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BUREAU OF REVENUE AND FINANCIAL SERVICES

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M E M O R A N D U M

TO: Portland City Council
Portland City Council Execs

FROM: Thomas Lannom, Revenue Division Director

SUBJECT: Arts Tax Cost Limitation Resolution 37214

DATE: August 25, 2017

CC: Ken Rust, Chief Financial Officer
Andrew Scott, City Budget Director

Background

The Arts Education and Access Income Tax (Arts Tax) is almost five years old. Portland City Code section 5.73.090 (A) requires that collection and administration costs of the Arts Tax not exceed 5% of gross revenue collections over a five-year period (hereafter referred to as the “cost limitation”). The five-year cost of collection currently stands in excess of the cost limitation; 7.7% over five years and 8.9% over the last three years, which is the most accurate representation of ongoing expenses.¹ Since 2013, \$47.99 million has been collected at a cost of \$3.69 million,² which is \$1.29 million in excess of the cost limitation.³

Portland City Council Resolution No. 37214 adopted June 16, 2016, directed the Revenue Division to “...provide City Council options for a permanent resolution to the issue of the cost limitation in time for consideration in the FY 2017-2018 Fall Budget Monitoring Process so that an adjustment can be made before the close of the fifth year of the tax.” This memorandum was prepared to meet the Council’s direction.

Cost Limitation Insufficiency

The 5% cost limitation is untenable and a City Code change and/or collection cost subsidy will be necessary to correct/meet it. There are three primary reasons for this. First, collecting a small dollar amount (\$35) from each of over 360,000 eligible taxpayers is an inherently complex and

¹ Tax years 2013, 2014 and 2015. These are the most recent years for which complete and final cost information is available.

² Collection costs shown here do not include credit card processing fees which are not part of the cost limitation calculation.

³ As of June 30, 2017. See “Where do my Arts Tax Dollars Go?” at <https://www.portlandoregon.gov/revenue/article/649815>. Over the last three years (tax years 2013-2015), \$29.84 million was collected at a cost of \$2.66 million (8.9%), or \$1.12 million over the cost limitation.

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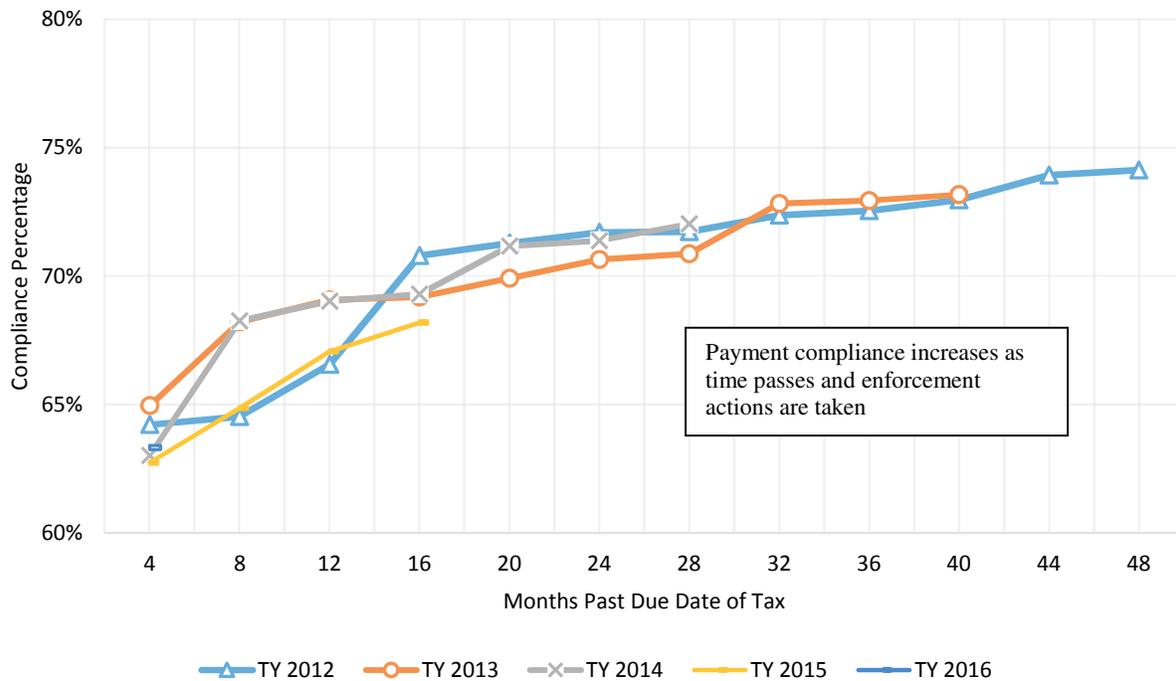
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time-consuming undertaking. The low total revenue and large workload make the 5% cost limitation unrealistic. Second, the tax underwent numerous changes in 2013 that resulted in substantially decreased revenue from original estimates, which in turn lowered the allowable collection budget (fixed at 5% of revenues).⁴ Third, the initial payment compliance estimate of 85% has proven to be incorrect, at least to date, with actual compliance for the first three years of the tax standing at an average of 73%.

While compliance will continue to improve with additional enforcement efforts including using federal taxpayer data to identify non-compliant taxpayers, modernizing Revenue Division tax administration databases and referring seriously delinquent accounts to collection agencies in greater numbers,⁵ it is not expected that increased compliance alone will raise revenues sufficient to correct the cost limitation. Compliance rates above 80% are anticipated after all collection tools are fully implemented,⁶ but no tax collection program collects 100% of taxes owed.

See Figure 1 and Table 1 below for payment compliance rates and tax collections, respectively.

Figure 1. Arts Tax Payment Compliance by Tax Year and Months Past Due Date



⁴ See Portland City Council work session documents, July 24, 2013, <https://www.portlandoregon.gov/revenue/article/486527>. See also “Arts Education and Access Income Tax Impact Analysis: Excluding Income Under \$1,000”, March, 2013, <https://www.portlandoregon.gov/revenue/article/486764>.

⁵ These tools will be fully implemented between 2018 and 2021.

⁶ The IRS reports final taxpayer compliance rates of 85.5% after enforcement actions are taken. See <https://www.irs.gov/uac/irs-releases-new-tax-gap-estimates-compliance-rates-remain-statistically-unchanged-from-previous-study>.

Table 1. Arts Tax Revenue by Calendar Year

Calendar Year	Tax Revenue (millions of dollars)	% Increase from Prior Year	Collections for Tax Years
2013	\$7.9	NA	2012
2014	\$9.5	20.0%	2012-2013
2015	\$9.7	2.1%	2012-2014
2016	\$10.8	11.3%	2012-2015
2017*	\$10.1	NA	2012-2016
Total	\$48.0		
*Year-to-date as of August 9, 2017.			

Budget Reduction Will Negatively Impact Revenue Collections

The Arts Tax budget cannot be reduced to meet the cost limitation without substantial lost revenue.⁷ Moreover, the program is currently understaffed by at least three positions and an expansion of budget is needed to maximize revenue yield.⁸

There are two primary components to the work of collecting the tax in any given calendar year: 1) voluntary compliance/taxpayer assistance (generally January-April) and; 2) enforcement action (generally May-December).

Table 2 on the following page summarizes the expenses, revenues and primary collection activities that occurred in calendar year 2016 (collections for tax years 2012-2015), the most recent year for which final expense data is available.⁹ If the 5% cost limitation had been strictly adhered to in 2016, collection efforts would have ceased after April saving \$524,000 in expenses while foregoing \$2.5 million in enforcement revenue, the majority of which was disbursed to the Regional Arts and Culture Council (RACC). A substantial body of voluntary compliance work would also not have been completed (taxpayer account reconciliation which is completed in July). Ending collection efforts after April would also create a negative feedback loop as taxpayers would realize no consequences exist for non-compliance and fail to file and pay in subsequent years in growing numbers.

⁷ Over 95% of the budget is comprised of direct expenses like staff salaries and printing and mailing costs or fixed expenses such as technology services and required City General Fund overhead. The Revenue Division already subsidizes the program by providing additional direct and indirect support without charge. No cuts are possible without impacting collection activities and revenue yield.

⁸ There are currently 4.5 FTE permanent staff positions allocated to the program. The staffing level is too low to send collection letters to all accounts in a timely manner. An expansion to 7.5 FTE will enable a 60% increase in collection letter volume and/or ensure more timely collection efforts. Increased enforcement revenue is expected to exceed the cost of the positions.

⁹ For purposes of the cost limitation calculation, Arts Tax revenues and expenses are accounted for on a tax/calendar year basis rather than the City’s fiscal year.

*Table 2. Calendar Year 2016 Expenses,
Revenues and Primary Collection Activities*

<u>Months</u>	<u>Collection Expenses</u>	<u>Tax Revenues</u>	<u>Cost Limitation Calculation</u>	<u>Primary Collection Activities</u>
January - April	\$425,515	\$8,205,694	5.2%	predominantly voluntary compliance work: 404,000 "reminder to file" notices mailed; 154,000 automated e-mail reminders sent; 10,000 "human-to-human" e-mails; 54,000 payments processed; 20,000 phone calls; 27,900 tax documents processed
May - December	\$524,428	\$2,544,372	20.6%	predominantly enforcement work: 90,000 collection letters mailed; 77,000 tax documents processed; 2,000 "human-to-human" e-mails; 18,000 phone calls
Total	\$949,943	\$10,750,066	8.8%	

The 5% Cost Limitation is Irrational

The 5% cost limitation was intended to assure voters that not less than 95 cents of every dollar collected (a measure of efficiency) would flow to art and music teachers and arts organizations. While this goal is certainly desirable and seems reasonable, it creates an irrational dynamic: spending \$1 to collect \$20 (5%) is allowable and legal, but spending \$2 to collect the next \$20 (10%) is not, even though it results in greater net revenues and increased disbursements to RACC.¹⁰

Adhering to the current cost limitation would also mean only voluntarily compliant taxpayers will pay the tax with no consequences for those that ignore the law. The cost limitation is, again, a measure of efficiency whereas maximizing revenue is a measure of effectiveness. A rational approach would be to focus on effectiveness by maximizing disburseable net revenue and increasing collection activities until the marginal expense and marginal revenue are in equilibrium.

Options for Council Consideration

- 1) Establish a fixed base collection cost of \$1.2 million and end the cost limitation percentage; increase the collection budget. This option would need to include an annual cost of living adjustment for salaries and materials and services. A City Code change would be required.
- 2) End the cost limitation percentage and insert language requiring the Revenue Division to maximize the revenue yield by emphasizing program effectiveness over efficiency; increase the collection budget. This would put the cost of the administration of the Arts Tax under the

¹⁰ RACC receives all the revenues collected from May-December because the revenues collected from January-April are enough to cover the City's cost of collection and disbursements to school districts; under the allocation methodology, RACC receives all revenues after the City and school districts.

Revenue Division's discretion subject to annual City Council budget approval and Arts Tax Citizen Oversight Committee (AOC) scrutiny. This option is both the most logical and potentially controversial resolution to the cost limitation issue. A City Code change would be required.

- 3) Change the cost limitation to 12%; increase the collection budget. This is a workable solution for the foreseeable future so long as the Revenue Division continues to subsidize the program, but there is some risk of a recurrence of exceeding the cost limitation if there is unanticipated revenue loss or unforeseen increases in costs such as, but not limited to, bank processing fees, overhead, postage, etc. The cost of collection will gradually rise with inflation and the only current hedge to potentially exceeding the cap in the future is in-migration (population projections indicate many more taxpayers will move to Portland over the next two decades).¹¹ A City Code change would be required.
- 4) Subsidize Arts Tax collection and fix the 5% cost limitation accounting only; keep the collection budget flat. The Council could subsidize the administration of the program to fix the cost limitation accounting, but not expand the collection budget. For the first five years of the program, the subsidy would be approximately \$1.29 million¹² rising to an estimated \$2.38 million each five years thereafter.¹³ An advantage to subsidizing the program is that the subsidy could be structured to offset direct program expenses and result in a dollar-for-dollar increase to RACC's Arts Tax disbursement. The disadvantages are that any subsidy will result in fewer available resources for other City Council priorities, will not actually maximize the revenue yield unless it increases the budget, and may still be perceived as a break with what voters approved in 2012 (as is the case with most of the options presented here). It is likely no City Code change would be required to implement this option, subject to City Attorney review.
- 5) Subsidize Arts Tax collection; increase the collection budget. The Council could subsidize the administration of the program to fix the cost limitation accounting as discussed in option 4 above. The advantages and disadvantages are the same as option 4, but the cost will increase by \$1 million in the second five-year window (approximately \$200,000 more per year, or \$3.38 million over five years).
- 6) Require the program to adhere to the 5% cost limitation. The consequence of this option is dramatically scaling back or ending collection efforts after April and foregoing \$2-\$3 million per year in enforcement revenue. Steadily declining rates of voluntary compliance and revenue yield are also expected after enforcement ends.

Hybrid options are possible. For example: 1) a lower subsidy combined with a smaller increase in the cost limitation, or; 2) subsidizing the first five years of the tax and changing the cost limitation requirement on the next five and subsequent years. If desired, such options could be modeled and presented.

¹¹ Another consideration is indexing the Arts Tax rate to an inflationary index such that the \$35 assessment is gradually increased to keep pace with inflation.

¹² A final figure will not be available until calendar year-end. The required subsidy will likely increase slightly.

¹³ As of June 30, 2017.

Revenue Division Recommendation

The Revenue Division recommends the first option (a \$1.2 million budget with annual adjustments) as it maintains a budget limitation concept while providing a more appropriate budget and adjustments for future costs increases. It also follows more traditional City budgeting practices. The second and third options are also workable approaches.

AOC and RACC Recommendations

The Arts Tax Citizen Oversight Committee (AOC) and RACC recommendations are below.

The AOC's recommendation is:

At its meeting on August 14, 2017 the AOC voted to support the Revenue Division's Recommendation 1, substituting a maximum administrative budget amount of \$1.2 million annually for the 5% cap. The AOC recognizes that the Taxpayers voted for a cap on expenditures. Advocating a change to that cap is difficult. But unless the cap is altered, the tax will not achieve the taxpayers' objectives for the tax.

RACC's recommendation is:

The Regional Arts & Culture Council supports city council subsidies (options #4 and 5) that would yield commensurate revenue for RACC to invest as grants that address the "access" goals of the Arts Education & Access Fund. These options would not likely require any changes to City Code, and would help ensure that more tax dollars flow to the intended beneficiaries. RACC also supports all efforts to maximize the tax revenue yield.

Attachments: Portland City Council Resolution No. 37214
Current and proposed Arts Tax collection budget