

A REVENUE REFORM PROPOSAL FOR OREGON
UTILIZING A MODIFIED GROSS RECEIPTS TAX
May 5, 2008

1. This proposal for revenue reform in Oregon is based largely on the belief that the following propositions are true:

1.1 Oregon's state and local revenue system is fundamentally flawed in many respects, including the following:

1.1.1 It fails to tax the "underground economy" at all and fails to impose commonly approved taxes on nonresident tourists. Because of these and other defects, it fails to provide consistently adequate revenues to meet the legitimate needs for state and local government services and infrastructure.

1.1.2 It is unacceptably volatile, largely because of its too-heavy reliance on net income taxes and its failure (due primarily to the "kickers") to facilitate saving.

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1.1.3 It taxes productivity and largely exempts consumption, and thereby perversely tends to discourage the former and promote the latter. These incentives are especially inappropriate in a time of global business competition and an increasing demand for environmentally sustainable business and lifestyle practices.

1.1.4 Oregon therefore must develop a more broadly-based, adequate, stable and reliable revenue system than it now has.

1.2 On the other hand, Oregon's overall revenue system is one of the most equitable, i.e., least regressive, state tax systems in the United States. Oregon should not lose this attribute in its quest for needed revenue.

1.3 Adam Davis and Duncan Wyse were correct in stating that Oregon voters will not approve a major new tax without a concurrent elimination of a major existing tax, and even then are not likely to approve a general retail sales tax.

1.4 The corporate net income tax (including both ORS Ch. 318 and the ORS Ch. 317 corporate excise tax measured by income) is arguably the major tax that Oregon can most easily give up, because it is highly volatile and seldom highly productive. (It is also the only tax that applies exclusively to corporate taxpayers who would be principal target payers of a new tax on modified gross receipts. Although Portland and Multnomah County might object to eliminating the corporate net income tax because they also base their business taxes on that income, they could piggy-back on a modified gross receipts tax as well as on a net income tax.)

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1.5 Radical changes are easier to make if someone else has already made them--and there is a growing appreciation among many states that a modified gross receipts tax may be an effective answer to their revenue problems. (One reason for this may be that a gross receipts tax is not subject to Pub L 86-272 and therefore has a somewhat broader reach than a net income tax for taxing out-of-state businesses--but that is a technical area beyond the scope of this memorandum.)

1.6 Major objections to traditional gross receipts taxes are that their "pyramiding" effect tends (a) to induce vertical integration of businesses, (b) to discriminate against small businesses, and (c) to impose an undue aggregate burden on ultimate consumers. Those objections are generally valid. However, the consumer burden issue is greatly minimized in Oregon by the absence of a sales tax, and it could be further ameliorated by appropriate adjustments in the personal income tax. The other objections could be largely overcome by allowing a broad deduction for all purchases of goods or services from unrelated vendors. (QUERY whether it

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would be legally valid and economically desirable to limit the deduction for purchases by a requirement that the vendor be subject to the modified gross receipts tax in Oregon?
Would such a limitation raise constitutional interstate commerce issues?)

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1.7 The conclusion from the above analysis is that some form of modified gross receipts tax on business is the new tax that is most likely to satisfy Oregon's needs and also be acceptable to a majority of Oregon voters.

2. Based on the foregoing propositions, this proposal calls for a tax on the modified gross receipts (i.e., gross receipts less the cost of all goods and services purchased from unrelated vendors) of substantially all business entities which derive more than X dollars (e.g., \$50,000) from business receipts in the state. The proposed reform package could borrow the perceived best practices from the laws of several states, including the "modified gross receipts tax" element of the reform package that Michigan adopted in 2007. For convenience, the proposed tax is referred to as the Modified Gross Receipts Tax, or "MGRT". The MGRT could use different thresholds and should use different rates for different types of business. The total revenue raised would have to be at least enough to cover the revenue reducing provisions described below, plus a reasonable amount for transitional costs and the contingencies inherent in moving to a new system. Just guessing at a comparison to the projections made for the 2007 HB 2350 Hopeful Reform package, the rates might range from less than 1 % to not more than 5 % on modified gross receipts.

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3. The specific provisions of the new tax would obviously need a great deal of thought and analysis, and a thorough vetting through the legislative process. The governing principles should take into account economic consequences, environmental and social considerations, and perhaps above all, political feasibility and appeal (or lack thereof). Subject to all of that, the following principles are suggested as basic guides for filling in the details:

3.1 Aim for a package that, like the 2007 Hopeful Reform, can fairly claim that every income group will pay less because of the portion of the MGRT that will be borne by the cheats, tourists, and out-of-state sellers who have an "economic presence" in Oregon. (This is a more sensitive goal for the MGRT than it was for the Hopeful Reform, because it requires pointing out that the MGRT will actually be borne largely by consumers, even though it is paid initially by businesses. The MGRT proposal could lose much of its potential political appeal if it is popularly seen as just another name for a sales tax.)

3.2 Aim for a package that can fairly be described as revenue neutral with our current income tax system in good, but not booming, economic conditions. (We should consider including specified increases for specific needs, such as education, transportation and additional support to local governments. However, revenue neutrality, coupled with the benefits of greater stability and predictability, would be a substantial improvement over the status quo.)

3.3 Adapt details from other states' programs except where there is a significant reason for going out on our own---but there may be many such reasons. In general, this proposal recommends avoiding exemptions in order to make the law relatively simple and the tax rates as low as possible overall. It is also recommended that we use rate differentials that reflect the typical margins in and the relative necessity of various types of business. For example, this plan would tax grocery and drug receipts at the lowest rates and jewelry receipts among the highest.

3.4 Given the continuing importance of the personal income tax in Oregon and our general tie to federal treatment, it is suggested that Oregon apply the MGRT to all pass-through

business entities at the entity level and allow individual recipients a nonrefundable credit on their Oregon personal income tax for the MGRT paid on their respective shares of pass-through income. Other issues include whether or not the MGRT should apply to real estate rentals or sole proprietorships, but the proposed tax would not apply to wages and salaries of employees.

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4. The tax relief elements of this MGRT package proposal include the following:

4.1 Eliminate taxes on or measured by a corporation's net income (ORS Chs. 317 and 318). This would naturally have the side benefit of also permanently eliminating the corporate kicker refund.

4.2 Substantially reduce personal income taxes. The precise manner and scope of this reduction would need careful analysis and could include many variations, but the following elements would be more-or-less essential:

4.2.1 Provide major relief to lower income groups to offset the adverse impact of the MGRT on them. This impact would be quite similar to the regressive impact of a general retail sales tax. Accordingly, the personal income tax changes should include items such as (a) a necessities credit to offset the MGRT impact on minimum levels of essential goods and services, (b) an increased refundable earned income tax credit, (c) a higher threshold before the income tax applies, and (d) wider brackets.

4.2.2 Provide some relief to middle and higher income groups by (a) reducing the top rate, perhaps to 7 per cent, and (b) granting some relief to long term capital gains. One suggestion for capital gains relief would be to increase the taxpayer's basis commensurately with the increase in the cost of living index during the holding period, so that the tax does not apply to gain attributable to inflation. Another suggestion (not new) would be to provide long-term income-averaging to reduce the impact of progressive rates on bunched income. (These approaches are suggested on the rationale that some form of capital gains relief is politically desirable, but a general favoring of investment income over wages and salaries is not desirable.)

5. Modify the personal income tax kicker by allowing a specified range above and below the end of session projection, and permit contingent appropriations within that range. Also, provide that the entire kicker would be added to the ESF and/or RDF to bring them up to target levels before making any kicker refund to taxpayers.

6. This proposal recognizes that the first and foremost test of its design is whether it will win at the polls. For that reason, it should include constitutional taxing and spending limitations that will provide reasonable assurance to a doubting public that the MGRT will not simply be an open purse for increased government spending. The details of the limitations would have to be tailored to the details of the revenue plan, and the revenue and limiting provisions must be tied together so that the people would vote on them as a single package. The limitations plan is beyond the scope of this memorandum. However, the LRO August 2006 Research Report # 5-06, relating to Measure 48 on the 2006 ballot, provides a good starting point for the discussion.

NOTE: Many other items could be included in the package proposal. This proposal contemplates that everything required to make a viable fiscal program will be included as part of the package, and other features will be added only if they improve the overall political appeal of the package.

Respectfully submitted to the RTF Advisory Council,
Milo E. Ormseth
Revised May 5, 2008