

Revenue Advisory Council
Strengths & Weaknesses Summary
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Strengths

- Income tax revenue outpaces economic growth. This is generally considered a strength in that it allows policy makers flexibility in terms of increasing spending or reducing taxes. However, many proponents of limited government consider it a weakness since it facilitates growth in government spending relative to the overall economy.
- The overall state and local tax system is one of the most progressive (or least regressive) of all states. Equity evaluations are always open to some debate, but most policy makers consider “ability to pay” a desirable criterion for tax policy. However, aside from the issue of equity, there is concern that a redistributive system tends to undermine economic growth. Public Finance economics generally concludes that some balance between taxes paid and the cost of service provided minimizes distortions in the location of economic activity motivated by tax differences. The lower the level of government, the more likely distortion is to occur when taxes paid differ from the cost of service provided.
- Property taxes are relatively stable and predictable. Under Measure 50, the tax cannot increase by more than three percent per year for most taxpayers unless there is a vote for additional taxes (or, for individual properties, there is a change in circumstances, such as new construction or a zone change). This reduces the potential for large increases in property taxes associated with re-assessment or with rapid changes in property values. This is likely viewed as a weakness from the perspective of local government financing.
- Having no sales tax may give Oregon a competitive advantage over neighboring states. Sales taxes are often levied on many business purchases as well as consumer purchases, so the absence of a sales tax may reduce some business costs in addition to its effect on consumers.
- Oregon’s corporate income tax system has a relatively low impact on start-ups and corporations with low or no profits. Since the corporate tax is based on profits and the minimum tax is low, it is only relevant when profits are being made.
- Recent enhancements to state reserve fund have improved the state’s fiscal position with the creation of the Education Stability Fund (2002) and the Rainy Day Fund (2007). Most states maintain some type of reserve fund to help smooth out expenditures over the business cycle. For many years, Oregon was one of the few states without any formal procedure for this. Development of reserve funds is seen as a positive step although there are still questions about adequate size, methods of funding, and disbursement triggers and criteria.
- Oregon’s state and local taxes have generally been deductible for federal tax purposes, but the relative advantage of this feature has decreased in recent years. Taxes that are deductible when calculating federal income taxes impose a lesser net burden on those who itemize deductions than taxes that are not deductible.

This reduces some of the distortions associated with high income tax rates. The growing application of the federal Alternative Minimum Tax (AMT) has reduced this effect over time.

- The close tie between federal and state income tax codes tends to minimize administrative and compliance costs, and facilitates enforcement. Oregon largely follows the federal tax code in defining taxable income. While this has advantages, it also limits Oregon's discretion with respect to certain policy issues embedded in the tax code, including temporary changes such as the recent stimulus package.
- Transparency due to a high reliance on visible direct forms of taxation such as income taxes and property taxes. Income and property taxes both have specific annual accountings of the taxes paid. Other taxes, such as Washington's Gross Receipts tax, are largely hidden from most taxpayers.

Weaknesses

- Income tax revenue is volatile. Many of the characteristics that cause income tax revenue to grow more rapidly than income over time also cause it to decline disproportionately when income declines. In addition, some components of income, such as capital gains, are subject to wide swings over time.
- Relatively high income tax rates, taxation of capital gains at ordinary income rates, and Oregon's retention of the inheritance tax in excess of an allowable federal tax credit may discourage some individuals and businesses from locating here and may also induce some residents to leave.
- Personal income tax brackets start low, are narrow, and have not been adequately adjusted for inflation. This is the counterpoint to the one above. A flat rate levied on most income reduces the progressivity of the state tax from an equity perspective. However, widening brackets would tend to reduce revenue.
- The property tax has horizontal inequities. The property tax is levied on maximum assessed value; and, historically, assessed value was based on market value so the tax was levied as a percentage of property value. Measure 50 limits the rate of maximum assessed value increase so that properties with high rates of market value increase may be paying a lower percentage of market value than other properties in the community that have had lower rates of value increase. This inequity is likely to increase over time.
- The property tax permanent rates established by Measure 50 have created highly variable constraints on the taxing authorities of local government. These rates were based on fiscal conditions in 1995-1997. The rates that were set may have been influenced by success or failure of temporary levies for various jurisdictions, and the expiration of temporary levies at a particular point in time. In addition, changing fiscal conditions, such as the loss of timber revenue, may make it desirable for a jurisdiction to change its permanent tax rate, but there is no provision for doing this.
- The Rainy Day Fund (2007) was largely funded with one-time revenue from suspension of the 2% surplus corporate kicker credit with future deposits subject to available funds from the General Fund ending balance. There are questions as to whether the replenishment rate will be adequate.

- There are many tax exemptions for local property and special assessments. These exemptions reduce revenue for local governments and special districts without reducing costs.
- The individual “kicker” is expensive to administer, and is widely viewed as poor policy. It is impossible for taxpayers to predict and, therefore, the policy provides no positive economic incentive. The kicker contributes to smaller government, but if that's the goal, the state should simply reduce income tax rates.

Risks

- Forest receipts. The uncertainty regarding this revenue source, as well as the likely loss at some point in time, create substantial fiscal issues for the recipients.
- Reduction in other federal revenues. Oregon receives substantial revenues from the federal government, but fiscal problems at the federal level will almost certainly curb spending on discretionary, non-defense programs, including Head Start, K-12 education, workforce development, and transportation.
- Changes in federal tax law. Because the state uses the federal definition of income, changes in the federal law may affect state revenue.
- Additional unfunded mandates (from federal or state). The State and local governments are concerned that higher levels of government can impose costly requirements on them without providing funding to meet those requirements.
- Inflation. Rapid increases in the price level pose a significant risk for local governments since the rate of increase in property tax collections is not commensurate with the rate of cost increase. The problem is less serious at the state level since income tends to rise commensurately with or faster than prices, and this would generate increases in income tax revenue.
- Recession. The state tax structure is especially sensitive to an economic downturn. The reserve funds provide some cushion but are not likely to be adequate in anything beyond a mild decline.
- Drop in property values (low risk relative to other states). Declining property values typically reduce property tax revenue, but the lag between assessed value increase relative to market value increase means that most reductions in real estate prices will not affect the revenue that local jurisdictions receive. However, properties where assessed value is close to or equal to market value may see reductions due to market value reductions.
- Voter initiatives that circumvent the legislative budget process. Initiatives, especially those that reduce revenues or mandate new or higher levels of service, may have substantial fiscal impact and are largely outside of the control of the legislature.
- Demographic changes. Aging of the population and other demographic changes are likely to increase the demand for services from the State and from local governments and, under current laws, reduce the revenue available to meet these demands.
- Changes in business activities. Unforeseen changes in either the level of business activity or in the types of business that operate in the state could affect both business tax revenue and the demand for services.

Issues

- Do the state's two stabilization funds acting in combination provide adequate reserves for future downturns? Are the triggers and revenue sources in the two funds appropriate? We may obtain useful guidance from the provisions of and experience with other states' reserve funds, but Oregon's plans must take into account its heavy reliance on the very volatile income tax. What works for other states may not work here.
- Property taxes are limited relative to cost drivers of local government services, 3% annual growth may not relate to cost increases. As noted earlier, this may be a significant issue if inflation increases, but it may be an issue even without substantial increases in inflation if the cost drivers for government services grow more rapidly than three percent per year.
- Should the state fully fund its statutory commitment to compensate local governments for lost revenue due to state actions that create new or expanded property tax expenditures? This is a high priority for local governments, but the state has so far failed to follow through on its promise of compensation.
- Should the state's corporate income tax be augmented by a benefit based, activity based, or entity based minimum tax? There is concern that many corporations pay relatively low corporate income taxes. Partly this is the result of legislated changes in how the tax is determined and partly it is due to the volatility of corporate profits. Other tax bases, such as the level of activity in Oregon, are likely to be more reflective of use of services and more stable over time. However, they are also likely to be challenged as anti-competitive in terms of our business climate.
- Should the state integrate its decisions on tax expenditures more fully with its budget appropriation process? New tax expenditures receive extensive review; but, once in place, ongoing tax expenditures may not get the same scrutiny that would be seen for direct budget allocations. Moreover, it may be easier for legislators to grant tax credits at a somewhat indeterminate cost than to appropriate specific sums for a program.
- Should the state expand the time horizon on current law revenue forecasts and revenue impact analysis for revenue proposals? The Oregon Business Council has suggested a 10-year horizon.
- Revenue sharing from state to local governments. Since the state reliance on the income tax is expected to lead to revenue rising faster than income while local governments have substantial constraints on property tax revenue growth, should the state increase the amounts of revenue passed through to local governments? If so, what principles should guide such additional support? For example, this raises the issue of comparable tax effort among the local governments.
- Should state provide tax administration for local option taxes? In many states, local governments have the option to levy local taxes that are administered by the state. For example, in some sales tax states, local governments can add a local amount to the sales tax, which is then administered and collected by the state. Arguments in favor of this concept are that local administration of certain taxes can be costly and difficult and that local variations aggravate the taxpayer compliance burden. Oregon does provide some "central assessment" for business

property for property tax purposes, and the state DOR did administer the Multnomah County business income tax at one time. Are there other types of taxes for which such state administration would be desirable?

- Should capital gains receive favorable treatment? Some argue that taxing capital gains at the same rate as ordinary income deters various types of investment in Oregon and may induce individuals to move out of the state before cashing out their capital gains. Capital gains taxes are also considered unfair insofar as the gain may simply reflect inflationary increases in asset value rather than a gain to the asset holder.
- Should high marginal income tax rates be flattened? High rates may deter high-earning individuals from locating here. On the other hand, “ability to pay” and rate progression are key elements of the equity consideration.
- Should state agencies be allowed to have reserves, i.e., develop their own rainy day funds? Currently, fee based agencies have some flexibility to carry over unspent revenue from one biennium to another, but general fund agencies have any unspent funds returned to the ending balance. This may inhibit careful long-term planning and induce wasteful spending near the end of a biennium. If they could carry over balances, it would tend to augment the effect of the state’s reserve funds, allow for better fiscal planning, and reduce incentives to spend all the money that has been allocated.
- How to fund capital needs? Most of the discussion has been related to operating expenses and revenue. However, there are substantial infrastructure issues at both the state and local levels.
- Business energy tax credit. There are concerns that marketability of this credit may be creating distortions in the tax system and that the value of marketable credits which sell at a discount in the market is less than optimal. Others see the expansion of this and other marketable credits as an opportunity to use these tax credits as an offset to other taxes, e.g. capital gains.
- K-12 local option: The local option process for schools is complex and inequitable. Should it be replaced by an alternative that operates outside the framework of Measures 5 and 50?

Possible Additional Issues

- Lottery Revenues
- Sales or other consumption tax
- Tax competition among jurisdictions
- Road finance system
- User Fees
- Inheritance Tax
- Gross receipts tax
- Opportunities to create incentives within state government to achieve change (e.g. technology advances, process efficiencies, etc)

Criteria

- Revenue adequacy

- Stability
- Equity
- Ability to Pay
- Efficiency
- Administrative and Compliance Cost
- Certainty
- Tax exporting
- Neutrality (i.e., minimum impact on business and personal decisions)
- Impact on economic development and state's relative competitive position
- Clarity