Review of Oregon's Tax System:

Policy Recommendations

John A. Kitzhaber, M.D.
GOVERNOR

Prepared by the

Governor's Tax Review
Policy Advisory Committee

January 1999

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January 7, 1999

Governor John Kitzhaber, M.D.
State Capitol
Salem, Oregon 97310-0370

Dear Governor Kitzhaber:

It is a pleasure to send you the final report of the Tax Policy Committee. You appointed this committee in July 1998 and charged us to review the following four specific areas:

- What tax policy changes would improve the stability of Oregon's tax system?
- How can Oregon's tax policy be aligned with its environmental goals?
- What tax policy changes are needed to help Oregonians move from welfare to work?
- How can Oregon's tax policy be changed to stimulate employee training and preparedness for high wage jobs?

The report contains a summary of short-term and long-term recommendations plus appendices with detailed analysis of the four areas studied. As requested, the recommendations are revenue neutral to the extent possible.

Oregon's tax system is based on an economy, tax sources and program funding responsibilities which have all changed markedly in recent years. Further, our very short experience with this new situation has occurred under very favorable economic condition in most of the state. The result is that Oregon's new tax system is known to be more volatile than the old one but it is untried under various economic situations and we know that tax policies are no longer in alignment with many of the state's goals. This situation provided energy and enthusiasm to the Tax Policy Committee as we brought together diverse perspectives from throughout the state. We sincerely appreciated the opportunity to work on issues which urgently need attention to assure Oregon's successful future.

The effectiveness of the committee which you appointed was magnified by the efforts and talents of many additional contributors. Special thanks are directed towards your staff and others who provided expertise in the four areas reviewed. They all provided research material and helped focus the committee work into useful conclusions.

Finally, the committee applauds your efforts to review Oregon's current tax system and to create an environment for the necessary tax policy changes.

Sincerely,

Ron

Ronald E. Timpe
Chair, Tax Policy Committee

Chairman, President and Chief Executive Officer
Standard Insurance Company

TABLE OF CONTENTS

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

CHAPTER 2

A. Revenue Stability

Problem Statement

State Government

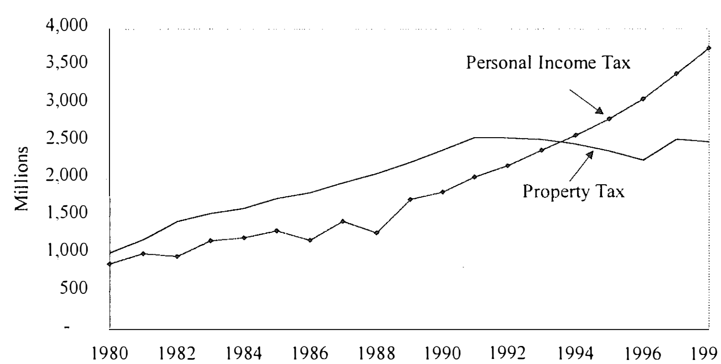
The major finding from Phase I is the state's growing reliance on income taxes (See Figure 1). Oregon is more reliant on the personal income tax for its tax revenue than any other state in the country. This tax is very sensitive to changes in economic conditions. Public finance experts consider it the 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.

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



Income Tax collections adjusted for kicker refunds.

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.

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.

CHAPTER 2

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.

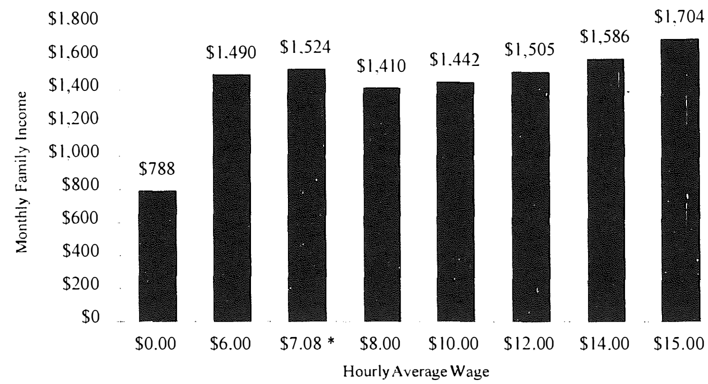
C. Economic Disincentive

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.

Figure 2

Welfare to Work Spendable Income



Assumptions: Family of Three (one adult, two children), child care costs of $650, receiving child support. All clients file tax reports and receive the credits available. Spendable income imcludes food stamps and TANF

* Average wage at placement as of June 1998

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.

CHAPTER 3

TAX POLICY ISSUES

During the Policy Committee's deliberations, three prominent issues arose. These issues do not directly involve tax policy options. However, they are linked to the tax policy debate sure to take place in the 1999 Legislative session. Hopefully a brief discussion here will give further guidance to the state's tax policy-makers.

1. School Finance

Shifting responsibility for school finance is at the root of Oregon's changing public finance system. Before 1990, school finance was mostly a local issue. It is now predominantly a state issue. Governments in Oregon are still adapting to the ramifications of this shift. The Policy Committee believes school finance will be a major issue in the 1999 legislative session and beyond.

The policy recommendations in this report are strongly influenced by the school finance shift. However, the report does not address the issue of local school options. A key distinction between local governments and schools is the fact that schools do not have local revenue options under current law. The establishment of local school revenue options is discussed in a 1996 report prepared by the Governor's Local Option Task Force. This report serves as a good starting point for further discussion of this issue.

2. Tax Incidence

A well-designed objective tax incidence study would be a valuable tool for policy-makers. It would be especially helpful in analyzing major tax proposals. An incidence analysis should be used when considering a number of the long-term alternatives discussed in the appendices of this report.

In Phase I of the Governor's Tax Review process, the TAC recommended development of a tax incidence study. The committee report stated: " Such a (incidence) study would give policy makers a better understanding of equity and business competitiveness issues surrounding the state's tax system."

The incidence of a tax is the distribution of its burden. Tax incidence measures who bears the ultimate burden of a tax. Individuals ultimately pay taxes in one form or another. They pay them as wage earners, consumers, resource owners or stockholders. Tax incidence analysis is an attempt to trace through both initial and secondary effects of taxes and tax changes and determine where the burden ultimately rests.

An incidence study can address a series of questions about the tax system. A sampling of these questions:

- Is the tax system ultimately regressive or progressive? Which taxes contribute most to this outcome? How would a tax change affect overall progressiveness of the system? Is the system becoming more or less progressive over time?
- How much of a state's tax burden is exported to out-of state residents?
- How do tax rates vary among industries?

The Policy Advisory Committee recommends that a tax incidence study be added to the state's tools of tax analysis.

3. Relationship between Government and the Public

A theme running throughout the Policy Advisory Committee discussions was the public's acceptance of tax change proposals. The Governor's charge to the PAC is to make sound common sense proposals regardless of the current political environment. However, public understanding and acceptance is essential for any new tax proposals.

The Policy Advisory Committee recommends that the Governor and the Legislature expand efforts to raise public awareness of state and local public finance issues. Whenever possible the public should be brought into the policy process.

State and local governments should play a leading role in expanding channels for public involvement. The state should work in conjunction with privately funded organizations dedicated to informed public decision making. A task force should be formed to develop innovative ways to foster further public involvement.

A long-term commitment to building public trust in government is a major step toward creating an environment that leads to an improved Oregon tax system.

APPENDIX A

APPENDIX A

A. Short-Term State Government

Problem Statement

Oregon's state government depends heavily on income taxes. Oregon's state government is more dependent on the personal income tax than any other state in the country. Two-thirds of Oregon's state tax revenue comes from the personal income tax. This compares with a national average of one-third.

The personal income tax along with the corporate income tax is highly sensitive to changing economic conditions. Income taxes grow rapidly during good economic times. However, their growth rate drops off when the economy slows or declines. Corporate income tax revenue typically falls in an economic downturn. These two taxes make up 94 percent of Oregon's General Fund. This means that the General Fund is sensitive to changes in the economy.

The General Fund now funds two-thirds of K-14 education (including community colleges) spending in Oregon. It funded one-third in 1990. Consequently, education budgets are now more susceptible to changes in General Fund revenue

Figure 1
Long-term and Short-term Stability Options Considered

	State	Local
Short-term	RECOMMENDED: • Establish stability fund. • Avoid unnecessary dedicated funding. • Manage size and timing of general obligation debt service. RECOMMENDED IF SHORTFALL ANTICIPATED: • Develop guidelines and priorities for cutting budgets. • Enact temporary tax increase. if necessary.	RECOMMENDED: • Prohibit property tax exemptions without revenue compensation. • Restrict state preemption of local revenue. • Increase local revenue alternatives.
Long-term	RECOMMENDED: • Revise Appropriation Growth Limit. OPTIONS DESERVING FURTHER CONSIDERATION: • Establish broad-based consumption taxes / equivalent reduction in income tax rates. • Increase revenue from excise and transaction taxes / equivalent reduction in income tax rates. • Eliminate some state personal income tax credits / equivalent reduction in personal income tax rates.	RECOMMENDED: • Take steps to diversify the local revenue base and decrease local government's reliance on the property tax. OPTIONS DESERVING FURTHER CONSIDERATION: • Foster environment that encourages local governments to diversify revenue sources. • Evaluation of service provision by level of government. • Tax sharing among governments. • Expansion of general revenue sharing.

An economic downturn at some point in the future is inevitable. Turning points in the business cycle are very difficult to predict. This means that an economic downturn is likely to depress income tax growth below projections. This will leave state government with a decision to raise taxes or make reductions in the middle of the two-year budget cycle. K-14 education spending makes up roughly one half of the state General Fund budget. This means that protecting school budgets from unanticipated revenue shortfalls will be increasingly problematic.

The chance of an economic downturn in the near future is growing. Job growth has slowed, corporate income taxes are declining and end-of-the-year personal income tax payments are likely to slow.

In summary, Oregon is highly dependent on income taxes. Income taxes are a volatile revenue source. Funding of K-14 education relies heavily on income taxes. This ties education finance closely to swings in the economy. The state economy is showing signs of leveling off. This adds urgency to the stability issue.

Background

Oregon's economy performed very strongly over the past 15 years. Only the relatively mild 1990-91 recession interrupted a period of steady growth. Strong income tax revenue growth over the 1992-97 period allowed the state to absorb a much larger share of K-12 education funding with only moderate reductions in other state programs.

The committee recognized that the strong income tax growth of recent years was due to a major high technology investment boom in Oregon and an unprecedented surge in stock market values. The Office of Economic Analysis estimates that capital gains income reported for state tax purposes doubled between 1995 and 1997 tax years. By late-1998, these trends have changed. High technology investment spending in Oregon has slowed significantly and stock prices have leveled off. The state's job growth rate has dropped below the national average.

If revenue growth drops below projections, the state General Fund has only a small budgeted ending balance (less than 1 percent in the last two biennium) and a small emergency fund (also less than 1 percent). If these sources are exhausted to fund current budgets, the state must either reduce planned expenditures or enact revenue-increasing measures.

The committee looked at plausible economic scenarios and their impact on the state's General Fund. These scenarios are compared with a base case where the economy grows near its long-term average. Inflation is expected to average about 3 percent a year. Under these conditions, General Fund revenue is expected to grow about 5 percent per year or 10.5 percent per biennium. Lottery revenue is assumed to remain constant.

Revenue generated under the base case is compared with expenditures that reflect a service level equal to the 1997-99 biennium. Expenditures are adjusted to reflect inflation and population growth projections. Expenditures tied to certain groups are linked to projected growth for those groups. In the case of K-12 education spending, growth is based on the forecast for the 5 to 17 year-old population. Growth in public safety spending is partly based on the projected increase in the state's prison inmate population. A portion of human resource expenditures are adjusted to reflect medical service costs inflation.

APPENDIX A

In the base case scenario, General Fund and Lottery resources tend to grow faster than continuing service expenditures. This is because General Fund revenue, through the income tax, is responsive to economic growth. Steady economic growth tends to generate more than enough revenue to fund a constant level of services over time.

The committee recognizes that an economic downturn is inevitable. It wanted to look at situations where revenue growth dropped below its long-term average. Two scenarios were developed. The first is a mild recession. The second is a severe recession based on the state's experience in the early 1980s.

1. Mild Recession Scenario

In this scenario, General Fund revenue falls 5 percent below its long-term growth rate. This reduction in revenue growth is consistent with recession simulations run by the Office of Economic Analysis. The result is spending cuts of 2.6 percent from the continuing service level. These cuts are assumed to occur after a 2 percent projected ending balance and emergency fund appropriations are spent. In the next biennium, even if revenue growth returned to its long-term average, spending would have to be 3 percent below its continuing service level to balance the budget.

2. Severe Recession Case

Roughly matching the revenue shortfalls of the early 1980's, General Fund revenue was assumed to be 6.5 percent below its long-term average in the first biennium and 8.0 percent below its long-term average in the next biennium. These numbers are comparable to the reductions during the 1979-81 and 1981-83 biennia. Spending cuts would have to be 5.1 percent in the first biennium and 13.7 percent in the second to balance the budget. These cuts are in addition to spending the projected ending balance and emergency fund.

The budget scenarios showed some key points:

- The impact of a recession is spread across more than one biennia. This is because the ending balance in one biennia affects resources available for spending in the next.

- State school spending is linked to local school property tax revenue growth. If local revenue growth slows, the state would have to increase spending to meet existing service levels.

- In the case of a severe recession, a reserve fund is unlikely to be large enough to prevent budget cuts.

Many other states have responded to concerns about revenue shortfalls with stabilization funds (See Table 1). Forty-five states have a budget stabilization fund. Thirty-seven states currently have a balance in their funds. For those that do have a balance, the average is 6.3 percent of General Fund spending. Excluding Alaska, which has an extremely large fund, the average is 3.5 percent.

Solutions

1. **The committee recommends that Oregon establish a stabilization fund**. This fund would be a tool for the Legislature and the Governor to manage periods of revenue shortfalls. A reserve fund should have the following characteristics:

- It should be Statutory
- It should be accessible only if certain economic criteria are met.
- Once the criteria are met, the reserve fund can be used only with Legislative majority approval.
- The reserve fund should be used to replace revenue shortfalls in the General Fund.
- The reserve fund should not be used to eliminate all budget cuts during difficult economic times. It should be used along with budget cuts. The cuts should try to preserve core services. The Governor and Legislature should be given flexibility to prioritize services. As a principle for managing shortfalls, each dollar in replacement spending should be matched by an equal budget cut.
- Use of the reserve fund should be coordinated with the 2 percent surplus kicker law.
- Funding of the reserve fund should be through appropriation. A second option is to place a portion of the ending balance from the prior biennium in the fund, if it exceeds a certain level.

The committee developed the reserve fund structure outlined above to insure that the fund is only used in times of serious revenue shortfalls. By setting specific economic based triggers, access to the fund is limited. The committee also felt it important that usage of the fund be combined with budget cuts. State government should be forced to re-evaluate spending in times of revenue shortfalls, like any private organization would under similar circumstances. The committee also recognized that it is not feasible to have a reserve fund large enough to cover a severe revenue shortfall similar to those in the early 1980s. Instead, the reserve fund is designed to give policy makers time to decide how to cut budgets.

The committee also felt that the reserve fund should be coordinated with the 2 percent surplus kicker law. Under certain conditions, the state could be obligated to pay out kicker refunds in the same biennium that it becomes necessary to access the reserve fund. This would not be prudent fiscal policy.

The funding of the reserve fund should be by appropriation. The fund would be treated like any other expenditure. One drawback to this approach is that that it may not be adequately funded initially. Finally, the committee felt the fund should be created in statute since it is an administrative issue. It does not belong in the Constitution.

The committee also considered other funding options. One is changing the surplus kicker refund law. This law provides refunds to taxpayers when revenue exceeds the two-year forecast by more than 2 percent. A portion of this refund could be put into a stability fund. The committee does not recommend this approach because of its impact on public perceptions. However, the committee does recommend that the Legislature retain its current statutory option to temporarily suspend payment of surplus refunds and credits.

Another funding option is a temporary tax dedicated to the reserve fund. A new tax with proceeds targeted for the reserve fund is an option to build reserves. The committee does not recommend this approach because it offers little gain relative to imposing a tax after a downturn occurs.

The committee recommends the following additional steps be taken to help prepare for economic downturns in the future.

- **Maintain flexibility in moving funds from one budget to another.** Dedicated funds make it harder for the Legislature to maintain core services when revenue shortfalls happen. Private sector managers have been moving toward greater flexibility in budget planning. This allows for more efficient decisions when changing circumstances force a change in plans.

- **Use discretion when incurring debt that must be repaid out of the General Fund and Lottery**. Debt service payments have first claim on spending. This restricts the Legislature and the Governor during hard economic times.

Other Recommended Steps

The committee strongly encourages the Governor and Legislature to take steps before the emergence of a budget shortfall. By developing tools such as the stability fund, shortfalls can be managed in a less disruptive way. However, the committee also recognizes that uncertainties are growing in the world economy. This may lead to a revenue shortfall before a stability fund can be created and filled. In case of a shortfall, the committee recommends:

- **Guidelines be established for reducing budgets**. Priority should be given to core functions. State agencies should be encouraged to search for additional efficiencies and productivity enhancing changes.

- **Enact a temporary tax increase if required cuts exceed 2 percent.** A number of temporary taxes including excise taxes, transaction taxes or a personal and corporate income tax surcharge could be considered. Any temporary tax increase should be set so that the revenue increase is matched by equivalent expenditure reductions.

Table 1
Budget Stabilization Funds

State	Budget Stabilization Fund (millions of dollars) FY 1996 (estimated)	FY 1997 (estimated)	FY 1998 (projected)	Percent of General Fund Appropriations FY 1997	FY 1998
Connecticut	80.5	241.0	336.9	2.6	3.6
Maine	38.2	45.5	48.0	2.5	2.6
Massachusetts	543.3	794.1	912.6	4.5	4.9
New Hampshire	20.0	20.0	20.0	2.3	2.2
Rhode Island	52.7	53.4	55.3	3.0	3.0
Vermont	4.8	35.1	36.0	4.9	4.6
Delaware	87.2	92.9	100.9	5.3	5.2
Maryland	461.2	489.3	551.7	6.6	7.2
New Jersey	272.3	327.7	327.7	2.1	2.0
New York	237.0	317.0	332.0	1.0	1.0
Pennsylvania	184.0	221.0	411.0	1.3	2.4
Indiana	439.5	466.2	478.0	5.9	5.7
Michigan	1143.6	1212.5	1287.0	14.6	15.0
Ohio	828.3	828.3	862.7	6.2	6.2
Wisconsin	-	-	-	-	-
Iowa	357.8	430.0	429.0	10.4	9.8
Kansas	-	-	-	-	-
Minnesota	570.0	697.3	522.0	7.2	5.1
Missouri	29.0	120.0	125.0	1.9	1.9
Nebraska	18.2	40.9	98.9	2.2	5.0
North Dakota	-	-	-	-	-
South Dakota	18.2	24.6	24.6	3.8	3.5
Alabama	-	-	-	-	-
Florida	409.4	686.0	788.4	4.4	4.7
Georgia	313.3	315.0	333.5	2.9	3.0
Kentucky	200.0	200.0	200.0	3.5	3.3
Louisiana	-	-	-	-	-
Mississippi	203.0	209.0	221.0	7.5	7.5
North Carolina	501.0	501.0	522.3	4.8	4.6
South Carolina	120.7	127.0	130.4	2.7	2.7
Tennessee	101.0	101.0	95.0	1.8	1.6
Virginia	85.0	160.0	227.0	2.0	2.6
West Virginia	54.7	71.5	71.5	2.9	2.9
Arizona	233.0	243.0	291.0	4.9	5.6
New Mexico	115.9	122.2	113.4	4.1	3.8
Oklahoma	114.3	307.8	307.8	7.5	6.8
Texas	8.0	8.5	45.3	-	0.2
Colorado	156.6	166.7	177.0	3.9	3.9
Idaho	31.9	28.5	28.5	2.0	2.0
Utah	71.8	71.8	71.8	2.4	2.4
Wyoming	14.9	-	22.6	-	4.5
California	113.0	408.0	112.0	0.8	0.2
Nevada	123.0	129.0	129.0	8.3	8.9
Washington	-	-	-	-	-
Alaska	2517.6	3135.9	2972.3	129.7	126.2
Averages:					
Including Alaska	$241.6	$298.9	$307.1	6.3	6.4
Excluding Alaska	$189.9	$234.4	$246.5	3.5	3.7

States without stabilization funds include: Illinois, Arkansas, Montana, Hawaii, and Oregon
Source: National Conference of State Legislatures

APPENDIX A

B. Long-Term State Government

Problem Statement

A narrow tax base is the state's primary long-term revenue problem. State revenue is highly dependent on the personal income tax base. Oregon has no general consumption tax and limited use of excise taxes. Following the passage of Measures 5 and 50, the Oregon property tax burden is likely to fall below the national average.

A narrowly based or unbalanced revenue system leads to a number of problems. Such a system tends to:

- Distort economic behavior. Oregon's overall tax burden is near the national average but taxes on personal income are among the highest in the country. These high rates act as a disincentive for income generating activities such as working and investing. This problem is compounded by Washington's revenue structure, which excludes income from the tax base.

- Create inequities among different groups. Personal income varies greatly over the life of an average person. Most economists believe that wealth and consumption are better measures of people's lifetime earnings. Wealth or value of property is the accumulation of assets over time. Consumption is steadier than income because it reflects longer-term earnings prospects. A system that focuses heavily on the personal income tax base directs most of the tax burden on taxpayers with high current earnings. It misses those with high past earnings or high future earnings.

- Limit options available to policy makers. A balanced system provides flexibility for marginally adjusting taxes as economic and social conditions change over time.

These problems tend to destabilize the revenue system over time. Discouraging productive behavior reduces economic growth. Growing inequities increase the risk of political instability especially through the initiative process. Limiting revenue options makes it more difficult for policy makers to respond appropriately to changing conditions.

Background

Phase I of the Governor's Tax Review thoroughly documented the shift in Oregon's revenue system since 1990. Property tax revenue has been limited by Measure 5. It will be further limited in the future by Measure 50. Personal income taxes have grown rapidly because of a growing base. The result is a revenue system increasingly dependent on personal income taxes to fund public services, especially education.

Oregon's revenue system is becoming increasingly unbalanced compared to other states. Table 2 shows Oregon's tax burden for the major revenue sources compared to national averages. Oregon's personal income tax burden is second only to New York among the states. Oregon's property tax burden ranked 18th in 1995 slightly above the national average. It is expected to drift lower. The sales and excise tax burden is slightly over 1 percent of personal income. This ranks Oregon number 50 among the states. Oregon's overall tax burden of 11.5 percent of personal income in 1995 ranks 28th in the nation, slightly below average.

Table 2
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

Table 3 shows relative dependence on the major revenue sources. Oregon is roughly twice as dependent as the average state on the personal income tax. It is slightly more dependent on the property tax (as of 1995). It is roughly one-quarter as dependent as the average state on sales and excise taxes

Solutions

Revise the Appropriation Growth Limit. Discussion of changes in the state's revenue system should be coupled with a reassessment of state spending limits. Oregon's current appropriation growth limit, which became law in 1979, restricts state spending growth to the rate of personal income growth. However, it has become outdated and difficult to administer. A new spending limit could be designed to restrain government program growth during good times. This could reduce the dislocation caused by economic downturns.

Table 3
Percentage of State and Local Tax Revenue from Major Revenue Sources
FY 1995

	Personal Income Taxes	Property Taxes	Sales & Excise Taxes
Oregon	46.9	41.6	11.5
California	26.2	32.3	41.5
Idaho	29.2	30.8	40.0
Washington	n/a	32.6	67.4
U.S. Average	23.8	35.2	41.0

Source: State Policy Reports, Volume 16, Issue 16, August 1998

Potential Long-Term Solutions

The committee recommends further analysis of each of these potential solutions to the state's unbalanced revenue system. These solutions are fundamental in nature. They should be viewed independently rather than as part of a package. Each deserves thorough study before a specific legislative proposal is put forward.

The purpose of the potential solutions is to generate discussion among policy-makers and the public. The goal is to increase the stability of Oregon's revenue system. This can best be done by making the system more balanced among the major tax bases. There are many ways to do this. Only a few are listed here. Both the personal and corporate income tax should be examined, although the majority of the problems lie with the personal income tax. This committee encourages an open, fresh discussion of these options and others.

1. **Reduce income tax rates and establish broad-based consumption tax.** Lower personal income tax rates will decrease the state's reliance on the personal income tax and reduce its economic disincentive effect. The establishment of a broad-based consumption tax would broaden the state's revenue base. It would also distribute the tax burden more widely. Most importantly for the purposes of this committee, shifting revenue from an income base to a consumption base would increase stability in the overall revenue system.

   Such a shift would bring fundamental change to Oregon's revenue system. The committee recognizes the risks. The most visible risk is to Oregon's economy. Oregon's economy developed in the absence of a broad-based consumption tax. Shifting the tax burden from income to consumption would clearly alter this environment, causing economic hardship to some during a transition period. A second concern of the committee is the potential impact of Internet transactions on the consumption base. The Internet is still in its infancy but it could dramatically change the way people buy goods and services. Finally, the committee voiced concerns over the interaction of a revenue neutral consumption tax proposal with the federal income tax code. Currently, federal tax law allows itemized deduction for income and property taxes. Consumption taxes are not deductible. 42 percent of Oregon taxpayers itemized deductions on their 1996 tax returns.

2. **Reduce personal and corporate income tax rates and increase revenue from excise and/or transaction taxes.** The benefits of reducing personal income tax rates are mentioned in long-term Solution 1. Shifting toward an excise tax base would broaden the state's tax system and make it more stable. Excise and transaction tax increases should be consistent with other state policy goals such as a clean environment and a healthy population

   The committee also recognized that increased dependence on excise taxes carries risks. A high tax rate on individual goods or services changes economic behavior. In some cases, this may be desirable. However, excise tax increases should be as broad as possible to reduce distortions. In addition, the impact across income groups should be carefully considered.

3. **Reduce personal income tax rates and eliminate some personal income tax exemptions and deductions.** Lower rates and a broader tax base would reduce economic distortions. It would also increase stability of the revenue system through lower tax rates.

   The committee supports the concept of a broad tax base and low tax rates. However, it also recognizes that many taxpayers, both business and individual, have made decisions based on the assumption that certain types of income would be treated favorably by the tax system. Careful analysis must precede any elimination of existing tax deductions and exemptions.

Other Recommended Steps

Echoing the Phase I committee, the stability subcommittee recommends that a tax incidence model be established to examine the equity and economic implications of proposals such as the three above.

APPENDIX A

C. Short-Term Local Government

Problem Statement

The ability of local governments to raise revenue is subject to Legislative authority. Legislative actions can erode the local tax base. This is a source of instability and uncertainty for local governments.

There are two primary ways that legislative action can erode the local revenue base:

- **Property Tax Exemptions.** Exemptions that reduce property tax payments of specific taxpayers force local governments to decide between reducing services to all citizens or searching for other revenue sources. This adds uncertainty and instability to local government's fiscal policy decisions

- **Preemption of local authority to raise revenue**. Legislative preemption of existing revenue sources forces local governments to decide between reducing services or searching for another revenue source. Preemption of potential revenue sources hinders local governments' ability to diversify revenue sources.

Background

Radical changes in Oregon's property tax system have altered the relationship between Legislative actions and local government revenue. First Measure 5 and then Measures 47 and 50 significantly changed this relationship.

Under the pre-Measure 50 levy-based property tax system, exemptions would not affect the total amount of local revenue collected unless the local government was in compression. The value of the exemption would be shifted to and spread among remaining taxpayers. Now with Measure 50 in effect, Legislative decisions to exempt certain types of property or provide more favorable tax treatment directly reduce local revenue.

There are many property tax exemptions. The Governor's Tax Expenditure Report for 1997-99 lists 102 property tax exemptions with a revenue impact exceeding $10 billion. Many of these exemptions are consistent with state social goals.

Two issues currently under discussion are examples. The first is the exemption of intangible property from the property tax base. The second issue is the taxation of timber in Oregon. The taxation of private timber is an important source of revenue for many local governments. Legislation to reduce revenue from this source would primarily affect school budgets.

Most Oregon local governments raise revenue through a mix of taxes and fees. In addition, several counties rely heavily on federal forest receipts. Revenue from this source has declined significantly because of decreasing federal timber sales. The nature of the revenue mix is related to the community's preferences and the structure of the local economy. Taxes or fees for business licenses, use of public rights-of-way, meals, hotel stays, public health and safety, and property development are examples of locally determined revenue sources.

On occasion, the Legislature has chosen to preempt local government from certain potential revenue sources. A recent example of such a preemption is the local real estate transfer tax, which local governments are prohibited from imposing until July 1, 2000.

Solutions

1. **Constitutional referral requiring full reimbursement to local governments for lost revenue due to any property exemption passed by the Legislature**. This change would stabilize local revenue while allowing the Legislature to exempt property when it is consistent with overall state goals.

2. **Statutory prohibition on preempting existing or potential local revenue sources.** This limitation will serve to highlight the disruptive impact of preempting local revenue.

3. **Increase options to diversify local revenue.** Local governments should be encouraged to replace dependence on local property tax revenue with other funding sources

D. Long-Term Local Government

Problem Statement

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. Finally, property taxes remain subject to political instability.

Reliance on property tax revenue presents two major long-term problems for Oregon local governments:

1. Local government's reliance on the property tax raises the long-term problem of adequacy. Property tax revenue tends to grow more slowly than income over time. This will almost certainly be the case under Measure 50. Moreover, the property tax system will not adjust to higher rates of inflation. Finally, the shifting economic base is reducing the amount of fixed capital used for production. This will erode the property tax base over time. All of these factors make it more difficult for local governments to meet increased public infrastructure needs and service demands.

2. The property tax is politically unstable. The public in Oregon and throughout the country has shown a high degree of dissatisfaction with the property tax. The public seems reluctant to accept a property tax, based mainly on real estate property value, as a standard for measuring ability to pay taxes. In Oregon and other states, this has lead to restrictions on property tax collections. Measure 5 and Measure 50 fundamentally changed the state's property tax system. However, the prospects for further changes in the system remain high.

Background

The sources of local revenue, including schools, are shown in Table 4 . These figures are for 1994 fiscal year. In some ways, Oregon's local revenue structure looks similar to the national average. Intergovernmental revenue from federal and state governments makes up 37.9 percent of total revenue, identical to the national average. The proportion of own source revenue raised from taxation is nearly the same for Oregon and the U.S. as a whole.

An area where Oregon local governments do stand out is their reliance on property taxes. Measure 5 and Measure 50 have reduced this proportion. It is likely to fall further over time. However, other states have also been trending away from property taxes. In 1978, property taxes made up 79.7 percent of local tax revenue across the country. By 1994, this figure had fallen to 74.8 percent. The percentage of tax revenue raised from property taxes is probably lower today.

In summary, Oregon's local revenue system remains highly dependent on property taxes. Historically this revenue source has been stable but not responsive to income growth over time. Measure 50 will make it even less responsive to income changes, particularly if these changes are combined with rising inflation.

TABLE 4
Percent of Local General Revenue by Source, FY 1994

	Intergovernmental			Own Source Revenues	
	Total	From Federal	From State	Total Taxes	Property Taxes
Oregon	37.9	6.5	31.5	39.6	33.8
California	48.1	4.0	44.2	26.6	18.2
Idaho	41.7	3.3	38.5	30.0	28.5
Washington	43.1	3.6	39.5	30.8	19.1
U.S. Average	37.9	3.8	34.1	39.5	29.5

Source: Significant Features of Fiscal Federalism, October 1997

Solutions

Take steps to diversify the local revenue base and decrease local government's reliance on the property tax.

Potential Solutions

- **Foster an environment that encourages local governments to diversify revenue.** The state should provide research and administrative support for local governments interested in diversifying their revenue base. This should include the development of local consumption taxes. It could also involve tax swaps between income sensitive state revenue sources and less income sensitive local revenues. The clearest example of this would be swapping a portion of the property tax base for a portion of the state income tax base.

- **Expansion of general revenue sharing.** Under current tax laws, the state revenue base will grow faster than the local base over time. It may be appropriate for the state to expand the current revenue sharing program. This could be coupled with a new redistribution system that accounts for variations in local government's tax capacity and public service demands.

- **Service provision evaluation.** State and local governments should work together to examine service provision and determine what level of government is most efficient at providing particular services. This evaluation should be ongoing because new technology and new public service demands change the cost structure of service provision. The provision of county and city services to state government should also be examined. When appropriate, revenue transfers should be considered. The relationship between tax-exempt state property and local finance should be examined.

- **Tax Sharing.** Sharing elastic state tax revenues with local governments can increase the responsiveness of local revenues to changes in the economy. One way to accomplish this would be swapping portions of the property tax base for a portion of the state personal income tax base. Another would be to share the income tax revenues associated with economic development projects with local governments.

E. School Funding

This report does not specifically address the issue of school funding. Instead it is included in the state issues. However, the committee felt that school funding is a very important, timely issue. Some issues identified by the committee are outlined below.

An increasing share of school funding comes from the General Fund. As a result, the stability of school funding is linked to the stability of the income tax. Property taxes are limited and schools have no local options outside this tax. The Governor's Local Option Task Force recommended changes in local options for schools. These changes would give schools the ability to raise additional revenue using non-property tax sources. A discussion of these options necessarily involves an evaluation of the state's school equalization policy.

APPENDIX B

APPENDIX B

GOVERNOR'S TAX REVIEW: ENVIRONMENT

Introduction

Of all the issues, environmental protection and conservation are the most difficult subjects to engage the public for a sustained period. Oregonians feel passionate about their livability but less enamored about the subject of paying for that quality of life.

Compared to most of the world we are blessed, at least temporarily, with most of the resources necessary for a high standard of living. But suddenly, global conditions are telling us that both economic and natural events are affecting us now rather than later.

The subcommittee discussed a wide range of ideas to improve Oregon's environment. These ranged from making our existing programs more effective to the more progressive areas of "green" type taxes. In the limited time available, most of the short-term options selected are integrated to be useful in moving towards the improvement and enhancement of the Oregon Plan and our Healthy Streams Partnerships. These will in turn play important roles in restoring watersheds, conserving fish and wildlife, improving water quality and restoring endangered species. Long-term options reflect difficult subjects, which need more background data and/or discussion, but have potential future applications.

Among the short-term options is a recommendation for pollution tax credits. The subcommittee discussed whether this program should be an economic incentive, an environmental incentive, or both. We approached the issue in an environmental context, recognizing there will be economic impacts.

On the following pages, you will find details about each of these options:

Short-Term Options
- Changes to the Pollution Tax Credit System
- An Integrated Tax System for Agricultural Practices
- Four Tax Incentives for Conservation

Long-Term Options
- Performance Based Approach to Environment Management
- Conservation Incentives Summit
- Environmental Tax Study Committee
- Variable Permit Fees
- Vehicle Miles Traveled (VMT) Fee

APPENDIX B

Short-Term Options

Changes to the Pollution Tax Credit System

Problem Statement

Oregon is currently one of only three states still offering tax credits to offset the cost to business of complying with environmental regulations. The Department of Revenue Tax Expenditure Report shows that Oregon will spend approximately $27 million in the current biennium. While the majority of these tax credits were certified in past biennia, and should not now be revoked, the Pollution Control Tax Credit (PCTC) is an ongoing program under ORS 468.150-190. We should anticipate that the resulting expenses would remain relatively level in each year until the program ends or is revised significantly.

The purpose of the PCTC is unclear, both from a policy point of view, and from existing statute. It is certain from the legislative record that the tax credit was initially an economic development tool. The stated intent was to help existing businesses with the costs of new pollution control requirements. Today the statute has been amended several times and appears to reward desired pollution control benefits from voluntary pollution control actions, and it could be argued that this is the purpose of the program. However, according to Department of Environmental Quality estimates, over 75% of all tax expenditures under this program are credits for facilities that were required by law.

Because the statute appears to have two different objectives, present statutory language makes it much more difficult to obtain a credit for voluntary pollution control than for required actions. It makes no provision for tax credits to companies which may choose facilities which achieve more pollution control than is required by law, and in fact requires that the Environmental Quality Commission (EQC) reduce the amount of the investment eligible for credit if less costly compliance options were available.

One of many factors that the EQC must consider in evaluating a tax credit application is the Return on Investment of a pollution control facility. This requirement introduced considerable complexity into the analysis, and the intended outcome is unclear. If the intent is to defray the cost of compliance then, presumably, a facility that generates its own return reduces the need for compensation. On the other hand, if we wish to reward innovation in finding ways of turning pollution into profit, then the credit might be increased *because* the facility produces some income. Depending on the assumed intent of the program, either approach can be defended, but the statute is not clear on how to apply the Return on Investment requirement.

Because environmental compliance has now been a part of the business landscape for more than 30 years, it is appropriate to reconsider the following issues:

- Does the program primarily serve economic development or environmental goals?
- Is this program the most cost-effective means of providing the benefits?
- Is deferral of business compliance costs still an appropriate use of tax revenues?

Background

In 1967, the original Pollution Control Tax Credit statute was enacted. The statute provides for the EQC to certify tax credits based on the statute and on rules the EQC is authorized by statute to adopt. The available tax credit is equal to 50% of the cost of the facility that the EQC certifies to be allocable to pollution control. The EQC issues a certificate to the applicant who is then entitled to take the credit over a period not to exceed the life of the facility, and not more than ten years in any case. There is no cap on the credits that may be certified by the EQC, either for a single credit, or in terms of program totals.

When the statute passed, the legislative intent was clearly to help cover the cost to Oregon's existing businesses of compliance with new regulations. Since that time, the program has been scheduled for sunset several times, and each time has been extended and slightly revised. Initially, the PCTC applied only to facilities (where facility is defined as the pollution control machinery or construct--not the business operating facility) required by federal or state environmental law. In 1987, the statute was amended to include facilities not required by law, but constructed for the "sole purpose of pollution control". This revision did not modify the original considerations required of the EQC, although it became unclear how they might apply (see return on investment, above).

The PCTC statute is slated to sunset in 2001, although it is likely that legislation will be introduced in the 1999 legislature to extend the program again.

Solutions

The Environment Subcommittee has not reached consensus about the intended or appropriate purposes of the PCTC. We have concluded that there are elements of both economic development and pollution control. We have further agreed that there are cases where some tax credit is warranted for compliance with regulations, where that compliance places the business at a competitive disadvantage. The Subcommittee recommends that the statutes authorizing the PCTC be revised as follows:

1. Eliminate tax credits for compliance with EPA or DEQ regulations except:

- Where Oregon imposes restrictions that require more costly controls than would be required by EPA. The financial impact of this provision would be minimal since state regulations are seldom more restrictive than federal requirements.
- Where geographic conditions lead to differences in the cost of compliance (e.g., water pollution control equipment may need to be more sophisticated in a rainy area of the state) relative to similar businesses elsewhere in Oregon.[1] The financial impact of this provision is unknown since facilities are not currently analyzed on this basis. Administrative costs of this provision would be high.
- Where new or more stringent requirements are imposed and apply to a business which was previously in operation and in compliance with existing regulations when the new regulations

APPENDIX B

[1] There may be constitutionality problems with implementation of this provision.

became effective. There would be no significant fiscal impact under the proposed provision for these tax credits.

2. Authorize tax credits for the marginal cost of facilities that exceed the minimum necessary for compliance. The administrative cost of this provision would be high in order to determine which portion of the facility costs are to meet the requirement (given a particular level of business activity) and which costs are to provide additional environmental protection. The financial impact on tax credits is unknown, but would probably be minimal unless businesses changed the type of facilities they choose to construct.

3. Authorize a pilot program to explore tax credits as a means of recognizing superior overall environmental performance (e.g. through ISO 14000, The Natural Step, etc.). Cap the available credits for this program at $1.5 million per year.

4. Indicate that a business whose commercial product is pollution control is not a "pollution control facility" for the purposes of this statute. Allow such businesses to qualify for tax credits based on the same criteria as other businesses. The rationale here is that the owner(s) of such an entity intend to produce income in addition to controlling pollution. Many aspects of such a business enterprise do not contribute materially to pollution control. However, some tax credit could be granted for pollution control businesses that are not economically feasible without the tax credit. This would serve to encourage the formation of such enterprises. The financial impact of this would be minimal as these businesses have generally been granted tax credits by the Environmental Quality Commission on the same basis as other businesses.

5. Include projects that control significant amounts of non-point source pollution within the definition of "pollution control facility." There would not be any financial impact from this provision as these projects are currently eligible. The change in wording may encourage increased use of the tax credit program.

6. Clarify the legislative purpose within the statute. Consider two separate pieces of legislation that would address credits for voluntary projects apart from tax credits for compliance with regulations.

A Fully Integrated Tax System for Agricultural Practices in Oregon

Problem Statement

Agricultural practices can be a significant source of non-point pollution into Oregon's water bodies. It is difficult to reduce the effect of agricultural practices through regulation because the activities are geographically dispersed and involve individual circumstances.

Background

Many streams in Oregon fail to meet water quality standards primarily because of non-point source activities, including the presence of pesticides and other pollutants in the water column and sediments. Many aquatic species are threatened by nutrients – including nitrogen and phosphorus from fertilizers, animal waste and other organic matter – that enter streams during rainy seasons and concentrate during low flow periods. Approximately 90 percent of the annual surface runoff of suspended solids (i.e. soil erosion) results from non-point source activities. Stream temperatures exceed standards in many segments throughout the state, causing fish mortality or reducing available habitat for fish. On some occasions, non-point sources of pollution can cause excessive stream temperatures.

New programs should be developed to encourage reduction of the adverse impacts of pesticides and fertilizers and control of soil erosion. Vegetative buffers along streams and wetlands should also be encouraged.

Solution

The revenue generation and tax incentives program for agriculture in Oregon should be a fully integrated system. This means the dollars raised by the taxes imposed should be fully utilized for an agricultural practices incentives program and for no other purpose other than the administration of both this tax system and the tax incentives program.

1. **Revenue Generation: Excise Tax on Pesticides and Fertilizers:** Impose an excise tax on the wholesale of pesticides and fertilizers in Oregon. The tax would be based on volume. The statutory tax rate should be determined by estimates of the amount necessary to administer the excise tax system and the amount necessary to cover state costs relating to the tax credit program for high quality agricultural practices (see paragraph 2 below.) There should be a graduated schedule of rates so that purchasers of small quantities will pay a higher rate than purchasers of large quantities.

2. **Incentives for High Quality Agricultural Practices:** Develop a financial incentives program for high quality agricultural practices. With the incentives, cover approximately 50 percent of the cost of implementing and maintaining high quality agricultural practices in accordance with an approved watershed recovery or maintenance plan. These financial awards should not duplicate financial support granted through the Governor's Watershed Enhancement Board, Conservation Reserve Program or other incentive programs. Grant authority to develop an income tax credit program or a grant program at the discretion of the administrative agency. Anyone engaged in agricultural practices that operates according to a state-approved plan (SB 1010, Oregon Plan or similar watershed recovery plans) and implements the best management practices detailed in that plan shall be considered to be instituting high quality agricultural practices.

   Require the practices for which incentives are granted be part of a state-approved plan for watershed restoration or maintenance. This will ensure that state dollars are spent appropriately and efficiently. It will also minimize the tax rate imposed upon wholesale of pesticides and fertilizers.

3. **Administration:** The Oregon Department of Revenue should administer the excise tax program. The Oregon Department of Agriculture should administer the tax credit program.

4. **Estimation of Revenue Raised:** Based on market estimates of 1995 pesticide sales of $131,000,000, these amounts could be generated from a wholesale purchase fee each year:

   At 1% -- $1,310,000
   At 3% -- $3,930,000
   At 5% -- $6,550,000

   For fertilizers, based on 1990 figures of 542,893 tons, total sales for that year came to $105,517,000. Consequently, the following dollar amounts could be generated:

   At 1% -- $1,055,170
   At $0.35/ton -- $190,013
   At $1.00/ton -- $542,893

   At a 1% rate, the financial impact for Oregon farmers would be an increase of approximately 0.2% of "Total Intermediate Farm Expenses" or 0.1% of "Total Production Expenses" according to the 1996 statistics from State Financial Summary Report of the U.S. Department of Agriculture Economic Research Service. Therefore, in keeping with the concept of a graduated tax, the cost per acre for farmers with large acreage would have to be considered in an inverse proportion to the small urban user.

Four Tax Incentives for Conservation

Problem Statement

Oregon already has several incentive programs that could be made more effective. One is the riparian tax incentive program. Although the concept is sound, very little riparian habitat has been restored using this incentive, apparently because the financial benefits to landowners are marginal.

The second program is SB 791, passed by the 1997 legislature after a successful pilot test in Marion and Polk Counties. Under this statute, landowners with an approved plan for managing fish and wildlife habitat are eligible for the same property tax rates available to people actively farming land. Prime farmland is not eligible except under certain conditions. At present, there are few landowners taking advantage of this opportunity. The reasons for the slow response are not entirely clear, but they appear to be related to lack of knowledge about the program and lack of technical support for landowners.

The USDA Natural Resource Conservation Service (NRCS) has numerous programs available to Oregon landowners interested in conservation and restoration efforts. The State recently negotiated an agreement with the federal government through the Conservation Reserve Enhancement Program. Under this arrangement, Oregon will supplement federal investments in the restoration of riparian buffers, filter strips and wetlands along streams that provide habitat for endangered salmon and trout species that cross agricultural lands. The estimated cost of the program over the next decade or so is about $250 million, of which the federal share is about $193 million. 100,000 acres are targeted for restoration. Although this program represents a substantial opportunity to improve the management of riparian areas, barriers remain. Under present circumstances, it is uncertain that the goals will be met. Obstacles include the narrowly defined scope of the program (exclusion of areas where endangered fish do not occur), the lack of technical support for landowners, and some landowner resistance to the implementation guidelines.

Background

Many committees are considering the development of improved incentives for conservation. From this, we may assume that there is a growing recognition that Oregon should better facilitate the effective delivery of programs for better land management practices in Oregon. However, developing a coherent proposal with a broad base of support is challenging. Tax policy can be adjusted to meet broad environmental goals, but only if those goals have been articulated and enjoy widespread support from the legislature, agencies, landowners, and the conservation community.

Solutions

1. **Riparian Tax Incentive:** Revisions to this statute have been proposed. For example, allowing landowners to receive a credit against their income tax for investments in land restoration might work better. Also, limitations on the number of miles restored could be removed, and landowners within urban growth boundaries could be eligible for benefits.

2. **SB 791:** The implementation of this new program should be examined with an eye toward using it to target lands that have been identified as high priority in basin-wide or watershed level plans. At a minimum, county officials and landowners need more technical support and improved outreach. Additional counties should be encouraged to participate.

3. **State Management of Federal Incentive Programs:** The State of Oregon could improve the administration of these programs. Participants need assistance to understand the programs and access funds. Landowners need more technical support to develop land management plans and restoration projects. Some landowners want more flexibility to allow innovative management of agricultural systems in which some commercial use is permitted. Additional state matching funds may be needed. It might be possible for Oregon to receive NRCS funds in a block grant and award them on a priority basis to landowners whose management plans conform to a watershed plan, although this would probably require a change in federal law. Possible mechanisms to provide this flexibility include expansion of the "Oregon Option" and special designation under the National Performance Review. Tillamook County has formed a "Performance Partnership," integrating federal, state and local efforts to achieve specific restoration goals.

4. **A Conservation Incentives Summit:** It would be helpful to take a complete inventory of public and private efforts in Oregon specifically designed to address conservation incentives. After assessing the status of these efforts, Governor Kitzhaber's natural resource staff could convene and facilitate a conservation incentives summit. All parties now engaged in disparate efforts to identify and implement incentive programs should be involved. One goal would be to develop legislative concepts for 1999. Another goal should be to identify the

longer-term issues worthy of more intensive research and evaluation. For example, many programs are underway and more contemplated to "certify" products that are produced sustainably. There may be a role for the State in recognizing and/or encouraging these efforts, and in offering additional incentives to certified producers.

Long-Term Options

Overview

Many notable and interesting ideas were brought to the subcommittee. Some are works in progress, some are being proposed as legislation for the 1999 session, and some are ideas that need more data and an established workable plan. The list includes a variety with different levels of completeness. However, they do provide ideas, which could spark the winds of change.

Performance-Based Environmental Management:

An existing stakeholder group, the Stewardship Group, has developed a legislative proposal outlining a new, performance-based approach to environmental management. The Stewardship Group is an informal group representing 20 to 25 business, academic, government and environmental interest groups. It has been meeting for the past two years, facilitated by Bob Doppelt of the Center for Watershed and Community Health at Portland State University. The draft bill proposed by this group articulates a policy of sustainability for Oregon and offers some principles for addressing conservation issues in a coherent, accountable, and cost effective manner. If approved, this bill could set the stage for further discussion about the role of incentives in encouraging improved environmental management.

The Stewardship Group and the Oregon Progress Board are sponsoring a **State of the Environment Report.** A panel of scientists is developing the report, guided by several stakeholder groups. Scheduled for completion in 1999, the report will serve as a basis for setting specific environmental goals and developing strategies, including adjustments in tax policy, to meet those goals.

Environmental Tax Study Committee:

Problem Statement

Shifting taxes to things we want less of, like pollution and resource degradation, in order to provide incentives for environmental restoration, is a powerful and attractive idea that needs more study and discussion than this subcommittee has been able to provide.

Background

This subcommittee, and many others, have identified the need to create economic and tax incentives that ensure that we all face the true environmental costs of our actions, and that provide incentives for environmental stewardship. However, these committees often operate in an ad hoc manner, have not had the time or financial resources to study these ideas in depth and produce detailed plans for implementing environmental taxes over time.

APPENDIX B

Solution

We recommend the creation of an Environmental Tax Study Committee to develop a plan and proposal for implementing environmental taxes over the next ten years. Ideally, this committee should be established and funded by the Oregon Legislature, but if the Legislature does not act then the Governor should create this committee by his own authority.

The Committee should consist of 12-24 thoughtful stakeholders from industry, agriculture, environmental and public health groups, as well as state legislators. The Committee should be given 12-18 months to develop a detailed proposal for implementing a system of environmental taxes that incorporates environmental costs into economic decisions by individuals and firms to the maximum extent feasible, while minimizing economic disruption in the process. This system should also be designed to result in no significant net increase in tax revenue kept by the state of Oregon. Any increase should be limited to fully funding legislative mandates for environmental and natural resource management. The committee should be provided with funding by the state of Oregon. The Committee should be provided with funding adequate for a coordinator, professional facilitation, and contract research services, and should be encouraged to seek additional support from appropriate federal and state agencies. This effort should be linked to other environmental efforts and processes.

Variable Permit Fees:

Problem Statement

While "point sources" of water pollution have been cleaned up quite dramatically through regulatory and permit processes, there is little incentive--and particularly little economic incentive--for them to be innovative and seek pollution prevention or process changes to exceed these minimum permit requirements.

Background

We have come along way, over the past few decades, in cleaning up "point source" discharges from factories and sewage treatment plants. However, the Clean Water Act's National Pollution Discharge Elimination System (NPDES) goal of eliminating pollution discharges to our rivers and streams is still elusive 25 years later.

Those who hold NPDES permits pay fees that help cover the cost of writing permits, but they do not, in all cases, cover the full damage their pollution does to our watersheds and fish. Furthermore, these permit fees are not based on the actual volume or toxicity of their discharges, so businesses and cities that reduce their pollution still pay the same fee. There are other successful volume-based revenue resources, such as the solid waste fee.

Solution

Develop a new system of NPDES permit fees based on actual discharge volume and the category of pollutant. This system should rank various pollutants into categories based on the toxicity of the pollutant and the degree to which that pollutant is a serious problem in the watershed in question. Facilities without adequate monitoring data to demonstrate actual pollution quantities should pay fees based on their permitted discharge levels.

This system should be designed so that total aggregate fee revenue is comparable to current aggregate fee revenue, plus any additional cost of implementing this new calculation system, but, in any case, does not exceed the cost of providing services. Any revenues in excess of these levels should be returned to the General Fund for distribution as the Legislature sees fit.

There are other successful volume-based revenue resources, such as the solid waste fee. DEQ is studying this approach for other pollution sources, along with toxicity, as part of the agency's long-term funding plan.

We recommend that DEQ be directed to appoint an advisory committee, including a range of interests, to help write the rules implementing the new fee structure for NPDES permits.

Vehicle Miles Traveled (VMT) Fee:

Problem Statement

The Portland Metropolitan Area is teetering on the edge of non-attainment of the Federal Clean Air Standards. Transportation vehicles are a principal source of air pollution, emitting 90% of the carbon monoxide emissions and resulting in more than 50% of the ground-level ozone nationally, and yet (with the exception of the Vehicle Inspection Program), most of the attention is given to industrial point sources of air pollution.

Background

A reduction in "vehicle miles traveled" would help maintain Oregon's quality of life in three significant ways:

1. Improve air quality,
2. Reduce the funding requirements for road and highway maintenance, and
3. Reduce congestion on our roadways.

DEQ has concluded that in the Portland airshed, Volatile Organic Compounds (VOCs) are the most important ozone-forming chemicals to control.

According to the Oregon Environmental Council, a $.02 per mile VMT fee would result in a 4-5% reduction in vehicle miles traveled. At $.05 per mile, miles traveled drop by about 10%, and at $.10 per mile they drop by nearly 20%.

Solution

Authorize DEQ, ODOT and DOR to develop a pilot project for a VMT fee. The objectives of the pilot project must be that it is aimed at improving air quality, reduce the use of the highway system and reducing congestion during peak travel times. The pilot project would study different collection mechanisms. Collection criteria shall include ease of collection, cost of collection, and likelihood of fraud and/or tax evasion. The pilot project should also address equity issues as they pertain to low income persons and urban vs. non-urban drivers. The VMT fee imposed as part of the pilot project should not exceed $.02 per mile traveled. At $.02 per mile, a family traveling 12,000 miles per year would pay $240 before any adjustments. The pilot project should include an evaluation component, which would measure the impact the VMT fee has on driving patterns.

APPENDIX C

APPENDIX C

GOVERNOR'S TAX REVIEW: ECONOMIC DISINCENTIVE

Introduction

One of the issues that has become apparent as more families in Oregon have moved from Welfare to Work is the inconsistent effect on spendable income. "Transition" subsidy programs, such as Food Stamps and Employment Related Day Care (ERDC) and state and federal taxes, including both income tax rates and credits have an impact. Particularly for families with child care costs, there are points on the income scale at which earning an additional dollar will result in a ***decrease*** in spendable income. This is because as earnings increase, eligibility is reduced or ended for a particular subsidy or subsidies.

Such dips in net spendable income are problematic for workers and employers alike. Obviously, a worker who loses spendable income after getting a raise suffers a penalty for work effort, when such effort ought to be rewarded instead. But, employers, too, are ill-served by a tax and benefit system that undermines the incentives of a compensation system designed to reward effort and encourage productivity. Mitigating such disincentives in our tax and benefit system will benefit workers and employers alike.

The Economic Disincentive Subcommittee (formerly the Self-Sufficiency Subcommittee) was charged by the Governor to investigate ways to provide for smooth transitions to economic independence. In particular, the Phase I Task Force presented us with the following questions:

- Should tax credits and subsidies be coordinated better so that increased earnings do not result in a lower standard of living and lower spendable incomes?

- Should tax credits that encourage and support work effort by low income Oregonians be refundable?

A Framework for Assessing Policy Changes

Both of these questions relate to tax and subsidy policies that seek to encourage work among those with low incomes. The first asks whether taxes and subsides can be coordinated to reduce the economic disincentives for some low income workers. The second asks whether incomes of the working poor should be made more adequate through a refundable tax credit.

Both questions confront the fundamental conflicts between benefit adequacy, behavioral incentives and public cost in any policy change that attempts to improve the economic situation of low income populations.

- A program change that improves the economic situation of the poor will provide work disincentives or increase public costs.
- A program change that increases the economic incentives to work or care for children will reduce benefits for some or increase program costs.
- A program change that reduces program costs will create work disincentives or reduce benefit levels for some participants.

APPENDIX C

This conflict among social goals was articulated by Henry Aaron in 1972, who labeled it the "iron triangle". Policy makers cannot affect one aspect of this "iron triangle" relationship without affecting the other two.

Oregon's Tax and Subsidy System for Low Income People

The structure of Oregon's system of state taxes and subsidies for low income population is quite complex. The most important elements of this system are: (1) the personal income tax with three nonrefundable state tax credits; and (2) two subsidy programs (Employment Related Day Care and Food Stamps).

Personal Income Tax

The structure of a tax is determined by its base and its rate.

Oregon excludes from its base certain sources of income (such as Social Security) and income below a "tax-free minimum level." The amount of this tax free minimum is an important factor in how much taxes low income people pay. In Oregon this minimum varies by marital status and family size, as shown in Table 1. The table shows that Oregon does require some persons substantially below the poverty level to pay state income tax. As was noted in the Key Findings section of the Review of Oregon's Tax System report that led to formation of this committee, " Income tax liability begins at a relatively low income level in Oregon, thereby creating a possible disincentive for moving into the workforce." While this committee did not address this possibility, we believe it deserves further study.

Oregon has a progressive rate structure, with taxpayers having higher taxable incomes paying higher rates. For 1997, Oregon Personal Income Tax rates vary from 5 percent on the first $2,250 ($4,500 for couples filing jointly) to 9 percent on the amount of income over $5,700 ($11,400 for couples filing jointly). However, actual tax liability after exemptions and credits shows a significantly different picture (Table 2).

Oregon has three nonrefundable tax credits for limited income workers: the Earned Income Credit (5 percent of federal EIC), Working Family Credit (a percent of qualifying child care expenses determined by household size if income is less than 200 percent of poverty level or about $2276 for a family of three), Child and Dependent Care Credit (a percent of qualifying child care and dependent expenses determined by family income for those qualifying for federal child and dependent care credit).

There are three important structural elements of a tax credit:

1. maximum credit;
2. benefit reduction rate, the percent that the credit is reduced for each additional dollar earned;
3. phase out level, the income level at which the credit is no longer given.

Table 3 shows these elements for each of the three tax credits.

Subsidies and In Kind Transfers

There are two important subsidy programs that affect low income populations:

1. Employment Related Day Care, a state payment to child care providers paying a portion of the child care costs for low income workers. The size of the copayment required of the worker increases as family income increases.
2. Food Stamps, a federal program that allows the purchase of food by low income people. The value of the subsidy declines as the family income increases.

As with the tax credits, there are three important structural elements of subsidy programs:

1. maximum benefits,
2. benefit reduction rate,
3. phase out level.

These are shown in Table 3.

The Cumulative Marginal Tax Rate Problem - Economic Disincentives Facing Low Income Workers (Note: by "marginal tax rate" we mean both the impact of taxes and loss of benefit dollars from subsidy programs).

Some low income workers face serious economic disincentives to working more or working at higher wages because of the interaction of the tax and subsidy programs outlined in the previous section. In many cases, if they earn an additional dollar, their net spendable income increases very little. In some cases, their net spendable income actually declines when they earn additional income.

An example of a single parent with two children shows how this works. (This example uses the information from Chart B.) Consider what happens when this worker earns an additional $187 per month as she (more than 90% of Temporary Assistance for Needy Families (TANF) households are headed by a single female) moves from a job paying $6.00 an hour to $7.08 per hour. Her FICA tax increases by $15. Because state tax credits offset her state tax liability, she pays no state tax, and no federal income tax. The increase in earnings leads to three changes in tax credits and subsidies that reduce her net spendable income: (1) her federal EITC is reduced by $38; (2) her copay for child care increases by $47; and (3) her food stamp benefits are cut by $44. Net spendable income increases by only $43 as a result of the wage increase of $187. For a single adult with two children earning between $6 and $8 per hour (annual gross incomes of $12,000 to $16,500), implicit marginal tax rates (for those who participate in ERDC and Food Stamps and claim available federal and state tax credits) are about 75 percent.

So even though the individual benefit reduction rates for any of these three programs individually do not exceed 25 percent (20 percent, 25 percent and 24 percent, respectively), the cumulative effect of these rates and the 7.65 percent FICA tax produce an implicit marginal tax rate of 77 percent. Net spendable income increases only 23 cents for each additional dollar earned by workers in this situation. For this same single parent with two children whose wages increase from $8 to $10 per hour in full time work, implicit marginal tax rates can exceed 100 percent. Net spendable income declines as wages increase. In the example in Chart B, the increased earnings of $346 leads to a $73 reduction in the Federal EITC, a $256 increase in the Employment Related Day Care (ERDC) co-payment and a $117 decrease in Food Stamps. When combined with the $26 increase in FICA, the net spendable income of the family decreases by $125 as gross income increases by $346. The implicit marginal tax rate is 137 percent.

For comparison purposes, the marginal tax rate on a single parent worker with two children earning $50,000 per year is 42 percent. For the same worker earning $100,000 per year the tax rate is 36 percent.

Oregon's new Working Family Credit can create similar effects for working families. The credit is calculated as day care costs times a percentage, with the percentage starting at 40% at low incomes and phasing down to 0% as income rises. Because the phase-out occurs rapidly over a fairly narrow income range, a small increase in income causes a large decrease in the credit, raising taxes dramatically. For example, a married couple with 2 children with an annual income of $30,000 and child care costs of $600 per month receives a working family credit of $1,152 and pays Oregon income tax of $160. If the couple's annual income increases to $31,000, their working family credit falls to $576 and their Oregon income tax rises to $826. The couple's federal income tax will increase by $150, and their FICA tax will increase by $76.50. Their combined tax increase due to the $1000 increase in income is $892.50, which is an effective marginal tax rate of 89.25 percent. One of the specific charges to this subcommittee was to consider ways in which the tax and subsidy system could be altered to avoid implicit marginal tax rates of more than 100 percent. As discussed earlier, any attempt to address the economic disincentives thus involves either reducing subsidies for some workers or increasing program costs (or reducing tax revenues).

A. Short-Term Recommendations

Problem Statement

Except in rare circumstances, families are significantly better off financially when they move from Welfare to Work. However, as discussed above, for many families with child care needs on the lower end of the wage scale (whether or not they ever received cash assistance from the State), there comes a point at which an increase in income will cause a decrease or "dip" in their spendable income. See charts A & B. This issue primarily affects families with child care needs who are served by the Employment Related Day Care Program (ERDC) but may also affect Food Stamp program recipients. As income increases, the required ERDC "co-payment" increase, along with declines in other subsidies can cause a significant decrease in spendable income. The point at which such a decline happens can range anywhere from minimum wage to $14 per hour, depending on which programs are included and the personal circumstances of the family. However, on the average, for families using the ERDC program the "dip" will occur in the $7 to $12 per hour range, or from about 100% to 185% of poverty.

Background

This Subcommittee has analyzed the impacts of federal and state income taxes and benefit programs on the spendable income of a family of three, with one adult and two children and focused on those making $12 per hour or less in full time employment. This is the most common family size for low-income workers receiving ERDC benefits. We have also looked at data for a family of two (one adult and one child), which is the most common size for welfare (TANF) recipients. We have received information, input and recommendations from Adult and Family Services Division, Department of Revenue, Progress Board, Oregon Center for Public Policy, Ecumenical Ministries of Oregon, Commission for Child Care, Office for Oregon Health Plan Policy and Research, and Department of Housing and Community Services.

We have reached consensus on the following **preliminary findings**.

1. ***Not only does a "dip in net spendable income occur as certain low-income workers move to higher pay rates, but this dip persists as these workers move to even higher pay rates before they eventually achieve a gain in net spendable income.***

   The most extreme example we found is illustrated in Chart A, where a 7.5% decline in spendable income occurs when a worker in certain circumstances moves from a pay level of $7.08/hour to $8.00/hour. In these circumstances, the worker does not recover the spendable income experienced at $7.08/hour until she achieves a pay level of more than $12.00 per hour.

2. ***These "dips" in net spendable income are not often caused by our tax system, but by the phasing out of government subsidies for such purposes as food ("federal food stamps) and work-related child care (state Employment Related Day Care (ERDC)).***

   Even in the extreme scenario illustrated in Chart A, federal and state income taxes are not the cause of the dip. For a single adult with two children, receiving child support, participating

APPENDIX C

in the state child care subsidy programs, and having actual child care costs for both children, the net state income tax liability remains zero until the worker is earning $ 14.00/hour. The same is true for federal taxes. Even as the refundable Earned Income Tax Credit (EIC) phases down, federal taxes owed do not exceed the credit until the worker is earning $14.00/hour.

As Charts A and B illustrate, and as all the scenarios we have examined so far confirm, the "dips" are experienced by subsidized low-income workers, who are most often single heads of households with significant child care costs.

The causes of these dips are subsidy programs, which target similar populations of low-income workers but were created at different times for different purposes. Although no single program was designed to withdraw more than a dollar of support for an additional dollar earned, the effect of phasing out subsidies for more than one program, combined with the phase-down of federal income supports via the EIC program, often has that effect -- especially for single heads of household with significant child care costs.

3. ***The phase-out of child care subsidies under the state's Employment Related Day Care program is the largest single contributor to the dips in spendable income identified above.***

   Low-income workers with high child care costs suffer the deepest and most persistent dips in spendable income as they move to higher pay levels, since they receive a greater portion of their spendable income from child care subsidies. As that subsidy is phased out, and the phase-out accelerates as income increases, the worker is forced to bear more of the cost of work-related child care. This cost combined with the loss of food stamps, declining amounts from the federal EIC and, potentially, other costs not identified on Charts A and B (e.g. higher health care premium payments resulting from reductions in state health care subsidies), often claims more than a dollar in spendable income for each additional dollar earned.

Other Issues/Points of Inquiry

1. With two different state child care credits now available for personal income tax payers, are these credits duplicative or inefficient? Should they be combined into one? Because the two credits target different income levels, there is not necessarily duplication or inconsistency in the credits. However, the Subcommittee does recommend that as we gain more experience with the usage patterns of these two credits the possibility of a combination should be reviewed.

2. The Office of Health Plan Policy and Research is preparing recommendations for legislation to establish a targeted tax credit for health insurance costs borne by families below 200% of the federal poverty level, who are not already covered by some type of subsidy for health care. It appears, based on limited information, that this tax credit would serve to improve the health care side of the equation so that this Subcommittee would not need to be concerned about including that specific issue in our options. That is, a broad spectrum of health care coverage options, including this proposed tax credit, would be available to ensure that health care affordability does not have a significant negative impact on spendable income as wages

increase. However, the potential cost for this option needs to be weighed in concert with other options suggested to deal with the dip.

3. We have also looked at housing assistance program issues. While housing costs and availability remain serious issues for Oregon's low income population, the structure of housing assistance programs does not seem to be a significant contributor to the spendable income "dips", and thus will not be further addressed by the Subcommittee.

Options

The Subcommittee has asked the question "Should the problem of 'dips' in spendable income be addressed through changes in the tax system, changes in the various subsidy programs or both? There are pros and cons to each approach. In general, it appears that an earned income tax credit solution would serve more families (especially those not using the current subsidy programs), but, per dollar invested, would not reduce the "dip" as efficiently as a program approach (e.g., reducing the Employment Related Day Care (ERDC) co-payment).

Additionally, in looking at income available to these families, there was unanimous agreement among the members that there was no short-term option that would be budget neutral. While, in theory, the dips could be eliminated by reducing subsidies on the lower end of the scale, that income is already so marginal that reductions would not only be impractical but might serve to undermine employment to the extent that families would lose jobs and return to cash assistance.

For those reasons, the Subcommittee considered six possible options. These options include both tax based and program based approaches, and include basic information about the cost of the option, the number of households served, and a representative income picture that can be compared against the current policy picture.

Recommendations:

The financial burdens of child care are most acute at the lowest end of the wage scale. However, due to nonrefundability, financial benefits of the Working Family Credit begin to become available only at the $6.00 per hour rate and become fully available only at the $12.00 per hour rate. This means that those most in need do not obtain the full benefits of the program. Given that there is no identified resource allocation available to attach to any option, and given that each option has a fiscal impact, the following recommendations are made by the Subcommittee.

1. The Subcommittee recommends option #1, making the Working Family Credit refundable ($13 million), as the highest priority. This would make the full 40% credit available to all families earning less than $10.00 (for a single parent and two children) and on a reduced basis to families between $10.00 and $13.50 when the program is phased out. In maximizing this credit, a more gradual phase-out schedule is recommended. Additional cost for this phase out improvement is approximately $5 to $6 million per biennium. Further, consideration should be given to a method of distributing a portion of this credit on an "advanced" monthly basis, similar to the Federal EITC to help assure the money is available as needed rather than just once a year.

2. The Subcommittee recommends, as an alternative or second priority, option #5, improving the Employment Related Day Care program to limit the co-payment to 10% of salary up to

150% of the poverty level ($8.6 million). However, the subcommittee cautions that the combined adoption of both options created a substantial "dip" at the $10 to $12/per hour range. See chart E for the combined effects of the adoption or recommendations 1 and 2. This is a further example of the need for a comprehensive treatment and coordination of subsidy programs as discussed below.

OPTIONS	*ESTIMATED BIENNIAL COST*	*NUMBER OF HOUSEHOLDS COVERED*	*IMPACTS*
1. Make the Working Family Credit refundable	$13 million	Households: 17,400 Persons: 54,000 Tied to child care	See Chart C Broad spectrum help to $12/hr, mitigates dip
2. Make the Oregon Earned Income Credit refundable	$12 million	Households: 180,000 Persons: 500,000 No child care tie	Helps below $10/hr, little effect on dip
3. Increase the Oregon EIC from 5% to 14%, refundable	$62 million	Households: 180,000 Persons: 500,000 No child care tie	Helps to $12/hr, little effect on dip
4. Increase the Oregon EIC from 5% to 14%, non-refundable	$23 million	Households: 160,000 Persons: 440,000 No child care tie	Helps from $7 to $12/hr, mitigates dip
5. Improve ERDC co-pay to 10% of income to 150% of Poverty Level	$8.6 million	Households: 15,540 Persons: 46,775 Tied to ERDC only	See Chart D Helps at $8 to $10/hr, good effect on dip
6. Improve ERDC co-pay to 10% of income to 175% of Poverty Level	$29.3 million	Households: 18,208 Persons: 54,803 Tied to ERDC only	Helps at $8 to $12/hr, good effect on dip

B. Long-Term

Problem Statement

The dips in income that families experience as they progress up the wage ladder are a result of both individual program issues (such as the Employment Related Day Care (ERDC) co-payment) and the manner in which programs interact. If you consider the situation depicted in chart A, the move from $7.08/hr to $8.00/hr included an increase in earnings but a decrease in federal Earned Income Credit, a higher ERDC co-payment, and an end of Food Stamp program eligibility. This yields a net spendable income loss of $114/month, despite an earnings increase of $160.

Background

As subsidy programs (and tax credits) were developed over the years, they were developed for specific purposes, by different agencies, using different eligibility criteria. As a result, it is not surprising that the benefit structures don't complement one another in an integrated fashion. Additionally, as many of the families in this situation are headed by a single parent, the question of the adequacy of child support payments has been raised.

Only about one in five families receiving Temporary Assistance for Needy Families (TANF) benefits also has child support being paid by the absent parent. One reason for that poor record is that there are so many TANF families who, for a variety of reasons, do not have a child support order established. For families not on assistance the picture is better but not good enough. About 70% of families with a child support order in place receive support, but only about 62% of the current support is paid. Additionally, there remains about $800,000,000 in unpaid child support (arrearage on established orders). While improvements are being made (e.g., employer reporting, in-hospital paternity establishment), they will not likely be of a breakthrough nature, and do not hold the promise to either fix the problem of the income "dip", or provide a general boost to low income families.

Long-Term Options

Coordination and integration of the current subsidy programs offer the possibility of a more comprehensive solution to the spendable income dips that are caused by the cumulative impact of separate programs all phasing out their subsidies at approximately the same pay levels. But, given the complexity and difficulty of this approach, we must consider this to be a longer-term option. Such coordination would, literally, take an act of Congress to allow the state to coordinate benefits and reprogram eligibility to achieve a more rational outcome. Certain programs over which the state has more control (e.g., the ERDC program) could be adjusted for a smoother benefit curve, but without including all state and federal programs in the mix, some of the dips would persist and this adjustment would increase budgetary costs unless benefit levels were reduced for some low income families.

Table 1: Impact of Child Care Credits on Taxable Income Threshold

Income at which Taxpayers Become Taxable Under Oregon's Income Tax
Tax Year 1997

	EIC and Child Care Credits			
	EIC Only	Monthly Child Care Costs Per Child		
	$0	$100	$200	$300
Single Without Children	$4,510	NA	NA	NA
Head of Household with 1 Child	$9,165	$15,900	$18,050	$19,100
Head of Household with 2 Children	$12,010	$21,490	$24,000	$25,350
Married Without Children	$8,040	NA	NA	NA
Married with 1 Child	$11,350	$17,660	$21,350	$22,650
Married with 2 Children	$13,915	$24,100	$27,860	$28,900

Assumptions: All eligible taxpayers utilize the Oregon Earned Income Credit.
All eligible taxpayers with child care costs utilize the Oregon Working Family Credit and the Oregon Child and Dependent Care Credit.
All eligible taxpayers use the standard deduction.

Federal Poverty Level for 1998

# in Household	Monthly Income	Annual Income
1	$ 671	$ 8,052
2	904	10,848
3	1,138	13,656
4	1,371	16,452
5	1,604	19,248
6	1,838	22,056

Table 2: 1995 Oregon Personal Income Tax

Distribution by Decile

Income Range	Decile	Percent of Total Tax	Effective Tax Rate
Less than $4,034	Lowest 10%	0.1%	N/A
$4,034 to $8,269	Second 10%	0.6%	1.8%
$8,269 to $12,659	Third 10%	1.4%	2.6%
$12,659 to $17,399	Fourth 10%	2.6%	3.4%
$17,399 to $23,007	Fifth 10%	4.3%	4.2%
$23,007 to $30,011	Sixth 10%	6.3%	4.6%
$30,011 to $38,866	Seventh 10%	8.8%	5.0%
$38,866 to $50,362	Eighth 10%	12.2%	5.4%
$50,362 to $69,022	Ninth 10%	17.3%	5.8%
$69,022 and above	Top 10%	46.6%	6.8%
	Total	100.0%	5.6%

Source: Oregon Department of Revenue, Research Section

Table 3: Oregon's Low Income Tax Credits and Subsidy Program

	Program	Eligibility	'97 Families Participating	Maximum Amount	Benefit Reduction Rate Per Income Increase	Income Level at Which Program Phases Out
TAX CREDITS	Earned Income Credit (nonrefundable)	Employee must have earned income from a job and earn less than $29,290 and have qualified for and claimed EIC on federal tax return	180,000	5% of federal EIC, with a maximum of $183*	20%*	$29,290 (220% FPL*)
TAX CREDITS	Child and Dependent Care Credit (nonrefundable)	Employee must have qualified for federal child care credit and earned income and paid for child care in order to work or look for work.	55,000	$1,440 for families within incomes of $5,000 or less	Credit reduced in broad income category steps: for family with 2 children credit is reduced $720 at $5,001, $336 at $10,001, $104 at $15,001, and $48 at $25,001 and $35,001	$45,000 (330% of FPL*)
TAX CREDITS	Working Family Tax Credit (nonrefundable)	Employee must have earned income (at least $6,000 but not more than 200% of poverty level) and paid for child care in order to work or go to school.	16,500	40% of qualifying child care expenses (no maximum)	15%* paying $433/month for child care	$26,650* ($58,850 for household of 8 or more) (156% FPL)
SUBSIDIES	Employment Related Day Care	Employee must require day care in order to accept or maintain employment. Family income must be less than 200% of poverty level	13,315		At $8,904* BRR is 19%. Increases to 70% at income of $24,000	$25,056* (185% FPL)
SUBSIDIES	Food Stamps	Household incomes must be below amount that depend on family size.	112,988	$313*	Benefit decreases by $30 for each additional $1.00 of income	$16,368* (130% FPL)

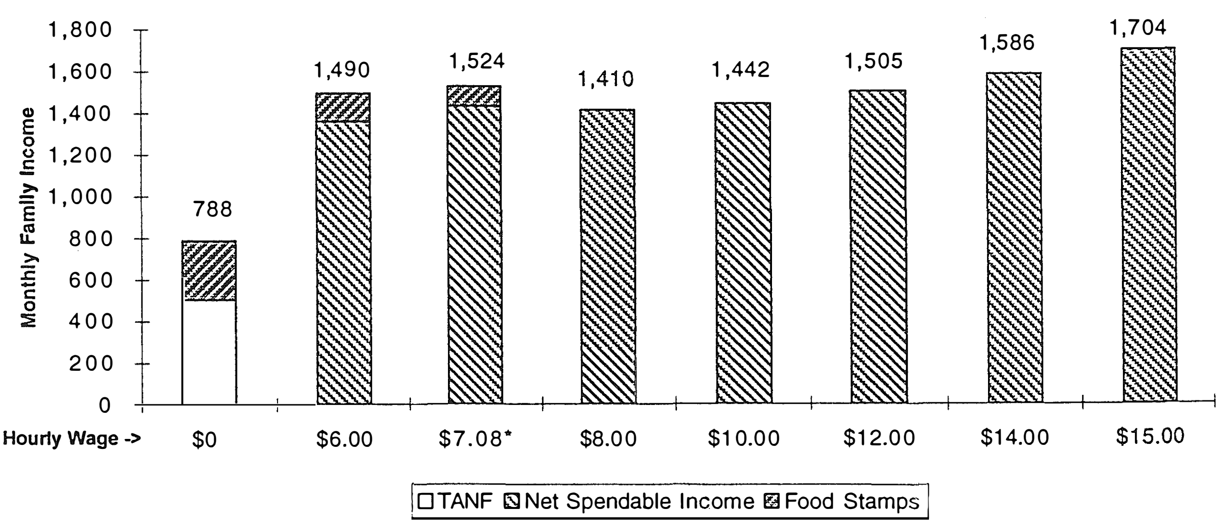
Sources: Oregon Department of Human Resources and Oregon Department of Revenue.
* indicates that the figure relates to a family of three.
Note: FPL is the Federal Poverty Level

CHART A

Welfare to Work Spendable Income
A Family of Three; 1 Adult and 2 Children
Total Child Care Costs of $650.00
Receiving Child Support

Salary	$0	$6.00	$7.08*	$8.00	$10.00	$12.00	$14.00	$15.00
Gross Wages	0	1,040	1,227	1,387	1,733	2,080	2,427	2,600
Plus Child Support	0	210	210	210	210	210	210	210
Subtotal Gross Income	*0*	*1,250*	*1,437*	*1,597*	*1,943*	*2,290*	*2,637*	*2,810*
Percent of FPL for family of 3 ($1138)	0.0%	109.9%	126.3%	140.4%	170.8%	201.3%	231.8%	247.0%
Less FICA	0	(79)	(94)	(106)	(132)	(159)	(186)	(199)
Less Workers' Comp	0	(3)	(3)	(3)	(3)	(3)	(3)	(3)
Subtotal Net Income	*0*	*1,168*	*1,340*	*1,488*	*1,808*	*2,128*	*2,448*	*2,608*
TANF	503	0	0	0	0	0	0	0
Less State Tax Liability	0	(50)	(64)	(79)	(110)	(136)	(163)	(175)
Plus State Credits	0	50	64	79	110	136	57	56
Less Fed Tax Liability	0	0	0	0	0	(49)	(109)	(135)
Plus Federal EITC	0	295	257	222	149	76	3	0
Less Child Care Costs	0	(107)	(168)	(300)	(515)	(650)	(650)	(650)
Subtotal Salary	*503*	*1,356*	*1,429*	*1,410*	*1,442*	*1,505*	*1,586*	*1,704*
Plus Food Stamps	285	134	95	0	0	0	0	0
Total Net Spendable Income	**788**	**1,490**	**1,524**	**1,410**	**1,442**	**1,505**	**1,586**	**1,704**
Percent of FPL for family of 3 ($1138)	69.3%	131.0%	134.0%	123.9%	126.8%	132.3%	139.4%	149.8%

Assumptions include:
- All clients file tax reports and receive the credits available
- Assumes maximum child care cost is $650/month



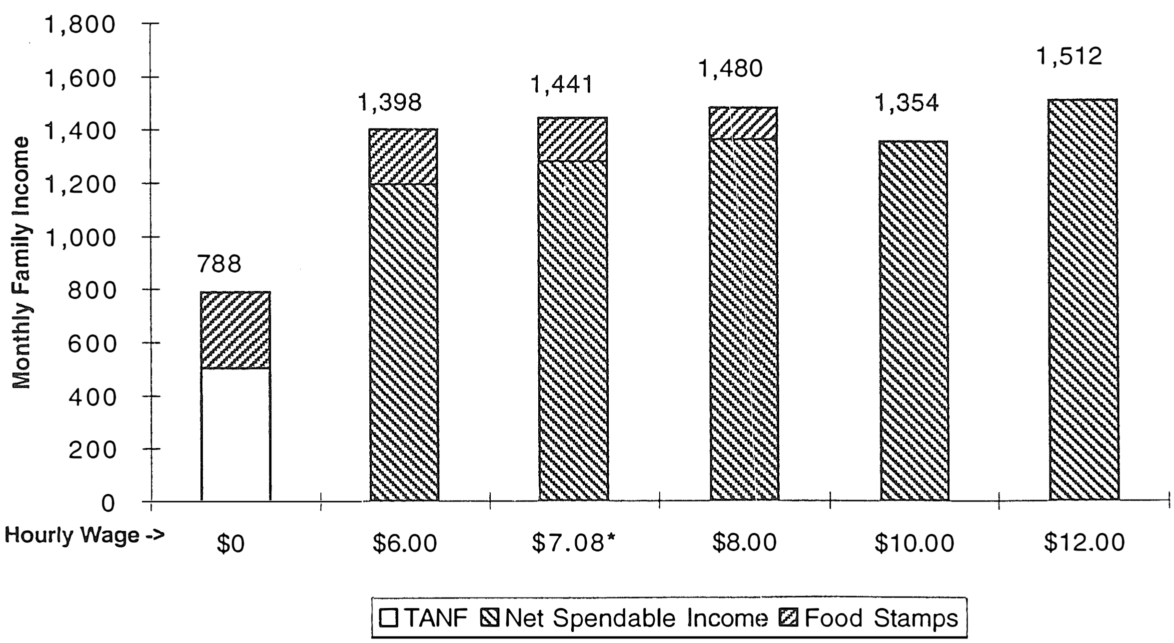
* $7.08 - Current Average Wage at Placement as of June 1998

APPENDIX C

Welfare to Work Spendable Income
A Family of Three; 1 Adult and 2 Children
Total Child Care Costs of $433.00
Excluding Child Support

Salary	$0	$6.00	$7.08*	$8.00	$10.00	$12.00
Gross Wages	0	1,040	1,227	1,387	1,733	2,080
Plus Child Support	0	0	0	0	0	0
Subtotal Gross Income	*0*	*1,040*	*1,227*	*1,387*	*1,733*	*2,080*
Percent of FPL for family of 3 ($1138)	0.0%	91.4%	107.9%	121.9%	152.4%	182.9%
Less FICA	0	(79)	(94)	(106)	(132)	(159)
Less Workers' Comp	0	(3)	(3)	(3)	(3)	(3)
Subtotal Net Income	*0*	*958*	*1,130*	*1,278*	*1,598*	*1,918*
TANF	503	0	0	0	0	0
Less State Tax Liability	0	(50)	(64)	(79)	(110)	(136)
Plus State Credits	0	50	64	79	110	136
Less Fed Tax Liability	0	0	0	0	0	(49)
Plus Federal EITC	0	295	257	222	149	76
Less Child Care Costs	0	(60)	(107)	(137)	(393)	(433)
Subtotal Salary	*503*	*1,193*	*1,280*	*1,363*	*1,354*	*1,512*
Plus Food Stamps	285	205	161	117	0	0
Total Net Spendable Income	**788**	**1,398**	**1,441**	**1,480**	**1,354**	**1,512**
Percent of FPL for family of 3 ($1138)	69.3%	122.9%	126.7%	130.1%	119.1%	132.9%

Assumptions include:
- All clients file tax reports and receive the credits available
- Assumes total child care cost is $433/month



* $7.08 - Current Average Wage at Placement as of June 1998

Spendable Income
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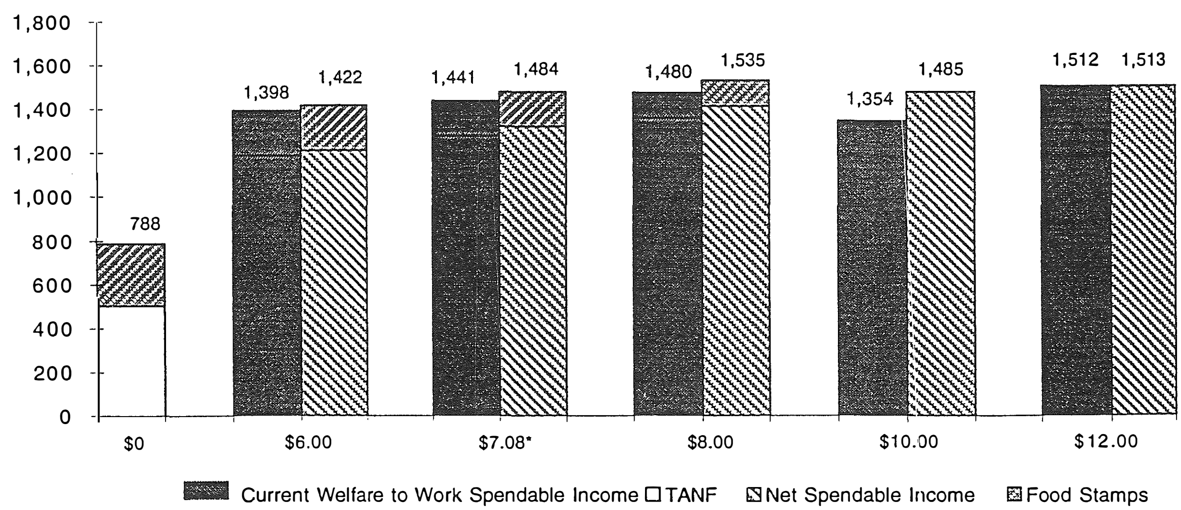
Welfare to Work Spendable Income
A Family of Three; 1 Adult and 2 Children
Total Child Care Costs of $433.00
Excluding Child Support
With Current Tax Credit Calculation
Receiving State Working Family Credit as a Refund

CHART C

Salary	$0		$6.00		$7.08*		$8.00		$10.00		$12.00
Gross Wages	0		1,040		1,227		1,387		1,733		2,080
Plus Child Support	0		0		0		0		0		0
Subtotal Gross Income	*0*		*1,040*		*1,227*		*1,387*		*1,733*		*2,080*
Percent of FPL for family of 3 ($1138)	0.0%		91.4%		107.9%		121.9%		152.4%		182.9%
Less FICA	0		(79)		(94)		(106)		(132)		(159)
Less Workers' Comp	0		(3)		(3)		(3)		(3)		(3)
Subtotal Net Income	*0*		*958*		*1,130*		*1,278*		*1,598*		*1,918*
TANF	503		0		0		0		0		0
** Plus Exemption Credit		32		32		32		32		32	
Plus State Earned Income Tax Credit	0	15		13		11		8		4	
Plus Child & Dependent Care Credit		18		32		41		59		32	
Subtotal Credits		65		77		84		99		68	
Less State Tax Liability	0	(50)	0	(64)	0	(79)	0	(110)	(11)	(136)	(68)
Plus State Working Family Credit			24		43		55		142		69
Less Fed Tax Liability	0		0		0		0		0		(49)
Plus Federal EITC	0		295		257		222		149		76
Less Child Care Costs	0		(60)		(107)		(137)		(393)		(433)
Subtotal Salary	*503*		*1,217*		*1,323*		*1,418*		*1,485*		*1,513*
Plus Food Stamps	285		205		161		117		0		0
Total Net Spendable Income	**788**		**1,422**		**1,484**		**1,535**		**1,485**		**1,513**
Percent of FPL for family of 3 ($1138)	69.3%		125.0%		130.5%		134.9%		130.6%		133.0%

Assumptions include:
- All clients file tax reports and receive the credits available
- Assumes maximum child care cost is $433/month



* $7.08 - Current Average Wage at Placement as of June 1998

** If combined State credits are greater than tax liability, the net taxes owed are zeroed out. If the State credits are less than the tax liability, the employee pays the difference.

APPENDIX C

Welfare to Work Spendable Income

CHART D

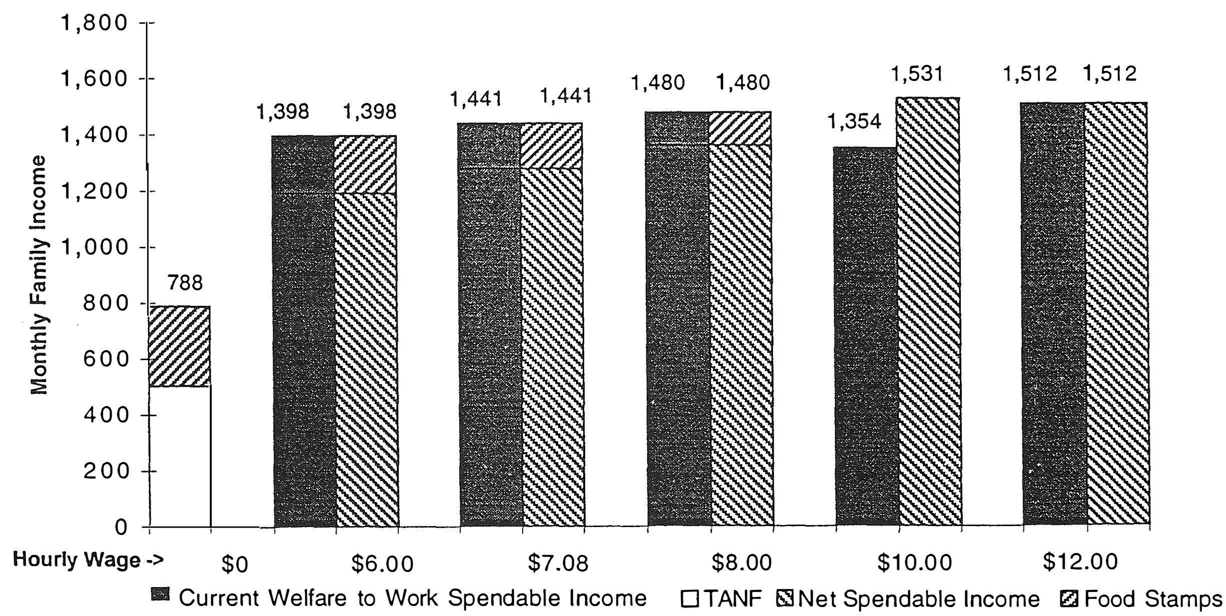
A Family of Three; 1 Adult and 2 Children

With CoPay Limited To 10% of Income Up To 150% of FPL

Excluding Child Support

Salary	$0	$6.00	$7.08*	$8.00	$10.00	$12.00
Gross Wages	0	1,040	1,227	1,387	1,733	2,080
Plus Child Support	0	0	0	0	0	0
Subtotal Gross Income	*0*	*1,040*	*1,227*	*1,387*	*1,733*	*2,080*
Percent of FPL for family of 3 ($1138)	0.0%	91.4%	107.9%	121.9%	152.4%	182.9%
Less FICA	0	(79)	(94)	(106)	(132)	(159)
Less Workers' Comp	0	(3)	(3)	(3)	(3)	(3)
Subtotal Net Income	*0*	*958*	*1,130*	*1,278*	*1,598*	*1,918*
TANF	503	0	0	0	0	0
Less State Tax Liability	0	(50)	(64)	(79)	(106)	(136)
Plus State Credits	0	50	64	79	106	136
Less Fed Tax Liability	0	0	0	0	(43)	(49)
Plus Federal EITC	0	295	257	222	149	76
Less Child Care Co-Pay	0	(60)	(107)	(137)	(173)	(433)
Subtotal Salary	*503*	*1,193*	*1,280*	*1,363*	*1,531*	*1,512*
Plus Food Stamps	285	205	161	117	0	0
Total Net Monthly Income	**788**	**1,398**	**1,441**	**1,480**	**1,531**	**1,512**
Percent of FPL for family of 3 ($1138)	69.3%	122.9%	126.7%	130.1%	134.6%	132.9%

Assumptions include:
- All clients file tax reports and receive the credits available
- Assumes total child care cost is $433/month



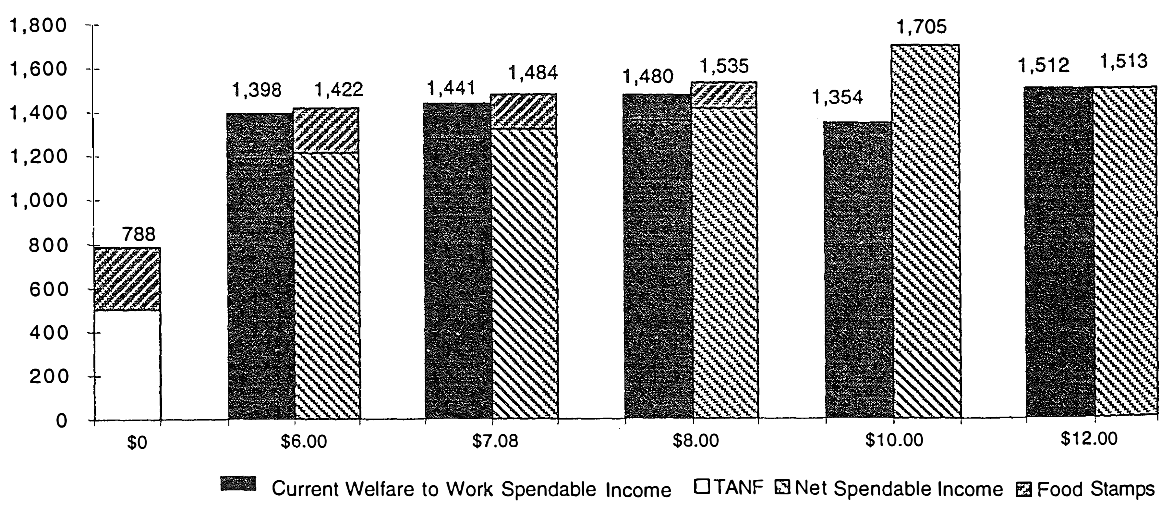
* $7.08 - Current Average Wage at Placement

Welfare to Work Spendable Income
A Family of Three; 1 Adult and 2 Children
Total Child Care Costs of $433.00
Excluding Child Support
With CoPay Limited to 10% of Income up to 150% of FPL
Receiving State Working Family Credit as a Refund

CHART E

Salary	$0		$6.00		$7.08*		$8.00		$10.00		$12.00
Gross Wages	0		1,040		1,227		1,387		1,733		2,080
Plus Child Support	0		0		0		0		0		0
Subtotal Gross Income	*0*		*1,040*		*1,227*		*1,387*		*1,733*		*2,080*
Percent of FPL for family of 3 ($1138)	0.0%		91.4%		107.9%		121.9%		152.4%		182.9%
Less FICA	0		(79)		(94)		(106)		(132)		(159)
Less Workers' Comp	0		(3)		(3)		(3)		(3)		(3)
Subtotal Net Income	*0*		*958*		*1,130*		*1,278*		*1,598*		*1,918*
TANF	503		0		0		0		0		0
** Plus Exemption Credit		32		32		32		32		32	
Plus State Earned Income Tax Credit	0	15		13		11		8		4	
Plus Child & Dependent Care Credit		18		32		41		59		32	
Subtotal Credits		65		77		84		99		68	
Less State Tax Liability	0	(50)	0	(64)	0	(79)	0	(110)	(11)	(136)	(68)
Plus State Working Family Credit			24		43		55		142		69
Less Fed Tax Liability	0		0		0		0		0		(49)
Plus Federal EITC	0		295		257		222		149		76
Less Child Care Costs	0		(60)		(107)		(137)		(173)		(433)
Subtotal Salary	*503*		*1,217*		*1,323*		*1,418*		*1,705*		*1,513*
Plus Food Stamps	285		205		161		117		0		0
Total Net Spendable Income	**788**		**1,422**		**1,484**		**1,535**		**1,705**		**1,513**
Percent of FPL for family of 3 ($1138)	69.3%		125.0%		130.5%		134.9%		149.9%		133.0%

Assumptions include:
- All clients file tax reports and receive the credits available
- Assumes maximum child care cost is $433/month



* $7.08 - Current Average Wage at Placement as of June 1998

** If combined State credits are greater than tax liability, the net taxes owed are zeroed out. If the State credits are less than the tax liability, the employee pays the difference.

APPENDIX C

APPENDIX D

APPENDIX D

GOVERNOR'S TAX REVIEW: EDUCATION/WORKFORCE

Oregon's Economic Stake in A More Skilled Existing Workforce

Oregon has a strong stake in the steady improvement of the knowledge and skills of our current workers. Whether we acknowledge it or not, much of the growth in the state's tax revenue reflects a "skill dividend" that the Oregon Treasury is earning based on the investments Oregonians have made in years past in improving their skills. A key factor in raising Oregon's income in the 1990s has been rising educational attainment. The proportion of the adult population with a four year degree in Oregon has increased more rapidly in Oregon than in the US in the 1990s, contributing to higher per capita incomes and fueling the growth in income tax receipts.

Much of the elasticity of the state's income tax system, especially in recent years is due to the fact that as a group, Oregon workers have become measurably better educated, earning higher wages and salaries and thereby paying higher amounts of personal income taxes. Future increases in tax revenues will depend critically on whether current workers add to their skills sufficiently to support continued improvement in wages in the years ahead.

Because of this close connection between improving education and skill levels and the state's fiscal well being, the subcommittee believes that Oregon ought to look at skill investment as an investment that will pay real fiscal returns, rather than merely a current expenditure. In concept, we should think about these investments in the same way Oregon cities and counties view tax increment financing of distressed areas: public investments in revitalizing blighted areas (or in our case, renewing and building current worker skills) will lead to a growth in future tax revenues that can pay back the initial public expenditure.

While it might theoretically be possible to construct a formula to estimate exactly how much the state gains in tax returns from rising education and skill levels and mandate that a portion of this skill dividend be re-invested in further improving existing worker skills, we don't think it would be wise to straight-jacket future policy makers. It would be more appropriate in our view, however, to set a goal of reinvesting a portion of the state's skill dividend in future skill enhancing activities.

The subcommittee has developed three recommended policies for reinvesting a portion of this skill dividend in ways that will support further growth in skills and thereby help promote the state's fiscal betterment. Our recommendations include a mix of industry-led, work-based training efforts, as well as added incentives for Oregonians, especially low income Oregonians, to invest in themselves. Specifically, we recommend the following:

- Creating an Industry Skill Investment Fund to provide matching grants to groups of firms and labor management collaborations to develop programs to enhance the skills of existing workers;

- Expand the federal Hope for All Tax Credit and a Lifelong Learning tax credit to help individual Oregonians pay for post-secondary and lifelong education.
- Expanding on the new federally required Individual Training Accounts, so that low and moderate wage Oregonians can set aside funds (to be matched by the state) to pay for future education and training expenses.

The subcommittee circulated the draft recommendations to over 350 stakeholders, received written comments from ten. The overall tone of the comments was supportive and offered advice on details of program designs and execution, a level of detail which is not included in this report.

Together, these three measures can help Oregon meet many of its key objectives and benchmarks for the 21^{st} Century. These efforts will help prepare Oregon's existing workforce for the high skill and high value added jobs that are increasingly being generated by the state's economy. Upgrading the education and skills of these existing workers has the double benefit of assuring that well-paid new jobs don't go disproportionately to out-of-state residents, and will help reduce the expense the Oregon employers face when they have to recruit nationally. Upgrading the skills of Oregonians is also the key to meeting our Oregon Shines benchmark of raising state per capita income to the national level. This demand side approach will help assure that training is responsive to the needs of the economy, business and Oregon citizens. In addition, at a time when new resources for many educational institutions are limited, these measures to improve worker skills will stimulate the development of new curriculum and capacity for training and education.

Tax Review Workforce Subcommittee Recommendations

Governor Kitzhaber challenged the Task Force to come up with ideas to use Oregon's tax system to help bolster the skills of the state's existing workforce. Our subcommittee recommends a three-part set of incentives to increase the skills of Oregon workers. Our recommendations recognize that both industries and workers will need additional incentives and resources to upgrade their skills in the years ahead. To the extent possible, we have designed our recommendations to dovetail with existing systems for providing workforce training, and to expand the depth and scope of those efforts to better meet the needs of workers and businesses for timely, effective training and education. Our recommendations are divided into three parts, first, an Industry Skill Investment Fund to underwrite a portion of the cost of cooperative, industry-led training efforts, second, an Oregon complement to new federal tax incentives for learning and third, a system of Individual Training Accounts for low income workers. These three initiatives, working together, will prompt Oregon workers and businesses to undertake the efforts needed to enhance worker skills, providing the basis for the state's economic competitiveness, higher earnings and resilient, sustainable communities statewide.

Recommendation 1: Industry Skill Investment Fund

We recommend that Oregon establish a permanent Industry Skill Investment Fund to underwrite a portion of industry-led training for existing workers. This program would be open to any group of three or more Oregon businesses or labor management cooperative efforts which include two or more firms and one union and or community based organization and would provide reimbursement for up to 50% of the cost of developing and implementing skill enhancement programs. These skill enhancement programs would include training in core skills—like workplace literacy, computer skills, and other skills relevant in a wide-range of work settings, as well as advanced skills specific to a particular industry or set of employers. We anticipate that groups of firms with similar skill needs, particularly businesses in the same industry, will find this program a powerful incentive to collaborate to design effective solutions to industry-wide skill shortages. Industry associations and trade groups around the state have consistently identified the lack of skilled workers as a key problem confronting their members; this proposal would give them the resources and incentive to work collaboratively with their members and training providers to address this problem directly.

- No public funds would be allocated unless private sector businesses first committed to participation in the project and ultimately agreed to pay fifty percent of the cost. This will help assure that training is relevant to and consistent with industry needs and standards and provides workers with marketable skills.

- Provision of training services could be arranged through any eligible public or private training provider. To the extent feasible, we would recommend that eligible training providers be determined through the certification process established under the recently passed Workforce Investment Act.

- Requiring that industry-based groups of firms work together to design and implement these skill enhancement programs has a number of important virtues. Providing funds for group efforts will help assure that skills and training will be geared to a wide range of needs rather than be narrowly focused on a single work environment, and that the economic benefits of training won't hinge solely on the ups and downs of any single firm. And, based on the experience of other states, requiring groups of firms to collaborate will greatly reduce the problem of public money simply substituting for private efforts that would have occurred even without the subsidy.

- Projects funded through the Industry Skill Investment fund would be encouraged to include unions, community-based organizations and other interested groups in order to maximize accessibility of such programs to a wide range of Oregonians and to assure that worker interests were represented. Nationally, there are many examples of successful labor/management training collaborations. Under this program, unions could be co-sponsors of training programs with employers, if they chose.

- The Industry Skill Investment Fund would require a modest level of staffing for administration, chiefly to market the program and make eligibility determinations (if this is not done by local workforce board development); actual development of training programs would be done by the industries involved, in collaboration with public and/or private training providers.

- The objective of this program should be to stimulate additional activity and not to duplicate, displace or subsidize existing efforts.

The subcommittee believes that a pilot program for this effort is unnecessary as this industry skill investment fund builds on some of the successful attributes of the Key Industry Training program which has been operated by the Economic Development Department for a number of years. Unlike the Key Industry training program however, this program would be open to any group of Oregon employers and unions, rather than simply to firms in one of the state's 14 designated key industries. We anticipate that any group of firms with similar skill needs, whether a group of small businesses, firms in a single community, or a statewide industry association would be able to band together to develop and deliver training. The flexibility of this approach will be particularly valuable in rural communities.

We are mindful that this recommendation is not a tax credit. We have consciously chosen to recommend a more conventional grant fund, because national experience shows this will be a more effective and less costly means to meet training needs. The experience of other states shows tax credits alone are unlikely to prompt additional training, and may merely reward firms for what they would have done in any event. Unlike tax credits, a grant system can encourage strong partnerships between businesses and training providers that will result in improvements in curriculum and expanded availability of training.

Recommendation 2: Individual Skill Investment Incentives

We recommend that Oregon establish a comprehensive set of incentives for individuals to undertake further training and education to upgrade their skills. Our recommendation is that

these incentives be closely integrated with existing federal and state incentives, but expand their reach to all Oregonians, especially those with the lowest levels of skills and incentives.
Two newly-enacted federal tax credits provide the foundation for our first recommendation. The 1997 Taxpayer Relief Act allows most taxpayers to claim an annual HOPE tax credit of up to $1,500 for the first $2,000 of expenses during the first two years of post-high school education, and also allows taxpayers to get a credit for 20 percent of lifelong learning costs. While these federal credits are a step in the right direction, many Oregonians, particularly low income, low skill workers will be unable to use them because they have little or no federal tax liability. Therefore, we recommend enactment of an Oregon version of the lifelong learning tax credit and HOPE tax credit that would be fully refundable to all eligible taxpayers. (Refundable means that taxpayers who had less income tax liability than the value of their credits could apply for a cash refund of the balance.) A refundable version of this credit for state taxpayers would give low income Oregonians the same opportunities upper income taxpayers have to use these credits to improve their skills and raise their incomes. Specifically, we recommend the following:

1. **Oregon Hope For All Credit:** Allow Oregon taxpayers who could not claim the full federal HOPE tax credit on their current year return because they did not have sufficient tax liability to apply any unused HOPE credit to their Oregon tax liability. In the event that the taxpayer did not have Oregon tax liability, this amount would be refundable to the taxpayer. This provision will assure that all Oregonians have access to the benefits of the HOPE tax credit, regardless of their current income.

2. **Oregon Lifelong Learning Tax Credit:** Allow Oregon taxpayers who claim the federal 20 percent tax credit for lifelong learning expenses to also claim a (to be established) percent tax credit against state income taxes.

Because federal law already establishes eligibility criteria for these credits, and because they will be widely publicized nationwide, we anticipate that the burden on Oregon to administer and market this program will be negligible. Piggy-backing on the federal tax credits will create a system that is easy for average Oregonians to use.

Recommendation 3: Oregon Individual Training Accounts

We would propose complementing the tax incentives proposed in Recommendation 2 with a program to help fund individual training accounts for current workers. The newly passed federal Workforce Investment Act will replace the existing Job Training Partnership Act program with a new system which includes individual training accounts administered by local workforce development boards on behalf of qualified workers. Locally selected Workforce Development Boards, consisting of a majority of private business members will have a broad mandate from Congress to create a flexible, new market-like system that lets eligible workers select their preferred training provider.

While this new system has considerable promise for improving training delivered to many Oregon workers, it has a key weakness. Only those Oregonians who meet certain federal categorical requirements (economically disadvantaged or dislocated) and who fail to find a job will be eligible to benefit from a training account. We recommend that Oregon broaden eligibility for individual training accounts to include all low wage Oregon workers. Oregon individual training accounts would operate under the same locally tailored structure as individual training accounts under the just-enacted Workforce Investment Act, but would be open to any Oregon worker with an income below 200 percent of the poverty line (about $30,000 for a family of four). By establishing a clear and simple standard for eligibility, we will make this program available to a broad range of Oregonians who need skill improvement, without forcing them to go through the complex federally prescribed eligibility determination and job search process.

Individual Accounts are not a new concept. Several states and municipalities have established successful programs to incent individuals, primarily low income, in asset development as a vehicle to enhance self reliance. The subcommittee, based on knowledge of these successful programs, focuses our recommendation on asset accumulation targeted to skill development. Any qualified Oregon worker, primarily those of moderate income, could open an individual training account administered by the local Workforce Investment Board through the One Stop Career Network. Worker contributions to these accounts would be matched dollar for dollar by state funds. Workers could then use these accounts to purchase training services from qualified public and private providers, through the same mechanism established under the Workforce Investment Act. Individual training accounts would encourage workers to set-aside funds over a period of time to upgrade their skills. Workers who elected to quit the program or terminated their accounts could get their money back, but not the state's matching contribution.

Fiscal Impact of Skill Investment Incentives

While we firmly believe that each of our recommendations represents a long-term fiscal benefit to the state, we recognize that in the short-term there may be some reduction in state revenue. Investments in education will be made now; the return to the state will be in the form of higher income tax revenues over the remainder of that worker's career. In each case, we recommend that the short-term fiscal cost to the state be capped to manage the impact on available revenues.

Industry Skill Investment Fund

A well-executed version of the Industry Skill Investment Fund could provide training to as many as 100,000 existing Oregon workers over the next decade. At an average cost per training of $5,000 per employee, the total decade-long cost of such a program would be about $500 million. Half of this cost would be borne by the private sector, and the remainder would be reimbursed by the Industry Skill Investment Fund. The 10-year fiscal cost of this program would be $250 million, or about $25 million per year.

The demographics of the Oregon workforce suggest that such a training effort would make a noticeable impact on overall skill levels. We estimate that there are approximately half a million Oregonians aged 25 to 54 with a high school education or less. Of these persons, probably sixty percent are in the labor force. An Industry Skill Investment Program targeted for low skill workers would be sufficient in size to reach nearly a third of these persons over the course of a decade.

Hope for All Tax Credits

The proposed HOPE for All Credit would be tied to existing federal tax definitions. The primary beneficiaries of this program are expected to be young high school graduates obtaining their first two years of post secondary education. In Oregon, approximately 60% of high school graduates will enter post secondary education, and 30%+ will get a four-year degree. Oregon has about 33,000 to 36,000 high school graduates annually. The difficult issue in forecasting this credit is in estimating the number of people who won't be able to use the federal credits because their income is too low. We assume for estimating purposes that approximately 20% of the people claiming federal HOPE credit would be unable to use it and the value of their unused credit averages $1,000 per year for each of their first two years of education. In this case, the cost to the state would be (35,000 * 60% * 20% * 1,000 * 2) or $8.4 million per year. Therefore, the approximate cost of this credit would be roughly $10 million annually.

Lifelong Learning Tax Credits

Our recommendation for an Oregon lifelong learning credit is two-fold. First, we propose that the state make the existing 20% federal tax credit refundable to low income Oregonians that do not have enough federal tax liability to claim the full value of the credit. Second, we propose that the state match the federal credit with a credit of its own, over and above the federal credit. To control the fiscal impact of this proposal, we recommend that the state adopt one or more measures to control its cost. First, we would recommend a lifetime cost cap for the program that would sunset the availability of the credit in tax years after a cumulative total (established by the Legislature) has been claimed. This would effectively limit the cost of the program and give future Legislatures the opportunity to evaluate program effectiveness. Second, as an alternative, we would propose that the Legislature make eligibility for the program contingent on prior issuance of a certificate (as explained below in "Limiting the Fiscal Impact of Proposals").
The estimated level of participation and cost of this program is indeterminate. The proposed tax credit is tied to a federal tax credit provision which goes into effect this tax year, and for which no data on actual use are available. The cost of this proposal is capped via an eligibility certificate system to regulate use of the credit. The proposal presented here is to authorize the issuance of $25 million of total certificates.

Individual Training Accounts

We would recommend that the state set a goal of providing $25 million in matching contributions to individuals training accounts over the next decade. This amount would be sufficient to match an average contribution of $2,500 by each of 10,000 Oregonians.

Limiting the Fiscal Impact of Proposals

Most provisions of the tax code are open to all eligible taxpayers who may want to claim them. This means that the fiscal impact of a new tax credit may be open-ended. Particularly where experience with a proposed credit is limited, it may be difficult to accurately forecast the demand for tax credits. In these cases, it is possible to limit the fiscal impact of a tax credit by requiring pre-certification of individuals eligible to receive a credit. This could apply with regard to both the lifelong learning credit and the Hope for All credit. For example, if it wished to limit the fiscal impact of either credit, the statute could require that persons seeking the credit obtain a certificate of eligibility prior to undertaking training. By law or regulation, the state could limit the number of certificates issues and thereby limit its fiscal exposure. The certificates might be distributed by any of a number of agencies, including one-stop training centers, the state scholarship commission or by education and training providers. A similar approach to controlling the access to a tax credit has been used for a number of years with the pollution control tax credit administered by the Department of Environmental Quality.

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