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The Worst of All Possible Worlds:
Plan Raises Taxes on Low Income Oregonians, Lowers Taxes for the Wealthiest, and Reduces Revenue for Education and Other State Services

by Jeff Thompson and Charles Sheketoff

With the state facing a billion dollar revenue shortfall this biennium and next, and with the Governor's race in full swing, it is not surprising that tax reform is being discussed within the majority party in the state Legislative Assembly.

One plan that has been circulated among legislators and lobbyists would raise some taxes while cutting others.[1] Since the combined effect of the tax proposal would reduce state revenues by approximately $450 to $750 million annually, the proposal would make it even more difficult for Oregon to meet taxpayers' demands and expectations for public services.

The plan would create a broad-based, four-percent sales tax on most goods and services, eliminate the income tax on capital gains, and lower the tax rates for the personal income tax. Despite two components targeting tax relief to low-income Oregonians, the plan would raise the tax burden on low-income Oregonians and give a disproportionate tax cut to those with very high incomes, with essentially no tax relief for middle-income Oregonians. Additionally, Oregonians would send over $550 million more to the federal government in higher federal income taxes

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Overall, who wins and who loses?

The plan increases taxes through a broad-based four-percent sales tax with exemptions for shelter, public transportation, health care, education, and personal insurance and pensions. The plan would also include some low-income tax relief – an expansion of the state's earned income credit (making it larger and refundable) or a credit for the sales taxes likely paid for by low-income Oregonians, or a combination of both. In addition, the plan would eliminate the tax on capital gains, currently taxed at the same rate as other types of income. Last, personal income tax rates would be reduced to 3, 5, and 7 percent, including a zero percent bracket on the first $50,000 of taxable income for joint filers.[2]

An analysis of the plan by the Institute on Taxation and Economic Policy (ITEP) for the Oregon Center for Public Policy shows that the richest one-percent of Oregon taxpayers, those with incomes above $293,000, would receive a net tax cut of $21,259, equivalent to 2.7 percent of their income (Table 1). The lowest-income fifth of taxpayers, with incomes below $15,000, however, would face a tax increase of $107, or about 1.1 percent of their income.[3]

Table 1. Tax changes in the plan

	Bottom 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less than $15,000	$15,000 to $27,000	$27,000 to $42,000	$42,000 to $70,000	$70,000 to $133,000	$133,000 to $293,000	$293,000 or more
Average Income	$9,500	$20,600	$33,500	$55,300	$91,400	$182,300	$779,300
Tax Increases							
Ave. $ change	$566	$1,068	$1,394	$1,888	$2,313	$2,802	$7,290
% of income	5.9%	5.2%	4.2%	3.4%	2.5%	1.5%	0.9%
share of total increase	7%	14%	18%	25%	23%	7%	5%
***Tax Cuts**							
Ave. $ change	-$458	-$766	-$1,473	-$2,593	-$4,326	-$6,512	-$28,549
% of income	-4.8%	-3.7%	-4.4%	-4.7%	-4.7%	-3.6%	-3.7%
share of total cut	4%	7%	13%	23%	29%	12%	13%
Net Change in Taxes							
Ave. $ change	$107	$302	-$79	-$705	-$2,013	-$3,710	-$21,259
% of income	1.1%	1.5%	-0.2%	-1.3%	-2.2%	-2.0%	-2.7%

*Includes impact of sales tax credit worth $78 million and a 20 percent, refundable earned income credit.
Source: Institute on Taxation and Economic Policy, April 2002.

Under the plan, middle-income taxpayers would see no real change. Taxes on the middle fifth of Oregon taxpayers, those with incomes ranging from $27,000 to $42,000, would drop by 0.2 percent of income, just $79. The lowest-income forty percent of taxpayers, those with incomes less than $27,000, would actually face tax increases.

The net tax increases on low-income households exist despite a zero-percent income tax rate on the first $50,000 in taxable income for joint filers, a refundable Earned Income Credit (EIC), and a sizeable sales tax credit for low-income households. Not only would the plan primarily benefit high income taxpayers, it would require substantial cuts in state support for schools and other programs important to all Oregonians. As currently configured, the plan would reduce the revenues available to the state by approximately $450 to $750 million annually.[4]

The Income Tax Changes

The proposal contains two significant changes to the income tax: it lowers the rates and eliminates the income tax on capital gains income. In lowering the rates, it also changes the brackets, including a zero percent bracket on the first $50,000 of taxable income for joint filers, and improves the state earned income credit for low-income working families[5] or provides for a credit for sales taxes similar to one proposed in Ballot Measure 1 and HB 2500 in 1993, or both.

Changes to the rates and credits: no help for the little guy

Even the elements of the plan that might seem to benefit lower-income taxpayers yield little help. Adopting a 20 percent refundable EIC would cut taxes on the lowest forty percent of taxpayers by an average of just $41 (Table 2). The reduction of income tax rates would cut taxes on the bottom fifth of taxpayers by $199, but it would reduce taxes on the highest-income one-percent by nearly $16,000.

Table 2. Impact of proposed income tax changes

	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Elimination of Capital Gains Tax							
Tax Change as a % of Income	–0.0%	–0.1%	–0.1%	–0.1%	–0.3%	–0.5%	–2.2%
$ Average Tax Change	$ –0	$–18	$–18	$–78	$–305	$–988	$ –17,035
Share of Tax Cut	0%	1%	1%	6%	16%	14%	61%
New Income Tax Structure							
Tax Change as a % of Income	–2.1%	–3.4%	–4.3%	–4.7%	–4.6%	–3.2%	–2.0%
$ Average Tax Change	$–199	$–695	$–1,430	$–2,589	$–4,200	$–5,881	$ –15,735
Share of Tax Cut	2%	7%	14%	26%	31%	12%	8%
20% Refundable EITC							
Tax Change as a % of Income	–0.4%	–0.2%	–0.1%				
$ Average Tax Change	$–41	$–43	$–31				
Share of Tax Cut	35%	37%	27%				
Source: ITEP April 2002. All Oregon Taxpayers, 2001							

Capital gains tax cut: help for those who don't need it

The component of the plan that would deliver the biggest cut to high-income Oregonians, however, is the elimination of the income tax on capital gains. The richest one-percent of Oregonians, those with incomes averaging $780,000, would reap more than 60 percent of the capital gains tax cut. The top one-percent would receive an average tax cut of $17,035, nearly double the average annual income of the bottom 20 percent of Oregonians. The bottom 80 percent of taxpayers would realize just eight percent of the benefit of eliminating the capital gains tax.

While eliminating the capital gains tax would deliver a huge windfall to the richest Oregonians, analysis of similar proposals in the past suggests little reason to expect economic benefits from cutting the capital gains tax.[6] Claims that the capital gains tax cut will result in increased economic activity and increased tax revenues do not withstand scrutiny.

Many Oregonians will pay more federal income taxes

Taxpayers who itemize may deduct state income tax liability when calculating federal taxable income. Sales taxes, on the other hand, are not deductible when calculating federal income tax liability. By shifting Oregon's revenue stream away from income taxes and toward a sales tax, Oregon lawmakers would be indirectly enacting a substantial federal income tax hike. The plan will result in an additional $550 million of Oregonians' income going to the federal government through higher federal income taxes.

Conclusion

Oregon's tax system needs to be reformed. Republicans should be congratulated for publicly discussing tax reform, after rejecting several revenue-raising proposals offered by Governor Kitzhaber in recent special sessions and failing to develop a tax reform proposal since gaining control of both houses of the Legislative Assembly in

1995. Regrettably, this plan would exacerbate Oregon's longstanding problem of inadequate revenues to meet taxpayers' demands and expectations for public services.

It is noteworthy that this sales tax proposal has both a broad base and a credit for low-income Oregonians to offset some of the regressivity inherent in a sales tax. However, the other provisions of the tax proposal help only the richest Oregonians while increasing the tax burden on low-income taxpayers. The plan would also send more of Oregonians' money to the federal government. Sales tax proposals have been repeatedly rejected in Oregon and may not have political viability no matter how well they are designed.

All proposals to change Oregon's tax system must be closely examined to determine who will benefit and who will lose from the changes. Review of the plan makes it clear that the bottom 40 percent of Oregon taxpayers will lose, those in the middle (the next 20 percent) will get next to nothing, and very high-income Oregonians will reap a windfall. This tax proposal ignores the majority to benefit primarily the minority of Oregonians who have the highest incomes. Reform proposals that raise taxes on low-income families, reduce revenue, and send more of Oregonians' money to the federal government give Oregonians the worst of all possible worlds.

Endnotes

[1] The plan is described in two documents. Both documents are available at www.ocpp.org/2002/rpt020515plan.pdf. One is an outline that a legislator provided to lobbyists, and the other is a breakdown of the revenue impacts of the components. The Legislative Revenue Office (LRO) created only the latter document showing revenue impacts. After the Institute on Taxation and Economic Policy (ITEP) calculated a revenue impact vastly different than this initial calculation by LRO, LRO discovered that its preliminary analysis had an error. The revenue impacts discussed in this paper reflect the revised preliminary assessment by LRO and that of ITEP.

[2] The zero income tax bracket also applies to the first $25,000 of single filers. Current Oregon income tax rates are five, seven, and nine percent.

[3] The plan modeled in this study includes both the refundable EITC and the sales tax credit. The descriptions of the plan refer to both an improvement and expansion of the state earned income credit and a credit to offset the sales tax similar to the one proposed in Ballot Measure 1 and HB 2500 in 1993, for a total of $78 million. In this analysis of the impacts of the tax plan, ITEP calculated that a 20 percent refundable EIC would total $75 million per biennia, while the sales tax credit would total $78 million annually. Even after including both of these low-income credits, the combined effect of the plan is still regressive.

[4] The Oregon Legislative Revenue Office estimates that the plan would reduce revenue by about $1.5 billion biennially, approximately $750 million annually. LRO's estimate includes taxes paid from out of state residents. The Institute on Taxation and Economic Policy estimates the annual revenue loss at $450 million annually. Both estimates of revenue loss are admittedly rough and cannot be made more exact until more details of the proposal are worked out. In addition, it is difficult to estimate revenues from a sales tax in a state that does not have a sales tax already in place. Once details of the plan are worked out, both LRO and ITEP can better estimate the revenue loss.

[5] The earned income credit is primarily for working families with children; however, very poor working adults without children are allowed a limited earned income credit.

[6] Thompson, Jeff, *Empty Promises and False Hopes: The Reality of Capital Gains Tax Cuts in Oregon*, Oregon Center for Public Policy, April 9, 2001.