

# Vox Populi? Oregon Tax and Expenditure Limitation Initiatives

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This article provides a brief history of tax and expenditure limitation initiatives in Oregon, along with a narrative of contemporary events. Largely as a consequence of the initiative's increased role in the formulation of Oregon's fiscal policy, state and local taxes paid by Oregon households declined from 7.4 percent of income in 1989 to 6.8 percent in 2003; state revenue, which is heavily dependent upon personal income taxes, has become increasingly income elastic; and state and local governments now rely on user fees to an almost unprecedented degree.

## INTRODUCTION

The initiative is not new to Oregon—it was practically invented here by William U'Ren at the turn of the last century, along with the referendum and recall,<sup>1</sup> but it now dominates the formulation of public policy in Oregon as never before.<sup>2</sup> In recent years, statewide ballot measures have given Oregonians more than 100 policies governing everything from bear hunting to nude dancing, from physician-assisted suicide to legislative term limits.<sup>3</sup> The outcomes of most of these initiatives probably accurately reflect the

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1. Richard W. Montague, "Home Rule in Oregon," *California Law Review* 8, no. 3 (March 1920): 151–169; and Thomas E. Cronin, *Direct Democracy: The Politics of Initiative, Referendum and Recall*, reprint ed. (Cambridge, MA: Harvard University Press, 1990).

2. Richard J. Ellis, *Democratic Delusions: The Initiative Process in America* (Lawrence: University Press of Kansas, 2002).

3. Lisa Grace Lednicer, Wayne Hoffman, and Jennie Drage Bowser, "Term Limit Turmoil in Oregon," *State Legislatures* 28, no. 7 (July 2002): 30–35; Peter Wong, "Power Parity in Oregon," *State Legislatures*

tastes and preferences of Oregon's electorate. Arguably, however, the same claim does not apply to the tax limitation initiatives approved during the 1990s. Nevertheless, these measures dramatically changed Oregon's public finances at both state and local levels.

## RECENT TAX LIMITATION MEASURES IN OREGON

Ordinary people do not like paying taxes, primarily because taxes leave them with less money to spend or save.<sup>4</sup> In Oregon, this understandable sentiment is the law of the land. Oregon, for example, is one of the last states without a broad-based sales tax. This is a direct result of referral of tax proposals (at both the state and local levels of government) to the voters, who have defeated state and local sales tax measures 33 times in 73 years.<sup>5</sup> Instead, Oregon relies on individual and corporate income taxes to fund state government, which is mildly idiosyncratic, and property taxes and user fees to fund local governments and special districts, which is not.

It is true that, prior to the recent wave of initiative-driven tax reforms, Oregon required property taxes to bear a disproportionate burden of support for public schools. Between 1978 and 1988, state aid fell from 45 percent of school funding to 28 percent. As a result, while Oregon's overall tax burden was not extraordinarily high, ranking 23rd out of 50 measured on a per capita basis and 16th against per capita income in 1988, its income and property tax burdens were, respectively, ranking 9th and 11th per capita and 4th and 5th against income.<sup>6</sup>

Moreover, state school aid formulas were exceedingly complex. The straightforward basic aid plus Strayer-Haig (foundation) equalization aid programs, which were in effect

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*(footnote Continued)*

29, no. 7 (July/August 2003): 22–28; and M. Dane Waters, “2002 Initiatives and Referenda,” *Spectrum: Journal of State Government* 76, no. 1 (2003): 20–22.

4. At a conference on the initiative process in Oregon held at Willamette University's law school in 2002, one of the speakers, political commentator (and Oregon State University political science professor) Bill Lunch, asserted that Oregon voters prefer lower taxes to higher taxes and more services to fewer services (which seems perfectly rational to us). He went on to say that voters (unlike their elected representatives) are inclined to ignore the discrepancy between these preferences and that they *heedlessly* vote to cut taxes and to increase spending. He pointed to Measures 5, 11, and 47 as evidence (47 cut taxes, 11 increased spending, and 5 promised to do both). Most of the audience nodded in agreement. Nevertheless, the evidence does not really support the notion that voters heedlessly oppose higher taxes: between 1925 and 2000, Oregon voters increased taxes on themselves in thousands of local elections. What the evidence shows is that voters are rarely willing to raise their taxes in statewide referenda and sometimes endorse statewide initiative measures promising to reduce them. More generally, prior to Measure 5, voters resisted centralization of tax and expenditure functions at the state level, which is a fairly widespread phenomenon. John G. Matsusaka, “Fiscal Effects of the Voter Initiative: Evidence from the Last 30 Years,” *Journal of Political Economy* 103, no. 3 (June 1995): 587–623.

5. Turtle McBride, “Serious Thinking about Sales Taxes,” *Oregon's Future* 2, no. 3 (2000): 22–24.

6. All tax figures reported here come from Oregon Tax Research reports, except where otherwise indicated.

during the 1940s, 1950s, and 1960s, had been replaced by a mishmash of special purpose funding arrangements. Attempts to increase equity, make local districts address legislative concerns (plus those of the state education department), comply with federal mandates, and promote greater tax effort at the district level and district consolidation, while at the same time holding districts harmless in terms of state aid, had produced a labyrinthine financing system, which required a 44-page booklet to describe.

Combined with Oregon's levy-based system of determining property taxes,<sup>7</sup> in which district voters adopted a school budget, state and federal funds were subtracted from the total, and the remainder determined the local property tax rate, the design of the state funding program meant that school districts that relied heavily on state dollars experienced large swings in property tax rates as a result of fluctuations in state school aid. Indeed, it would not be wrong to say that Oregon's unstable school funding in the pre-Measure 5 era was largely the fault of the state legislature: between 1950 and 1989, state aid provided as much as 55 percent and as little as 19 percent of total school spending. Furthermore, fluctuations in state school aid were not random; the state legislature tended to increase funding during economic upswings and cut it during recessions, thereby exacerbating the local property tax's bite.

In 1988, then-governor Neil Goldschmidt proposed to fix the school finance system in Oregon by making all local levies permanent, thereby ending school closures,<sup>8</sup> and stabilizing state support, by increasing state aid and indexing it to the rate of inflation multiplied by enrollment growth. While the legislature complied with the first half of the governor's proposal, enacting the so-called school safety net into law, they balked at Goldschmidt's funding proposal. Several legislative leaders were reported to say that Goldschmidt was proposing a band-aid, when what the state school finance system needed was radical surgery. They concluded that it would not be possible to really fix the system unless things got worse. What they seemed to want was a state sales tax, and they were evidently willing to let things get worse to win one.

### *Measure 5*

In any case, Oregonians did not get a sales tax. Instead, we got Ballot Measure 5 (brought to us in 1990 by populist activist Don McIntire and former Reed College professor Thomas P. Dennehy), which set property tax rate limits for support of local governments and for school districts.<sup>9</sup> Because Measure 5 required the state to replace property tax revenue lost to school districts, responsibility for decisions about school

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7. Levy-based systems were in effect for all home-rule jurisdictions, primarily municipalities, and most school districts. Other local jurisdictions were subject to statutorily established tax rates that could be changed only by approval of the voters.

8. Joe B. Stevens and Robert Mason, "Political Markets, Property Tax Referenda, and Local School Spending," *Public Choice* 86, nos. 3–4 (1996): 257–277.

9. These were separate limits: one maximum rate governing school districts, 0.5 percent, and one governing all other local jurisdictions, 1 percent.

spending was largely shifted from local voters to the state legislature, thereby abandoning a voter-controlled system that had worked fairly well for nearly 100 years (although prior to the enactment of the safety net, some school districts flirted with closure year in and year out).

Measure 5 had several expected consequences. In the first place, it reduced property taxes. According to the best evidence, it saved high-income (top quintile) households about \$740 a year on average and low-income (bottom quintile) households about \$35.<sup>10</sup> Waters and his colleagues also suggest that Measure 5 increased total output and income in Oregon, although even with this increase, state and local government tax revenues were measurably constrained. They concluded that each three-dollar reduction in property tax revenues resulted in a two-dollar reduction in state and local revenues and an increase in federal revenues of somewhat less than one dollar.

Measure 5 also reduced tax support for the public schools. David Figlio<sup>11</sup> found that, as a result of Measure 5, Oregon student–teacher ratios increased significantly, while the ratio of administrative to instructional spending remained unchanged.<sup>12</sup> He further concluded that teacher salaries and benefits fell *vis à vis* median state incomes, contrary to nationwide trends for teacher salaries.<sup>13</sup> Interscholastic variations in per pupil spending have decreased as well (probably more than interscholastic resource variations). This means that spending has increased in many rural districts, while most urban districts have lost resources on a per pupil basis.

Measure 5 also had various unanticipated consequences. One of the most bizarre of these derived from a fact noted earlier, that some local jurisdictions could not change their tax rates without an election, while those with a permanent levy could. Measure 5 limited the sum of local (nonschool) tax rates that could be imposed on a property to 1 percent of actual market value. In most instances, this total was shared between

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10. E. C. Waters, D. W. Holland and B. A. Weber, “Economic Impacts of a Property Tax Limitation: A Computable General Equilibrium Analysis of Oregon’s Measure 5,” *Land Economics* 73, no. 1 (1997): 72–89.

11. David N. Figlio, “Short-Term Effects of a 1990s-Era Property Tax Limit: Panel Evidence on Oregon’s Measure 5,” *National Tax Journal* 51, no. 1 (1998): 55–70.

12. Note that Oregonians traditionally spent more on public schools than other Americans. This is still true, although less noticeably than was once the case. The relative decline in school support following Measure 5 can be explained in various ways. However, we would like to note the spending preferences of the mean voter would likely exceed the preferences of the median voter by a greater amount at the state level than at the district level (because districts tend to be more homogenous than the state as a whole). Consequently, if both reflected the preferences of median voters, the sum of school spending decided at the district level would likely exceed spending decided at the state level (see Fabio Silva and Jon C. Sonstelie, “Did Serrano Cause a Decline in School Spending?” *National Tax Journal* 48, no. 2 (1995): 199–215. Stevens and Mason make a strong case for believing that, prior to Measure 5 but after the adoption of the safety net, district-level school spending closely reflected the preferences of median voters. Stevens and Mason.

13. David N. Figlio, “Can Public Schools Buy Better-Qualified Teachers?” *Industrial & Labor Relations Review* 55, no. 4 (2002): 686–699.

levy-based jurisdictions and other overlapping jurisdictions. Where their combined tax rates exceeded 1 percent, each individual jurisdiction was supposed to suffer a pro rata reduction based upon the share its tax rate represented of the total. Quick-witted financial officers in districts with approved levies soon realized that this meant they could increase their shares simply by raising their tax rates (as long as revenues were less than the approved levy) and that this could be done without at the same time affecting their residents' tax payments. Instead, their gain came at the expense of other jurisdictions sharing the common tax base.

More significantly, because commercial and residential properties were (and still are) assessed differently, Measure 5 caused a shift in the property tax burden. Assessments on commercial property were based upon whichever was the lesser of the present value of a property's income stream (using a statutorily determined discount rate), replacement value less depreciation or book value. Under Measure 5, assessments on individual residences reflected the full market value of the property and its improvements, including capitalization of the property tax itself.<sup>14</sup> Hence, when Measure 5 reduced tax rates, housing prices jumped and so did their assessments, while commercial assessments were largely unaffected, causing a substantial but probably unintended shift in the burden of the property tax from commercial property owners to homeowners.<sup>15</sup> Of course, this also

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14. Capitalization is the process by which a stream of benefits or costs is converted into asset prices. Benefit streams increase asset values, and cost streams decrease them. If the benefits and costs flowing from an asset are constant over time, the following formula shows how capitalization works (ignoring real wear and tear and obsolescence and value appreciation):

$$P = B/i. \quad [1]$$

This formula says that the price (P) is equal to the annual net benefit flow from the piece of property (B) divided by an appropriate discount rate (i). A tax rate (t) on the land price would be capitalized as:

$$P = B/(i + t). \quad [2]$$

As t increases, P decreases, but B is unaffected. As a result, a local government that relies on the property tax cannot easily shift the cost of capital improvements or current operations into the future by borrowing. Municipal debt is also capitalized, and thus land prices are decreased by an amount equal to the present value of future property tax payments.

The capitalization of locally provided services and taxes into land values has been extensively tested by economists and generally upheld (see D. L. Weimer and M. J. Wolkoff, "School Performance and Housing Values: Using Non-Contiguous District and Incorporation Boundaries to Identify School Effects," *National Tax Journal* 54, no. 2 (2001): 231–253). For example, W. Bogart and B. A. Cromwell, "How Much Is a Neighborhood School Worth?" *Journal of Urban Economics* 47, no. 2 (2000): 280–305, reported finding that where other things were held equal (including taxes and school spending per pupil), the reputation of its schools could add up to \$50,000 to the average price of homes in a district. Another example: A. Q. Do and C. F. Sirmans, "Residential Property-Tax Capitalization—Discount Rate Evidence from California," *National Tax Journal* 47, no. 2 (1994): 341–348, found that each dollar paid in property taxes reduced housing prices about \$25. The point is that housing prices, local government services, and property tax rates are all evidently substantially interdependent.

15. To a degree this reversed the situation before Measure 5, when residential property was generally under-assessed, on average about 20 percent to 30 percent less than actual market value, although the degree of under-assessment varied considerably from county to county.

meant that most homeowners probably got less tax relief under Measure 5 than they had expected.

### *Responses to Measure 5*

To fix the problems caused by Measure 5, Oregonians got Measure 47 (sponsored by Taxpayers United in 1996). Among other things, Measure 47 rolled back assessments on residential and farm properties to pre-Measure 5 levels and fixed them there. It also created the so-called double-majority requirement for taxing and spending measures (initiatives and referenda), which specified that increases had to be by a majority where a majority of the voters *registered* to vote actually did so.

Measure 47 was approved by the voters in November 1996, but immediately ran into trouble in the courts, both because of the vagueness of some of its language and because it violated a rarely enforced rule in the Oregon constitution prohibiting initiatives with multiple subjects (in this instance, assessment practices and rules governing expenditure measures).

As a result of a deal brokered in the state legislature, Measure 50 was referred to the voters in May 1997 to revise the state constitution to fix Measure 47. Measure 50 capped property tax assessments at the level of the 1994–1995 tax year or 10 percent less than the 1995–1996 tax year, whichever was less, with new construction appraised at the average rate of similar properties in the area,<sup>16</sup> and limited assessment increases to 3 percent per annum.<sup>17</sup> This means that annual property tax increases are also limited to 3 percent, except where rate increases are authorized to pay for voter-approved bonds (which require a double majority for approval).

Along with Measure 5, Measures 47 and 50 led to substantial property tax savings for Oregon's taxpayers—property tax payments dropped from 5 percent of personal income in 1991 to less than 3 percent today. Oregonians now pay less property tax than the national mean, with the state ranking 23rd out of 50 on a per capita basis and 25th as a percent of personal income. Measures 47 and 50 also went a long way toward balancing tax burdens between businesses and homeowners.

Unfortunately, they also created new problems of their own, the most important being that a majority of local governments and most of remaining school districts were

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16. While county assessors have considerable latitude in the selection of appraisal method, all use some kind of multi-attribute method. In Multnomah and Lane counties, for examples, they use hedonic-pricing models and regression analysis. In any case, property owners can appeal assessments, administratively at the local and state levels and then to the courts, if still not satisfied.

17. Oregon's property tax assessments under Measure 50 are different from California's in one important respect—tax obligations are not readjusted when property is sold. The California system is arguably fairer, because low-income and older homeowners move less frequently and are thus reassessed less often than younger and richer families. Arthur O'Sullivan, Terri A. Sexton, and Steven M. Sheffrin, *Property Taxes and Tax Revolts: The Legacy of Proposition 13* (New York: Cambridge University Press, 1995). In Oregon, by contrast, the beneficiaries are the homeowners whose assets are appreciating most rapidly in value. To be sure, Oregon's system avoids the lock-in inefficiencies characteristic of California's system. However, O'Sullivan and colleagues plausibly argue that even in California these are small.

subjected to Measure 5's overall property tax rate limits. Because Measure 50 established rules for allocating combined revenues to jurisdictions subject to Measure 5 limits, this has, for most practical purposes, converted the property tax from a local tax into a state tax.

Measure 50 had one further effect worth noting—it relieved the beneficiaries of general fund-financed local service improvements from the obligation to pay for them (tax payments do not automatically increase when local improvements are capitalized in property values, but under Measure 50 may do so only where voter-approved debt financing is in place<sup>18</sup>). Instead, the costs of general fund-financed improvements are spread across the community. Not surprisingly, following enactment of Measure 50, local opposition to general fund-financed capital improvements and real estate development intensified.

The most salient local government response to these changes has been to increase user charges and fees, especially development charges or “impact fees.” The city of West Linn, for example, now charges more than \$12,000 in impact fees for construction of a single-family dwelling; Corvallis charges almost twice that. As O’Sullivan, Sexton, and Shiffren explain, market conditions determine who pays these fees: when the housing market is strong, buyers do, in the form of higher prices, otherwise, the burden is shifted back to developers and landowners; rarely if ever are existing homeowners adversely affected.<sup>19</sup> Given Oregon’s population growth and its land use controls, we suspect that these fees are usually shifted forward to buyers. In any case, prior to Measure 5, fees and charges amounted to less than 5 percent of local government revenue in Oregon; they now account for 35 percent of the total and overshadow the property tax as a source of revenue for many jurisdictions in Oregon.<sup>20</sup>

Overall, taking account of both state and local finances, Measures 5, 47, and 50 also made Oregon more reliant than ever before on individual and corporate income taxes, where Oregon remains near the top of the league table of the states—sixth in income taxes paid per capita and first as percent of personal income. Some commentators argue that, as a result, the Portland metropolitan area bears well over half of the burden of supplying public services, which flow disproportionately to the rest of the state.<sup>21</sup>

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18. This is not entirely a bad thing, even from the standpoint of those of us who are inclined to accept the “homevoter” thesis. William A. Fischel, *The Homevoter Hypothesis: How Home Values Influence Local Government Taxation, School Finance, and Land-Use Policies* (Cambridge, MA: Harvard University Press, 2001). It makes explicit a mechanism which otherwise relied on the efficacy of local zoning practices to achieve Tiebout sorting.

19. *Ibid.*

20. That fees and charges do not count as taxes is one reason for the chief anomaly of Oregon’s current system of public finance. While Oregon is now a reasonably low-tax state, ranking 28th in per capita tax collections and 34th as a percent of income, it is still a high-spending state, ranking 7th highest in total expenditures per capita and 8th highest in terms of total state and local expenditures a percent of personal income.

21. Fred Thompson, “Introduction: Tax Policy, Liberty and the Pursuit of Happiness,” *Oregon’s Future* 2, no. 3 (2000): 2–7.

Perhaps more significantly, increased reliance on progressive income taxes has increased the volatility of combined state and local tax revenues—producing revenue/income elasticities greater than one.<sup>22</sup> This circumstance was mildly exacerbated by a 1999 tax referendum, which increased the deduction on Oregon personal income taxes for federal income tax payments from \$3,000 to \$5,000. For taxpayers with federal tax liabilities of more than \$5,000, this is a first-dollar reduction. For most others it merely raises their personal exemption. Consequently, its fiscal impact is not particularly sensitive to fluctuations in personal income—it produces a revenue loss of about \$180–\$190 million per annum in good years and bad (out of a total of approximately \$3.6 billion in fiscal 2003).

Throughout the 1990s, Oregon’s heavy reliance on progressive income taxes caused state revenue to grow faster than nominal incomes—in 1991 state personal income tax receipts were \$2 billion; by 2000, they had almost doubled to \$3.9 billion. Unfortunately, with the onset of recession in 2001 and with unemployment increasing from one of the lowest levels in the country to the highest, over 7 percent in 2002–2003, state income tax receipts stumbled and then dropped precipitously.

### *Measure 28 and Its Aftermath*

According to the *Economist*:

Almost every state in America is in a budget bind. Most are required, by their own constitutions, to balance their budgets. But with a weak economy and a battered stock market, that is easier said than done. Oregon is in the worst mess of all. Its two-year budget of \$11 billion faces a shortfall of \$1.9 billion.<sup>23</sup>

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22. As one anonymous referee explained, “The income tax is more volatile if it is progressive. . . . Large budget shortfalls are due, in part, to overreliance on a progressive income tax. This is certainly true in California, and California relies less on the income tax than does Oregon. This argument has been used to reject increasing the maximum income tax rate as a budget solution in California.”

The following result from a Monte Carlo model based on state data illustrates the relative volatility of Oregon revenues. Using this model, we found that the relationship between rainy day fund size and the probability of a revenue shortfall is best expressed as follows:

$$y = 0.3439e^{-0.0012x} \quad [3]$$

where  $y$  is the average probability of a budget shortfall and  $x$  is the size of the rainy day fund in millions. Solving for  $x$  yields the following:

$$x = \frac{\ln\left(\frac{y}{0.3439}\right)}{-0.0012} \quad [4]$$

which indicates that if the state of Oregon is willing to accept a shortfall once every 20 years (a probability of 0.05), it should have a rainy day fund of \$1.5 billion, about one-third the annual general fund budget. By contrast, using Washington State data, the same level of security could be achieved with a rainy day fund of only \$350 million, less than 5 percent of Washington’s budget. See Philip G. Joyce, “What’s So Magical about Five Percent? A Nationwide Look at Factors that Influence the Optimal Size of State Rainy Day Funds,” *Public Budgeting and Finance* 21, no. 2 (2001): 62–87.

23. “More Taxes, Anyone?” *Economist*, 2 January 2003, p. 43.

This circumstance is in part a consequence of the changes to Oregon's system of public finance brought about in recent years by the initiative process.

It is also a consequence of the condition of the state's Public Employees Retirement System (PERS). In 1994, with the stock market booming, the state guaranteed its employees an 8 percent return on their individual contributions to PERS (the mandatory portion of individual contributions, which, in a wonderful example of new-speak, the state has paid since 1979). Then the stock market took a dive; and PERS, which had appeared overfunded during most of the 1990s, found itself with an actuarial shortfall of nearly \$10 billion.

Finally, the severity of Oregon's fiscal crisis is at least partly due to the state government's inexperience managing cyclical instability. Oregon's constitution requires the legislature to enact a balanced spending-taxing plan (budget). Before Measure 5, the legislature typically coped with cyclical instability by varying the amount of state funding for things that were also supported by local property tax levies, such as schools.<sup>24</sup> It was then possible to increase support, when the state was flush, and to cut back, when things were tight. Under the old levy system, local taxpayers typically received property tax relief at the peak of the business cycle, but they were forced to make up for state revenue shortfalls in the trough. Consequently, the legislature could usually avoid large, unpopular cuts in service levels.

The state also tended to adjust salaries and maintenance of physical assets to track the business cycle, deferring spending in lean times and catching up in fat, an expedient they have adopted in this downturn as well.

Other states deal with the problem of volatility in a similar fashion, but Oregon's levy-based system made it much easier for the legislature to shift fiscal responsibility to local property taxpayers. Moreover, because shifting the tax burden was so easy, Oregon's legislature remained largely unfamiliar with the kinds of mechanisms used in other states to manage cyclical instability—using current revenue to support construction and maintenance of buildings, highways, bridges, parks, and so on during periods of prosperity, and using debt financing to support these items during hard times, maintaining rainy day funds, relaxing restrictions on transfers between restricted funds and general funds, and cutting services.

Because the previous 10 years were especially kind to Oregon, the legislature continued to ignore the state's lack of preparation for a fiscal emergency, although the implications of its reliance on individual and corporate income taxes were inescapable. After 2001, the fiscal climate of the state rapidly deteriorated. Of course, the legislature has wide latitude to respond to a fiscal emergency. It could borrow from the state cash pool, from other funds, or even from the public. It could defer scheduled payments to fiduciary accounts such as PERS. All of which it proposed to do, along with enacting fairly severe spending cuts and some new excise taxes and fees.

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24. A referee notes that California, for example, shifted responsibility for funding schools to local taxpayers in the two most recent recessions, via ERAF in 1992 and 1993 and the "Triple Flip" in 2003.

However, then-governor John Kitzhaber consistently opposed borrowing to balance the budget and held out instead for an across the board tax increase, recommending either a gross receipts tax or a value added tax, and criticized many of the other devices pursued by the legislature as accounting gimmicks. Consequently, he vetoed three different proposals that would have given Oregon a nominally balanced budget. Finally, the legislature partially acceded to the governor's demands, formally balancing the budget by enacting a three-year income tax hike, which was referred to voters in the form of Measure 28 in January 2003, shortly after the current governor, Ted Kulongoski, took office. A 54 percent majority defeated Measure 28.<sup>25</sup>

### *Measure 30 and Subsequent Legislative (In)Action*

In August of 2003, after the longest legislative session in Oregon's history, a balanced budget including a bundle of temporary and permanent tax increases and changes that would have raised \$1.25 billion during the 2003–2005 biennium was enacted and signed into law. A temporary surcharge on individual income taxes was once again a key feature of the state's fiscal plan. The surcharge would have generated more than \$800 million. There were two differences between this tax hike and the one rejected in January 2003: it was somewhat more progressive,<sup>26</sup> increasing rates from 9 percent to 9.9 percent at the top end, versus 9.5 percent, and it called for automatic cuts in school aid, social services, and other specified state programs, if voters overturned it. Opponents of the surcharge called this second feature of the surcharge a "poison pill," arguing that it was a strategic ploy, whose only purpose was to ensure that the adverse consequences of overturning the surcharge were viewed as inescapable, thereby increasing the reluctance of voters to overturn it.

If so, it didn't work. The whole bundle of temporary and permanent tax increases and changes enacted in 2003 was referred to the voters by Measure 30 and overturned by them February 3, 2004, by a 60 percent majority.

In the fall of 2003, the legislature also passed a measure to convene a special legislative session on tax reform in June 2004, after an interim panel drafted recommendations on overhauling the state's tax system. The 20-member Joint Interim Committee on Tax Reform followed a three-step process to carry out its mandate:

1. In December and January, it studied the state's revenue stream over time and compared Oregon's tax system to surrounding states'.

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25. Ironically, the state's treasurer dealt with the resulting cash shortfall by borrowing from the public through issuance of revenue and bond anticipation notes, precisely the result Governor Kitzhaber claimed he wanted to avoid. The borrowing alternative was nominally preempted in the 2003 legislative session by enacting into law the steps required to be taken if the voters repealed the temporary income tax surcharge that balanced the budget.

26. Oregon's personal income tax was already moderately progressive: in 2001, the top 20 percent of households in the state earned about half of the state's adjusted gross income and paid two thirds of its income taxes (Oregon CAFR, 2001: extended statistical section).

2. In February and March, it conducted hearings around the state to allow citizens to voice concerns and recommendations about Oregon's tax system.
3. During April and May, the committee met in the state capital, Salem, to review testimony, and to study findings of their own research and that of public finance experts brought into the process. It was supposed to develop specific language for legislation and report its plan to the legislative leadership.

As a consequence of this process, the committee considered outright repeal of Measure 5, loosening Measure 47 growth limits from 3 to 4 percent, relaxing the state's debt limit during recessions, a strict state expenditure limit (TEL) combined with a rainy day fund (the so-called bucket plan), and the perennial chestnuts—a comprehensive sales, value added, or transactions tax. Ultimately the committee deadlocked, with Democrats supporting a sales tax and Republicans the bucket plan.

Oregon has actually had a state-level TEL on the books since 1979, limiting state general fund appropriations to the rate of growth in personal income over the previous two calendar years and returning excess revenues, that is, more than 2 percent greater than budgeted, to the taxpayers.<sup>27</sup> This second aspect of Oregon's TEL is known as the "kicker." Clearly, Oregon's TEL did not appreciably constrain expenditure growth during the 1990s, although the kicker probably counted against setting up a state rainy day fund insofar as it required over \$2 billion to be refunded to income tax payers between 1994 and 2001.

The Republican majority generally endorsed the TEL model outlined by Dean Stansel in *Taming Leviathan: Are Tax and Spending Limits the Answer?*<sup>28</sup> They wanted to extend the existing limit to include all government spending and not merely the state's general fund (although presumably the constraint would be exercised on state rather than local spending), restrict the rate of spending growth to the product of population growth and the rate of inflation, and require that excess state revenues be placed in a rainy day fund, with any remainder automatically refunded to taxpayers once the rainy day fund was filled.

As it turned out, the special legislative session on tax reform failed to convene. Many feared that a special session would be hijacked by opponents of gay marriage. As Senate President Peter Courtney (D-Salem) observed, it would be unwise to interject the gay marriage issue into what was intended to be a limited session. He also said that legislative enthusiasm for tax reform had waned after voters rejected the 2003 legislature's tax increases.

Given the legislature's inability to grapple with serious tax reform, combined with widespread dissatisfaction with the existing state and local tax system, it seems more than likely that private entrepreneurs will continue to shape Oregon's fiscal policy via the initiative and the referendum in this decade, just as they did in the 1990s.

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27. This provision was incorporated into the state constitution in 2000—by initiative.

28. Dean Stansel, *Taming Leviathan: Are Tax and Spending Limits the Answer?* (1994); available from: <http://www.cato.org/pubs/pas/pa-213.html>; accessed 12 December 2003.

## EXPLAINING THE SUCCESS OF RECENT TAX INITIATIVES

Survey researchers have identified a group of hard-core supporters of tax and expenditure limitation. Using statewide mail and telephone surveys conducted among voting age residents several weeks prior to and immediately after various elections involving statewide fiscal measures, they have identified some of the determinants of public support of tax and expenditure limitation, including various socio-demographic factors such as age cohort, gender, education, level of income, and occupational sector (public versus private); acquaintance with the terms of the initiative; perceptions of self-interest; and various political indicators, including partisan identification, ideology, basic knowledge of how government and finance works in Oregon, degree of cynicism concerning state politics, and perceptions of state budget waste.

Findings suggest similar patterns of support and opposition from initiative to initiative. Supporters of tax and expenditure limitation measures are typically blue-collar workers, 50 years of age or older, with a high school education. They are more often than not homeowners who have lived in their homes for more than 10 years (a disproportionate number own their homes free and clear).<sup>29</sup> They get the majority of their news and information from television and usually score 4 or less out of 10 on a quiz included in the survey that tests their knowledge of how government and finance works in Oregon. They vote in every election. Finally, perceptions of high state waste and political cynicism are strongly associated with support for tax and expenditure limitation.<sup>30</sup>

While this group provides solid support for tax and expenditure limitation measures, it is by no means a majority. Moreover, the determinants stressed by survey researchers are quite stable. Consequently, they do not really explain why some tax and expenditure limitation measures pass and others fail, let alone the wrenching changes that have occurred during the 1990s. For example, between 1978 and 1990, McIntire and Dennehy took six property tax limitation measures to the electorate; the first five failed by an average margin of 9 percent. The sixth attempt, Ballot Measure 5, passed on November 6, 1990, with 52.5 percent of the popular vote. Hard-core anti-tax voters had presumably already expressed their taste for property tax limitation. Clearly, their support was insufficient to pass Measure 5. Something else had to change.

Unlike scholars who have tried to explain California's Proposition 13, we cannot point to an intervening set of policy shifts that might have influenced feelings against

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29. To an economist, these voters sound like non-itemizers—taxpayers who cannot deduct state and local income and property tax payments from federal taxable income. It is not particularly surprising that taxpayers who pay state and local taxes with after (federal income)-tax dollars are less enthusiastic about them than federal taxpayers who itemize deductions. Edward M. Gramlich, "The Deductibility of State and Local Taxes," *National Tax Journal* 38, no. 4 (1985): 447–465.

30. B. S. Steel and N. P. Lovrich, "Determinants of Public Support for Tax and Expenditure Initiatives," *Social Science Journal* 35, no. 2 (1998): 213–229.

property taxes.<sup>31</sup> Oregon had not recently allowed state property tax relief measures to lapse, so that the state government could be run at a substantial surplus, as was the case in California,<sup>32</sup> nor had its courts played Robin Hood with local school districts.<sup>33</sup>

Participants in the campaign against Measure 5 attribute their failure to several factors: a leadership crisis at the Association of Oregon Industries (AOI; Oregon's foremost business gathering) meant that it did not weigh in against Measure 5 as it had against McIntire and Dennehy's earlier efforts; a massive influx of Proposition 13-loving retirees from California, which tipped the balance in Measure 5's favor; and Multnomah County (Portland and its environs) sent out property tax bills the week before the election,<sup>34</sup> thereby reinforcing distaste for the property tax in that crucial part of the state.<sup>35</sup>

It is hard to assess these assertions. According to the Oregon secretary of state, Measure 5's supporters spent at least half as much money as their opponents, whereas McIntire and Dennehy's earlier initiatives were outspent five to one or more. AOI's failure to take charge of the fight against Measure 5 unquestionably weakened the ability of Measure 5's opponents to raise funds for their campaign. Both the demographic story and the tax bill story are also consistent with one of the major differences in voting patterns between Measure 5 and its immediate predecessor: an increase in the percentage of yes votes in Portland and its suburbs, which were among the fastest growing regions of the state. Moreover, Motor Vehicle Department records show that two thirds of

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31. To be sure, the California case raises a much harder question. California voters overwhelmingly rejected Proposition 14—also known as “Watson II” (for its sponsor, Los Angeles County Tax Assessor Phillip Watson)—in November 1972, yet approved Proposition 13 in June 1978 by an equally sizable margin—a 25 percent shift. Hence, the question: What caused voters to change their views so dramatically in such a short period of time? In Oregon, the shift was less than 10 percent.

32. Kirk Stark and Jonathan Zasloff, “Tiebout & Tax Revolts: Reexamining the Role of School Finance Reform” (unpublished manuscript, UCLA School of Law, Los Angeles, 2001).

33. Fischel (*The Homevoter Hypothesis*) hypothesized that *Serrano v. Priest* (1974), which called for equalized per pupil school spending, played a key role in the passage of Proposition 13, because it meant that increased local property taxes no longer went to local schools. While Oregon's 44-page school aid formula flirted with power equalization, it did not materially redistribute local school taxes. Moreover, limited power equalization was a long-standing element of Oregon's system of school finance, dating to the 1970s. It seems unlikely that, even if equalization were a material cause of Proposition 13, it had a similar effect on Measure 5. The effects of court cases influencing the allocations of resources within districts, especially those inspired by the Americans with Disabilities Act, cannot be so easily dismissed, however.

34. Interestingly, the same thing happened in Los Angeles County the week before the vote on Proposition 13.

35. These observations and those attributed to other campaign insiders are based on informal discussions with then-assemblyman Bryan Johnston; Don Homuth, staff director “No on 5”; Mark Nelson, No on 5's pollster; and Henry Breithaupt, executive director Oregon Tax Research; Matteo G. Luccio, “Interview with Bill Sizemore: Rebel with a Cause,” *Oregon's Future* 2, no. 3 (2000): 8–9; and Don McIntire. Statistical analysis reported in the section following are based on postelection analysis performed for No on 5.

Oregon's in-migrants during this period were from California.<sup>36</sup> Our point here is that the opponents' insider story is consistent with the somewhat stylized facts of the case.

Nevertheless, we would like to propose the following counter-narrative. This story attributes the success of Measure 5 to a change made by McIntire and Dennehy in its formulation. A series of focus groups held at various sites around the state in 1988 and 1989 clearly demonstrated that proposals to limit property taxes were highly vulnerable to the claim that they would reduce funding for public schools. McIntire and Dennehy dealt with this concern by including a provision in Measure 5 requiring the state to replace funds that school districts lost as a direct result of property tax limits. When tested, this provision largely allayed the concerns raised by earlier focus groups. McIntire and Dennehy finessed the constitutional prohibition against multipurpose initiatives by reformulating their proposal in terms of funding sources for local jurisdictions. Subsequently, McIntire attributed most of the vote swing associated with Measure 5 to increases in the number of yes votes in high-spending school districts.<sup>37</sup>

Presuming that McIntire understands the reasons for his success with Measure 5, this story illustrates an important point about voting in general and direct democracy in particular: voter preferences aren't everything; institutions (or rules) and the way issues are framed also matter. Indeed, the basic meaning of Arrow's possibility theorem is that, in the absence of institutional constraints, preference-based majorities are inherently cyclical, even arbitrary. Nevertheless, as William Riker explains, direct democracy's problem is not that preference-based majorities are inherently cyclical, a necessary consequence of unrestricted majority rule, but rather the instability and potential manipulability of majority-rule outcomes that cyclicalities permits.<sup>38</sup> In contrast, American legislative *institutions* tend to produce considerable policy stability. The design of our

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36. Unfortunately, we do not know how many Oregon voters are from California or how they voted. Nevertheless, using county level voting data, we calculated the swing in voter approval between Measure 5 and the average of its five predecessors, and regressed population growth rates between the 1980 and 1990 censuses against that measure. We found that population change explained a quarter of the variance in the vote ( $r^2 = .24$ ) and that, by applying the estimated coefficient value of the independent variable (population change) to size-weighted county-level demographic changes, one could fully account for the victory of Measure 5. Frankly, however, these results, as well as those reported below, should be taken with a large grain of salt. What we really want to explain is why individual voters went from opposing property tax limitation initiatives in the 1980s to supporting one in 1990. What we have is aggregate level data. Consequently, our results are plagued by significant problems of ecological bias. Moreover, it is very hard to understand why support for property tax limitation should have fallen in slow growing or negative growth rural counties, for instance, although it evidently did.

37. Using voting data for the 40 largest municipalities in the state with corresponding school districts, we regressed the yes vote swing on the log of reported per pupil spending, producing coefficients with the right signs and an  $r^2$  of .31. It must be acknowledged, however, that there was a high correlation between per pupil spending and population growth, although with this data set, school spending marginally better explained the vote swing than did population growth.

38. William H. Riker, *Liberalism against Populism: A Confrontation between the Theory of Democracy and the Theory of Social Choice* (San Francisco: W. H. Freeman, 1982; reissue Prospect Heights, IL: Waveland Press, 1988).

legislative process, for example, ensures that major change is usually possible only where supported by extraordinary and enduring majorities.<sup>39</sup>

The initiative, however, provides us with very few practical safeguards against instability or, its complement, manipulation. The only sure way to defend against instability in direct democracy is by carefully restricting the voting agenda, so that voters confront policy dimensions or attributes one at a time. Where voters vote on a single quantity (e.g., local school spending), the majority outcome must be that preferred by the median voter. It will, therefore, be both stable and relatively hard to manipulate.

In contrast, where initiative managers are free to construct multi-dimensioned alternatives, they will always find it possible to bring down the status quo<sup>40</sup>—even where their alternatives would be rejected by the median voter on every single dimension.<sup>41</sup> The ability to frame multi-attribute initiatives makes voting outcomes both amenable to manipulation and unstable—which is another way of saying they are unlikely to reflect the preferences of a stable or an enduring majority. It is our assessment that the instability of Oregon’s public finances in the post-Measure 5 era illustrates precisely this kind of political manipulation.

Of course, Oregon has had the initiative for a long time. According to our colleague Richard Ellis, what is different about the contemporary initiative process is not that it can be manipulated, but that it is increasingly dominated by private entrepreneurs who have come to understand the art of multidimensional policy design and who now use all the modern tools of market research and analysis to shape, package, and position their proposals.<sup>42</sup>

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39. Fred Thompson, “Legislative Decision Making and the Size Principle,” *American Political Science Review* 73, no. 4 (1979): 1100–1108.

40. Possible does not mean easy. The legislature’s failure to manipulate the outcome of Measure 30 shows that it is harder than Riker makes it sound. Nevertheless, consider the following: under the temporary income tax surcharge quashed by Measure 30, 15 percent of the state’s taxpayers would have paid 90 percent of the increment. The state could have obtained roughly the same revenue gain if the legislature had held harmless the remaining 85 percent, by, for example, imposing a 10 percent surcharge on all taxpayers with state income tax liabilities in excess of \$9,000. Perhaps, in this case, failure was due to an excess of principle, a fault attributable to few of the professional initiative managers with whom we have talked.

41. Riker.

42. Ellis; Elisabeth R. Gerber, *Stealing the Initiative: How State Government Responds to Direct Democracy* (Upper Saddle River, NJ: Prentice-Hall, 2000); see also William H. Riker, *The Art of Political Manipulation* (New Haven, CT: Yale University Press, 1986).