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City Club of Portland Report on Tax Reform in Oregon

City Club of Portland (Portland, Or.)

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The City Club membership will vote on this report Friday, May 21, 1993. Until the membership vote, the City Club does not have an official position on this report. The outcome of the vote will be reported in the City Club *Bulletin* dated June 4, 1993 (Vol. 75, No. 1).

EXECUTIVE SUMMARY

This report reviews existing proposals for tax reform in Oregon, sets forth principles of taxation by which to weigh such proposals, and recommends a tax reform package to the Legislature.

Any tax reform proposal in this state must take into account the effects of Ballot Measure 5. Measure 5 has placed significant pressure on the state general fund and state programs, and has created a largely state-financed system of K through 12 education with limited local control.

Tax reform proposals should not be based on perceived revenue "gaps" or desired cuts in government spending, but on balanced principles of taxation. The criteria for evaluating tax reform proposals should be: understandability, fairness, competitiveness, reliability, efficiency and political viability.

The property tax is not progressive but does offer a stable source of funding. There is little sentiment among Oregonians to reverse the Measure 5 limits on property taxes for homeowners. Oregon's income tax is barely progressive, and the rates are high in comparison to other states. Revenues from the income tax fluctuate significantly with economic conditions. The state general fund has become increasingly dependent on the income tax.

A sales tax is generally regressive but can be made less so if it contains appropriate features. A sales tax levied on both goods and services could achieve a low rate, enhance revenue stability, and reduce the impact on individuals. Exemptions and credits could meet specific concerns of individuals and businesses. The political viability of a sales tax could also be increased by fixing the rate in the state Constitution and dedicating the revenues to education.

Oregon's total tax system fails to satisfy the criteria for a balanced tax system. Therefore, the Legislature should adopt and send to Oregon voters a tax reform package that includes the following elements:

- A split roll property tax.
- A local option for limited, voter-approved property tax levies for schools, outside the Measure 5 cap.
- Acceleration of Measure 5 property tax limitations.
- A more progressive income tax with reductions for most taxpayers.
- Indexing of income tax brackets to inflation.
- A low-rate sales tax on goods and services with targeted credits and exemptions, the rate fixed in the Constitution, and revenues dedicated to K through 12 education.

CITY CLUB OF PORTLAND
REPORT ON
TAX REFORM IN OREGON

I. INTRODUCTION

In July 1992, the Board of Governors of the City Club of Portland charged this committee with reviewing proposals for tax reform in Oregon. Specifically, the committee was asked to analyze Measure 7, the 1992 general election ballot measure to create a statewide split roll property tax,[1] and then to review existing proposals for tax reform and recommend principles of taxation for the Club to endorse. This report builds on previous City Club studies spanning more than a decade.[2]

II. BACKGROUND

A. The New World of Measure 5

Under Measure 5, the property tax limitation measure passed by voters in 1990,[3] revenue available for state and local government services in Oregon is shrinking. Understanding how Measure 5 is operating to reduce government revenue is necessary for an informed discussion of tax reform options in Oregon.

Measure 5 imposes property tax rate limits of $10 per $1,000 of assessed value for all non-school local services. It also imposes property tax rate limits for local schools that by 1995 will decline to $5 per $1,000 of assessed value.[4] Figure 1 shows how the school and non-school property tax limits phase in from 1991 to 1996.[5]

Figure 1

Maximum Property Tax Rates Under Measure 5
(per $1,000 in assessed property value)

Fiscal Year	Schools	Non-Schools	Total
1991-1992	$15.00	$10.00	$25.00
1992-1993	$12.50	$10.00	$22.50
1993-1994	$10.00	$10.00	$20.00
1994-1995	$7.50	$10.00	$17.50
1995-after	$5.00	$10.00	$15.00

Source: Section 11b, Article XI of the Oregon Constitution.

1. *Report on Ballot Measure 7:* (Split Roll Property Tax), October 9, 1992.
2. *A Review of Property Taxation in Oregon*, 1980; *Report on Oregon's Tax System*, 1984; *Report on a Model Sales Tax for Oregon*, 1985.
3. Now Section 11b, Article XI of the Oregon Constitution.
4. Schools include all public schools from pre-kindergarten through high school and community college. Non-schools include all other taxing districts, such as city and county governments, special districts (such as urban renewal districts, fire and water districts), and taxing units which cross local government boundaries (such as Metro and the Port of Portland).
5. Taxes levied to pay debt service on general obligation bonds are excluded from these limits.

Measure 5's property tax limitations do not affect state revenues collected, because the state does not levy property taxes. However, Measure 5 has the effect of substantially reducing revenues available for state general fund expenditures, because it requires the state to replace local school revenue lost under Measure 5. Through 1996, the state is constitutionally obligated to replace the difference between the property taxes approved for school districts by local voters and the amount the schools may collect under the Measure 5 restrictions.[6] Measure 5 does not require the state to replace revenue lost to non-school taxing units, such as cities, counties, ports and special districts.

When the sum of the property rates for all non-school taxing units exceeds the $10 limit, Measure 5 requires the revenues collected by all the taxing units to be proportionately reduced to meet the limit. This proportionate reduction ("compression") in revenues is also imposed when school district boundaries overlap and their combined tax rates exceed the school tax limit (see Figure 1).

As a result of the changes imposed by Measure 5, state policymakers are facing unprecedented pressures in balancing the state budget and addressing tax reform. While the effect of Measure 5's limitation on local property taxes for non-school purposes varies widely across Oregon, some non-school jurisdictions have experienced substantial cuts. However, Measure 5's effect on Oregon's system for funding local public education is creating the greatest pressure on state officials.

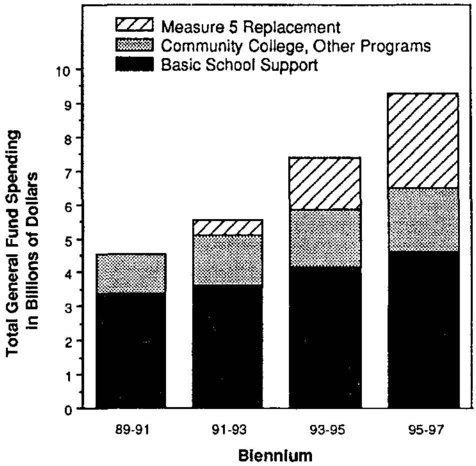
Before Measure 5, public schools in Oregon were funded by a combination of local property taxes, at levels approved by local school boards and voters, and "basic school support" monies from the state general fund. The state's funding assistance to local schools via the basic school support program was purely a matter of state policy agreed upon by the Governor and the Legislature. The amount of state revenue each school district received was determined each legislative session and was distributed according to a school aid formula.[7]

State funding for local schools has become more complicated with the passage of Measure 5. While Measure 5 placed in the Oregon Constitution the requirement that the state spend enough to replace local school property taxes lost due to the Measure 5 limitations, it was silent regarding the state's discretionary basic school support program. As a result, for public schools in Oregon to receive the equivalent revenue after Measure 5 as before, the state not only must pay for all local school property taxes lost, but also must continue the same level of discretionary basic school support. Figure 2 (next page) indicates the state expenditures for local education required if the pre-Measure 5 levels of basic school support are to be continued, with increases to account for inflation and population growth.

6. Measure 5 does not require the state to replace local revenue lost to schools after 1996.

7. The 1991 Legislature adopted a new school aid formula, under which many districts that traditionally have had low spending receive more state money, while districts that have had high spending receive proportionately less from the state. Because the spending levels in many districts will soon reach the Measure 5 cap, the Legislature adopted a distribution formula based on a fixed amount per pupil for each district.

Figure 2
Projected State General Fund Expenditures Required to Fund Education at Pre-Measure 5 Levels

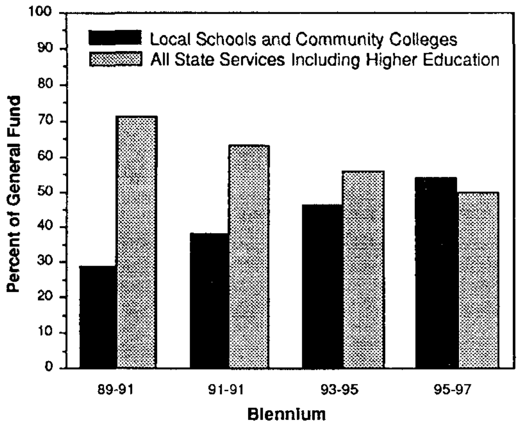


Assumes: Continuation of current service levels for education and basic school support. Except for Measure 5 replacement, increase is due to inflation and population growth. Source: Legislative Revenue Office, Sept. 1992.

Because Measure 5 provides no new state revenues, the new demands on the state general fund to finance local schools pose a significant problem. While there is political pressure to fund schools fully, other demands on the state general fund for ongoing state programs such as corrections, human services and higher education, as well as all other state programs, must also be met.

Even under Governor Roberts' mandated budget for 1995-1997, which includes substantial cuts in state funding for local schools, without additional state revenues the share of the state general fund that would have to be spent to fund local education would increase from 29 percent in 1989-91 to 52 percent by 1995, leaving only 48 percent for other state government programs (see Figure 3).

Figure 3
State General Fund Spending After Measure 5 Without Replacement Revenue



Assumes: Reductions in state services as recommended in the Governor's mandated budget with no replacement revenue. Source: *Governor's Budget in Brief, 1993-1995.*

Another significant effect of Measure 5 is that it is creating a largely state-financed system of K through 12 and community college education. Once a school district reaches the tax rate limit established by Measure 5, it is prohibited from raising additional funds locally, even with local voter approval. Accordingly, the state school fund distribution formula will ultimately determine the total spending level of each school district. This method of funding eliminates most local control over the level of support for programs desired by local school boards and citizens. It appears that Oregon voters generally did not understand this impact of Measure 5 when they approved it.

In short, Measure 5 substantially reduces revenue available to state and local government in a way that diminishes local control. At the same time, Measure 5 has created an opportunity for meaningful discussion of tax reform. While views differ across the political spectrum as to the amount of revenue that state and local governments need, many argue that the state's entire tax system needs re-examination.

B. State Spending Levels

Has Measure 5 created a "gap" or shortfall in revenues? That depends upon your political point of view. Many Oregonians believe that more fat can and should be cut from state and local spending, while others are fighting to save what they believe are desperately needed state services and education from drastic cuts.

The committee learned early in its study that there is no common language or frame of reference for review of the state's budget. Each constituency adopts a language that serves its point of view of the budget. Rather than use an existing framework, the committee's analysis considers total revenue for education and for other purposes collected from major sources only, i.e. the income tax, property tax and sales tax. This way, meaningful discussion of tax reform is not sidetracked by partisan arguments or by discussions of specialized and relatively minor expenditures and revenue sources.

Reviewing all programs and determining the appropriate levels of service are beyond the scope of this report and belong to the legislative process. However, in order to test any tax reform package we needed an expenditure target. The committee chose a target level of 5 percent below current service levels. This level is the choice of at least one witness before the committee, state Senator Shirley Gold. The committee has not endorsed this level of aggregate spending as opposed to any other level. The selection of this target is largely arbitrary, but it allows any proposals for tax reform to be translated into specific dollar amounts. Notwithstanding this choice, the revenue framework that the committee has chosen should work with any revenue target simply by increasing or decreasing the percentages collected in a sales or income tax.

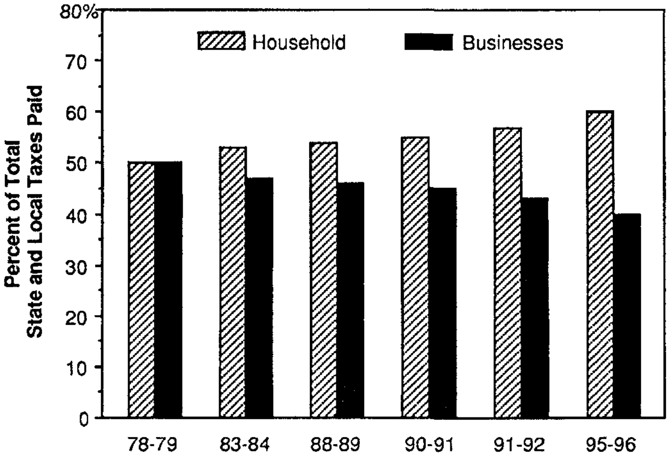
C. Distribution of Tax Burden

One aspect of Oregon's tax system that has historically received attention is the relative distribution of the tax burden borne by businesses and individuals. For many years, this tax burden was nearly equally distributed between two groups of taxpayers.

Since 1978, however, various changes to the tax system have taken place, culminating with Ballot Measure 5. As Figure 4 (next page) shows, these changes have shifted the tax burden to support government services from businesses to individuals.

Figure 4

Overall Tax Burden on Businesses and Households



Source: Legislative Revenue Office, 1992.

D. Criteria for Evaluating the Tax System

The challenge facing Oregonians is to create a tax system which adequately finances state services, including the quality education system we demand, and at the same time satisfies the criteria for a balanced tax system.

The committee tested the reform proposal it reviewed against the following criteria taken from prior City Club reports, the *Model Revenue System for Minnesota*[8] and ORS 316.003.[9] Although each individual element of the tax system need not have all of the desired characteristics in full measure, the composite of all taxes in a package should be designed to satisfy all of the following criteria:

8. Testimony indicated that the Minnesota report is a highly regarded, comprehensive review of the characteristics of a "good" tax system.

9. ORS 316.003 provides:
"(1) The goals of the Legislative Assembly are to achieve for Oregon's citizens a tax system which recognizes:
(a) Fairness and equity as its basic values; and
(b) That the total tax system should use seven guiding principles as measures by which to evaluate tax proposals.
(2) Those guiding principles are:
(a) Ability to pay;
(b) Fairness;
(c) Efficiency:
(d) Even distribution;
(e) The tax system should be equitable where the minimum aspects of a fair system are:
(A) That is shields genuine subsistence income from taxation;
(B) That it is not regressive; and
(C) That it imposes approximately the same tax burden on all households earning the same income;
(f) Adequacy; and
(g) Flexibility.
(3) To meet those goals of Oregon's tax system, any tax must be considered in conjunction with the effects of all other taxes on Oregonians."

1. Understandability

Taxpayers, public officials, and revenue administrators should understand the revenue system. This objective can be achieved by simplifying the revenue laws and educating taxpayers about the tax system.

2. Fairness

Taxpayer revenue burdens should be progressive — that is, the tax burden as a percent of income should rise as income rises; the revenue burdens on taxpayers with equal incomes, consumption or wealth (depending on the basis of taxation) should be approximately equal; and tax bases should be broad and rates low as a result of minimal exclusions. Enforcement should be consistent and even-handed.

3. Competitiveness

Oregon's ability to compete economically with other states and nations should be maximized. On the one hand, taxes should not be so high as to be a negative factor in business location choices. On the other hand, taxes should be adequate to fund high-quality and effectively delivered public services which enhance competitiveness.

4. Reliability

The revenue system should be stable, sufficient and certain. *Stability* means that revenues are relatively constant over the business cycle. *Sufficiency* means that revenues grow with the economy over time, increasing government revenues to keep pace with increasing demands for public services. *Certainty* means that tax laws do not change frequently or significantly, facilitating revenue administration and taxpayer planning.

5. Efficiency

Collection and enforcement costs should be kept to a minimum for taxpayers and revenue administration. There should be maximum compliance, neutrality among different forms of economic activity, and clarity and accountability in state and local relationships.

6. Political viability

A tax reform proposal should be acceptable to voters as a reasonable alternative that is preferable to the present system. Any tax reform proposal must be politically viable, or its creation will be only a futile exercise.

E. Major Proposals for Change

The committee began its analysis by studying other reform proposals. These included the plan proposed by Governor Barbara Roberts in the fall of 1992 (the Governor's Plan), the "balanced option" plan proposed by state Senate Democrats in the fall of 1992 (the Senate Democrat Plan) and House Speaker Larry Campbell's initial one-year tax plan proposed in early 1993 (the Campbell Plan).

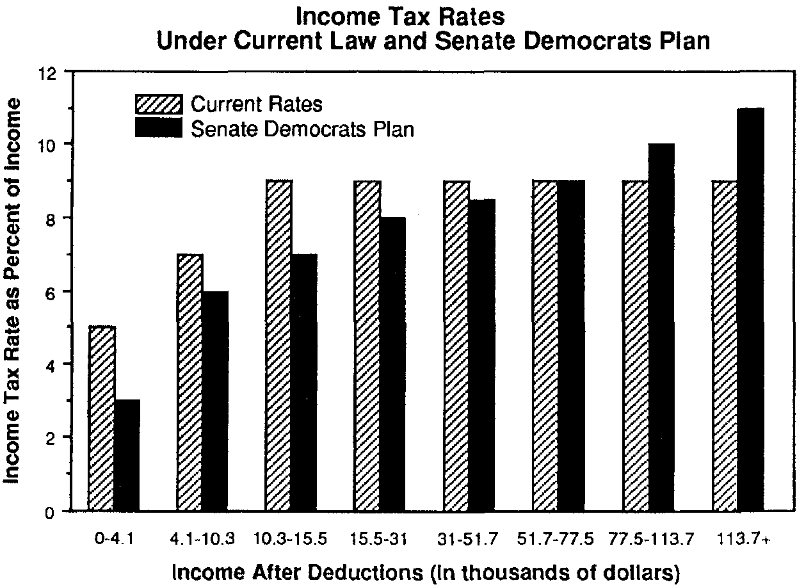
The Governor's Plan and the Senate Democrat Plan both call for dramatic cuts in income tax collections and rates, and propose a sales tax to make up revenue lost due to these reductions and to reductions in property taxes under Measure 5.

The Governor's Plan includes a goods-only sales tax of 3.5 percent, while the Senate Democrat Plan includes a goods-only sales tax of 3.8 percent. Each plan includes a form of split roll property tax, with business property capped at $20 per $1000 of assessed property value and owner-occupied property at $15 per $1000 of assessed property value (cap includes both school and non-school taxes).

Under the Governor's Plan, all taxpayers would receive income tax cuts, with lower- and middle-income groups receiving the greatest benefit. Income taxes under the Governor's Plan would be cut by $300 million during the 1993-95 biennium, by changing the current tax rates of 5 percent/7 percent/9 percent to 3 percent/6 percent/9 percent as applied to current tax brackets.

The Senate Democrat Plan would cut income tax rates for 98 percent of taxpayers, with all but the 2 percent of Oregonians with annual taxable incomes above $75,000 receiving relief. The Senate Democrat Plan would achieve much larger cuts in income taxes than the Governor's Plan, particularly at the lower- and middle-income levels. Under the Senate Democrat Plan, income tax reductions over the 1993-95 biennium of $610 million would be achieved by changing the current tax rates and creating new tax brackets with rates from 3 percent to 11 percent (see Figure 5).

Figure 5



Sources: ORS 316.037 and Senate Democrats Plan, Fall 1992.

The Campbell Plan would freeze the property tax limit at $20 per $1000 of assessed property value and limit assessment increases to 2 percent annually, with a jump to current assessed value upon resale. It allows substantial budget cuts estimated at $500 million in 1993-94.

III. DISCUSSION

The following sections discuss each of the three major tax sources — property, income and sales taxes — and their cumulative impact. These sections will not discuss other revenue sources (sin taxes, lottery, fees, etc.) because, according to the Legislative Revenue Office, they are insubstantial relative to the revenue raised from property, income and sales taxes.

A. Property Tax

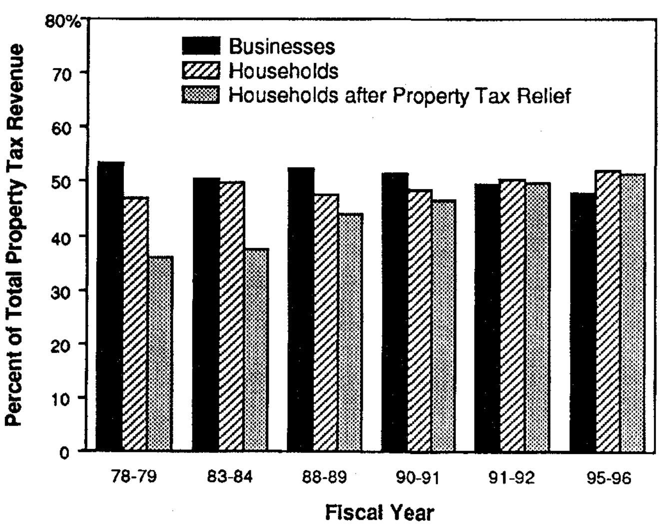
Previously in Oregon, property taxes were levied both by state and local governments. The state property tax was discontinued in 1940. Since then, property tax revenues have been dedicated to local schools and municipal services.

Property taxes are not as progressive with respect to income as other taxes because they are levied on property value, not on the taxpayer's ability to pay (income). The rise in real property values over the past two decades, particularly in the Portland metro area, has made Oregon's tax system even more regressive.

Measure 5 has not remedied regressivity with respect to homeowners. In fact, since 1978, the tax burden in Oregon has been shifting from businesses to homeowners (see Figure 6). According to testimony before the committee, most parties would support some reversal of this phenomenon, shifting some of the tax burden back to business through a split roll.

Figure 6

Property Tax Burden on Businesses and Households



Source: Legislative Revenue Office, May 1993.

The property tax is relatively stable, with values gradually increasing during economic prosperity and decreasing only slightly during recessionary periods. It is the least efficient of the three major revenue sources because of the high costs of administration, including assessment, dispute resolution and collection.

Of concern to many property taxpayers (addressed by the Campbell Plan) is that increases in assessed property values offset decreases in property tax rates. This causes increases in tax payments regardless of Measure 5's decreasing rate. Citizens and legislators have put forth various ideas to address this concern, including limiting incremental assessed value increases and freezing assessments until sale as in California. However, this would create disparities in values between similarly situated homeowners and reduce the desirability and number of home sales. It would further reduce the likelihood that property tax revenues would increase with overall economic increases.

The committee heard significant concern for the fact that Measure 5 has not reduced property tax bills. There appears to be little interest in reversing Measure 5 or returning to higher property tax rates for homeowners.

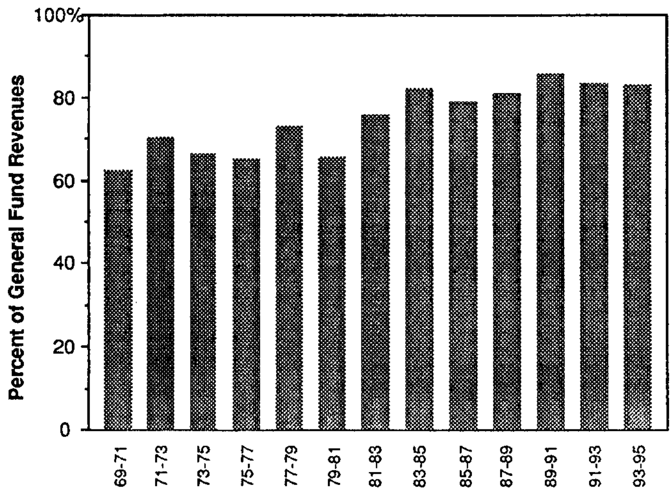
B. Personal Income Tax

Oregonians amended the state Constitution in 1917 to allow an income tax. Six years later, in 1923, the Oregon Legislature passed and voters adopted an income tax. It was repealed in 1924 by a successful initiative petition drive. But rapidly increasing state real property taxes led the Legislature in 1929 to enact an income tax provision again. The electorate adopted this measure in 1930.

Income tax collections became sufficiently high by 1940 for the state to discontinue the statewide property tax. Since then, Oregon's income tax collections have risen dramatically, both in terms of dollars collected and as a proportion of the general fund (see Figure 7).

Figure 7

Income Tax as a Percent of the State General Fund



Source: Legislative Fiscal Office, May 1993.

The Oregon income tax has traditionally been the most progressive of the state's revenue sources. The tax rate from the state income tax tables varies from 5 percent for those with taxable income at or below $2000 to 9 percent for those with an income of $50,000 or more. Oregon has historically used the income tax to offset other more regressive taxes such as the locally generated property taxes and state excise taxes.

Citizens for Tax Justice, in its April 1991 publication, states that Oregon's income tax remains progressive. According to this publication, families in the lowest 20 percent income group pay 1.2 percent of their average income as income tax, while families in the upper 20 percent income group pay 6.2 to 7.6 percent. However, others contend that, as personal income has risen without indexing of the brackets to an outside source or other periodic legislative adjustment, Oregon's income tax has become less progressive. Other data indicate that state limits on deductibility of federal income taxes and capital gains exemptions have somewhat lessened the effect of this bracket creep.

Regardless of the progressivity of Oregon's income tax, Oregon's total tax system is hardly progressive at all, measured in terms of income. According to Citizens for Tax Justice, the progressivity of Oregon's income tax does not fully mitigate the regressivity of real property and excise taxes. Oregon families in the lowest 20 percent income group pay total taxes averaging 9.8 percent of their average income, as compared to families in the highest 20 percent, who pay 9.9 to 10.8 percent.

Furthermore, while the income tax remains the fairest and most progressive part of Oregon's tax system, marginal tax rates on upper-income taxpayers have declined somewhat since 1984. When the City Club issued its 1985 report on Oregon's tax system, upper-income taxpayers paid a top rate of 10.8 percent of their income, as opposed to the current 9 percent.

Oregon currently ranks third in the nation for income tax paid as a percentage of personal income. Testimony suggests that high income taxes may impair Oregon's ability to attract business, because decision-makers and companies with higher-income employees don't want to move to a state with high personal income taxes. Other witnesses, however, stated that income tax considerations rank low in these decisions.

Measure 5 makes it unlikely that Oregon's heavy reliance on the income tax will change. In fact, income tax rates would have to be raised drastically at all income levels if state support for local education and state services were to be maintained near pre-Measure 5 levels.[10]

Shifting dependence away from the income tax would make revenue more stable, due to the high elasticity of the income tax. Income tax revenues can change dramatically with increases or decreases in economic activity. Collections during periods of state economic growth amplify economic activity, providing government coffers with funds that may be more than sufficient. Conversely, income tax collections during an economic downturn may be insufficient to fund even existing government programs. Accordingly, the major source of discretionary funds for state support of schools and state programs displays significant economic volatility. Past efforts to build a "reserve" or "rainy day" fund have mitigated the impact of this elasticity only to a limited degree.

10. One difficulty in making further increases in Oregon's income tax rates is demonstrated by the fact that, of the eight states which ranked ahead of Oregon in marginal tax rates in the City Club's *Report on Oregon's Tax System*, 1984, seven have since decreased their top marginal tax rates.

The income tax is easy and inexpensive to collect. Voters understand income tax collection but are less clear on the services income taxes fund.

C. Sales Tax

Oregon has a long history of fruitless attempts to initiate a sales tax. Oregon voters have rejected sales tax proposals four times since 1968, most recently in 1986.[11]

Generally, a sales tax is regressive because it is based not on the ability to pay but on purchases made. However, exemptions and credits can make it less regressive. The Governor's Plan, for example, exempts food consumed at home, prescription drugs, utilities, intangible personal and real property, animal feed, seed, plants and fertilizer. The Governor's Plan also would provide tax credits for child care and other necessities, based on income level. (These exemptions and credits are fully set forth in the Governor's Plan.)

A sales tax is generally well understood by taxpayers and public officials alike. It is immediately identifiable at the point of sale. The only aspects which need significant public education are the exemptions and credits.

A sales tax that exempts basic items such as food and housing would be somewhat unstable, because the tax would be on purchases made with discretionary income. However, broadening the tax base to include services would offset the narrowing effect of exemptions and credits.

The committee heard four reasons for including services in a sales tax base:

1. Including services would reduce the sales tax rate required to raise the desired revenue.
2. Including services would broaden the base of the tax and increase revenue stability.
3. Including services would mitigate any shift of tax burden from business to individuals, because individuals use more taxable goods and business is the predominant user of services.
4. Including services would make the sales tax more progressive, because businesses and wealthier individuals consume more services than do lower-income households.

An important consideration regarding a sales tax is whether to exempt medical services. It would appear that assessing a sales tax on medical services would impose an additional burden on some individuals who can least afford it.

One of the concerns expressed in electoral battles over the sales tax has been its supposedly high costs of administration. Yet the committee learned that the sales tax, although more costly to administer than the income tax, is less costly to administer than the property tax.

The sales tax is adequate to meet state needs in the sense that collections will increase with growth in the economy over time.

11. In every state with a sales tax, the sales tax was adopted by the state's legislature, not by a popular vote of the people.

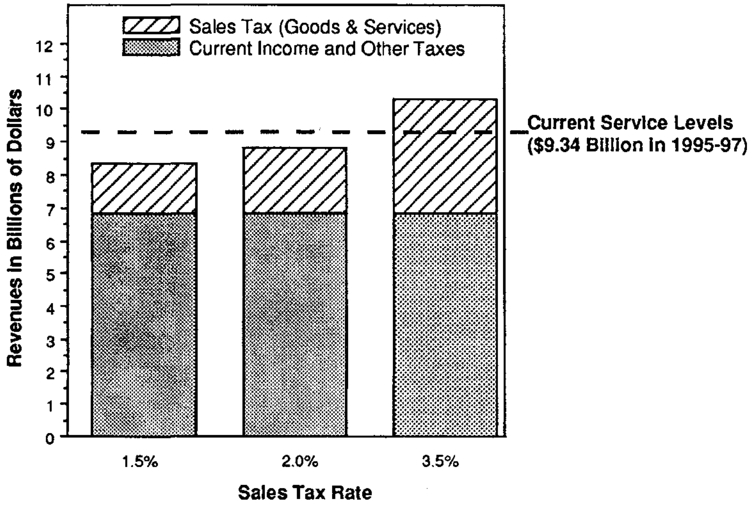
Because Oregon is one of only five states without a sales tax, adding a sales tax at a competitive rate would not significantly alter our competitive position. A low rate would raise substantial new revenue, yet would be competitive with neighboring states which have high rates. The state of Washington, for example, has a statewide rate of 6.5 percent, which can be increased by local option to as much as 8.2 percent.

Other significant concerns to business, especially small businesses (which are the majority in Oregon), include costs of collection, imposition of the tax on components which are purchased for inclusion in manufactured goods, and the ability of business to pass the tax on to consumers. These concerns can be alleviated, if not eliminated. The costs of collection can be addressed through delayed payments and tax credits, and the manufactured goods exclusion through a carefully crafted exemption. Both of these are included in the Governor's Plan. If the sales tax rate is low, businesses should not incur significant consumer resistance.

As shown in Figure 8, with no change in income tax rates, a minimal sales tax on goods and services could allow Measure 5 reductions in property taxes, yet maintain the adequacy of the overall state revenue system. The sales tax rate could be adjusted to achieve the desired aggregate revenue.

Figure 8

Projected State General Fund Revenues Based on Different Sales Tax Rates (1995-97)



Source: Legislative Revenue Office, Sept. 1992.

The political viability of the sales tax remains one of the barriers to tax reform in Oregon. To make it more politically acceptable, the sales tax could be dedicated to basic education. Safeguards such as fixing the sales tax rate in the state Constitution could assure voters that the rate would not increase without voter approval. Such politically motivated assurances as fixing the rate in the Constitution and dedicating the revenues might not be considered "good tax policy" because they remove discretion to meet public needs. However, the committee heard that any attempt to implement a sales tax without the voters' perception of voter-controlled safeguards would likely be overwhelmingly defeated at the polls.

IV. CONCLUSIONS

A. Criteria

Oregon's present tax system and any reform proposals should be evaluated according to comprehensive criteria for a balanced tax system, not according to the politics of particular spending targets or government programs. The criteria for a balanced tax system are: understandability, fairness, competitiveness, reliability, efficiency, and political viability. These criteria should apply to the tax system as a whole.

B. Oregon's Tax System

Oregon's present tax system fails to satisfy the six criteria for a balanced tax system and, therefore, should be reformed. The committee's conclusions with regard to each criterion are as follows:

1. Understandability

Citizens grasp the connection between local taxes and local services and between state taxes and state services. However, especially since Measure 5, the combination of state and local funding for education is poorly understood. To allay this confusion, any new major tax source should be dedicated solely to education.

2. Fairness

The property tax falls too heavily on households. A small split roll element would increase fairness between businesses and households. While increases in property values can make the property tax unfair to those whose incomes do not rise commensurate with property value, freezing assessed values would only introduce a different unfairness — a disparity in property taxes for similarly situated properties. The income tax is the most progressive of taxes and makes the current tax system more fair, but bracket creep has eroded its fairness. Progressivity could be restored by cutting income taxes for lower-income taxpayers while raising income taxes for the very highest income taxpayers. A more progressive income tax could mitigate the regressivity of the property and sales taxes. A sales tax could be fair if applied to both goods and services but not to necessities that lower-income taxpayers use.

3. Competitiveness

While lower taxes may be an incentive and higher taxes may be a deterrent to business competitiveness in Oregon, these tax effects must be balanced against enhanced competitiveness generated by quality government programs financed by higher taxes. Oregon's aggregate tax burden is probably not significantly uncompetitive in relation to competing states, but any increase in Oregon's already high income tax could negatively affect economic development. Introducing a sales tax with a relatively low rate, coupled with reduced property and income taxes, could keep Oregon competitive compared to neighboring states.

4. Reliability

Oregon's tax system, which relies heavily on the income tax offset only by the property tax, is relatively unreliable and unstable. Income taxes rise and fall with fluctuations in economic activity. Adding a sales tax would make the overall tax system more balanced and dependable than the present system in meeting minimal funding levels, particularly in periods of reduced economic activity. Imposition of a sales tax should be offset by adjusting property and income taxes as required.

5. Efficiency

The income tax is the most efficient tax to collect, followed by the sales tax and the property tax. Introducing a sales tax would add new costs of collection, but the burden on small businesses to collect the tax could be mitigated.

6. Political Viability

Measure 5 represents the will of the people that property taxes be reduced, yet most voters did not understand that Measure 5 would eliminate local options for funding. This problem could be addressed by providing limited local authority to increase property taxes for desired programs. Oregonians' historical resistance to a sales tax might be overcome if the proposal were for a tax dedicated to K through 12 education that contained adequate safeguards against increases. Fixing the sales tax rate in the Oregon Constitution would assure that future tax increases be approved by a majority of state voters.

Political viability depends upon the perception of fairness. Business and individual taxpayers alike will perceive fairness in a system that offers continued reductions in property taxes, a more progressive income tax, and a low sales tax made progressive through exemptions and credits. The business community in particular will perceive fairness in a system that has a modest split roll property tax preserving many of the benefits of Measure 5, has no increase in the corporate tax rate, and has a sales tax crafted with sensitivity to business impacts (e.g., mitigate costs of collection, keep the rate low, and exempt manufacturing components). In the final analysis, voters will favor tax reform only if they understand the benefits derived from government services.

V. RECOMMENDATION

To correct the failures of Oregon's existing tax system, the Oregon Legislature should approve and refer to the voters a tax reform package having the elements set out below. The recommended tax reform package that follows is phrased in terms of certain principles of tax reform, followed by specific dollar or percentage amounts that exemplify these principles. The dollar and percentage examples have been calculated to reach the arbitrary target level of 95 percent of 1991-93 state spending levels as discussed in Section II(B) of this report. However, a tax reform proposal based on similar principles could have higher or lower aggregate revenue levels simply by adjusting the various tax rates.[12]

12. Working with the Legislative Revenue Office, the committee developed a spreadsheet with detailed financial information based on recommended rates and revenue targets. This information is available upon request from the City Club office.

A. Property Tax Element

1. Add Split Roll

Adopt a split roll that somewhat increases property taxes levied on businesses and non-owner-occupied residential properties.

For example, non-owner-occupied property tax limits could be $20 per $1,000 of assessed value total with $10 per $1,000 of assessed value for schools, as recommended in the Governor's Plan.

2. Allow Additional Local School Levies

Allow local taxpayers the authority to approve limited property tax increases above Measure 5 limits.

For example, local taxpayers could be allowed to approve an additional property tax level of $1 per $1,000 of assessed value for local schools in three-year levy periods.

3. Accelerate Measure 5 Limitations

Accelerate Measure 5's property tax limitations as necessary to offset new revenues generated from any significant new source of taxation.

For example, if the committee's proposed sales tax were adopted and imposed in 1994, the imposition of Measure 5 limitations could be accelerated one year.

B. Income Tax Element

1. Increase Progressivity

Increase the progressivity of the income tax and reduce the tax rates for most taxpayers, particularly those with lower incomes.

For example, income tax rates could be 3 percent through 11 percent as outlined in the Senate Democrat Plan.

2. Index Tax Brackets

Index income tax brackets according to inflation.

C. Sales Tax Element

1. Adopt Goods and Services Sales Tax

Enact a low-rate, broad-based sales tax on goods and services, with credits and exemptions for consumer and manufacturing component goods as identified in the Governor's Plan.

For example, a sales tax of 2 percent could be levied on goods and services, with credits, exemptions and relief to small business as identified in the Governor's Plan.

2.Fix Tax Rate in Constitution

Fix the rate for the sales tax in the Oregon Constitution.

3. Dedicate Tax Revenue to Schools

Dedicate the revenues from the sales tax to K through 12 education.

Respectfully submitted,

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Brian Teller
Alan Brickley, chair

VI. APPENDICES

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B. Witnesses

Ballot Measure 7
Dreyer, Phil, petitioner
Starr, George, petitioner

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Oregonians for a Sound Economy
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