REVENUE REFORM IN OREGON

Background

The modern era of tax reform debate in Oregon goes back to the passage of property tax limiting initiatives in the 1990s. These initiatives (Measure 5 in 1990 and Measure 50 in 1997) effectively reduced the statewide property tax burden from 4.9% of personal income to 3.4%. This is equivalent to about $2.8 billion annually in today's terms. Oregon shifted from a high property tax state (5th highest among the states in 1990) to an average property tax state (number 25 in 2014). In addition to the revenue loss, the most significant outcome of the property tax initiatives was the shift in school funding responsibility. In 1990, state resources funded 29% of school operating costs. In 2017, the state picks up about 67% of school operating costs, primarily through income taxes. At the state level, no state is as dependent on the personal income tax for revenue as is Oregon. In terms of the major state and local taxes, Oregon now finds itself with relatively high personal income taxes, roughly average property taxes and corporate income taxes and no retail sales or broad consumption taxes.

Oregon's unbalanced revenue system also can be seen in the split between business and household taxes. The 2016 Council on State Taxation (COST) state and local business tax study estimates that Oregon businesses directly pay about 37.2% of total taxes in the state. This compares with a national average of 44.1%. A primary reason for Oregon's relatively low business tax share is the absence of a retail sales tax. The COST study (conducted by Ernst and Young), estimates that businesses directly pay 42% of retail sales taxes in the country through taxed business to business purchases.

Reform Alternatives

State and local governments generally rely on three broad tax bases: income, property (or wealth) and consumption. The most obvious void in Oregon's state and local tax system is a broad consumption tax. Forty-five states currently impose a retail sales tax. On a national basis, sales taxes generate roughly the same amount of revenue as personal income taxes. However, in addition to being frequently rejected by Oregon voters, the sales tax base has been declining relative to the economy on a national basis. This is due primarily to legal constraints on taxing internet sales and the movement to largely untaxed services such as health care. For example, Washington's retail sales tax base has declined from 60% of personal income in 1979 to about 38% in 2016. This long-term decline puts state policy-makers in the position of having to raise rates or cut back services in response to growing service demands as the economy expands.

The tax reform discussion in Oregon has shifted to a search for alternative business tax methods. The corporate income tax, currently imposed in 44 states, has been declining steadily as a state revenue source in recent decades. This is largely due to its complexity, narrow base (net income) and the shift toward other entity types such as S-Corporations and LLC structures. There are two clear business tax base options: a value-added tax or a gross receipts tax. Both taxes are paid directly by businesses but are viewed as consumption taxes by economists.

A value-added tax is based on the value added by each business to the final product. It can either be calculated as the sum of business inputs (labor, capital, natural resources) or by taking the value of the final product and subtracting out all purchases from other businesses. The value-added tax is used extensively by developed economies around the world. However, only New Hampshire currently operates a value- added tax at the state level. One reason why states have tended to shy away from value added taxes (Michigan phased theirs out in 2012), is because they are legally constrained to use the business input or additive approach. This puts businesses exporting outside the state at a competitive disadvantage because their inputs are the basis of the tax. This disadvantage can be corrected at the national level with a tax credit for exports but interstate commerce provisions restrict states from using this approach. Oregon's current use of a single sales apportionment method for interstate corporations reflects this concern about keeping exporters competitive.

In recent years, Ohio (2006) and Nevada (2014) have turned to the gross receipts tax base as a method of taxing business. Ohio eliminated its corporate income tax while Nevada has never had one. The gross receipts base offers some clear advantages over the other means of taxing business:

1. It has a broad base which allows for a low rate while still generating significant revenue. A broad base means most elements of the economy are included in the tax while a low rate minimizes economic distortions.
2. A gross receipts tax has low administrative costs and is difficult to evade with tax planning strategies.
3. A gross receipts tax is a destination based tax meaning it is based on where sales take place. Similar to the single sales corporate income apportionment method, the gross receipts tax does not impose undue tax burdens on exporters while taxing imports that are coming into the state.

The table below shows the estimated revenue from a .25%, .5% and .75% gross receipts tax in Oregon based on the Ohio Commercial Activities Tax (CAT) base, including a separate financial activities tax which is also based on a calculation of gross receipts. They are stand-alone estimates and do not include complimentary policies such as eliminating the current corporate income tax. The estimates assume a January 1, 2018 start date. Under Ohio's CAT, all business entity types (C-Corporations, S-Corporations and non-corporate structures) are subject to the tax. The rate (0.26%) applies to receipts in Ohio over $1 million. Businesses with sales less than $150,000 are not required to file a tax form.

Rate	2017-19	2019-21	2021-23
	Estimated Oregon Commercial Activity Revenue (in millions)		
0.25%	$948	$1,469	$1,543
0.5%	$1,883	$2,960	$3,067
0.75%	$2,820	$4,371	$4,592

Gross Receipts Tax Criticisms and Possible Strategies

Two major criticisms of the gross receipts tax can be found in the public finance literature. The first is the risk of pyramiding. Because the gross receipts tax is based on transactions, a final product can be taxed multiple times moving through the production process as the tax is imposed and then built into the price at each stage. While pyramiding is endemic to the gross receipts tax base and cannot be fully eliminated, states have generally used two approaches to mitigate these effects. The first is multiple tax rates, with lower rates for industries that are characterized by multiple transactions. Both Washington and Nevada use this approach. The approach adopted by Ohio is to minimize exemptions in order to keep the base broad. This allows for a lower overall tax rate, thereby limiting the effects of pyramiding.

The second major criticism is that gross receipts taxes generally put upward pressure on consumer prices. Because the ratio of consumption to income falls as income rises, consumption taxes are generally regressive. The most widely accepted strategy to address this issue is to make adjustments for low income households through the income tax. This can involve expansion of credits that benefit low to middle income households such as the earned income tax credit or the exemption credit.