Response to Budget Note B
Oregon Department of Revenue
January 2012

Through a 2011 Budget Note, the text of which follows, the Ways and Means Committee of the Oregon State Legislature directed the Oregon Department of Revenue (DOR), in conjunction with the state’s Office of Economic Analysis (OEA) and Legislative Revenue Office (LRO), to develop a methodology of identifying tax receipts which result from DOR’s enforcement activities such as audits and collections.

The Department of Revenue is directed to work with the Office of Economic Analysis and the Legislative Revenue Office to develop a methodology to determine what portions of the state’s personal and corporate income tax receipts are attributable to the enforcement work (audit and collection efforts) performed at the Department of Revenue. The intent is to quantify the return on investments made in the agency’s enforcement resources and to use that information to help inform decisions about potential future investments.

In addition, a baseline calculation for enforcement efforts can be used to delineate between enforcement revenues and revenues from voluntary collections within the context of the quarterly revenue forecast.

Prior to formally adopting a methodology, the Department will report on its proposed methodology to the House and Senate Revenue Committees (either interim or session). In addition, the Department will report to the Joint Committee on Ways and Means during the 2012 Legislative Session on the methodology and a plan for integrating it into budget development for the 2013-15 biennium.

Addressing this Budget Note, the Research Section at DOR conducted a research project in consultation with OEA and LRO to formally examine the nature of and factors affecting the agency’s enforcement revenue. The results of this project are detailed in a paper which outlines the following objectives1:

1. Describe a framework to estimate Oregon’s enforcement revenue that is directly due to enforcement activity performed by DOR personnel and examine that revenue from a variety of perspectives.
2. Provide some understanding of the various internal and external factors that influence enforcement revenue and how those factors have affected revenue in the recent past.
3. Create a methodological basis for estimating impacts of changes in DOR enforcement efforts.

1 From “Enforcement Revenue Identification and Modeling,” January 2012, Oregon Department of Revenue, Research Section.
Tax Receipts Attributable to Enforcement Work

The first charge of the Budget Note, and the initial step in examining enforcement revenue, is to identify the receipts that occur because of DOR’s enforcement activities. This is a complex task. Although financial transactions data is utilized to quantify enforcement revenue, the task of specifying the types of enforcement revenue cannot be carried out as a financial accounting exercise. Every payment that DOR receives has been influenced by enforcement activity, so our goal in creating a specification was to estimate which payments were the direct result of enforcement activity performed by DOR personnel. Because it is impossible to know the motivation behind every payment, or to ascertain if any DOR action was the sole cause, a specification process must be relied upon in order to estimate the direct and indirect receipts received.

One of the initial steps in the project was a review of reports and existing literature related to compliance activities in other states. We did not identify an existing methodology to build from, so we developed a custom specification process. To our knowledge, this is the first specification of its kind, and it has the potential to be a significant contribution to the existing research on this subject. This specification process is a tool for examination and modeling of enforcement revenue; it is quite detailed, yet it is designed to be flexible.

SPECIFICATION OF DIRECT ENFORCEMENT REVENUE

Following is a high level view of the specification process, which somewhat understates its complexity. For a more complete view, see the discussion in the full research report.

An understanding of the Department’s collections and audit processes is the foundation for the development of the enforcement revenue specification. Within the conceptual framework of the working business processes, selected characteristics of financial data transactions are used to appropriately categorize tax liabilities within the proposed framework of the enforcement revenue specification.

An underlying question to keep in mind when working through the specification process is: **Was this revenue received due to direct DOR employee involvement?** If the answer is ‘no,’ then the revenue is considered indirect, whereas a ‘yes’ results in a direct revenue specification. Each revenue payment transaction is assigned as either direct or indirect by working through the following specification.

**Source of Liability: How did the tax liability come about?** The initial classification is based upon one of three potential ways in which the tax liability was initiated: the taxpayer reported the correct tax due, but did not make the full payment (self-assessed); the taxpayer reported an incorrect amount of tax due, and a liability was created due to an audit or other adjustment
(audited/adjusted); or the taxpayer did not report tax due, and a liability was created either from the taxpayer filing a return at the request of the Department or from a tax return created by the Department on the taxpayer’s behalf (filing enforcement).

**Collections process:** Was the payment received prior to or while in DOR’s collections process? Except in the case of payments applied to audit liabilities, all payments received prior to DOR’s collection process are considered indirect because the payment was received without any Department enforcement effort. Payments applied to audit liabilities are considered direct because without the creation of the audit liability by the Department, the payment would not have been received or would have been refunded to the taxpayer.

**Payment Type:** Is the revenue generated from an offset or garnishment payment? Once the source of the liability is identified, the next step is to separate liabilities which have payments associated with offsets or garnishments. Offset payments occur when a refund from one tax liability is used as a payment for another tax liability. Garnishment payments may be remitted from a taxpayer’s employer or financial institution after the process is initiated by DOR. These payment types are separated from other payments since they represent estimable levels of involvement by DOR staff in the collection of debt. Most offsets are largely automated and would occur without direct involvement by DOR collection staff, whereas garnishments are largely manual and would not occur without some direct involvement by DOR collection staff.

**Collection Status:** Was the liability being actively worked by a collector at the time of payment? For the final classification, we incorporate DOR’s Automated Collections Tracking system data to identify the collection status of each liability at the time a payment was made. Payments received for liabilities which were in an active collection status, or for which taxpayers were set up on a pay plan are considered direct enforcement revenue; payments received for liabilities which were being worked by an outside collection agency or which were in an ‘on hold’ or ‘unassigned’ status, and hence not being actively worked by a DOR revenue agent, are considered indirect enforcement revenue.

Below is a simplified version of the enforcement revenue specification matrix from the full research report.
Using the described specification, we are able to create a series of data representing direct enforcement revenue. Below is a graph of direct enforcement revenue from personal income tax (PIT) receipts, estimated to be $146.6M in fiscal year 2010-11. Significant increases in fiscal year 2010-11 were in self-assessed liabilities and audits associated with payments received through payment plans and garnishments.

![PIT Direct Revenue](chart.png)

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<th>COLLECTION STATUS (Considered After Pay Type)</th>
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The specification is also applied to the withholding and corporate income tax programs. Withholding receipts due to direct enforcement efforts are estimated at $23.0M for fiscal year 2010-11.

The graph below illustrates the volatility in direct revenue from corporate income tax receipts. Corporate tax revenue from direct enforcement efforts is estimated to be $14.5M in fiscal year 2010-11.
APPLICATION OF THE DIRECT ENFORCEMENT REVENUE SPECIFICATION

The specification of direct enforcement revenue is the deliverable for this project. The development of the specification in this project gives a tool which may be used to help develop future estimates of the impact of factors on the enforcement revenue stream, to examine the components of enforcement revenue using financial transactions data, and to stimulate discussion regarding the nature of enforcement revenue.

Two points related to the examination of enforcement revenue should be noted. One is that DOR enforcement efforts have multiple goals. While much of the agency focuses on processing revenue, enforcement functions hold current revenue generation as an important outcome but not necessarily the primary goal. Fundamental questions of tax policy principles such as uniformity and equity affect enforcement strategy. In fact, in pursuing compliance and fairness, some of DOR’s work results in negative net revenue.

Another point to consider is that there are many important components of strategy pursued by DOR in its compliance activities. One way to look at strategy is the balance between short-term revenue generation and long-term revenue protection. Generally, shifting the emphasis on one necessitates an opposite (though not necessarily equal) shift in the other. Any emphasis placed on one area comes at the expense of emphasis placed on another.

Utilizing the specification to model influences on direct enforcement revenue

No single quantitative model. We do not expect to find a single comprehensive model of enforcement revenue because there is not a simple quantitative relationship between inputs and outputs in DOR enforcement work. No two questions can be answered with the same model, and even the same question asked at different points in time will require a fresh look at the modeling process. We don’t expect any model to have all the answers.

When analyzing the return on investments made in DOR’s resources, the impact of hiring collections or audit staff is typically the primary focus. Unfortunately, initial exploratory modeling for this project indicates that the level of investment in staff or systems is a minor driver of the long range trend of direct enforcement revenue compared to more influential factors such as economic conditions and the level of outstanding accounts receivables. Because of this, we explored the development of a model which could be used to estimate the marginal impact of hiring or system changes separate from a model which would be estimating the impact of the major drivers such as the economy.

Two examples of modeling PIT direct enforcement revenue. In the research paper, we utilized the data series for PIT direct enforcement revenue to explore two specific models. The first is a short range model which estimates the marginal impact of adding an additional enforcement
related FTE. The second is a model which predicts the level of direct enforcement revenue based on economic indicators (unemployment rate and gross state product) and the level of new liabilities to the outstanding accounts receivable. The latter economic model would be appropriate for revenue forecasting applications. The short range FTE model would be appropriate for use in preparing budget estimates of the impact of enforcement staffing changes on enforcement revenue.

**Enforcement Revenues and the Quarterly Revenue Forecast**

Because revenue streams are influenced by many factors, including large economic and tax policy drivers, forecasters strive to understand these factors and revenue sources to the greatest extent possible. The specification of enforcement revenue outlined in this paper helps provide context regarding the magnitude of certain administrative actions that influence tax revenue. However, the magnitude of this direct enforcement revenue is relatively small relative to overall receipts. For example, in fiscal year 2011, PIT enforcement revenue as specified here was $147 million, less than three percent of total PIT receipts. Historically, the share of ‘enforcement revenue’ has been in a fairly narrow range from two to three percent of PIT revenue. This means that, all other things remaining equal, increasing enforcement revenue by ten percent will only increase total PIT receipts by roughly 0.3 percent. So, while this analysis allows separate tracking of ‘enforcement revenue’, there will remain many larger factors to consider in producing quarterly forecasts of total tax revenue.

If a separate forecast of enforcement receipts is necessary, it would be possible to produce one using several methods. The long range economic model presented in the research paper could be utilized to compare the historical pattern of revenue to the corresponding pattern of macroeconomic variables to produce an expected enforcement revenue estimate. This can be subjectively modified if the Department expects to undertake significantly different enforcement actions during the forecast period relative to recent history.

**Enforcement Receipts and the 2013-15 Budget**

Estimating the impacts of DOR resource or policy changes on direct enforcement revenue requires assumptions about external influences, along with an understanding of:

1. The parameters of the policy or resource change,
2. DOR’s current and historical operations in relation to the proposed change,
3. The current and historical direct enforcement revenue resulting from DOR’s operations.

Creating a specification of direct enforcement revenue helps with understanding the revenue component, but is only part of the understanding necessary to make meaningful estimates of enforcement revenue. In evaluating the impact of changes, program managers can use the
history of enforcement revenue along with their understanding of proposed changes and historical program operations.

For instance, if a proposal is made to add five Revenue Agents to DOR staff, a model like one of those presented in the appendix of the research paper can be used to create a base idea of the marginal impact of changing staff. However, we strongly caution against using the reported figure as a rule of thumb. Rather, the model may be considered a framework to begin the process of addressing a specific question.

Even with a mathematical model, assumptions still must be made about how those resources will be used. For instance, the marginal impact of new staff would be largely dependent on factors such as whether the new agents are doing similar work as existing agents or working on projects with higher (or lower) revenue impacts. In addition, because many of the drivers of direct enforcement revenue are external, assumptions must be made about changes in those external factors. For instance, if revenue agents are hired at the beginning of an economic expansion, their marginal impact may be lower than historical data would otherwise suggest.

Along with the estimation of a marginal impact of FTE or system changes, we could utilize the enforcement specification and the insight gained from the project to quantify an appropriate average rate of collection. To prepare an estimate of the return on investment in enforcement resources, these marginal and average figures would be weighed with qualitative information. Implicit in this methodology is the need for staff expertise, as the appropriate application of qualitative data and contextual information is extremely important.

We emphasize that the results of this research do not provide a new and absolute way to prepare accurate estimates – an absolute method does not exist. The work does provide a new tool to better inform the agency’s process of generating estimates.