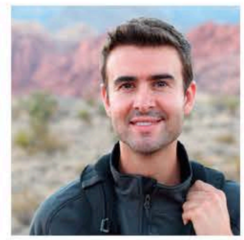
Policy Playbook for 2017

DEFICITS HEALTH COSTS COMPROMISE SPENDING GROWTH

BUDGET INVESTMENT



PATH PERS

JOBS TAXES

Where Do We Go From Here?

14th Annual Leadership Summit

December 5, 2016

Oregon Business Plan.org

OREGON BUSINESS PLAN FRAMEWORK

Goal

Quality Jobs in Every Corner of Oregon

- 25,000 net new jobs per year through 2020
- Per capita income above the national average by 2020
- Reduction of poverty below 10 percent by 2020

Vision

Clusters of Innovative, Globally Competitive Industries

Traded-sector businesses drive the Oregon economy. They export products and services outside of Oregon, bringing in fresh dollars that re-circulate through payrolls, employee spending in the local economy, purchases from vendors, and tax revenues that fund critical public services like education. Industries that sell globally are both big and small. These industries tend to cluster based on access to shared resources, talent, suppliers, and other factors. The diversity of our traded-sector clusters is illustrated below.

Advanced Manufacturing

- Metals (Primary and Secondary)
- Machinery + Transportation Equip.
- Food Processing
- Defense

High Tech

- Computer and Electronics Equipment
- Software
- Education Technology + Services
- Biotechnology

Natural Resources

- Forestry and Wood Products
- Agriculture Products
- Wine/Winemaking
- Beer/Brewing
- Nursery Products
- Tourism and Hospitality

Aviation

- Heavy Lift Helicopters
- Unmanned Aerial Systems
- General Aviation

Clean Technology

- Green Building and Design
- Energy Efficiency
- Solar Manufacturing
- Wind Energy Development
- Wave Energy Development
- Environmental Technology + Services
- Electric Vehicles + Green Transportation

Footwear, Apparel and Outdoor Gear

Creative Industries

Strategy

4Ps for Prosperity – Conditions Essential to Promote High-Wage Job Growth in Oregon

People: A talented workforce.
Productivity: Quality infrastructure, resource utilization, competitive regulations and business costs.
Place: A high quality of life that attracts and retains talented people.
Pioneering Innovation: A culture of research, commercialization and innovation in product and process design.

Priorities for 2017

Adopt a three-part framework to assure vital public sector services.

1. Maintain strong economic growth (it's the best way to grow public sector revenue).
    - Pass a major transportation investment package.
    - Pursue public-private research and development partnerships.
    - Do no harm in regulating the workplace.
2. Slow the unsustainable growth of government costs and tie spending to desired outcomes.
3. Adjust the tax code to improve stability and to generate more revenue for investment in health care and in high school and college completion.

WELCOME

Fellow Oregonians,

Welcome to the 14th Annual Leadership Summit.

Where Do We Go From Here? After a hard-fought election, nationally and here in Oregon, this year's Summit provides the opportunity for all of us to convene, reflect on our common vision for Oregon, and move forward together.

Bringing Oregonians together on important issues is what the Leadership Summit and the Oregon Business Plan have been about since 2002. We look forward to this gathering once again.

At the first Summit, the Business Plan presented a framework for advancing Oregon's economy. That framework, on the opposite page, has held up well over the past 14 years. Working with elected leaders and other partners, we have accomplished many important initiatives on issues as wide ranging as education, health care, transportation, water, and forest management. It has been a good run.

Oregon's economy is thriving right now, outperforming the nation in job growth, one of our key goals. There are good reasons for optimism about Oregon's future. Firms are growing and seeking talent. We've made gains on raising incomes and reducing poverty.

Investments in education, health care, and the social safety net have played a key role in these gains and, clearly, we want to build on this momentum. However, we face a fundamental challenge to our state's fiscal well-being. As explained in this playbook, we anticipate a structural state budget deficit for at least a decade, even under a moderately good economic outlook. Unless we find a remedy, severe strain on state budgets will impede our ability to provide key services – education, health care, transportation and more – that are vital for a healthy economy and quality of life.

This year we have focused the Summit and the Business Plan on how we might work together to address this fiscal challenge, not just for the upcoming biennium but for the long run. We don't have all the answers, of course, and know there are some difficult choices and trade-offs to be made. The point is to start a dialogue. Because we know that without a plan to sustain vital services, the opportunity for Oregon to thrive will be diminished.

The Oregon business community stands ready to partner in this work. Thanks for joining this conversation.

Patrick Criteser, Chair
Oregon Business Plan Steering Committee

Oregon Business Plan Steering Committee

Business Association and Economic Development Partners (Ex-Officio)

WHERE DO WE GO FROM HERE?

Oregonians largely agree on the things we want for our state. These include good jobs, good schools, health and health care access, safe communities, enjoyment of our natural world, and quality of life for everyone in all parts of Oregon. What we don't always agree on is *how to get there*.

Ballot Measure 97, the proposed gross receipts tax, is a case in point. While the Oregon business community believes in quality public services and understands that those services have a price, we didn't see Measure 97 as the solution to government's revenue needs. Oregon voters agreed overwhelmingly.

At the same time, we recognize that Oregon government faces serious fiscal challenges in the coming biennium, and, in fact, for the next four budget cycles to come. With the ballot fight settled, with budget issues unresolved, and with the needs of all Oregonians in mind, it's appropriate to consider the question, *Where Do We Go From Here?*

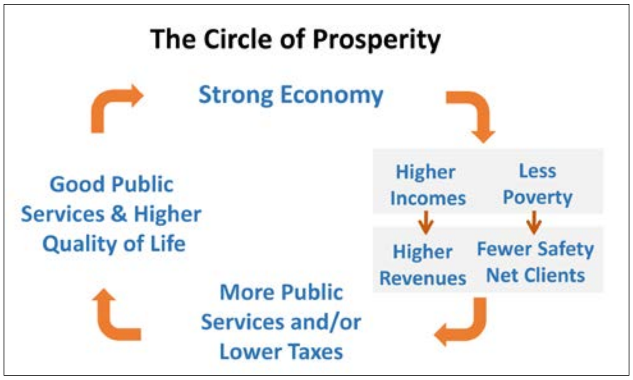
An Approach to Consider

We don't profess to have all of the answers to that question. But we do propose a three-part strategy that should guide our efforts. This strategy would allow our elected officials, who must lead on this issue, to convene stakeholders and experts to forge a solution. The components of the proposed strategy are:

1. Maintain strong economic growth. It's the best way to lift up families and the state budget.
2. Slow the unsustainable growth of government costs and tie spending to desired outcomes.
3. Adjust the tax code to improve stability and to generate more revenue for investment in health care and in high school and college completion.

All three of these components are necessary. Spending reform and tax increases, in particular, must go hand in hand. Tax increases without control of government cost increases, such as those driven by PERS, would not achieve desired results. They would simply fund unsustainable spending obligations rather than direct funds to new investments in Oregon students and families.

This approach to Oregon's budget challenge fits within the Oregon Business Plan's larger framework (see inside front cover) for achieving prosperity.



The Oregon Business Plan is based on a concept that we call the Circle of Prosperity. Through good jobs, a strong, healthy economy provides the resources to families, communities, and the public sector that enable Oregon to be the kind of place where we want to live. In turn, citizens, communities, and public services buoy a healthy economy.

In this virtuous cycle the economy grows when we have more dollars for education, health care, public safety, transportation and many other services provided by the public and nonprofit sectors. Those services in turn are vital for achieving the key goals in the Business Plan: more good jobs, higher incomes, and reduced poverty.

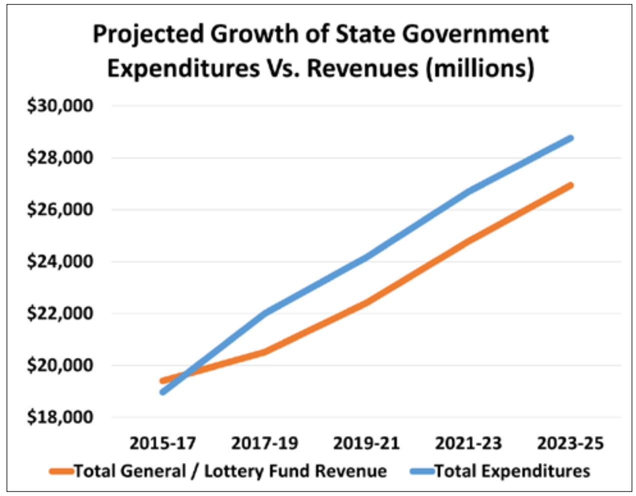
Over the past six years, the Circle of Prosperity has worked well for Oregon.

- We have exceeded our job creation goals by nearly 90,000 jobs.
- Incomes are up and the rate of poverty is down.
- The public sector has benefited from over $6 billion in additional income and property tax receipts.

In turn we have seen significant investment increases in education and health care.

- Investments in early childhood programs, including day care and pre-school, have more than doubled.
- K-12 investment is up 22 percent, and we have implemented full day kindergarten.
- Funding for community colleges and higher education is up 40 percent and need-based student aid has increased.
- Increased funding has begun to revitalize CTE and STEM education.
- Thanks to federal support, we have expanded Medicaid to over 400,000 more Oregonians.

Assuming these investments lead to better outcomes for education and health, Oregonians should be better prepared to participate in an expanding economy. Well prepared Oregonians will help to fuel economic growth.



Despite such investments however, we still have much to do to make these outcomes a reality for all Oregonians. Too many young people enter early adulthood without the skills to take advantage of available opportunities. Many working adults need education and retraining to advance their prospects. And while Oregon's economy is thriving overall, many communities and families in them still struggle. This is particularly the case with communities of color and rural areas.

Now there's another complication. Despite being in a period of strong economic growth that's producing tax revenues faster than nearly every other state in the nation, Oregon faces significant funding challenges just to maintain current services.

Tackling Oregon's structural budget deficit is the most important issue facing the state in 2017. Failure to address this problem threatens to halt or even reverse the investments and gains we've made over the past six years, particularly in education. But the problem, as illustrated in the figure above, extends through 2025. The more granular Business Plan forecast in the table below confirms that under current services, Oregon faces a fiscal deficit ranging from about $1.5 billion to $1.9 billion for each of the next four biennia, assuming a baseline state government revenue forecast. Not included in our projection of next biennium's deficit is the $300 million investment voters approved with Measure 98, nor the lottery fund investments in veterans and outdoor school that voters approved with Measures 96 and 99, respectively. The state will need to decide how to pay for these investments, whether through reprioritizing spending, new revenues, or some combination of the two.

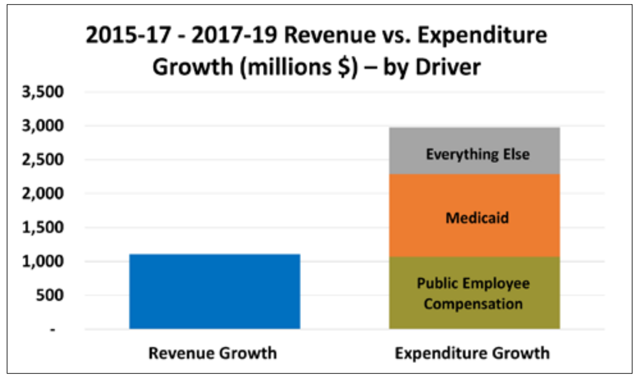
Projection of Oregon State Budget Through 2023-25 Under Current Services

REVENUE ($millions)	2015-17	2017-19	2019-21	2021-23	2023-25
General Fund + Lottery Revenue	$19,409	$20,514	$22,411	$24,783	$26,939
EXPENDITURES	**Current**	**Projected**	**Projected**	**Projected**	**Projected**
Education	$9,820	$10,685	$11,700	$13,039	$13,936
Human Services	$4,931	$6,471	$7,328	$8,086	$8,904
Public Safety	$2,370	$2,495	$2,701	$2,936	$3,126
Other	$1,852	$1,985	$2,202	$2,370	$2,511
Ending Balance, SPAs and Other	$52	$367	$239	$264	$285
Total Expenditures	$18,973	$22,002	$24,170	$26,696	$28,762
Biennial Surplus/Deficit	**$383**	**-$1,488**	**-$1,759**	**-$1,912**	**-$1,823**
Total Reserves	**$789**	**$1,257**	**$1,779**	**$2,357**	**$2,995**

The Cost Drivers

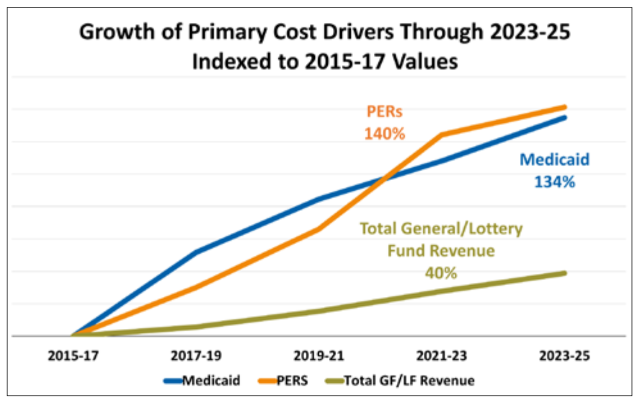
There are two major reasons for the $1.488 billion shortfall forecasted in the coming biennium and beyond: increased Medicaid expenses and public employee compensation costs, including PERS.

Medicaid Expansion. Over the past four years, some 400,000 Oregonians were added to Oregon's Medicaid program, immeasurably improving their lives. The Business Plan supported this expansion, carried out by Oregon's innovative Coordinated Care Organizations. CCOs have made enormous strides to improve health and slow the growth of health care costs. However, up until now the federal government has paid for 100 percent of this expansion. Starting on January 1, 2017, Oregon will need to pay for 5 percent of the expanded Medicaid cost. Over the next four years after that the state's contribution will increase until it reaches 10 percent of the total.

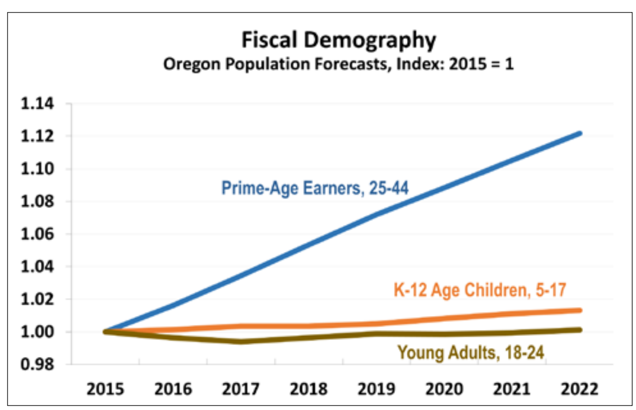


In addition to the increase in those covered under the Oregon Health Plan, there are a variety of other factors that will accelerate Oregon Medicaid spending. For example, a greater number of special needs and aging individuals are expected to be added to the rolls, and their care is typically more expensive.

Unfunded PERS Liabilities. Last year the Business Plan pointed out that the growth of total compensation costs in the public sector (salaries, retirement, and healthcare) are on a trajectory to consume a growing share of public sector budgets in the next four biennia. This trend has not abated, and one cost in particular – PERS – has intensified. As the figure at right shows, the Business Plan projects PERS costs to the General Fund will grow by 140 percent over the next four biennia, while revenue will grow by 40 percent over the same period.



The PERS system's unfunded liability now totals $21.8 billion, an amount that is likely to increase if investment returns fail to meet expectations. Under the current system, these costs will have to be borne in full by public jurisdictions and their taxpayers. As a result, nearly $6 billion in additional pension payments will have to be carved out of public budgets to shore up the PERS pension system over the next six years. This will decimate funding for public services at all levels of government, diverting revenues from services to a growing pension deficit. For school districts alone, the increased PERS obligations will amount to an inflation-adjusted $600 per student statewide. That equates to lost funding for 14 attendance days of school.



Some Relief: Education Demographics. These Medicaid- and PERS-driven deficits would be even larger if not for a source of good fiscal news: education demographics.

The biggest general fund expenditure is for K-12 education and in this category relief is on the way. After a couple of decades of exerting pressure on education funding, the children of Baby Boomers (the big cohort sometimes called the Baby Boom echo), have left school and are aging into their prime earning – and taxpaying – years. From 2015 to 2022, the state will add nearly 131,000 prime-age earners (age 25-44) compared with just under 9,000 school-aged children and young adults. In other words, the state will add about 15 new potential taxpayers for every new student. Low enrollment growth rates will offset to some degree the high growth rates of Medicaid and PERS.

The Impact of Variables. This outlook is sensitive to assumptions, particularly those relating to the growth of the economy and the growth of public employee compensation. For instance, deficits could be whittled down by as much as a billion dollars in each of the coming biennia if the economy were to follow a more optimistic growth trajectory. Additionally, legal adjustments to the PERS system and slight changes to payroll growth rates could shave projected deficits by hundreds of millions of dollars both immediately and in the long term.

Inadequate Reserves. Alternatively, state government reserve funds are not sufficient to cover the deficit should Oregon be hit with a moderate recession. Coming into the next biennium we expect the state to have roughly $1.2 billion in reserves across its two major funds. However, this amount of savings does not measure up to the projected $2.5 billion shortfall in the next biennium if a moderate recession were to occur in early 2017. The resulting ficsal scenario would severly strain state budgets and raise the specter of cuts to critical programs serving Oregonians.

A Three-Part Strategy to Move Oregon Forward

In keeping with the Circle of Prosperity concept, Oregon has an opportunity to create a long-term fiscal plan that drives stronger education and health outcomes, which, in turn, will help to bolster our economy, grow incomes, and reduce poverty. The results for the state General Fund will be more revenue, lower demand for social safety net services, and more dollars for education and training. That is a prize that all Oregonians should be able to rally behind.

The Oregon Business Plan supports a budget solution that maintains our momentum on health care access and that increases investments in early learning, career and technical education, and college affordability and completion. These investments should lead to higher levels of high school and postsecondary completion, better health, higher incomes, and lower rates of poverty.

However, to afford these investments, we need to keep the economy growing and revenue coming in, keep government costs under control, and revise and stabilize our revenue structure. That, in effect, becomes the three-part strategy that we recommend: 1) maintain strong economic growth, 2) slow the unsustainable growth of government costs and tie spending to desired outcomes, and 3) adjust the tax code to improve stability and generate more revenue for targeted investments in health care and high school and college completion.

Because all three of these strategy elements are interrelated, they are all required. And just as importantly, they must all be implemented concurrently for the strategy to be successful.

Growing the economy is by far the best way to raise revenue for public services and improve the lives of Oregon families.

1. Maintain Strong Economic Growth

Growing the economy is by far the best way to raise revenue for public services and improve the lives of Oregon families. Economic growth brings in billions of dollars in new tax revenue for education and other services through personal and business income taxes and property taxes. Just as important, it puts people to work, lifts people out of poverty and meets essential needs of Oregon families**.** As a result of a growing economy, Oregon's General Fund revenues will be more than 40 percent higher in 2017-2019 than they were in 2011-2013.

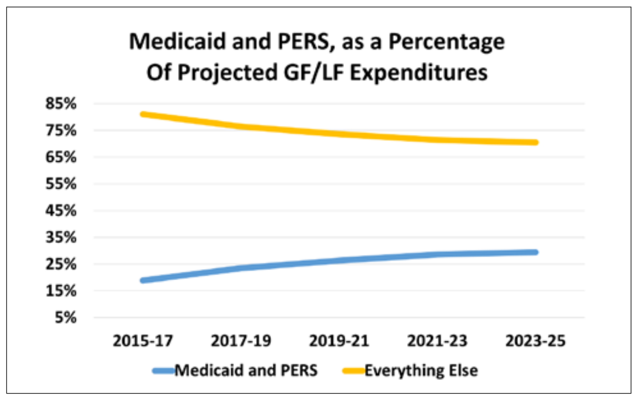
While global forces will dominate the business cycle, the pace at which Oregon grows is influenced by the decisions we make here at home. The Leadership Summit packet is full of ideas for how to maintain and accelerate Oregon's economic growth from more productive natural resource policies to investments in transportation, education, and workforce training. It also contains papers outlining initiatives that can be advanced in 2017 and beyond to support the growth of our traded-sector industry clusters.

While all of these initiatives are worth pursuing, three rise to the top.

- ***Pass a major transportation investment package***. Aging and inadequate infrastructure, and unprecedented levels of congestion, pose a serious impediment to Oregon's economy and quality of life. Action on this issue is overdue.
- ***Pursue public-private research and development partnerships*** such as the Oregon Manufacturing Innovation Center, the Phil and Penny Knight Center for Accelerating Scientific Impact, and the Oregon State University Soil to Shelf Initiative.
- ***Do no harm*** in regulating the workplace. Allow Oregon's small businesses time to absorb the plethora of new workplace mandates and business regulations that the Legislature has passed in recent sessions, rather than adding new burdens to businesses and state agencies.

2. Slow the Unsustainable Growth of Government Costs and Tie Spending to Desired Outcomes

No amount of economic growth or tax increase will solve Oregon's budget woes if policymakers do not bring government costs under control. They must insist that public funds be spent wisely and that cost structures be sustainable. In particular, they must slow the unsustainable growth of large costs such as Medicaid and public employee compensation.



Medicaid. One of the leading reasons for the spending growth in the state budget is the reduction of federal subsidies under the Affordable Care Act – a factor we cannot control. Expanding Medicaid was the right thing to do. It has improved the lives of hundreds of thousands of Oregonians. We should not turn our back on these Oregonians, but we do need to figure out how to keep Medicaid costs from running away.

There *are* avenues to achieve cost savings in the Medicaid program. The most promising may be to reduce Medicaid demand – by growing Oregon's economy, connecting lower-income Oregonians with meaningful job opportunities, and lifting more Oregonians out of poverty. In addition to ideas for growing the economy, the Leadership Summit packet includes our poverty reduction strategy.

Another way to reduce costs is to make investments with Medicaid dollars that lead to better health and reduce the costs of health care. Under Oregon's pioneering Medicaid reform model, Coordinated Care Organizations are given a global budget to provide care for eligible clients. If we can improve health through early interventions, we can get a better value for our expenditure *and* reduce costs. There are opportunities for the private sector and nonprofit sectors to make investments in areas such as prenatal care, early learning, and mental health that can reduce some of the Medicaid burden on the state budget. These ideas will be discussed at length in sessions at the Summit.

Public Employee Payroll Costs and PERS. There is room for improvement in controlling the growth of total payroll costs in the public sector. This requires a comprehensive look at the growth of salaries, healthcare, and retirement costs. Oregon's teachers and other public sector workers are some of our greatest assets and they deserve to be paid well. At the same time, policymakers need to slow the unsustainable growth of compensation expenses. One idea that makes sense is to establish a collective bargaining framework that ties compensation increases to available public resources.

PERS still represents the biggest opportunity for slowing cost growth. Much of the $21.8 billion unfunded PERS liability is associated with retirees and cannot be reduced as a result of the Oregon Supreme Court's *Morrow* decision. However, 30 percent of the liability – or $6.54 billion – is associated with current workers. That liability *can* be addressed under *Morrow*, and it is fair to ask that current employees contribute to the solution.

A paper in the Summit packet describes options still available for addressing Oregon's PERS crisis, including one proposed by the Portland City Club in 2011 – to redirect future employee contributions from the Individual Account Program (IAP) to the pension plan to help offset the costs of financing its promised benefits. In recent years many states have boosted both employer and employee contribution rates to shore up their pension plans. Treating the IAP as a source of employee support for the pension plan and as a way to mitigate increases for employers is, to our thinking, the most feasible way to do this – especially since it can be done without reducing take-home pay for employees and without touching IAP balances accrued to date. Repurposing the IAP in this fashion will facilitate a phase-in of employee contributions to the PERS pension plan (currently employees do not contribute anything to the pension plan) that can offset half of the rate increases that will be borne by employers over the next six years.

Another sensible reform would be to reduce the annuitization rate for the PERS system Money Match from 7.5 percent to 3.5 percent. That would reflect financial market realities and would produce significant savings. Other ideas, and a discussion of their legality and potential cost savings, are included in the paper.

3. Adjust the tax code to improve stability and to generate more revenue for investment in health care and in high school and college completion.

Taxes also need to be part of the solution. The current revenue system, with extraordinary reliance on the personal income tax, suffers from two major flaws.

First, it is unstable, swinging wildly with economic cycles. This roller coaster effect impairs vital services, especially schools, which inevitably suffer budget cuts during downturns. This volatility is exacerbated by the kicker law, which refunds revenue that exceeds forecasts rather than building up a reserve fund.

Policymakers deserve credit for improving the reserve policy over the past decade. Reserves currently stand at about 5 percent of the General Fund, which is much better than levels during our two most recent recessions. But our reserves won't reach an adequate level – 7.5 percent of the General Fund – until the end of the 2017-19 fiscal year, so we are left hoping this economic expansion continues its run.

Oregon Revenue and Taxes Rankings Among the States (1st= highest)

- **Own Source Revenues: 12th**
- **Total Taxes: 26th**
- **Personal Income Taxes: 2nd**
- **Corporate Income Taxes: 24th**
- **General Sales Taxes: 47th**
- **Selective Sales Taxes: 28th**
- **Property Taxes: 18th**

Source: Oregon Legislative Revenue Office Basic Facts 2016. Fiscal year 2012-2013

Second, our revenue structure is inadequate to pay for the new health care liabilities we have taken on while also affording the investments we want to make in early learning, high school success, and college affordability and completion.

This is a problem that business leaders want to help address. We need a system that pays for vital services throughout economic cycles but also is predictable, contains strong incentives for economic growth, and is equitable.

We believe that elected leaders, in conjunction with stakeholders, should tackle our unwieldy revenue system, so we are not proposing a specific tax plan. We do, however, believe that the following principles should guide the effort to achieve tax reform:

- Taxes should only be increased as part of an overall plan that supports economic growth and includes reforms to slow the unsustainable costs in state government, as described above.

- While additional revenue is needed, stability is the most important aspect of our tax sytem that needs to be addressed. Oregon needs larger reserves to get through the next recession.
- Any tax plan should boost economic activity but at the same time protect low-income Oregonians.
- Proceeds from tax increases should be invested in areas that are proven to help students succeed: early childhood education, better high school graduation rates through programs like career and technical education and dual enrollment, and improved college affordability and completion. At the same time we should honor our commitment to increased health care access for Oregonians. In making such investments, we should use clear measures to track progress and outcomes for improvement and accountability.

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