COMPREHENSIVE SOLUTIONS
TO
OREGON'S MOST COMPLEX PROBLEM

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SUMMARY

OREGON'S NUMBER ONE PROBLEM – FISCAL:

1) Adequacy of revenue driven by accumulative effects of initiatives that have no identified funding source.

2) Stability of revenue which is compounded by the tax code and the inability to create a Rainy Day Fund.

NEED:

1) Greater performance and accountability of state government. Spend money more wisely.

2) Greater performance and accountability of the Legislature in the budget process.

3) Strengthen the economy by increasing employment, increasing investment, and by reducing the net burden of taxes.

4) Decrease the volatility of tax revenues.

5) Close the Structural Budget Gap.

6) Create a Rainy Day Fund.

SOLUTIONS:

1) Continuous Improvement Statute: Change the expectations of government by formally requiring agency initiatives to reduce cost, improve quality, and improve service.

2) Budget Reform Statute: Memorialize fiscal discipline and integrity in the legislative budget processes.

3) Tax Reform Statute: Strengthen the economy, increase employment, increase investment, decrease volatility, net reduction in personal tax burdens, and close the Structural Budget Gap.

4) Legislatively Referred Constitutional Amendment: Ask voters to set tax rates in the Constitution with any increases allowed only by popular vote.

5) Kicker Reform: Legislatively refer to voters a Constitutional Amendment to amend the Kicker law to allow the creation of a Rainy Day Fund with the same "lock up" provisions of the Education Stability Fund.

NARRATIVE

OREGON'S NUMBER ONE PROBLEM - FISCAL

Adequacy

The year is 1990. Picture in your mind's eye a sturdy wagon that is fully loaded and is being drawn by a big healthy draft horse. The wagon is loaded with boxes labeled public safety, public education (including K-12 and Higher Education), and Human Services. The draft horse is called General Fund. The wagon's wheels are intact, the axles are greased, and the wagon is moving quite easily.

Now fast forward to the year 2005. What has happened to the wagon? We have now given our horse General Fund some help. He is joined by a little pony called Lottery Fund. They both are lathered in sweat and pulling for all their might, but the wagon is hardly moving. For you see, the wagon not only is carrying the public safety, public education and human services cargo of 1990, it is now piled high with bags it cannot carry. The bags are labeled Measure 5, Measure 11, Measure 47, Measure 50, Measure 66, and Measure 99. The axle is bent, the grease is gone and the wagon is barely moving.

The truth is that the populist budgeting of the 90's isn't working. There simply are not enough horses to pull the load voters want. And the great paradox is that many voters believe spending is out of control and are all too ready to vent their anger at the Legislature and Governor. The reality is that nearly one third of today's General Fund and Lottery Fund dollars are directed to voter initiatives. The other reality is that when adjusted for inflation, population growth, and voter initiatives, General Fund and Lottery Fund spending has actually decreased from $1,625 per person in 1990 to $1,453 per person in 2005 (Legislative Revenue Office). And to further complicate our state's fiscal woes, it is likely there will be a spending cap initiative on the November ballot.

A further review of our state's finances from 1990 to 2005 reveals an interesting picture. Adjusted for inflation and population, general fund revenues for this 15 year period have had a real increase of 19.5 %. Real spending on education has increased 44% but spending on higher education has decreased by 2.8%. In 1993, higher education was allocated 8.59% of the General Fund. In 2005, higher education received 6.59% of the General Fund. In 2002, Oregon universities became the 2nd highest for tuition and fees of the 15 western states. Human Services spending for this period has generally been thought to have dramatically increased due to the Oregon Health Plan. Quite the contrary. Real spending for human services has increased only .01%. Public Safety has been the greatest beneficiary, having received a real spending increase of 55%. This data most notably reflects the effects of voter initiatives.

The casualties of the 90's wave of initiatives have been primarily in higher education and human services but also in K-12 education as well. The buggy simply will not carry all the load required of it. Sustainable revenues are inadequate to meet the needs demanded by voters.

Stability
Not only are revenues inadequate, they are exceedingly unstable. Income tax and capital gains tax revenues are the most volatile of all forms of tax revenues. The California Department of Finance analyzed the volatility of income taxes over a period of 24 years and determined that for every 10% change in personal income there is a 30% change in income tax collections. Which means that when times are good, income tax revenues are really good. When times are bad, income tax revenues are really bad. This volatility also leads to a false sense of revenue security among legislative members. Or to state it another way, is the recent revenue forecast an accurate assessment of the true state of our economy? If personal income is up 10% and the corresponding income tax collections are up 3 times as much, there is great risk for the legislature to spend more than our economy will truly support.

Also, the higher the volatility, the greater the risk of inaccurate revenue forecasts. Our revenues are not only volatile and difficult to forecast, there is also no effective way to mitigate the volatility by creating a Rainy Day Fund.

While the original intent of the Kicker was to restrain the growth of government, it is now time to assess its affects on the state's ability to create stable funding for critical services.

The current Kicker law embedded in the Oregon Constitution revolves around the accuracy of revenue forecasts and has nothing to do with increasing or decreasing tax rates. If the actual revenue collected for a biennium exceeds the forecasted revenue by 1.99999%, all of the actual revenue in excess of the forecasted revenue is carried forward as a beginning General Fund balance. If the actual revenue collected exceeds the forecasted revenue by 2.00001%, *all* of the excess is returned to taxpayers as a Kicker. Personal taxpayers receive a check and corporate taxpayers receive a credit against their tax liability.

What is clear is that accurate forecasting is impossible. If it was possible to be perfect, there would never be a Kicker. Based on the March 2006 revenue forecast, we now know that the expected corporate and personal Kicker will be $666 million.

Oregon is now at a crossroad. It is clear that the fiscal policies of the past will not carry us forward into the future. The very foundations of our economy and society are at serious risk of erosion as a result of inadequate and unstable revenues. *This is not a plea for more taxes. Quite the contrary, it is a plea to reform the fiscal affairs of our state, strengthen our economy, and reduce the total tax burden for current income taxpayers.*

WHAT ARE THE NEEDS?

Greater Performance and Accountability of State Government
The very successful Patagonia brand is well known. Less known is it's owner Yvon

Chouinard, who in his recent biography writes about complacency and the need for change. “Only those businesses operating with a sense of urgency.....constantly evolving, open to diversity and new ways of doing things, are going to be there 100 years from now.”

Constantly evolving and open to new ways of doing things in highly competitive environments is what makes private sector companies successful. What then makes the public sector successful? Or another way of asking the same question would be to ask what would make any organization successful that enjoys the status of a monopoly?

Government agencies are appropriately classified as monopolies and lack the same market driven forces as do private companies to initiate change to survive. In fact survival of public agencies is rarely in question. What is needed is a statute that requires state agencies to constantly evaluate their operations and initiate the changes that will result in increased quality, reduction of costs, and reduction in the time required to deliver services.

The Legislature is quite limited in its ability to effectuate change in the efficiency and effectiveness of state government. The authority for management of government is the constitutional responsibility of the Executive Branch. What is required to effectuate meaningful change is a statute that requires the Executive Branch of government to constantly think in terms of Continuous Improvement. The Legislative budget process is the ideal venue to review, monitor, assess, and eventually approve the budgets of agencies, but only if they have formally implemented processes for Continuous Improvement. Voters expect nothing less.

Greater Performance and Accountability in the Legislative Budget Process

The budget process in the 73rd Assembly was notable in that it identified for the first time the “size of the revenue pie”. However, what began well, ended with few members making essentially all budget decisions in a highly fractured process between the House and the Senate. The process also resulted in trading budget votes for policy votes. Is such a process in the best interests of representative government and the interests of Oregon citizens as a whole?

The budget process should be as inclusive and transparent as possible, including the concepts of delegation to budget committee members to make meaningful decisions within the broad goals set by legislative leadership. The agreed upon broad budget goals should be adopted by both the House and the Senate as a non binding Budget Resolution Plan. If legislative members know what the broad budget plan is at the beginning, and a majority agree through a non-binding budget resolution, it is much more likely there will be an efficient budget process and much less likely there will be the budget dysfunction present in the last two legislative sessions.

Strengthen the Economy by Increasing Employment, Increasing Investment, Reducing the Net Burden of Taxes / Decreasing the Volatility of Tax Revenues / Closing the Structural Budget Gap

There is near universal agreement with these needs. However, what is little understood is that reform of our tax codes is required to satisfy these needs. What is also little understood is that tax reform can lessen the total burden of personal taxes but yet produce the additional revenues needed to fund critical services.

There have been persistent efforts in the last two legislative sessions to change parts of the tax code, but no sanctioned efforts to comprehensively amend the tax code so that it will deliver the desired objectives of all political persuasions. It is now time to amend the tax code by statute and refer to voters a constitutional amendment to cap the rates, thus assuring voters that tax reform is not a tax increase in disguise.

The Legislative Revenue Office has developed what is known as Group Plan A, with the most recent revisions completed November 11, 2005. It is a blended income tax and consumption tax plan that when implemented will result in a stronger economy through increased employment, increased investment, reduction in net taxes, reduction in the volatility of tax revenues and will at the same time provide substantial increases in revenues to close the Structural Budget Gap we now have.

Create a Rainy Day Fund
There is no disagreement that the economy flows through up and down cycles. Given this certainty, Oregon's Kicker law is a very strange paradox. When the economic cycle is up, unanticipated revenues are returned to taxpayers. When the economic cycle is down, there are insufficient reserves to maintain critical services, resulting in chaos and crisis in the down cycles. Oregon's fiscal policies are also a paradox among other states. While we have the most volatile revenue system in the nation, we also are one of the very few states without Rainy Day Fund reserves.

It is commonly accepted that states should have a reserve fund equal to 15% of their General Fund dollars. The current Education Stability Fund which is funded by Lottery dollars is capped at 5%, leaving a major shortfall in providing stable funding in a down economic cycle. What is critically needed is a Rainy Day Fund equal to 10% of General Fund Dollars.

SOLUTIONS:

A) Continuous Improvement Statute
Agency budget presentations to the Joint Ways and Means Committee must include:
1) Performance measures.
2) Prioritized lists of services.
3) Continuous Improvement Plans in agency operations to reduce costs, improve quality of services and shorten the time to deliver services.
4) Measurements for their Continuous Improvement Plans.
5) A Business Case analysis for Continuous Improvement efforts.
6) How the Continuous Improvement processes relate to the Performance Measures.
7) Continuous Improvement Process funding requirements and identification of possible funding sources.
8) Reporting results of the improvements in the prior budget periods.

Require Continuous Improvement reports to the Legislative Fiscal Office at least once in the interim.

Include Continuous Improvement processes in the Governor's Balanced Budget.

Continuous Improvement Savings:
1) Agencies could keep one-half of the savings as verified by the Dept. of Administrative Services.
2) Agencies could use the savings only for one-time expenditures, not to increase staff.

B) Budget Reform Statute

1) Impanel a Joint Revenue Committee to determine the amount of General Fund and Lottery Fund available to spend, including tax and fee increases, if any, to the Speaker of the House and the President of the Senate.

2) The Speaker and the President, inclusive of the Ways and Means Co-Chairs, prepare a Budget Resolution Plan and recommend to both chambers for adoption. A majority approval of both chambers would be required. The Budget Resolution Plan would incorporate the following:

- Income and expenditures must balance.

- The amount of borrowing, if any. i.e. Set an allowance for capital expenditures financed by debt.

- The amount of tax and fee increases, if any.

- Changes in population, inflation and personal income.

- The financial impacts of unfunded voter initiatives and federal law.

- Moneys available in the Education Stability Fund.

- Moneys available in other accessible reserve accounts.

- A reasonable and prudent ending balance.

- An allowance for Emergency Fund allocations.

- An allowance for Special Purpose Emergency Fund allocations.

- An allowance for state employee salary and benefit adjustments.

The Budget Resolution Plan would make discretionary fund allocations (General and Lottery Funds) to the Joint Ways and Means Committee with allowances for the maximum amount of discretionary funds to each of the Ways and Means Subcommittees.

The Ways and Means Subcommittees would be responsible for appropriating their respective GF and LF allocations. (Education, Public Safety, Human Services, General Government, Transportation and Economic Development, and Natural Resources).

If the Joint Ways and Means Committee would cease to exist, the Budget Resolution Plan would become void.

If the revenue forecast is revised downward before adjournment, the Speaker and the President, inclusive of the Co-Chairs of Ways and Means, would recommend a Revised Budget Resolution Plan for adoption by majorities of the House and Senate.

If the revenue forecast is revised upward before adjournment, the increase would be allocated 25% to the ending balance, 50% to the Education Stability Fund, and 25% for allocation as determined by the Co-Chairs of Ways and Means.

An important goal of the budgeting process should be to educate voters regarding what their tax dollars buy. It is very difficult to provide education when the process is cloaked in secrecy and is conducted behind closed doors. There is a very real need to create a prescriptive, fiscally sound budget process.

C) Tax Reform Statute

Group Plan A Updated 2007–09 Estimates	2007–09 Millions of $
Personal Income tax Reductions:	
Reduce rates to 2, 4, 6%.	
Reduce Capital Gains to 4%.	
Refundable Earned Investment Tax Credit at 25%.	
Net Impact	-4,411
Estate Tax Relief by Realigning with the Federal Code	
The Oregon Personal Exemption is $1.0 million.	
The Federal is $2.0 going to $3.0 million.	-30
Other Corporate Stimulus Measures to Encourage Capital Investment	-30
Homestead Exemption @ $25,000 for low income elderly	-726
Low Income Rent Relief	
$15,000 income @ 20%	
$20,000 income @10%	
$25,000 income @ 5%	-288

Consumption Tax
Broad Based Goods and Services Tax @ 5%
1.5% Retailer Compensation
Key Exemptions: Food, Shelter, Utilities, Cigs, Gas, Machinery and Ag

Net Consumption Tax Revenue	6,479
Net Gain in Revenue	994

Refer a Constitutional Amendment to voters to set the tax rates, providing change only by popular vote.

Impacts
Business/Household Shifts:
Business currently pays 32% of the General Fund tax burden. Under this plan business would pay 37%. Where does the money come from to make up for the shift? 1) Out of state. 2) Businesses shift the 5% cost to their products. 3) Unreported income. The Dept. of Revenue reports that 10% of taxable income is unreported and evaded.

Personal Income Tax Reductions:
Adjusting for a 5% Sales Tax, the reduction in the marginal state income tax rates, the property tax/renter relief, and the change in federal taxes, **every taxpayer in every tax bracket would experience an overall reduction in their tax burden.** ($15,000 income = $344; $35,000 = $133; $55,000 = $269; $75,000 = $473; $125,000 = $700; $150,000 = $1,022)

ECONOMIC RATIONALE FOR TAX REFORM – NOTES FROM PAUL WARNER, CHIEF LEGISLATIVE REVENUE OFFICER:

STRENGTHEN THE ECONOMY "Most economists agree that the tax structure tends to affect state economies over the long run. State economies long-term growth is more closely tied to attracting labor and capital over time, not consumers. Regional economic models like OTIM (Oregon Tax incidence Model), are built on the assumption that labor and capital locate where they receive the highest net after-tax return. Income taxes reduce the net return to both capital and labor. Reducing income tax rates increases the net return to capital and labor. Although a portion of sales taxes are paid on business-to-business purchases, the majority are paid directly by consumers when they make purchases. OTIM indicates that the reduced competitive advantage caused by sales taxes on sectors such as tourism and retail trade are more than offset by the enhanced competitive position of Oregon in terms of attracting labor through in-migration and capital through new investment. The net effect of this gain is sufficient to offset the loss of federal tax dollars through the shift from deductible income taxes to non-deductible sales taxes – though under current federal law the highest of the two can be deducted."

INCREASED INVESTMENT "Lower income tax rates, including capital gains, combines with a targeted investment tax credit to increase investment. OTIM estimates that investment would rise by about $35 million (2007 dollars). Investment tax credits increase the after tax return to capital thereby attracting more investment in Oregon."

INCREASED EMPLOYMENT “The OTIM model estimates that the package would increase employment by about 35,000 after the changes have worked through the system. Reduced income tax rates are the primary cause of the increase. This works in two ways. First, lower taxes mean higher take-home pay. This encourages workers to work more for the same before tax wage. This has the effect of lower before tax wages and reducing employer costs – making them more willing to hire. Employment is also affected by a rise in population through additional in-migration. This is caused by lower income tax rates, especially capital gains. The model estimates that population would rise by 3,300. The employment gains are net figures. Some sectors such as retail trade would have some losses due to the sales tax.”

REDUCED TAXES “The package is designed so that the initial incidence of the tax increase through the sales tax and the tax reductions through the personal income tax and the property tax is lower taxes for households across the income spectrum. A homestead property tax exemption combined with renter relief more than offsets the impact of the sales tax at the lower end of the income distribution. Lower income taxes and capital gains tax rates more than offsets the sales tax impact among the higher income groups.”

STABILITY OF THE REVENUE SYSTEM “Revenue stability is best measured by the relationship of revenue to changes in total income (or economic activity). Income elasticity measures this relationship. An income elasticity of 1 means that revenue changes by the same percentage as income. An elasticity of more than one means that a given percentage change in income leads to a larger percentage change in revenue. The higher the income elasticity of a revenue source, the greater its instability. California’s Department of Finance estimates that the state income tax (similar to Oregon) has a short term (over the business cycle) elasticity of 2.94 over the 1980 to 2004 period. This means that a 10% change in income leads to roughly a 30% change in income tax collections. The California estimates are considerably higher in the 1990’s due to the impact of capital gains through the stock market boom and bust. The same California study estimates a short-term sales tax elasticity of 1.19 meaning an income change of 10% leads to about a 12% change in sales tax collections over the 1980 to 2004 period. Substituting less elastic sales tax revenue for more elastic income tax revenue reduces the overall elasticity of the tax system thereby making the system more stable. The proposal would also reduce the elasticity of the income tax itself by reducing the reliance on capital gains income – currently the most volatile source of taxable income.”

D) Kicker Reform – Legislatively Refer a Constitutional Amendment and Implement by Statute

Legislatively refer to voters a Constitutional amendment, not to repeal the Kicker, but to suspend it to allow the creation of a Rainy Day Fund.

- The first 1% of actual revenue collected in excess of the forecasted revenue would be carried forward as a beginning balance in the next biennium.

- All revenues collected in excess of 1% of the forecasted revenues would accrue into a Rainy Day Fund until the Fund would equal 10% of the General Fund.
- Once the 10% was met, then all revenues in excess of the forecasted revenues would be returned to taxpayers.
- The Rainy Day Fund would have the same “lock up” provisions of the current Education Stability Fund allowing for withdrawal only in the event of a recession.

SUMMARY

What is now required is **visionary bipartisan leadership** from elected officials, the business community, organized labor, and civic and community leaders. What is required is an honest and thoughtful assessment of Oregon’s fiscal affairs and awareness of the substantial likelihood that the growth of our economy will NOT close the **STRUCTURAL BUDGET GAP** that exists between sustainable revenues and initiative driven spending. Fiscal reforms in how we collect money, how we budget money, how we spend money and how we save money are past due.