

**Review of
Oregon's Tax
System:**

**Policy
Recommendations**

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Prepared by the
Governor's Tax Review
Policy Advisory Committee

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CHAPTER 1

INTRODUCTION

In November of 1997, Governor Kitzhaber announced a process to review Oregon's tax system. The Governor divided the process into two parts. Phase I assessed how changes in Oregon have affected the revenue system. The role of Phase II is to recommend policy responses to these changes.

The Governor appointed the Technical Advisory Committee (TAC) to address Phase I. He instructed the TAC to report on a set of findings. These findings reflect changes in the state's public finance system since 1980. The TAC was further charged with developing a set of policy questions.

The Governor appointed a follow-on Policy Advisory Committee (PAC). This committee is charged with developing policy options to address the questions posed in Phase I. The Governor outlined some guidelines for the PAC:

1. Policy options should be put into a short-term and long-term context.
2. The PAC should strive for revenue neutrality. This means that proposed tax credits or rate reductions should be roughly matched by revenue raising measures.
3. Policy options should be based on sound analysis and common sense. They should stand on their own merit without consideration of the current political environment.

The Technical Advisory Committee released its Phase I report in June 1998 and they found that Oregon's tax system has changed significantly over the past decade. The primary causes are voter initiatives and a changing economy. The most important change is a shift in the relative importance of property and income taxes. The local property tax was once the largest tax in the revenue system. Now we rely more on state collected income taxes. We also increasingly rely on income taxes to fund our educational system.

The tax shift raises two fundamental issues. First, income taxes are highly sensitive to economic growth. Income taxes grow rapidly when the economy is performing well and they slow appreciably when the economy slows. Property taxes are less responsive to changes in the economy. The tax shift means that the revenue system is now more sensitive to economic conditions.

The second issue raised by the tax shift is the relationship between state and local governments. The local revenue system is still centered on the property tax. Measure 50, approved by voters in 1997, will limit future property tax revenue growth. State decisions, such as exempting property, directly affect local revenue. This means local revenue stability is more closely tied to state policy.

The tax shift and corresponding issues led the TAC to identify revenue stability as the key tax policy issue.

At the behest of the Governor, the TAC also examined the relationship between Oregon's tax code and the state's strategic policy goals. These goals are outlined in *Oregon Shines II*. The TAC found no systematic link between policy goals and the tax system. The TAC went on to identify areas where tax policy may help achieve these objectives. These areas are work force quality, the welfare-to-work transition, and the environment.

The Policy Advisory Committee was structured to respond to the questions outlined in Phase I. The work of the PAC is divided into four parts and separate subcommittees met to prepare policy options for each area. These policy areas are:

1. Revenue stability. This subcommittee looks at stability from the perspective of both state and local governments.
2. The environment. The current pollution control credit as well as new options to encourage environmentally sound decisions were the focus of this subcommittee.
3. Education and workforce development. This subcommittee developed options centered around skill investment incentives.
4. Economic disincentive. This subcommittee investigated ways to smooth the transition of low-income families to economic independence.

This report is based on the work of the Policy Committee and the policy area subcommittees. Chapter 2 contains a brief problem statement and key policy recommendations for each policy area. This chapter only summarizes the work of the subcommittees. A more thorough discussion of the extensive work done by each subcommittee including further policy recommendations can be found in Appendices A through D.

Some issues related to tax policy development are discussed in Chapter 3. These are not directly part of the Governor's charge but the Committee felt they might assist policy-makers in formulating tax policy.

CHAPTER 2

SUMMARY OF POLICY RECOMMENDATIONS

A. Revenue Stability

Problem Statement

State Government

The major finding from Phase I is the state's growing reliance on income taxes (See Figure 1). 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.

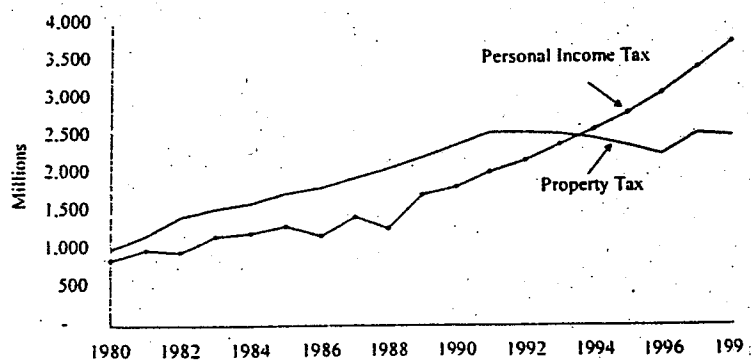
The income tax is a state government revenue source. Two-thirds of state tax revenue comes from the personal income tax. Personal and corporate income taxes make up 94 percent of the state's General Fund. This means that state revenue, especially the General Fund, is highly sensitive to changes in the economy.

The General Fund now funds two-thirds of public school and community college spending in Oregon. It funded one-third in 1990. Consequently, education budgets are now more susceptible to changes in General Fund revenue.

An economic downturn at some point in the future is inevitable. A downturn is likely to depress income tax growth below projections. Kindergarten through community college spending makes up one half of the General Fund budget. This means that protecting school budgets from unanticipated revenue shortfalls will be increasingly problematic.

Oregon has a mechanism for dealing with unexpected revenue increases. It is the 2 percent surplus kicker law. This law returns revenue to personal and corporate taxpayers if collections exceed the forecast by more than 2 percent. However, the state has no formal mechanism for dealing with unanticipated revenue shortfalls.

Figure 1
Personal Income Tax Collections vs.
Property Tax Levies Imposed



Income Tax collections adjusted for kicker refunds.

Forty-five states have a formal stabilization fund. Oregon is one of five states that do not. Thirty-seven states currently have a balance in their funds.

Local Government

Local governments differ greatly in their size and revenue structure. However, the local revenue system is still highly dependent on the property tax and this tax has been radically altered by voter initiatives. These initiatives (Measures 5 and 50) put restrictions on property tax rates and assessed property values. This has significantly changed the relationship between local revenue and Legislative actions. The ability to raise revenue through the existing property tax system and to find alternative revenue sources is subject to Legislative authority.

Legislative actions can erode the local tax base and restrict flexibility. Property tax exemptions directly reduce revenue to local governments. Preemption of local authority restricts local government's ability to diversify revenue sources. These actions are a source of revenue instability and uncertainty for local governments.

Recommended Policy Options

Short-term Options

State Government

1. Creation of Stability Fund

A stabilization fund should be established. The fund should be built up during good economic times and would then be available when revenue growth slows due to a weak economy. Resources for the fund should be directly appropriated or taken as a portion of the ending balance from the previous budget.

Oregon has a narrow and volatile tax base when compared with other states. Oregon's vulnerability is compounded by being one of only five states that do not have a stability fund. State government's now dominant role in education funding exacerbates this unfavorable combination of circumstances.

A stabilization fund is a critically necessary tool for the Governor and the Legislature to manage periods of revenue shortfalls. The fund should only be used during economic downturns. It should be used along with budget cuts.

Local Government

2. Constitutional referral requiring full reimbursement to local governments for revenue lost due to any property exemption passed by the Legislature.

This measure would provide some local revenue stability while allowing the Legislature to exempt property when it is consistent with state goals.

3. Statutory prohibition of Legislative actions to preempt existing or potential local revenue sources.

This prohibition will serve to highlight the disruptive impact of preempting local revenue sources.

Long-Term Options

State Government

4. Revise Appropriation Growth Limit

The state needs a new spending limit. The current limit is out-of-date and no longer effective.

5. Move toward more balanced revenue system.

The state should begin planning to move toward a more balanced revenue system. It should be one that is less dependent on the personal income tax. Personal income taxes account for a higher percentage of state and local tax revenue than any other state. Oregon personal income tax revenue as a percentage of total personal income in the state is second only to New York (See Table 1). Options deserving further exploration are discussed in Appendix A.

**Table 1
Oregon's Unbalanced Revenue System**

	Personal Income Taxes as a percent of Income	FY 1995 Rank	Property as a percent of Income	FY 1995 Rank	Sales & Excise Taxes as a percent of Income	FY 1995 Rank	Total Taxes as a Percent of Income	FY 1995 Rank
Oregon	4.43	2	3.92	18	1.09	50	11.5	28
California	2.61	20	3.21	28	4.13	24	11.6	25
Idaho	2.88	15	3.04	35	3.95	29	11.5	26
Washington	n/a	n/a	3.63	24	7.51	1	12.3	12
U.S. Average	2.44		3.60		4.20		11.7	

Source: State Policy Reports. Volume 16. Issue 16. August 1998. FTA. September 1997

Local Government

6. Diversify Local Revenue Base.

Political and economic forces are likely to continue eroding the property tax base. Property tax revenue is likely to grow more slowly than income over time due to the constraining effect of Measure 50. Measure 50 also increases the risk of horizontal inequities. Horizontal inequities occur when taxpayers living in similarly valued homes in the same tax district pay

different amounts in taxes. This will create more voter dissatisfaction with the property tax. For these reasons, local governments need to diversify their revenue sources.

A number of options for diversifying the local revenue base are discussed in Appendix A.

B. The Environment

Oregon's tax system does not reflect the environmental goals contained in *Oregon Shines II*. The current tax system does very little to discourage environmentally damaging activity and encourage actions that are environmentally beneficial.

Problem Statement: Pollution Control Tax Credit

Oregon's Pollution Control Tax Credit became law in 1967 and there are currently only two other states which offer such credits. The Pollution Control Tax Credit is the state's largest corporate income tax credit (See Table 2), reducing corporate income tax collections by \$18 million in the 1997-99 biennium.

In its existing form, the purpose of the credit is unclear. It does reduce business costs. In this sense, it serves as an economic development tool. However, its effectiveness as a tool to discourage pollution is questionable. The Department of Environmental Quality estimates that 75 percent of tax expenditures under the program are credits for facilities that are already required by law. This means that these investments would have taken place without the credit.

Table 2
Top 5 Corporate Income Tax Credits
Ranked by 1997-99 Revenue Impact

Credit	(\$ 000's)
Pollution Control	18.100
Qualified Research Activities	16.800
Business Energy Facilities	15.500
Assessments Paid to Oregon Life and Health IGA	15.000
Low Income Housing Lender's Credit	4.200

Source: State of Oregon 1999-2001 Tax Expenditure Report

The complexity of the Pollution Control Tax Credit is compounded because the Environmental Quality Commission is required to consider return on investment. This may also discourage innovative investments.

In summary, the Pollution Control Tax Credit is:

- Costly.
- Complex.
- Limited in its environmental impact because credits are received for complying with current law.

Problem Statement: Non-Point Pollution Sources

The state and the nation have achieved significant success in reducing pollution caused by direct discharge into streams and rivers. However, many non-point or area sources damage water quality.

Many streams in Oregon fail to meet water quality standards. The primary reason is non-point source activities. The presence of pesticides and fertilizers in the water threatens many aquatic species.

One source of non-point pollution is pesticides and fertilizers used in agricultural practices. These practices are difficult to control through regulation because they are so dispersed.

Another growing source of non-point water pollution is fertilizers and pesticides applied by casual urban users.

Recommended Policy Options

Short-term options

1. Modify Pollution Control Tax Credit

The credit needs to be updated. It should be modified in a way that encourages investment that reduces pollution. Investments that bring business into compliance with existing environmental regulations should not be eligible for the credit. Credits should be applied to expenditures that are over and above the cost of meeting current regulations.

2. Establish excise tax on pesticides and fertilizers.

An excise tax on the wholesale volume of pesticides and fertilizers should be imposed. Revenue from the tax could then be used as financial incentives to encourage high quality agriculture practices. This would move Oregon toward a fully integrated tax system in which taxes are collected from agricultural and urban pesticide users. The funds could then be used to assist agriculture in developing more environmentally sound practices. This will result in a net transfer of resources from casual urban users of pesticides to agricultural users.

Long-term options

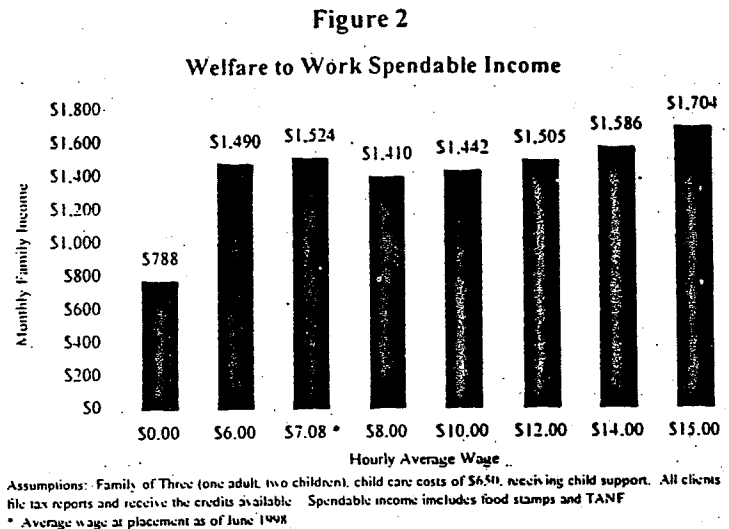
3. Systematically incorporate environmental goals into Oregon's revenue system.

A system of taxes and subsidies that encourages conservation and discourages environmental degradation should be put into place. An Environmental Tax Study Committee should be appointed to develop proposals for implementing environment taxes over the next ten years. Some long-term options are discussed in Appendix B.

C. Economic Disincentive

Problem Statement

Except in rare circumstances, families are financially better off when they move from welfare to work. However, for many families there comes a point where an increase in income will cause a decrease or "dip" in their spendable income (See Figure 2). Moving from the low end of the wage spectrum in Figure 2 to the higher end shows that a doubling of the hourly wage rate leads to virtually no increase in spendable income.



The issue primarily affects families with subsidized day care. Food Stamp recipients can also be affected.

The point at which the dip occurs can vary between minimum wage (\$6.50 per hour effective January 1, 1999) and \$14 per hour. The level depends on circumstances. The decrease in spendable income is most likely to happen in the \$7 to \$12 per hour range. This is typically 100 to 185 percent of the poverty level. The annual poverty threshold for a family of four in 1998 was \$16,452.

These dips in spendable income are not directly caused by our tax system. The phasing out of government subsidies causes them. The combination of rising taxes and declining subsidies is called the implicit tax rate.

In 1997, the Legislature passed two credits aimed at the working poor. The first is an Oregon earned income credit. Eligible Oregon residents can now receive a credit equal to 5 percent of their federal credit. The second is the Oregon Working Family Credit. This credit assists low-income workers in meeting day care costs. This measure most directly addresses the disincentive effects. However, it has only a minimal impact on the dip. This is because the credit is nonrefundable. This means that low-income workers receive little actual tax relief.

Recommended Policy Options

Short-term options

The following options should be viewed as alternatives rather than part of a package. This is because they may interact in some instances to worsen the disincentive effects over some wage ranges.

1. Make the Working Family Credit Refundable

Making the credit refundable means that the amount of the credit can exceed a family's tax liability. This would make the credit available to most families earning less than \$10 per hour. The benefits of the credit would phase out between \$10 and \$13.50 per hour. The refundable credit would help an estimated 17,400 Oregon households. It would help a broad spectrum of low-income families. Most importantly, it would mitigate the earnings dip.

This is the preferred alternative.

2. Improve the Employment Related Day Care Program

The state's day care subsidy program could be changed to reduce disincentive effects. The Employment Related Day Care program is the single biggest contributor to the dips. The program could be improved by limiting the co-payment to 10 percent of salary. The co-payment would be in effect up to 150 percent of the poverty level.

Long-term options

3. Coordination and integration of low-income subsidy programs

Individual programs and the way these programs interact cause the spendable income dips that families suffer as they progress up the wage scale. A coordinated approach would help alleviate the disincentive problem.

Some suggestions on how to move in this direction are discussed in Appendix C.

D. Education and Workforce Development Incentives

Problem Statement

Oregon Shines II clearly spells out the state's strategic workforce goal:

"Oregon's workforce will be the best educated and trained in America by the year 2000 and equal to any in the world by 2010."

Government at all levels invests large amounts to educate and train the workforce of tomorrow. Other public programs are aimed at those who have lost or do not have a job.

However, most Oregonians currently have jobs and existing training programs do not reach them. As the pace of technological change quickens and the world economy integrates, many workers are affected because their skills are not being upgraded. They face economic hardship if they are unable to keep up with changing labor market demands. This is a source of considerable economic uncertainty for many workers and Oregon will lag in meeting its workforce goals.

One approach to this problem is employer job training tax credits. However, research shows this approach is usually ineffective. Tax credits to reimburse employers for a portion of job training expenses are reported to be little used among states that have such programs. When training credits are used they appear to be for expenditures that would have taken place in the absence of the credit.

Recommended Policy Options

Short-term options

1. Establish Industry Skill Investment Fund

This fund would build on the existing Key Industry Training program now operated by the Economic Development Department. The new program would provide matching grants industry wide to groups of Oregon businesses working with public or private sector training providers. The program would focus on raising skills for jobs with current or future skills shortages. All public funding should be on a match basis with private sources.

2. Establish a set of individual skill investment incentives

Oregon should establish two tax credits for individuals investing in their own training needs.

- a. Establish an Oregon Hope for All tax credit patterned after the recently passed federal HOPE credit. The federal tax law allows a \$1,500 credit for the first \$2,000 spent on post-secondary education in the first two years after high school graduation. Oregon should establish a refundable supplement to the federal credit. This would direct the benefits to low income individuals.

- b. Supplement the federal "Lifetime Learning" credit by creating a refundable state credit. This credit allows any taxpayer to claim a 20 percent credit on any qualified skill training program. Adding the refundable Oregon supplement would provide a strong incentive for low income individuals to invest in their training needs. The lifelong learning credit is directed at the large group of workers whose training needs are currently ignored by the state tax system.

Long-term options

3. Establish Individual Training Accounts

The tax system should encourage individuals to invest in themselves over time. This will reduce worker uncertainty and improve the quality of the Oregon labor force. One approach is to set up individual training accounts patterned after newly established federal accounts. These subsidized accounts could be used by Oregon residents to pay for future education and training needs.

Workforce training options are discussed further in Appendix D.