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How Does Oregon Government Spending Rank?

Ideas for Budget Stability

by Randall J. Pozdena, PhD
Eric Fruits, PhD

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About the Authors

Randall J. Pozdena, Ph.D., is a consulting economist in Portland, Oregon. Dr. Pozdena is a former professor of economics and finance and a former research officer with the Federal Reserve Bank of San Francisco. He is an academic advisor to Cascade Policy Institute and has authored previous Cascade reports on K-12, higher education, Social Security and health care. He has served on numerous public and private boards and commissions, including the Governor's Council of Economic Advisors, the Oregon Investment Council, the Pacific University Investment Committee and the Symphony Endowment Fund.

Eric Fruits, Ph.D., is a consulting economist in Portland, Oregon, and an adjunct professor at Portland State University. Dr. Fruits has conducted numerous economic impact studies and has provided testimony to the Oregon Supreme Court regarding the economic impacts associated with reforming Oregon's public employee retirement system.

About Cascade Policy Institute

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Summary

This report updates and expands on a previous Cascade Policy Institute report by Dr. Pozdena.¹ The purpose of this report is to compare Oregon's state and local spending level against that of other states through benchmarking.

Benchmarking helps Oregon citizens understand the extent to which their state's spending choices differ from those of other states. Since individual states vary widely in both their ability to pay for public services and in population characteristics that determine the demand for spending, simple ratio comparisons are insufficient to fairly benchmark individual states.

The authors of this report use a multi-factor benchmarking system to account for differences in population characteristics. Specifically, they control for the major demographic and economic factors that affect fiscal capacity and the demand for public services. The resulting information creates a model to determine what would happen if Oregon's characteristics were confronted by other states' policy makers. This allows Oregon's spending to be fairly compared with that of other states.

The most recent data available that allows comprehensive benchmarking is from fiscal year 2000. The years since have been a time of economic weakness for Oregon and the available data offer insights into the likely cause of the current state of Oregon finances. The authors' basic conclusions are as follows:

- Spending significantly accelerated in relation to personal income from 1998 to 2000, the final two years of the economic boom
- Overall spending was 19 percent higher than expected

- Healthcare spending by the public sector was 57 percent higher than expected
- Spending on corrections and police was 26 percent higher than expected
- Welfare spending was 24 percent higher than expected
- Education spending was six percent higher than expected
- Highway transportation spending was eight percent lower than expected

Though only benchmark estimates, these results suggest a consistent pattern of greater spending by Oregon at the state and local level than one should expect given the state's characteristics. The recession that began in 2001 substantially reduced tax revenues to the state. Oregon voters resoundingly rejected subsequent efforts to raise taxes. The reduction in tax revenues led to budget cuts that have brought Oregon's state and local spending in some areas more in line with economically and demographically similar states.

The recent slowdown in spending was largely a result of revenue constraints, not spending restraint. The authors outline several prescriptions to control government's pro-spending bias and to dampen the spend-and-cut cycle in government spending associated with a boom-and-bust revenue cycle. These prescriptions include:

- Cut back programs with small net economic impacts
- Incorporate flexibility into government operations by reducing wage rigidity and seniority rules in layoff decisions

Spending significantly accelerated in relation to personal income from 1998 to 2000, the final two years of the economic boom.

The recent slow-down in spending was largely a result of revenue constraints, not spending restraint.

- Establish “rainy day” funding to smooth government cash flows
- Rely on less volatile revenues sources, especially capital gains tax revenues
- Institute greater accountability and choice in public education
- Reform the Oregon Health Plan to provide healthcare savings accounts, rather than healthcare
- Establish a system of charging for roadway use that more fairly targets the users of the roadways who are imposing the greatest burdens on capacity and wear and tear
- Involve the private sector in policing and corrections
- Direct welfare efforts toward encouraging work and education
- Eliminate “prevailing wage” rules in government contracts

Introduction

The issue of what is the proper level of government spending at the state and local level is a perennial policy debate. In Oregon, advocates of increased government spending, who embrace the notion that government and not the private sector should be the primary provider of many services, have given the state very large roles in education, healthcare, transportation, liquor distribution, welfare policy, land use policy and numerous other areas. Oregon has seen efforts to offer single-provider health insurance to everyone in the state. State ballot measures have sought to increase marginal tax rates in order to maintain or increase government spending. A ballot measure in Multnomah County successfully instituted a 1.25 percent income tax to maintain the current level of government spending. This indicates that some residents believe that the role of government in Oregon is too small, rather than too large.

Opponents of this view often contend that state and local governments are too large and insufficiently restrained in their spending habits. Politicians have unfairly entered into enterprises that are better left to the private sector. Others contend that the lack of fiscal discipline causes public suppliers to operate in an inefficient and costly manner.

At the root of this debate lie fundamental issues of how well representative democracy is functioning in state and local settings and also to what extent public service providers are disciplined to provide services in a cost-effective manner. Advocates of expansive government contend that government is simply delivering the kind of services the public wants at a cost that is consonant with the quality of the services desired. Advocates of smaller government counter that the state and local governments in Oregon are captive to potent interest groups that unfairly benefit from

government spending. These groups use their political influence to advance self-serving policies beyond those desired by the general populace. Additionally, they argue, the lack of market competitive discipline causes government to become more costly over time. This causes government to accede too readily to compensation demands of its employees.

Oregon governments tend to spend at a level that grows in concert with personal income, even when—as in 1999 and 2000—personal income gains were from capital gains and other “one-time” sources relating to the dot-com boom. In response to excesses, Oregon voters passed tax limitations, such as Measure 5 (limiting property taxes). In addition, one or more initiatives to limit the growth of state spending may soon be on the ballot. These efforts indicate that many Oregonians are concerned about elected officials’ spending decisions.

Oregon policy makers have been strongly resistant to efforts to introduce private market discipline in areas such as education, transportation and corrections. To the extent that this resistance to market discipline causes greater government expenditures, it is consistent with, though not necessarily proof of, a pro-spending bias.

While the data presented here cannot settle debate about the fundamental role of government in a representative democracy, it can help to better frame this debate by describing Oregon state and local governments’ spending relative to economically and demographically similar states. These data can at least establish that Oregon’s patterns of government spending are not a necessary consequence of the state’s circumstances. Moreover, if Oregon “overspends” during normal times, then the state should not be surprised to find it especially difficult to balance its budget during times of economic crisis.

In response to excesses, Oregon voters passed tax limitations, such as Measure 5 (limiting property taxes).

[I]f Oregon “over-spends” during normal times, then the state should not be surprised to find it especially difficult to balance its budget during times of economic crisis.

In the remainder of this report, we first describe the multi-factorial benchmarking procedures used to compare Oregon with other states. We then look at recent levels of spending in Oregon to put the spending debate in context. Next, we provide the results of that benchmarking exercise through the 2000 fiscal year (the last year of available comprehensive data) to see whether Oregon’s level of spending is over or under what we should expect. Next, we provide some preliminary observations using the less comprehensive available data through 2003. The report concludes with some policy observations and recommendations.

Measure Over- or Underspending of Oregon’s Public Sector

In this report, we employ a very specific definition of the public sector, and of the phenomena of over- or underspending. Specifically, we define Oregon’s public sector as both the State of Oregon and its various local governments and districts. This definition is necessary because states vary in how they assign responsibility for providing public services among state government, local government and special districts. Hence, if one focuses only on one level of government, one derives a potentially meaningless comparison.

In Oregon, the state government assumed primary school funding responsibility after the passage of Measure 5 in 1990, and relieved local governments of a significant portion of their fiscal responsibility. Other states have not centralized finances in the same way. Consequently, if one were to examine education spending patterns across states, and focus naïvely on only local government spending, one would conclude that Oregon was “underspending” on K-12 education, when it was actually overspending. In this report, public spending is the total of spending by all state, local and school district entities in Oregon.

We also define relative spending and “over- and underspending” in an agnostic way. Namely, we ask the basic question: Does Oregon tend to spend more *in toto* and by major spending categories than other states when differences in economic and demographic conditions are held constant? The resulting measures are neither normative nor prescriptive. They simply better compare Oregon’s spending patterns with those of other states. The innovation in this method of measuring spending is that, unlike other comparisons of spending across states, we control for multiple economic and demographic characteristics.

In contrast, it is a very common practice of other analysts to normalize spending by a single factor, such as spending per capita, or spending per student when making such comparisons. Other analysts’ single-factor benchmarking techniques abstract the fact that costs of providing services, the characteristics of those served and taxed populations vary widely across states. In our view, this makes these so-called “single factor” benchmarks of limited use for understanding relative spending tendencies. Indeed, there is good reason to expect simplistic benchmarking of Oregon’s public spending to be misleading, because Oregon is very different from other states in a number of ways that are relevant to spending levels:

- Oregon’s per capita personal income is six percent below the national average
- The proportion of school-age children in Oregon is three percent lower than the national average
- The proportion of the population with a high school diploma is five percent higher than the national average
- The proportion of Oregonians living in nonmetropolitan areas is 35 percent greater than the national average and population density is 55 percent lower

- Oregon’s minority population is 46 percent lower than the national average

Oregon also has a slightly lower youth population and a slightly higher proportion of college graduates, as well as slightly lower dependent population—those under 18 or over 65. One must respect that variations in these factors affect both the need for and the fiscal effort required to support public services.

Statistical Procedures

To address cross-state diversity, our approach employs multi-factor benchmarking. Specifically, with multiple factor statistical techniques, we control simultaneously for several measures of economy and demography. Since there are 50 states in our database, we can include many factors to account for interstate variations. Different types of spending, of course, are linked more intimately to certain factors than are others. In our benchmarking research, we exclude factors that do not add to the cross-state explanatory power of the technique. To develop the benchmarks, we first estimated the average statistical relationship between a spending category and the economic and demographic factors that are logically and statistically relevant to it. Having measured that average relationship, we can then apply Oregon’s particular economic and demographic characteristics and obtain an expected level of spending. To the extent that actual spending exceeds expected spending, Oregon is said to be “overspending.” Conversely, Oregon is said to “underspend” in cases where Oregon’s spending is lower than expected.

Implicit Assumptions in the Benchmarking Procedure

We do not adjust spending by the source of revenue that finances that spending. It is

common among some advocates of larger state and local spending to imply that spending financed by federal dollars is, somehow, different from spending financed by state or local revenues. By such reasoning, enlarging the public sector by spending federal dollars is not the same as so-called “own-financed” spending.

There are several flaws to this argument. Federal money is not costless to Oregon taxpayers in the long run. Many so-called “federal dollars” are actually dollars that were collected by various taxes levied on Oregon taxpayers. In some cases, such as transportation fuel taxes, specific formulae exist for repatriating those dollars back to the collecting state. Moreover, the lure of federal funding and the expansion of state and local spending with it may not be a sign of fiscal prudence if the federal dollars come with restrictions and requirements that make the program inefficient or ineffective in the local context. To the extent that federal funding creates or enlarges a state or local bureaucracy that may not be supported with federal funds in the long-run, such funding imposes a future obligation on the state and its taxpayers.

General Patterns of Spending and Revenue Sources

The pattern of government revenue and spending in Oregon is—at least superficially—consistent with the notion that Oregon is a relatively high-expenditure and high-revenue state. Tables 1 and 2, constructed from U.S. census data, illustrate that per capita state revenue and spending in Oregon is considerably above national levels. Indeed, when adjusted for the relative per capita personal income levels of the various states, Oregon is seventh highest in total expenditure and fourth highest of all states in total revenue.

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Table 1: State and Local Revenues (2000)

Description	Total	Share of Total	Per Capita	Adj. Oregon % of Average	U.S. Per Capita	Adj. Rank	Memo: 1998 Adj. Rank
	(\$ mil.)	(%)	(\$)	(%)	(\$)		
Revenue							
Total revenue	\$ 28,644	100	\$ 8,373	130	\$ 6,902	4	12
General revenue	20,969	73	6,130	120	5,477	9	21
Intergovernmental revenue	5,233	18	1,530	158	1,037	8	18
Taxes	9,412	33	2,751	95	3,100	39	39
General sales	-	0	-	0	764	47	47
Selective sales	912	3	267	85	335	36	44
Individual income	4,097	14	1,198	170	752	2	12
Corporate income	407	1	119	99	128	17	1
Motor vehicle license	375	1	109	201	58	5	33
Other	832	3	243	147	177	12	38
Current charges	3,696	13	1,080	145	794	7	14
Miscellaneous general revenue	2,628	9	768	151	546	6	6
Utility revenue	761	3	222	79	302	26	19
Liquor store revenue	228	1	67	438	16	4	5
Insurance trust revenue	6,686	23	1,954	189	1,107	3	6
Memo: Per Capita Personal Income			\$27,836		\$29,760		

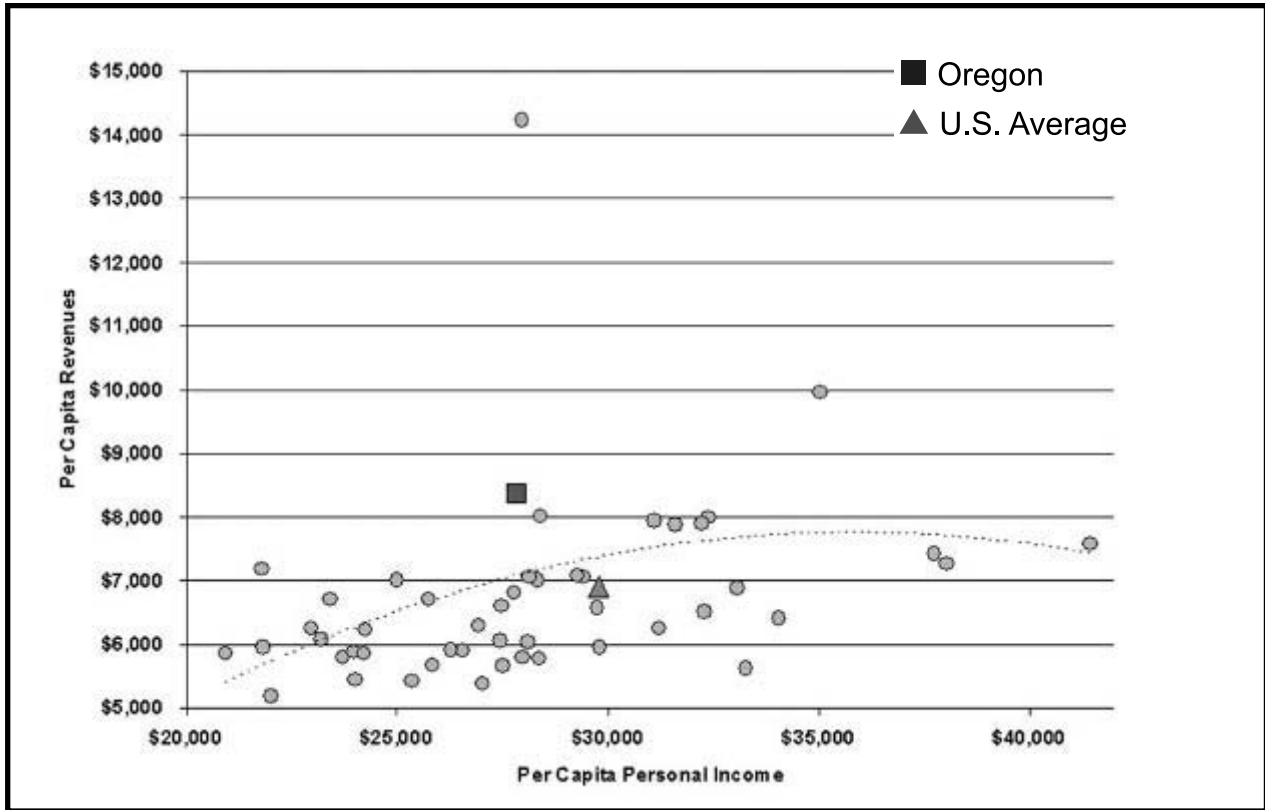
Table 2: State and Local Expenditures (2000)

Description	Total	Share of Total	Per Capita	Adj. Oregon % of Average	U.S. Per Capita	Adj. Rank	Memo: 1998 Adj. Rank
	(\$ mil.)	(%)	(\$)	(%)	(\$)		
Expenditure							
Total Expenditure	\$ 24,086	100.0	\$7,041	121.3	\$6,208	7	11
Current operations	17,685	73.4	5,170	120.7	4,579	7	20
Capital outlay	2,607	10.8	762	105.6	771	25	28
Assistance and subsidies	324	1.3	95	90.9	111	21	18
Interest on debt	932	3.9	273	101.9	286	20	24
Insurance benefits and repayments	2,537	10.5	742	178.2	445	2	2
Exhibit: Salaries and wages	7,183	29.8					
General expenditure by function							
Direct general expenditure	\$20,161	83.7	\$5,893	118.0	\$5,340	11	22
Education	6,448	26.8	1,885	108.7	1,853	28	18
Public welfare	3,070	12.7	898	115.7	829	17	22
Hospitals	1,253	5.2	366	145.0	270	8	13
Health	698	2.9	204	119.6	183	14	26
Highways	1,246	5.2	364	108.1	360	29	18
Police protection	696	2.9	203	107.8	202	11	10
Correction	747	3.1	218	134.7	173	5	5
Natural resources	342	1.4	100	148.8	72	16	13
Parks and recreation	321	1.3	94	112.9	89	18	34
Financial administration	650	2.7	190	195.2	104	3	-
Judicial and legal	356	1.5	104	115.8	96	8	-
General public buildings	176	0.7	51	166.1	33	7	-
Other governmental administration	199	0.8	58	109.5	57	26	-
Interest on general debt	855	3.5	250	107.7	248	19	-
Other and unallocable	919	3.8	269	97.4	295	17	38
Utility expenditure	1,251	5.2	366	99.0	395	15	24
Liquor store expenditure	137	0.6	40	317.5	14	11	13
Insurance trust expenditure	2,537	10.5	742	178.2	445	2	2

The figures on the following pages illustrate the relationship between per capita personal income and several selected expenditure categories. The square represents Oregon and the triangle

represents the U.S. average. With the exception of highway expenditures (Figure 5), Oregonians see a greater portion of personal income spent by government than do people in other states.

**Figure 1: State and Local Government Revenues and Personal Income
50 States and U.S. Average, Per Capita (2000)**



**Figure 2: State and Local Government Expenditures and Personal Income
50 States and U.S. Average, Per Capita (2000)**

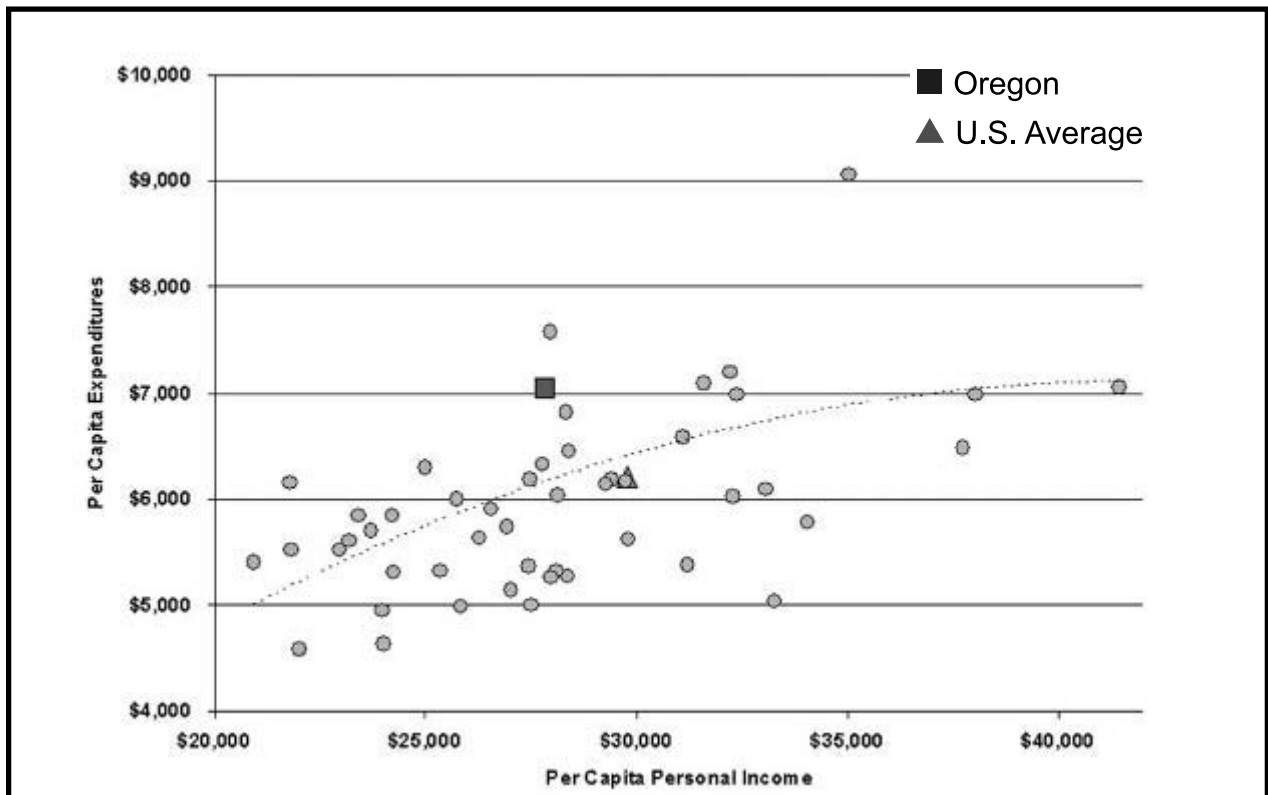


Figure 3: State and Local Government Education Expenditures and Personal Income: 50 States and U.S. Average, Per Capita (2000)

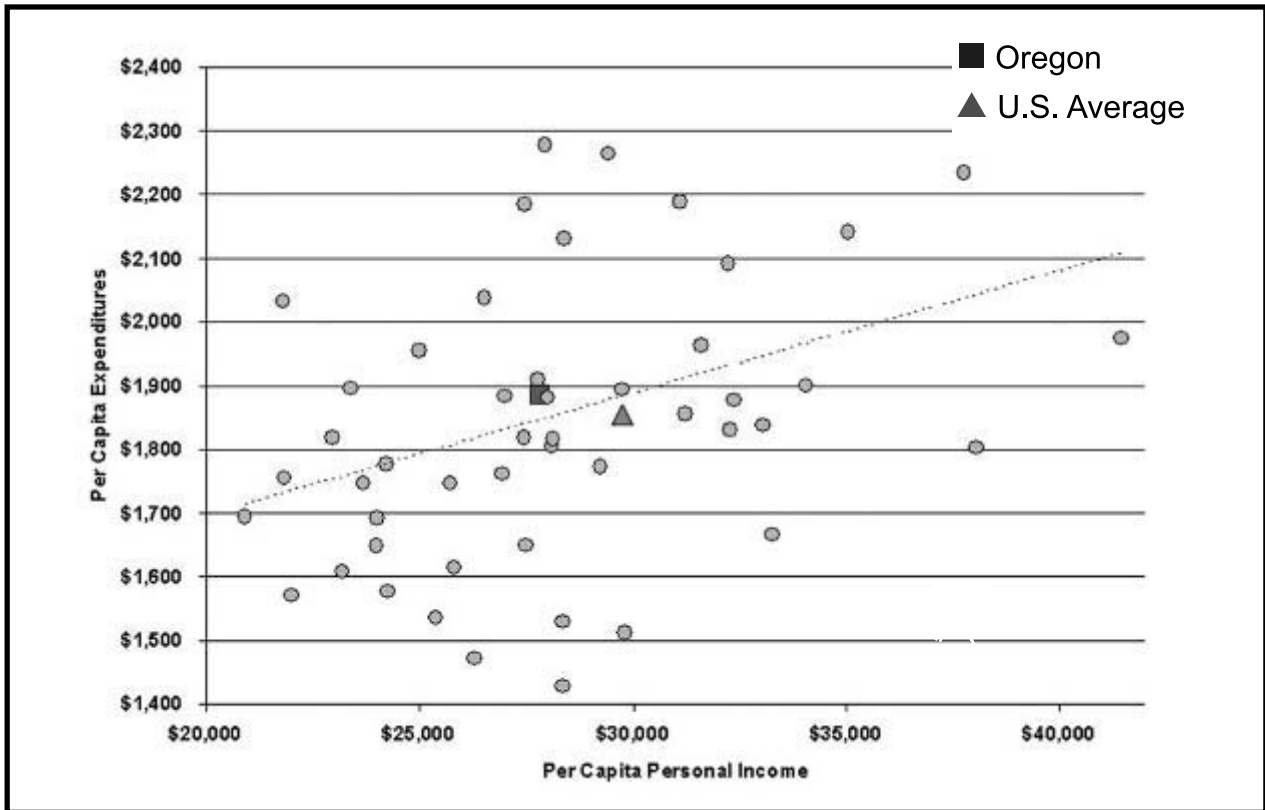


Figure 4: State and Local Government Health and Hospital Expenditures and Personal Income: 50 States and U.S. Average, Per Capita (2000)

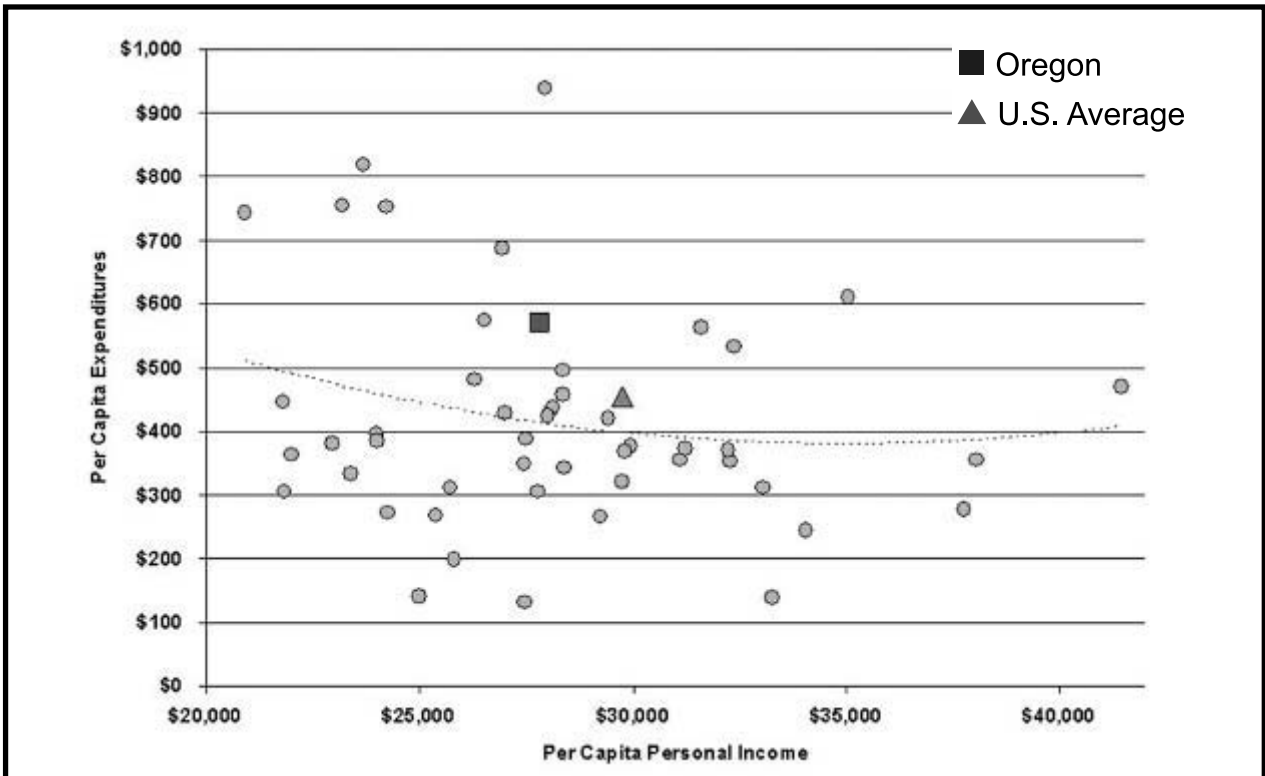


Figure 5: State and Local Government Highway Expenditures and Personal Income: 50 States and U.S. Average, Per Capita (2000)

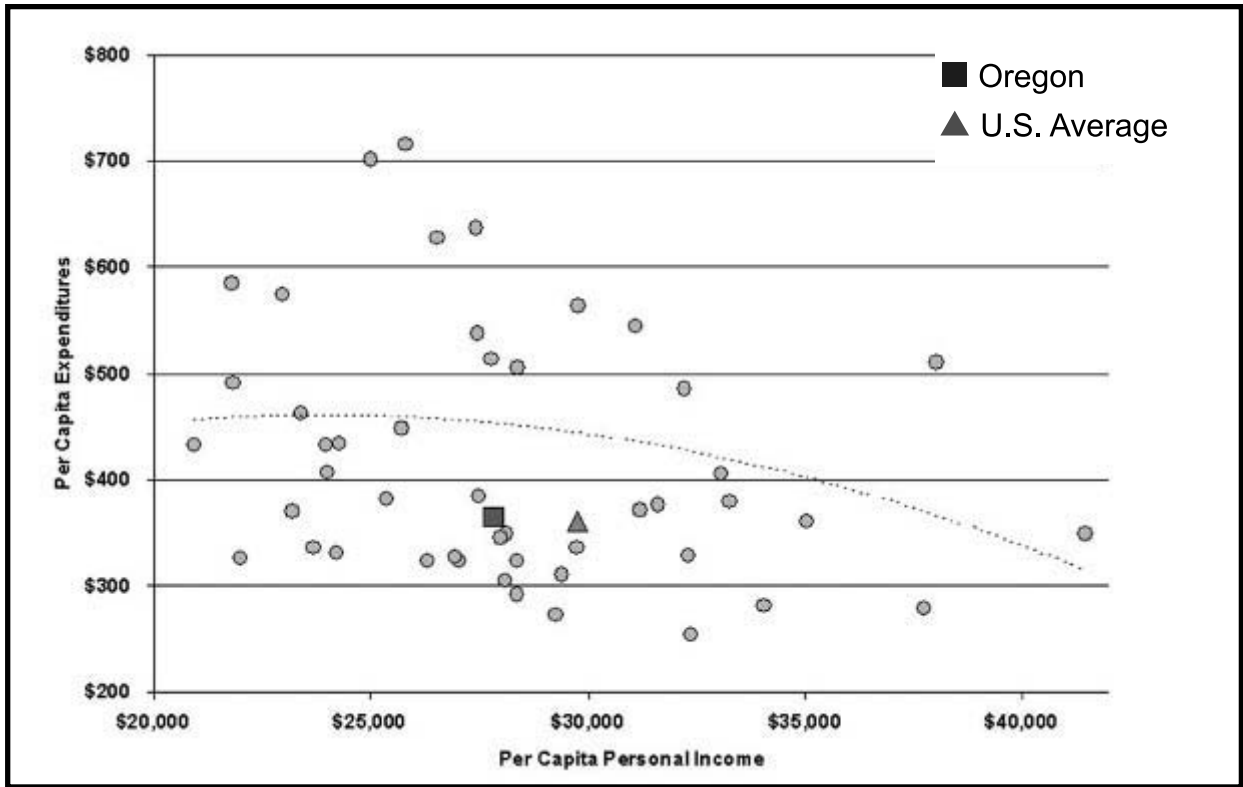
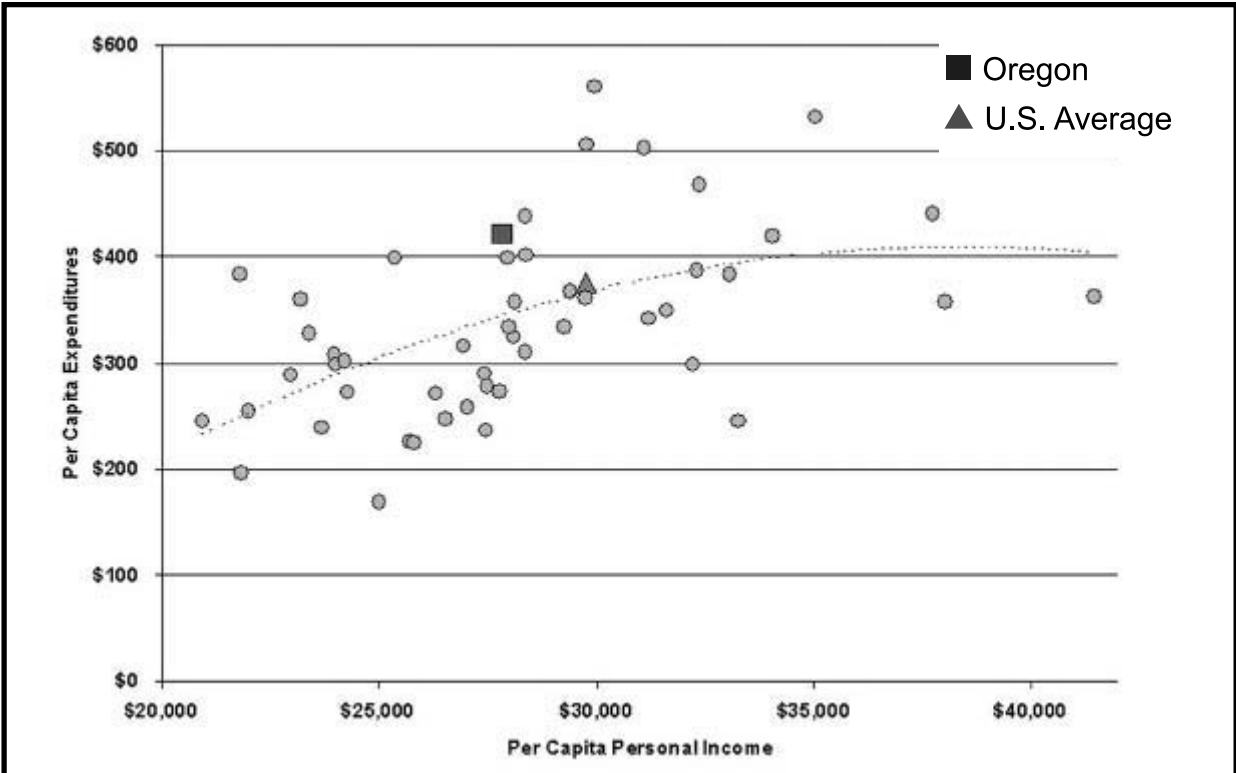
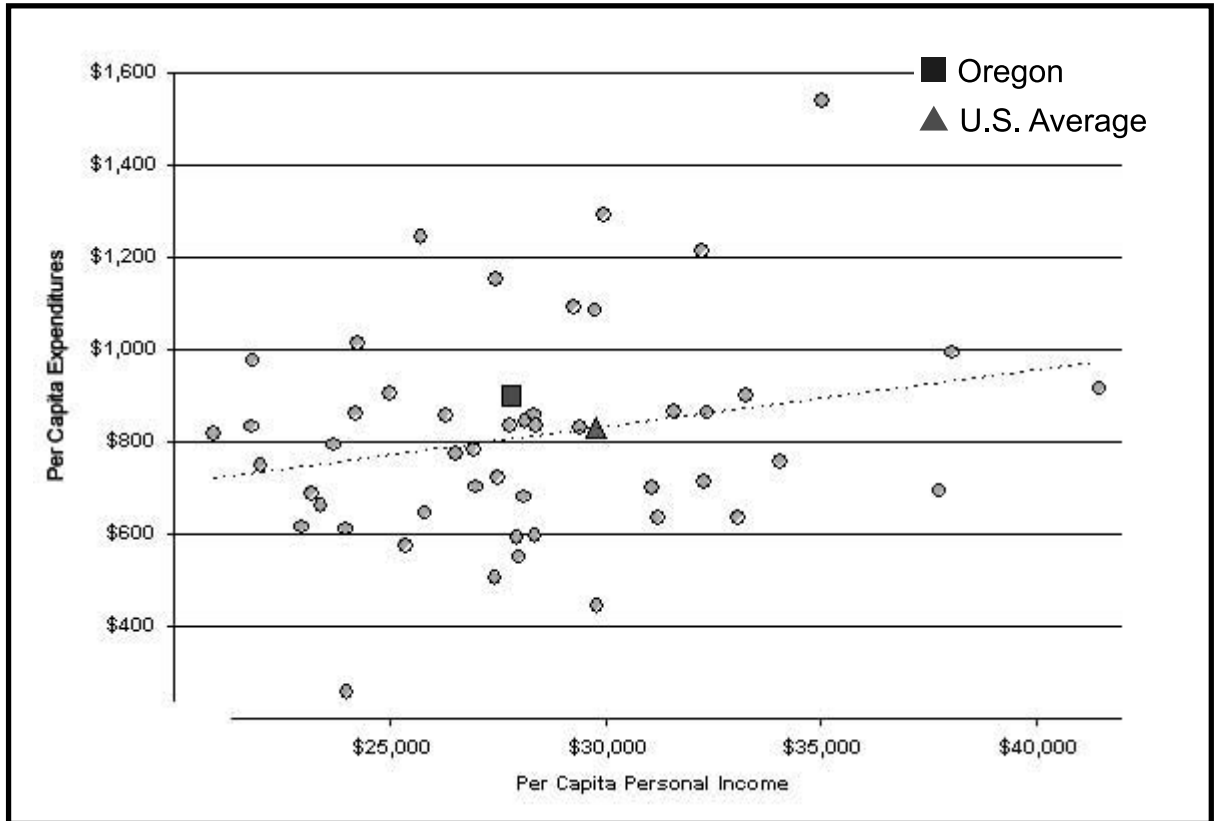


Figure 6: State and Local Government Police and Corrections Expenditures and Personal Income: 50 States and U.S. Average, Per Capita (2000)



Consistent with the findings of the earlier report, Oregon continued to display a pattern of overspending relative to its statistically equivalent peers.

Figure 7: State and Local Government Welfare Expenditures and Personal Income: 50 States and U.S. Average, Per Capita (2000)



Benchmarking Oregon Spending

In this section, we report the results of efforts to benchmark Oregon spending using data on all states for the fiscal year ending in 2000. The source of the data is the U.S. Census Bureau, to which individual state and local jurisdictions report their state and local spending. Over- or underspending is measured as the percentage by which Oregon spending is higher or lower than would be predicted by its economic and demographic characteristics.

Consistent with the findings of the earlier report, Oregon continued to display a pattern of overspending relative to its statistically equivalent peers. Total spending, and all but one major category of spending, continued to be much higher than would be predicted

on the basis of the economic and demographic features of the state alone. Moreover, the rate of “overspending” measured for Oregon in 2000 was even higher than that measured in 1998 in Dr. Pozdena’s prior report.

General Comments on Oregon’s Spending Pattern

One can never be certain whether the observed overspending is a consequence of undisciplined budgetary practices or a reflection of the desires of Oregon citizens to consume public services. However, the behavior of spending in this period is certainly consistent with a spending policy that was disciplined by nothing but available revenue. It is notable that 2000 marked the end of a period of unprecedented economic growth. State income tax revenues grew by

100 percent from 1992 to 2000.² Total revenue to state and local governments from all sources grew by 86 percent over the same period.³

Although defenders of Oregon’s spending growth during this period would be quick to point out that some of the largest growth in spending (e.g., healthcare) was supported by federal funds, the pattern of own-source revenues during this period is not consistent with the notion that federal revenues were used to ease the burden of spending on Oregonians. During this period, the total of all own-source revenues in Oregon remained in excess of 17 percent of personal incomes, a level that has been maintained for

approximately a decade (Table 3). In essence, the total of state and local levies has the effect in Oregon of taxing 17 percent of total personal income *whether the level of income or federal funding availability is usually high or not*. That is, there is no evidence that policy makers considered using the availability of a larger tax base or greater federal funds to relieve Oregon taxpayers of their own-source burden. Rather, Oregon’s strong dependence on the income tax at the state level created highly elastic revenue growth and state and local officials appear to have been quick to balloon spending accordingly. This is suggestive of a spending policy that is limited primarily by available revenues, rather than managed by a disciplined budgeting process.

[T]he behavior of spending in this period is certainly consistent with a spending policy that was disciplined by nothing but available revenue.

Table 3: Trends in Own-Source Revenues as Share of Oregon Personal Income

Fiscal Personal Income State and Local Own Source Revenue			
		(\$ mil.)	(% of personal income)
1991-92	54,891	9,607	17.5
1992-93	58,163	9,938	17.1
1993-94	61,916	10,517	17.0
1994-95	66,130	11,251	17.0
1995-96	71,206	12,093	17.0
1996-97	75,561	13,411	17.7
1997-98	80,575	13,659	17.0
1998-99	85,305	14,304	16.8
1999-00	89,080	15,736	17.7

Source: U.S. Census Bureau and Bureau of Economic Analysis

[G]iven Oregon’s economic and demographic makeup . . . Overall spending is 19 percent higher than expected.

Table 4: Benchmark Estimates of Oregon Spending (2000)

Spending Category	Percent Over/(Under) spending	Benchmark Accuracy (Percent)	Key Demographic Determinants
Total	19.45	98.9	Personal income, school age population, poverty population, non-metropolitan population
Control for liquor and utilities	7.52	99.3	Personal income, school age population, poverty population, non-metropolitan population, liquor store expenditures, utility expenditures
<i>Selected Subcategories of Total Expenditures</i>			
Education	6.44	99.3	Personal income, school age population, nonwhite population, rural population, population with bachelor’s degree
Health & hospitals	56.51	95.3	Dependent population, nonwhite population, rural population
Highways	(7.83)	96.7	Personal income, rural population; controls for Alaska and Wyoming
Police & corrections	26.38	98.7	Personal income, poverty population, youth population
Welfare	23.75	92.3	Personal income, personal income growth, dependency population, rural population

Evaluating Oregon’s Spending Patterns

The results of our multi-factor benchmarking are summarized in Table 4. It presents an estimate of the relative over spending or under spending by Oregon for each of the selected, major spending categories. The estimates presented in Table 4 suggest that Oregon has been spending more than would be expected for an economically and demographically identical state. Specifically, given Oregon’s economic and demographic makeup:

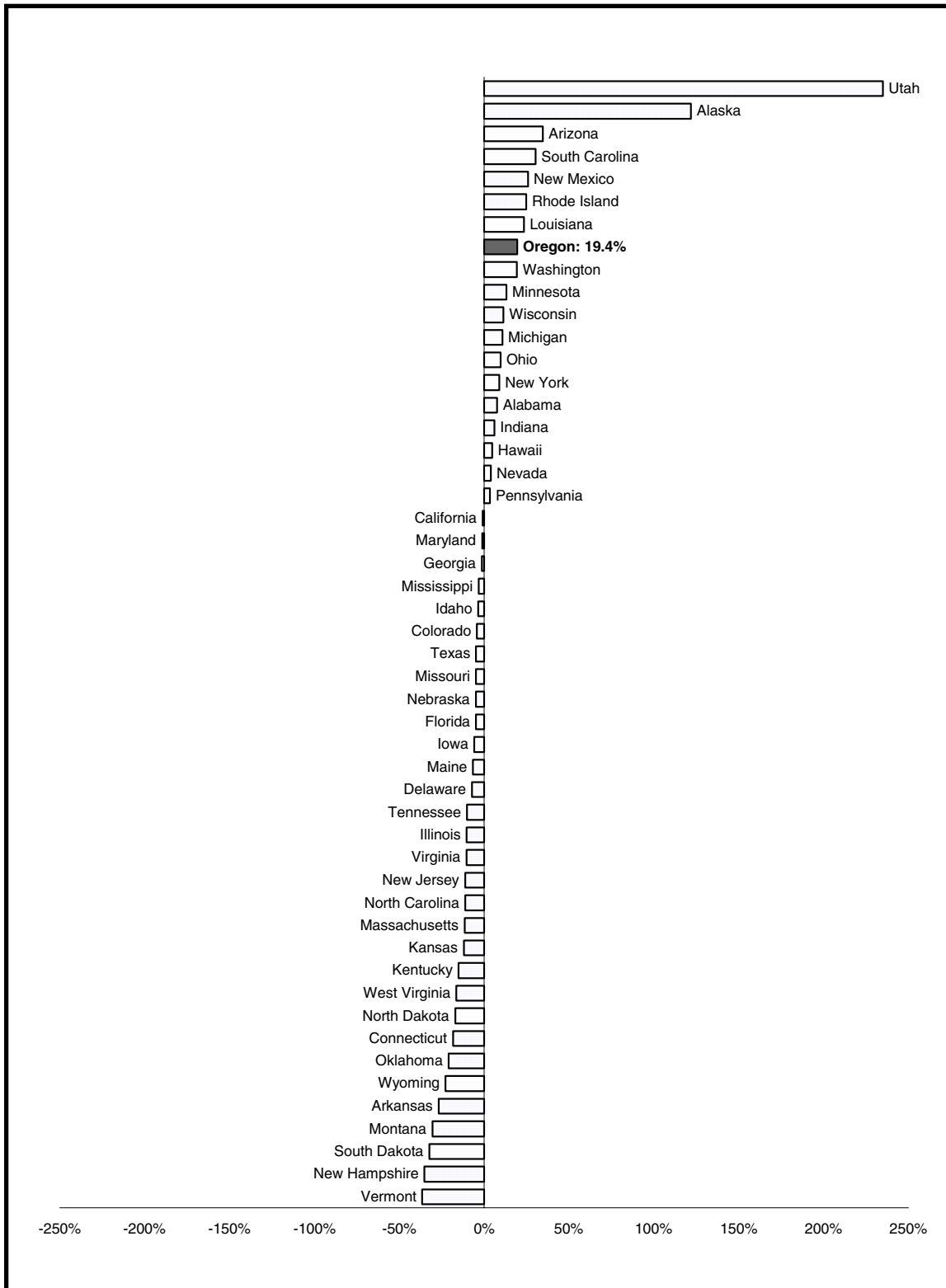
- Healthcare spending by the public sector is 57 percent higher than expected
- Welfare spending is 24 percent higher than expected
- Education spending is six percent higher than expected
- Spending on corrections and police is 26 percent higher than expected

- Highway transportation spending is eight percent lower than expected
- Overall spending is 19 percent higher than expected

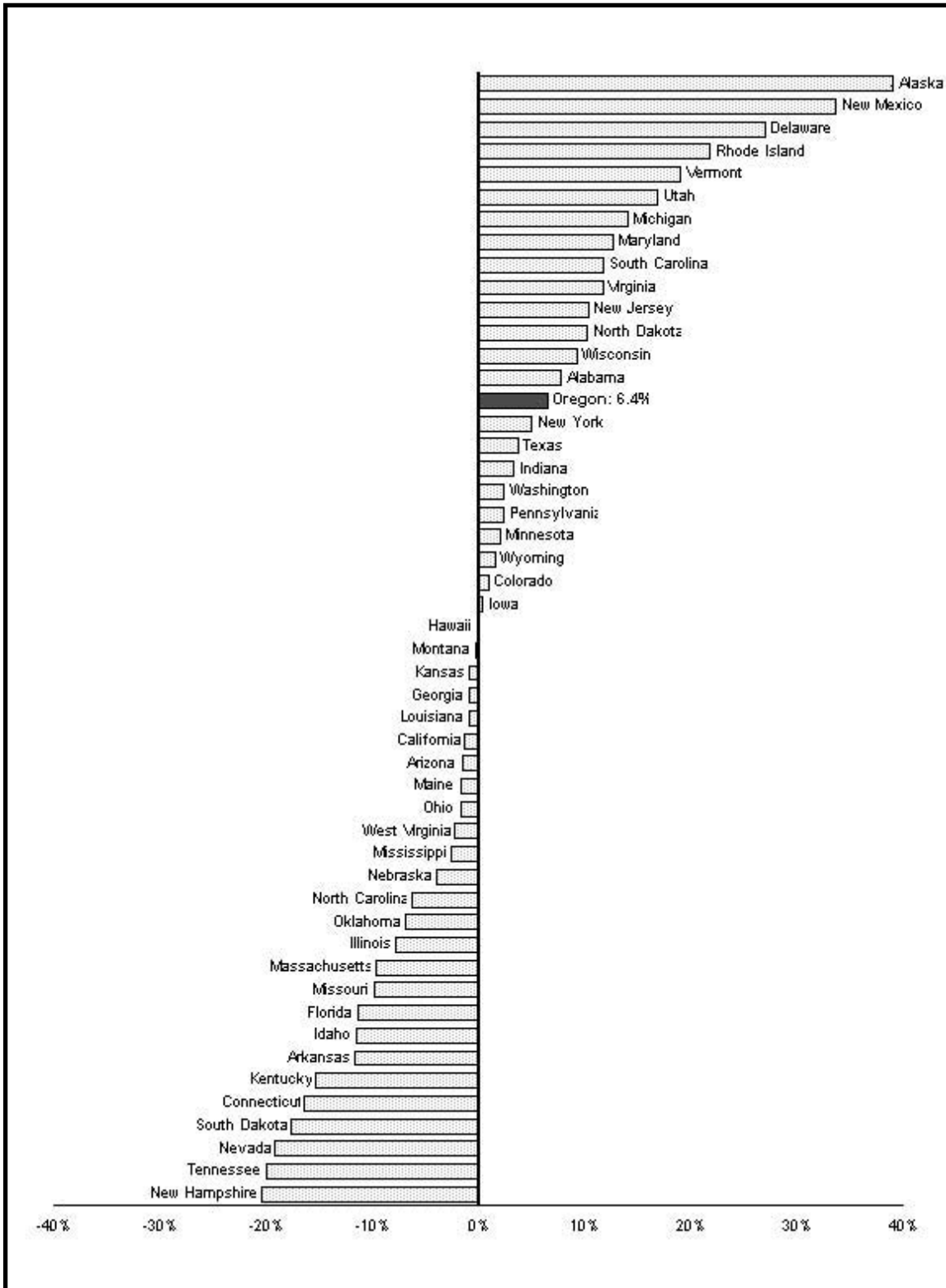
Though only benchmark estimates, these results suggest a consistent pattern of greater spending by Oregon at the state and local level than one might otherwise expect.

In addition to the percentage deviations from Oregon’s expected spending level, the over- and underspending rankings are also an important measure to observe. These results are presented in Figure 8 through Figure 13. In many of the overspending categories, Oregon’s rank is very high. That is, even though a number of other states are prone to overspending, Oregon’s consistent pattern belies the possibility that Oregonians occasionally find certain areas of government spending to be desirable for one reason or another. The consistency of this overspending across quite disparate areas of government expenditure suggests that Oregon may have an endemic budget discipline problem.

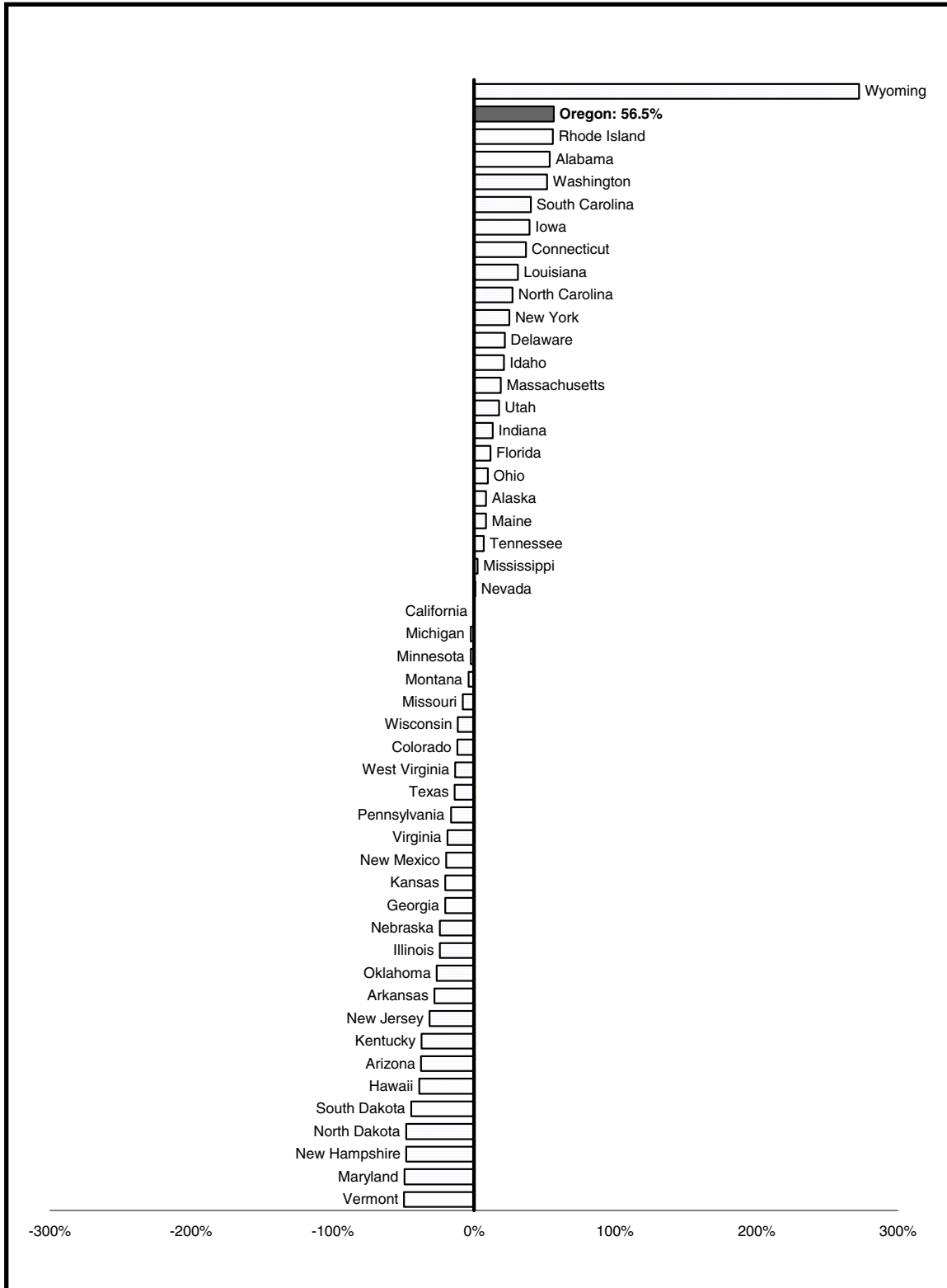
**Figure 8: Government Over-/Underspending on All Expenditures
Benchmark Estimates of State Spending (2000)**



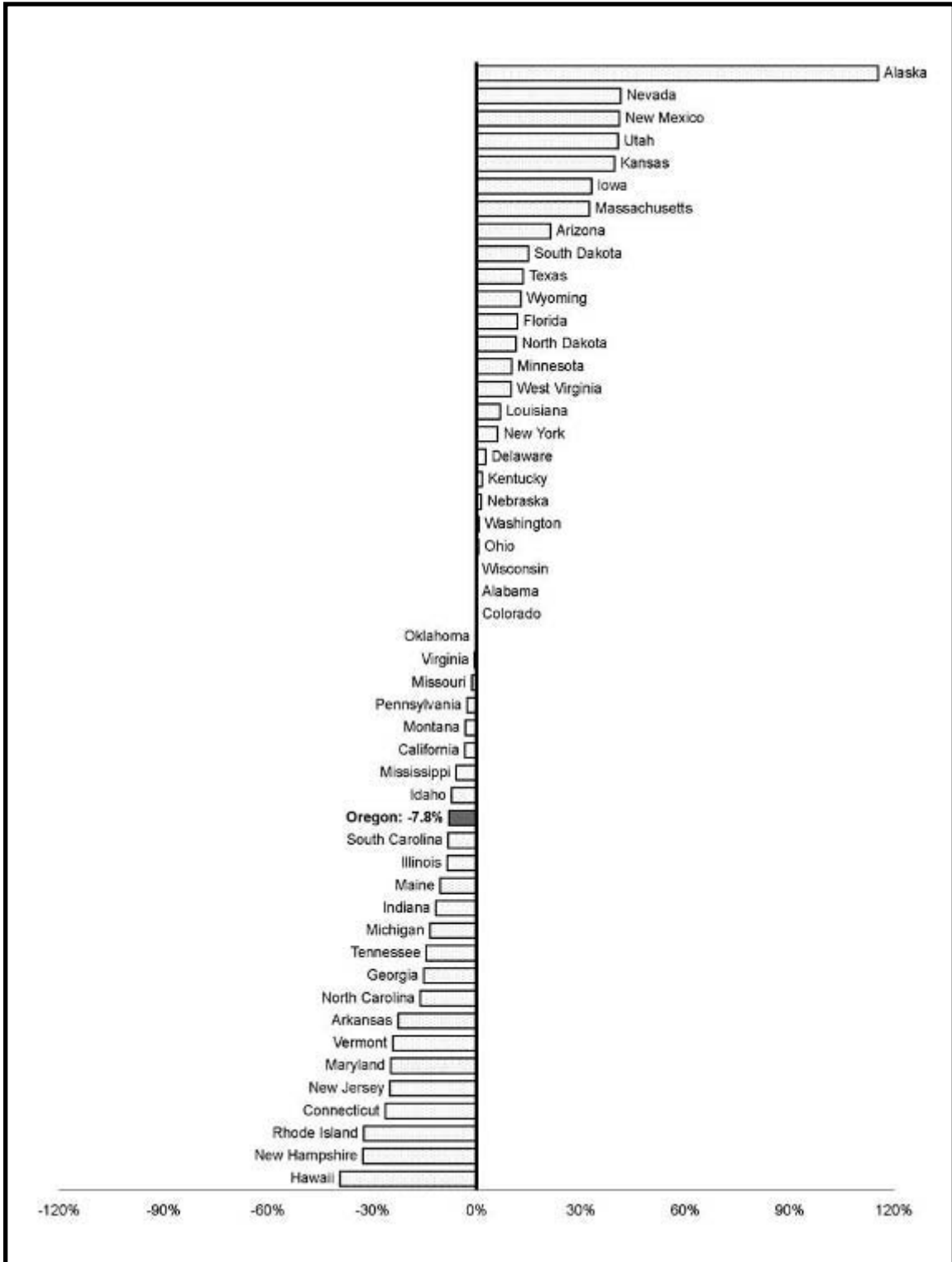
**Figure 9: Government Over-/Underspending on Education
Benchmark Estimates of State Spending (2000)**



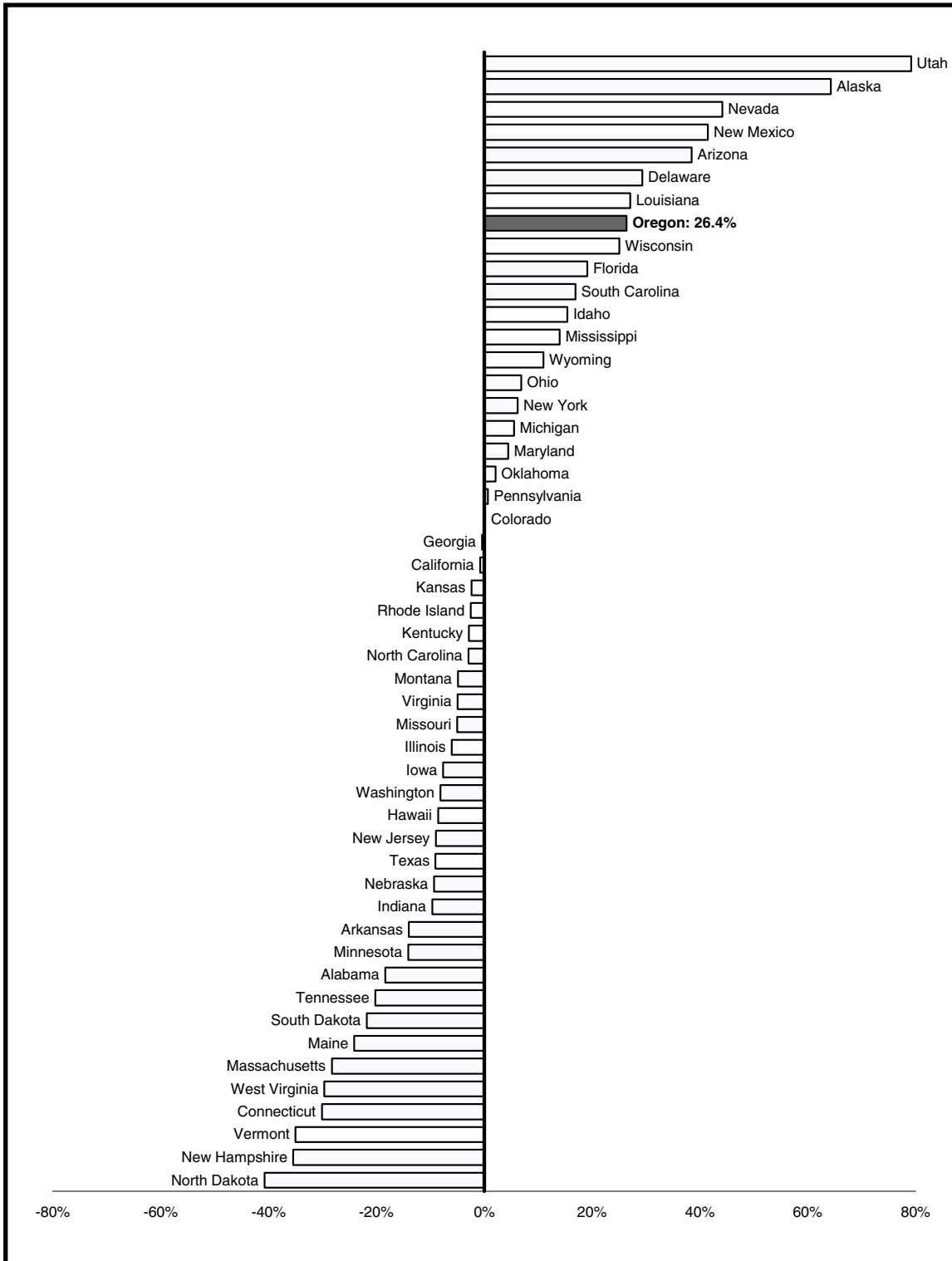
**Figure 10: Government Over-/Underspending on Health and Hospitals
Benchmark Estimates of State Spending (2000)**



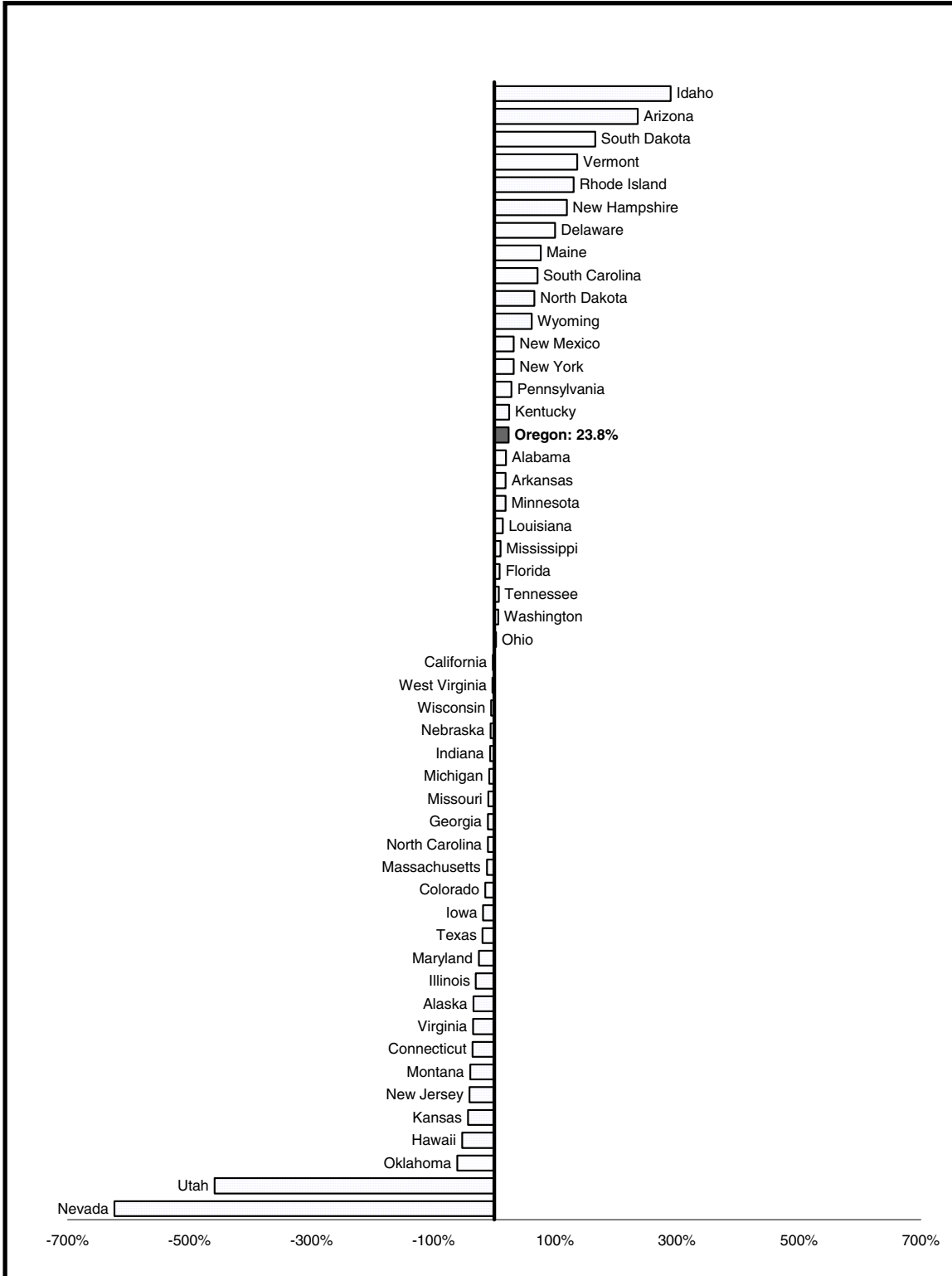
**Figure 11: Government Over-/Underspending on Highways
Benchmark Estimates of State Spending (2000)**



**Figure 12: Government Over-/Underspending on Police and Corrections
Benchmark Estimates of State Spending (2000)**



**Figure 13: Government Over-/Underspending on Welfare
Benchmark Estimates of State Spending (2000)**



In summary, the multi-factor benchmarking analysis suggests strongly that, as of fiscal year 2000, Oregon had continued to spend at a rate that was not easily explained by economic and demographic relationships of the kind observed across the United States as a whole.

Although some of the data is suggestive of a generally undisciplined budgetary process, only Oregonians can answer the question of whether this spending level is what they actually desire, or is thrust upon them by a legislative process that is not representative of their interests.

Oregon Spending Since 2000

The analysis above confirms that the pattern of overspending observed in 1998 was continued through 2000, and spending growth in relation to income accelerated

substantially. Throughout the 1990s and into 2000, Oregon government spending grew faster than state personal income. From 1992 to 2000, personal income increased by 64 percent and state and local expenditures grew by 75 percent (Table 5). In other words, every one-percent increase in personal income was associated with a 1.17 percent increase in state and local expenditures. From 1998 to 2000, every one-percent increase in personal income was associated with an even greater 1.33 percent increase in state and local expenditures. Economics provide no justification for tying the growth of government expenditures to the growth of personal income in that the services provided by state and local governments are only tangentially related to the level of personal income in the state. Rather, personal income growth represents a restraint on the state's capacity to extract taxes from its residents, businesses and landowners. Spending

Throughout the 1990s and into 2000, Oregon government spending grew faster than state personal income.

Table 5: Oregon Personal Income and State and Local Expenditures (\$billions, 1992-2004)

<u>Personal Income</u>		<u>Actual State & Local Expenditures</u>	
1992	\$ 58.2	\$ 13.8 (23.7% of income)	
1998	85.3	20.8 (24.3% of income)	
2000	95.5	24.1 (25.2% of income)	
2004	108.9	n/a	
<u>Growth</u>		<u>Taxes Grew Faster Than Income by a Factor Of:</u>	
1992-1998	47%	51%	1.08
1998-2000	12%	16%	1.33
1992-2000	64%	75%	1.17

Source: U.S. Census Bureau; Oregon Office of Economic Analysis

As of July, 2004, Oregon's unemployment rate was exceeded only by Alaska's and the District of Columbia's.

increases that outpace personal income growth are unsustainable over long periods without increasing the tax burden in the state.

Since 2000, Oregon has been in a deep and persistent recession. Between 2000 and 2003, employment fell by nearly three percent, a loss of about 44,000 jobs.⁴ Although Oregon's personal income trend after 2000 has been more or less in step with the national pattern, several factors made Oregon's recession experience different from other states'. First, Oregon continued to attract and retain job seekers, with the result that its unemployment rate continues to be among the highest in the nation. As of July, 2004, Oregon's unemployment rate was exceeded only by Alaska's and the District of Columbia's.⁵

Second, Oregon's reliance on personal and corporate income taxation made state tax revenues drop substantially with the downturn in the economy. Like other states reliant on income taxation, the most dramatic declines were in capital gains receipts, which fell over 50 percent between the 2000 and 2001 tax years.

Unfortunately, a complete picture of the trends in local tax revenues is not yet available, so the overall picture of state and local revenue capacity is unclear. Because local governments tend to rely on property tax revenues, it is likely that local revenue was generally not adversely affected by the recession; Oregon's residential housing values continued to rise during this period. However, some local activities such as schools, law enforcement and corrections are funded in part by the state, and so would be affected.

By conventional measures, the state faced a 17 percent difference between its budgeted general fund spending and its revenues for fiscal year 2003-2004—about 70 percent higher than the national median revenue shortfall. Ballot Measure 30, put before the

voters in the spring of 2004, would have temporarily increased personal income, corporate income, property and cigarette taxes by a total of \$802.4 million in the 2003-05 biennium, which would have paid for approximately 5.7 percent of the legislatively budgeted state and local school expenditures. The measure was resoundingly defeated even though its advocates claimed that failure to adopt the tax increases would result in draconian cuts to critical public services.

The Example of K-12 Spending

A key question after the voter rebuke of Measure 30 is whether the reported budget shortfall represents a true revenue problem or a revenue-management (i.e., spending) problem. Lacking sufficient information after 2000 to analyze either total state and local spending or most categories of spending, we examined spending on K-12 education in Oregon vis-à-vis other states. The National Education Association (NEA), a teachers union, forecasts school spending by state each year. For 2003, all but two states had reported spending in this category.⁶ According to the NEA data, expenditures per student in public schools in Oregon fell by an estimated 6.1 percent between the 2002 and 2003 school years and student-teacher ratios increased from 18.8 to 20.4. Over the same time period, average teacher salaries increased by 3.3 percent.⁶

The NEA data allow, selectively, an analysis of the relative circumstances of K-12 spending in Oregon after three years of deep recession and reductions in operational spending. Using the same statistical technique as described earlier for the 2000 data, we measured the average relationship between various demographic and economic factors and school spending. We used data from the 48 reporting states to predict the level of spending that would be expected of Oregon

given its economic and demographic circumstances. The results suggest that, as of 2003, the effect of the spending reductions has been to bring Oregon in line with its national benchmark; that is, its actual level of spending was approximately that expected by the average behavior of other states.

Current State and Local Spending

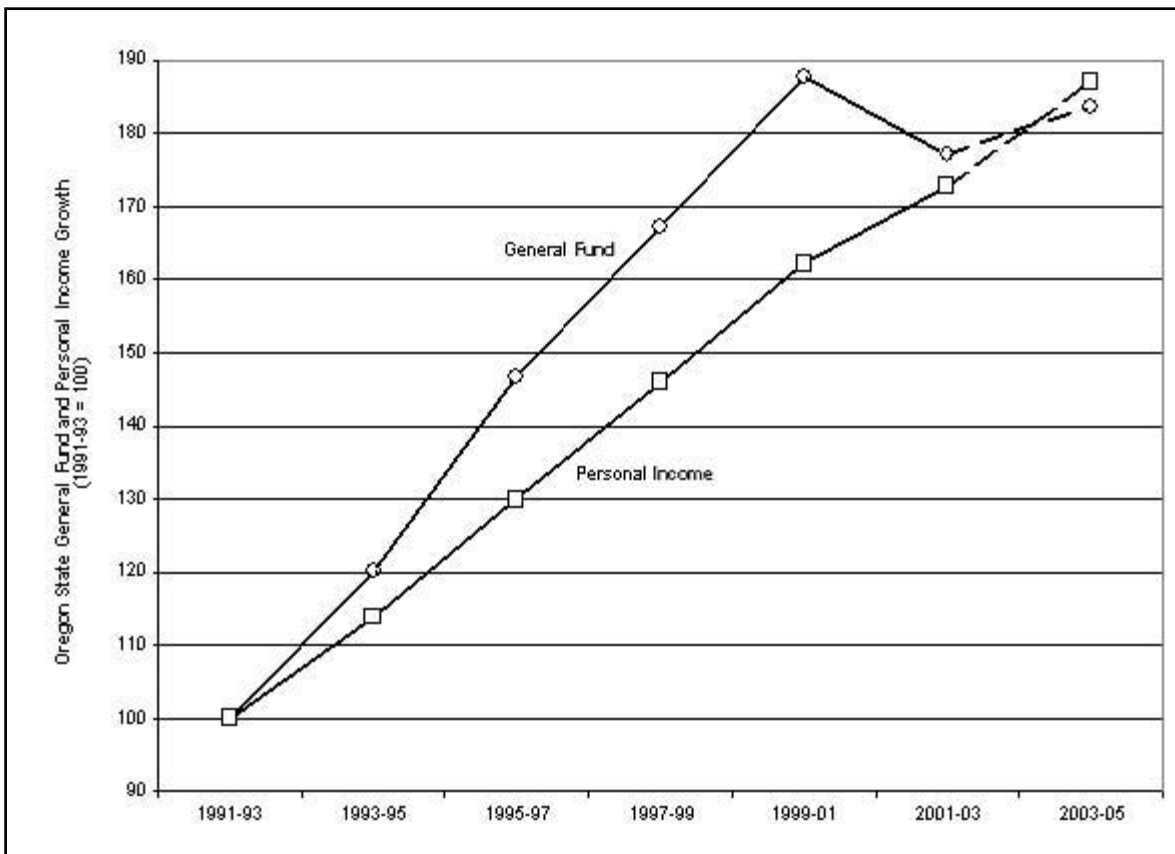
If one accepts the naïve premise that government expenditures should keep pace with personal income, then 2004 state and local spending in Table 5 should be approximately \$25.8 billion. Our benchmarking analysis also provides guidance by adjusting for differences in average personal income as well as demographics. We used the most recent demographic data from the U.S. Census Bureau (2002) and the Oregon Office of

Economic Analysis (2004).⁷ We came to a benchmarking estimate of \$24.6 billion in 2004 state and local expenditures in Oregon.

Figure 14 shows the growth in the Oregon state general fund and personal income. The general fund is only one component of state and local government spending in Oregon, comprising approximately 20 percent of all state and local spending. From 1991 to 2001, general fund expenditures mirrored the statewide trend of increased government spending. Concomitant with the precipitous drop in 2001 tax revenues, general fund expenditures fell by approximately six percent from the 1999-01 biennium to the 2001-03 biennium. This drop, combined with the attenuated growth in expenditures from 2001-03 to 2003-05, has brought the long-run growth in general fund expenditures roughly in line with personal income growth.

From 1991 to 2001, general fund expenditures mirrored the statewide trend of increased government spending.

Figure 14: Oregon State General Fund and Personal Income Growth (1991-93 = 100, Biennia 1991-2005)



Source: Oregon Department of Administrative Services data.

The tendency of government to spend any available revenue—no matter how transient the source—is strong evidence of a ratchetlike spending bias in our policy making processes.

Implications and Remedies

The analysis of 2000 and the abbreviated analysis of K-12 spending in 2003 suggest that Oregon has a history of overspending relative to its statistical peers in times of economic health. The limited analysis for 2003 indicates that even with the sharp declines in state revenue growth during the recession, Oregon spending may still be high relative to its benchmark. There are three reasons to believe this. First, despite spending cuts, K-12 spending is still at its benchmark. Second, given that K-12 spending in Oregon is more dependent on state revenue than are other categories of local spending, it is likely that other areas of local spending have fared better after state budget cuts. Finally, to the extent that spending on other state services (such as the Oregon Health Plan) fared similarly to K-12 education spending, it is not clear that overspending tendencies have been exhausted. Consequently, although we cannot say with certainty that state and local spending in Oregon remains greater than its benchmark would predict, neither can we point to definitive evidence to the contrary.

What one can definitively conclude is that state and local taxing and spending processes must be better disciplined than they were before 2000. First, the tendency of government to spend any available revenue—no matter how transient the source—is strong evidence of a ratchetlike spending bias in our policy making processes. Second, the fact that revenue increases are sought first in times of fiscal stress suggests that there may be inadequate flexibility in the way that government services are provided. Finally, if the defeat of Measure 30 is any indication, voters are not convinced that public services in Oregon are a good value. If this is an accurate interpretation, Oregon should reconsider the way it delivers those services.

Containing Spending Bias

Milton Friedman and others have attributed spending bias to asymmetrical representation of special interests in policy making circles. Namely, entities with a strong interest in a program or policy have a strong economic incentive to lobby for their special interest. The average voter, on the other hand, has a small financial stake in any one program or policy, and thus has little incentive to engage in aggressive advocacy against it. If one accepts this model, as many market economists do, there needs to be a mechanism by which individual voters can more economically make their views on individual programs and policies felt in the policy making process. In this section, we propose mechanisms by which the “influence asymmetry” could be mitigated.

Voter Access to Legislators

The conventional means available to a voter for expressing an opinion on an individual issue is to write or phone one’s legislator. This mechanism is probably underutilized, perhaps for the same reason that Friedman hypothesized: It is too expensive for individual voters to learn about a government program, determine the impact of individual program or policy initiatives and contact their representative. With low-cost access to the Internet, however, the cost of learning about initiatives that affect taxpayers and contacting representatives is lowered considerably. Numerous Internet initiatives have been used to facilitate such communication and even voting by Internet has already been used.⁸ Oregon legislators use the Internet to provide easy access to clear, consistent information, including the cost and benefits to taxpayers for each proposed initiative and a means of registering one’s opinion with the appropriate representative.

Automatic Referral of Revenue and Spending Initiatives

Expressing opinions and communicating with legislators may not suffice in a world in which campaign contributions or other means of influence are dominant in legislators' decisions. Consequently, some countries, like Switzerland, have adopted *direct democracy* mechanisms that limit the ability of legislatures to enact policy or spending changes without referral to a popular vote *even at the national level*.⁹ Indeed, research indicates that Swiss cantons that require voter approval of new spending projects spend at least 17 percent less on average than those that do not require voter approval.¹⁰

Representatives left to themselves tend to overspend, and referendums and initiatives are an effective constraint on overspending. Oregon voters must already approve any increase in the property tax, but not all taxes and fees. Many omnibus tax proposals, including Measure 30, have been referred to voters, but these omnibus referrals give the voter no opportunity to choose the particular policies he or she wishes to support.

Voter Ballot Initiatives

The ballot initiative is a direct-democracy mechanism to advance or oppose programs or policies. The frequent use of initiatives in Oregon is seen by critics as weakening the representative nature of our government. Advocates of the initiative process see it as a necessary escape valve from unresponsive or incompetent representation. Oregon makes the initiative process weaker than it should be by not providing legal assistance *ex ante* to initiative writers; many initiatives that voters support are subsequently ruled constitutionally invalid or have unintended side effects that could have been avoided had the language been better crafted.

Automatic Spending Caps

Another mechanism to control spending bias is the automatic spending cap.¹¹ The caps can be linked to population and inflation to build in a certain amount of responsiveness to growth. This device limits the total spending permitted by a state or local authority, but leaves that authority free to allocate among programs within the cap. Consequently, there can be contention over the composition of programs, or the way in which programs are implemented, unless the governing authority(s) are very diligent.

It may require one or more of these direct democracy and spending cap policies to fully contain the potent spending bias that asymmetric lobbying incentives create.

Improving Service Flexibility

Oregon's experience with its recent deep recession has illustrated that it is difficult to maintain a steady level of government services while depending on a volatile revenue source like income taxes. However, government is not alone in having to manage its affairs in a volatile world. Many private businesses saw equal or greater deviations in their pattern of revenues than did the state. Implicit in the concern about public fiscal volatility is the notion that public sector services are either more important to maintain at a steady level, or more difficult to adjust to a lower cost, or both, than are private sector services. In our view, both assumptions are open to challenge.

Are public services more important to the well-being of the citizenry and the economy than privately provided services? The question is not simple to answer, since it is difficult to maintain public services without impacting the private sector adversely—something that is especially problematic

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Labor contracts in K-12 education usually require that layoffs occur first among the most junior staff, irrespective of productivity. This amplifies both the number of individuals laid off and the decline in productivity.

during a recession. Certainly the argument could be made that some public services deserve priority during tough economic times; for example, aid to the truly handicapped, who have no prospect of providing for themselves without state assistance, or public safety.

This prioritizing leads to several possible solutions to the problem of inflexibility in allocating public money.

Cut Back Programs With Small Net Economic Impacts

Many public services have close analogues in the private sector, where capital improvement and operating program initiatives are traditionally scaled back or delayed when cash flow is tight. Education services, transit, highway, sewer and improvements, and other such capital-enhancing programs could selectively be reduced in quality or cut back. The test for whether such cutbacks should occur is whether the long-term cost imposed by delay or degradation of the service is *greater than* the long-term cost or delay imposed on the economic recovery by further taxing private activity. Japan learned in the 1980s and 1990s that a policy of preserving public spending through times of low revenue to the government by increasing taxation had the effect of creating a 15-year recession, with a potent, negative net benefit.

Avoid Inherently Inflexible or Unproductive Operating Strategies

Some policies exaggerate the impact of fiscal stress. Labor contracts in K-12 education usually require that layoffs occur first among the most junior staff, irrespective of productivity. This amplifies both the number of individuals laid off and the decline in productivity, creating an injurious impact on both students and the economy. It is difficult to justify downward wage inflexibility in the

public sector during times when labor in the private sector is taking sharp wage cuts. Airline personnel, for example, are experiencing significantly lower wages during their industry's recession.¹² Even in industries where actual wage cuts did not occur, *de facto* wage cuts occurred as workers were pressed to higher productivity at the same wage. We do not know why labor in the public sector should not bear similar adjustments.

Rainy Day Funding

Setting aside cash reserves to preserve public sector spending during weak economic times has been proposed many times in Oregon.¹³ In theory, once a "normal" level of spending is defined for a given year, then any excess revenues are added to the fund or any budget shortfalls are paid out of it. Cash management is the hallmark of any well-managed enterprise, public or private. Hence, most firms maintain cash reserves or lines of credit on which they can draw. There are several difficulties in applying this concept in the public sector. First, because of the bias toward overspending, some see every day as a rainy day and the funds never grow large enough to be useful.¹⁴

Second, the public sector does not follow the same principles of cash management as the private sector. In the private sector, the virtue of maintaining cash reserves is determined by balancing their benefits to the corporation against the value of the cash to shareholders or lenders. Firms are penalized in the marketplace for holding excess cash reserves. In a public agency, little discipline is imposed on the agency for over-holding cash reserves. In Oregon, the voters have passed so-called "kicker" legislation that returns excess revenue to taxpayers, suggesting that the public believes it has better uses for excess cash than does the state.

Finally, the existence of a rainy day fund

reduces pressure to find other remedies to budget imbalance. If one believes in the overspending bias model, periodic fiscal crises may be necessary to reset the appropriate level of public spending. To our knowledge, there have been no formal studies of the effect of rainy day funds on spending bias.

Rely on Less Volatile Funding Sources

The reliance by the State of Oregon on the income tax contributes to the volatility of revenue to the state. Other revenue sources, notably property taxes and sales taxes, are less volatile over the business cycle. Some Oregon legislators are considering enacting a sales tax, although Oregon voters have rejected such a tax nine times.¹⁵ The reduction in revenue volatility has to be balanced, of course, against many other considerations, including the equity of the tax, and its impact on business development. In general, sales taxes are considered more regressive than income taxes. The fact that Oregon is one of only five states without a sales tax may also be a circumstantial economic development advantage for the state. In addition, communities hosting retail enterprises typically lay claim to some portion of locally generated sales tax revenues—a policy that can degenerate into inefficient inter-community competition for retail activity.

Eliminate or Reduce the Capital Gains Tax

Oregon has the third highest capital gains tax rate in the country and ranks second among the states in the importance of the capital gains tax to government revenues.¹⁶ Capital gains is a volatile source of income to the state of Oregon and a major source of uncertainty to the revenue forecast. The “booms” associated with large capital gains give elected officials and bureaucrats a false sense of tax wealth, resulting in budgets and

expenditures that may be untenable when the economy turns down. Reducing or eliminating the capital gains tax would eliminate a large source of revenue uncertainty at the state level and dampen the boom-bust cycle in state budgets.

Policies adopted to maintain public spending levels irrespective of the condition of the private economy need to be evaluated in terms of their long-term economic impact—not simply short-term dislocation effects. There is no strong economic argument for balancing public budgets during times of economic stress by increasing taxation. Not only spending-stabilization policies, but policies that facilitate efficient and equitable cyclical flexibility in the cost of public services also need to be considered. The effect of smoothing techniques such as rainy day funds on the overall path of public spending and agency efficiency needs to be evaluated.

Improve the Efficiency and Effectiveness of Public Services

Whether cyclically or in the long run, it is important to provide public services efficiently and to provide services for which taxpayers are willing to pay. In the original report to which this is an update, Dr. Pozdena argued that the only reliable way to improve the effectiveness of public services is to use competitive forces in their delivery. This can be accomplished in only two ways:

- Lower barriers to the private provision of public services
- More often charge beneficiaries of a service, rather than diffuse the cost through a broad-based tax

We stand by the recommendations in the earlier report. Both of these mechanisms would increase the ability of the marketplace to adjust to cyclical and long-term changes

Oregon has the third highest capital gains tax rate in the country.

Under the Swedish reforms, students attending either public or independent schools receive public financing on essentially equal terms. All types of schools . . . and all children are eligible.

in spending preferences and priorities. We summarize here briefly how they could be used in several spending categories and make a few new recommendations.

K-12 Education Spending

Education is the largest nonmilitary sector of the American economy, yet it is lacking in any significant exposure to competitive forces to ensure quality and accountability. This is especially true of K-12 education, which has increasingly been provided by larger districts with regulated curricula and bureaucratized management and labor relationships. This makes it exceedingly difficult for average parents to seek an alternative education-services supplier for their children.

Other nations are recognizing the hazard of entrusting this important education service to a *de facto* public monopoly. Denmark and Holland have had vouchers for private education for decades, and New Zealand has turned over all of its schools to parent-owned corporations, which run them with great flexibility. In 1992, Sweden made an exception from its long history of socialized service provision and adopted one of the world's most flexible education reforms. Under the Swedish reforms, students attending either public or independent schools receive public financing on essentially equal terms. All types of schools (sectarian, nonsectarian, for-profit, nonprofit, etc.) and all children are eligible. This sets the Swedish policy apart from experiments in Milwaukee, Cleveland and elsewhere in the United States, which provide vouchers only to low-income families.

According to a recent statistical analysis¹⁷ of the performance of Swedish independent schools, the benefits of this reform have been manyfold. It has increased the quality of education for all students, as the public schools have responded to private

competition. Low-income families especially have taken advantage of the independent schools. The independent schools have not become a harbor for isolationist religious or philosophical views. In fact, according to the study's authors, most of Sweden's private schools do not cater to any income group or philosophy but compete with public schools for the majority of students. Most of the schools are run as businesses, and the socio-economic composition of students attending independent schools is similar those attending public schools.

In Oregon, the education bureaucracy and other special interests have actively opposed the consumer choice model of K-12 education, believing instead that the state knows better what is good for Oregon students than do their parents. Oregon believes it can create quality education through central administration, and bureaucratic accountability and management mechanisms. The growing number of successful, and durable, implementations of the consumer choice model belie this reliance on an outmoded, command-and-control model of service delivery. The implication is that Oregon is condemning itself to more inefficient and ineffective K-12 education than it might otherwise enjoy.

Higher Education Spending

Oregon's community college and state university systems are exposed in most cases to stronger competitive forces than the K-12 system. In the four years since Dr. Pozdena's report, state subsidies of the four-year university system have fallen from 51 percent to 36 percent of its budget at the seven four-year public Oregon universities. Nevertheless, Oregon's state university and community college systems represent significant budget components. In the 2001-2003 biennium, the seven state universities received \$746 million

and the 17 community colleges received \$428 million in direct state support. In contrast, the Oregon Student Assistance Commission, which gives aid to students, received only \$35.9 million.¹⁸

The direct state subsidy of institutions lowers average tuition, even for those who could afford higher tuition. State colleges are thus insulated from full competition with private and out-of-state public institutions, lowering their need to offer educational quality to attract students. Creatively structured for-profit institutions like the University of Phoenix are rapidly growing by focusing on the underserved student populations like older students and those desiring “remote” education services. The University of Phoenix grew from under 10,000 undergraduate students in 1990 to about 75,000 in March, 2000.¹⁹

In addition, public colleges’ lower tuition reduces students’ commitment to complete their degrees. This happens particularly in the community colleges, which regard for-profit two-year schools as a “competitive threat” because they are more likely to see their students graduate with a degree.²⁰

A logical reform in this area would be to privatize the universities, and use state funding to provide means-tested or scholastically-tested financing to individual students. In so doing, the university system would be fully exposed to competition for the best students, regardless of need, and not be attractive simply because of an artificially created price advantage.

Community colleges raise some different reform issues. It is our observation that the community college system in Oregon functions partly as a remediation service for the deficits of K-12 education. In this sense, community colleges take pressure off of the K-12 system to perform to standard, since the

problem can be pushed “upstream.” Privatizing the community college system and providing financial assistance to students would both improve the quality of a community college education and remove the artificial “backstop” it provides the K-12 system.

Healthcare

Recent reforms at the federal level potentially permit Oregon to economically redirect the funding for the Oregon Health Plan to an alternative that would provide superior service and help contain the spiraling costs of healthcare in general. Specifically, the adoption in recent Medicare legislation of Health Savings Accounts (HSAs) (replacing Medical Savings Accounts) opens the door to significant reform opportunity.²¹

The idea behind the Oregon Health Plan was to pay for expanding the base of publicly insured individuals in Oregon by rationing the number of qualifying services. The Oregon Health Plan may have broadened coverage, but not, in fact, by rationing care; rather, it increased coverage by increasing revenues and lowering the unit cost of providing care, primarily through engagement of managed care providers.²² The wheels fell off this strategy over time as aggressive regulation of private health insurance thrust greater demand on the OHP and the managed care model of cost containment weakened under withdrawals of providers. The public support for additional revenue for the OHP dissipated with the recession and the failure of Measure 30.

The nationwide adoption of HSAs offers Oregon an opportunity to limit public involvement in providing health care. Under the new HSA regulations, virtually anyone not eligible for Medicare is eligible to obtain a high-deductible health insurance policy,

Privatizing the community college system and providing financial assistance to students would both improve the quality of a community college education and remove the artificial “backstop” it provides the K-12 system.

In addition to helping the state get out of the healthcare management business, [Health Savings Accounts] will save money by making the insured more sensitive to the price of healthcare.

which is then combined with an IRA-type account that is endowed each year with cash that can be used either to pay for the insurance deductible or can be saved and invested tax-free. The cost of high-deductible plans is very low, because most healthcare visits, and the associated insurance administration costs, are not covered. For a 20-year old man, the insurance component of the HSA in Oregon would cost only \$134 per month, and for a 55 year old man, only \$350 per month.²³ The insurance component *and* an endowment to the savings account equal to the deductible would cost only \$301 a month for the 20 year old, and \$517 a month for the 55 year old. These low costs would permit many private employers not currently offering insurance to afford to do so, reducing demand on the state and allowing it to use its resources on the most needy.

In addition to helping the state get out of the healthcare management business, HSAs will save money by making the insured more sensitive to the price of healthcare. It will give them an incentive to spend less because the savings account element is money that they can save and invest, if not spent on healthcare. This, in turn, helps discipline market prices and reduce medical inflation. Careful analysis of the Singapore experience (where HSAs have been in effect for two decades) suggest that the price disciplining effect is very strong. HSAs have also caused individuals to recognize directly the cost of lifestyle choices on their health.²⁴

Oregon was unsupportive of the earlier Medical Savings Account experiment by virtue of the coverage mandates imposed on insurers. Fortunately, the new federal legislation permits the establishment of these plans whether the state of Oregon likes it or not. Even if the OHP continues in its current form, HSAs will transform the private market to the state's benefit.

Transportation

Relative to other states, Oregon generally underspends on transportation. As Dr. Pozdena opined in his report in 2000, this is likely not because the state is spending money efficiently, but because of the anti-automobile sentiment among those that design Oregon's transportation planning. Like most command-and-control approaches, the results have been to increase costs. For example, in the Portland-Vancouver metro area, the percent of daily travel spent in congestion has risen from 9 percent in 1982 to 30 percent in 2001—the largest increase of any of the 75 cities studied by the Texas Transportation Institute.²⁵ This extra congestion has cost the Portland area approximately \$750 million annually, as of 2001.²⁶

Our recommendation for policy reform remains the same as in 2000. Use a system of charging for roadway use that better matches the revenue collected to the facilities affected. The current gasoline tax and weight-mile reporting system should be replaced by a system that charges the road users more directly based on the costs they cause. Users whose vehicles cause greater damage to the pavement would pay according to the damage they do and where they do it. Users whose vehicles or time of use reduces the highway

capacity available to others would pay accordingly.

Heavily used roads would generate more revenue for their upkeep than would lightly used roads. In general, drivers would pay more during the commute period when road capacity is scarce, but less (or nothing) in off-peak times. Heavy trucks would pay more when using lightly-built facilities such as arterials and local roads but may pay less than they do today for using well-built structures such as interstate highways.

Market-like pricing for highways has not been used before because the tracking technology did not exist. This excuse is no longer viable, as numerous technology vendors have developed electronic means of doing this in a privacy-preserving manner.²⁷ Both Oregon and Washington are in the process of conducting demonstration projects involving some of these technologies. The effect would be to encourage both efficient use of existing highways and timely investment in new capacity, if needed. Oregon's policy toward highways could evolve from one of inefficient social engineering to one with marketlike incentives and responsiveness.

Corrections Services

As Figure 12 indicates, Oregon spends more than most other states on its corrections system. Recent economic research attributes the large decline in the crime rate from 1991 to 2001 to increases in the number of police and the rising prison population.²⁸ Oregonians passed Measure 11 in 1994 by nearly two-thirds vote. That measure sets minimum mandatory sentences for serious crimes such as murder, rape and robbery. An attempt to repeal Measure 11 was defeated by a three-to-one margin in 2000. Such support indicates that Oregon's spending on corrections is consistent with the voting majority's preferences. Regardless, Oregon can pursue means of lowering the cost of delivering corrections services.

Police and corrections services are another area where the introduction of private competition might improve efficiency and lower costs. Although many Oregonians do not tend to think of these areas as ripe for privatization, in fact they have been extensively privatized in some settings and in some states. The evidence strongly suggests

that Oregon would benefit from further efforts in this regard.

Public police services are difficult to tailor to the actual policing needs of the diverse members of a community. Most community surveys indicate little satisfaction with police, mostly because of too little police presence, and satisfaction ratings have barely improved over time.²⁹ There is little opportunity for the "consumer" to influence the composition and nature of police services. The delivery of these services is highly politicized, and the crimes that police departments focus on may or may not comport well with the individual citizen's view of what is needed. Property crimes, for example, get low priority in the arrest and recovery efforts of metropolitan police bureaus, but are important to the survival of businesses and neighborhood property values. This need is reflected in the growing use of private security services to protect private property. Indeed, there are three times as many private security guards today as there are police officers and one in ten homes is wired to a central burglar alarm service.³⁰ Such partial privatization is of limited usefulness, however, if police response to alarms is limited. In New York City, for example, police will respond only to alarms at jewelry stores and banks.

Although most "privatization" of security services occurs on private property, there are some notable exceptions. Downtown Portland merchants, for example, provide roving patrols of casually uniformed individuals who assist the police but have no police powers. From the 1880s until the 1990s, San Francisco used privately patrolled "beats," which were sold by the Police Commission to so-called Patrol Specials. These Patrol Specials were deputized as peace officers and were not paid by the City but by businesses and neighborhood associations. The Patrol Specials were trained in arrest and firearms

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A new study by economists at Vanderbilt University suggests that, in addition to lowering costs directly, the competitive discipline of private prisons helps reduce cost inflation at public facilities as well.

procedures at the police academy and were monitored by the City's Police Commission.³¹ In 1986, it was estimated that 44 percent of law enforcement officials used private firms to patrol private property or public facilities such as arenas.³² In Switzerland, several dozen communities contract out policing to Securitas, a private security firm. The potential to economically and effectively allow regulated, private policing is constrained primarily by the opposition of self-interested parties. According to some studies, such outsourcing would reduce policing costs by 30 percent or more.³³

In the area of corrections, privatization has been used more widely—but not in Oregon. Almost two-thirds of the 50 states have authorized private companies to house prisoners, with about six to seven percent of prisoners under private management. In the United Kingdom, it is estimated that by 2007 approximately 10 percent of all prisoners will be privately managed.³⁴ Twenty or so studies have confirmed that prison costs are as much as one-third lower under private ownership.

A new study by economists at Vanderbilt University suggests that, in addition to lowering costs directly, the competitive discipline of private prisons helps reduce cost inflation at public facilities as well. The study suggests that cost inflation was cut by about one-third.³⁵ The private prison providers themselves are subject not only to the same administrative sanctions as their public counterparts, but they are also subject to loss of their operating contract. Recent evidence suggests that private companies are vigorously and quickly disciplined by the stock market for any problems that occur at their facilities.³⁶ No such discipline exists in publicly run institutions.

Welfare Policy Reform

Oregon's spending on welfare is largely driven by its relatively large rate of food stamp

dependency. Approximately 10 percent of Oregonians are eligible for food stamps and 74 percent of those that are eligible are actually in the program. Federal block grant policies give Oregon an incentive to overspend on welfare services. From September 1999 to December 2001, the number of Oregonians receiving food stamps increased seven percent, resulting in increased welfare spending relative to the previous benchmarking study.

Child support enforcement is one area where the public sector's involvement is questionable and likely counterproductive. The original interest of garnishing of the wages of non-custodial parents was to offset the public's cost of providing welfare support to their children. Today, however, 85 percent of child support enforcement in Oregon involves wage garnishment of individuals whose children are not a public burden. Oregon taxpayers might reasonably ask why they should subsidize the collection of debts on behalf of people who are not a public burden. More importantly, however, it is also clear that child support enforcement, even for its original purpose, is simply not cost-effective. In 1997 in Oregon, for example, the state and federal governments spent a full dollar to collect only 69 cents of child support to offset expenditures of the Temporary Assistance for Needy Families (TANF) program.

In addition, the wage garnishment procedures themselves likely have serious, adverse effects on the work effort of poor, noncustodial parents. Child support payments are not tax-deductible by the payer. In addition, a special exception in consumer credit regulation allows up to 65 percent of a noncustodial parent's income to be garnished for child support. Consequently, the effective tax rate on the income of noncustodial parents can easily exceed 65 percent, in addition to the burden of social security and other taxes. Such high tax rates

undoubtedly have the counterproductive effect of thwarting work effort and thus limiting the amount of support from such parents.

Other welfare policies may have similar effects on recipients. Cash welfare assistance has declined significantly since the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, and the bias against work built into the old Aid to Families with Dependent Children program has diminished. But the remaining child care and food stamp programs still create strong incentives to “lock” an individual into poverty. According to a welfare-to-work model used by one Oregon county, a wage earner supporting two children would be no better off working full time at \$13.35 per hour than at the minimum wage of \$7.05 per hour. This is because food stamp, child care and housing benefits are lost at the higher wage.

The lesson of the welfare policy practices of the last 40 years is that it is difficult to provide assistance to some people without adversely affecting either their willingness to work or their willingness to invest in their own future. Oregon would be well advised to direct its policy efforts at those behaviors that unnecessarily create welfare need, since a benign way of providing welfare assistance probably does not exist. Such policies would improve the self-sufficiency of the able-bodied, and allow the available public resources to be better directed to those truly in need.

Other General Reforms

Some reform possibilities are applicable to a variety of spending programs. The State of Oregon has adopted policies that affect the cost at which it acquires a variety of services and products. Two of the most important are the policies affecting the price the state pays for new construction and the price it pays

for its labor. As Table 2 (page 6) indicates, these items together constitute 20 percent of the state’s spending, and spending policies in these areas contribute to the cost of services that the state supports through intergovernmental transfers, such as education.

The Cost of Capital Outlays

The Davis-Bacon Act is a controversial federal act that requires that capital projects funded with federal money be built using labor paid the “prevailing wage” in the relevant labor market. It was passed in 1931 to protect high-wage construction labor in the Northeast from the competition of low-wage labor migrating to the region, primarily African-Americans from the South. Oregon adopted its own version of this law in 1959 as the Oregon Prevailing Wage Law. Under Oregon’s prevailing wage law, wages and benefits paid on public projects are established for Oregon by the Secretary of Labor of the United States, pursuant to the federal Davis-Bacon Act, and the Oregon Labor Commissioner. Oregon’s Bureau of Labor and Industries implements the Oregon Prevailing Wage Law (OPWL). Because of its direct link to federal Davis-Bacon policies, Oregon’s law is frequently referred to as “Little Davis-Bacon.”

This policy compels government to pay more, by definition, than the competitive price for capital projects. Consequently, state expenditures are greater than they would otherwise be. Schools are more expensive, highways are more expensive and state buildings are more expensive as a consequence of this policy. Calculating the effect of the policy on the cost of public capital expenditures is complex because the stipulated “prevailing” wage must be compared with the competitive wage of equal labor productivity, and the share of wage expenses in total capital expenditures must be determined.

[C]hild care and food stamp programs still create strong incentives to “lock” an individual into poverty.

Conclusion

Both naïve single-factor comparisons and comprehensive benchmarking analysis indicate that Oregon governments had a tendency to spend more than governments in economically and demographically similar states through 2000, with expenditures accelerating substantially in relation to income from 1998 to 2000. These tendencies may have been somewhat attenuated since then by the reduced tax revenues available to Oregon governments.

We outline several prescriptions to control governments' pro-spending bias and to dampen the spend-and-cut cycle in government spending that is associated with a boom-and-bust revenue cycle. The prescriptions include:

- Establish a system of charging for roadway use that better matches the revenue collected to the facilities used
 - Involve the private sector in policing and corrections
 - Direct welfare efforts toward encouraging work and education
 - Eliminate “prevailing wage” rules in government contracts
- Cut back programs with small net economic impacts
 - Incorporate flexibility into government operations by reducing wage rigidity or seniority rules in layoff decisions
 - Establish automatic spending caps to limit unsustainable spending
 - Establish “rainy day” funding to smooth government cash flows
 - Reduce reliance on volatile revenues sources such as capital gains tax revenues
 - Institute greater accountability and choice in public education
 - Reform the Oregon Health Plan toward the provision of healthcare savings accounts, rather than the provision of healthcare

Notes

¹ Randall Pozdena, *Can Oregon Tighten Its Fiscal Belt? Benchmarking Oregon Government Spending*, Cascade Policy Institute (November 2000); the report used 1998 U.S. Census data.

² Oregon Department of Revenue, *Oregon Personal Income Tax Statistics and Oregon Corporate Excise and Income Tax Statistics* (various editions).

³ U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State* (various years).

⁴ Oregon Office of Economic Analysis, *Employment by Industry, 1990-2011*, employment-annual.xls (accessed May 14, 2004).

⁵ U.S. Department of Labor, Bureau of Labor Statistics, *Local Area Unemployment Statistics* (August 2004). <http://www.bls.gov/web/laumstrk.htm>

⁶ National Education Association, *Rankings & Estimates: A Report of School Statistics, Update* (Fall 2003).

⁷ U.S. Census Bureau, *American Community Survey Profile* (2002); Oregon Office of Economic Analysis, *Personal Income: 1990-2011*, income-annual.xls (accessed May 14, 2004).

⁸ A pilot program in Anieres, Switzerland, was instituted in 2003. For security, voters received an ID card containing a special ID number, security code, and secret code that could only be revealed by scratching the card. Voters must also provide birthdate and other identifying information. According to the Associated Press, legally binding online voting has also been used in British tax votes, the 2000 Democratic primary in Arizona, and in a pilot of overseas absentee military voters in the general election. (Jonathan Fowler, *Detroit News*, January 16, 2003).

⁹ Gregory A. Fossedal, *Direct Democracy in Switzerland*, Transaction Publishers (June 2001).

¹⁰ Lars Feld and John Matsusaka, "Budget Referendums and Government Spending: Evidence from Swiss Cantons," *Journal of Public Economics* (December 2003).

¹¹ The Oregon legislature's Joint Tax Reform Committee is required by a measure passed by

the 2003 Legislature to make tax and spending reform recommendations in the spring of 2004. As of this writing, some Republican members are backing a state spending cap.

¹² According to press reports, American Airlines pilots, flight attendants, mechanics, baggage handlers and other ground workers suffered wage cuts of between 16 and 23 percent in 2003. At this writing, Delta Airlines is seeking 30 percent cuts in pilot wages. (Harry R. Weber, *Associated Press*, April 15, 2004.)

¹³ Oregon has a nominal (one percent) rainy day fund policy. At this writing, a special committee of the Oregon legislature is considering a rainy day fund of more conventional dimensions (typically, 5 percent of the budget), among other tax and spending reforms.

¹⁴ Indeed, even states with rainy day funds had budget deficits during the recent recession. See, *Heavy Weather: Are State Rainy Day Funds Working?*, Center on Budget and Policy Priorities, (May 2003).

¹⁵ According to *CFM Insider Online* (April 14, 2004), "At Tuesday's hearing in Salem, Senators Kurt Schrader, D-Canby, and Ben Westlund, R-Tumalo, unveiled a proposal to impose a 5 percent sales tax on goods and services that is estimated to generate \$6.1 billion in the 2005-07 biennium. The Schrader-Westlund proposal would reduce personal income tax rates and the capital gains tax rate. It also would provide for a property tax exemption, and equivalent renter relief, on the first \$25,000 of assessed value for owner-occupied residences."

¹⁶ William B. Conerly, *Capital Gains in Oregon: Economic Effects of a Tax Cut* (January 31, 2001).

¹⁷ F. Mikael Sandström and Fredrik Bergström, *School Vouchers in Practice: Competition Won't Hurt You!* The Research Institute of Industrial Economics, Working Paper No. 578, (2002).

¹⁸ <http://www.highereducation.org/crosstalk/ct0403/news0403-cause.shtml>

¹⁹ <http://www.phoenix.edu/factbook>

²⁰ Thomas Bailey et al., *For-Profit Higher Education and Community Colleges*, National

Center for Postsecondary Improvement, Stanford University School of Education, (2001), p. 51.

²¹ Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Pub. L. No. 108-173 (the Medicare Modernization Act), added section 223 to the Internal Revenue Code (Code) to permit eligible individuals to establish Health Savings Accounts (HSAs). In general, HSAs are established to receive tax-favored contributions by or on behalf of eligible individuals, and amounts in an HSA may be accumulated over the years or distributed on a tax-free basis to pay or reimburse "qualified medical expenses." In order to establish an HSA, an eligible individual, among other conditions, must be covered under a High Deductible Health Plan (HDHP). Contributions to an HSA established by an eligible individual who is an employee may be made by the employee, the employee's employer or both in a given year. Amounts in an HSA may be rolled over to another HSA. If an employer makes contributions to HSAs, the employer must make available a comparable contribution on behalf of all eligible employees with comparable coverage during the same period. (Source: US Department of Labor, Field Bulletin 2004-1.)

²² See, for example, Jacobs, Marmor, and Oberlander, "The Oregon Health Plan and the Political Paradox of Rationing," *Journal of Health Politics, Policy and Law* (February 1999).

²³ Quote as of this writing from Lifewise for a non-smoking male. The premium assumes a \$2,000 deductible.

²⁴ Phua, Kai Hong (1997), *Medical Savings Accounts and Health Care Financing in Singapore. Innovations in Health Care Financing*, (World Bank Discussion Paper No. 36) Hanvoranavongchai, Piya, 2002. *Medical Savings Accounts: Lessons Learned from International Experience*, (World Health Organization. EIP/HFS/PHF Discussion Paper No. 52) Nichols, Len. M., Nicholas Prescott, and Kai Hong Phua, 1997. *Medical Savings Accounts for Developing Countries, Innovations in Health Care Financing* (World Bank Discussion Paper No. 365, 233-245) Ramsey, Cynthia, 1998. *Medical Savings Accounts: Universal, Accessible, Portable, and Comprehensive Health Care for Canadians*, the Fraser Institute (Canada).

²⁵ Texas Transportation Institute, *2003 Urban Mobility Study*, Exhibit A-14.

²⁶ Ibid. Exhibit A-8.

²⁷ See for example the Siemens technology described at http://www.is.siemens.de/traffic/en/de_its/news/vl/its_march_2004/its_mag_march2004.htm

²⁸ Steven D. Levitt, "Understanding Why Crime Fell in the 1990s: Four Factors that Explain the Decline and Six that Do Not," *Journal of Economic Perspectives* (Winter 2004).

²⁹ See, for example, Portland Police Bureau Community Assessment Survey, MDC Research (November 2003).

³⁰ *Using the Private Sector to Deter Crime*, National Center for Policy Analysis, Study 181, (2000).

³¹ Christine Dorffi, "San Francisco's Hired Guns," *Reason*, (August 1979); Randall Fitzgerald, *When Government Goes Private: Successful Alternatives to Public Services* (New York: Universe Books, 1988), p. 73. Referenced in *The Freeman*, a publication of the Foundation for Economic Education, Inc., February 1991, Vol. 41, No. 2. The authors could not confirm the continued existence of the Patrol Specials.

³² Hallcrest Report II (1986).

³³ Op. cit. *Using the Private Sector to Deter Crime*.

³⁴ James F. Blumstein and Mark A. Cohen, *Do Government Agencies Respond to Market Pressures? Evidence from Private Prisons*, Vanderbilt University, (September 2003).

³⁵ Ibid.

³⁶ Mackinac Center for Public Policy, *Private Prison Firm Held Accountable by Stock Market*, (November 16, 1998).

CASCADE POLICY INSTITUTE

813 SW Alder, Suite 450
Portland, Oregon 97205
(503) 242-0900



info@cascadepolicy.org
www.cascadepolicy.org
fax (503) 242-3822