STATE OF OREGON

Research Report

LEGISLATIVE REVENUE OFFICE
RM 143 State Capitol Building
Salem, Oregon 97301-1347

(503) 986-1266

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Measure 59
Full Deductibility of Federal Income Taxes

Measure Description

If passed by voters in the November 2008 general election, this statutory measure would make federal income taxes fully deductible for Oregon personal income tax filers. It takes effect for tax years beginning on or after January 1, 2010. Under current law, personal income tax filers can subtract up to $5,600 of their federal income taxes in tax year 2008. This limit is indexed to inflation and is currently projected to be $6,150 in 2010.

Revenue Impact

The measure would reduce General Fund revenues below the current forecast by $1.136 billion in 2009-11 and $1.905 billion in 2011-13, as shown in the table below. The revenue impact increases in the 2011-13 biennium because the measure would be in effect for both years of the biennium. These estimates are the static estimates. The economic feedback effects are discussed in a later section.

($ Millions)	2009-11 Biennium	2011-13 Biennium	2013-15 Biennium
State General Fund	-$1,136	-$1,905	-$2,227

The estimates depend on certain assumptions made pertaining to federal tax policy, which is uncertain due to a change in administration next year and a series of scheduled sunsets. Several of the federal tax cuts passed earlier this decade are scheduled to sunset at the end of 2010. It is unlikely that all of these sunsets will stand. The September 2008 Economic and Revenue forecast includes the assumption that a portion of these sunsets will occur. The others will either be extended or replaced with other provisions resulting is a similar level of federal taxation. The impact estimates presented here are based on that September Revenue Forecast and incorporate those assumptions. To the extent that federal tax policy differs from these assumptions, the actual revenue impact of the measure will be correspondingly higher or lower.

These estimates differ from those prepared for the Financial Estimate Committee for two primary reasons. First, the estimates presented in this paper are calibrated to the newly released

September Economic and Revenue forecast. Second, the estimates prepared for the committee were based on current law, meaning that every change in taxation (e.g. each federal sunset provision) was assumed to occur according to current law.

The calibration to the latest forecast has two notable impacts. First, general economic activity is now expected to be lower. This change translates into lower federal tax liabilities meaning lower federal tax subtractions. Second, the updated forecast contains significant increases for inflation in 2008 and 2009 compared to the June forecast. Because many elements of the tax code are indexed to inflation, changes in the projections for inflation directly affect the amount of tax owed for a given amount of income. Directly pertinent to Measure 59 is the projected cap on the federal tax subtraction under current law. Prior to the September forecast the cap was projected to be $5,900 in 2010; it is now projected to be $6,150. The change reduces the estimated impact of Measure 59, compared to earlier estimates. Fewer taxpayers would be affected and the size of the impact would be reduced.

History

Through the actions of the Legislature and voters, Oregon income tax law has undergone a number of changes in how federal taxes are treated for purposes of calculating state income taxes. Voters have also rejected a number of proposals concerning treatment of federal deductibility over the years. Under current law, personal income taxpayers are allowed to subtract up to $5,500 for income taxes paid to the federal government in 2007. The cap will be adjusted for inflation in 2008 and each year going forward.

Origins of the current law can be traced back to the 2000 general election. Two measures affecting federal deductibility were before voters in that election. Measure 91 allowed for full deductibility of federal income taxes while Measure 88, referred by the 1999 Legislature, increased the subtraction cap from $3,000 to $5,000 starting with the 2002 tax year. Starting in 2003, the cap was to be indexed for inflation under Measure 88. Measure 88 was approved by voters (739,270 to 724,097) while Measure 91 was rejected (661,342 to 814,885).

Measure 88 was modified by the Legislature in the June 2002 special session. The increase in the subtraction cap was phased in over 5 years instead of jumping from $3,000 to $5,000 in one step. The phase-in was part of a series of budget rebalancing actions taken by the Legislature in response to the 2001-02 recession. Under the legislative phase-in (HB 4054 from 2002 Special Session III), the cap was adjusted according to the following schedule:

Tax Year:	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Subtraction:	$3,250	$3,500	$4,000	$4,500	$5,000	$5,500

This is the amount allowed on state returns filed in April of each year. The $5,500 cap is adjusted for inflation beginning with the 2008 tax year; the 2008 cap is $5,600. The cap will rise with inflation in each subsequent year under current law.

Measure 59 is similar to Measure 91 but there are some major differences. Like Measure 91, Measure 59 allows full deductibility of federal taxes for personal income taxpayers, in effect removing the cap. This means that many of the economic, distributional and budgetary effects anticipated for Measure 91 will apply to Measure 59. However, Measure 91 was a constitutional amendment while Measure 59 is a proposed statutory change. This is a significant difference because the Legislature has the discretion to modify statutes (though a 3/5 vote is required if the modification results in an increase in general revenue) while constitutional changes require voter approval. Another significant difference between the 2 measures is that Measure 91 applied to all federal income taxes including corporate income taxes. This represented a significant policy change because, unlike personal income taxes, Oregon law has never allowed any deductibility for federal income taxes from corporate income and excise taxes since the inception of the corporate excise tax in 1929. Measure 59 states that the proposed new statute "does not apply to corporate income or excise taxes." Finally, Measure 59 has a more clearly defined start date (tax years beginning or after January 1, 2010) than was the case for Measure 91.

Prior to 1974, Oregon personal income taxpayers were allowed to fully subtract federal income taxes from their state income tax base. In 1975, the Legislature established a subtraction cap of $5,000, later increased to $7,000 by the 1979 Legislature. In 1987, the Legislature reduced the cap to $3,000 as part of a major overhaul of the state's personal income tax. Under the 1987 tax package, Oregon connected to major base broadening changes enacted by Congress in the prior year and consolidated income tax rates from a 5-rate structure with a top rate of 10% to a 3-rate system with a top rate of 9%. The 3-rate structure (5%, 7% and 9%) remains in effect today.

Other States

Currently 44 of the 51 states (including D.C.) have a personal income tax.[1] Eight states allow at least some deductibility of federal income taxes. Alabama, Iowa, and Louisiana allow full deductibility while Missouri, Montana, Oregon, and Utah limit the amount that can be deducted. Missouri allows a deduction of up to $5,000 per return ($10,000 if a combined return). Montana has the same dollar limits but allows the deduction only for those who claimed itemized deductions. Utah allows taxpayers to deduct 50% of their federal taxes.

North Dakota allows filers to deduct federal taxes if they use a certain tax form, however higher tax rates would generally apply. The tax form used by most North Dakota filers does not include the deduction. Oklahoma had until recently allowed some deductibility of federal taxes; they eliminated the deduction beginning with tax year 2006.

Distributional Effects

Table 1 shows the distributional impact for tax year 2011.[2] As shown in the table, total Oregon liability is estimated to be reduced by $882.5 million in 2011. Of the anticipated 1.8 million

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[1] New Hampshire's income tax only applies to interest and dividends.

[2] While the effective year for the measure is 2010, tax year 2011 was chosen for this analysis because of expected changes to federal tax policy in 2011.

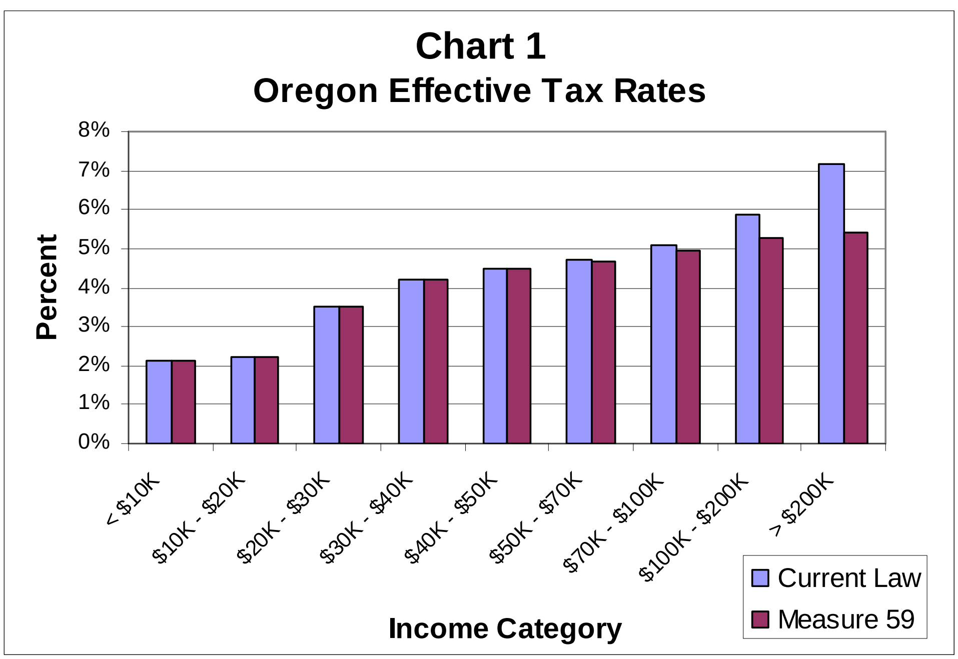
Table 1
Measure 59 Distributional Impact
(Tax Year 2011)

Income Class	Returns	Percent of Returns	Oregon Tax: Current Law Taxes ($M)	Oregon Tax: Proposed Law Taxes ($M)	Oregon Tax: Tax Change ($M)	Oregon Tax: Percent of Total Change	Oregon Tax: Percent Tax Change	Oregon Tax: Average Tax Change ($)	Federal Tax: Current Law Taxes ($M)	Federal Tax: Tax Change ($M)	Total Income ($M)
All Returns											
Less Than 10,000	299,115	16.3%	8.9	8.9	0.0	0.0%	0%	0	-71.7	0.0	417
10,000 TO 20,000	261,138	14.2%	85.6	85.6	0.0	0.0%	0%	0	-78.3	0.0	3,826
20,000 TO 30,000	226,438	12.4%	195.6	195.6	0.0	0.0%	0%	0	160.0	0.0	5,594
30,000 TO 40,000	172,790	9.4%	253.1	253.1	0.0	0.0%	0%	0	340.7	0.0	5,988
40,000 TO 50,000	139,033	7.6%	280.5	280.3	-0.2	0.0%	0%	-2	414.2	0.0	6,239
50,000 TO 70,000	221,531	12.1%	629.1	623.9	-5.2	0.6%	-1%	-24	1,009.0	0.7	13,385
70,000 TO 100,000	227,418	12.4%	994.6	961.9	-32.7	3.7%	-3%	-144	1,645.0	5.7	19,478
100,000 TO 200,000	213,603	11.7%	1,699.2	1,524.0	-175.2	19.9%	-10%	-820	3,245.4	33.0	28,950
200,000 and over	71,539	3.9%	2,718.8	2,049.8	-669.0	75.8%	-25%	-9,352	7,875.4	69.9	37,959
TOTAL	1,832,605	100.0%	6,865.4	5,982.9	-882.5	100.0%	-13%	-482	14,539.8	109.4	121,836
Single Returns											
Less Than 10,000	218,050	25.1%	13.7	13.7	0.0	0.0%	0%	0	-12.7	0.0	830
10,000 TO 20,000	173,461	20.0%	91.6	91.6	0.0	0.0%	0%	0	75.7	0.0	2,555
20,000 TO 30,000	132,413	15.3%	159.6	159.6	0.0	0.0%	0%	0	215.6	0.0	3,334
30,000 TO 40,000	94,834	10.9%	174.6	174.6	0.0	0.0%	0%	-1	264.4	0.0	3,361
40,000 TO 50,000	72,997	8.4%	173.3	173.1	-0.2	0.2%	0%	-3	280.3	0.0	3,328
50,000 TO 70,000	86,614	10.0%	275.8	270.7	-5.1	3.3%	-2%	-59	511.7	0.7	5,212
70,000 TO 100,000	51,982	6.0%	245.8	227.3	-18.5	11.9%	-8%	-355	513.7	3.5	4,331
100,000 TO 200,000	27,511	3.2%	219.0	188.5	-30.4	19.5%	-14%	-1,106	500.7	4.8	3,564
200,000 and over	9,993	1.2%	385.9	284.2	-101.6	65.2%	-26%	-10,171	1,200.2	6.7	5,554
TOTAL	867,856	100.0%	1,739.3	1,583.4	-155.9	100.0%	-9%	-180	3,549.5	15.7	32,069
Joint Returns											
Less Than 10,000	81,064	8.4%	-4.8	-4.8	0.0	0.0%	0%	0	-59.0	0.0	-414
10,000 TO 20,000	87,677	9.1%	-6.0	-6.0	0.0	0.0%	0%	0	-154.0	0.0	1,271
20,000 TO 30,000	94,024	9.7%	36.0	36.0	0.0	0.0%	0%	0	-55.5	0.0	2,261
30,000 TO 40,000	77,956	8.1%	78.5	78.5	0.0	0.0%	0%	0	76.3	0.0	2,626
40,000 TO 50,000	66,036	6.8%	107.1	107.1	0.0	0.0%	0%	0	133.9	0.0	2,911
50,000 TO 70,000	134,917	14.0%	353.4	353.2	-0.1	0.0%	0%	-1	497.3	0.0	8,173
70,000 TO 100,000	175,436	18.2%	748.8	734.6	-14.2	2.0%	-2%	-81	1,131.4	2.2	15,147
100,000 TO 200,000	186,092	19.3%	1,480.2	1,335.4	-144.8	19.9%	-10%	-778	2,744.7	28.1	25,386
200,000 and over	61,546	6.4%	2,332.9	1,765.5	-567.4	78.1%	-24%	-9,219	6,675.2	63.3	32,406
TOTAL	964,749	100.0%	5,126.1	4,399.6	-726.6	100.0%	-14%	-753	10,990.3	93.6	89,767

filers, roughly 450,000 are expected to receive some degree of tax reduction from this measure, with the majority of the reduction concentrated among those filers at the top end of the income distribution. Filers with at least $200,000 of income account for 3.9% of all filers and are expected to receive 76% of the tax reduction. The vast majority (98.7 percent) of filers with income less than $60,000 will not benefit from this measure because their federal tax liability is below the deduction limit that exists in current law – they can already deduct all of their federal taxes.

The average reduction for all filers is $482 but is highly correlated with income. It ranges from $0 for filers with an income of less than $40,000 to an average of $9,352 for filers with at least $200,000 of income. Another way to think about the measure's impact is by the average percentage tax reduction across the different income categories. As shown in the table, filers with an income of less than $50,000 would see very little benefit while those with an income between $50,000 and $70,000 would see an average state income tax reduction of one percent. That percentage increases to six percent if income is between $70,000 and $100,000; to 10 percent if income is between $100,000 and $200,000; and is 25 percent for filers whose income is above $200,000.

Chart 1 shows the change in the effective tax rate should Measure 59 become law. The effective tax rate is determined by dividing tax liability by income. A progressive tax system is one in which the effective tax rate increases with income. Oregon's current personal income tax is considered progressive, as shown in the chart below via the lighter shaded bars. The effective tax rate increases from 2.1 percent for filers whose income is less than $10,000 to 7.2 percent for filers whose income is greater than $200,000. Measure 59, while maintaining the general progressive structure of the tax, would significantly reduce the effective tax rate for those at the top end of the income distribution. The effective rates would be reduced for the top two income groups to rates of 5.3 and 5.4 percent, respectively.



Specific examples also provide some insight into the measure's impact. The six examples in Table 2 illustrate the measure's impact in tax year 2011 on hypothetical taxpayers. Many simplifying assumptions have been made in an effort to focus on the impact of Measure 59. Income is assumed to be taxed at both the federal and state levels, itemized deductions are used that are commensurate with the income level and type of filer. The only credits used are the federal child credit and the Oregon personal exemption credit. Each example shows the filing status, number of children, the income level and the amount of federal taxes. The amount of federal taxes above $6,000 is the additional amount that each taxpayer would be allowed to deduct. The examples also include the current law Oregon tax liability, what the tax liability would be under the measure, and the difference.

Generally, the examples show that as income increases, the tax reduction increases, depending on certain factors. Example 1 shows a single filer without children and an income of $45,000. Under current law, the taxpayer is already allowed to fully deduct their federal taxes of $5,265, so they would be unaffected by the measure. Example 2 is also a single filer without children, but has an income of $60,000 and itemized deductions. Under current law, they would be allowed to deduct $6,200 of their $6,527 of federal taxes; under Measure 59, they could subtract an additional $327 for a tax reduction of $30.

Table 2

Examples of Revenue Impact (Tax Year 2011)*

Example 1		*Example 2*	
Filing Status / Children:	Single / 0	Filing Status / Children:	Single / 0
Deductions:	Standard	Deductions:	Itemized
Income:	$45,000	Income:	$60,000
Federal Taxes:	**$5,265**	**Federal Taxes:**	**$6,527**
Oregon tax, current law:	$2,621	Oregon tax, current law:	$3,271
Oregon tax, Measure 59:	$2,621	Oregon tax, Measure 59:	$3,241
Measure 59 impact:	**$0**	**Measure 59 impact:**	**-$30**
Example 3		*Example 4*	
Filing Status / Children:	HoH / 2	Filing Status / Children:	Joint / 0
Deductions:	Itemized	Deductions:	Itemized
Income:	$80,000	Income:	$100,000
Federal Taxes:	**$6,031**	**Federal Taxes:**	**$11,551**
Oregon tax, current law:	$4,158	Oregon tax, current law:	$6,007
Oregon tax, Measure 59:	$4,158	Oregon tax, Measure 59:	$5,525
Measure 59 impact:	**$0**	**Measure 59 impact:**	**-$482**
Example 5		*Example 6*	
Filing Status / Children:	Joint / 2	Filing Status / Children:	Joint / 2
Deductions:	Itemized	Deductions:	Itemized
Income:	$100,000	Income:	$250,000
Federal Taxes:	**$8,055**	**Federal Taxes:**	**$44,616**
Oregon tax, current law:	$5,641	Oregon tax, current law:	$17,982
Oregon tax, Measure 59:	$5,474	Oregon tax, Measure 59:	$14,525
Measure 59 impact:	**-$167**	**Measure 59 impact:**	**-$3,457**

* Assumes no impact from federal Alternative Minimum Tax

Examples 4 and 5 represent identical joint filers except for the number of children. While each has an income of $100,000, the filers without children has a federal tax liability that is $3,496 greater than the other. Because the federal liability is larger, so will be the tax reduction from Measure 59. The subtraction for the taxpayers without children would increase by $5,351 compared to an increase of $1,855 for the family of four. The corresponding tax reductions are $482 and $167.

Interaction with Federal System

One of the ways the Oregon and federal personal income tax systems interact with each other is through their cross-deductibility; federal taxes are deductible in Oregon for all filers and Oregon income taxes are deductible at the federal level for those who itemize their deductions. Their interaction means that a reduction in one tax may lead to an increase in the other tax. Table 1 shows that for 2011, the $882.5 million reduction in Oregon taxes leads to an increase of roughly $109.4 million in federal taxes. In effect, 87.6 percent of the Oregon tax reduction goes to Oregon tax payers while the remaining 12.4 percent is collected by the federal government through higher income taxes.

By way of specific example, Table 2 shows that the taxpayers of Example 6 would receive an Oregon tax reduction of $3,457. This reduction affects their federal itemized deductions by reducing their state income tax deduction. The resulting lower deductions would increase their federal income taxes by $1,072. Taken together, their federal and state income taxes are reduced by $2,385 ($3,457 - $1,072).

Economic Effects

To gage the long term effects of Measure 59 on the state economy, LRO ran a simulation using the Oregon Tax Incidence Model (OTIM). OTIM is a computable general equilibrium model designed to show how tax changes affect wages and prices and how these changes ultimately affect the overall level of economic activity as measured by total personal income and employment. OTIM compares the current economy (baseline) to how it will look after wages, prices and income have adjusted to the tax change. This is assumed to reflect a 5-year adjustment period. After accounting for these changes OTIM produces new estimates for the distribution of income and state revenue.

Economic Activity

When fully implemented, Measure 59 results in a 13% reduction in Oregon personal income taxes. This is expected to trigger a series of economic responses. The most fundamental effect is an increase in after-tax wages. This leads to an increase in the supply of labor. New labor comes from 2 sources in the long run—an increase in the ratio of employment to existing state population and an increase in migration from other states. The labor supply response reduces before-tax wages in Oregon. The return to capital is expected to rise because there are more workers making each unit of capital more productive. This is what economists call the complementary effect.

Table 3 summarizes the OTIM simulation calibrated to 2011 projected levels. As expected gross (before-tax) wages fall (-0.8%) and the return to capital rises slightly (+0.2%). The higher return to capital leads to a $33 million increase in investment. When the economy reaches a new equilibrium, employment is projected to be 13,927 higher (+0.6%) and state population is projected to rise by 5,762 (+0.1%) due to in-migration. Overall personal income is projected to be slightly higher (+$208 million or 0.1%).

Table 3
Economic Impact of Measure 59

Economic Measure	Baseline	New Equilibrium	Change from Baseline	Percent Change
Personal Income ($M)	159,900	160,108	208	0.1%
Employment	2,369,720	2,383,647	13,927	0.6%
Population	3,951,000	3,956,762	5,762	0.1%
Investment ($M)	17,698	17,731	33	0.2%
Wage Index	100.0	99.2	-0.8	-0.8%
Return to Capital	100.0	100.2	0.2	0.2%

The OTIM simulation also produces employment impacts by sector. As expected state government jobs drop sharply due to the loss of personal income tax revenue to the state. State employment is projected to decline 8,551. Private sector jobs are projected to rise 22,478 with retail trade (including eating & drinking establishments) expected to account for 18% of the private sector employment gain.

Distribution Effects

The OTIM simulation indicates that the secondary economic effects tend to re-enforce the initial effects of Measure 59 on the distribution of household income in Oregon. Middle to lower income households receive no initial tax relief because most are able to fully subtract their federal tax payments under the current cap. High income households receive virtually all of the initial tax relief. The dynamics of the labor market further depress net income for lower income households by reducing average wages. The share going to upper income households is further increased by an expected influx of high income households from other states due to the more favorable tax climate for this income group. Table 4 shows the OTIM simulation in terms of net household income for the 8 income groups specified in the model.

Table 4
Distribution Effects of Measure 59

Household Income Group	Number of Households (Baseline)	Number of Households (New Equilibrium)	Change in Number of Households	% Change in Total income	Change in Mean Household Income
Less than $16,579	230,773	230,823	+50	-0.20%	-$56
$16,579-29,413	210,936	210,936	0	-0.30%	-$143
$29,413-41,768	196,517	196,483	-34	-0.30%	-$244
$41,768-60,474	276,977	276,931	-46	-0.30%	-$275
$60,474-86,675	287,443	287,574	+131	-0.30%	-$408
$86,675-117,067	178,814	179,228	+414	0.30%	$5
$117,067-185,879	128,488	129,023	+535	1.00%	$628
Above $185,879	63,341	64,311	+970	4.70%	$5,964

The number of households in the state is expected to increase by 2,020. High income households (income greater than $185,879) account for almost one-half of the increase although this group makes up only 4% of total households. The mean net household income for the high income group also rises by $5,964 as a result of the lower state income taxes. For the next highest household income group, both the number of households and the mean income within the group also increase. However, mean household income for the five lowest income groups (topping out at $86,675) decline. For the lowest income group (<$16,579), the number of households rises by 60 in response to increased job opportunities but mean household income for the group declines as a result of lower gross wages.

Revenue Effects

Because the OTIM simulation results in a different level of economic activity, the initial or static state revenue impact is modified by the estimated impact of the tax change on the state economy. OTIM also produces estimates of how changes in state economic activity indirectly affect local and federal revenue. Table 5 shows the revenue impact, calibrated to 2011, for the state General Fund (all income tax revenue goes into the General Fund), for state Other Fund revenue, local government revenue (primarily property taxes and fees) and for federal tax revenue from Oregon residents.

Table 5
Revenue Impact Estimate for Measure 59

2011 Levels	Static Estimate ($M)	Dynamic Estimate ($M)	Indirect Impact ($M)	Total Impact (% Change)
State General Fund	-882.5	-915.3	-32.8	-12.90%
State Other Fund	0.0	11.9	11.9	0.07%
Local Revenue	0.0	15.5	15.5	0.10%
Total State & Local Revenue	-882.5	-887.9	-5.4	-2.60%
Federal Tax Revenue	109.4	225.4	116.0	0.70%

The static General Fund revenue impact based on a sample of personal income taxpayers for the 2011 tax year is -$882.5 million. The General Fund revenue impact for that year after accounting for projected changes in the economy and distribution of income is -$915.3 million. In other words, the indirect effects of changing economic activity and distribution increase the estimated revenue loss to the state General Fund by $32.8 million. State Other Fund revenue (largely fees and excise taxes) increases slightly due to population growth (+$11.9 million) while the indirect effect on local revenue is also slightly positive (+$15.5 million). The overall indirect effect on total state and local government revenue is -$5.4 million.

The indirect revenue impact slightly re-enforces the static impact estimate for state and local revenue combined. In most cases the indirect effect offsets a portion of the initial revenue impact estimate. In other words, tax increase proposals tend to slow economic activity and thereby reduce the estimated revenue gain. The reverse is true for tax reductions, where higher economic activity leads to positive indirect revenue effects offsetting a portion of the initial estimated revenue loss. This means that the sign of the indirect impact is usually the opposite of the initial estimate. However, in the case of Measure 59, the indirect effect on revenue is also negative making the dynamic revenue loss estimate larger than the initial or static estimate.

The reason why the indirect effect increases the revenue loss estimate is because of Measure 59's impact on the distribution of income and the interaction of the state income tax system with the federal tax code. Table 5 also shows the estimated increase in federal taxes paid by Oregon residents. Initially, lower state income tax collections increase federal taxes by an estimated $109.4 million because taxpayers have less state income tax to deduct on their federal return. This estimate accounts for the impact of the federal alternative minimum on deductability of state and local taxes. The indirect effects add an additional $116 million to the federal tax burden of Oregon residents. This is due to higher overall income but more importantly it is caused by the shift to high income households. The federal personal income tax is highly progressive with the top 1% of taxpayers accounting for roughly 1/3 of personal income tax payments. As the federal income tax payments from this group grow, state tax payments are reduced through Measure 59's full deduction allowance.

Limitations of OTIM Simulations

OTIM provides some valuable insights into how the state economy would respond to a major change in tax policy and how that policy would ultimately affect the distribution of the tax burden. However, like all models, OTIM is subject to limitations. OTIM is based on a set of equations that link the sectors of the state economy and how those sectors are linked to the economy outside of Oregon (for a full description of OTIM see LRO Research Report number 2-01). To the extent that these relationships are miss-specified due to data limitations or changes in the economy, the results are subject to error. In the case of Measure 59 perhaps the most severe limitation is the specification of how state government expenditures affect the state economy over time. OTIM requires that the state balance its budget. This means that revenue reductions such as those caused by Measure 59 necessarily lead to spending reductions to rebalance the state budget. This is why the simulation shows a large reduction in state employment. However, OTIM does not capture the long-term impact of state expenditures on the overall performance of the state economy. For example, spending on education should lead to a more productive labor force over time thereby making the state more competitive. OTIM does not capture these longer run relationships for two reasons. First, it has a 5-year time horizon. Secondly, there is only very limited empirical research on how state expenditures and productivity are linked making it very difficult to quantitatively specify these relationships in a model. This likely means that the long-term impact of state expenditures on the economy is underestimated in the OTIM simulations.

State Budgetary Implications

Passage of Measure 59 would reduce state biennial General Fund revenue by an estimated $1.136 billion in the upcoming 2009-11 budget period and $1.905 billion in 2011-13 budget period. For budget planning purposes, state policy-makers combine the General Fund with Lottery revenue to develop state discretionary spending plans. Measure 59 would reduce the revenue available in the General Fund/Lottery budget by an estimated 7.5% in 2009-11 and 10.1% in 2011-13 when it is fully implemented. The Legislature would have a series of options to consider when balancing the budget in response to the lost revenue. Rather than attempt to lay out all those options, this section shows how the current 2007-09 General Fund/Lottery budget is allocated in order to get a sense for how such a revenue loss may affect state services.

The 2007 Legislature, with slight modifications by the February 2008 special session, allocated $15.1 billion in General Fund/Lottery revenue in the following manner:

- 41.3% to K-12 Education
- 12.9% to all other education including Higher Education & Community Colleges
- 22.6% to Human Services
- 15.8% to Public Safety including Corrections & the Judicial Branch
- 7.4% to all other programs

Legislative Fiscal Office analysis shows that projected General Fund/Lottery revenue is not sufficient to meet anticipated current service level costs for the 2009-11 biennium. This means that some reductions in service level are likely to occur in the absence of Measure 59. It also means that the projected loss in General Fund revenue resulting from Measure 59 will translate into service reductions unless the Legislature enacts off-setting revenue increases. If the Legislature allocates service level reductions on a proportional basis state General Fund/Lottery spending on education will absorb 54.2 % of the reductions. This would translate into a cut of $616 million in education spending from current service levels in the 2009-11 biennium.