

DEMISE OF THE CALIFORNIA ORACLES: REFLECTIONS ON THE
LONG STRUGGLE TO PRODUCE DYNAMIC REVENUE ESTIMATES

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To

FTB Tax Policy Conference

San Diego, California

November 1, 1995

Two-and-one-half weeks ago, I was in Greece and learned a lot about the ORACLE at Delphi. I was told that the ancient Greeks used the ORACLE for all kinds of predictions including revenue estimates.

I was astonished at the parallels between the ancient and our modern-day ORACLES, the staffs of the Franchise Tax Board, Board of Equalization and Department of Finance.

Do you know what ORACLE stands for? (You may want to write this down.) It is an acronym for: Organization Responsible for Accurate and Comprehensive Long-Range Estimates.

The “priestesses” who made the forecasts at the ORACLE sniffed gases emitted from cracks in the mountain. This put them in a trance-like state, from which they would utter words of wisdom.

First, let me say that I have no evidence that our modern-day ORACLES are sniffing gasses or other substances.

However, in other ways, they are much the same. They both issue forecasts without public input or discussion. Estimates of both came down from the mountain on high. Both forecasts were sought and relied upon by high government officials.

Perhaps the most interesting parallel is the inaccurate forecasts made by both. The ancient ORACLE gradually fell into disuse because of inaccurate forecasts. We see the same thing happening to the California ORACLES. Their continuing inaccurate forecasts, because they use a “static estimating philosophy,” has eroded their credibility, eventually prompting the Legislature to make a change.

The “static” model is one where estimates are made on the revenue impact of tax law changes without consideration that changes in tax law change taxpayer behavior. Everyone knows changes in tax law change taxpayer behavior!

The problems with “static” revenue estimates are not new. I am informed by reliable sources that King George III (the last American King) was furious with the static estimate on the revenue he would receive from

the tax on tea. These static estimates may have eventually drove him mad.

For 30 years, first as a legislative staff consultant and now as an advocate for the California Taxpayers' Association, I have watched as the state's "static" revenue estimating methodology produced wrong answers, infuriating legislators and the public alike.

In 1967, the Assembly Revenue and Taxation Committee scaled back Governor Ronald Reagan's proposed tax increase program, due to faulty estimates. Later, the cost of a proposed renters' tax credit was shown to be too high due to the fact that the administration argued all renters would apply. Each year a number of estimates on bills were challenged, primarily because of the failure to recognize changes in behavior.

In 1986, the Assembly Revenue and Taxation Committee went so far as to hire an outside Washington, D.C. estimating firm, at a cost of around \$200,000, to do estimates for the committee. This action was

unprecedented and ruffled feathers in the Department of Finance and tax agencies. They demanded to meet with committee staff and suggested that the committee had no business meddling in their turf.

For years, static revenue estimators in California and at the federal level operated, as did the Wizard of Oz, behind a veiled curtain, in anonymity!

What's that I hear? "Pay no attention to the man behind the curtain!" Sorry, the California ORACLES no longer have the luxury of producing distorted estimates without exposing themselves.

The Legislature's in the process of lifting the curtain. There has been a serious public policy debate on this issue for the last few years. In fact, a report on the subject was prepared by the Franchise Tax Board staff last year.

As a result of this debate, the advocates of static forecasting are losing ground.

No one objects to honest differences of opinions on revenue estimates (with the possible exception of Saddam Hussein). There can be different assumptions, each of which may have some validity.

The decline and fall of the static revenue estimating philosophy has come about because policy makers and that segment of the public interested in fiscal issues have come to see “static” estimates as inaccurate and misleading. Legislators must have the best and most accurate information available in order to make good policy decisions.

Inaccuracy is the primacy objection to static estimates. In fact, I’ll let you in on a secret. Static estimates are often wrong on even a static basis.

During my stint at Assembly Revenue and Taxation, we had a number of meetings trying to find out the basis for certain revenue estimates. In many cases, what we would find is estimators had to make a number of heroic assumptions to arrive at a static estimate. When queried for the basis for the assumption, the estimator would always say, “That’s my assumption and I’m sticking with it.”

I must tell you that I know some people who believe that the purpose of the static estimate is to try to influence the policy debate on tax policy in a way to fit a certain and ideological or political agenda.

Even if this is not the purpose, it cannot be denied that static revenue estimates play into the hands of those who hold a certain point of view on tax policy. Static estimates generally reinforce those who have a status quo point of view and oppose bills reducing taxes for equity or economic development reasons.

For example, a key tax issue at this year's legislative session was whether key pro-taxpayer bills should be "revenue neutral." ("Revenue neutral" is a euphemism for raising one person's taxes to lower another's.) If one is going to make bills "revenue neutral," what is the revenue loss? To make bills neutral to a static and incorrectly high estimate, may result in a tax increase.

So, you can see why some critics of static estimates believe the use

of static estimates is to influence legislative action (a better word would be inaction) on tax bills.

Adding momentum to the drive for dynamic estimates has been recent developments at the federal level.

The federal government is still using the flawed static approach to scoring legislative proposals. This has led to many disasters in tax policy at the federal level. (Some would say the total federal tax system is a disaster.)

Often cited as evidence of damage this estimating policy can create is the 1990 federal luxury tax on boats. The Joint Committee on Taxation scored the proposal as a \$31 million revenue gain in 1991.

According to Pete duPont, chairman of the National Center for Policy Analysis and a former Governor of Delaware, the tax actually raised \$12 million; it cost \$24 million in unemployment benefits for laid-off workers and cost the national economy over \$3 billion.

According to Martin Feldstein, former chairman of the president's Council of Economic Advisors, "There is really no excuse for tax analysts to ignore basic economic behavior that changes national economic output."

It has only been within the last few years proponents of dynamic forecasts have had an actual working dynamic model to point to. In 1991, Massachusetts' Governor William Weld wanted unvarnished estimates of proposals designed to help balance the state budget. As in California, the credibility of available data was subject to challenge.

Massachusetts contracted with Price Waterhouse to develop a microsimulation model for the state's sales, corporation and income tax structures. The data is run through a regional economic model provided by contract with REMI, Inc. The total bill for both was less than \$350,000.

Alan Clayton-Matthews, economist with the Commonwealth of Massachusetts' Department of Revenue, said the general purpose model provides credible information that is respected by members of the

Legislature. In part, he added, the credibility was ensured by an oversight panel of economists (representing academia, the private sector and the Federal Reserve Bank).

Larry Dildine, national director of tax economics of Price Waterhouse in Washington, D.C., said “Our model simulated changes in tax law, using sample tax returns by people that are fed into a regional forecasting model.” He added, “Not only do we determine direct revenue impacts, but also the forecasting of behavior changes among taxpayers.”

The death knell for static estimating in California began in 1993, when the static estimating crowd -- may we call them “static -sticians” -- produced static and, thus, what were viewed by proponents as inaccurate estimates for the state’s new manufacturing equipment investment tax credit.

This experience so angered key legislators and private sector movers and shakers alike that plans were laid to change the system.

In 1994, Senator Tom Campbell introduced legislation (SB 1837) to require dynamic forecasts.

Governor Pete Wilson and a bi-partisan majority of the Legislature agreed with the need for dynamic modeling, and the bill easily moved through the Legislature. It is now the official policy of the state. The Department of Finance and Legislative Analyst have been directed by law to furnish dynamic estimates on major bills. Cal-Tax supported the Campbell bill and applauds its enactment. Californians deserve information they can trust.

However, there is still cause for concern:

1. We have gone one whole legislative session since the requirement for dynamic forecasts have become law, and the department is still using static estimates, (without apology!), and the representatives of the department are still getting beat-up at legislative hearings due to their static estimates.

2. The “in your face” approach to revenue estimating is still being used. Estimates are concocted behind closed doors, with no input from or interest in the views of the private sector or even the legislative branch of government. This is one aspect of revenue estimating that hasn’t changed from the days of the ORACLE in Delphi.

We would prefer to see a much more open and collegial approach, perhaps with a revenue estimates’ advisory committee. When I was with the Legislature, I organized what we called the “Impact Data Task Force” to share data and discuss estimates. We note Massachusetts uses such an approach.

3. Those who strongly oppose dynamic estimating are responsible for implementing it. Will they produce a model that will work? Will static biases creep into the effort? Will there be delays -- allowing the static system to continue on a defacto basis? To what extent will reputable private sector firms be involved?

Cal-Tax believes that the most prudent course of action is to contract

with a reputable private consulting firm, such as Massachusetts did, to create the dynamic model. This will insure that the model is free of criticism. We want to have a revenue estimating system which everyone has a stake in. This would go along way to minimizing future conflict. We also suggest creating an advisory committee, such as exists in Massachusetts, to provide the necessary oversight of the process.

We hope that revenue estimates for California in the 21st century are going to be as “state-of-the-art” as they can be. We no longer need or want ORACLE-like forecasts. We will be watching, with some apprehension, as the implementation of SB 1837 unfolds.

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