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WHAT DO WE DO NOW?

OPTIONS FOR ADDRESSING STATE BUDGET SHORTFALLS

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SPECIAL POINTS OF INTEREST

- Oklahoma is in the early stages of what could be a deep and extended budget crisis;
- Assuming a budget downturn comparable in magnitude to the last one, we project that the state could face an estimated shortfall of some \$2.4 billion in the years ahead;
- During the last downturn, the state utilized a wide array of options at its disposal to balance its budget by tapping into the Rainy Day Fund, enacting revenue enhancements, and implementing budget cuts;
- The state's Rainy Day Fund, which is at its maximum capacity, and state fiscal relief included as part of a federal economic stimulus package can help minimize the magnitude of budget cuts that will harm the economy and threaten essential public services.

Although Oklahoma managed to stave off the national economic downturn longer than most states, the impact of plummeting energy prices and a slowing economy is now clearly being felt on the state budget. Oklahoma has now joined the vast majority of states that are projecting shortfalls for the upcoming budget year.¹ Most analysts are predicting that the current recession will be relatively long and deep, ensuring that the state fiscal crisis will continue beyond the upcoming budget year. If the downturn is of a similar magnitude to the one following the last recession of 2001, we estimate that the state may face a cumulative shortfall over the coming years well in excess of two billion dollars.

The deteriorating budget situation obviously presents tough choices for Oklahoma policymakers. Since Oklahoma is constitutionally prohibited from running a deficit, its options for keeping expenditures aligned with revenues consist primarily of three choices: it can tap reserve funds; it can raise new revenues; and/or it can cut expenditures. In addition to options directly under its control, the state may also be able to draw upon substantial, if temporary, federal funding if Congress approves an economic stimulus package that includes state fiscal relief.

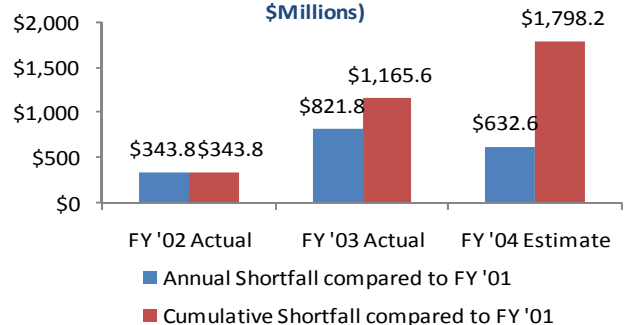
The goal of this brief is to explore the potential and the pitfalls of each of these approaches for addressing the problem of budget shortfalls. We will draw especially on the experience of the last budget downturn from 2002 – 2004 to offer some indication of the potential magnitude of the challenges ahead and of the choices and trade-offs involved in bringing the budget into balance. We conclude that while some level of budget cuts may prove inevitable in the current situation, policymakers will be well advised to consider the full range of available options, including reserve funds, new revenues and potential federal fiscal relief dollars, as alternatives to deep and painful budget cuts that will hurt our economy and threaten essential public services.

How Large of a Shortfall May We Be Facing?

The State Board of Equalization in December provided an initial FY '10 certification of \$6.759 billion, which is \$309.6 million, or 4.4 percent, less revenue than was available for appropriation in FY '09. In advance of delivering his FY '10 budget in early February, Governor Henry pegged the shortfall for the coming year at close to \$600 million, once the need to replace one-time revenues and deal with lost federal funds are considered.²

There is, of course, no way to know the magnitude of the total budget shortfall the state will face over the coming few years. However, looking back to the last economic downturn provides strong

Fig. 1: Annual and Cumulative Revenue Shortfall in Appropriated Funds Compared to FY '01 Baseline (in \$Millions)



Calculated from Board of Equalization Certification Packets, 2001-2004

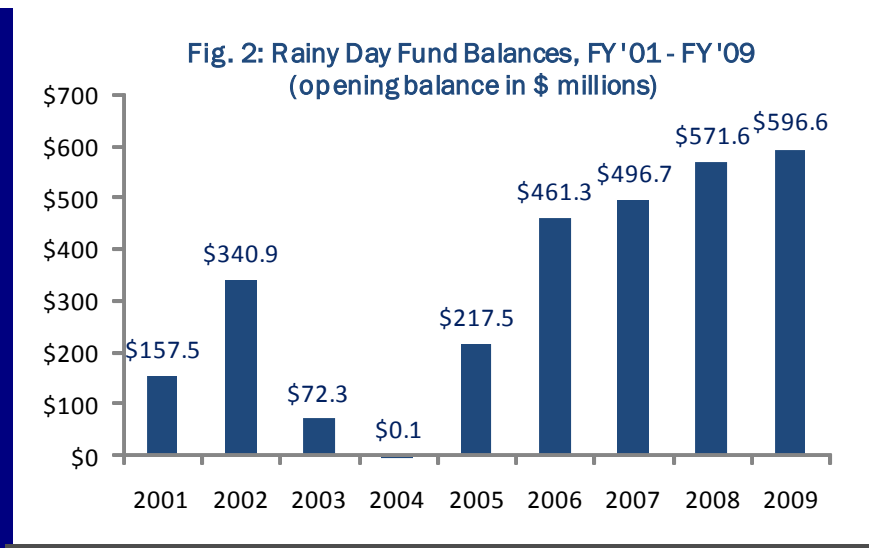
grounds for anticipating that the challenges ahead will be substantial. In the wake of the relatively mild and brief economic recession of 2001, Oklahoma suffered through a deep and extended budget downturn. Declining revenue collections left the Legislature with shortfalls for the three consecutive budget years from FY '02 – FY '04. As can be seen in Figure 1 (previous page), comparing total appropriated revenues over those three years to the last year prior to the downturn (FY '01), we calculate the cumulative shortfall of the last downturn to be just over \$1.8 billion.³ The shortfall does not adjust for inflation or increased costs over the three years of shortfalls.

As great and challenging as this shortfall proved to be, the total was mitigated by an estimated \$200 million in *automatic income tax increases* that were triggered under existing state law as a result of declining revenues.⁴ In the absence of this additional revenue, the FY '02 – FY '04 shortfall would have reached about \$2.0 billion, or roughly 35 percent of baseline revenue collections.

Using FY '09 appropriations minus one-time revenues (\$6.94 billion) as our baseline for the current situation, a budget downturn comparable in magnitude to the last one leads us to project an estimated shortfall of some \$2.4 billion in the years ahead. This figure represents the potential budget gap that would need to be filled through a combination of reserves, new revenues, and budget cuts. Since all indications are that the current economic downturn will be significantly more serious than the one of 2001, the \$2.4 billion estimate may be a conservative projection of the budget gap facing the state before revenues begin to recover.

FILLING THE GAP

During the last downturn of FY '02 – FY '04, Oklahoma policymakers used a wide array of available options to fill budget shortfalls by tapping into reserve funds, enacting revenue-enhancement measures, and cutting agency budgets. We will examine each of these approaches in turn, re-



viewing actions that were adopted during the last downturn and considering the choices that face policymakers in the current budget situation.

OPTION 1: TAPPING THE RAINY DAY FUND

Of the three basic approaches that Oklahoma can take to keep revenues and expenditures aligned, tapping into the Constitutional Reserve Fund, or Rainy Day Fund (RDF), is the least painful and harmful to the state's economy and population. However, even though the Rainy Day fund is currently filled to its maximum level, withdrawing these reserves is likely only to cover partially the budget chasm ahead.

In 1985, following the severe revenue declines and budget cuts that accompanied the oil bust of the early 1980's, Oklahoma voters approved a constitutional amendment that created the Constitutional Reserve Fund. Oklahoma is among 45 states that currently have a separate fund to help cushion the budget impact of a recession.

Under Article 10, Section 23 of the Constitution, deposits are made into the Rainy Day Fund of all General Revenue (GR) collections that exceed 100 percent of the final certified estimate made by the State Board of Equalization for a given year. Deposits are capped at 10 percent of the GR certification for the preceding year. Since passage of SQ 708

in 2004, *withdrawals* from the Fund are subject to the following rules:

- Up to 3/8th to cover gaps when revenue collections for the *current fiscal year* fall short of appropriated amounts;
- Up to 3/8th to cover a decline between current year GR certification and projected GR certification for the *upcoming year*; and
- Up to 1/4th upon the declaration of an *emergency* by the Governor with legislative concurrence.⁵

As can be seen in Figure 2, the state entered the last downturn in 2002 with \$341 million in the Rainy Day Fund. As revenues came in below the estimate in FY '02 and then plunged further in FY '03, virtually the entire amount of the RDF was tapped in order to minimize cuts and protect essential state services. RDF appropriations totaling \$340.7 million were used to cover major shortfalls in the ongoing operations of the Oklahoma Health Care Authority (\$84 million in RDF appropriations over two years), Higher Education (\$79 million), Common Education (\$72 million), and Human Ser-

vices (\$49 million), along with smaller amounts for Corrections (\$24 million), Transportation (\$17 million), and other agencies (\$15 million).⁶

The Rainy Day Fund was depleted to almost zero by the end of 2003, but was quickly replenished as revenue collections exceeded projections by hundreds of millions in FY '04 and FY '05. Although there have been several bills proposing a vote of the people to raise the 10 percent cap on the Rainy Day Fund to 15 percent, none of these bills gained legislative approval. In each of the last four years, the money available for deposit to the RDF exceeded the ten percent cap, creating "spillover funds". Between FY '06 and FY '08, the Legislature appropriated "spillover" RDF funds totaling \$783 million for a variety of purposes, including: capital and one-time expenditures; ongoing agency operations; the Governor's EDGE research endowment fund; and one-time tax rebates. Last year, a spillover deposit totaling \$82.6 was left unappropriated and has now become part of the revenue available for appropriation in FY '10.

The current balance in the Rainy Day Fund is \$596.6 million. Of the total reserve, up to \$373 million, or 5/8th, is potentially available for appropriation by the 2009 Legislature as follows:

- Up to 3/8th, or \$224 million, to cover part of the decline in projected GR certification for FY '10 compared to the FY '09 GR certification;
- Up to 1/4, or \$149 million, upon the declaration of an emergency by the Governor with legislative concurrence.

A major issue for this year's Legislature will be whether to tap the Rainy Day Fund to help offset revenue shortfalls and mitigate potential budget cuts. There is a temptation *not* to tap into reserve funds, particularly near the start of a downturn when the situa-

tion has not yet reached full-fledged 'crisis'. This was the approach adopted last year when the implementation of income tax cuts enacted in previous sessions helped create a shortfall for the FY '09 budget in the range of \$150 million.

However, while depleting the RDF to the full permissible extent in a single year may seem ill-advised, a strong case can be made that the state's current budget situation is precisely the kind for which the Rainy Day Fund

"Rainy day funds were specifically designed to provide a quick infusion of resources into the economy during a downturn ... It makes little sense to save money as a means of preventing possible cuts in the future if doing so means making definite cuts in the present."

was created. As a recent report from the Center on Budget and Policy Priorities (CBPP) emphasizes, "Rainy day funds were specifically designed to provide a quick infusion of resources into the economy during a downturn to help avoid debilitating cuts to public services at the very time the services and programs are needed most. It makes little sense to save money as a means of preventing possible cuts in the future if doing so means making definite cuts in the present."⁷

The CBPP's report provides several arguments in favor of states beginning to use their rainy day funds now:

- *It's good for the economy:* Unlike budget cuts and tax increases, which pull money *out* of the economy, using rainy day funds takes money from savings and injects it *into* the state's economy. In par-

ticular, spending down reserves can help avoid cuts to programs, such as Medicaid, that serve as "automatic economic stabilizers" during tough economic times.

- *It gives the state time to respond sensibly to its budget problems:* Balancing the budget with rainy day funds is a sensible stopgap measure giving policymakers more time to make decisions about appropriate budget reductions and revenue increases, if the downturn worsens.
- *It won't hurt a state's bond rating:* Credit rating agencies recognize that reserves are accumulated in order to be spent, and expect states to adopt a balanced approach of adjusting spending and drawing on reserves.

However, even if Oklahoma opts to draw down its reserves during the upcoming and subsequent budget years, it is unlikely that the RDF will suffice as a solution. Based on our estimate of a potential \$2.4 billion cumulative shortfall in the years ahead, if the downturn is of a similar magnitude to one following the 2001 recession, the RDF balance would cover just one-quarter of the shortfall, leaving a gap of \$1.8 billion to be addressed by other means.

OPTION 2: RAISING REVENUES

The second option for addressing budget shortfalls is to identify new sources of ongoing or one-time revenues. New revenues can take the form either of *tax increases* or *other revenue-enhancement measures* that do not involve new or increased taxes.

It is widely appreciated that the political and constitutional barriers to raising taxes in Oklahoma are formidable. As a result of SQ 640, passed by a vote of the people in 1992, tax-increase bills must either gain approval of three-quarters of the members of both

chambers or be approved by a majority vote of the people at the time of the next general election.⁸ Since passage of SQ 640, only once has the legislature submitted a revenue increase to a vote of the people (SQ 712, the tobacco tax increase, which was approved in 2004). Tax increases can also be put on the ballot by initiative petition, as was the case with SQ 723, the unsuccessful proposal to raise fuel taxes in 2005.

The experience of the last downturn provides an indication of the strength of the obstacles to tax increases in Oklahoma. Several tax proposals – in particular, a sales tax increase to fund education – were proposed and discussed during the 2003 legislative session, when the budget crisis was in its deepest throes, but none were ever brought up for a formal vote.

While actual tax increases were kept off the table during the last downturn, the Legislature did approve a wide assortment of “revenue-enhancing mechanisms” to help bring the budget into balance. Over the course of FY '03 and FY '04, these measures were projected to generate a total of \$298 million. Over 90 percent of this total involved one-time revenues. As displayed in Table 1, revenue-

enhancements included such measures as: offering a tax amnesty; transferring balances from agency revolving funds; accelerating tax collections; refinancing debt; diverting tax revenue from retirement systems to the General Revenue fund; bolstering tax enforcement; and increasing user fees, among others. The Legislature was also able to get a one-time \$57 million boost by revising its method for forecasting natural gas revenues. While some of these measures were labeled as “tricks” and “gimmicks”, they did minimize the extent of budget cuts to essential state services until tax revenues began to recover, without doing any apparent long-term damage to state finances.

Facing a \$145 million shortfall last session, the Legislature approved several revenue-enhancing measures in order to bring the FY '09 budget into balance and avoid cuts in appropriations.⁹ These measures included:

- A taxpayer “voluntary compliance” initiative, or tax amnesty, that waived penalties, interest and fees for taxpayers filing delinquent returns. The measure was expected to generate \$34.7 million in one-time revenue, but ended up exceeding projections;

- Closing a questionable corporate tax loophole involving Real Estate Investment Trusts (REITs), expected to generate an additional \$6 million in ongoing revenue;
- Transfers of cash reserves from several funds totaling over \$120 million. The bulk of this amount

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(\$108.2 million) was transferred from the fund that collects a portion of tobacco tax revenues intended for the premium assistance health insurance program. The budget also transferred \$10 million from the Treasurer’s Unclaimed Property fund and \$4 million from the Secretary of State. These are all one-time revenues.

Unfortunately for this year’s Legislature, last year’s revenue-enhancement measures already picked clean most of the low-hanging fruit, which means that most other sources of new revenue would involve downsides and difficult trade-offs. Among the proposals that have been floated in discussions at the State Capitol and in bills filed for the 2009 session include: re-evaluating a broad range of tax incentives and exemptions; adopting combined reporting for multistate corporations; privatizing the state lottery; selling water rights; assessing new Medicaid provider fees; and boosting various user fees. These and

Table 1: Revenue Enhancing Measures Approved in the 2002 and 2003 Legislative Sessions

FY'03 Revenue Changes	2003 Revenue	1-Time Revenue
Tax Amnesty Program	\$ 18,800,000	\$ 18,800,000
Workers Compensation Rebate	\$ 11,717,000	
Bonus Depreciation Decoupling	\$ 23,473,800	\$ 23,473,800
FY'04 Revenue Changes	2004 Revenue	1-Time Revenue
Insurance Premium Tax Diversion to GR	\$ 85,792,500	\$ 85,792,500
Natural Gas Price Forecasting Method Revision	\$ 57,700,150	\$ 57,700,150
Debt Refinancing	\$ 35,189,438	\$ 35,189,438
Transfers from State and Agency Funds	\$ 14,003,373	\$ 14,003,373
Sales and Use Tax Remittance Acceleration	\$ 12,952,360	\$ 12,952,360
Increased Court Fees (dedicated to District Ct's)	\$ 9,500,000	
Federal Election Law Compliance Payment	\$ 8,400,000	\$ 8,400,000
Data Mining for Uncollected Taxes	\$ 7,312,413	\$ 7,312,413
Federal Tax Refund Revenue to Offset State Debt	\$ 4,099,680	\$ 4,099,680
Withholding of Non-Resident Pass-through Income	\$ 1,913,184	
State Employee Income Tax Compliance	\$ 1,822,080	
Reduce Holding Period for Abandoned Securities	\$ 1,900,000	\$ 1,900,000
Contractor Sales Tax Compliance Requirement	\$ 921,580	
Sales Tax at Special Events	\$ 917,893	
Miscellaneous	\$ 1,118,126	\$ 326,952
TOTAL	\$ 297,533,577	\$ 269,950,666

Source: Adapted from OSF, Proposed FY'04 Revenue Certification, June 16, 2003 and Oklahoma Senate Staff, FY '03 Appropriations report

other proposals will vary in the extent to which they *represent responsible long-term policy, are politically feasible and would actually generate expected revenues.*

Yet, given the limited reserves in the Rainy Day Fund and the costs associated with budget cuts, options for finding additional sources of revenue should receive serious consideration.

OPTION 3: CUTTING BUDGETS

Whenever there are budgetary shortfalls, making cuts to agency budgets is a virtual certainty. If the budgetary downturn is temporary and mild, there are usually several belt-tightening measures that agencies can implement that may cause minimal disruption to services or undue hardships to clients or employees. These include such things as: spending down reserves; prohibiting non-emergency travel; postponing capital purchases; and implementing hiring freezes. Agencies can also attempt to implement savings and efficiencies in such areas as purchasing, information technology, and financial transactions. Periods of tight funding can be beneficial to the extent that they compel agencies to review and prioritize their operations and identify ways to operate more cost-effectively,

Yet, if most government agencies have a short-term capacity to absorb flat funding or even get by with some level of reduced funding, it should be recognized that, when downturns are extended and severe, cutting budgets is difficult to accomplish and involves painful and harmful consequences to citizens and to the economy. The downside to cutting budgets as a strategy to weathering shortfalls includes the following considerations:

1. *Slashing budgets is economically harmful in a downturn.*

Economic theory suggests that during an economic downturn, govern-

ments should attempt to stimulate the economy by cutting taxes and boosting public spending. However, while running a deficit to stimulate the economy is an option for the federal government, states that are constitutionally required to balance their budgets are left with choices that are all less than ideal in terms of their impact on the economy. Cutting state budgets can have a direct impact on employment and disposable income not only for public employees but for the wide network of private contractors who provide publically-funded services.

There has been growing recognition of the serious economic costs associated with slashing state budgets, which is one of the reasons that aid

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to state (and local) governments has figured prominently in most economic stimulus proposals in recent months (see discussion below). However, to the extent that states will still be left with shortfalls that exceed their available reserves, it is now recognized budget cuts will do more economic harm than raising taxes as an approach to bringing the budget into line. A study issued during the last state budget crisis by two of the nation’s most prestigious economists – Joseph Stiglitz and Peter Orszag – sets out this argument in compelling fashion. Stiglitz and Orszag wrote:

Basic economy theory suggests

that direct spending reductions will generate more adverse consequences for the economy in the short run than either a tax increase or a transfer program reduction. The reason is that some of any tax increase or transfer payment reduction would reduce saving rather than consumption, lessening its impact on the economy in the short run, whereas the full amount of government spending on goods and services would directly reduce consumption....¹⁰

In fact, the economic damage caused by cutting budgets in such areas as Medicaid, human services, or transportation may be multiplied by the loss of federal matching funds, resulting in greater than a dollar-for-dollar reduction in economic demand. By contrast, if Oklahoma were to raise the state income tax, some of the increased tax liability on state residents would be offset by taxpayers’ ability to deduct state taxes from their federal tax liability.

2. *Economic downturns create increased demands on state services.*

An important constraint to cutting budgets in hard times is the fact that some government programs are intentionally designed to expand during an economic downturn. That is especially the case with the Medicaid program, the largest state-federal entitlement program, which accounts for some 16 percent of current state appropriations.¹¹ Medicaid enrollment invariably grows during a downturn as more people become eligible due to loss of employment or stagnating income. A 2005 article in the journal *Health Affairs* reported that enrollment for families increased 11.6 percent between 2000 and 2002 and another 7.1 percent between 2002 and 2003.

The authors noted that:

The notable growth in enrollment among nondisabled adults and children is largely related to the economic slowdown that occurred between 2000 and 2003. Because of the economic decline, many people experienced job losses and income declines. The number of people below 200 percent of the federal poverty level greatly increased; thus, more people became eligible for Medicaid under existing eligibility standards.¹²

This counter-cyclical component of the Medicaid program means that demands on the budget are likely to expand just as available funds are shrinking. This situation could force legislators either to enact cuts to health care eligibility and benefits for seniors, persons with disabilities, and low-income children during a period of economic hardship, or to further squeeze funding for other agencies and programs to keep Medicaid intact.

3. Agencies are already struggling to absorb rising costs, unfunded mandates, growing enrollments, and the effects of the last budget cuts.

While it is popular to imagine that there is an enormous amount of fat to be trimmed from government

budgets, the reality is that most state agencies are already living close to the bone. For many agencies and public school districts, rising costs combined with flat funding have already led to hiring freezes, unfilled vacancies and cutbacks in services. The last round of budget cuts ended only five years ago and appropriations for over a dozen state agencies have never recovered to pre-downturn levels. With few exceptions, state agencies received no increase in appropriations in FY '09. Yet agencies were faced with increased operating costs for transportation and utilities associated with rising energy

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and fuel costs, as well as mandated increases in employee retirement contributions that the Legislature has failed to fund.

Rising health insurance costs present a

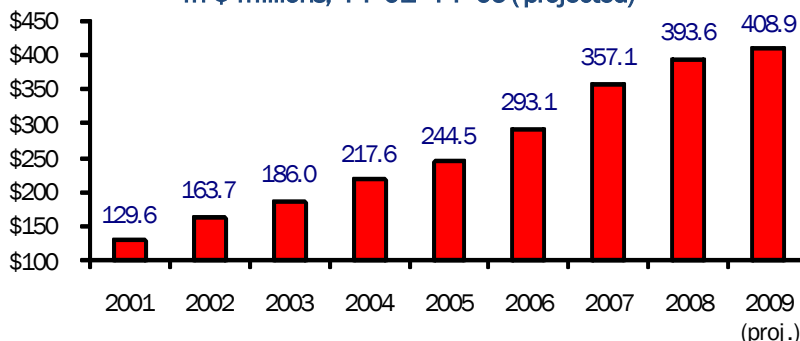
special strain on agency budgets. As seen in Figure 3, since 2001, agencies have had to absorb nearly \$280 million in increased health care costs. Most recently, health insurance premium rates for state employees, retirees and educators jumped 13.6 percent in 2009, representing an increase of \$15 million for state agencies and \$34 million for all branches of education in the 2009 calendar year.¹³

Some agencies also must confront rising caseloads and enrollments in non-discretionary programs. The Department of Human Services, for example, requires millions of additional dollars each year to cover enrollment growth in the ADvantage waiver program serving seniors and persons with disabilities, while the Medicaid program must cover annual increases in the cost of health care services. The Medicaid program has also been hit by consecutive years of declining federal match rates, which has obliged the state to assume a growing share of the cost of the program. Further cuts in the federal matching rate will affect the state budget in FY '10 and FY '11.¹⁴

4. Vital state services and programs already face chronic funding shortages.

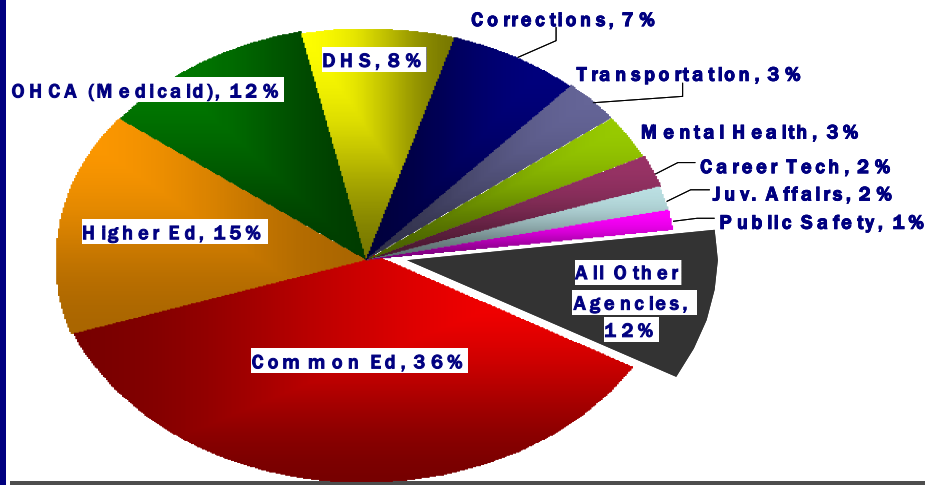
Independent experts, advocates, and political leaders from both parties agree that the state has seriously underfunded key areas of public service, including: prisons and juvenile detention centers; roads and bridges; foster care and child welfare systems, and the teachers' retirement system. Failing to bolster funding for these programs jeopardizes public safety, economic development, and family well-being, and could, in some instances, expose the state to legal liability.

Fig. 3: State Employee Health Benefit Allowance, in \$ millions, FY '01 - FY '09 (projected)



Source: Oklahoma Senate Overview of State Issues, Nov. 2008

Fig. 4: FY '09 Appropriations by Agency, as Share of Total



5. It is difficult to protect key agencies and services when there are serious budget shortfalls.

Even when budget times get tough, few elected leaders are eager to cut funding to core agencies in the areas of education, health care, social services, public safety, and transportation. However, close to 90 percent of state appropriations go to ten agencies that provide the most essential public services (see Figure 4). As a result, the ability to exempt key agencies in even a modest downturn is limited.

During the last downturn, the Legislature and Governor did their best to protect education, health care, social services, prisons, and transportation from budget cuts by imposing the steepest funding reductions on regulatory and administrative agencies, such as the Labor Department, Water Resources Board, and Treasurer's Office, and by targeting Rainy Day Fund revenues to core agencies (see above). Yet over the three years of the downturn, state budgets ended up being cut by a cumulative total of \$1.05 billion. Even with the best efforts of elected leaders to protect core agencies from the full brunt of shortfalls, budget cuts had far-reaching and serious conse-

quences for vital services.¹⁵ Faced with funding cuts from 2002-04:

- The Oklahoma Health Care Authority (OHCA) approved major reductions in benefits to the Medicaid program, including: eliminating coverage of adult dental services; reducing pre-

“Yet even with the best efforts of elected leaders to protect core agencies from the full brunt of shortfalls, budget cuts had far-reaching and serious consequences for vital services.”

scription drug coverage and inpatient hospital stays; and eliminating the medically needy program. Only an eleventh hour guarantee of supplemental funding spared some 50,000 low-income children from losing SoonerCare coverage entirely.

- In common education, school districts across the state laid off teachers and staff. A 2003 survey by the Department of Education found that 2,400 teachers were laid off or not rehired and 1,800 positions were left unfilled,

which led to larger class sizes and reduced class offerings. In order to fund teacher salaries and benefits at the maximum level possible, the Legislature cut \$30 million from targeted school programs by substantially reducing or eliminating special education grants, school lunch funding, home visitation programs, professional development services, and more than a dozen other programs.

- In higher education, the Legislature waived its traditional oversight of tuition rates, which allowed the state's colleges and universities to raise tuition and fees by as much as 29 percent for the 2003-04 school year.¹⁶ In FY '04 the Regents reported a net loss of 199 faculty and 452 staff positions. In addition, funding shortfalls led the Regents to implement substantial cuts to nonresident tuition waivers and institutional nominee scholarships for gifted and minority students.
- Community Mental Health Centers (CMHCs) endured consecutive years of contract cuts of 7 to 8 percent. The Mental Health department reported serving 3,000 fewer clients and experienced a steep increase in crisis intervention services.
- The Department of Human Services cut over 220 staff through voluntary buy-outs and attrition, thereby increasing caseloads and wait times. The Department also imposed service caps on clients with disabilities and elderly clients in its home-and-community based waiver programs.

THE FEDERAL GOVERNMENT

TO THE RESCUE?

In assessing the state's budget outlook, the role of the federal government in providing state fiscal relief is perhaps the most important wild card. During the last state fiscal crisis, Congress provided vital, if belated, help to the states by approving the Jobs and Growth Tax Relief Reconciliation Act of 2003. As part of a \$20 billion national package, Oklahoma received \$219 million in federal funds, divided between an unrestricted grant (\$117 million) and enhanced federal Medicaid matching rates (\$102 million). These funds, which were appropriated as part of the state FY '05 budget, helped avert an additional year of cuts and allowed for a partial restoration of Medicaid benefits beginning in FY '05.

State fiscal relief has been an important component of federal stimulus proposals since early 2008. According to data collected by the Center on Budget and Policy Priorities, 44 states face budget shortfalls for the upcoming budget year, with shortfalls exceeding 20 percent of general revenues in such states as California, New York, and Arizona. Overall, the CBPP projects total shortfalls for FY '09 – FY '11 to total more than \$350 billion.¹⁷ State organizations such as the National Conference of State Legislatures and National Governors Association, policy organizations like CBPP, and many economists have sounded the alarm about the potential economic harm if state budgets are slashed and have argued the case for aid to state governments as providing an efficient bang-for-the-buck among economic stimulus options.¹⁸

At this point, states do not know for certain if and when an economic stimulus package will be approved, the amount of assistance that will be provided to the states, or how funds will be allocated between the states. On January 15th, the House of Representatives unveiled the

outlines of an \$825 billion package that combined a mixture of direct spending (\$550 billion) and tax cuts (\$275 billion).¹⁸ The spending proposals included \$87 billion in enhanced federal Medicaid matching funds and a substantial number of grants to state and local governments in various domains, including: Title I education for low-income students (\$13 billion), special education (\$13 billion), energy efficiency (\$6.9 billion), and law enforcement (\$3 billion). The package also contained \$30 billion for highways infrastructure and \$79 billion in general "state fiscal stabilization" for education and other high priority needs. Under the House proposal, a portion of the funds made available to states would require them to invest in new infrastructure and construction projects, while other funds would be available to plug shortfalls in state revenue collections and maintain existing levels of services. An analysis from Federal Funds Information for States calculated that Oklahoma's share from the House stimulus proposal would total at least \$2.5 billion.²⁰

Clearly, state fiscal relief of any substantial size will greatly ease Oklahoma's budget situation. However, even if a substantial package is approved well in advance of the end of the 2009 session, Oklahoma legislators will have to decide how much of the federal relief money to appropriate for FY '10 and how much to leave aside for FY '11. They will also have to weigh the risk of using a large

amount of one-time federal dollars to plug budget holes for ongoing expenditures, which brings about the potential to create funding shortfalls even when revenue collections begin to recover.

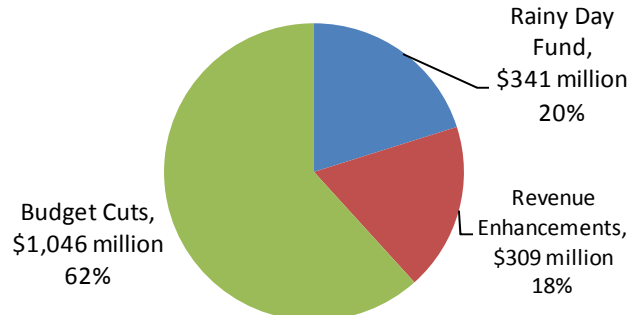
SUMMARY

The example of the last state fiscal crisis shows that a variety of approaches are needed to address substantial budget shortfalls accompanying an economic downturn. Faced with budget shortfalls totaling just under \$1.7 billion, the Legislature balanced the budgets in FY '02 – FY '04 in the following ways (Figure 5):

- \$340 million (20 percent) from the Rainy Day Fund;
- \$309 million (18 percent) from revenue-enhancement measures;
- \$1.046 billion (62 percent) from budget cuts.

Adjusting for the growth in the state budget in recent years, we calculate that the state could expect to face cumulative shortfalls over the coming years in excess of \$2.4 billion if faced with a downturn of similar magnitude to the last one. It bears repeating that the last state fiscal crisis accompanied a relatively brief and mild economic recession. Given the more severe turbulence in the current economy, state policymakers will need to display a great deal of flexibility and willingness to utilize all the policy options at their disposal to keep the state budget afloat.

Fig. 5: Measures to Address Budget Shortfalls, FY '02 - FY '04



END NOTES

¹ Elizabeth McNichol and Iris Lav, "State Budget Troubles Worsen", Center on Budget and Policy Priorities, updated December 23, 2008, at: <http://www.cbpp.org/9-8-08sfp.htm>

² Barbara Hoberock, "Governor: Painful cuts in store", Tulsa World, January 16, 2009.

³ For FY '01-FY '03, revenues were calculated using actual collections for the General Revenue Fund and HB 1017 Fund and appropriated revenues for other funds. We use projected rather than actual revenues for FY '04 because these are the numbers on which the FY '04 budget was built.

⁴ The top income tax rate for Tax Years 2003 and 2004 rose from 6.65% to 7%, while eligibility for the Sales Tax Relief Credit was narrowed.

⁵ Oklahoma Constitution, Article 10, Section 23. An emergency can be declared by the Governor with 2/3rds concurrence from both the House of Representatives and Senate, or upon a joint declaration of the Governor and President Pro Tempore of the Senate with ¾ concurrence of the House of Representatives.

⁶ For details, see Table 3 of Oklahoma State Senate, "FY '09 Appropriations Report: Actions of the 2008 Legislature".

⁷ Liz McNichol, "Is It Raining Yet? Yes, And It's Time for Many States To Use Their Rainy Day Funds", Center on Budget and Policy Priorities,

February 21, 2008, at <http://www.cbpp.org/2-21-08sfp2.htm>

⁸ Oklahoma Constitution, Article 5, Section 23.

⁹ See Oklahoma House of Representatives, FY '09 Legislative Appropriations, August 2008.

¹⁰ Cited in Nicholas Johnson, "Budget Cuts or Tax Increases at the State Level: Which is Preferable During a Recession?", Center on Budget and Policy Priorities, updated January 12, 2009, at: <http://www.cbpp.org/1-8-08sfp.htm>

¹¹ State appropriated Medicaid funds include \$842 million to the Oklahoma Health Care Authority and \$272 million to DHS and other state agencies. Oklahoma Health Care Authority, "The Financial Outlook Today", January 2009.

¹² John Holahan and Arunabh Ghosh, "Understanding The Recent Growth In Medicaid Spending, 2000-2003", Health Affairs, January 26, 2005, at <http://content.healthaffairs.org/cgi/content/full/hlthaff.w5.52/DC1>

¹³ "State insurance rate hikes a sign of the times", Tulsa World, August 29, 2008.

¹⁴ Oklahoma Policy Institute, "Passing the Buck: How Federal Policies are Worsening State Budget Problems", September 2008, at: <http://okpolicy.org/passing-the-buck>

¹⁵ This section is based on CAPerspectives, "Session Wrap-Up: 2003-04 Budget Softens Some Blows, But No End to Cuts in Sight", July 2003, available upon request from the author.

¹⁶ This increase was for lower division courses at OSU. See The Oklahoma State System of Higher Education, "Educational and General Budget Summary Analysis: Fiscal Year 2004", June 2003.

¹⁷ Elizabeth McNichol and Iris Lav, "State Budget Troubles Worsen", Center on Budget and Policy Priorities, updated December 23, 2008, at: <http://www.cbpp.org/9-8-08sfp.htm>

¹⁸ See the testimony from Mark Zandi of Moody's Economy.com at: <http://budget.senate.gov/democratic/testimony/2008/Zandi1119081.pdf>

¹⁹ Committee on Appropriations, "Summary: American Recovery and Reinvestment", January 15, 2008, at: <http://appropriations.house.gov/pdf/PressSummary01-15-09.pdf>

²⁰ Unpublished analysis. The FFIS analysis excludes Medicaid allocations that would be based on state unemployment rates.

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