



STATE OF OREGON

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## **Research Report**

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# **THE EDUCATION STABILITY FUND**

## **Overview**

Oregon created a stability fund for education in 2002 in the midst of an economic downturn that led to five special sessions to keep rebalancing the 2001-03 General Fund budget. The process took three constitutional amendment proposals. The second rescinded the first and then was defeated by voters. As the school funding situation worsened, the third proposal passed by about 62%. The result was a significant change in Oregon fiscal policy.

The Legislature created the Education Stability Fund as a constitutional amendment subject to voter approval. The legislation was House Joint Resolution 80 (HJR 80) in the June 2002 third special session. The Legislature referred the constitutional amendment to the voters at a September 2002 special election and voters approved. HJR 80 converted the former Education Endowment Fund into the Education Stability Fund. The 1995 Legislature clearly indicated that the Endowment Fund principal would not be spent. Only the interest could be used to support education. The motivation to convert to a stability fund was to be able to immediately use the principal for funding education. Since the Endowment Fund was a constitutional amendment, converting the fund to a stability fund required another constitutional amendment approved by voters.

Effective July 1, 2003, the new fund receives 18% of lottery net proceeds rather than the 15% that formerly flowed into the Endowment Fund. The Stability Fund has criteria, reflective of an economic recession, allowing the Legislature to access the fund principal. If these criteria are met, the Legislature by a 3/5 vote in each chamber can spend principal from the Stability Fund. The fund balance can also be spent if the Governor declares an emergency and the Legislature approves by a 3/5 vote in each chamber. Moneys from the fund can only be spent on public education.

HJR 80 transferred \$150 million from the new Stability Fund to the State School Fund by May 2003. The State School Fund is allocated to all school districts in the state through the school distribution formula. These dollars were used as part of the final state school payment for the 2001-03 budget. This transfer offset a \$150 million

General Fund reduction in the State School Fund approved during the third special legislative session. The Legislature subsequently provided for the transfer of an additional \$234.7 million from the Stability Fund for a total of \$384.7 million by the end of 2004-05. The projected ending balance on June 30, 2005 is about \$34 million.

## **Initial Legislation: Education Endowment Fund**

### **Constitutional Amendment**

The 1995 Legislature referred a constitutional amendment to voters to establish the Education Endowment Fund. Voters approved the constitutional amendment in May of 1995. The amendment allocated 15% of lottery net earnings to the fund and dedicated earnings from the fund to public education. The constitutional amendment was silent on use of the fund principal. However, the 1995 Legislature clearly indicated in material for the 1995 primary election voter's pamphlet that the principal would not be allocated.

### **Implementing Legislation**

Implementing legislation in 1995 allowed lottery funds to be used for public education. Education included pre-kindergarten through higher education as well as continuing education and workforce training. Refer to the Legislative History Summary table (page 9) for session, bill and chapter references.

Initially earnings could only be used by the State Scholarship Commission. The 1997 Legislature changed this to 75% for the State School Fund and subsequently in 1999 to the Oregon Education Fund to pay school lottery bonds. The other 25% stayed with the State Scholarship Commission (subsequently renamed to the Oregon Student Assistance Commission) to fund scholarships for low income students.

The Endowment Fund already had the statutory provisions now part of the Stability Fund except for the School Capital Matching Subaccount. These are described in the current law section.

Lottery revenue began flowing into the Endowment Fund in the 1997-99 biennium. The fund had a balance of \$91.4 million on July 1, 1999 and grew to a balance of \$222 million at the end of 2001-02 before the conversion to the Education Stability Fund.

## **Current Law: Education Stability Fund**

The stability fund legislation passed by the Legislature and adopted by Oregon voters in 2002 (HJR80) has all the components of a typical state finance stabilization fund. The constitutional amendment spells out many of the fund's features. Other detailed features were already in place as part of the Endowment Fund or created by statutes

that took effect when voters approved the constitutional amendment. Refer to the Legislative History Summary (page 9) for session, bill and chapter references.

## **Constitutional Features (Art. XV, Sec. 4)**

- **Revenue Source**

The Education Stability Fund receives 18% of state lottery net proceeds. This increased and redirected the 15% formerly going to the Education Endowment Fund. Lottery revenue, 80% of which is video poker, showed a great deal of stability during the recent recession. This suggests that lottery revenue, in the absence of a structural change in the lottery or a shift in market share to Indian tribes, is likely to grow at a slow steady rate over time. Consequently the funds flowing into the Stability Fund should grow at the same rate.

- **Size**

The size of the Stability Fund is limited to 5% of General Fund revenue in the prior biennium. If the Fund exceeds the limit, lottery deposits stop until its size is drawn down below the limit. Then 15%, not 18%, of lottery net proceeds are deposited in the School Capital Matching Subaccount for matching capital costs incurred by school districts. How long the Stability Fund will take to reach the size limit depends on (1) the growth of lottery net income going into the fund, (2) the growth of General Fund revenue, (3) the size and frequency of withdrawals and (4) if reinvested, which by statute does not currently happen, the rate of return on fund investments. This is discussed in more detail in the rate of accumulation section.

- **Triggers**

The Stability Fund has all three types of triggers: (1) economic, (2) budgetary and (3) political. It has one economic trigger and two budgetary triggers. It also has separate political triggers. The fund cannot be accessed unless the political conditions are met.

**Economic trigger:** Two or more consecutive quarters show a decline in seasonally adjusted non-farm payroll employment within the last 12 months. Non-farm payroll employment is based on a monthly survey conducted by the Oregon Employment Department. The methodology for the survey is set by the federal government and carried out in all states. A two-quarter decline is indicative of a recession. Employment declined four quarters in a row beginning in the first quarter of 2001. Prior to the recent recession, such a decline last occurred in the 1989-91 biennium during the 1990-91 national recession. It also occurred in the 1981-83 and 1979-81 biennia, a time of severe recession in Oregon.

**Budgetary triggers:** (1) The final quarterly forecast of the biennium indicates that General Fund revenue in the next biennium will be at least 3% less than General Fund appropriations in the current budget or (2) the quarterly General Fund revenue forecast for the current biennium projects that revenue will be at least 2% below the forecast used for the legislatively adopted budget. The first trigger would be indicative of an anticipated severe recession at the time the budget is being developed by the Legislature. This has not happened in the history of Oregon's

modern forecasting system, which began in 1981. The second trigger condition was met in the 1981-83 biennium, the 1979-81 biennium and the 2001-03 biennium.

**Political Triggers:** (1) A 3/5 vote in both houses of the Legislative Assembly. A vote can be taken if the economic trigger or one of the budgetary triggers is met. The 3/5 vote is an additional requirement which must be met after one or more of the economic/budgetary triggers have been met. (2) The fund can also be accessed in the absence of the non-political triggers if the Governor declares an emergency and 3/5 of the Legislature in each chamber approve.

- **Uses**

Once the triggers have been met, allocations from the fund must be used for “expenditure on public education.” Public education is broadly defined to include all levels from pre-kindergarten through higher education as well as continuing education and workforce training.

Since education funding in Oregon is a major portion of the state General Fund, the Education Stability Fund serves as a surrogate stability fund for the General Fund. Using stability fund dollars for education in place of General Fund dollars frees up General Fund dollars for other expenditures.

Refer to the Financial Summary table later in the report (page 7) for the use of funds. The State School Fund has been the major beneficiary with expected transfers of about \$385 million by the end of 2004-05.

## **Statutory Features**

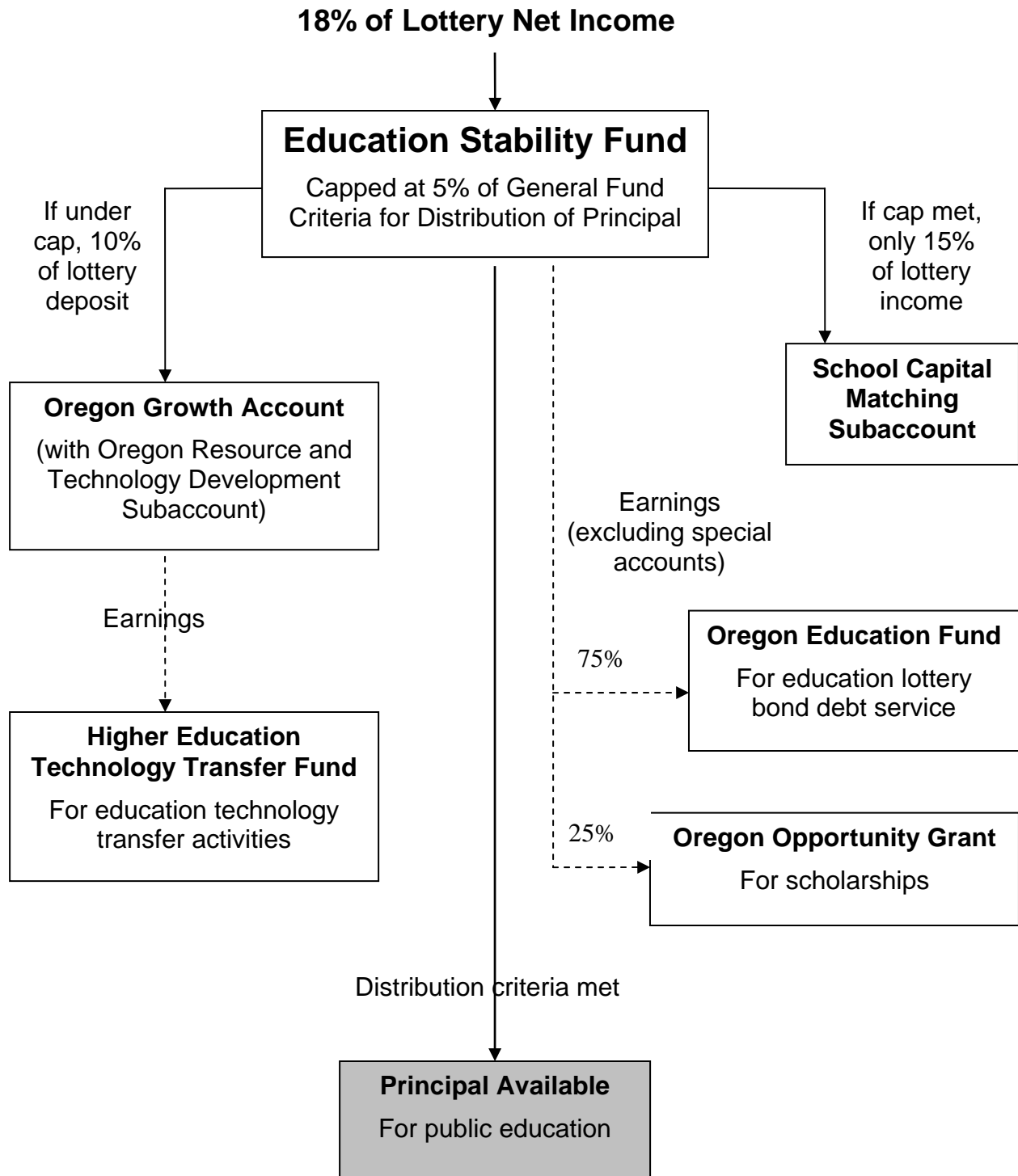
The statutes provide for the investment of the Education Stability Fund and the use of the earnings from the fund. Refer to the Fund Structure Summary chart (next page) for an overview.

## **Investments**

The Oregon Investment Council invests the Education Stability Fund (ORS 348.696). However, some accounts and subaccounts within the Fund have boards that control their investments. The Council can invest up to 65% in stocks.

The Oregon Growth Account (ORS 348.701-.710) within the Fund receives 10% of the lottery funds deposited into the Stability Fund. The Oregon Growth Account Board controls the investment vehicles. The purpose is to earn returns for the Stability Fund by providing seed capital for emerging growth businesses in key industries in Oregon. This is venture capital. Within this account, there is the Oregon Resource and Technology Development Subaccount. The subaccount funds are invested for the same purpose. Earnings go to the Higher Education Technology Transfer Account.

# FUND STRUCTURE SUMMARY



## **Earnings**

As already stated, earnings on the special accounts and subaccounts within the Stability Fund stay with the account or have a specific use. The earnings from the Stability Fund core principal are allocated as follows:

- 75% of earnings are dedicated to the Oregon Education Fund. Dollars from the Oregon Education Fund are used to pay debt service on lottery backed bonds for schools approved by both the 1997 and 1999 Legislatures. These bonds have debt service costs of about \$60 million per biennia until paid off in 2016
- 25% of earnings are dedicated to the Oregon Student Assistance Commission for the Oregon Opportunity Grant program. These funds are used for college scholarships for low income students.

## **Actions and Outlook**

### **Transfers of Fund Principal**

The constitutional amendment (HJR 80) provided for the transfer of \$150 million from the Fund to the State School Fund on May 1, 2003. The initial transfer to the State School Fund offset a \$150 million disappropriation from the State School Fund. This was an important factor in the rebalance of the state General Fund during the third special session of 2002.

The 2003 Legislature made two additional transfers. The Legislature found that the March 2003 General Fund revenue forecast for 2001-03 was more than 2% below the close-of-session forecast for the 2001-03 adopted budget. This allowed the Legislature with a 3/5 vote in both chambers to transfer an additional \$112 million to the State School Fund by May 2003. This was part of the final rebalance of the 2001-03 budget during the 2003 regular session. Using the same budgetary trigger based on the May 2003 forecast, the Legislature provided for the transfer of 90% of the lottery deposits made between July 1, 2003 and May 1, 2005 to the State School Fund. This transfer of principal is currently estimated at \$122.7 million and helped balance the 2003-05 General Fund budget. The estimated Stability Fund balance at the end of the 2003-05 biennium is \$33.6 million.

Besides reducing the Fund principal, the transfers reduce future earnings. This reduces earnings going to the Oregon Education Fund and to the Oregon Student Assistance Commission.

## FINANCIAL SUMMARY

### Education Endowment Fund

Fiscal Year	Source		Transfers and/or Earnings					Fund Ending Balance
	15% Lottery Deposit	Investment Earnings	OR Education Fund (Bonds)	Scholarship Commission	OR Growth Account	State School Fund	Other	
1997-98	\$44.6	\$1.2						\$45.8
1998-99	46.6	3.9	3.5	1.3				91.4
1999-00	43.8	6.4	4.3	1.4	4.1	0	0.2	131.7
2000-01	43.2	8.9	7.2	2.4	2.4	0	0.3	171.6
2001-02	52.6	5.3	3.5	1.2	2.3	0	0.3	222.2

### Education Stability Fund

Fiscal Year	Source		Transfers and/or Earnings					Fund Ending Balance
	18% Lottery Deposit	Investment Earnings	OR Education Fund (Bonds)	Scholarship Commission	OR Growth Account	State School Fund	Other	
2002-03	\$60.7	\$3.8	\$2.5	\$0.8	\$4.8	\$262.0	\$0.4	\$16.1
2003-04 Est.	65.7	0.7	0.3	0.1	1.5	0	-5.0	85.6
2004-05 Est.	70.6	1.1	0.9	0.3		122.7		33.6
2005-06 Est.	70.8	0.8	0.5	0.2				104.5
2006-07 Est.	73.1	2.2	1.8	0.6				177.5
2007-08 Est.	75.7	4.5	3.0	1.0				253.8
2008-09 Est.	77.9	8.5	6.8	2.3				331.2
2009-10 Est.	80.5	14.5	9.8	3.3				413.1
2010-11 Est.	83.1	19.5	15.7	5.2				494.8

Notes: Dollars in millions. Numbers may not add due to rounding.

Oregon Growth Account includes Oregon Resource and Technology Development Subaccount

Conversion to Stability Fund effective October 17, 2003

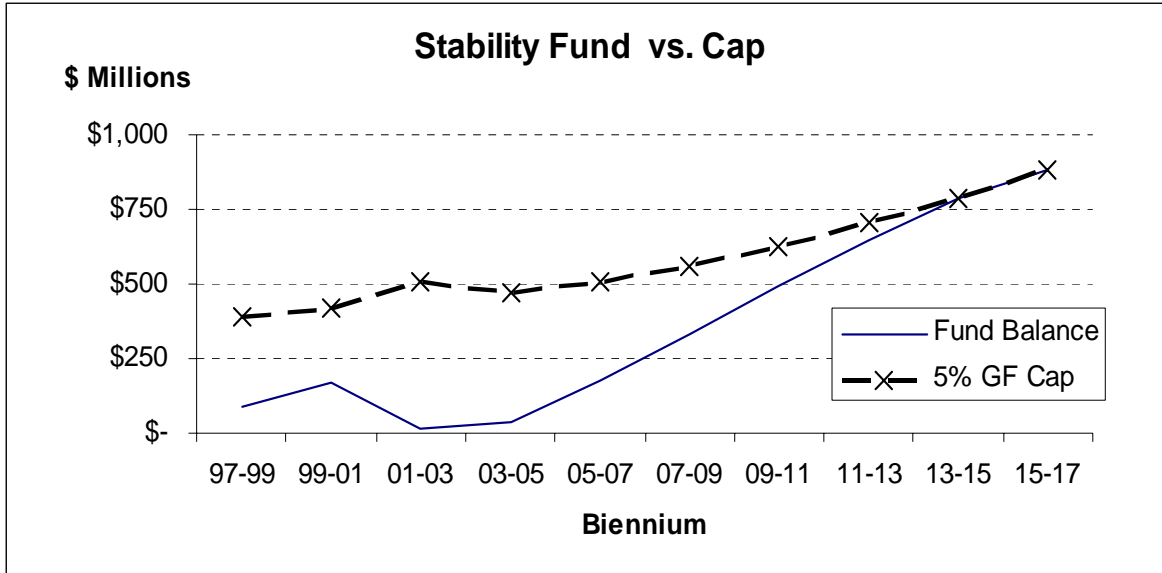
Estimates from June 2004 Oregon Economic and Revenue Forecast





**Rate of Accumulation**

The Financial Summary table (page 7) shows a history of deposits to the fund, earnings and transfers from the fund. The fund initially grew to \$222 million at the end of 2001-02. After three withdrawals, the fund will have about \$34 million at the end of 2004-05.



As the graph above illustrates, under current projections the fund will grow to roughly \$800 million over the next ten years. This assumes (1) the current lottery structure has annual growth at about 3.25%, (2) Stability Fund earnings are not re-invested, (3) the General Fund grows about 12% per biennium and (4) there are no intervening withdrawals after May 1, 2005. Given these assumptions, the Fund reaches its cap after 10 years during the 2013-15 biennium. However during this 10 year period there are likely to be conditions that would allow transfers of fund principal. This could extend the date for reaching the cap, perhaps indefinitely.

A key issue is the use of fund earnings. If earnings are invested back into the Fund, it will grow faster. If earnings continue to be allocated as they are under current statute (75% to debt repayment and 25% to scholarships) the fund will grow more slowly. Re-investing earnings could add \$150-300 million to the fund balance over the next 10 years depending on the rate of return. However, debt repayment would have to shift to another source. Re-investing could reduce the time to reach the cap.

**2005-07 Biennium Outlook**

Currently (July '04) the prospect is that no budget or economic triggers are likely to be met prior to the end of the 2005 regular legislative session. If this happens, the only alternative trigger is the Governor declaring an emergency, presumably financial in nature requiring a reduction in General Fund dollars allocated to the State School Fund, and both chambers approving by a 3/5 vote.

## LEGISLATIVE HISTORY SUMMARY

Session/ Date	Bill/ Election	Law Chapter	Summary
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### Education Endowment Fund

1995	HJR 15	Measure 21	Constitutionally creates the Education Endowment Fund and dedicates 15% of lottery net income to it beginning in 1997 if voters approve.
	HB2634	17	Refers HJR 15 to voters.
	May Special		Voters approve Measure 21 by 671,027 to 99,728.
	HB2491	12	Implements HJR 15. Defines education. Transfers earnings to State Scholarship Commission for distribution.
	SB696	811	10% of lottery transfers to Oregon Growth Account
1997	SB355	804	Allows up to 65% of fund to be invested in common stocks
	HB3695	524	Allocates 25% of earnings to the State Scholarship Commission and 75% to the State School Fund.
1999	SB200	44	Shifts 75% of earnings to Oregon Education Fund to pay school lottery bonds

### Education Stability Fund

2002 February Special 1	SJR 50		Constitutionally converts Endowment Fund to Education Stability Fund. Transfers \$120 million of balance to State School Fund in May 2003.
	SB1010	12	Submits SJR 50 to voters for approval at primary election
2002 March Special 2	HJR 76	Measure 13	Rescinds SJR50. Constitutionally converts Endowment Fund to Education Stability Fund. Specifies conditions for use of principal. Transfers \$220 million to the State School Fund on May 1, 2003. Refers measure to voters.
	HB4032	3	Specifies election procedures for HJR76.
2002	May Primary		Voters reject State Measure 13 by 376,605 to 411,923.
2002 June Special 3	HJR 80	Measure 19	Constitutionally converts Endowment Fund to Education Stability Fund. Allocates 18% of lottery net income to the Stability Fund. Specifies conditions for use of principal. Transfers \$150 million from the Stability Fund to the State School Fund. Refers measure to voters.
	HB4052	6	Implements HJR 80 fund conversion
	HB4059	1	Specifies special election procedures for HJR 80.
2002	September Special		Voters approve State Measure 19 by 496,815 to 306,440.
2003	SB855	10	Transfers \$112 million from the Stability Fund to the State School Fund by May 2003.
	HB3642	515	Directs State Treasurer to transfer 90% of Stability Fund deposits between July 1, 2003 and May 1, 2005 to the State School Fund.
	HB3613	606	Allows 10% of Stability Fund deposits to be credited to the Oregon Growth Account for venture capital investments in Oregon