Ready for Recession?

The state's failure in 2001 and its prospects for the next economic downturn

BY WILLIAM B. CONERLY

IS OREGON READY FOR A RECESSION? Many business leaders have given some thought to the risk, pondering how they might cut expenses, sell assets, or find new revenue streams. The state of Oregon, however, is woefully ill prepared. The last recession hit the state government hard, but it appears that few lessons have been learned.

I advise my business clients to engage in a four-step process for contingency planning. It's mostly used for downside risk, but it can also be applied to upside questions, such as whether a company will be able to increase production in the event sales are strong. The process can be applied to nonprofits and to governments, such as the state of Oregon. Although often described in terms of recession, even a slowing of growth rates can have a significant impact on institutions that are highly sensitive to the economy.

The process begins with an assessment of the enterprise's vulnerability to recession, how much their revenue will be hurt in a downturn. Next, companies should set up an early warning system to monitor the factors that drive their revenues. After that, real contingency planning begins with a one-page outline of steps that might be taken in a downturn. The fourth step continues all the time: managing the enterprise to provide the flexibility to implement the contingency plan, if needed.

Oregon's vulnerability to recession

For most companies, analyzing industry sales data is usually the best way to gauge a company's vulnerability to a downturn. For Oregon, however, it has long been clear that state revenue is highly sensitive to the economy.

The recession of the early 1980s clobbered state revenues. Revenue ended the biennium of 1981-83 less than forecast by 7.2 percent, despite tax hikes enacted in special legislative sessions.

What did we know going into the 2001 legislative session? A special task force appointed by Governor John Kitzhaber and headed by Dr. John Mitchell, U.S. Bank's chief economist, reached some strong conclusions back in 1998:

- "Oregon's revenue system is more sensitive to changes in the economy than it was in 1980."
- "General Fund revenue growth has varied widely from biennium to biennium."
- "General Fund revenue has had a high degree of unpredictability on a biennial basis."

Although the state's economy had diversified away from wood products, it had increased its concentration in high technology manufacturing — another highly cyclical industry.

Oregon's early warning system

Businesses need a routine system for monitoring the factors that drive their revenue. Companies should find measures that indicate the decisions made by the ultimate buyers of their goods or services. For the state of Oregon, the quarterly revenue forecast fills that function.

We actually have a good system. The state economist and his staff develop a forecast of the Oregon economy and from that a forecast of state revenue. The preliminary economic forecast is reviewed by a team of economists from various state agencies and then by the Governor's Council of Economic Advisors, comprised of private sector economists and business leaders. (A separate private sector team has recently been added to focus on the revenue outlook, as distinct from the economic forecast.)

The state forecast did not predict the recession of 2001, but it did provide timely notice that things were not going as planned. The budget was put to bed in July 2001. By August, economic conditions had deteriorated and the state forecasted a budget deficit for the current biennium, then only two months old.

The attacks of Sept. 11 ended any notion that the economic outlook was about to improve. Indeed, the December 2001 forecast showed a budget shortfall. It was only in February that the legislature was called back into session to deal with the crisis. They would be called back for a total of five special sessions.

Like many corporate early warning systems, Oregon's revenue forecasting process did not actually foretell the downturn in revenues ahead of time, but it did give timely notice as revenues started to change. The only thing lacking was action on that notice.

The contingency plan

Business leaders should sketch out a contingency plan well before any signs of recession appear. They should plan ahead of the recession because some steps in the contingency plan need advance preparation.

In Oregon, the only contingency plan for a revenue shortfall is the "ending balance," which is the amount of money the state plans to have left over at the end of the biennium. In 2001, the projected ending balance was $96 million, less than a 1 percent cushion, despite past shortfalls of over 7 percent.

What else could the governor and legislature have done? A contingency planning exercise would have helped. Budgeted spending could have been divided into three groups

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(not necessarily of equal size). The "A" list would consist of the highest priority items. The "B" list would be discretionary spending that is highly desirable. The "C" list would be the first programs cut, or new programs not to be started until revenues were more certain.

In 2001, the governor and legislature failed to set priorities in such a way that they could promptly decide what to cut.

Manage for flexibility

The final step that good business leaders take after completing a vulnerability assessment, developing an early warning system, and sketching out a contingency plan, is to manage the business on a day-to-day basis to allow the company to implement its business plan. That means that before making long-term commitments, the ability to cut costs in a downturn is considered. Sometimes a deal is so good that the business agrees to a long-term commitment despite loss of flexibility. That's fine, so long as the loss of flexibility is explicitly taken into account.

The state of Oregon did little or nothing to manage the enterprise to be prepared for a possible downturn. It did nothing because there was no contingency plan in mind, thus they had no idea what steps might be needed to implement the plan. This failure to plan added to the pain of the recession.

The next recession

This is not a doom-and-gloom projection. As of this writing, a recession is not expected in the coming 12 months. But recessions do occur and frequently without a lot of warning. All enterprises should be prepared.

This year, the governor has signed into law a rainy day fund and has asked for a larger-than-average ending balance. These are laudable goals, but they are not enough. State revenues are highly uncertain. The legislature and the governor should act as good business leaders do, by developing a contingency plan and managing the state enterprise so that the plan can be implemented when a recession comes.

Without these last two steps, the forecast is easy. Some day there will be a crisis, multiple special sessions to deal with the budget shortfall, disruption of government programs, and hastily conceived tax increases. That's no way to run a government. □

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