Chapter 1
Introduction
Draft 2—October 30

House Bill 2530

HB 2530 (2007) establishes the Task Force on Comprehensive Revenue Restructuring. The bill directed the Governor to appoint the Chair of the Task Force along with four members from the general public representing the major regions of the state, a member representing small business, a member representing large business and two members from organized labor. The Speaker was responsible for appointing four members from the House while the Senate President appointed four members from the Senate. These seventeen Task Force members constitute the voting members of the Task Force. The bill also designates the State Treasurer and twelve members appointed by the Governor representing various groups and interests in the state as non-voting Task Force members. The bill directed the Chair of the Task Force to appoint a seven-member Advisory Council to provide technical analysis. Finally, the Legislative Revenue Office was assigned staffing responsibilities for the overall Task Force. The complete text of HB 2530 can be found in Appendix A.

HB 2530 directs the Task Force to develop a "blueprint for comprehensive revenue restructuring for local and state government." The blueprint is to provide ways to promote a stable state and local government revenue flow, create positive economic benefits for the state and provide for a financial foundation that enhances the state's global competiveness. Within the blueprint the bill calls for a plan for revenue and economic competitiveness that includes tax restructuring that leads to a more stable revenue system, promotes agreements among different levels of government and that stimulates economic growth.

Following appointments by the Governor and Legislative Leadership the Task Force first met on November 29, 2007. The Task Force convened a total of 12 meetings, at the conclusion of which the Task Force issued its draft report. This was followed by 6 public meetings around the state to discuss the draft report. A summary of the public meetings can be found in Appendix B.

Previous Tax Reform Efforts & Studies

By the end of the 1960s, the majority of states had evolved into revenue systems characterized by 3 major tax sources. Most states imposed a general sales tax and an income tax while reducing their reliance on the property tax. Property taxes became the primary tax source for local governments. After passing an income tax in 1929 to provide property tax relief, Oregon chose not to adopt a general sales tax as most states did in the 1930s. That left Oregon's revenue system dependent on comparatively high income and property taxes.

Prior to 1990, most major tax restructure proposals were directed at the adoption of a sales tax, coupled with substantial property tax relief. The two most prominent proposals along these lines were Governor McCall's plan (defeated 41% to 59% by voters in 1973) and Governor Atiyeh's plan (defeated 22% to 78% by voters in 1986). In 1990, voters approved Measure 5 (52% to 48%) which limited property tax operating levies to $15 per $1,000 of market value. In an effort to restore revenue to the system the Legislature, working in conjunction with Governor Roberts, and after an extensive set of public

meetings statewide developed yet another sales tax plan that also contained additional property tax relief. This proposal was referred to voters (Measure 1) in 1993 and defeated 25% to 75%.

In 1996, voters approved Measure 47, a constitutional amendment that limited assessed property value growth in addition to setting property tax rates. The language of the measure proved unworkable prompting the 1997 Legislature to refer Measure 50 to voters as an alternative. Measure 50 was designed to capture the key provisions that voters had adopted in Measure 47. Voters approved Measure 50 in the May 1997 primary election. Measure 50 reduced assessed values by 10% and limited future growth on existing property to 3% annually. It also established permanent rates for all taxing districts.

The approval of Measures 5 and 50 moved Oregon from a relatively high property tax state to one near the middle of the states in property tax burden. This has had the effect of substantially muting public concerns over the property tax burden. It also made the state's revenue system highly dependent on the personal income tax. Concerns over the implications of this dependence and the consequences of a limited property tax system have dominated tax reform discussions since 1997.

The first thorough analysis of the post Measure 5/50 revenue system was Governor Kitzhaber's Review of Oregon's Tax System completed in 1998. The Governor appointed a technical committee and a policy committee consisting of citizens/experts to evaluate how the revenue system had changed in the wake of Measures 5 and 50. The policy committee's report emphasized the dangers of the state's over-reliance on the traditionally unstable personal income tax, especially to fund K-12 education. The report also noted the consequences for the local revenue system of dependence on a slow growing, initiative-constrained property tax. The policy committee recommended the establishment of a substantial reserve fund to counter the instability in the state revenue system and a series of steps such as abstaining from additional local revenue preemptions, state reimbursement for new property tax exemptions and increased revenue diversification in response to the stable but inflexible local revenue system.

Governor Kitzhaber's policy committee's warning of the dangers of revenue instability proved prescient as the 2001 recession and the bursting of the 1990s stock market bubble triggered the largest percentage reduction in state General Fund revenue since the 1930s. The effects of the recession also shifted the tax reform discussion toward a means of stabilizing the revenue system. The Legislature responded with formal tax reform committees following both the 2001 regular session and the 2003 regular session. The "Revenue Options, School Funding & Accountability Task Force" issued a report in 2002 emphasizing broad principles for tax reform efforts to stabilize school funding. In 2004, the "Joint Interim Committee on Tax Reform" conducted a series of public meetings around the state to gather input on ways to make the tax system more stable and more equitable.

The Legislature did take substantive fiscal reform actions in response to the severe 2001-03 revenue contraction. In 2002 the Legislature referred Measure 19 to voters, amending the constitution to change the previously adopted Education Trust Fund to the Education Stability. This fund was tapped to provide immediate revenue for schools and established as an ongoing reserve in which 18% of Lottery earnings (estimated at $241 million in the current 2007-09 biennium) are directed. The 2007 Legislature further strengthened the state's reserve position by establishing a new statutory Rainy Day Fund. The new fund received $319 million from revenue that would have been returned to corporations through the 2% surplus kicker credit mechanism and will receive up to 1% of General Fund appropriations from the ending balance in future biennia. For a description of the reserve funds see Appendix C.

Report Outline

The Task Force on Comprehensive Revenue Restructuring began its analysis of Oregon's revenue system by thoroughly reviewing these previous tax reform discussions and recommendations. The Task Force found these previous efforts useful in framing the problems associated with the current revenue system. In particular, the Task Force found two quotes from Governor Kitzhaber's "Review of Oregon's Tax System: Policy Recommendations" report released in January 1999 to remain very much true today:

"Oregon is more reliant on the personal income tax for its tax revenue than any other state in the country. This tax is very sensitive to changes in economic conditions. Public finance experts consider it the most volatile of the major state-local revenue sources." (p 3)

"Oregon's local government revenue system remains highly dependent on the property tax. The property tax has been significantly altered by Measure 50. By limiting growth in individual property tax bills to 3 percent per year, overall property tax revenue is likely to grow slower than the economy over time. Moreover, property tax revenue will not keep up with increases in the inflation rate." (p 30)

The Task Force found strong evidence supporting these concerns when analyzing recent fiscal trends in the state. In addition, other related findings were identified. These findings and supporting evidence can be found in Chapter 2. Chapter 3 discusses a series of short-term recommendations to address some of the problems caused by the findings. These recommendations are intended to be implemented in the 2009 Legislative session. Chapter 4 discusses broader long-term options for addressing the structural problems embedded in Oregon's revenue system.

CHAPTER 2
FINDINGS

Summary

Based on previous studies, updated analytical work and recent fiscal experience of state and local government in Oregon, the Task Force identified the following key findings:

- The state revenue system, dominated by the personal income tax, remains highly volatile. State policy-makers have taken major strides to offset revenue instability by the creation of the Education Stability Fund (2002) and the Rainy Day Fund (2007) but risks to major programs remain substantial in the event of future recessions.
- Oregon's General Fund budget has been forced out of balance in the past by passage of voter initiatives that either mandate new program expenditures without new revenue or reduce revenue without specifying offsetting revenue or desired program reductions.
- Because state revenue makes up roughly two-thirds of K-12 operating revenue, school finance remains especially vulnerable to the volatility of the personal income tax.
- Many decisions made by state government have long-term fiscal implications that are not properly accounted for in the current budget process. The state has a well developed system of short-term expenditure and revenue analysis but does not systematically factor in long-term trends such as demographic changes and structural revenue changes into the planning process.

- The state faces immediate revenue needs in transportation and health care due to developments in dedicated revenue sources that put those critical program areas at risk.
- Local government revenue (cities, counties and special districts) remains closely tied to the property tax. Assessed property values are restricted to 3% annual growth for existing property and the average assessment ratio in the county for new construction. This means that local revenue generally falls behind the growth in the cost of providing services.
- Property tax revenue is largely set by Measure 50 and property tax revenue growth is independent of the rate of inflation. This means that local governments are put under significant stress when the inflation rate rises above 5% such as it has over the 2006-08 period.
- Property tax rates for local taxing districts (permanent rates) were determined when Measure 50 was put into the constitution in 1997. Although many local governments can raise short-term option levies, a constitutional change would be required to raise these permanent rates making it difficult for local governments to respond to institutional changes such as the phase out of federal timber payments to counties.
- Many government services are jointly provided by state and county governments. This means that fiscal stress at one level of government affects the other.

Key Finding: State revenue system is volatile.

Since the Kitzhaber Policy Committee report was released in January of 1999, state personal income tax revenue peaked along with the state economy and the stock market in 2000, experienced its largest percentage decline since the 1930s in the 2001-03 recessionary period, recovered sharply in 2003-07 and now appears poised to drop sharply again as the country enters another recession.

The state's dependence on the personal income tax becomes apparent when state taxes are broken down by source. Chart 2.1 shows Oregon state taxes by source compared to national averages. Personal income taxes make up 72.3% of tax revenue for state government in Oregon. This is the highest percentage reliance on any single tax source among the 50 states.

Chart 2.1: State Tax Sources (percent of taxes from each source in 2006-07 fiscal year)

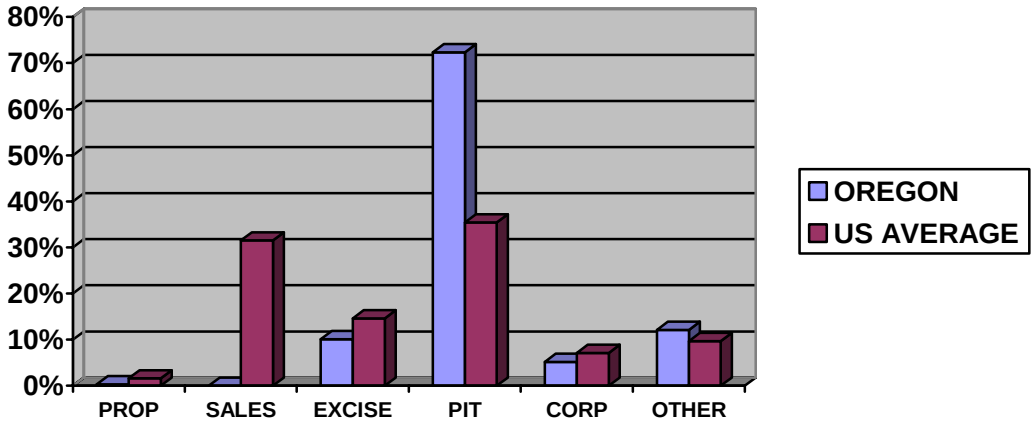
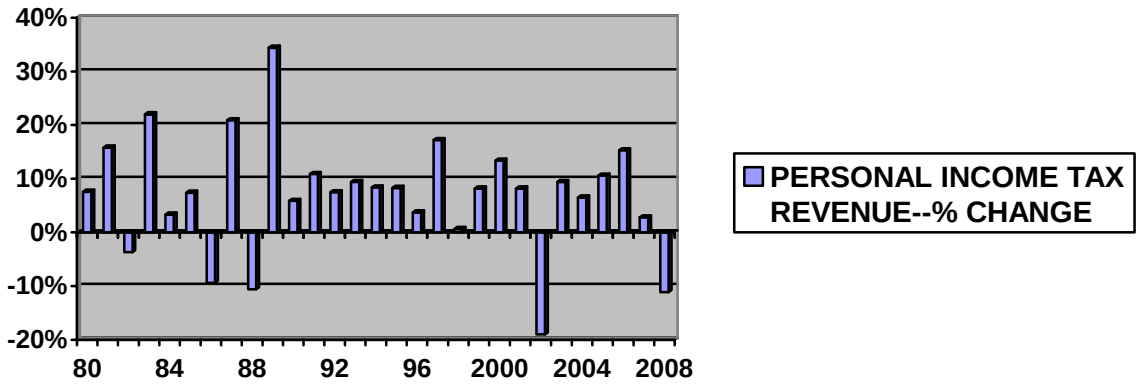


Chart 2.2 shows the annual volatility of personal income tax revenue in Oregon. The volatility of the personal income tax is due to its sensitivity to changes in the rate of growth for personal income. When the economy is expanding and personal income is growing rapidly, a larger proportion of income is

being taxed at the top rate (9% in Oregon's case), while the reverse is true during downturns in the economy when income is falling or growing slowly. Another factor contributing to volatility in state revenue is the 2% surplus kicker. The kicker requires that an income tax refund be mailed to taxpayers following biennia in which revenue has exceeded the state's two-year budget forecast by 2% or more. These refunds reduce personal income tax revenue for the year which they are sent out. A separate credit is calculated for corporate income tax revenue.

Chart 2.2: Annual Change in Personal Income Tax Collections



Fluctuations in personal income taxes have a major impact on the state's General Fund. Chart 2.3 breaks out General Fund revenue sources. Personal income taxes comprise 86% of General Fund revenue with corporate income taxes making up another 7%.

Chart 2.3: Sources of General Fund Revenue (2007-09 Biennium)

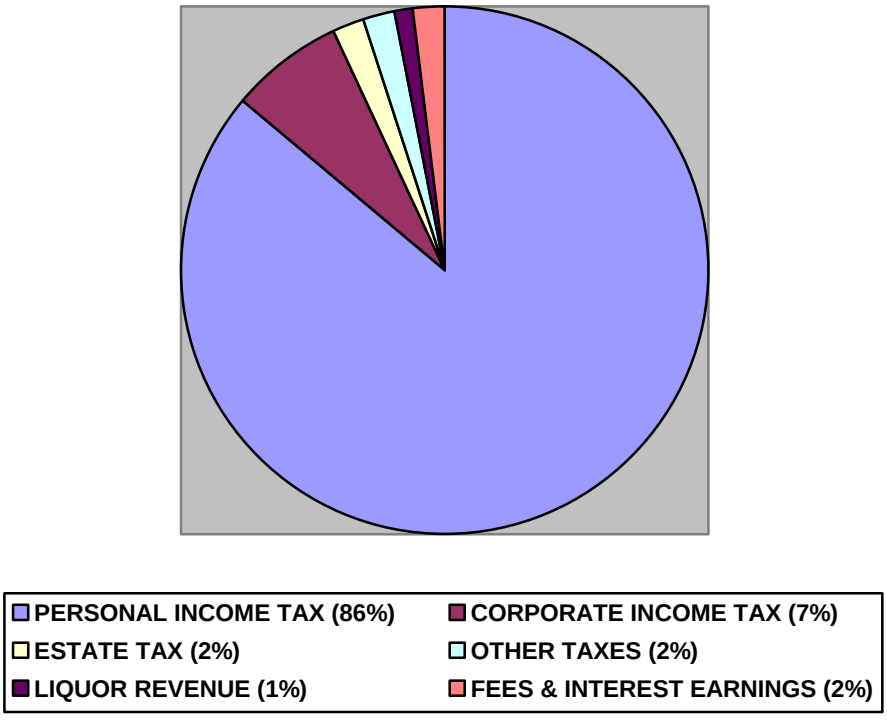


Chart 2.4: Breakdown of General Fund Expenditures (2007-09 Biennium)

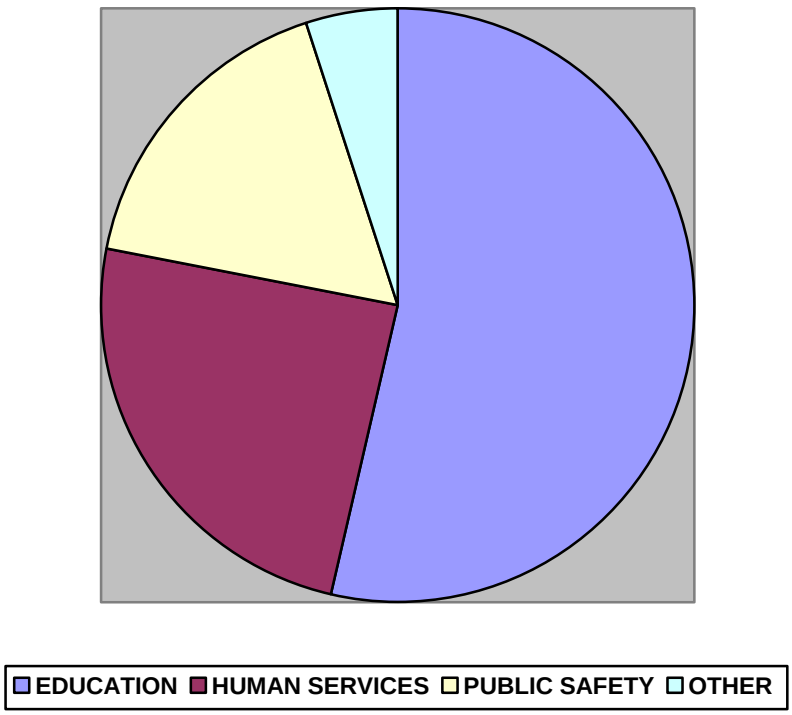


Chart 2.4 shows the allocation of General Fund revenue by major program area. Over one-half of General Fund revenue goes to education, including K-12, community colleges and higher education. Human services and public safety (including the judicial branch) are the other major program areas within the General Fund budget. Less than 5% of General Fund revenue went to all other programs outside these three areas in the 2007-09 budget.

The overwhelming importance of the volatile personal income tax to the General Fund translates into instability for General Fund revenue. Chart 2.5 traces biennium-to-biennium fluctuations in General Fund revenue over the past 20 years. It is important to note that the 7.5% decline in revenue during the 2001-03 biennium incorporates the $450 million the state borrowed to balance the General Fund budget. Without this infusion of one-time revenue, scheduled to be paid back through 2013, General Fund revenue would have declined 12.0%.

Chart 2.5: General Fund Revenue Growth

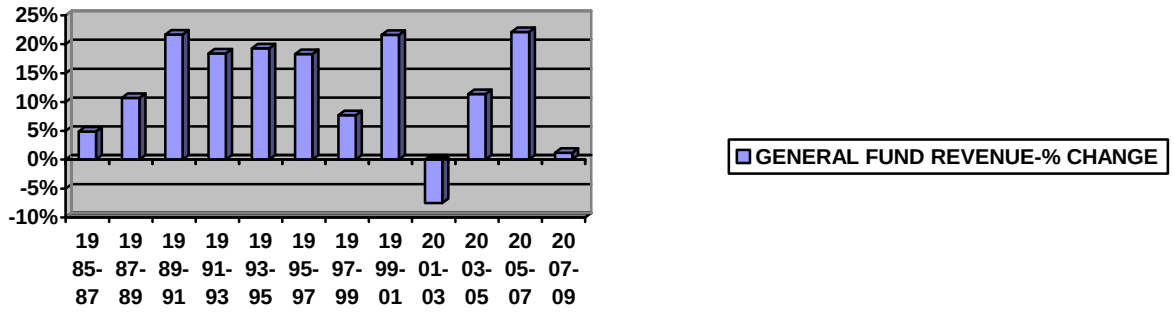
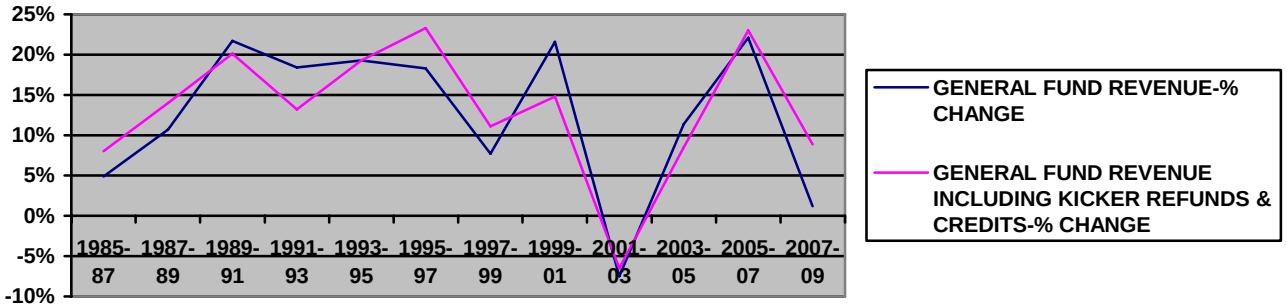


Chart 2.6: General Fund Revenue—Impact of Kicker Refunds/Credits on Volatility



As can be seen in Chart 2.6, the surplus kicker revenue limit does slow revenue growth during periods of high growth such as the 1990s but it also tends to reduce revenue further during recessionary periods such as the 2001-03 biennium and the current 2007-09 biennium. On average kicker refunds and credits have reduced General Fund by revenue by $222 million per biennium or 2.8% since the kicker was put into statute in 1979.

It was the combination of the sharp 2001 downturn and a 2% surplus kicker refund that left the Legislature in crisis management to rebalance the General Fund budget in 2002. Table 2.1 shows the relative impact of the downturn on Oregon tax revenue compared to other states. Only Alaska—almost totally dependent on oil and gas revenue, was harder hit on a percentage basis in the 2002 fiscal year. Both California and Massachusetts have relatively high personal income tax rates even though both have a sales tax.

Table 2.1: Oregon among Hardest Hit by 2001-02 Recession

FY 2002 COMPARED TO FY 2001	% CHANGE IN TAX REVENUE	RANK AMONG THE STATES
ALL STATES	-5.6%	--
ALASKA	-28.1%	50

OREGON	-20.3%	49
CALIFORNIA	-17.6%	48
MASSACHUSETTS	-14.6%	47

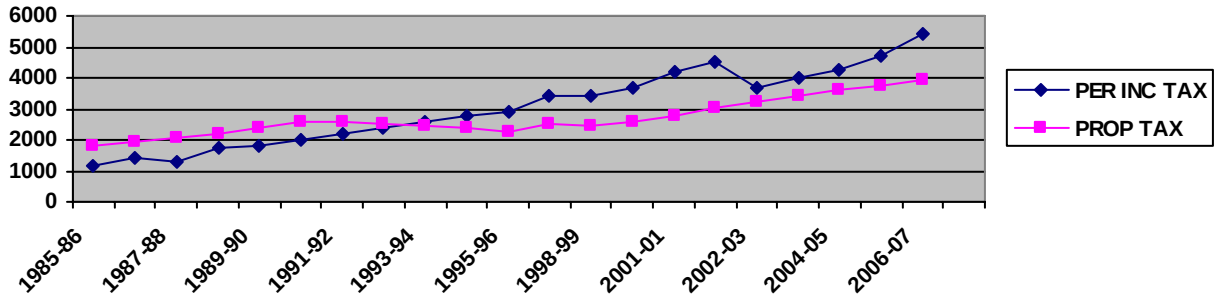
In summary, the state revenue system is highly dependent on the personal income tax. The personal income tax has grown rapidly during periods of strong economic performance such as the 1990s but has also turned down sharply when the economy weakens. It is this pattern of instability that has prompted the Legislature to adopt two formal reserve funds: the Education Stability Fund (2002) and the Rainy Day Fund (2007). For a description of these funds see Appendix C. The question of the adequacy of these reserve funds to protect programs during future downturns was discussed at length by the Task Force and the Advisory Council. The Task Force response to this issue is addressed in Chapter 3.

Key Finding: State's General Fund budget has been forced out of balance by voter initiatives

Voters approved a series of initiatives in the 1990's that have had a major impact on the state-local fiscal system. Most prominent of these for the state budget was Measure 5 approved in 1990. Measure 5 limited property tax operating levies to $15 per $1,000 of market value. Schools (including community colleges) were limited to $5 per $1,000 under the constitutional measure. Most importantly for the state budget, the state was required to "replace" the property tax revenue lost by the schools.

Chart 2.7 shows how Measure 5 fundamentally changed Oregon's revenue system. Throughout the state's history, property taxes had been the largest tax in the state-local revenue system. Measure 5 changed that by reducing property tax levies over a 5-year period (1991-96). During this period property tax collections fell by 12%. It was also during this period that personal income tax collections first exceeded property tax collections in the state.

Chart 2.7—Personal Taxes vs. Property Taxes (Millions of $)



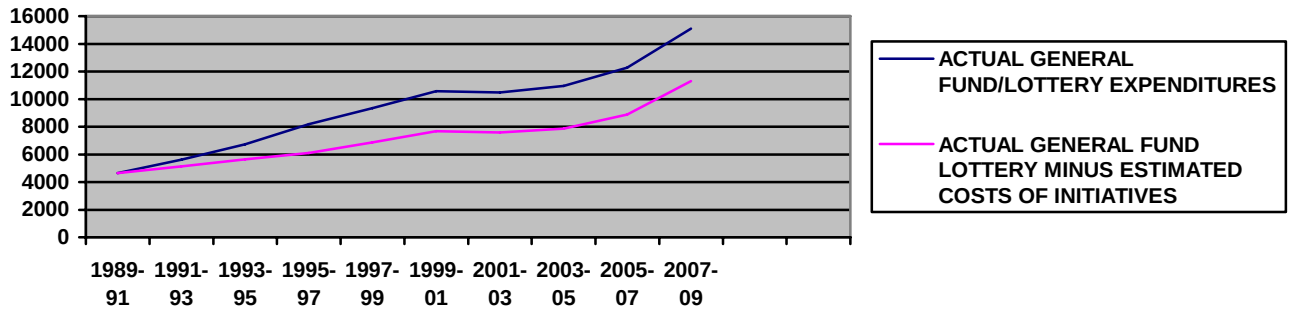
Although Measure 5 has had the largest impact of the voter approve initiatives on the General Fund budget, a series of other initiatives have also had the effect of mandating a portion of the state budget. These are:

- Measure 11 (1995)—requiring mandatory prison sentences for certain crimes.
- Measure 47 (1996) and Measure 50 (1997)—limiting property assessed value growth and establishing permanent tax rates for schools and other taxing districts. Expanded state mandate to replace reduced school property tax revenue.

- Measure 66 (1998)—dedicating 15% of Lottery revenue to parks and natural resources.
- Measure 99 (2000)—ensuring quality home care providers for elderly.

The cumulative effect of these initiatives on state discretionary spending—General Fund plus Lottery revenue—can be seen in Chart 2.8. *Since 1990, roughly 50% of new General Fund/Lottery spending has been determined by the voter initiatives listed above.* The bulk of the additional spending is associated with the mandate to support school operating budgets required by Measure 5 and reinforced by Measure 50.

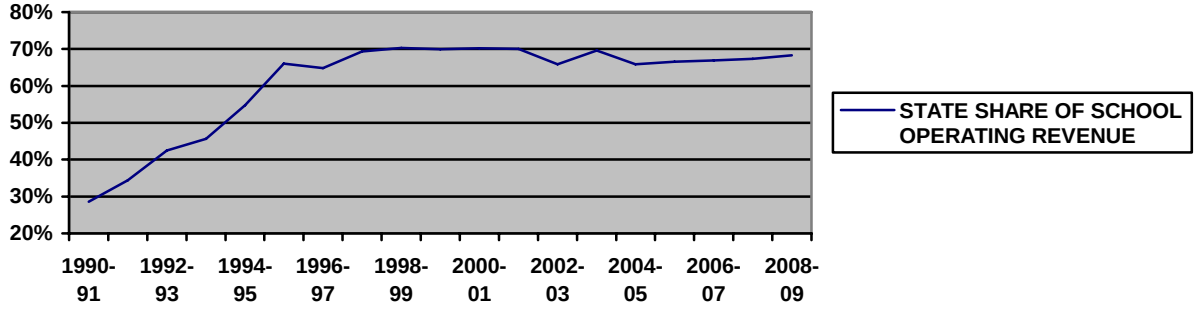
Chart 2.8: Impact of Voter Initiatives on State General Fund/Lottery Spending



Finding: The state's increased role in funding schools means that school finance is especially vulnerable to the volatility of the state revenue system.

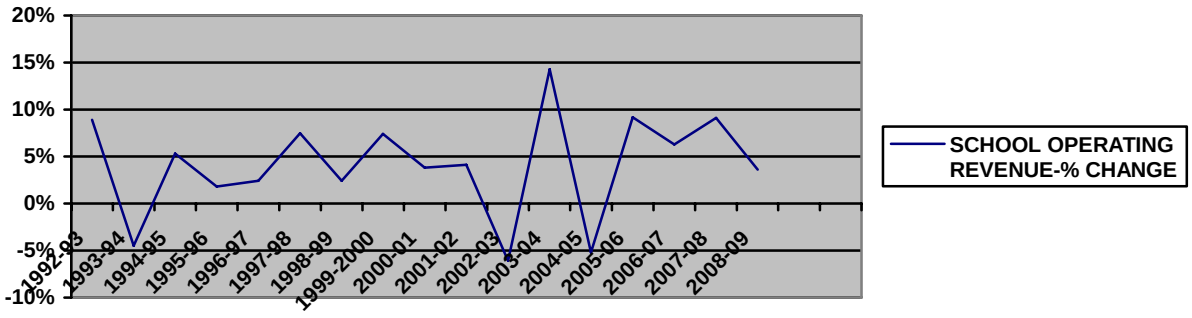
This finding is the logical consequence of the first two. Measures 5 and 50 shifted the predominant responsibility for funding local school operations from local property taxpayers to the state General Fund which has left school funding subject to the volatile personal income tax. This shift can be seen in Chart 2.8. Prior to the passage of Measure 5, local property taxes funded roughly 70% of school operating budgets. The phase-in of Measure 5 completely reversed these proportions leaving the state with roughly 70% responsibility. Measure 50 locked in this relationship with permanent tax rates and limits on value growth.

Chart 2.9: Proportion of School Operating Revenue Funded by State



The annual (schools budget on an annual basis) volatility of school operating revenue since the state took over primary responsibility for funding can be seen in Chart 2.10. The sharp declines in the 2002-03 and 2004-05 school years are directly attributed to the fiscal crisis brought on by the 2001 recession and the defeat of revenue packages to restore balance by voters (Measures 28 and 30).

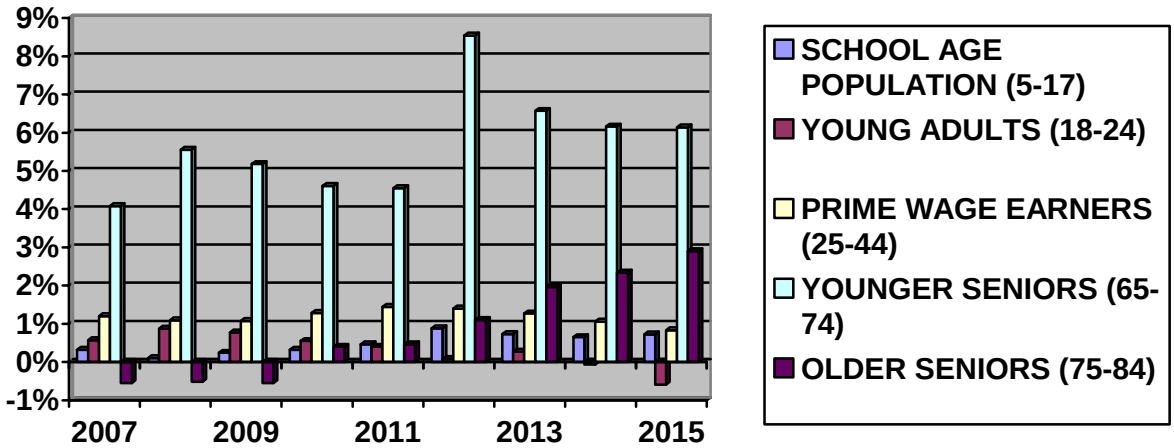
Chart 2.10: Percentage Annual Change in School Operating Revenue



Key Finding: The state's budget environment is influenced by long-term predictable forces. In addition, state fiscal decisions often have long-term spending & revenue implications.

The state's fiscal decision process carried out by the Governor and the Legislature has tended to focus on short-term implications. While the volatility of the revenue system forces this short-term focus at times, longer term forces interact with these policies in broadly predictable ways. For example Chart 2.11 shows the current projections for the changing age composition of Oregon's population. The growth in the 65-74 population has major implications for the state fiscal system. This group does not tend to be heavy users of state services but the 75+ population is far more important for the state human services budget. On the revenue side, many state tax expenditures such as exclusion of social security income from taxation and the elderly medical subtraction kick in when adults near 65.

Chart 2.11: Projected Annual Growth Rates for Various Age Groups in Oregon

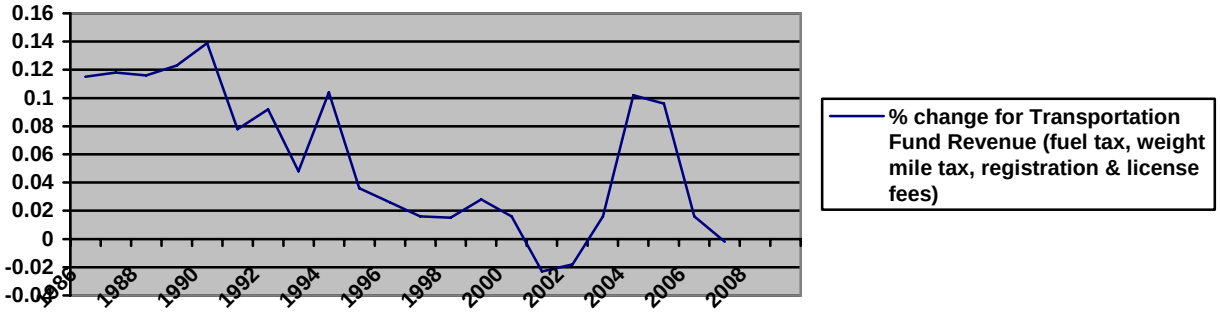


Key Finding: Funding for transportation and health care appear to be inadequate for the upcoming 2009-11 biennium due to developments in dedicated revenue sources.

As the state braces for the revenue impact of a recession on income tax revenue, two non-General Fund revenue sources are under severe strain for unrelated reasons.

Oregon's transportation system is funded separately with dedicated revenue sources. These sources are the fuel tax, the weight-mile tax on heavy vehicles and registration and license fees for vehicles. The history of these revenue sources over the past 20 years can be seen in Chart 2.12. These revenue sources tend to grow only when tax rates or fees are increased. A series of gas tax increases were implemented in the late 1980s and early 1990s followed by years of relatively flat revenue until 2003-04 when registration fee increases triggered revenue growth. Although vehicle miles traveled have increased with the state's population, cars and trucks are becoming more fuel efficient and the recent surge in gas prices limited revenue growth from fuel taxes. The weight-mile tax is more sensitive to vehicle miles traveled but the state constitution requires that the share of revenue coming from heavy vehicles must be consistent with the state's most recent cost allocation study. The flat to down trajectory of highway fund revenue is in sharp contrast to the trends in the cost of maintaining and expanding the state's transportation system. If the trend lines between revenue and expenditures continues to diverge, maintaining and expanding the state's transportation system will be increasingly problematic.

Chart 2.12: Transportation Fund Revenue Sources (Annual % Change)

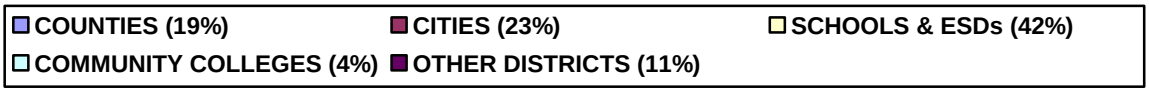


Oregon's existing medical provider taxes will expire at the end of the current federal fiscal year (October 2009). This revenue source generates roughly $300 million per biennium and the current tax paid by Medicaid providers will no long be eligible for federal matching revenue due to federal rule changes. This revenue plays a critical role in funding health care for the state's low income residents.

Key Finding: Local government revenue remains closely tied to the property tax which is strictly limited by Measure 50.

Property taxes remain by far the largest tax source in the local revenue system. The distribution of property tax revenue can be seen in Chart 2.13. Slightly less than 50% of property tax revenue still goes to education, despite Measure 5 limits, while the remainder goes to cities, counties and other districts. Other districts include special districts such as fire and irrigation districts, and urban renewal districts.

Chart 2.13: Distribution of Property Tax Revenue (2006-07 Fiscal Year).

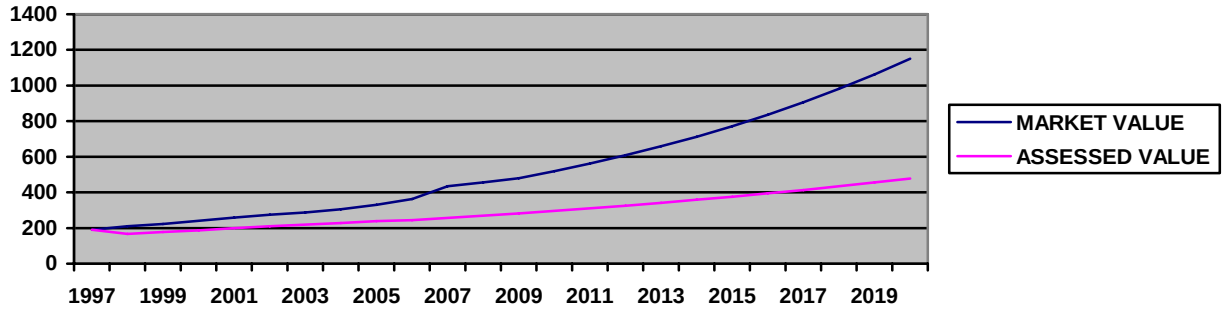


Voters, many of whom were disappointed in the degree of tax relief provided by Measure 5, approved Measure 47 in 1996. The key to voter dissatisfaction was the use of market value to determine the assessed value of property. Measure 47 limited assessed value growth to 3% annually, thereby divorcing assessed value from market value. When the language of Measure 47 proved unworkable, the Legislature referred Measure 50 as a replacement. Measure 50 established a new property tax system based on the principles approved by voters in Measure 47. The key elements of Measure 50 are:

- Assessed value growth limited to 3% annually for existing property
- Exception value, such as new construction, is to come on the roles at the property change ratio. The property change ratio is equal to the average assessment ratio (assessed value/market value) in the county for a class of property.
- Permanent rates based on existing tax levies in 1995-96 are set for all taxing districts.
- Voters can approve local options above the permanent rate for up to 5 years but cannot exceed the Measure 5 limits for any property.
- Local options above the Measure 50 permanent rates must be approved by a double majority (>50% approval in an election with >50% turnout) with the exception of the biennial November election.

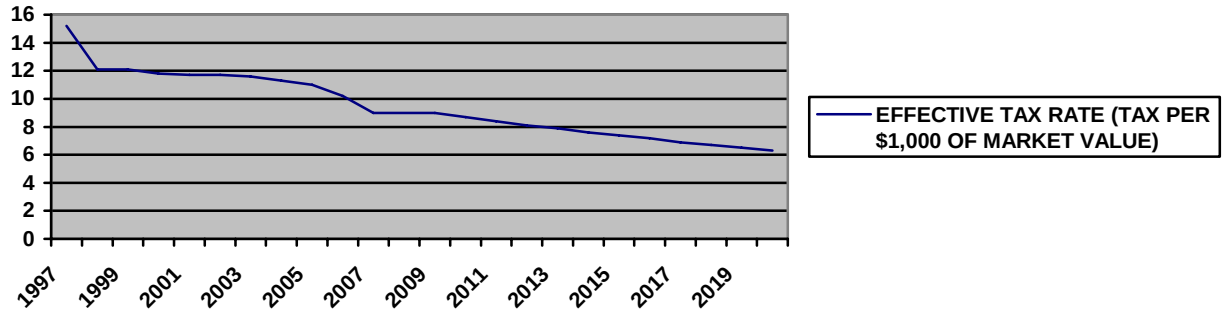
The impact of separating assessed value from market value can be seen in Chart 2.14. Projections are based on the average annual change in market value since Measure 50 was approved (8.3%) and the average annual change in assessed value (4.9%).

Chart 2.14: Historical and Projected Growth of Market and Assessed Property Value since Passage of Measure 50



By separating assessed property value from market value, Measure 50 is expected to lead to lower effective property tax rates over time. Effective rates are defined as the property tax bill divided by market value. This will generally be the case as long as market value growth exceeds 3%. Chart 2.15 shows how effective tax rates are expected to fall based on the projections for market and assessed value in Chart 2.14. The effective tax rate fell sharply with the introduction of Measure 50, dropping from $15.20 per $1,000 of market value in 1997 to $12.10 per thousand in 1998. The rate of decline since that time has been determined by the difference between market value growth and assessed value growth. By 2007, the effective tax rate had fallen to $9.00 per $1,000 of market value. It is projected to fall to $6.30 per $1,000 in 2020.

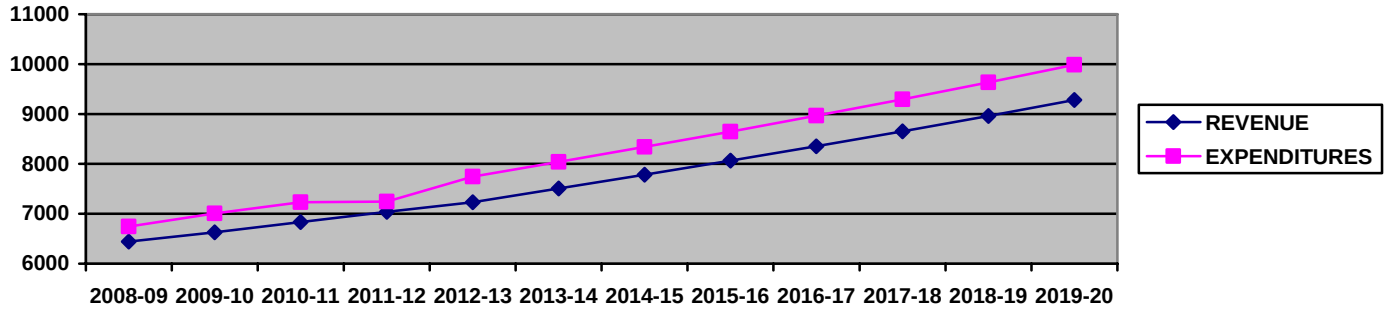
Chart 2.15: Measure 50 Means Falling Effective Property Tax ($ per $1,000 of market value)



The downward drift of the effective property tax rate has put continuous fiscal pressure on city and county governments. To get an understanding for how counties and cities have been affected by this trend, the Task Force requested a long-term fiscal projection for cities and counties as a whole. Using audited data from all 36 counties and cities accounting for 88% of total city population, the Association of Oregon Counties and the League of Oregon Cities tabulated revenue and expenditure data for the most recent period available. These data served as the base year (2005-06 for counties and 2006-07 for cities). Projections for revenue and expenditures were then developed by the Legislative Revenue

Office. These data are projected forward using known inflation rates and estimated revenue to the 2007-08 base year. Chart 2.16 shows that current service expenditures, largely driven by population growth and inflation, are expected to grow faster than revenue growth. By 2019-20 current service expenditures are expected to exceed current law revenue by $702.2 million.

Chart 2.16: Long-Term City & County Fiscal Position under Trend Projections (in millions of $)



Key Finding: The local fiscal system is put under significant stress when the inflation rate rises.

In order to develop long-term fiscal projections for city and county governments as a whole, each of the revenue and expenditure categories in Table 2.2 is projected forward using variables from the state economic and demographic forecast (September 2008). The projections rely heavily on inflation forecasts using various deflators for specific GDP components from the national economic forecast upon which the state forecast is based. The most common inflation measure used is the state and local government deflator. Overall state population projections are also used extensively to estimate growth in demand for services and growth of the revenue base. For a complete list of the variables used to project each of the categories see Appendix D.

Table 2.2: Base Year Revenue and Expenditure Estimates for Cities and Counties

	2007-08 FISCAL YEAR ($ IN MILLIONS)
REVENUE	
PROPERTY TAX	$1,740.5
HOTEL/MOTEL	54.3
OTHER TAXES & ASSESSMENTS	427.4
LICENSE, PERMITS & FINES	407.0
CHARGES FOR SERVICES	595.0
SYSTEM DEVELOPMENT CHARGES	85.5
FRANCHISE FEES	172.7
INTERGOVERNMENTAL REVENUE	1,685.3
FEDERAL FOREST PAYMENTS	203.1
INTEREST EARNINGS	130.3
MISCELLANEOUS	324.7
BOND PROCEEDS	368.4
TOTAL REVENUE	6,190.3
EXPENDITURES	
GENERAL GOVERNMENT	859.9

PUBLIC SAFETY	1,849.1
TRANSPORTATION	752.6
HEALTH	942.2
COMMUNITY DEVLOPMENT	420.8
CULTURAL & EDUCATION SERVICES	236.2
PARKS & NATURAL RESOURCES	180.4
CAPITAL OUTLAY	589.9
DEBT SERVICE	409.5
MISCELLANEOUS	55
TOTAL EXPENDITURES	6,295.7
NET FISCAL POSITION	-100.7

The baseline data shows that property taxes and intergovernmental revenue (primarily from the state), are the two major sources of revenue for cities and counties. On the expenditure side public safety and health are the largest categories. The extrapolations show that the cities and counties have a -$100.7 million fiscal position in the 2007-08 base year. This means that cities and counties as a whole were required to go into reserves or reduce expenditures by cutting or eliminating programs and services-or both-- in order to balance their budgets for the base year. The primary reason for the current fiscal pressure is that costs are rising faster than local government revenues. The state and local government deflator, designed to measure inflation for the market basket of goods and services purchased by governments, increased 5.1% in 2007 and a projected 6.4% in 2008.

It is important to note that the future fiscal position for cities and counties is highly dependent on the assumed inflation rate. The baseline forecast assumes that the recent resurgence of inflation is temporary and overall inflation is expected to return to the 2 to 2.5% range. The baseline forecast for the state and local government deflator (used extensively in the projections) is forecast to drop from 6.4% in 2008 to 2.7% in 2009 and average between 2 and 2.5% annually through the remainder of the forecast. This would tend to keep property tax revenue growth relatively close to the increasing cost of services. To see the importance of this assumption, the Task Force examined an alternative scenario in which inflation, as measured by the state and local government deflator drops backs to 5.1% (the rate for both 2006 and 2007) and remains there through 2019-20. Chart 2.17 shows the impact of the alternative inflation assumption on the city/county fiscal position.

Chart 2.17: Long-Term City and County Fiscal Position under Higher Inflation Assumptions
(in millions of $)

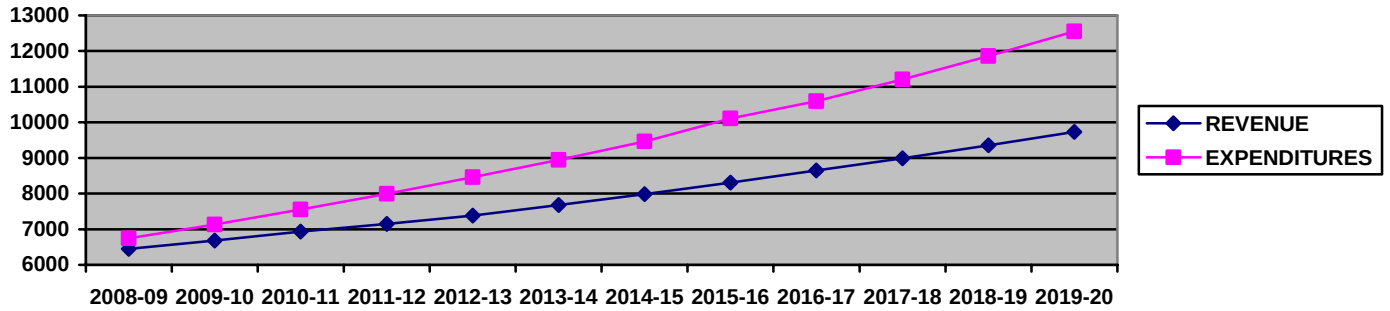
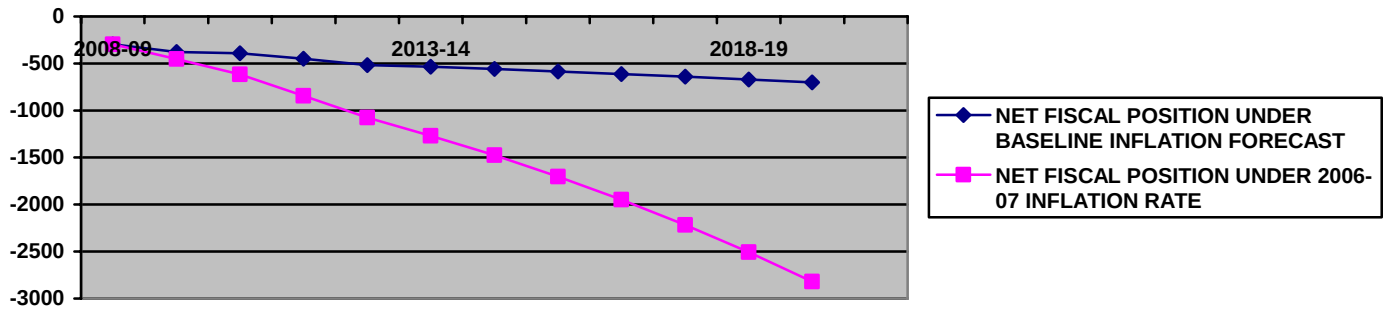


Chart 2.17 compares the city and county net fiscal position for the baseline projections with the alternative scenario based on the higher 5.1% inflation assumption. Under this scenario, current service expenditures continually outpace revenue. The net fiscal position of the county-city system deteriorates annually reaching -$2.8 billion by the 2019-20 fiscal year. This is because assessed property values do not respond to the higher inflation environment—property tax revenue growth remains locked in at 4.5% per year regardless of the inflation rate. This scenario shows the risk that higher inflation poses for the relatively inflexible county and city revenue system.

Chart 2.18 compares the fiscal gap estimates under the two inflation scenarios.

Chart 2.18: Fiscal Gap Estimates under the Baseline Inflation Assumptions and the Higher 2006-07 Inflation Rates (in millions of $)



Key Finding: Permanent property tax rates were locked into the constitution based on the fiscal realities of 1997 and do not reflect changes since then.

When Measure 50 was approved by voters in 1997 it contained permanent property tax rates for all taxing districts. The permanent rates for counties were based on the rates in existence at the time. This meant that the wide variation in existence at the time was locked into the constitution. Historically, one factor causing divergent county property tax rates has been the amount of federal timber receipts available for individual counties. Table 2.4 shows the variation across the state in county permanent tax rates.

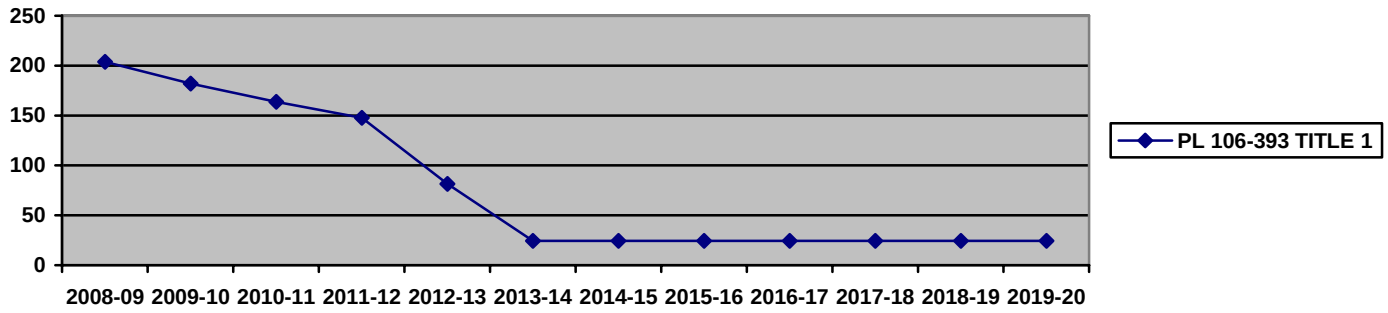
Table 2.4: Permanent Tax Rates by County

COUNTY	RATE PER $1,000 OF ASSESSED VALUE
BAKER	$3.7286
BENTON	2.2052
CLACKAMAS (RURAL)	2.9766
CLACKAMAS (CITY)	2.4042
CLATSOP	1.5338
COLUMBIA	1.3956
COOS	1.0799
CROOK	3.8702
CURRY	0.5996
DESCHUTES	1.2783
DOUGLAS	1.1124
GILLIAM	3.845
GRANT	2.8819
HARNEY	4.5016
HOOD RIVER	1.4171
JACKSON	2.0099
JEFFERSON	3.5662
JOSEPHINE	0.5867
KLAMATH	1.7326
LAKE	3.7619
LANE	1.2793
LINCOLN	2.8202
LINN	1.2736
MALHEUR	2.5823
MARION	3.0252
MORROW	4.1347
MULTNOMAH	4.3434
POLK	1.716
SHERMAN	8.7141
TILLAMOOK	1.4986
UMATILLA	2.8487
UNION	2.8515
WALLOWA	2.5366
WASCO	4.2523
WASHINGTON	2.2484
WHEELER	8.5266

YAMHILL	2.5775

Federal timber payments are clearly a factor influencing permanent county tax rates. For example, two of the most dependent on federal revenue: Curry and Josephine Counties, have the lowest permanent rates in the state at roughly 60 cents per $1,000 of assessed value. Following a great deal of uncertainty, Congress recently approved (October 2008) a 4-year extension of the federal timber payment program. The extension calls for a decline in county payments with no guarantee of an extension following the 4-year period. Title 1 timber payments (from both Forest Service Lands and O & C Lands) are projected to drop from $203.8 million in 2007-08 to $182.1 million in 08-09, $163.8 million in 09-10, $147.7 million in 11-12 and $81.5 million in 12-13 before dropping off to the residual level of $24.5 million through the remainder of the forecast horizon. In effect, the extension moves the county fiscal crisis out into the future but does not avoid it. Chart 2.19 traces the projections for federal timber payments to counties through 2020.

Chart 2.19: Projected Federal Timber Revenue for Counties (in millions of $)



The expected phase-out of Federal timber payments will have a major impact on a number of counties especially those with low permanent property tax rates. The inflexibility created by Measure 50 makes it difficult for these counties to respond to a new fiscal environment without severe cuts in programs and services—and it is questionable whether some counties will be able to make large enough cuts to balance their budgets and remain viable.

Key Finding: Because of the linkage in service provision between state government and the counties, fiscal stress at one level of government affects the other.

Funding of schools and transportation are two key areas where state and local government revenue systems overlap. But there are many other areas as well. Table 2.4 shows areas where the state and counties jointly provide services. The table is based on results of the 5520 project directed by the 2005 Legislature in a budget note that accompanied passage of SB 5520. The budget note directed the counties and the Legislative Fiscal Office to gather information about the eight shared services listed in the table. The results of the study highlight the interconnection between the state and local fiscal system and the importance of considering the state-local revenue system as a whole.

Table 2.4: State and County Shared Services

SERVICE—2003-05 BIENNIUM	COUNTY	STATE	OTHER REVENUE*
PROPERTY TAX ASSESSEMNT & COLLECTION	55%	34%	11%
COMMUNITY CORRECTIONS	20%	60%	20%
DISTRICT ATTORNEY	70%	7%	23%

ECONOMIC DEVELOPMENT	51%	12%	37%
JUVENILE SERVICES	68%	17%	15%
MENTAL HEALTH	11%	29%	60%
PUBLIC HEALTH	27%	11%	62%
VETERANS SERVICES	63%	10%	27%

*Other revenue includes federal grants & contracts and fees.

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CHAPTER 3
SHORT TERM RECOMMENDATIONS

The Task Force developed a series of short-term recommendations based on the findings detailed in Chapter 2. Throughout its discussions, the Task Force remained focused on the two fundamental weaknesses of the revenue system: instability at the state level and inflexibility at the local level. The following recommendations are intended to serve as guidance for the Governor and Legislature for the 2009 session. These short-term recommendations do not entail fundamental reform of the revenue system but they do address critical ways to strengthen and further stabilize our current system. The options for more fundamental long-term changes in the system are addressed in Chapter 4.

Summary

The short-term recommendations are:

- **Establish methodology for more reliable forecasting and more prudent budgeting; direct ending balances into the Rainy Day Fund.**
- **Apply a balanced budget rule to ballot initiatives.**
- **Reduce restrictions on local government's ability to raise revenue and refrain from approving any new property tax expenditures or state level mandates on local governments.**
- **Develop systematic long-term budgeting process including long-term capital spending plan.**
- **Develop adequate revenue sources to meet state's immediate critical needs in health care and transportation.**

Recommendations: Discussion and Explanation

Establish methodology for more reliable forecasting and more prudent budgeting; direct ending balances into the Rainy Day Fund.

The Task Force recommends that the Legislature prepare a joint resolution to amend the state constitution for consideration by voters. The constitutional amendment should contain the following elements:

- Place Rainy Day Fund in constitution
- Require Governor to develop both a point estimate for corporate income tax revenue and all other General Fund revenue and a range for both estimates.
- Specify that the range is based on historic forecasts compared to actuals.
- Require all revenue above the top of the forecast range to be returned to taxpayers
- Require revenue that exceeds the point estimate up to the top of the range to go into the Rainy Day Fund unless fund is full.
- Increase cap on Rainy Day Fund from 7.5% of General Fund revenue in the prior biennium to 10% of General Fund revenue in the prior biennium.
- Specify that when cap is reached, revenue above cap is returned to taxpayers. When making deposits into the fund, corporate income tax revenue above the point estimate is calculated first then all other General Fund revenue.
- Put current statutory Rainy Day Fund triggers in constitution.
- Put 2/3 withdrawal limit in constitution but change date from beginning of biennium to beginning of fiscal year.
- Put statutory ending balance calculation (up to 1% of prior biennium appropriations) into constitution.

Explanation: The Task Force spent considerable time examining the consequences of the 2001 recession. There was agreement that the state should avoid the disruptive program cuts that occurred in the 2001-03 and 2003-05 biennia, particularly the cuts in school budgets. The Task Force also recognized the need to avoid a recurrence of the situation that occurred in 2003, when the state issued $450 million in appropriation credit bonds in order to balance the 2001-03 budget. These bonds will not be fully paid off until 2013.

The Task Force reviewed the details of the state's two reserve funds (see Appendix C) created in response to the 2001 downturn and asked the Advisory Council to analyze the adequacy of these funds to protect state programs in future recessions. The Advisory Council responded with the following recommendations:

- The target for the reserve funds (the Education Stability Fund plus the Rainy Day Fund) saving rate should be to maintain average growth in spending during the average recession.
- Meeting the target would require a savings rate between 3 and 4% of General Fund revenue during expansions.
- The maximum for the Rainy Day Funds should be 12 to 15% of the biennial budget.
- The current policy of adding the General Fund ending balance up to 1% of General Fund appropriations should be continued. However, historical analysis shows that this method would not have been sufficient to fully fund the Rainy Day Fund.
- Sources should be identified that would provide an additional 0.5% to 1.5% of General Fund revenue on average during periods of economic expansion.
- One proposal is to change the forecast method to allow for any revenue up to one standard deviation above the current forecast method to be allocated to the Rainy Day Fund. Historical analysis shows that this change would have restored the Rainy Day Fund within two biennia of recent recessions, and it is recommended as the most promising method of additional funding.

For the complete text of the Advisory Council recommendations see Appendix E.

Table 3.1 shows the historical simulation of how the proposed changed in forecast methodology would affect reserve funds referred to by the Advisory Council:

Table 3.1: HISTORICAL SIMULATION BASED ON PROPOSED FORECAST METHODOLOGY CHANGE: RAINY DAY FUND DEPOSITS IN MILLIONS OF $

BIENNIUM	81-83	83-85	85-87	87-89	89-91	91-93	93-95	95-97	97-99	99-01	01-03	03-05	05-07
GENERAL FUND EXCEPT CORP													
BUDGET EST	2,704	2,887	2,915	3,302	4,145	5,063	5,797	6,533	7,567	9,113	10,195	10,199	10,827
ACTUAL	$2,641	2,976	3,139	3,477	4,331	5,123	5,960	7,047	7,736	9,367	8,946	9,797	11,898
%DIFFERENCE	-2.3	+3.1	+7.7	+5.3	+4.5	+1.2	+2.8	+7.9	+2.2	+2.8	-12.3	-3.9	+9.9
RDF DEPOSIT	0	89	163	175	186	60	164	366	168	255	0	0	606
CORPORATE REV													
BUDGET EST.	348	285	291	288	320	337	409	428	658	799	860	540	500
ACTUAL	249	299	298	325	297	355	576	684	589	755	420	641	844
%DIFFERENCE	-28.9	+4.7	+2.3	+12.6	-7.2	+5.3	+40.9	+59.8	-10.4	-5.5	-51.1	+18.7	+68.8
RDF DEPOSIT	0	13	7	36	0	18	130	137	0	0	0	101	160
RDF CALC													
TRIGGERS MET?	YES*	NO	NO	NO	YES*	NO	NO	NO	NO	NO	YES*	YES*	NO
1% ENDING BALANCE DEPOSIT	0	28.6	27	0	37.4	45.3	55	0	0	0	101	96.7	102.2
RDF BALANCE**	0	130.7	334.2	373.9	135.7	265.7	628.1	742.7	878.5	1,010	366	1852	1,028
% OF GENERAL FUND	0	4.2	10.0	10.0	3.0	4.8	9.8	10.0	10.0	10.0	3.8	1.5	8.8

*No deposits are assumed to be made when triggers are met.
** Assumes 10% cap.

The historical simulation covers the 1981-83 biennium through the 2005-07 biennium. Deposits to the Rainy Day Fund are up to one standard deviation of the forecast error for the General Fund. The calculation is done separately for corporate income tax revenue just as is current done for the 2% surplus kicker calculation. The standard deviation, a measurement of the difference between actual revenue and forecast revenue, is based on the forecast error for the 13 biennia covered in the simulation. One standard deviation for all non-corporate General Fund revenue is 5.6%. For the corporate income tax forecast, one standard deviation is equal to 35.6% of the forecast. Revenue above the forecast but less than one standard deviation is assumed to be deposited into the Rainy Day Fund. The simulation shows that the 10% cap is consistently reached within two biennia of when one of the triggers has been met for withdrawing funds from the Rainy Day Fund balance.

Apply a balanced budget rule to ballot initiatives.

The Task Force recommends that the 2009 Legislature introduce a bill that amends current statutes to do the following:

- Require ballot title to declare if an initiative will have a significant unbudgeted fiscal or revenue impact that will require eliminating or reducing funding for current programs and services.
- Incorporate financial impact statement into ballot title where appropriate.
- Establish $ amount (indexed for inflation) for what constitutes “significant unbudgeted fiscal or revenue impact.”

Explanation: The Task Force applauds recent legislation (2005) that increased the latitude given to the Financial Impact Committee (consisting of the State Treasurer, Secretary of State, Director of the Department of Revenue and the Director of the Department of Administrative Services) that examines the revenue or fiscal impacts of initiative measures to include secondary fiscal and economic effects in their voter's pamphlet statement. However, the Task Force recommends that further efforts need to be made that encourages voters to recognize the fiscal consequences of ballot measures. The current ballot (November 2008) has Measures (58, 59, 60, 61 and 62) that have a combined fiscal impact of $2.165 billion (13%) on the 2009-11 General Fund-Lottery budget.

In developing its recommendation the Task Force reviewed the work of a National Conference of State Legislatures committee which issued a report in 2002. The report emphasized the potential budget disruptions caused by initiatives that either mandate new spending without a revenue source or reduce revenue without identified alternative revenue or spending reductions. The study cited 11 states with various laws designed to establish restrictions on imposing fiscal policies through the initiative process. See Appendix F for the list of states with restrictions.

Reduce restrictions on local government's ability to raise revenue and refrain from approving any new property tax expenditures or state level mandates on local governments.

The Task Force does not have a recommendation for new legislation in this area for 2009 but does have some recommended guidance for the major legislative fiscal policy committees:

- Revenue Committees
  - No new property tax expenditures unless offsetting revenue included.
  - No new preemptions of potential local revenue sources.
  - Review existing local preemptions for possible modification or repeal.
- Ways & Means Committee
  - No new expenditure mandates for local governments.
  - Fully fund (at 100% of estimated impact) any new property tax expenditures with appropriations to the Property Tax Expenditure Account.

Explanation: Led by its local government representatives, the Task Force had lengthy discussions concerning the fiscal situation of local governments around the state. Given the long-term fiscal analysis of local fiscal trends discussed in Chapter 2 and a report from the Governor's Task Force on Federal Forest Payments and County Services, the Task Force recommends that the Legislature take no action in the short-term that will worsen the fiscal strains on the local fiscal system. This means a moratorium on new expenditure mandates and additional preemptions of potential revenue sources.

The Task Force reviewed existing preemptions such as real estate transfer taxes, hotel-motel taxes and construction excise taxes. The Task Force also heard a formal presentation from the League of Oregon Cities recommending consideration of substituting a more responsive tax based on gross receipts of telecommunications providers for the existing franchise fee for city rights-of-way. Franchise revenue has been declining and is expected to continue its downward trend in the future. The Task Force does not endorse any single revenue diversification suggestion but does recommend that the Legislature thoroughly explore these options for diversifying local revenue and continue to work with local officials and other interests to find the best approaches to increase the diversity of the local revenue base.

The Task Force does recommend that the Legislature appropriate enough funds for the Property Tax Expenditure Account to fully reimburse local governments for any new property tax expenditures that

would be enacted. The Account established by the 1999 Legislature, is designed to reimburse local governments for 50% of the cost of new tax expenditures though only a nominal amount has ever been appropriated to the account. The Task Force feels that the current fiscal situation for local governments in Oregon warrants full reimbursement if new tax expenditures are approved.

Develop systematic long-term budgeting process including long-term capital spending plan.

The Task Force recommends that legislation requiring a 10-year forecast for state discretionary expenditures and revenue be developed as a regular part of the budget development and reporting process. Specifically the new legislation should contain the following:

- A 5-biennia projection for General Fund-Lottery expenditures and revenue under current law to be included with the Governor's budget report. These forecasts should include a range of economic scenarios.
- The Governor's budget report should also include a 5-biennia plan implementing programs to meet benchmark goals established by the Oregon Progress Board and adopted by the Legislature.
- Requirement for the Legislative Fiscal Officer to prepare a 5-biennia estimate in all fiscal impact statements.
- Requirement for the Legislative Revenue Officer to prepare a 5-biennia estimate in all revenue impact statements.
- Require the Governor, the Treasurer and the Legislature to develop a 10-year capital spending plan.

Explanation: The Task Force received a presentation from the Department of Administrative Services based on projections for current spending programs and revenues. Given the long-run consequences of many fiscal decisions and the changing economic and demographic background, the Task Force recognizes the need for including long-run fiscal projections at regular intervals as part of the budget planning process. The Task Force also heard testimony from the Metro regional government outlining the long-term infrastructure needs of the Portland Metropolitan area and the likely capital needs of other parts of the state over the long-term. Given the long life of these assets and the large cost of maintaining and replacing them, the Task Force recommends inclusion of a capital spending plan based on infrastructure needs as a formal part of the long-term budget planning process.

Develop adequate revenue sources to meet state's immediate critical needs in health care and transportation.

Explanation: The Task Force does not a have a recommendation for a specific revenue plan to meet the short-term needs in these two important areas. However, the Task Force, based on reports given by the Governor's Transportation Task Force and the Health Fund Board recognizes the need for action in the 2009 session to develop additional sources of revenue for the state's transportation system and to replace expiring provider tax revenue to use in combination with federal matching funds to maintain health care programs.

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Chapter 4
LONG-TERM OPTIONS

In fulfilling its charge from HB 2530, the Task Force identified two general approaches for long-term structural change in the revenue system to address its current weaknesses:

- Restructure the tax system by adding or increasing some taxes and reducing or deleting others. Evaluate these different combinations compared to the current system in terms of how they affect:
  - Distribution of the tax burden.
  - Overall state economy (jobs and income)
  - Stability of the revenue system
  - Administration of the tax system.

- Develop ways to increase the flexibility of the local revenue system to allow local governments to better respond to growth in demand for services, inflation and changing fiscal conditions.

Process

The Task Force recognizes the critical need to engage the public in any discussion of options for changing the structure of Oregon's revenue system. The link between public services and revenues

needs to be clearly understood by the public before proceeding to a discussion of revenue options. Without public engagement and acceptance any major proposal is unlikely to be successful. The Task Force received a presentation on the successful Virginia experience with revenue reform and recommends that the Virginia process be used as a possible model for engaging the public in future tax restructure efforts.

Tax Restructure Proposals

The Task Force considered five major approaches to restructure the tax system:

- Eliminate the personal income tax and establish an equal yielding general retail sales tax
- Reduce personal income and property taxes and establish a retail sales tax
- Eliminate residential property taxes for most residences, reduce personal income taxes and establish retail sales tax
- Eliminate corporate income tax and replace with higher yielding corporate franchise tax
- Eliminate corporate income tax and replace with equal yielding value added tax on all business.

There is a limitless number of ways in which the elements of the major approaches examined by the Task Force can be combined; the identification of particular combinations for the purpose of analysis in this report does not indicate a specific recommendation by the Task Force. Rather, the combinations are shown to assist in a general evaluation of each proposal, for further consideration.

The Task Force relied on a number of tools to consider the impact of major tax restructure proposals.

Economic and distribution effects

To gage the long-term economic and distribution effects the Task Force requested simulations using the Oregon Tax Incidence Model (OTIM). OTIM is a computable general equilibrium model of the Oregon economy. It is designed to show how tax changes affect wages and prices and how these changes ultimately affect the overall level of economic activity as measured by total personal income and employment. The OTIM simulation compares the current economy (baseline) to how it will look after wages, prices and income have adjusted to the tax change. This is assumed to reflect a 5-year adjustment period. After accounting for these changes OTIM computes new estimates for the distribution of after-tax income and state-local revenue. For the OTIM results of the individual scenarios see Appendix G.

Stability

OTIM compares the economy at two points in time and is therefore not a useful guide to the impact of tax changes on the stability of the revenue system. In order to examine how different state and local taxes move up and down over the course of the business cycle, a series of stability simulations were run. These simulations are based on historic U.S. Census data for quarterly state and local government tax collections. The data are based on collections for the 12-month period ending in March, June, September and December of each year. The quarterly series begins in December 1988 and runs through March of 2008. From these data, a base case is developed that starts with the national tax source proportions in December 1988 and applies the historic growth rate to each source, in effect replicating history. This allows for a comparison of hypothetical tax combinations with the actual national averages in terms of average growth, standard deviation (a measure of stability) and the minimum and maximum quarterly change. For the results of the stability simulations see Appendix H.

Administration

In order to consider the potential administrative issues posed by the various tax restructure proposals, the Task Force requested comments from the Department of Revenue. Those comments are included in the analysis of the proposals.

SCENARIO 1

Description

- Eliminate state personal income tax.
- Impose 8.5% retail sales tax with exemptions for in-home food, shelter, insurance, utilities, manufacturing, agriculture inputs, private education, already taxed items (gas, tobacco).

Static Revenue Impact

Sales tax rate set to make net revenue estimate neutral for 2011 calendar year. Over time the net revenue impact will be negative because the long-term income elasticity for the retail sales tax is less than the personal income tax.

Long-Term Economic Impact

Dramatic changes in a state's tax structure causes significant short-term dislocations as businesses and individuals adapt to the new system. In this case Oregon's retail trade sector would shrink particularly along the border. Gains could be expected in high wage sectors as the income tax burden falls. Over the long-term, the overall economy would be expected to benefit from the switch to a sales tax. Employment is expected to rise by over 5%. This triggers a 1% increase in the population as net in-migration picks up. The return to capital is expected to increase leading to a 0.7% increase in business investment. Elimination of the personal income tax results in higher after-tax wages. This causes an increase in the supply of labor leading to lower gross (before-tax) wages. In the simulation, net household income rises by $550 million (0.4%).

Dynamic Revenue Impact

An increase in employment and population is expected to generate additional consumption above the baseline thereby triggering a positive revenue feedback for sales tax collections. The increase in investment and in-migration would also be expected to increase property tax collections driving up local government revenue. On net, the $6.837 billion sales tax (at 2011 levels) would be expected to generate an additional $29 million in sales taxes through feedback effects, $55 million in state other funds revenue and $167.5 million in local revenue for a total revenue feedback of $252 million. These estimates are all at 2011 levels after the assumed 5-year adjustment period has taken place in the state economy.

Distribution Effects

The shift to the sales tax reduces net income for the majority of households. Net income is expected to decline on average for all household income groups below $117,067. The primary beneficiary of the shift is high income households. Households above $185,879 are expected to see a 9.2% increase in net household income. Overall the swap of the personal income tax for a retail sales tax would change the distribution of Oregon's tax burden from largely proportional (with a slightly regressive lower end and slightly progressive higher end) to regressive throughout the income spectrum. This effect could be mitigated by providing additional tax relief in the revenue system to low income taxpayers (such as increasing the Earned Income Tax Credit), but such changes would reduce net revenues to the General Fund that would have to be offset by increases elsewhere, such as a higher sales tax rate or fewer exemptions, or by reduced spending.

Revenue Stability
Historically, the retail sales tax has exhibited less volatility than the personal income tax. This is particularly true for the last business cycle (1991 to 2002). Stability is influenced by the definition of the base and tax rate structure. In general, the broader the sales tax base, the more stable the revenue stream will be. For the personal income tax, more progressive rate structures tend to increase volatility. In practice, the sales tax has shown greater stability at the national level. Based on historic revenue stability calculations switching from a personal income tax dominated revenue system to a sales tax dominated system reduces the standard deviation of quarterly revenue collections from 1.06% to 0.68%. However, in the current recession consumer spending appears to be particularly weak putting downward pressure on sales tax revenue in many states.

Administrative Issues
The Department of Revenue would experience budget savings due to the elimination of the personal income tax however it would continue to enforce the corporate income tax under this scenario. The DOR would also have to gear up to ensure compliance with the new sales tax. A potential administrative complication is the fact that the state works in cooperation with the Internal Revenue Service to gather data for enforcement efforts. Under a sales tax system that partnership would no longer be applicable. Administrative costs for the sales tax are expected to be between 1 and 1.5% of total collections depending on the number and complexity of exemptions. More complexity generally leads to higher administrative costs. A sales tax also imposes administrative costs on businesses that collect them. Generally, businesses are allowed to retain a portion of sales tax collections to offset their administrative costs, but this reduces net tax revenue to the state.

Task Force Evaluation: Despite the positive job creation and stability effects (based on 20 years of historical data) of moving to a Washington type sales tax dominated revenue system, the dramatic shift in the tax burden from high income to low income families makes this option unacceptable without significant additional measures to offset the negative equity effects.

SCENARIO 2
Description
- Reduce personal income tax rates to 2,4,6,8% (8% rate starts at $75,000 single)
- Increase earned income tax credit to 50% of federal
- Establish $50,000 homestead exemption
- Establish low income renter relief program
- Impose 5.0 % retail sales tax with exemptions for in-home food, shelter, insurance, utilities, manufacturing, agriculture inputs, private education, already taxed items (gas, tobacco).

Static Revenue Impact
This proposal is expected to generate a net revenue increase of $150 million in 2011 calendar year. Over time, revenue would likely be expected to grow slightly slower due to the lower elasticity of the retail sales tax.

Long-Term Economic Impact
Imposition of a sales tax would cause significant short-term dislocations as businesses and individuals adapt to the new system. Significant reductions in personal income tax rates and expansion of the earned income tax credit are expected to stimulate labor force growth. On net, employment would be expected to increase 120,588 or 5.1 %. The state's population is expected to rise 51,857 as in-migration

picks up in response to the stronger labor market. Lower personal income tax rates increase the after-tax return for workers. This leads to an increase in the labor supply and a lower gross (before-tax) wage rate. This process pushes the wage index down 4.5%. Net household income is expected to rise by $1.7 billion despite the increase in state revenue. Imposition of the sales tax is expected to push up the state price level by 0.9%.

Dynamic Revenue Impact
Despite the increase in net static revenue from the combination of changes, the dynamic revenue impact is also positive. The net increase of $150 million would be expected to generate an additional $255 million in state and local revenue after the economy has fully adjusted.

Distribution Effects
Net household income rises for all household income groups under this scenario due to the increase in population across the income spectrum. However, average household income within the groups falls for all groups with the exception of those groups with incomes between $117,067 and $185,879 and above. The sales tax works through the price system to lower average net after tax income for most income groups.

Revenue Stability
Switching from a personal income tax dominated revenue system to a balanced sales tax/personal income tax system would be expected to significantly increase overall stability. Historically (1988 to 2008), a personal income tax dominated system has a quarterly standard deviation of 1.06%. A balanced sales tax/personal income tax system, such as the national average for all state and local revenue systems, has a quarterly standard deviation of 0.78% based on the past 20 years.

Administrative Issues
Administrative costs can be expected to rise under this scenario. The Department of Revenue would continue to administer the personal income tax system, though the incentives for non-compliance would decline due to the lower overall rates. The DOR would have to gear up to ensure compliance with the new sales tax. Administrative costs for the sales tax are expected to be between 1 and 1.5% of total collections depending on the number and complexity of exemptions. More complexity generally leads to higher administrative costs. In addition the DOR would work through the county assessor to establish the new homestead exemption and the renter relief program. A sales tax also imposes administrative costs on businesses that collect them. Generally, businesses are allowed to retain a portion of sales tax collections to offset their administrative costs, but this reduces net tax revenue to the state.

Task Force Evaluation: This approach patterned after the plan outlined in the original HB 2530 as introduced in the 2007 session, merits further consideration. The plan produces positive economic and stability effects that are consistent with the Task Force's goals for the revenue system. However, Task Force members remain concerned about the administrative costs and equity implications of a new major consumption tax. The Task Force recommends that other consumption taxes such as gross receipts and value taxes remain under consideration as a substitute for the retail sales tax.

SCENARIO 3

Description

- Create property tax homestead exemption up to $750,000 of assessed value for owner occupied residences.
- Double personal income tax brackets to $6,400 and $16,100 for single taxpayers
- Impose 2.7% retail sales tax with exemptions for in-home food, shelter, insurance, utilities, manufacturing, agriculture inputs, private education, already taxed items (gas, tobacco).

Static Revenue Impact
This combination of changes generates a projected static revenue impact of +$170 million in the 2011 calendar year. Over time, net revenue impact will likely be slightly positive as sales tax revenue is expected to grow faster than the initiative-constrained property tax.

Long-Term Economic Impact
Imposition of a sales tax would cause significant short-term dislocations as businesses and individuals adapt to the new system. In this case Oregon's retail trade sector would shrink particularly along the border. The relative price of housing would fall significantly as the residential property tax is removed for most home owners. This would lead to a jump in jobs (77,633 or 3.3%), population (35,951 or 0.9%) and investment ($129 million or 0.7%). Net household income is expected to be $1.4 billion or 1.1% higher after all adjustments have taken place.

Dynamic Revenue Impact
An increase in employment and population is expected to generate additional taxable activity at the state level. However, the feedback effect on local government revenue is expected to be negative as capital shifts from taxable commercial and industrial property to non-taxable residential property. The net effect is a positive dynamic revenue impact of $162 million (2011 levels) resulting from the positive economic effects of the change.

Distribution Effects
In general middle income households benefit under this scenario, with income groups between $16,579 and $86,675 experiencing net income gains largely because they receive full property tax relief through the homestead exemption. Households above $117,067 experience a net loss because they are likely to have residences above the $750,000 homestead exemption cap.

Revenue Stability
At the national level, the property tax has historically shown slightly less stability than the retail sales tax with a quarterly standard deviation of 1.2% compared to 1.0% for the sales tax. However, in Oregon's case the property tax is likely to be more stable because of the effects of Measure 50. A simulation with a sales tax dominated revenue system and lower property tax (1/2 the national average) exhibits slightly less stability than the base case.

Administrative Issues
Under this scenario the Department of Revenue would maintain oversight of the property tax assessment function. The DOR would administer the homestead exemption tracking eligibility. County assessors would also continue to determine market and assessed values though property tax collections would fall sharply. The DOR would also have to gear up to ensure compliance with the new sales tax. Administrative costs for the sales tax are expected to be between 1 and 1.5% of total collections depending on the number and complexity of exemptions. More complexity generally leads to higher administrative costs. A sales tax also imposes administrative costs on businesses that collect them. Generally, businesses are allowed to retain a portion of sales tax collections to offset their administrative costs, but this reduces net tax revenue to the state.

Task Force Evaluation: Similar to the evaluation for Scenario 2, this simulations leads to compelling gains in employment, household income and revenue stability. Another positive feature is that it targets middle income household income groups for tax relief more effectively. However, the proposal raises a series of institutional and administrative questions around such a dramatic drop in reliance on the property tax. Among these issues is the fate of existing bonds backed by the property tax base, the impact of the scenario on tax-increment financing (such as Urban Renewal), and administrative issues, such as the administration of a large homestead exemption program. A further complication of this scenario would be the need to establish some method for the state to distribute state sales tax revenue to local governments (including counties, cities and special districts) to replace property taxes lost by local governments. In view of the positive economic and distribution effects the Task Force recommends that this approach continue to be analyzed and modified by the Legislature as a possible long-term option.

SCENARIO 4

Description

- Eliminate corporate income tax
- Impose .3% tax on value added

Static Revenue Impact

Static revenue impact is set to be revenue neutral for 2011 calendar year. Over time revenue is likely to grow slightly faster than the current system because the value added base has demonstrated greater long-term income elasticity than has the corporate income tax base.

Long-Term Economic Impact

Employment and population decline slightly but investment increases in response to elimination of the corporate income tax. The return to capital rises 0.22%. Net household income falls $101 million in the simulation because the burden of the corporate income tax is born partially by non-state residents while the value added tax falls predominantly on state residents.

Dynamic Revenue Impact

The dynamic revenue impact from this simulation is very small (<$5 million).

Distribution Effects

The lower household income is spread roughly proportionately across the income spectrum. The highest income group (with incomes greater than $185,879) essentially breaks even after wage, price and economic activity changes.

Revenue Stability

Replacing the corporate income tax with a value added tax has the unusual result of increasing both stability and long-run revenue growth. This is because the corporate income tax demonstrates the greatest short-term instability (highest quarterly standard deviation) of the major state and local revenue sources and the lowest long-term quarterly growth rate (tied with excise taxes). The stability and long run growth characteristics of the value added tax are similar to the retail sales tax. Simulating the switch from a system with an average corporate income tax to one with no corporate income tax and higher consumption taxes leads to less volatility (the quarterly standard deviation drops from 0.78% to 0.74%) and a higher long-term growth rate (average quarterly growth in revenue of 1.41% compared to 1.39%).

Administrative Issues

The corporate income tax is highly complex with substantial enforcement and compliance issues at the state level. Its elimination would reduce Department of Revenue costs significantly. This would be offset by the costs of implementing and administering a new value added tax. Only Michigan and New Hampshire have imposed a tax on the value added base at the state level. However, value added taxes are used extensively in other countries around the world, at the national level.

Task Force Evaluation: The Task Force recommends further exploration of the value added base as a long-term option. This base is generally considered superior to other widely used business taxes on a theoretical basis. However, there is little experience at implementing a value added tax at the state level and there would likely be considerable uncertainty among business taxpayers regarding implementation issues and the impact of the base on their operations.

SCENARIO 5

Description

- Eliminate corporate income tax
- Impose franchise tax based on gross business investment

Static Revenue Impact

Static revenue impact is set to raise revenue of $500 million for the 2011 calendar year. Over time revenue is likely to grow slightly faster because the gross investment base has historically grown faster than the net corporate income base over the long-term.

Long-Term Economic Impact

Employment and population decline slightly but investment increases in response to the elimination of the corporate income tax. The return to capital rises 0.28%. Net household income falls $278 million in the simulation primarily because of the increase in the overall tax burden.

Dynamic Revenue Impact

The dynamic revenue impact from this simulation is projected to be very small ($3 million).

Distribution Effects

The higher tax burden is spread roughly evenly across the household income spectrum.

Revenue Stability

The impact on stability is expected to be slightly less than Scenario 4. Gross investment consists of net investment which adds to the capital stock and replacement investment due to depreciation. Net investment is volatile over the business cycle but overall gross investment is considerably less volatile than the net corporate income base. However, gross investment is likely to be more volatile than a consumption oriented base such as value added or gross receipts.

Administrative Issues

This scenario represents a relatively new tax base. Clearly the Department of Revenue administrative costs would drop with the elimination of the highly complex corporate income tax but a number of detailed decisions regarding the exact definition of the investment base would have to be made to

implement the franchise tax. In general, the more understandable these definitions are for corporate taxpayers, the lower the ratio of administrative costs to collections is likely to be.

Task Force Evaluation: Similar to the evaluation for scenario 4, the franchise tax base should continue to be considered as part of overall business tax reform, but the relative novelty of the base among states means that definitional and administration issues would have to be addressed very carefully before implementation.

Ways to Increase Flexibility of Local Revenue System

The Task Force discussed long run options designed to make the local revenue system more responsive to economic, demographic and institutional changes or give more options to local policy makers to respond to these inevitable changes. The Task Force considered three general approaches:

- Modifications to Measure 50.
- Local revenue diversification discussed in Chapter 3.
- Reassignment of tax revenues between state and local governments.

Modifications to Measure 50

The Task Force examined a series of proposals for modifications and enumerated the pros and cons of each option.

- Rebase assessed value to market value at time of transaction, including sale of property and new construction.
  - Pro
    - Slows long-term revenue loss for local governments.
    - Preserves certainty for taxpayers when not buying or selling property.
    - Minimizes cash flow disruptions for taxpayers.
  - Con
    - Exacerbates horizontal inequities—taxpayers with equally valued homes paying widely different taxes.
    - Creates incentive to lock-in residential property investments leading to dislocations in the state economy.
    - Would sharply increase the amount of compression under Measure 5.

- Establish a ceiling and floor for the property change ratio.
  - Pro
    - Slows long-term revenue loss for local governments.
    - Constrains degree of horizontal inequities.
    - Maintains certainty for those taxpayers above the minimum property change ratio.
  - Con
    - Creates uncertainty over annual tax change once the property change ratio floor is reached.

        - Could result in considerable horizontal inequities if property change ratio limits are set widely apart.
        - Revenue gains for local governments would be minimal if floor is set at low levels.

- Adjust the 3% annual assessed value change with a 5-year moving average change in the consumer price index.
    - Pro
        - Allows property tax revenue growth to more closely match service cost increases for local governments.
        - Maintains some certainty for taxpayers by limiting unexpected annual jumps in assessed values.
    - Con
        - If inflation is high, taxpayers will receive higher annual property tax bills.
        - Does not address horizontal equity issues.

- Provide voters one time option to change permanent tax rates.
    - Pro
        - Allows for response to significant change in fiscal circumstances, such as the loss of federal timber payments.
        - Retains taxpayer certainty over value growth after change in permanent rate.
    - Con
        - Does not correct variations in assessment ratios.
        - Does not prevent erosion of revenue over the long-term.

- Repeal Measure 50/ Reset Measure 5 limits at $10 per $1,000 of market value ($6.67 local governments, $3.33 schools)
    - Pro
        - Resolves inequities caused by variations in assessment ratios
        - Restores link between market value growth and revenue growth
    - Con
        - Reduces taxpayer certainty over year-to-year variations in tax bills
        - Will initially create "winners and losers" as assessed values are returned to market value

Task Force Evaluation: While supporting further discussion of ways to modify Measure 50 as being critical to address the shortfall in revenue for local governments and schools, the Task Force voiced concern that even small changes are likely to require a constitutional amendment and could easily result in a major political effort for a relatively small gain in terms of addressing the fundamental problems of the local revenue system.

Local Revenue Diversification

The Task Force heard a series of suggestions from local governments regarding ways to diversify local revenue. The Task Force recommends that local revenue diversification continue to be explored as a long-run option for restoring balance to the local fiscal system. See Chapter 3 for further discussion.

Reassignment of major tax sources between state and local governments

The Task Force discussed the instability of the state revenue system and the inflexibility of the local revenue system at length. The root of these fundamental problems at the two levels is the major tax source each relies on. The Task Force considered a proposal developed in the last legislative interim that would swap a portion of the state personal income tax with the cities/counties in exchange for a statewide property tax.

The revenue system of the cities and counties, dominated by the property tax, is characterized by relatively slow but stable growth. The state's system, highly dependent on income taxes, is much more responsive to growth over time but is highly unstable over the course of the business cycle. The cities are projected to raise $843.5 million in the 2007-08 fiscal year on permanent rates averaging $4.87 per $1,000 of assessed value. The counties are projected to raise $668 million on a permanent rate of $2.49 per $1,000 of assessed value. The proposal calls for cutting the rates of the cities and counties in half on a statewide basis and imposing a $3 per $1,000 state property tax. This would have the effect of shifting about $1.7 billion dollars from the cities and counties to the state in the 2009-11 biennium. The cities and counties would then receive a portion of personal income tax revenue to hold them harmless in the aggregate. For the cities this translates into 7% of personal income tax collections. For the counties the proportion of income tax revenue is 5.6%.

The net fiscal impact of the proposal is roughly neutral for the cities and counties with a short-term gain for the state. However, the net fiscal position for cities and counties will swing positive over time because the personal income tax is expected to grow more rapidly than property tax revenue. Cities and counties are likely to experience more revenue volatility because of the cyclical nature of the personal income tax. The state would experience slower revenue growth but more stability over time.

The proposal would have major implications for Oregon's state and local public finance system. The main ones are:

- Stability of State Revenue System.
    - Nearly $1 billion dollars in property tax revenue per year. Property tax revenue under Measure 50 has demonstrated a very narrow range of annual change because of the limitations on assessed value. Statewide assessed property value grew 4.4% 3.7% and 4.8% respectively, for the three recession years of 2001, 2002 and 2003.

    - Reduced reliance on the volatile personal income tax. Under the proposal the state would redirect 12.6% of personal income tax revenue to cities and counties.

- Local Revenue System:
    - Increase elasticity of city and county revenue. Cities and counties would have a considerably more sensitive revenue system under the proposal. Their reliance on the property tax and the personal income tax would be equivalent. This would give local governments greater revenue growth over time at the cost of greater cyclical instability. This means that these governments would have to adopt reserve policies that would help them manage this more volatile revenue stream.

    - Decentralize revenue system over time. Under current law, Oregon's revenue system is becoming more centralized because the personal income tax grows rapidly with the economy but property tax revenue is constrained by Measures 5 and 50. Under this proposal, the centralization process would slow and could be reversed to some extent as

city and county revenue becomes more dependent on personal income tax revenue and less reliant on the property tax.

The clearest benefit of the proposal is increased stability for the state revenue system. State revenue stability is enhanced by the property tax/personal income tax swap with local governments and reduced magnitude of future 2% surplus kicker refunds. Although cities and counties would face more instability under the proposal they would gain increased revenue growth and greater flexibility over the long term.

The most difficult implementation issue revolves around the imposition of a statewide property tax corresponding with a reduction in county and city property taxes. This is caused by the wide variation in current property taxes across the state (for the variation in county permanent rates see Table 2.4). Given that a statewide property tax must meet uniformity standards, a complex formula would have to be developed to redistribute revenue back to the cities in an equitable way. Even then it is likely that some counties that have experienced very low property tax rates because of federal timber revenue would end up with higher combined state-county property taxes that they currently have.

Task Force Evaluation: The approach has merit because it offers the prospect of addressing the fundamental weakness of the state revenue system and the fundamental weakness of the local revenue system simultaneously. The biggest roadblock is the uniformity requirement for a statewide property tax. If implemented across the board, the statewide property tax would lead to major tax increases for low property tax jurisdictions. In addition, the issue of how to distribute personal income tax revenue back to individual counties and cities would have to be carefully considered.

APPENDICES

A Text of HB 2530

B Public Meetings

C Stability Funds
- Education Stability Fund
- Rainy Day Fund

D Variables used for Local Government Projections

E Advisory Council Recommendations for Managing Reserve Funds

F NCSL List of States with Statutes Limiting Initiatives with Fiscal and Revenue Impacts

G OTIM Scenarios—Summary Results

H Stability Study Results