes with one-time fixes.

While the economy has already begun to recover and will continue to do so, mounting evidence suggests that Oklahoma is unlikely to return to the days of the mid-2000s when revenue

growth was sufficient to meet many of the state's greatest needs. Several factors suggest prolonged constraints on the budget, even as revenue grows in response to the economic recovery:

- Revenue growth will be relatively constrained for



- the foreseeable future;
- Decisions already entrenched in law will further erode revenue collections;
- Federal relief and state reserve funds that prevented a complete fiscal meltdown have largely been used up;
- The cost of restoring

essential services like education, health care, transportation and public safety to pre-downturn levels and keeping pace with caseload growth and inflation will far exceed revenues available under current law; and

- We've made little progress in improving our fiscal planning and management capabilities.

Oklahoma Policy Institute's forecasting project is designed to help Oklahomans better understand the fiscal picture for the next few years. It also seeks to help leaders develop and use tools to create a fiscal system that helps us meet the new budget reality of limited revenue growth and extensive budget needs. This brief makes several contributions to this effort. First, it presents up-

dated revenue forecasts for the current and three successive fiscal years that suggest that revenues are unlikely to return to pre-downturn levels before 2014. Second, it describes the budget outlook for fiscal year 2011-12 (FY '12) and beyond, suggesting that the state will face serious ongoing budget shortfalls over the coming years in the absence of new revenues. Third, it recommends changes in revenue and expenditure decisions and in fiscal management that can help Oklahoma create a budget that meets the state's needs in a changing environment and be better prepared for the next economic downturn.

**II. Revenue Outlook: FY '11– '14**

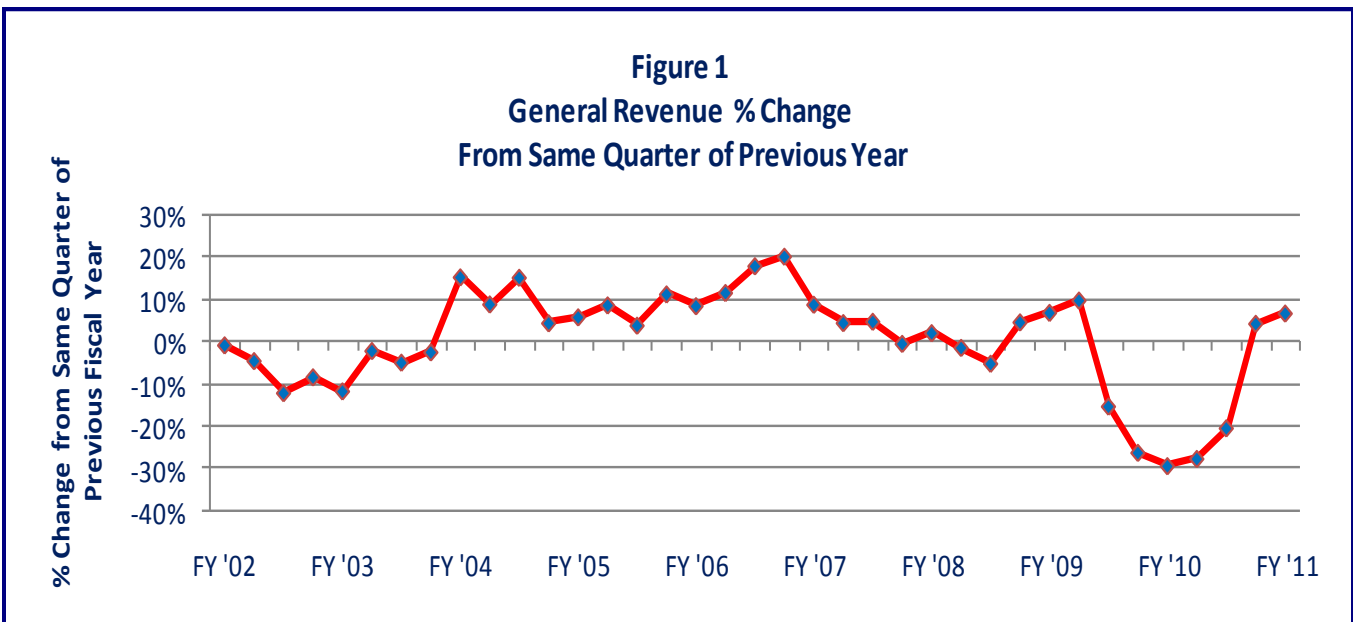
Sound financial decisions require a thorough understanding of the revenue outlook, not just for a single budget year, but for several years. This section briefly summarizes Oklahoma's recent revenue experience and presents the results of OK Policy's revenue forecasting efforts.

Figure 1 shows quarterly changes in state General Revenue (GR) collections compared to the same quarter for the previous year. After the last revenue downturn, which ended in FY '03, revenue grew steadily (for 20 of the next 22 quarters) and strongly (up to a 20 percent increase over the same quarter of the previous year). This prolonged period of growth, in which taxes were cut and new programs funded, was followed by dramatic revenue collapse beginning in the middle of FY '09 as the effects of the national economic recession hit Oklahoma. Revenue fell for five straight quarters and fell by as much as 30 percent from the previous years' level. While the figure shows two quarters of growth have followed this dramatic revenue drop, it does not indicate what to expect for the rest of the current fiscal year, or into the near-term future.

Our forecasting project relies on several different approaches to forecasting. Forecasting always involves

a study of the past to inform a prediction about the future, but there are several methods, ranging from simple and intuitive to complex and mathematical, to transform past fact into future forecast. We made seven forecasts, using four different methods (The methods are explained in detail in a Technical Memorandum available on our website at [okpolicy.org/current-budget-information](http://okpolicy.org/current-budget-information)).

- Two forecasts are based on analyzing revenue trends during the downturn to estimate the path of the expected upturn. One of these forecasts is more optimistic about a strong economic recovery, while the other assumes a prolonged period of limited economic growth.
- Two forecasts are based on analysis of revenue data over a longer history.



One of these matches this revenue downturn to the last one, which began in 2002, and seeks to use the previous experience to project the current one. The other historical forecast uses the revenue from the first quarter of the current year (FY '11) to estimate the full year's revenue.

- Two forecasts use regression analysis to study the past relationship between revenue and economic conditions, specifically the gross domestic product and natural gas prices. Formulas derived from these analyses are then used to project future revenue. These forecasts must rely on experts' forecasts for future economic growth and gas prices, which may not be accurate.
- One forecast is an autoregressive forecast that studies quarterly revenue changes for the past decade and then predicts underlying trends into the future.

The forecasts only project recurring revenue for the General Revenue Fund (GRF), which in FY '11 accounts for 80 percent of ongoing state revenue and 69 percent of all available revenue (including federal and reserve funds). The forecasts provide revenue estimates for 16 fiscal quarters, from July-September 2010 (the first

quarter of FY '11) to April-June 2014 (the fourth quarter of FY '14).<sup>1</sup> Each forecast result is adjusted for changes in revenue that will result from laws that are already in place. The largest of these is continued income tax reductions, which will increase the standard deduction and reduce the top tax rate. Together, these reductions will cost an additional \$245

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million – nearly five percent of total revenue - by the end of the forecast period. Other changes, such as diverting revenue to the ROADS transportation program and Oklahoma's Promise scholarship program, eliminating the estate tax, and various one-time revenue enhancements passed in recent legislative sessions, will cost an additional \$200 million in net revenue by FY '14.

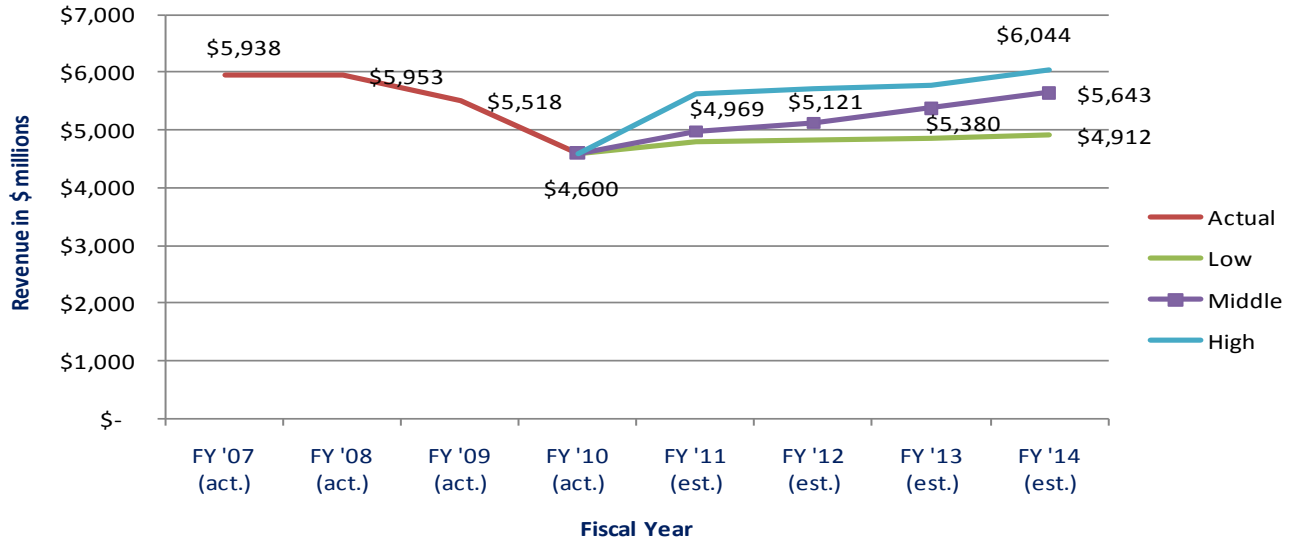
In order to simplify the discussion and give a clearer picture of the most likely fiscal path, discussion in this brief is limited to the lowest and highest forecast values as

well as a “middle scenario,” which represents the median (the figure where half the individual forecasts are above and half below) for each quarter. Revenue estimates in this brief are compiled into annual forecasts from the more detailed original quarterly forecasts. Readers are encouraged to review the 2010 Technical Memorandum on our website for more information on how each forecast was developed, the impact of law changes discussed above, and the quarterly and annual results for each of the seven forecasts.

Figure 2 (next page) shows the forecasts in the context of recent years' actual revenue. These forecasts paint a clear picture of slow but steady revenue recovery through the next four fiscal years. They do not, however, suggest a return to the high growth rates from FY '04 through FY '08. Indeed, **they indicate that even by FY '14 it is unlikely that revenue will return to the FY '08 peak.** In other words, Oklahoma can expect to experience *at least seven fiscal years with revenue below the 2008 level.*

The middle scenario, which OK Policy recommends for the purposes of budgeting and fiscal planning, indicates healthy revenue growth in FY '11 (\$369 million, or 8 percent, over FY '10 actual), followed by lower growth for FY '12 (an increase of \$152 million, or 3 percent) and five percent growth each in FY '13 and '14. The lower

**Figure 2  
GRF Revenue, FY '07 to FY '14,  
Actual and OK Policy Forecasts**



growth for FY '12 results from the end of one-time revenue increases for the FY '11 budget and the expected 0.25 percentage point reduction in the state income tax, which under current law is triggered the first year that revenues are projected to grow by more than four percent. *By FY '14, revenue under our middle scenario - \$5.6 billion - would have increased \$1 billion from FY '10 but would still be below FY '07 and FY '08 levels.* Forecasts are uncertain, however, and it is important to consider that a much broader range is possible. Revenue could be as low as \$4.9 billion or as high as \$6.0 billion.

It is important to remember that the figures incorporate revenue losses already built into law. The FY '14 revenue could be \$140 million higher if the ROADS fund

deposit were capped at its current level, another \$120 million higher if the top income tax rate is left unchanged, and \$130 million higher yet if tax incentives that were temporarily suspended in FY '11 were repealed. If all were adopted, the middle scenario would result in a forecast of slightly over \$6 billion for FY '14. Yet given inflation, population growth and growing unmet needs, even this figure would not restore public services to their FY '08 level, let alone make investments in a better economy and society that most Oklahomans expect.

**II. Budget Outlook: FY '11-14**

General Revenue Fund revenue forecasts provide an important part of the budget picture, but not the whole thing. There is more revenue to consider than just the GRF and it is just as important to

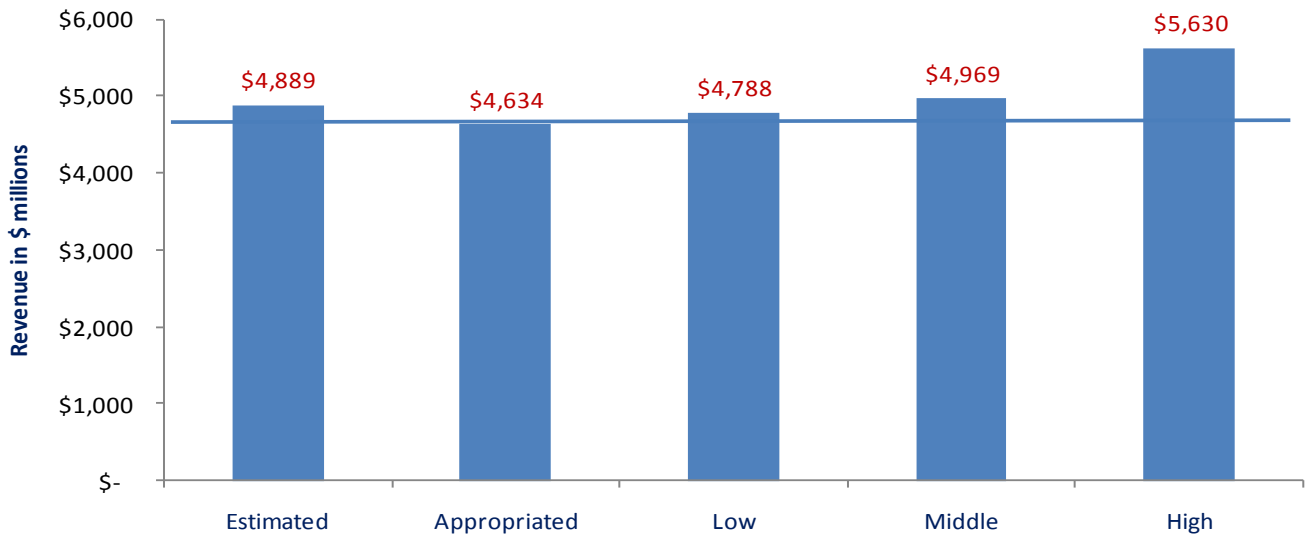
look at the budget – and the services it will buy – as it is to examine revenues.

This section addresses three key questions about the state's mid-range budget outlook:

- Will current year revenue be sufficient to sustain the adopted FY '11 budget?
- What is the likely budget picture for FY '12?
- What is the budget outlook beyond FY '12?

To the first question, Figure 3 shows that current year revenue should be sufficient to support the budget and start building up the state's depleted cash balances. The first bar shows the original GRF estimate, \$4.889 billion. The next bar is the appropriated amount, \$4.634 billion, which is

**Figure 3**  
**FY '11 Forecast Revenue**  
**Compared to Estimate and Appropriation**



95 percent of the certified estimate allowed under Oklahoma law. Even the low forecast indicates revenue higher than this appropriated amount. The middle forecast, with revenue of \$4.969 billion, would be sufficient to exceed appropriations and would exceed the original estimate. The amount by which revenue exceeds the estimate (\$80 million in our projections) would be deposited in the now-depleted Constitutional Reserve, or Rainy Day Fund (RDF). The high forecast indicates significantly higher revenue - \$741 over the estimate and more than a billion higher than appropriations. This seems unduly optimistic given recent history .

The message of the forecasts as a whole, that current year revenue will be sufficient to meet the budget, is supported by revenue

results for the first four months of the fiscal year, in which actual revenue has exceeded the estimate by four percent.<sup>2</sup> If that performance were to continue, the revenue for the year would be \$5.08 billion or about \$190 million over the middle forecast .

The second question – the budget outlook for FY '12 – is uppermost in the minds of legislators, state agencies, and all Oklahomans who benefit from public services as the Legislature prepares for the 2011 session. *OK Policy's forecasts indicate that in the absence of revenue-generating measures, the overall budget in FY '12 will be nearly \$400 million less than in FY '11.* This is particularly troublesome given that two years of repeated budget cuts have significantly hampered many Oklahoma

public services. Public safety is jeopardized by staff reductions in Corrections, and other departments. Funding cuts to common education have led to layoffs of teachers and support staff, increased class sizes, elimination of programs, and reductions in essential support services. Social services have been reduced or eliminated just when economic conditions make them more essential than ever. Mental health and substance abuse services have been drastically curtailed, as have youth detention and gang prevention programs, important Medicaid benefits, and services for young children with developmental delays. Across all agencies, services have been reduced and delayed by high employee vacancy rates.

Figure 4 suggests that state services will continue to erode in FY '12 and beyond. The graph shows recent state budgets along with OK Policy's projections through the FY '14 budget. It is important to note that our scope here shifts from the GRF to all resources available for appropriation. In addition to the GRF, this includes available cash carryover and other state funds such as the HB 1017 Education Reform Fund and the Transportation Fund. It also includes the RDF, which is available to appropriate in certain revenue shortfall situations, and federal stimulus funding from the American Recovery and Reinvestment Act (ARRA). Readers are again encouraged to refer to the Technical Memorandum for information on how future budgets are estimated and should be aware these estimates are

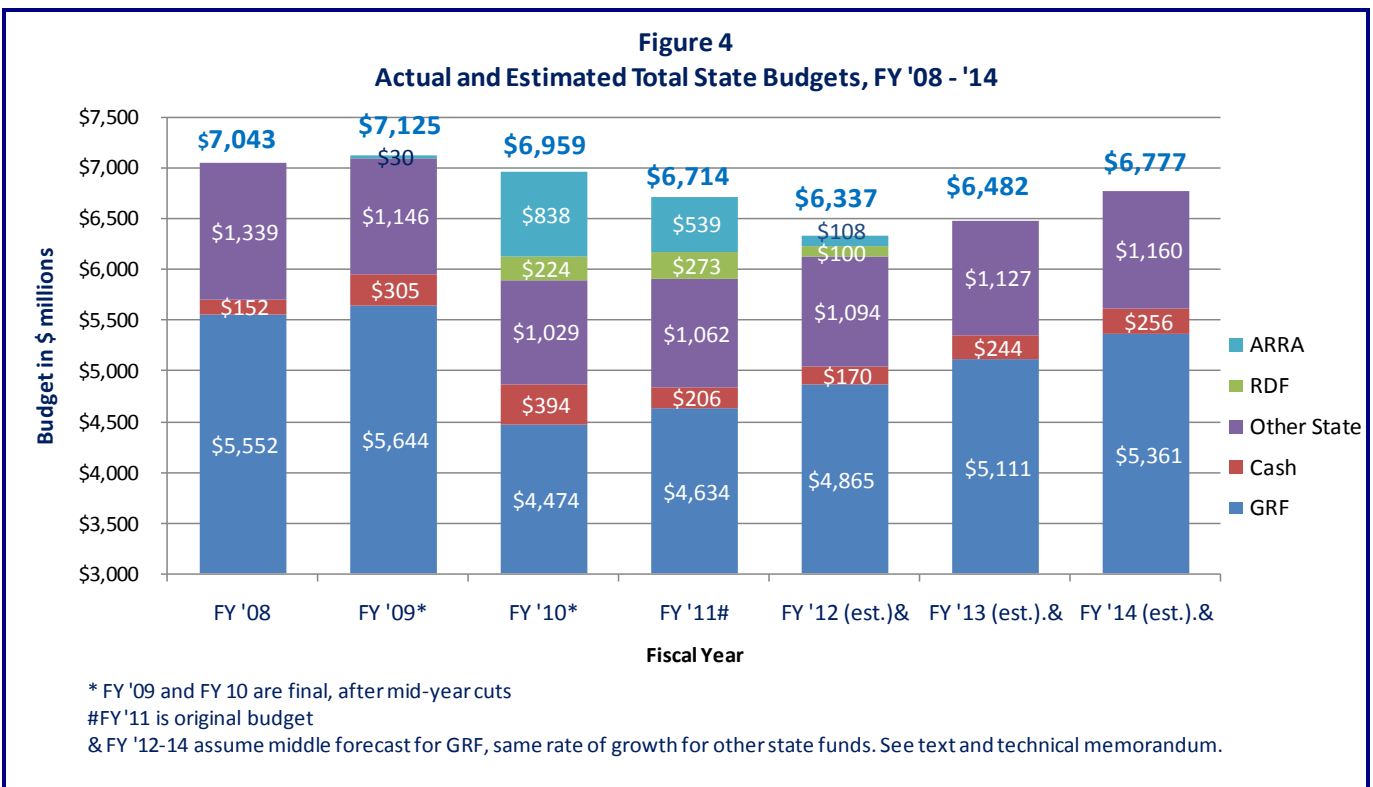
less precise than the forecasts of GRF revenue alone.

The figure shows the importance of the RDF and ARRA funds in mitigating the magnitude of cuts to agency budgets in FY '10 and FY '11. In spite of these infusions of funds, however, appropriations fell by \$166 million from FY '09 to FY '10 (after midyear reductions) and by another \$245 million to FY '11. Without additional revenue, OK Policy's projections suggest that the FY '12 budget will have the biggest reduction yet - \$377 million, or 6 percent more. *This could mean a cumulative budget reduction of nearly \$800 million or 11 percent across all areas of state government, in three fiscal years.*

Figure 4 shows that the forecasted increase in GRF and other state funds is not nearly sufficient to make up for the drop in RDF and ARRA funds. GRF is forecast to increase \$231 million (5

percent) in FY '12. That projection is 95 percent of the middle revenue forecast discussed above. Other state funds are assumed to grow 3 percent per year. The FY '12 estimate for the Rainy Day Fund consists of amounts set aside for that year by the 2010 legislature. ARRA money, which contributed as much as 12 percent of the budget in FY '10, will be down to \$108 million in carry-over funds in FY '12, just 2 percent of the budget.

As bad as this appears at first glance, the reality may be worse. Budgets do not stand still, and even if FY '12 funding reached FY '11 levels, it would not meet the growing needs of state government and its services. The Oklahoma Health Care Authority, for example, has identified \$120 mil-



lion in additional costs just to maintain existing SoonerCare (Medicaid) services and to increase payments to doctors and other medical providers back to their FY '09 rates.<sup>3</sup> The State Department of Education has requested \$295 million to restore spending for schools to the FY '10 level.<sup>4</sup> The Department of Corrections needs additional funding to address critical staffing shortages and end furloughs. The Department of Public Safety will need additional funding to once again recruit and train new officers. Many state and local programs will need funding to replace ARRA money that flowed outside the state budget for special education (\$75 million), educating disadvantaged students (\$55 million), Supplemental Nutrition Assistance Program (SNAP, or food stamps, \$110 million), and other needs. The higher education system faces the loss of \$80 million in ARRA-funded Pell Grants for low-income students. In short, the \$377 million drop in revenue represents only about half of the total budget shortfall for FY '12.

Future legislatures will face similar difficulties. In FY '13, the loss of the remaining ARRA and reserved RDF money will be exceeded by forecasted growth in GRF, cash, and other state funds, but net budget growth is estimated at just \$145 million, or 2 percent. Only in FY '14 is forecast revenue growth significantly greater than the loss of one-time revenue. Even then, our forecast is for the budget to remain well below the FY '10 final budget and

would not begin to meet growing costs of and demands for services. Teachers and state employees will justifiably expect pay increases after years of flat pay rates and furloughs. Retirement and health care costs will continue to grow. Most agencies and school systems will still be well below historical staffing level. Demand for many state services will grow, largely outside the control of the Legislature and agencies.

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It is unlikely that Oklahoma will have sufficient resources under current law to restore services to the FY '08 level within our forecasting horizon. Nor is the FY '08 level of service necessarily the appropriate yardstick. Oklahoma state and local governments spent 18 percent less per capita than the national average in FY '08.<sup>5</sup> Results of this under-spending are easy to spot in low educational performance, low rates of college attendance and graduation, infrastructure in poor condition, inadequate service and poor outcomes in health and mental health, and failure to develop and invest in alternatives to incarceration.

#### IV. Recommendations for the New Fiscal Reality

If Oklahoma wishes to restore its public services to pre-recession levels, meet its financial commitments, invest in better education, support those in need, and be ready to compete in a knowledge-based national and world economy, it cannot continue its present fiscal structure or approach. A new fiscal reality requires a fresh perspective and new strategy. Oklahoma Policy Institute's recommendations can help move in this direction.

**1. Create a revenue structure that supports public services even in times of modest revenue growth:** Most of the benefits of economic growth are threatened by revenue decisions that were made in better times. Those times are over, and decisions should be evaluated in a new light. Specifically, Oklahoma should:

- *Defer or repeal additional income tax cuts.* The cut in the top income tax rate from 5.5 to 5.25 percent is likely to be triggered in 2012 even though revenue collections and budgets remain substantially below pre-downturn levels. This tax cut will cost \$120 million per year when fully phased in, representing more than a two percent cut

in GRF revenue at a time when even five percent revenue growth may be optimistic.

- *Reduce tax exemptions, credits, and rebates.* These are expenditures, regardless of what we call them, and they should undergo the same scrutiny as all expenditures. This can begin with a thorough review of income and gross production tax credits and rebates that were suspended or deferred for FY '11, but Oklahoma should undertake a review of the economic benefits and costs of all tax preferences within the next three years.

- *Find new revenue to support the Medicaid program.* Oklahoma was spared extreme fiscal hardship by the increase in ARRA funding for Medicaid. The state's cost for the Medicaid program will shortly return to record high levels. We cannot afford not to provide health care for our neediest neighbors, nor can we afford further cuts in other services to fund Medicaid. We should explore hospital assessments and other revenue streams aggressively.

- *Look at raising taxes on costly and risky behaviors,* such as alcohol consumption, tobacco usage and perhaps sugared drinks to help pay for the cost of treat-

ment and prevention of such social and health problems as addiction, lung disease, and obesity.

- *Make our tax base both broader and fairer,* so the state can restore a sustainable budget while reducing the share of taxes paid by low- and middle-income Oklahomans. The state income tax can be made both fairer and simpler

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by following the lead of states that do not allow taxpayers to itemize deductions but give all taxpayers a more generous standard deduction.<sup>6</sup> Under this proposal, the state could fund more services while twice as many taxpayers would pay lower taxes than higher ones. Similarly, expanding the base of the sales tax to cover more services could increase revenue, allow for modest rate reductions, and reduce taxes for many taxpayers. Both changes would better fit the evolving service-based economy.

## **2. Make smarter expenditure decisions that reduce future costs.**

Oklahoma will not be able to meet the demands for service in the forecast period and beyond. We must be sure our spending for each service is proportionate to the need and that spending is, wherever possible, an investment that reduces costs later. Oklahoma should:

- *Consolidate agencies and programs and streamline services where savings can be reasonably expected.* Oklahoma splits power and resources among several agencies with similar responsibilities in such key areas as education, law enforcement, environmental protection, and economic development. We should determine how much can be saved by combining programs to take advantage of centralized administration and reduced duplication in the field.
- *Prioritize prevention, diversion, and surveillance over detention.* Oklahoma cannot afford to lead the nation in incarceration any longer. We should cap and then reduce spending on corrections and shift funding to mental health and substance abuse treatment, and programs that help prisoners re-enter society when their sen-

tences are complete.

- *Develop and implement a plan to fund public pensions without renegeing on commitments made to current teachers, police officers, firefighters, and other public employees.* In Oklahoma and across the nation, government services are threatened by the ultimate cost of these benefits. They must be controlled and funded now, while financially feasible solutions still exist.

**3. Create a budget process and structure that better supports sound and responsible financial planning and management.** The revenue downturn has shown once again that Oklahoma is not prepared for sudden fiscal shocks. Among the few certainties in forecasting is that we will be facing another such shock in the next few years. Whether it is in three years or ten, we must prepare now so that to improve our abilities to both understand and withstand that shock. Specifically, Oklahoma should:

- *Incorporate mandatory long-range forecasting of revenues and expenditures in its annual budget process.* The December and June Board of Equalization certifications, which are presently limited to estimates for the current and upcoming year, should include three-year, non-binding forecasts. Initially, say with the June

2011 certification, this can be done with existing staff in the Office of State Finance, Tax Commission, and legislative branch. Beginning in FY '12, the state should convene university and private economists to develop ongoing forecasts that help guide all major financial decisions.

- *Adopt mandatory pay-as-you-go legislation in the 2011 ses-*

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*sion.* No new programs, significant changes in existing programs, and new tax expenditures and credits should be adopted unless offset by new revenues or reduced expenditures that pay for the changes over at least five years.

- *Continue to improve reserve policies.* Approval of State Question 757, which increased the maximum level of the RDF to 15 percent of one year's revenue to the GRF, was an important first step. Had this been in place four years earlier, the state could have avoided \$300 million in

budget cuts in FY '10 and '11 or put more aside for FY '12 and FY '13. Work still remains, though. We should determine whether it is more prudent to tie RDF deposits to economic growth, rather than the current system of making deposits that depend on the accuracy of revenue forecasting. We should also re-evaluate limitations on how funds become available to spend over the course of a revenue downturn. Further, we should create an additional reserve of gross production tax revenue that smoothes out budget growth by automatically reserving tax revenue in years of high prices and production and spends it in years when tax revenue falls.<sup>7</sup>

#### IV. Conclusion

Oklahoma has been through a period in which economic contraction and a collapse in the natural gas market have left us little choice but to drastically reduce the public services Oklahomans depend on. As the economy returns to a growth path, now we do have choices. We can choose to keep on emptying the revenue stream, spending

on favored programs without demanding results, and taking life one fiscal year at a time, as we have through many years. Or we can choose to reevaluate our environment and craft a new fiscal approach that values good planning, effective spending, and generating sufficient revenue to make Oklahoma smarter, safer, and more competitive. We must choose wisely.

This brief was authored by Paul Shinn, Consultant, under the supervision of David Blatt, Director. The Technical Memorandum accompanying this brief and a one-page summary can be found at:

<http://okpolicy.org/new-fiscal-reality>

#### ENDNOTES

<sup>1</sup> One forecast is limited only to FY '11, because its method offers no information on future fiscal years.

<sup>2</sup> Oklahoma State Treasurer, "October Revenue Collections Continue Positive Trend, Top Prior Year and Estimate," Nov. 9, 2010; available at <http://www.nga.org/Files/pdf/1010STATEGOVTRDESIGN.PDF>.

<sup>3</sup> Oklahoma Health Care Authority, "SFY 2012 Budget Request Detail," (Nov. 16, 2010).

<sup>4</sup> Megan Rolland, "Oklahoma's Department of Education Seeks \$295M to Close Budget Gap," *The Oklahoman*, Nov. 17, 2010; available at [http://www.newsok.com/article/3515225?searched=department%20of%20education&custom\\_click=search](http://www.newsok.com/article/3515225?searched=department%20of%20education&custom_click=search).

<sup>5</sup> For the United States as a whole, state and local government expenditures totaled \$2,838,835,748,000 and population was 304,374,846, for per capita expenditures of \$9,327. For Oklahoma, expendi-

tures were \$27,429,577,000 and population was 3,644,025, for per capital expenditures of \$7,527. Source for expenditures: U.S. Bureau of the Census, "Table 1, State and Local Government Finances by Level of Government and by State, 2007-08;" (2010) available at <http://www.census.gov/govs/estimate/>; Source for population: U.S. Bureau of the Census, Population, population change and estimated components of population change: April 1, 2000 to July 1, 2009 (NST-EST2009-alldata), (2010); available at <http://www.census.gov/popest/states/states.html>.

<sup>6</sup> Oklahoma Policy Institute, "Limiting itemized deductions would improve the fairness and adequacy of the state income tax," (August, 2010); available at <http://okpolicy.org/blog/taxes/limiting-itemized-deductions-would-improve-the-fairness-and-adequacy-of-the-state-income-tax/>.

<sup>7</sup> In 2010, Governor Henry vetoed HB 3032, which the Legislature passed to create such a reserve.

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## Better Information, Better Policy

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