State of Oregon

2005–2007

# Tax Expenditure Report

Budget and Management Division
Department of Administrative Services

Research Section
Department of Revenue

Additional copies of this publication are available through the Budget and Management Division at 503-378-3106.

In compliance with the Americans with Disabilities Act (ADA), this publication is available in alternate formats by calling the Budget and Management Division at 503-378-3106 (voice) or 503-378-4672 (TTY).

## GOVERNOR'S MESSAGE

# To the Citizens of Oregon:

I am pleased to submit the 2005-07 version of the biennial Tax Expenditure Report. This document is an important tool in understanding how government supports the achievement of education, social, economic and environmental policies through the use of Oregon's tax structure.

This report is a valuable companion to my biennial Governor's Balanced Budget and contains extensive information that can help policymakers understand the broad scope of spending by Oregon's public sector. We should ensure that the tax expenditures outlined in this report make as much sense for Oregon today as they did when first enacted, particularly in these fiscally tight times and in light of the recent congressional passage of a major corporate tax overhaul package.

Because tax expenditures amount to approximately 50% of spending through our tax system, it is important that they receive a thorough examination during the 2005 Oregon Legislative session. In so doing, we can ensure that they are being used effectively to reach our desired goals. Full disclosure of how well the system is working is something all Oregon citizens deserve. This report provides a factual contribution to a healthy debate regarding our public finance system.

Sincerely,

Theodore R Kulongoski

THEODORE R. KULONGOSKI
Governor

# TABLE OF CONTENTS

# TABLE OF CONTENTS (CONT.)

# INTRODUCTION

The 1995 Budget Accountability Act (the Act) requires the governor, with the assistance of the Department of Revenue and the Department of Administrative Services, to produce a tax expenditure report every biennium, along with the Governor's Recommended Budget. The report was first prepared in 1996 for the 1997–99 biennium. This report covers expenditures for the 2005–07 biennium.

## Tax Expenditure Defined

The Act defines a tax expenditure as

> any law of the Federal Government or of this state that exempts, in whole or in part, certain persons, income, goods, services, or property from the impact of established taxes, including, but not limited to tax deductions, tax exclusions, tax subtractions, tax exemptions, tax deferrals, preferential tax rates, and tax credits.

The term "tax expenditure" derives from the parallel between these tax provisions and direct government expenditures. For example, a program to encourage businesses to purchase pollution abatement equipment could be structured with an incentive in the form of a tax credit or a direct payment by the state to businesses. Tax expenditures can be viewed as: (1) providing financial assistance to certain groups of taxpayers, (2) providing economic incentives that encourage specific taxpayer behavior, or (3) simplifying or reducing the costs of tax administration. While the third of these policy objectives eliminates inefficiencies within the tax code, the first two *could* be implemented with direct expenditures rather than tax expenditures.

This report describes 352 tax expenditures contained within 15 Oregon tax programs. Because tax expenditures impart special treatment to groups of taxpayers, it is necessary to begin with a clear definition of the "normal" tax base from which that special treatment departs. Because there may be different opinions about the normal base for each tax, a description of the tax base for each of the 15 tax programs begins each chapter.

In some tax programs, an alternative tax is imposed for recipients of a tax expenditure. In the interest of being comprehensive, this report includes all provisions involving tax relief from a specific tax, even if those taxpayers are subject to an alternative tax. The alternative taxes paid are reported as "In Lieu" payments in the descriptive information for each tax expenditure.

## Purpose of the Tax Expenditure Report

The Act declares the necessity of

> a review of the fairness and efficiency of all tax deductions, tax exclusions, tax subtractions, tax exemptions, tax deferrals, preferential tax rates, and tax credits. These types of tax expenditures are similar to direct government expenditures because they provide special benefits to favored individuals or businesses, and thus result in higher tax rates for all individuals.....It is in the best interest of this state to have prepared a biennial report of tax expenditures that will allow the public and policy makers to identify and analyze tax expenditures and to periodically make criteria-based decisions on whether the expenditures should be continued. The tax expenditure report will allow tax expenditures to be debated in conjunction with on-line budgets and will result in the elimination of inefficient and inappropriate tax expenditures, resulting in greater accountability by state government and a lowering of the tax burden on all taxpayers.

The Act specifies that the report include the following information: a list of the expenditures; the statutory authority for each; the purpose for which each was enacted; estimates of the revenue loss for the coming biennium; the revenue loss for the preceding biennium; a determination of whether each tax expenditure is the most fiscally effective means of achieving its purpose; and a determination of whether each tax expenditure has achieved its purpose, including an analysis of the persons that benefit from the expenditure. Each tax expenditure is to be categorized according to the programs or functions that it supports. Finally, for those expenditures that will sunset next biennium, the report is to include the governor's opinion on whether the sunset should be allowed to take effect as scheduled or be revised to a different date.

## How to Use This Report

***Organization***

This report has been designed to allow a quick overview of Oregon's current tax expenditures as well as a perusal of more extensive details. There are five main sections: the summary, the governor's recommendations on tax expenditures scheduled to sunset in the 2005–07 biennium, an index of all tax expenditures by tax program (Table 1), an index of all tax expenditures by program/function (Table 2), and detailed descriptions of each tax expenditure (Chapters 1–15).

The indexes in Tables 1 and 2 are good starting points to identify those expenditures for which more information is desired. Table 1 provides a list of all tax expenditures sorted by tax and numbered sequentially from 1.001 to 15.004. This numbering system can be used as an index to locate the full description of each tax expenditure in Chapters 1–15. Similarly, Table 2 lists all the tax expenditures, but groups them by program/function rather than tax. This categorization has been done so that all tax expenditures related to a particular program area can be viewed together.

The main body of this report, Chapters 1–15, is organized by tax program. Each chapter begins with a description of that chapter's tax and contains detailed descriptions of the tax expenditures associated with that tax program.

Appendices A to C include the full text of the Budget Accountability Act, a list of agencies that evaluated the tax expenditures, and a list of Oregon tax programs that do not contain tax expenditures. Appendix D lists the tax expenditures that are new, modified, or that have expired since this report was last published. Appendix E lists the corporation income tax expenditures and personal income tax expenditures separately along with their corresponding revenue impacts.

***Program/Function Categories***

Each tax expenditure has been assigned to one of 10 program/function categories. Wherever possible, an expenditure was categorized as one of the budget program areas used in the Governor's Balanced Budget: Education, Human Resources, Economic and Community Development, Natural Resources, Transportation, and Consumer and Business Services. Those that did not fit one of these program areas were assigned to one of four function categories: Tax Administration, Government, Social Policy, and Federal Law. Because some tax expenditures can fit neatly into more than one category, those who wish to sum the revenue impacts by program or function should be careful that they agree with these assignments or change them accordingly. The tax expenditures are listed by program/function in Table 2.

***Evaluations***

The evaluations of whether these tax expenditures achieve their purpose and if they are a fiscally effective means of doing so were conducted by personnel in 30 state agencies (see Appendix B). Agencies were asked to evaluate tax expenditures if the expenditure directly related to their program responsibility or if they had appropriate knowledge of the subject matter.

***Revenue Impacts***
The revenue impact of a tax expenditure is intended to measure what is being "spent" through the tax system with respect to that one provision, or alternatively the amount of relief or subsidy being provided through that provision. The dollar impact is NOT the amount of revenue that could be gained by repealing the tax expenditure. There are three main reasons for this:

- The estimates do not incorporate behavioral changes that may occur if a tax expenditure were eliminated.
- Each provision is estimated independently. A tax expenditure beneficiary may qualify for a tax reduction under more than one law.
- Government may not be able to collect the full liability for some tax expenditures for administrative reasons.

For these reasons, and because tax expenditures interact with each other and the rest of the tax system, caution should be used when summing the revenue impacts.

The tax expenditures reported here represent revenue loss to the state and local governments and higher tax rates for taxpayers. For example, income tax expenditures reduce state General Fund revenue while property tax expenditures reduce revenue to local governments and may increase property tax rates. The property tax is unique in that exempting property from property taxation may result in both a revenue loss to local governments and a shift of taxes to other taxpayers. A complete explanation of revenue loss and shift can be found at the beginning of Chapter 2. The introduction to Chapter 2 also contains a brief description of the changes to the property tax system brought about by Measure 50 in 1997. For all property tax expenditures, the detailed descriptions report the revenue loss and shift separately. In a departure from prior editions of this report, Tables 1 and 2 report only the loss amount. Prior reports included both the loss and shift amounts.

The revenue impact estimates are rounded to the nearest $100,000. For tax expenditures below $50,000, the revenue impact is indicated as "Less than $50,000."

Several data sources and methods were used to estimate the revenue impacts. For the income tax expenditures, the primary and secondary data sources were Oregon and federal tax returns, respectively. Estimates of federal tax expenditures made by the Joint Committee on Taxation of the U.S. Congress were used to develop estimates of those income tax provisions incorporated in Oregon law through connection to the Internal Revenue Code. For property tax expenditures, the primary data source was information gathered by county assessors. For all tax programs, data from various federal and state agencies were used where available.

## Acknowledgments

Although the Department of Revenue coordinated the construction of this report, numerous Oregon state agencies provided important information and analysis regarding the objectives and effectiveness of individual tax expenditures. These agencies are listed in Appendix B. The original report prepared in 1996 relied heavily on the tax expenditure report prepared by the Legislative Revenue Office in 1994 for the House and Senate Committees on Revenue and School Finance. The 2002 (the next one is expected to be published in December 2004) Congressional Research Service publication, *Tax Expenditures: Compendium of Background Material on Individual Provisions,* is used extensively throughout this report to describe and evaluate the tax expenditures that result from Oregon's connection to the federal income tax.

# SUMMARY

This report describes 352 individual tax expenditures currently specified in Oregon law. Of those, 120 are related to local property taxes and 195 to Oregon's personal and corporation income taxes. The remaining 37 are related to various other state tax programs.

One hundred nine of the 195 income tax expenditures result from Oregon's connection to the federal income tax code. By adopting the federal definition of income, Oregon also adopts most of the exclusions and deductions from income that are part of the federal personal and corporation income taxes. As of the printing of this report, Oregon is generally tied to the federal definition of taxable income as of December 31, 2002 (there are a few exceptions). This means that Oregon has adopted the exclusions, adjustments, and deductions from income that were part of the federal personal and corporation income taxes as of that date. While the legislature will consider whether to tie to more current federal law during the 2005 session, most federal changes relating to the definition of taxable income that occurred in 2003 or 2004 will not be reflected in this report.

For the 2005–07 biennium, total tax expenditures will result in the "spending" of about $27 billion through Oregon's tax code. Over the same period the state of Oregon and local taxing districts will collect roughly $21 billion in taxes for spending on various state and local programs. This indicates that governments in Oregon "spend" more through special provisions in the tax code than they do through direct outlays. However, it is important to note that there are a small number of extremely large tax expenditures that magnify the total revenue impact.

The table below shows estimates of tax expenditures by tax program for the 2003–05 and 2005–07 biennia. The table also shows estimates of the total revenue to be raised in 2005–07 by each tax. The largest tax expenditures occur in the property tax program, where aggregate tax expenditures of almost $18 billion are more than double the amount of estimated revenue. However, roughly $14 billion of this amount is represented by the three largest property tax expenditures: the exemption of intangible personal property ($10 billion), the exemption of federal property ($3 billion), and the exemption for state and local property ($1 billion).

**SUMMARY OF OREGON TAX PROGRAMS WITH TAX EXPENDITURES**

(Millions of Dollars)

| Tax Program | Number of Tax Expenditures | Estimated Revenues 2005-07 | Estimated Tax Expenditures 2003-05 | Estimated Tax Expenditures 2005-07 |
|---|---|---|---|---|
| Income (Personal and Corporate) | 195 | $10,461.7 | $7,978.2 | $8,792.8 |
| Federal Exclusions | 61 | | $3,655.3 | $4,189.2 |
| Federal Adjustments/Deductions | 48 | | $2,192.2 | $2,099.5 |
| Oregon Subtractions | 24 | | $1,039.0 | $1,262.1 |
| Oregon Credits and Other[1] | 62 | | $1,091.7 | $1,242.0 |
| Property[2] | 120 | $8,193.8 | $16,406.1 | $17,962.1 |
| Full Exemption | 85 | | $15,937.3 | $17,470.5 |
| Partial Exemption | 24 | | $210.0 | $229.3 |
| Special Assessment | 11 | | $258.9 | $262.4 |
| Gas and Use Fuel | 5 | $832.3 | $13.1 | $13.2 |
| Weight-Mile | 7 | $455.0 | $12.3 | $13.5 |
| Cigarette & Other Tobacco | 5 | $498.1 | $2.9 | $2.9 |
| Beer and Wine | 2 | $27.0 | $1.7 | $2.0 |
| Other State Taxes | 18 | $342.3 | $4.1 | $4.2 |
| All Taxes | 352 | $20,810.3 | $24,418.4 | $26,790.7 |

[1] *There are 6 'Other' tax expenditures*

[2] *The estimates include only the loss amounts.*

Income tax expenditures (personal and corporation) in 2005–07 will total almost $9 billion, about $2 billion less than expected income tax revenues over this period. Although not as extreme as the property tax program, there are also several very large tax expenditures. The largest expenditures are for Oregon's personal exemption credit ($1 billion), employer paid medical benefits ($1 billion), and the deduction of home mortgage interest ($960 million).

**Composition of Oregon's Income Tax Expenditures**
Of Oregon's 195 income tax expenditures, some apply exclusively to individuals, some apply exclusively to corporations, and some may be claimed by both individuals and corporations. The table below provides the numbers of tax expenditures and their revenue impacts in each of these categories.

**Income Tax Expenditures by Type of Taxpayer**
**2005-07 Revenue Impacts of Expenditures Received by Individuals, Corporations, or Both**
**(Millions of Dollars)**

| | Individuals Only | | Corporations Only | | Both | | |
|---|---|---|---|---|---|---|---|
| | Number | Total | Number | Total | Number | Individuals Total | Corporations Total |
| Exclusions | 43 | $3,861 | 7 | $90 | 11 | $218 | $20 |
| Adjustments | 8 | $255 | 0 | ---- | 0 | ---- | ---- |
| Deductions | 6 | $1,406 | 8 | $48 | 26 | $319 | $72 |
| Subtractions | 19 | $1,261 | 2 | $1 | 3 | $0 | $0 |
| Credits | 16 | $1,151 | 12 | $37 | 28 | $23 | $27 |
| Other | 2 | $2 | 2 | $1 | 2 | $0 | $0 |
| Total | 94 | $7,935 | 31 | $177 | 70 | $560 | $119 |

The remainder of this report provides more detailed descriptions and revenue impact estimates for each tax expenditure currently specified in Oregon law.