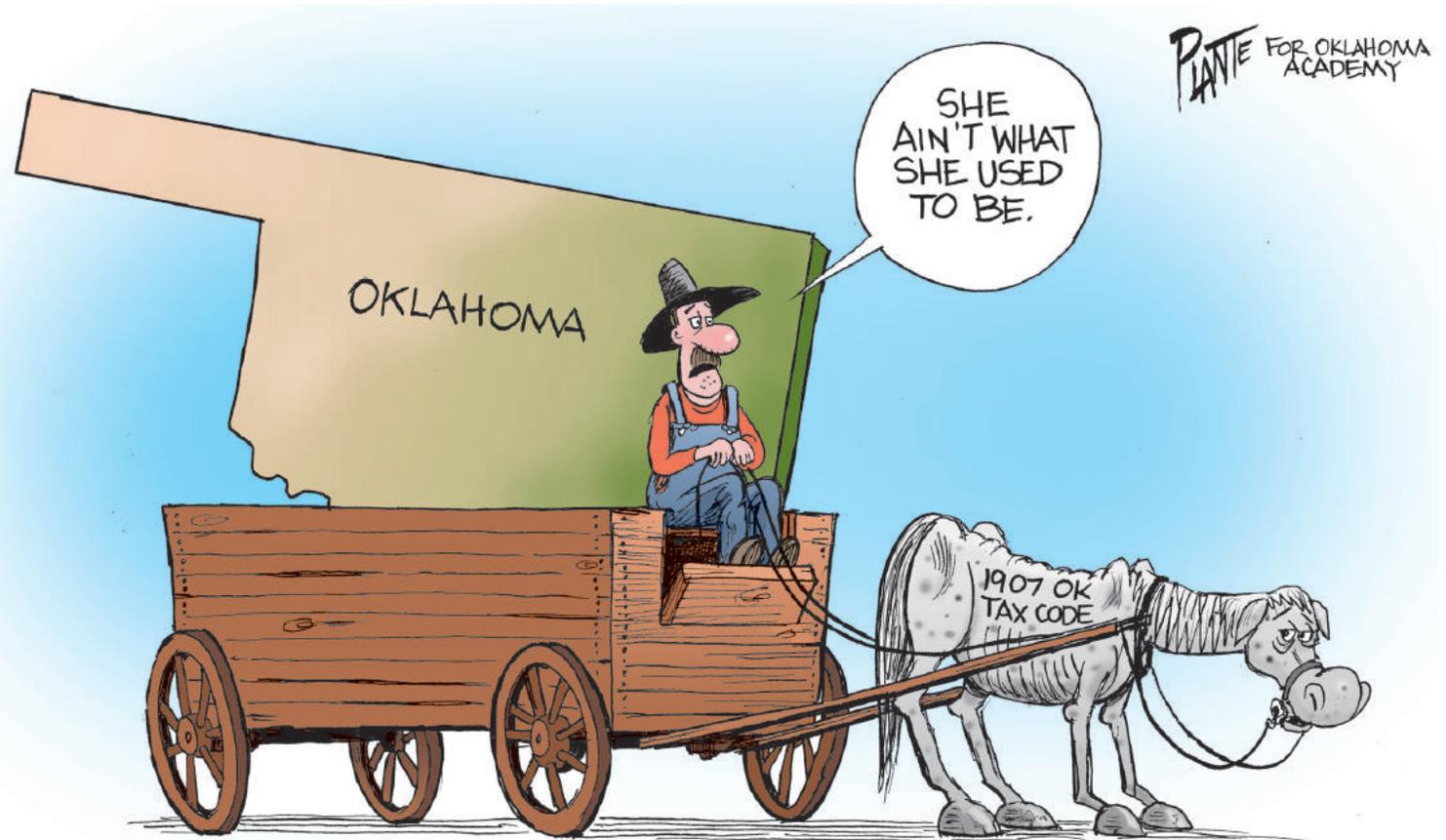




Building Awareness, Developing Policies, Inspiring Oklahomans to Move Ideas Into Action!

Aligning Oklahoma's Tax Code with Our 21st Century Economy

Equity, adequacy, simplicity, transparency, and administrative ease



**The 2018 Oklahoma Academy Town Hall
November 11–14, River Spirit Conference Center, Tulsa**



The Oklahoma Academy is a statewide nonprofit, nonpartisan, membership organization founded by Governor Henry Bellmon to bring public attention to policy issues, provide objective, thorough research and act as a catalyst for positive change.

After his first term as governor, Bellmon knew there was a need for open, nonpartisan dialogue in the young state. He sought to create a public policy organization that was independent, nonpartisan and inclusive. The purpose of which was to provide citizens the opportunity to participate in a truly democratic process designed to shape the future of Oklahoma. To this day, The Oklahoma Academy upholds Bellmon's vision and the organization's long-standing reputation as the state's premier citizen-based organization for nonpartisan public policy development.

From its inception in 1967 to its revitalization in 1985 to its adoption of the Town Hall process in 2001, The Oklahoma Academy has maintained its relevance in raising awareness and shaping public policy in Oklahoma. Despite its small staff and limited resources, The Oklahoma Academy generates and manages an impressive amount of public policy information, engages the citizens of Oklahoma in discussing and developing policy recommendations and works ardently with the community leaders and policymakers to implement the resulting ideas through community and legislative action. To date more than 53 pieces of legislation passed since the adoption of the Town Hall process in 2001.

The Academy Process identifies areas of need and problems facing Oklahoma, conducts research on identified critical issues, and develops long range goals, consensus recommendations, and agendas for action.

Through the Town Hall conference process, citizens are given the opportunity to honestly and openly discuss the issues, determine the solutions, and collaborate to develop public policies that they believe will achieve the greatest good. Then, the attendees are empowered to lobby their legislators and other policy makers about the proposed policies.

The Academy has covered a wide range of topics, including education, small business development, government structure, crime, technology and the future, and the state's constitution.

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Dear Town Hall Member Participant:

The 2018 Town Hall focus on Aligning Oklahoma's 111 year-old tax code with our 21st century economy is very timely. It is a serious opportunity to make thoughtful and significant change to this code to modernize it so that it combines equity, adequacy, simplicity, transparency, and administrative ease. Our current tax code is an amalgamation of individual legislative actions over the past 111 years which has left it hardly strategic in nature and rarely, if ever, tied to a consensus, long-term vision of where the state is headed.

By accepting your invitation to participate, you have promised to be prepared. This resource book has been developed to help you do that. It is important that you read the document. With this topic especially, if you have not read the document, you will not be prepared, and you will stifle your group's discussion. You have also accepted the responsibility to represent others in your geographic, demographic, and vocational area as you discuss and deliberate the discussion questions at Town Hall. It is critical to be prepared. The success of any Town Hall is dependent upon the preparedness of its participants. As a Town Hall member your voice can be heard, should you choose it to be.



Julie Knutson
President and CEO

Your Assignment and Role...

Take advantage of your unique opportunity. Be prepared. Listen actively, share your thoughts and ideas, and importantly, learn. The work of the Town Hall is much easier, more satisfying, better done, and more fun to those who have prepared themselves appropriately for the discussions. While there are some plenary session speakers who share information with us during the Town Hall, the real speaker and developer of what comes out of a Town Hall is YOU. The better prepared you are, the richer the discussions and the better the consensus recommendations and solutions.

So, I say again, Be Prepared!

Many thanks to our two Town Hall Co-Chairs, Dan Boren and Darryl Schmidt. They have collaboratively participated in the work of the research committee in developing the details and specifics of this Town Hall. Huge thanks to Howard Barnett, Town Hall Planning Committee Chair, and to the Town Hall Planning Committee members. And, many thanks to Craig Knutson, Research Committee Chair, along with Research Committee members Mark Snead and Mark Kinders.

Throughout late spring, summer and early fall, we held community and organization "listening sessions" on the topic of Oklahoma's Tax Code. By "listening session," I mean gatherings where we have sought information from people about how much they know and don't know on our tax code. We have responses from more than 300 Oklahomans across the state. The information they shared with us has been processed and will be provided to you as a Town Hall participant in advance of the Town Hall.

Recognition also needs to be given to: new staff member, Lynn Thompson, Communications & Development Director, for the design and production of the Background Resource Document; to Michael Gordon, Board member and Membership VP for his work in setting up many and leading several of the listening sessions; to Academy Board Members Dan Schiedel, Sandy Washmon, Rachel Hutchings, and Member Harolynn Wofford for arranging listening sessions in their respective regions, and to Together Oklahoma members Sabine Brown, Conner Hess, and Tori Moore for assisting us in setting up three special listening sessions. Special recognition to Roberta Botello, Dr. Tracy Morris and student with the University of Central Oklahoma for their work in scoring the information provided from the listening sessions. And, recognition needs to be given to our other new staff member Lauren Williams, Membership & Programs Manager, for her work in maintaining good contact with those interested in participating or observing this Town Hall and working with the Town Hall facility to ensure all is set up properly.

Enjoy your Town Hall!

2018 Town Hall Leadership



Dan Boren, Town Hall Co-Chair



Darryl Schmidt, Town Hall Co-Chair

Dear Town Hall Member Participant:

Oklahoma had had a rich history as a populist state, and Oklahomans have been skeptical of the tax code coming from policymakers at the state capitol. We have relied upon a state income tax, and have also received revenue from the energy industry, or exclusivity fee payments from Native American tribes.

In addition, we have further complicated our revenue streams by adding tax credits for various industries and causes while placing exemptions from others where we saw a need. As our economy has diversified and changed over the years, our tax code has not kept pace with these systemic changes.

We have seen structural deficits at the State Capitol and some would argue that has occurred because of an over-reliance on cyclical industries for revenue or that we have not looked at broadening the base or reducing exemptions. Much has changed in Oklahoma in the 111 years that have passed since statehood...but not so much our fundamental tax system.

These and other factors lead us to come together for this Town Hall to find common sense and reasonable reforms to provide sustained revenues while also creating an environment where businesses can grow and compete in a global economy.

The goal of the Town Hall is to develop specific consensus recommendations to modernize Oklahoma's tax code into one that is more balanced; one that would reduce volatility and the structural imbalances, while improving revenue reliability and sufficiency, so that core governmental services can be funded at appropriate levels annually.

This is our task. We are glad you are with us to accept this challenge!

A handwritten signature in black ink, appearing to read "Dan Boren".

Hon. Dan Boren
President, Corporate Development
Chickasaw Nation Department of Commerce
Oklahoma City

A handwritten signature in black ink, appearing to read "Darryl Schmidt".

Darryl Schmidt
President and Chief Executive Officer
BancFirst
Oklahoma City



Thoughts from our Town Hall Planning Committee Chair...

I have had the privilege of chairing several Town Halls – and this year I am chairing the planning committee which was an included function for those other Town Halls – and so I can safely say that this Town Hall is going to be a difficult one.

While we all pay taxes and most of us pay a number of different taxes to a number of different taxing authorities, we are not required to necessarily understand all of the policy choices that were made by those authorities in deciding what to tax and how much to tax. This Town Hall will require you to do some of that.

Over the last few years we have seen that our state’s current “business model” (meaning, for this purpose, the way we raise and spend money as a state) is, if not broken, certainly in need of some work. The other introductory pieces to this Resource Document give you a little flavor for the issues you will face in this Town Hall. Let me just add that we do not expect you to solve all of our “business model” issues. What we want is your views on the alternatives and some good thinking that we can pass on to our legislators.



Howard Barnett

I have an undergraduate degree in Economics and, while I remember very little from that (!), I do remember that when it comes to taxes, economists want to tax a lot of things and all low so as not to affect decision making in the private sector. That is one issue you must confront – the reliance in Oklahoma on a few, often unpredictable sources of revenue which add to the volatility we have seen in recent legislative sessions.

So buckle down and go to work! Oh, and don’t forget to have some fun!

Howard Barnett
Town Hall Planning Committee Chair
President of Oklahoma State University-Tulsa

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Building Awareness, Developing Policies, Inspiring Oklahomans to Move Ideas Into Action!

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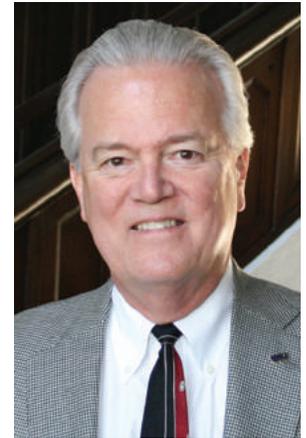
Thomas Lewis II, Field Representative for Congressman Tom Cole



Thoughts from our Town Hall Research Chair...

Just the thought of spending two and one-half days talking about taxes can cause the onset of migraines, even for those who don't suffer from them. So let's begin with a quote from J. Paul Getty, industrialist and founder of Getty Oil Company: "If you get up early, work late, and pay your taxes, you will get ahead --- if you strike oil." There are a number of Oklahomans who can probably relate to that . . . but I am not one of them and I'll bet the vast majority of those reading this aren't either.

While researching for this Town Hall, I came across an article from the Mercatus Center, a free market-oriented nonprofit at George Mason University. The article was entitled "What the Ideal Tax Code Looks Like," and while a number of its recommendations were expected ("one thing policy makers should not do is raise taxes"), the author lamented that while the Tax Reform Act of 1986 should be considered model legislation, "it failed to fix the revenue system's large institutional problems . . . and as a result, the tax code looks even worse today than before the reform." And that's the Mercatus Center!



Craig Knutson

We may never all agree on any individual tax reform package, but perhaps we can all agree on one thing (from the same article): "The most basic goal of tax policy is to raise enough revenue to meet the government's spending requirements in the way that has the least impact on the economy." To meet that goal, research suggests – and some included in your background research document, that the system contain a number of attributes like simplicity, equity, and predictability, to mention just a few.

This Town Hall will cover a number of topics and one of them is defining the principles to a successful revenue system. We have included a detailed discussion put together by the National Conference of State Legislatures (NCSL), looking at both principles and the primary taxing sources governments traditionally rely upon. Any successful tax reform must start with the guiding principles of the system that needs reform.

We are likely to address a number of dicey questions at this Town Hall. Like, how does the choice of taxes affect the yield of the tax collections? How do those choices affect the distribution of the burden of taxation on individuals? How do those choices affect the decision-making of both individuals and businesses? Does our current system reflect and maximize revenue collections given the current structure of our economy? Is Oklahoma's constitutional requirement limiting appropriations to 95% of the revenue estimate realistic in today's rapidly changing economy? In fact, given the importance of revenue estimating in the state budgeting process, should we consider alternative approaches given our recent history (itemized estimates exceeded actual collections in five of the last nine years).

The Economist ran an article recently entitled "Overhaul Tax for the 21st Century." In it, the author recounts a statement by Jean-Baptiste Colbert, a finance minister of Louis the XIV of France, comparing the art of raising taxes to "plucking the goose so as to obtain the largest possible amount of feathers with the smallest possible amount of hissing." The article concludes with "rewriting the code means winning over skeptical voters and defying rapacious special interests. It's hard work. But the prize is well worth the fight."

Our hope is that between the background resource document, the results from our summer/fall listening sessions, and what you bring to the table, we will have a lively and constructive discussion on the changes required to make our tax code simpler, transparent, and more reliable than it is today. And to do so with a limited amount of hissing!!

Craig Knutson

Town Hall Research Chair

President/CEO of Potts Family Foundation

The following quiz was given during the Town Hall Listening Sessions held in the northwest, southwest, northeast, and southeast quadrants of the state including the metropolitan areas of Oklahoma City and Tulsa.

The Academy’s intent for the listening sessions was two-fold. First, determine how well informed the attendees were about Oklahoma’s “sources of tax revenue” by having them take the 22-question quiz and then having them submit their responses. And second, utilizing an unmarked survey for each attendee, and providing the correct answers to each of the questions, thus allowing the attendees to be better informed about how tax dollars are raised and to where they are being allocated.

Now it is your turn! Answer the following 22-question quiz that was taken by Oklahomans from around the state, and see how informed you are about Oklahoma’s 111-year-old tax code. Then when you are done, the answers can be found throughout this resource document in green.

Aligning Oklahoma’s Tax Code to our 21st Century Economy 2018 Town Hall Listing Sessions Information Quiz

Please circle the answer you believe to be correct for each question.

1. What was Oklahoma’s “Overall Business Climate Index Rank” as of July 1, 2017? (Source: The Tax Foundation; please note that a rank of “1” means the state’s tax system is more favorable to business; a rank of “50” means the state’s tax system is less favorable.)

- a. 13
- b. 18
- c. 32
- d. 16

2. Circle the correct ranking for each of Oklahoma’s five component taxes. (Source: The Tax Foundation; please note that a rank of “1” means the state’s tax system is more favorable to business; a rank of “50” means the state’s tax system is less favorable.)

a.	Corporate Tax	1	9	15	36	38
b.	Individual Income Tax	1	9	15	36	38
c.	Sales Tax	1	9	15	36	38
d.	Unemployment Insurance Tax	1	9	15	36	38
e.	Property Tax	1	9	15	36	38

3. According to our state’s constitution, the Legislature can appropriate up to what % of general revenue expected to be collected in the coming year? (Source: OK Comprehensive Annual Financial Report -CAFR)

- a. 100%
- b. 90%
- c. 95%
- d. 85%

4. Which of the following offices is responsible for the review and approval of all debt issued by the state? (Source: OCAFR)

- a. OMES
- b. State Treasurer
- c. State Auditor and Inspector
- d. Council on Bond Oversight

5. Circle the correct % on the right for the category. (Source: OCAFR)

a.	Licenses, Permits, and Fees	4.0%	38.1%	46.3%
b.	Federal Grants	4.0%	38.1%	46.3%
c.	Taxes	4.0%	38.1%	46.3%

6. What was the 31 year average (1986 through 2016) of TOTAL ACTUAL COLLECTIONS/TOTAL REVENUE ESTIMATES (100.1% and above means the actual collections exceeded the initial estimates; 99.9% and below means that the actual collections fell short of the initial estimates)? (Source: OCAFR)

- a. 96.8%
- b. 91.7%
- c. 104.9%
- d. 99.7%

7. Over the 31 years, how many of those years resulted in an ACTUAL/ESTIMATE under 100%? (Actual Tax Collections failed to meet or exceed the estimate.) (Source: OCAFR)

- a. 17
- b. 14
- c. 11
- d. 20

8. What revenue source provides the vast majority of revenue for general operations of Municipalities? (Source: OK Municipal League)

- a. Income Taxes
- b. Property Taxes
- c. Sales Taxes
- d. State Appropriations

9. Which of the following revenue sources is lower today than it was in FY98? (Source: OK Tax Commission)

- a. Cigarette Tax
- b. Gasoline Tax
- c. Diesel Fuel Tax
- d. Use Tax

10. What was Oklahoma's "overall tax burden" (proportion of total personal income that residents pay toward state and local taxes) ranking in the most recent WalletHub report? (Source: WalletHub; please note that a #1 ranking reflects the state with the HIGHEST TOTAL TAX BURDEN – New York; and a #50 ranking reflects the state with the LOWEST TOTAL TAX BURDEN – Alaska.)

- a. 48th
- b. 33rd
- c. 39th
- d. 45th

11. Which two tax streams have been the most volatile in recent years and introduced the most uncertainty into the state budgeting process? (Source: State of OK Executive Budget Fiscal Year 2018 and US Census Bureau Annual Survey of State Government Tax Collections)

- a. Individual Income Tax
- b. Corporate Income Tax
- c. Motor Fuel Tax
- d. Oil and Gas Severance Taxes

12. How often have funds been used for the Rainy-Day Fund to supplement the state budget in the past two decades (FY1996 to FY2016)? (Source: State of OK Executive Budget Fiscal Year 2018)

- a. 10 out of 20 years
- b. 14 out of 20 years
- c. 8 out of 20 years
- d. 12 out of 20 years

13. What share of total state taxes did oil and gas severance taxes comprise at the height of the Oil Boom in FY1982? (Source: OK Tax Commission and US Census Bureau Annual Survey of State Government Tax Collections)

- a. 27.4%
- b. 31.6%
- c. 18.7%
- d. 22.5%

14. What share of total state taxes did oil and gas severance taxes comprise following the recent state-level oil and gas recession in FY2016? (Source: OK Tax Commission and US Census Bureau Annual Survey of State Government Collections)

- a. 8.7%
- b. 6.9%
- c. 2.1%
- d. 3.9%

15. There is a distinct mismatch since FY2001 between the rate of growth in the state economy and the rate of growth in total tax revenue collected by the states. What are the respective annual growth rates? (Source: OK Tax Commission and US Census Bureau Annual survey of State Government Tax Collections)

- a. 6.2% for state GDP but only 1.0% annually for state tax revenue
- b. 4.5% for state GDP but only 1.5% annually for state tax revenue
- c. 3.7% for state GDP but only 1.2% annually for state tax revenue
- d. 5.8% for state GDP but only 2.3% annually for state tax revenue

16. Oklahoma is one of only 13 states to apply the general sales tax in full or in part to purchases of groceries. What measure does the state use to offset it? (Source: Center on Budget and Policy Priorities)

- a. \$40 sales tax credit on income tax
- b. Property tax rebate
- c. \$400 sales tax credit on income tax
- d. Sales tax holiday

17. The state has experienced 10% annual declines in total tax revenue in three years since the early 1980s. Which year did the state not experience a 10% decline? (Source: US Census Bureau Annual Survey of State Government Tax Collections)

- a. FY2016
- b. FY2001
- c. FY1987
- d. FY2010

18. Federal transfers to the state declined from \$8.02 billion in FY2010 to _____ billion in FY2015.

- a. \$ 7.62 billion
- b. \$ 6.05 billion
- c. \$ 5.21 billion
- d. \$ 7.04 billion

19. Federal transfers to local governments in OK declined from \$632.6 million in FY2009 to _____ million in FY2015.

- a. \$ 592.5 million
- b. \$ 301.7 million
- c. \$ 423.7 million
- d. \$ 395.6 million

20. The Oklahoma voters passed State Question 640 in March of 1992. Essentially, any revenue bill would require 75% of both legislative chambers and the signature by the governor before it would become law. How many times has the legislature passed a revenue-raising bill since the passage of SQ 640 in 1992?

- a. 0
- b. 1
- c. 2
- d. 4

21. How many times have the voters of Oklahoma (by simple majority) passed a revenue-raising bill through the passage of a State Question?

- a. 0
- b. 1
- c. 2
- d. 4

22. What is the estimated amount (\$\$) of credits, deductions, and exemptions, from income tax, sales tax, motor vehicle tax, etc. sources, that reduces total tax collections annually in the state of Oklahoma?

- a. \$950 million
- b. \$2.5 billion
- c. \$6.1 billion
- d. \$10 billion

*(*The answers can now be found throughout this Town Hall Background Document in this color.)*

Answers can be found on the following pages:

Q1- pg. 6; Q2- pg. 28; Q3- pg. 37; Q4- pg. 54; Q5- pg. 59; Q6- pg. 68; Q7- pg. 74; Q8- pg. 84; Q9- pg. 86; Q10- pg. 89; Q11- pg. 96; Q12- pg. 97; Q13- pg. 98; Q14- pg. 103; Q15- pg. 106; Q16- pg. 110; Q17- pg. 117; Q18- pg. 120; Q19- pg. 141; Q20- pg. 159; Q21- pg. 166; and Q22- pg. 167



Achieving Tax 'Equity' Will Require Careful Thought

By Mark Kinders

As a public policy issue, taxation revolves in two competing orbits.

The first is respected, traditional public policy framing that seeks the optimal technocratic solution: frame your issue; invite stakeholders to the table; investigate potential solutions; settle on the optimal solution; sell it to decision-makers. In a perfect world, technocratic solutions are devoid of politics.

However, we can't avoid the second policy orbit of politics. It intrudes every step of the way: from how broadly or narrowly the problem is framed, to who gets invited to the table to discuss it, to the preferred solution, and which powerful decision-makers are to be influenced to act. A great example of framing is asking whether the state seeks to resolve the single problem of Oklahoma's nursing shortage, or whether it is more advantageous to address the broader critical shortage of practitioners in 21 health care disciplines.



Mark Kinders, Ed. D.

The problem you frame is the problem you solve. If you only fix the nursing shortage in the former construct, have you resolved the state's health care practitioner challenge?

A brilliant study on the methods and manners of political intrusion into public policy framing and resolution is found in "Policy Paradox: The Art of Political Decision Making," by Deborah Stone (2002).

Stone makes an equity and efficiency argument that directly applies to the premise of the taxation and revenue Town Hall: every policy issue will have conflicts on what constitutes equity as a solution.

As Stone offers, "...process is important because in the polis, distributions do not happen by magic. They are carried out by real people taking real actions, not by invisible hands."

Stone notes there are eight different political philosophy definitions of equity. She illustrates this through a yarn about a faculty member who brings a chocolate cake to class, thinking she'll give an equal slice to each student. She quickly runs into a buzz saw because her students have lots of other ideas of how to achieve equity.

1. Some people skipped class that day, and others actually decided not to enroll at all. They all say that if they had known that cake was to be served in class, they would have acted differently. Philosophy: equal slices, but unequal invitations of who gets to benefit. People shouldn't be penalized when they weren't notified that cake would be served.
2. The department chair gets wind of the cake and comes up with her own discriminatory distribution formula. It ranges across seven ranks, from the enrolled undergraduates who merely get crumbs, to the department chair who gets a full slice, with extra frosting, served on china, with a linen napkin. Philosophy: unequal slices for unequal ranks, but equal slices for equal ranks. Status/Rank has its privileges, or not.

3. Male students aren't happy. They were forced to play football outdoors while growing up, while girls had the advantage of learning to bake. Further, female students are more likely to enroll in classes dominated by women who know how to bake, and who are more likely to bring cake to class. So, gender is a de facto determinant on who is privileged to get more cake over the course of their lives. The solution to this discrimination, male students argue, is the cake should be cut in equal halves for men and women, and then subdivided among the members in the respective groups. Philosophy: unequal slices, but equal blocs. (Note: college enrollment nationally and in Oklahoma is about 62 percent female. Who's more likely to get larger slices of cake in class?).

4. Everybody goes to a dinner buffet. Class members are ravenous. A result is that those last in line only get remnants of potatoes and other scraps. The delicious roast beef slices are gone. Those students argue they should get larger slices of the cake so they, too, will be as equally full as those who got all of the good stuff. Philosophy: unequal slices, but equal meals. Chocolate cake has no greater intrinsic value than potatoes.

5. Unbelievable! Some students hate chocolate! Others have a gene that rejects the nutritional value of chocolate. These two categories politely seek a small portion, take a nibble, and then leave the balance of their share for others to enjoy. Philosophy: unequal slices, but equal value.

6. The economic majors want a free market approach. Just give everyone a fork and let them have at it. The most efficient fork wielder gets the most cake. Philosophy: unequal slices, but equal starting resources. (Note: Does a youngster in an underperforming school district, or from a dysfunctional family, have the same size fork as a student from a good school district with great parenting and role models at home?)

7. Oops! There's only enough chocolate to bake a cupcake. The math students fix this by putting everyone's name in a hat and drawing a winner. Philosophy: unequal slices, but equal statistical chances of winning. (Note: Sounds like Powerball. Does the state get a commission on cake?).

8. But wait! Student government activists say the cupcake should go to the winner of an election to the office of "official cupcake eater." Philosophy: Democracy provides for unequal slices but equal votes.

When sorting through the political complexities of the emotionally charged issue of taxation and revenue, it's important to recognize the full range of numerous competing, and often opposing, philosophies of how to define equity.

The best way to arrive at that optimal policy solution is to respect, understand and accept the legitimacy of each of those competing philosophical lenses in Oklahoma's polis. That's the first step to finding common ground.

Mark Kinders, Ed. D., is Vice President of Public Affairs at the University of Central Oklahoma, and is a member of the Academy executive committee.

“Great minds discuss ideas; average minds discuss events; small minds discuss people.” - Eleanor Roosevelt

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Notes

**This is a resource document for you to use.
Take notes, highlight, use as a text book.**

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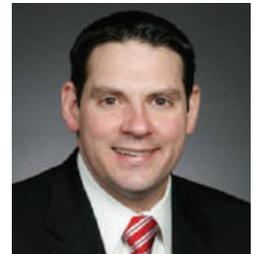
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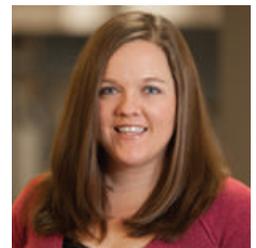
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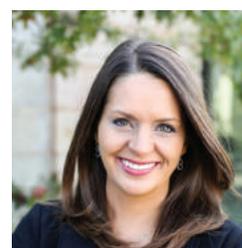
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Fred has served as the President and Chief Executive Officer of the State Chamber of Oklahoma since 2010. Prior to joining the Chamber, Morgan worked for the Oklahoma Senate President Pro Tempore and in 2006 helped broker an historic power-sharing agreement between the Republicans and Democrats. Fred is also currently Chairman of the Board for the Council of State Chambers.



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Randy has been with the Tulsa World since 1979. He is a native of Hinton, Okla., and graduate of Oklahoma State University. Krehbiel primarily covers government and politics.



Mary Murphy

Mary directs Pew's work on states' fiscal policy, which helps policymakers identify and implement effective fiscal management strategies. She leads research and outreach to state and local policymakers on a range of issues, including strategies to manage volatility, stabilize budgets, and strengthen local governments.



Mike Neal

Mike serves as president and CEO of the Tulsa Regional Chamber where he leads a full-time professional staff of 65 in the areas of regional economic development, convention and visitor development, government affairs, education, workforce development, small business, sports, young professionals, downtown and river development, political action, and membership services.



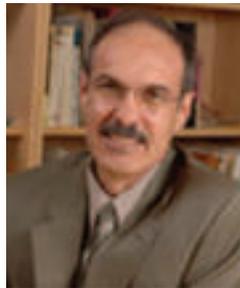
Sen. Roger Thompson

Senator Roger Thompson was elected to the Oklahoma State Senate in November, 2014. He represents Senate District 8, which is comprised of Okmulgee and McIntosh counties, and parts of Okfuskee and Muskogee counties. He is the chair of Appropriations Subcommittee on Finance and is the incoming Senate Appropriations Committee chair for the 57th Oklahoma Legislature.



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Dr. Warner is a Regents Professor Emeritus of Economics at Oklahoma State University. Warner has a doctorate from Indiana University and joined the faculty at Oklahoma State University in 1960. From 1974 to 1979, he was director of the Economic Studies Division of the Kerr Foundation in Oklahoma City. He returned to OSU in 1979 and served until he retired in 1998.



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Section 1
The Economy of Oklahoma

TAX POLICY CENTER:

Q: *How do taxes affect the economy in the long run?*

A: *Primarily through the supply side. High marginal rates can discourage work, saving, investment, and innovation, while specific tax preferences can affect the allocation of economic resources. But tax cuts can also slow economic growth by increasing deficits. The long-run effects of tax policies thus depend upon not only their incentive effects but also their deficit effects. While there are multiple models that attempt to simulate the effects taxes impact individuals, businesses, and governments, the one area of consensus is that the most pro-growth policies are those that improve incentives to work, save, invest, and innovate without driving up long-term deficits.*

(Note: By law, Oklahoma cannot run deficits, but can and has had revenue failures and shortfalls due inadequate revenue; credit rating agencies grade the health of Oklahoma's ability to have adequate and sustainable revenue to cover expenses over time).

BROOKINGS INSTITUTION:

From the report "Effects of Income Tax Changes on Economic Growth"

Reforms that improve incentives, reduce existing distortionary subsidies, avoid windfall gains, and avoid deficit financing will have more auspicious effects on the long-term size of the economy, but may also create trade-offs between equity and efficiency. We define income tax reform as changes that broaden the income tax base and reduce statutory income tax rates, but nonetheless maintain the overall revenue levels and the distribution of tax burdens implied by the current income system.

Tax reform is complex as it involves tax rate cuts as well as base-broadening changes. Base-broadening has the benefit of reallocating resources from sectors that are currently tax-preferred to sectors that have the highest economic (pre-tax) return, which should increase the overall size of the economy.

URBAN INSTITUTE:

From the report “Using the Tax Structure for Economic Development”

Every state uses a different combination of taxes to fund government services. Some rely more heavily on income taxes, and others see the most revenue from consumption taxes, such as general sales taxes or excise taxes. The effect of state taxes on business decisions is far more complex than just the composition of taxes. The effect of a state’s tax structure on economic development includes not just the mix of taxes BUT the specific features of those taxes as well. It also depends on the overall tax burden from the combination of different taxes levied.

A state’s tax structure touches all taxpayers, not just businesses. Composition changes affect all businesses and residents in the state. Pushing down one tax may push up another, or lower funds for government services, both of which may harm economic development.

FORBES MAGAZINE:

From the article “Tax Rates and Economic Growth: Is There Really a Correlation?”

Don’t forget this number: 243. Discussions about tax rates rouse emotions almost as much as discussions about where those taxes are spent. The proverbial bottom line is that the influence of tax rates isn’t as significant as the emotional response to them might suggest.

Finally, an explanation of that power-packed mystery number: 243. Add some zeroes and a dollar sign and that 243 becomes \$243 billion; what the GDP totaled in 1947. By 2017, GDP totaled \$18,905 billion. Over that period taxes increased and decreased; wages climbed and dropped; interest rates rose and fell; deficits grew and decreased; inflation, deflation, stagflation, oil crises, wars, recessions and recoveries occurred.; social and fashion trend fell in and out of favor; the White House was occupied by twelve different administrations. Through it all GDP grew. It grew because something other than money drives the undeterred American spirit, spurring it to create, produce, and reinvent itself.

Economy of Oklahoma

Wikipedia, last edited August 2, 2018

The economy of Oklahoma is the 29th largest in the United States. Oklahoma's gross state product (GSP) is approximately \$185.6 billion as of December 2016.

GSP

Historical GSP

The history of Oklahoma's GSP according to the Bureau of Economic Analysis, in nominal terms, with percentage of total to GDP of the United States:

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
OK GDP	97.7	99.5	106.1	114.2	125.1	136.8	144.3	157.5	143.5	152.1	162.1	169.3	176.4	183.5	183.1	185.6
% of US GDP	0.9	0.9	0.9	0.9	1.0	1.0	1.0	1.1	1.0	1.0	1.1	1.1	1.1	1.1	1.1	1.1

GSP growth

The development of the Oklahoma's GSP according to the Bureau of Economic Analysis, in nominal terms, with comparison to growth of the economy of the United States:

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
% change of OK GDP	6.1	1.8	6.6	7.6	9.5	9.4	5.5	9.1	-8.9	6.0	6.6	4.4	4.2	4.0	4.2
% change of US GDP	3.9	2.8	4.6	7.0	6.6	6.2	4.3	1.4	-2.1	4.2	3.4	4.5	3.7	3.6	3.6

GDP by industry

Industries value added to Oklahoma GDP in Q4 2016. Sectors percentages are compared to sector percentages of United States GDP.

Sector	OK value (\$ billions)	Sector % of OK GDP	Sector % of US GDP
Agriculture	2.232	1.2%	1%
Mining	20.182	10.9%	3%
Utilities	4.550	2.5%	2%
Construction	8.146	4.4%	4%
Manufacturing	17.751	9.6%	12%
Trade	21.688	11.7%	12%
Transportation	10.299	5.5%	3%
Information	4.303	2.3%	5%
Finance	25.534	13.8%	20%
Professional	16.017	8.6%	12%
Education and Health	14.631	7.9%	8%
Entertainment	6.638	3.6%	4%
Other Services	4.076	2.2%	2%
Government	29.552	15.9%	12%
Total	185.602	100%	100%



Flag of Oklahoma

Currency US\$ (USD)
Fiscal year July 1 - June 30

Statistics

GDP \$181.5 billion (nominal, 2017)^[1]
GDP rank 29th (2016)
GDP growth ▼-4.2% (2016)^[2]
GDP per capita \$43,449(2017)^[3]
GDP by sector Agriculture 1%
 Industry 27%
 Services 72%
Population below poverty line 15.9% (2011)^[4]
Gini coefficient 0.461 (2013) ^[5]
Labor force 1,868,500 (2015)^[6]
Labor force by occupation Agriculture 4%
 Industry 16%
 Services 80%
Unemployment 3.9% (2015)^[7]

External

Exports \$6.3 billion (2014) ^[8]
Main export partners
 🇨🇦 Canada 30.2%
 🇲🇽 Mexico 9.5%
 🇯🇵 Japan 4.7%
 🇨🇳 China 4.3%
Imports \$13.6 billion (2014)^[9]
Main import partners
 🇨🇦 Canada 47.8%
 🇨🇳 China 19.9%
 🇲🇽 Mexico 7.4%
 🇯🇵 Japan 2.9%

Public finances

Public debt \$1.9 billion; 1% of GDP (2015)^[10]
Revenues \$17.5 billion (FY2014)^[11]
 (Federal Grants 38.3%, Income Tax 19.1%, Sales Tax 14.8%, Other 30.2%)
Expenses \$17.5 billion (FY2014)^[12]
 (Health Services 32.6%, Education 25.1%, Social Services 12.7%, Gov't Admin 12.7%, Public Safety 4.6%, Debt Service 2.3%, Other 10.1%)
Credit rating
 • Standard & Poor's: AA+
 • Moody's: Aa2
 • Fitch: AA+ ^[13]

All values, unless otherwise stated, are in US dollars.

Oklahoma's Economic History

Larkin Warner and Brad Agnew, Oklahoma Historical Society

Oklahoma's economic history is divided into four periods. The first period covers the nineteenth century, encompassing settlement by American Indians of the Southeast followed by new arrangements facilitating private land ownership. The second extends from 1900 to the onset of the Great Depression in 1930. The third ends in 1973 with the first of the major oil shocks. The fourth comprises the energy boom and bust of the late twentieth century, along with contemporary conditions.

The century from 1800 to 1900 encompassed the time of Indian and white settlement. During the nineteenth century Oklahoma was characterized by very high ratios of land to labor and capital, by almost total dominance of primary (natural resource based) production, and by unique institutional and cultural features, of which the effects of some remain important in today's economy. The initial settlement by the Five Tribes in the 1820s, 1830s, and 1840s in what is now Oklahoma (at that time Indian Territory) did not reflect free-market labor migration in response to income differentials. Added to the coercion of removal was the fact that the Five Tribes had adopted the institution of slavery in their former southern setting. Slave-owning Indians brought with them an additional labor supply.

Economic analysis of Oklahoma prior to white settlement is complicated by the cultures of the Five Tribes. Some members of those groups had adopted the dominant white culture's modern economic and political systems prior to Removal. Others, frequently full bloods, did not wish to become part of the modern sector. There was thus a dual economy. The modern sectors of the Five Tribes apparently prospered during the period from removal to the Civil War. Tribal governments were reestablished, and although land was owned collectively, the tribes granted effective control to large-scale landholders raising cotton and livestock. No doubt per capita incomes grew significantly during this "Golden Era."

The Civil War was an economic disaster for the Five Tribes. The North-South conflict was played out in miniature in the territory. Assets were destroyed and agricultural activities interrupted. After the war ended, punitive measures against tribes that had sided with the South involved confiscation of their lands in the western half of the state.

From the Civil War until the initial land run in 1889, the western half of Indian Territory served as the destination for the removal of various additional tribes from the western United States. These Indians, as well as those who already lived there, continued their traditional activities of hunting and subsistence agriculture and were not part of a modern economy. In the eastern half, however, there was rapid economic recovery spurred by railroad construction, expansion of timber and coal mining, and immigration of a substantial



A truckload of money, July 1961

(2012.201.B0962.0532, photo by M. Matheson, Oklahoma Publishing Company Photography Collection, OHS).

number of whites. The growth of the non-Indian population grew remarkably. A census of the Indian agency with jurisdiction over the Five Tribes reported an 1888 total population of 177,000, only 37 percent of whom were members of those tribes.

By the late 1880s there was great political pressure to open Oklahoma to white settlement. Nationally, the population "escape valve" provided by the western frontier was being closed. The ratio of land to labor in Oklahoma was too small to be politically sustainable. When the political pressure finally resulted in policy, quite different processes were used to settle the eastern and western halves of the state.

The contrast between methods of obtaining property rights in land in the east (Indian Territory, or I.T.) and the west (Oklahoma Territory, or O.T.) could not have been greater. In O.T. rights were obtained through land runs and lotteries and by court order between 1889 and 1906. Migrants from the Midwest and other places obtained homesteads and town sites through clearly defined legal processes. Rewards were anticipated for the hard work required to develop farms and ranches and to develop urban enterprise. Legal institutions were created by a central territorial government established in 1890 (following passage of the Organic Act on May 2, 1890) and were complemented by new local governments.

In contrast, throughout much of the nineteenth and early twentieth centuries non-Indians migrating into eastern Oklahoma were largely from the South. They were not discouraged by existing conditions regarding the lack of opportunity to own land, to participate in government, or to educate their children. Some were squatters, some were sharecroppers, some were blacks escaping the onset of Jim Crow laws in the South. No doubt many of these people anticipated the eventual availability of property rights in land. Nevertheless, land continued to be held collectively by the tribal governments until the late 1890s. A new federal government policy forced the process of allotment of individual parcels to Indians determined to be on the tribal rolls. Unfortunately, it then became easy for whites and mixed-blood entrepreneurs to separate less sophisticated Indians from their individual land holdings. Thus, although in the western half of Oklahoma property rights were largely obtained through hard work involved in homesteading, in the eastern half rights were obtained through business practices that were sometimes legal and sometimes not, but that today appear unethical.

Between 1900 and 1930 Oklahoma was spreading out and filling in. This was a period during which Oklahoma's economy began to look like that of a typical state. Having already doubled during the 1890s, population soared from 790,000 in 1900 to 2,396,000 in 1930, and gainful employment grew from 266,000 to 828,000. Although agriculture remained the dominant economic activity in the state, its relative role was much diminished. Agriculture's share of employment dropped from 70 to 37 percent, and employment shares grew in trade and technical occupations. Much of the new manufacturing growth was related to the natural resource base, for example, petroleum refineries, meat-packing plants, and cotton gins.

The very high ratio of land to labor characterizing the late 1880s was rapidly lowered. In fact, there were areas in which the agricultural work force overshot the supportive capacity of the land, that is, initial homesteads were too small to be profitable. More than half of Oklahoma's counties experienced their peak population during this period. After about 1910 farming and ranching were never again important sources of statewide employment and population growth.

Between 1910 and 1930 the share of state employment in mining (largely oil and gas) grew from 2 percent to 5 percent as a series of oil fields were opened. This generated a good deal of local economic instability. It also meant that the state's economy was now buffeted by world commodity price changes in petroleum as well as agriculture.

Rapid population growth from 1900 to 1920 created demands for public infrastructure and demands for the growth of tertiary (service) activities to be provided, largely in urban areas. As needed investment took place, no doubt the productivity of the state's economy was enhanced. Between 1900 and 1919, for example, total personal income was estimated to have grown from \$90 million to \$1 billion.

From its beginning, Oklahoma was relatively poor in com-

parison with national norms. It is estimated that the state's per capita personal income was only 52 percent of the national average in 1900. By 1919, with heavy wartime demands for farm produce and petroleum, per capita income reached 83 percent of the U.S. figure but dropped quickly to 67 percent in 1921. At the national and the state levels the Roaring Twenties was a period of serious recession in agriculture.

The results of the strikingly different cultural characteristics of the migration flows to the eastern and western parts of the state were evident quite early. In 1910, for example, illiteracy rates were significantly lower in the western counties, which had been the former Oklahoma Territory, as compared to the eastern Indian Territory counties.

With statehood in 1907 came a new state constitution and an institutional framework for business that reflected widespread skepticism of concentration of power, whether in big business or in government. Elements of this populist philosophy remain embedded in some of the state's institutions. Immediately included was a new system of racial segregation practices not present during territorial days. No longer could Oklahoma serve as a destination for migrating blacks escaping Jim Crow laws.

The years from 1930 to 1973 were a time of a quest for stability and diversification. Economic forces from outside buffeted the Oklahoma economy during this period. There was the Great Depression of the 1930s, the boom times of World War II and postwar recovery, and the dramatic restructuring of the farm economy in the 1950s. At last, in the 1960s and early 1970s Oklahoma began to have significant success in economic diversification with expanded manufacturing activity.

There was a continued decline in agriculture's share of jobs, from 33 percent in 1940 to 5 percent in 1970, and manufacturing's share grew from 8 percent to 16 percent. In spite of the trauma of the Great Depression, the number of farms only declined from 204,000 to 180,000 during the 1930s. By far the most significant period of farm consolidation and out-migration from rural areas was the 1950s, during which the number of Oklahoma farms declined from 142,000 to 95,000. Although the number of farms has continued to trend downward, there were still 74,000 reported in 1997. Concentration of output in larger units has continued; in 1997, 8 percent of the farms with sales over \$100,000 accounted for 79 percent of total sales.

From 1930 to 1960 the state's economy was unable to generate enough nonfarm jobs to offset the declines in agriculture. Although population growth began to accelerate in the 1960s, during the entire forty-year period 1930–70 Oklahoma's population expanded only 6.8 percent, while the national population grew 65.6 percent. The performance of incomes in Oklahoma reflected the relatively loose labor market characteristic of low rates of employment and population growth. The state's per capita personal income was 65 percent of the national norm in 1929 and dropped to 54 percent in 1932. Between 1940 and 1944 the state's per capita income grew

from 63 to 79 percent relative to the nation's as the state capitalized on wartime expenditures at military installations and war plants and in the oil and agriculture sectors. State manufacturing employment grew from 37,000 in 1939 to 102,000 in 1944, a level that was not to be achieved again until 1965. And Oklahomans took advantage of the wartime boom in employment elsewhere. In spite of the "Dust Bowl" image of Oklahoma in the 1930s, the years of World War II witnessed some of the most intense out-migration in the state's history as people left to acquire defense jobs, particularly on the West Coast.

By 1960 state per capita income had risen to 85 percent of the national norm, and it appeared as though Oklahoma was on the way to achieving wage scales comparable to many other states. A challenge lay ahead, however, in achieving a more diversified economy. Manufacturing employment had expanded from 65,600 in 1950 to 86,600 in 1960. As a result of investment impulses from a prosperous national economy in the 1960s, significant federal assistance in infrastructure development, and new state/local government economic development incentives, sixty-five thousand new manufacturing jobs were added to the state's economic base between 1960 and 1973.

A very important but often overlooked development during the 1950s and 1960s was the widespread adoption of mechanical air conditioning. The productivity of industrial and commercial establishments was enhanced during the heat of the summer, and housing was more comfortable. No longer was a hot summer climate a major barrier to attraction of business from cooler climes.

An important feature of the period 1930–73 involves the growing economic influence of the federal government. During the 1930s the New Deal greatly expanded the federal role in infrastructure, industry, and labor markets. Depression-era agricultural policies have remained a major source of support for Oklahoma farms. Output controls, import quotas, and favorable tax treatment created a more stable environment for Oklahoma's oil industry. Social Security and public assistance ("welfare") helped individuals and families lead more secure lives. Oklahoma took special advantage of the joint federal-state public assistance program by earmarking the state's new general sales tax to its Department of Public Welfare (now the Oklahoma Department of Human Services), under the direction of Lloyd Rader. By 1960–61 Oklahoma led the nation in per capita public assistance payments. Although the state no longer holds that distinction, the transfer payment share of personal income remains well above the national average.

The growth of military bases and defense-related industry during World War II created an important new sector in the state's economy. With forty-six thousand civilian and military personnel in 2000, this sector remained a mainstay of the state's economy, generating massive inflows of federal dollars. Although the 1950s was not a period of major expansion of the federal government, the new federal-state interstate

highway system, along with state turnpike development, transformed Oklahoma's transportation facilities in the 1960s and 1970s. Completion of the McClellan-Kerr Arkansas River Navigation System added transportation advantages and provided a new system of water-based recreation as Corps of Engineers built lakes. Expanded airline service meant quicker access to economic centers on the East and West coasts and permitted Oklahoma to take advantage of its central geographical location.

Another period of expanded federal economic programs came in the 1960s. Emphasis on fighting poverty, promoting regional development, and improving education put Oklahoma in a favorable position to seek federal support; the state had plenty of poverty and badly needed regional development. New federal policies supporting education for skilled trades were the basis for an extensive system of area vocational-technical schools.

From 1973 to 2002 Oklahoma endured shocks from the global economy and federal retrenchment. Except perhaps for the periods 1910–30 and 1950–73, the economic history of Oklahoma has involved a great deal of turbulence, for example, rapid settlement prior to 1910, the Great Depression, and World War II. The oil price shocks of 1973–86 maintained this tradition. There was a ten-fold increase in the price of Oklahoma crude oil between 1972 and 1981 as the OPEC cartel drove up world oil prices. Employment in the oil patch grew from around 34,000 in the early 1970s to a peak of 102,000 in 1981 and then fell back to around 40,000 in the late 1980s as Oklahoma oil prices dropped by 50 percent. The traumatic collapse of the energy business led to substantial out-migration, failure of financial institutions, excess capacity in real estate, and fiscal crises in state government.

During the energy boom, incomes rapidly rose. The state's per capita personal income was virtually identical to that of the nation's in 1982; by 1987, the state's income relative to the nation's had fallen back to 81 percent. Total state nonfarm employment, which had risen from 852,000 in 1973 to 1,201,000 in 1981, fell to 1,108,000 in 1986. Although incomes had collapsed, the state did not give back all the employment gains of the boom years.

As a generator of jobs, the state's economy proved to be remarkably resilient after the collapse of the energy boom. During the period 1986 to 2002 the nonfarm employment rose by nearly 400,000. Oklahoma's employment growth kept pace with the nation's during a period of steady expansion from 1991 to 2001. As this occurred, the state became relatively more diversified. By 2000 the mix of state nonfarm employment among major sectors of the economy looked similar to that of the nation as a whole, with only a slightly lower share in manufacturing (12.3 percent in Oklahoma versus 14.0 percent for the United States). By far the most significant contrast with the nation's industry mix was for government employment, which accounted for 19.4 percent of nonfarm jobs for Oklahoma and only 15.6 percent for the nation.

Oklahoma's population continued to follow trends of employment strength and weakness. During the booming 1970s many people migrated into the state, and population grew 18.2 percent, rising to a little more than three million residents in 1980. Population growth during the 1980s was only 4.0 percent, though growth picked up to a 9.7 percent rate in the 1990s. In 1990s as well as the 1980s, however, state population growth lagged that of the nation.

The expanding national economy between 1991 and 2001 was characterized by some as a "New Economy," relying on rapid productivity growth driven by computer-based technology and related improvements in communications and facilitated by growth in world trade. At the national level, nominal per capita personal income grew 50.7 percent during this period. Oklahoma did not quite keep up with the nation, with per capita personal income growth of 48.2 percent. At 82 percent of the nation's, the state's 2001 per capita personal income was still far behind the rest of the country. No doubt some of this gap is due to the fact that a less than average share of the adult population in Oklahoma is in the labor force. Relatively low wage levels remained another factor. Some of this gap is ameliorated by the fact that costs of living are perhaps as much as 10 percent lower in Oklahoma than is typical of the nation. Recent research indicates that the state's low income may be due to low labor productivity rather than having the "wrong" fundamental mix of industries. Labor effectiveness is partially determined by education or investment in human capital.

The income gap is also associated with the persistently low levels in much of eastern rural Oklahoma and a few counties in the southwest. The pattern of differential east-west economic well-being observed at the time of statehood was still maintained in 2000, but with important distinctions. During the 1990s individual incomes and population tended to grow throughout the eastern half of the state, but incomes were, for the most part, relatively stagnant in the west. More than two thirds of the state's nonmetropolitan counties west of Interstate 35 lost population in the 1990s, but all of the nonmetropolitan counties in the east, except one, gained population.

The state's institutional environment changed as a result of a reorientation of federal policies. The intense reliance on linkages with the federal government that was so important between 1930 and 1973 weakened during the recent period. Federal government budgetary retrenchment meant that state/local governments were less reliant on federal grants-in-aid, and deregulation meant more intense free market forces in fields such as banking, transportation, communications, and utilities. Emphasis on fewer government barriers to international trade, both for the nation and the rest of the world, meant increasing participation by Oklahoma in the global economy. As the new century began, the future of Oklahoma's economy appeared increasingly tied to its competitiveness in international as well as national markets.

Since the Great Depression, state leaders had urged diversification of Oklahoma's economic base, which rested primarily

on petroleum and agriculture. Continuing to value low taxes over civic improvement, Oklahoma voters frustrated efforts to strengthen the very services and facilities that would attract business. The state's disappointing economic growth was masked by the general postwar prosperity fueled by the Cold War and occasional hot conflicts. Concern about the narrowness of the state's economic foundation was forgotten almost entirely as international crises sent the price of beef, wheat, and oil soaring in the 1970s. While Sooners did not share equally in the economic bonanza, most Oklahomans and their government enjoyed the good times spurred by a spending spree underwritten by financial institutions with little apparent concern for tomorrow. Success was marked not by how much a firm could produce and sell, but how much it could borrow and spend.

While this buccaneer attitude was not unique to Oklahoma, the collapse of Penn Square Bank in Oklahoma City in 1982 marked the end of a spending binge fanned by unsound loans and left many Oklahomans and their government reeling. Bankruptcies, soaring unemployment, and plunging state revenue rekindled memories of the 1930s. Despite a population exodus from the industrial states of the Northeast, Oklahoma's economic development remained lackluster, its per capita income ranked in the bottom quarter, and its population growth lagged behind the national average. Many of the state's brightest youth sought economic opportunity beyond its borders.

In the final decade of the century Oklahoma shared in the nation's longest period of economic boom. Oil prices rose, and increased state revenue enabled the legislature to allocate additional funds for education, highways, and other public services and facilities. In April 1995, as Sooners were savoring the economic upturn, international attention was again focused on the state when an explosion rocked Oklahoma City and destroyed the Alfred P. Murrah Federal Building, killing 168 people and wounding hundreds of others. Whatever other problems they had confronted, Oklahomans, like most Americans, had felt safe from the threat of terrorism. With the Oklahoma City Bombing, their security vanished in the smoke and debris of the explosion.

Adversity has a long history in Oklahoma. Many of the state's American Indians arrived via the Trails of Tears. The Plains tribes battled unsuccessfully to preserve their way of life. The pioneers faced isolation, drought, and an unforgiving land. The state's farmers, oilmen, and miners lived with the knowledge that forces beyond their control could turn boom to bust. The Great Depression and Dust Bowl of the 1930s made "Okie" synonymous with poverty and failure. Tornadoes regularly cut swathes of destruction through the state. The bankruptcies of the 1980s still haunt those affected. Most Sooners who survived those tragedies picked up the pieces and began again as did the victims who lived through the bombing of the Murrah building. Some, like those who endured the Great Depression, will bear the scars for the rest of their lives. The pioneers who dreamed of establishing a new Eden might have been disappointed by the repeated trials that beset the state, but they could be proud of the way their children and grandchildren confronted them throughout the twentieth century.

Capitol Insider: OU's Bob Dauffenbach On Economic Growth In Oklahoma

Caroline Halter, KGOU, August 3, 2018

Oklahoma's economy is tracks closely with the price of oil, which have risen significantly since the 2014 downturn. In this episode of Capitol Insider, Bob Dauffenbach, the Senior Associate Dean for Economic Development and Impact at the University of Oklahoma, joins KGOU's Dick Pryor and eCapitol's Shawn Ashley to discuss the state's economic outlook. Dauffenbach also offers his thoughts on what policymakers should be doing to harness the state's economic growth.

This is the full transcript of the discussion between Dick Pryor, Robert Dauffenbach and Shawn Ashley on Oklahoma's economy:

Dick Pryor: Our guest is Dr. Robert Dauffenbach, Senior Associate Dean for Economic Development and Impact at the University of Oklahoma Price College of Business. Bob, welcome.

Robert Dauffenbach: Thank you. Glad to be here.

Pryor: Shawn, after years of cutting budgets because of declining state revenue the economic situation in the state is improving.

Shawn Ashley: Yes, one of the things that was sort of overlooked back in December and February, when the Board of Equalization talked about state revenues for the now current fiscal year, was that there was some growth in those revenue collections-- about 100 million dollars. Now that was offset with a lot of obligations, and as a result of that we saw lawmakers of course pass House Bill 1010XX, the big revenue bill, as well as some allocation changes and the Amazon sales tax proposal, all which have taken effect. And we will begin to see those revenues coming into state coffers in the months to come.

Pryor: Bob, in your expert opinion what does Oklahoma's economy look like right now?

Dauffenbach: Quite good. Not evenly good...some areas doing better than others. Oklahoma City has in that metropolitan area has really flourished in recent times and growing much better than Tulsa, and then the balance of the state kind of pulling up the rear. But still we're looking at a state economy that has, as evidenced by as was mentioned increases that we've seen the state tax collections, that's certainly a good indicator of how the economy is doing.

Pryor: Crude oil prices are up, and there is a correlation between those prices and Oklahoma's economic outlook.

Dauffenbach: Absolutely. Absolutely. And we don't really fully understand the plight that our economy, state econ-

omy, was taken to as a consequence of declining energy prices. In fact as a consequence of the 2014 slide that we saw in energy prices we got down to almost a negative 5 percent year over year change in gross state product-- a 5 percent loss! And as it's come back, oil prices have come back, well then we're looking at better and better gains. In fact, more recently we've been doing in about the 2 percent area-- 2 percent area of year over year growth.

Ashley: The Oklahoma Employment Securities Commission and then Chad Wilkerson at the Oklahoma City Fed did a report that showed our rebound in the oil patch didn't bring as many employees back in as it had before it dropped off. Will that hinder growth going forward?

Dauffenbach: Well I think... I think that it's hard to examine all of the...all the tentacles that energy has in the economy, but it's certainly the case that it extends beyond employment. For example, royalties, and land values and certainly the entrepreneurial side, the small business side of energy flourishes.

Ashley: I've heard you speak at the Economic Roundtable, the Oklahoma City Chamber of Commerce, and offer a variety of opinions on what policymakers maybe should or maybe shouldn't do. As you look at our state government, what would you say they're getting right and where might they be drifting wrong?

Dauffenbach: I think that the attention that we're getting to education, and that that showed of course in the passage of legislation to raise tax revenues...that's K-12. What we're getting wrong is support for college education. What we need to recognize, and I think we fail to do so, is that nationally there has been no growth--now get this: zero growth in employment for those who have high school education or less-- absolutely no growth despite a 33 million gain in employment since 1992, a quarter century ago. Now that tells you about the demand for labor and its educational content. And that's what we need to be proving, that we're capable of forming policies to direct our future for those new demands for labor.

Pryor: Bob Dauffenbach, as always, it's very good visiting with you. Thank you.

Dauffenbach: Thank you.

You can listen to the conversation between OU economist Robert Dauffenbach, KGOU's Dick Pryor and eCapitol's Shawn Ashley at <http://www.kgou.org/post/capitol-insider-ou-s-bob-dauffenbach-economic-growth-oklahoma>.

(c. 32)

Oil and Gas Productivity Doubled in the Past Five Years—What Happens Next?

Chad Wilkerson, Policy insights from the Kansas City Fed, June 18, 2018

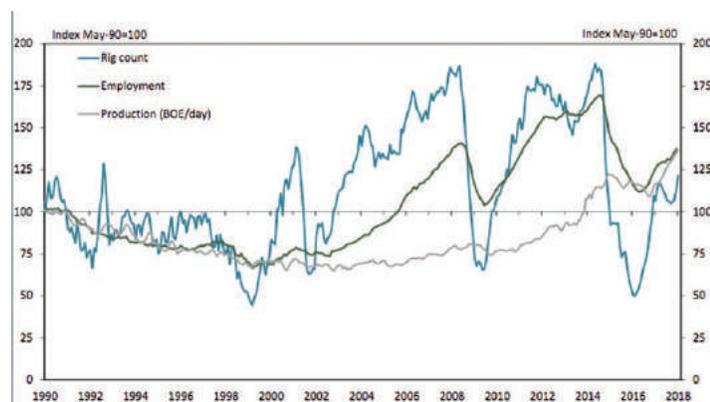
Oklahoma oil production, after dropping more than 20 percent in 2015, rebounded to an all-time high in December 2017 and has continued to grow rapidly in 2018. The state’s natural gas production also is at a record high. Yet the number of active oil and gas rigs remains almost 40 percent below the level of late 2014—despite solid increases over the past year—and oil and gas jobs in the state remain almost 20 percent below their previous peak. The oil and gas sector nationwide in recent years has experienced a similar surge in output per rig and worker. Indeed, from 2012 to 2017, productivity in the U.S. oil and gas extraction sector more than doubled.

Only rarely have other sectors of the economy experienced such rapid productivity gains. Analyzing what happened in those sectors in the years that followed may provide insights into the future of the oil and gas industry in the United States and Oklahoma. This edition of the Oklahoma Economist looks first at some of the data and factors behind the recent rise in U.S. oil and gas productivity. It then identifies other industries that have experienced similar surges in productivity, and what happened to their output, investment and employment in the decade that followed.

The boom in Oklahoma and U.S. oil and gas productivity

In both Oklahoma and the United States, total oil and gas production (measured on a barrels of oil equivalent basis, or BOE) is now about 10 percent higher than its previous record highs reached in mid-2015 (Charts 1 and 2).

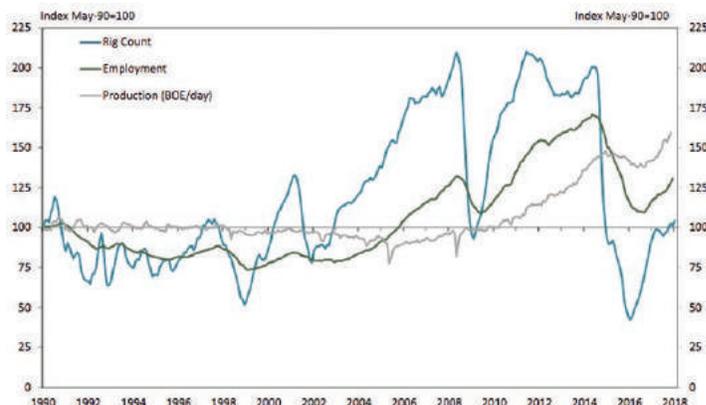
Chart 1. Oklahoma oil and gas rig count, employment and production



Note: Employment is for total mining and logging, which in Oklahoma is almost completely oil and gas related. Production is shown as a three-month moving average.

Source: Baker Hughes, Energy Information Administration/Haver Analytic

Chart 2. U.S. oil and gas rig count, employment and production



Note: Employment is for NAICS 211, 213111 and 213112. Production is shown as a three-month moving average.

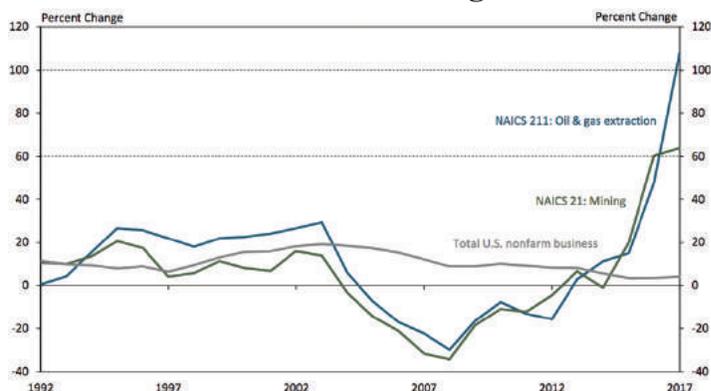
Source: Baker Hughes, Energy Information Administration/Haver Analytics

Despite this performance, rig counts and oil and gas employment in both the state and nation remain well below previous peaks. This contrasts with previous upturns in oil and gas activity in 2004-08 and 2010-14, when larger increases in rigs and workers were needed to push production higher.

While this recent surge in production per rig and per worker has been driven in part by a focus on more core areas of plays in recent years, which naturally are more productive, there have been a number of key drilling and technology enhancements. These include longer horizontal laterals, multi-well pad drilling, walking rig systems and increased proppant concentrations in hydraulic fracturing. Firms also are making greater use of data analytics to increase drilling accuracy and create process efficiencies.

Based on national industry productivity data, official labor productivity growth (output per hour) in the U.S. oil and gas industry in recent years indeed has surged (Chart 3).

Chart 3. Industry labor productivity five year cumulative change



Source: Bureau of Labor Statistics/Haver Analytics, Author’s calculations

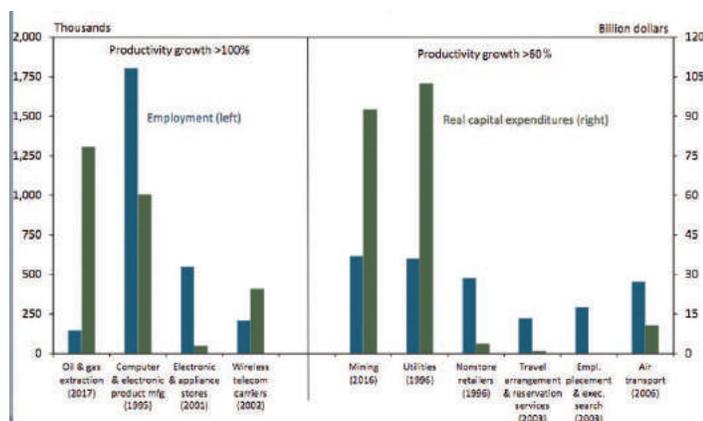
From 2012 to 2017, output per hour more than doubled in the narrow oil and gas extraction industry, rising 108 percent. Firms in this industry, as defined by the Bureau of Labor Statistics, “operate and/or develop oil and gas field properties ... up to the point of shipment from the producing property.” Productivity also rose more than 60 percent from 2011 to 2016 in the broader mining sector—which also includes “establishments primarily providing support services, on a contract or fee basis ... for the extraction of oil and gas,” such as companies that provide drilling or completing services. Most of the mining sector’s productivity growth in recent years has been in oil and gas extraction, while productivity growth in other types of mining (coal, metals, etc.) and in support services for mining (including for both oil and gas extraction and other types of mining), has been lower, although less detailed and timely data are available.

Past industries with similar productivity surges

Only rarely have other U.S. industries experienced such rapid productivity growth. Detailed industry productivity data are available starting in 1987. Of 75 unique industries with data available, only three other than oil and gas extraction have had productivity double in a five-year period. Only five additional industries other than the broader mining sector have experienced greater than 60 percent growth in productivity in five years.

The other three sectors to have productivity double over a five-year period include: computer and electronic product manufacturing (reached in 1995), electronics and appliance stores (2001) and wireless telecommunications carriers, except satellite (2002). In terms of size, the oil and gas extraction industry has fewer jobs than these three industries did when they first doubled in productivity, but greater capital investment (Chart 4).

Chart 4. Size of industries in which 5-year productivity growth reached 100% or 60% since 1987



Note: Number in parenthesis denotes year in which five year productivity first reached the 100% or 60% threshold.

Source: U.S. Census Bureau, Bureau of Labor Statistics/Haver Analytics, Author’s calculations

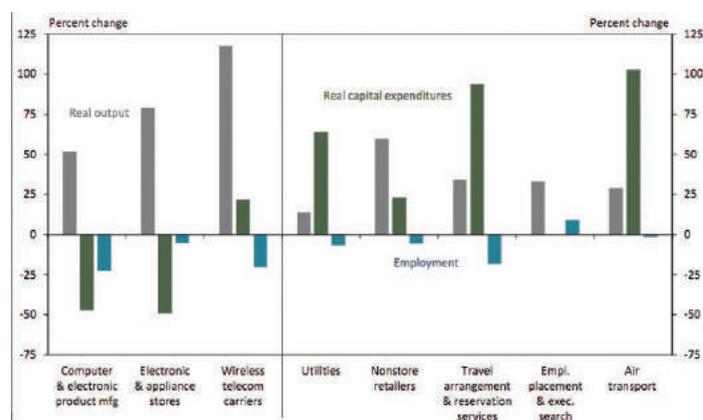
The other five sectors to have productivity rise more than 60 percent over a five-year period include: utilities (1996), nonstore retailers (1996), travel arrangement and reservation services (2003), employment placement agencies and executive search services (2003) and air transportation (2006). For comparison, the overall mining sector has more jobs than all of these industries did when they reached 60 percent productivity growth, and higher capital investment than all but utilities. The vast majority of mining sector investment is in oil and gas extraction, but employment is spread more evenly across oil and gas extraction (29 percent of mining sector employment), mining excluding oil and gas extraction (29 percent), and support activities for mining, including for oil and gas (42 percent).

Future output, investment, and jobs in high-productivity industries

All of the previous U.S. industries to experience a rise of more than 60 percent in productivity over a five-year period first reached those peaks more than 10 years ago. Thus, unlike for the oil and gas industry at this stage, data exist on what happened to output, investment and employment in those industries in the decade following their productivity surge.

In all eight of the past industries to experience rapid productivity gains—and as might be expected—output (or production) rose further in the following decade, in most cases significantly so (Chart 5).

Chart 5. Change in output, investment and employment 10 years after productivity surge



Source: U.S. Census Bureau, Bureau of Economic Analysis, Bureau of Labor Statistics/Haver Analytics, Author’s calculations

In the three industries in which productivity doubled in the previous five years, output grew more than 50 percent over the next 10 years. Among the five industries with slightly smaller productivity growth, output grew more than 25 percent in all but one.

In terms of the capital investment needed to boost future output in those industries, the trends are more mixed. Future capital investment rose in all industries experiencing

between 60 and 100 percent productivity gains for which data are available (not available for employment placement and executive search industry). However, in two of the three sectors in which productivity rose more than 100 percent, investment fell in the following decade, despite sizable increases in output, and rose only moderately relative to huge output gains in the wireless telecommunications industry.

Future employment trends were more uniformly negative across the eight industries. Only one industry added jobs in the following decade—the employment placement and executive search industry—and in that case by less than 10 percent. Jobs fell in the other seven industries, and dropped by more than 20 percent in two of the three industries in which productivity doubled—computer and electronic product manufacturing and wireless telecommunications carriers.

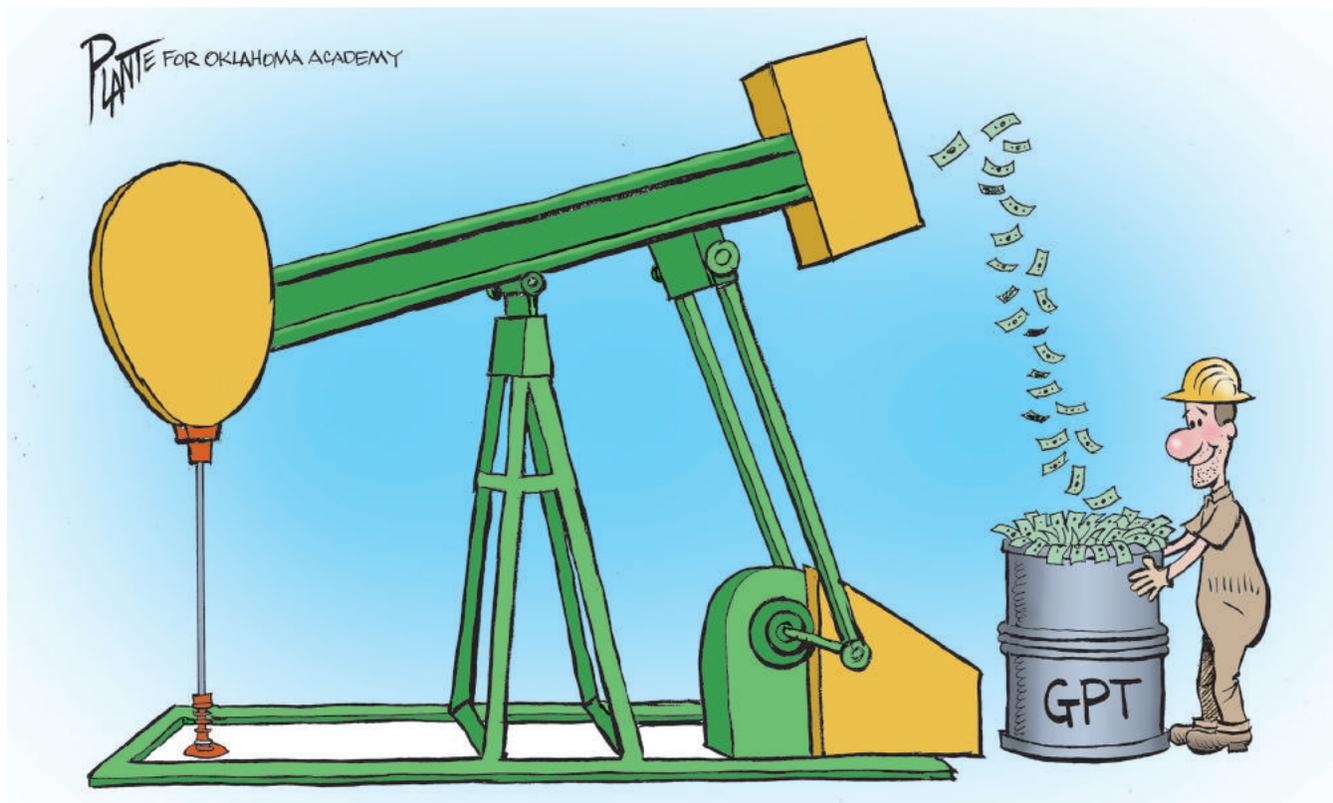
Summary and implications

The Oklahoma and U.S. oil and gas industries have experienced historic productivity growth since 2012. Only a few other industries in recent decades have experienced such rapid growth in output per hour. Of those, all continued to increase output in the decade that followed, in many cases significantly, and most also increased capital investment. However, employment fell in almost all of them, in two cases by more than 20 percent.

These past examples suggest the outlook in the next decade for Oklahoma and U.S. oil and gas production could be

quite positive, but the outlooks for oil and gas investment and employment may be more uncertain. As such, tax revenues related to oil and gas production may benefit in the years ahead, while taxes on investment or incomes and sales in areas heavily concentrated in oil and gas activity may be more at risk. This is an important consideration since oil and gas is the highest-paying industry to experience such rapid productivity growth. If fewer resources are needed to increase oil and gas production over the next decade than in the past, affected areas may need to intensify efforts to diversify their economies into other industries that could use some of the workers and capital currently allocated to the oil and gas industry. At the same time, if production of oil and gas continues to rise, increased investment and workers in midstream and downstream energy businesses may be needed to move the increased production out of producing areas.

However, several factors make the oil and gas industry somewhat different from past industries that experienced rapid productivity gains, and thus future outcomes also may differ. Oil and gas is a commodity industry, and thus generally more susceptible to wide positive and negative swings in prices and activity. Somewhat related, it is also an industry with a sizable cartel, OPEC, which can affect production levels of producing countries across the world. As such, future production trends could be considerably higher—or lower—than in past high-productivity industries. In addition, the part of the oil and gas industry that employs the most workers—contract support services for oil and gas extraction—has experienced slower productivity growth than oil and gas producers. As such, that segment's future employment risks may be lower.



Accountability for a Competitive Economy

ACE Facts 2017 summarized by Craig Knutson

ACE: OK State Chamber	ARK	COLO	KAN	MO	N.M.	TX	OK
State Business Climate	36	14	20	24	39	15	22
Median HH Income	49	13	29	38	45	26	43
Health: % Uninsured	29	22	27	31	37	50	47
Health: Access to MDs/DDS	50	10	35	43	36	34	38
Education: 4th Grade Reading	39	11	23	23	51	44	44
Education: 4th Grade Math	41	15	15	25	50	22	36
Education: 8th Grade Reading	41	7	19	26	50	42	42
Education: 8th Grade Math	44	13	22	33	50	28	45
K-12 Per Pupil Expenditures	37	44	29	32	39	42	48
College Readiness Benchmark	38	27	21	32	43	25	36
Innovation and Growth	46	9	25	34	32	19	42
Broadband/Internet Usage	39	27	30	24	38	41	44
New Economy Index	49	38	34	40	48	42	43

Each year the State Chamber publishes Accountability for a Competitive Economy (ACE) facts. Historically, this data has been provided in booklet form. The data is now offered in a series of on-line, interactive charts (<https://public.tableau.com/profile/scresearchfoundation#!/>). There are 27 metrics covered, from the Hidden Costs of Bad Roads to State Unemployment Rates. We have selected 13 that represent a good cross-section of where Oklahoma stands relative to our regional counterparts, from health and education to technology and business climates. Like the Tax Foundation, a ranking of 1 is favorable/high and a ranking of 50 is unfavorable/low.

The State Business Climate metric is a compilation of eight different surveys: Ball State, Tax Foundation, George Mason, Forbes, CNBC, Chief Executive Magazine, Institute for Legal Reform, and Pollina. As you can see, Oklahoma's overall business climate is quite impressive/attractive. While no state in the region made it into the Top Ten, we had four states in the top 25, with Oklahoma ranking a respectable 22nd from the top.

As with wages, Oklahoma's Median Household Income is weak, ranking 3rd from the bottom regionally. Oklahoma has historically been a bottom tier state in this metric, unless we see a combination of high energy prices and recessionary conditions nationwide. The metric includes wages and salaries, governmental entitlements, and investment incomes.

The Health metrics should not surprise too many, given our historically poor health outcomes. America's Health Ranking had Oklahoma at 43rd and 46th the past two years. With a number of states participating in the Medicaid ex-

pansion, their uninsured rates improved, sending Oklahoma and Texas plummeting. Our region, with the exception of Colorado, has a dearth of both primary care physicians and dentists, and the pipeline to add more takes a long time.

The four Education metrics also spell trouble, whether growing your own jobs and trying to attract them. Education Week recently gave Oklahoma a score of d+, ranking us 45th from the top. The next indicator – K-12 Per Pupil Expenditures is likely highly correlated to the previous education metrics. Ranking last in a region where the best ranking is 29th from the top/best is troubling.

The College Readiness Benchmark reflects the % of ACT-tested high school graduates meeting ACT College Readiness Benchmarks in all four subjects (English, reading, math, and science). Not a strong regional performance and only New Mexico and Arkansas performed worse than Oklahoma.

The Innovation and Growth metric reflects the patents issued per one million people. Again a weak regional performance and even weaker Oklahoma performance.

The Broadband/Internet Usage metric reflect home broadband coverage. Given the rural nature of our state, geography and low household incomes likely contribute mightily to our low ranking.

Finally, the New Economy Index combines home broadband adoption plus average internet connection speeds. Sadly, Oklahoma is competitive with the rest of the region... near the bottom.

Fiscal 50: State Trends and Analysis

The Pew Charitable Trusts and Craig Knutson

PEW State Data	ARK	COLO	KANS	MO	NM	OK	TEX	50 State Avg
Total Rev/Expenses from Pre-rec. peak	10.1%	24.8%	2.4%	0.6%	-14.4%	-14.2%	6.6%	9.1%
Federal Share of State Revenue	36.3%	30.6%	23.0%	37.3%	41.2%	33.9%	33.5%	32.6%
Tax Revenue								
Volatility('98-2017)	3.7	8.4	5.3	4.1	8.4	7.1	5.9	5
Employment:								
Popul. Ratio	0.5%	3%	-0.03%	-0.1%	-6.4%	-1.3%	-0.3%	-1.3%
Personal Income:								
2007 to Present	1.4%	2.4%	1.1%	0.8%	0.9%	1.2%	2.5%	1.6%
2016-2017	0.1%	2.5%	0.3%	1.2%	0.1%	1.1%	1.5%	1.7%
Population Change								
2007-2017	0.53%	1.6%	0.5%	0.4%	0.5%	0.8%	1.7%	0.7%
Days, Total Balances	8.6	38.3	14.6	21.1	36.3	5.9	70.7	31.4
Total Rev/Expenses								
2002-2016	102.3	102.5	100.7	101.3	99.5	104.1	105.6	102.2

The Pew Trusts recently published a report entitled Fiscal 50: State Trends and Analysis. The report focuses on the recovery (or lack thereof) in all states since the Great Recession (4Q 2007 to 1Q 2018). Above is a table that contains nine distinct indicators used in their REVENUE section.

The table includes data for Oklahoma, our six surrounding states, and the the 50 state averages. The first indicator, Tax Revenue, looks at the percentage change in total tax revenue from each state's peak quarter prior to the recession. In Oklahoma's case, that was the 4Q of 2008. A decade after the start of the Great Recession, 34 states were taking in more tax revenue at the end of 2017 than before receipts plunged in the downturn (after accounting for inflation). Only Oklahoma and New Mexico lag behind the region, with the former down 14.2% below its pre-recession high.

The next indicator, Federal Share of State Revenue, looks at the share of states' revenue made up by federal dollars. With the exception of Kansas and Colorado, all regional states exceeded the 50 state average. The federal share in Oklahoma was almost 34%, and would have been much higher had the state participated in the Medicaid expansion many states took advantage of.

The next indicator, Tax Revenue Volatility, looking at tax revenue fluctuations from 1998-2017. The three states have the greatest volatility — Alaska, North Dakota, and Wyoming — are all natural resource-dependent economies. Oklahoma, with a volatility score of 7.1, ranked the 11th most volatile state, with only New Mexico and Colorado exceeding our state (6th and 7th places, respectively).

The next indicator, Employment-to-Population Ratio, looks at prime age employment rates since 2007. Overall, the ratio remains negative, with the 50 state average 1.3% lower after ten year. Regionally, New Mexico ranked the worst at -6.4%, with Colorado the only state to post a positive change. Michigan was the best at +1.5, one of only ten states to improve their ratios.

The next indicator, Personal Income, covers a ten year period since the recession and a one year look back. Ironically, North Dakota had the highest growth rate in the ten year comparison and the largest one year DECLINE of all states. Oklahoma failed to match the 50 state average in either of the time period comparisons. Both Texas and Colorado showed strong performances.

The next indicator, Population, looks at the growth rates of states from 2007-17. Again, Colorado and Texas lead the way regionally, with Oklahoma finally outperforming the 50 state average and the remaining regional states.

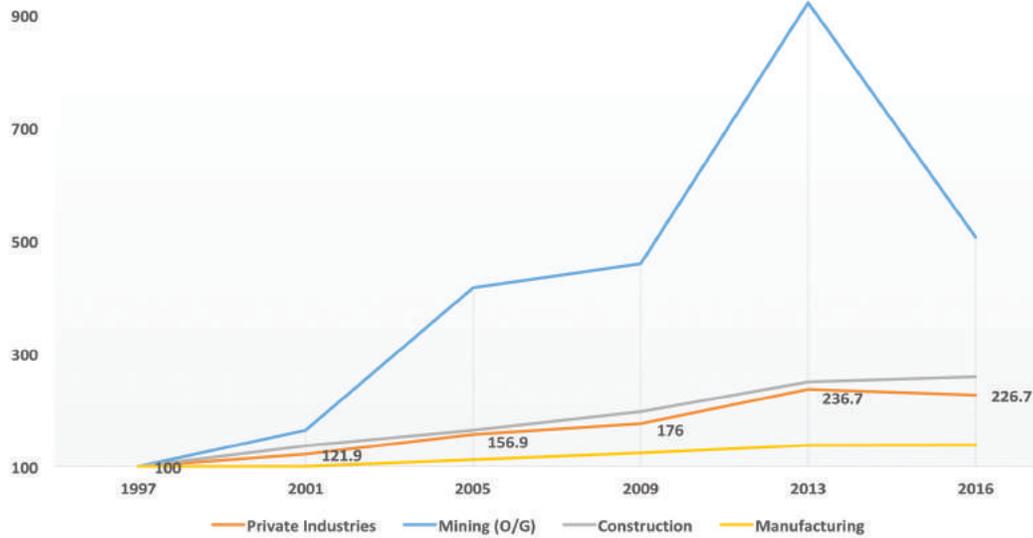
The next indicator, Reserves and Balances, looks at the number of days that each state could run on total balances, time period 2000-2018. Oklahoma had had enough in their total balances to fund government operations for 1.2 days, versus the 50 state median of 31.4 days.

The final indicator, Fiscal Balance, looks at total revenue as a % of total expenses, FY 2002-16. Four of the seven regional states outperformed the 50 state average. Alaska had the highest value at 132.3%; New Jersey the lowest at 92.2% of expenses, with deficits in 15 out of 15 years.

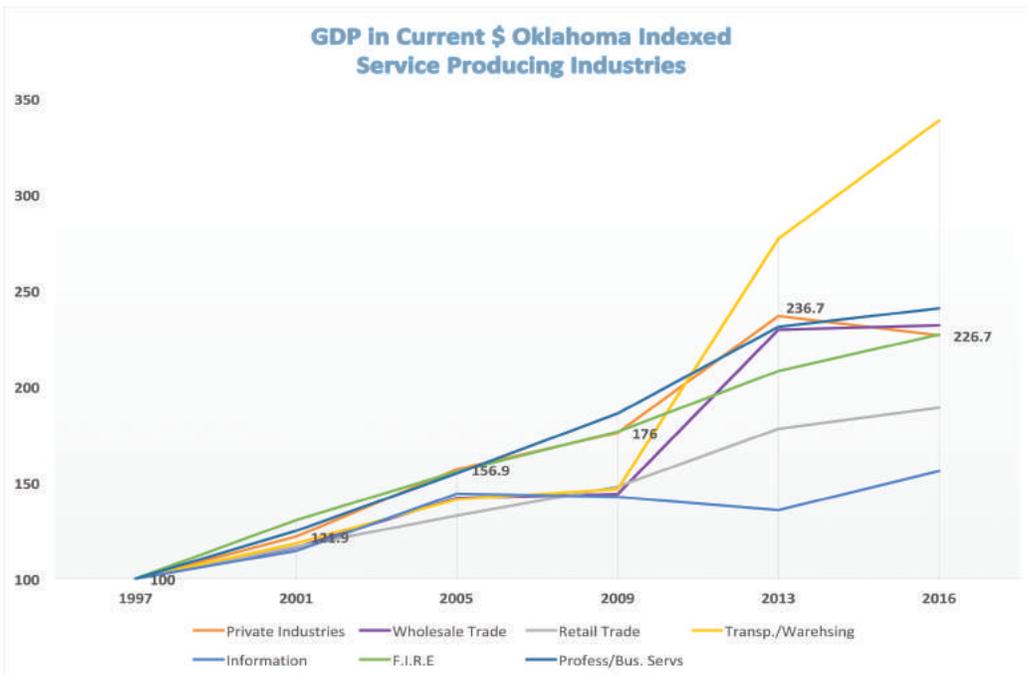
GDP Analysis of Oklahoma Industries

Craig Knutson and Mark C. Snead, Ph.D.

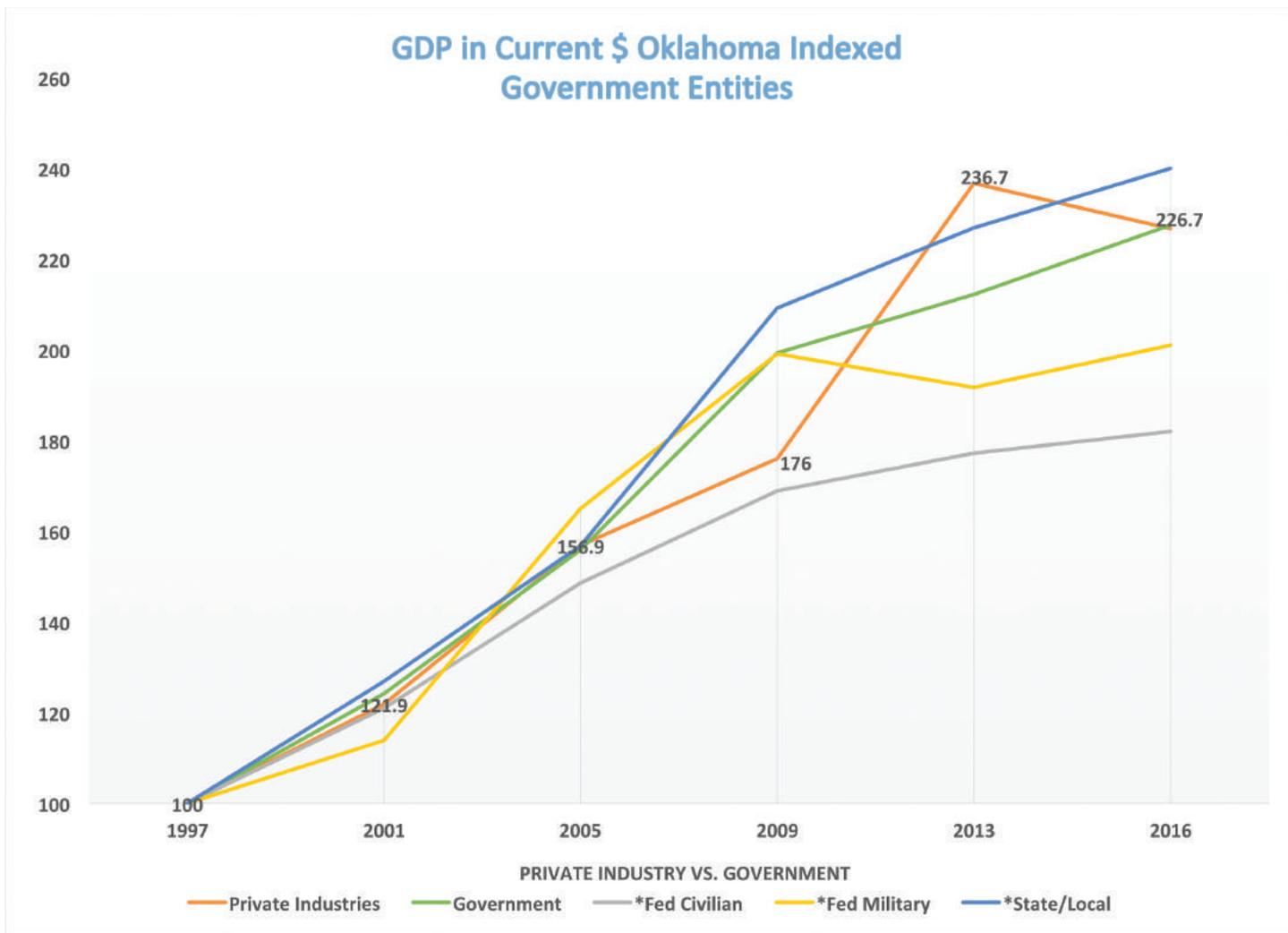
GDP in Current \$ gp Oklahoma Indexed
Goods Producing Industries



GDP in Current \$ Oklahoma Indexed
Service Producing Industries



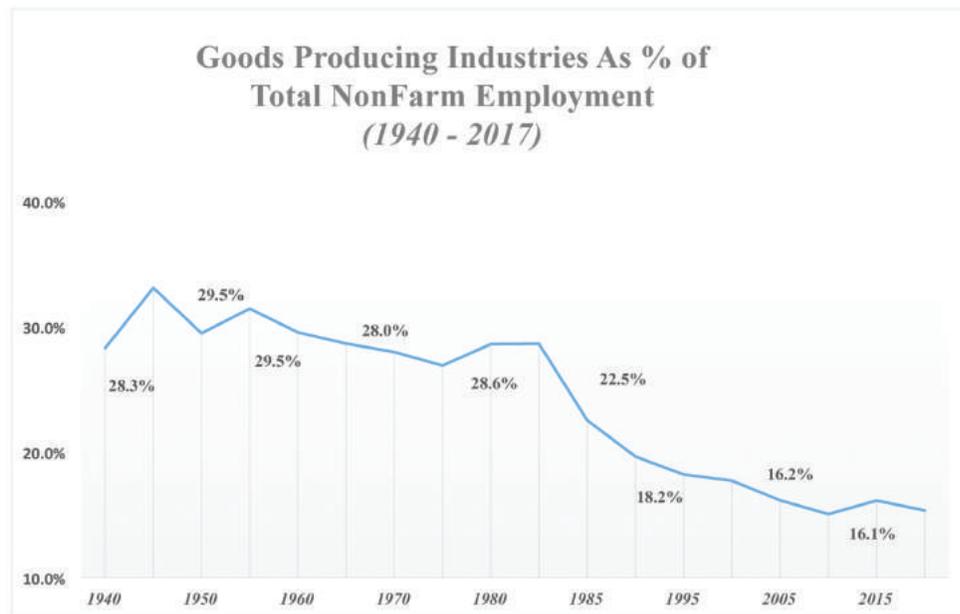
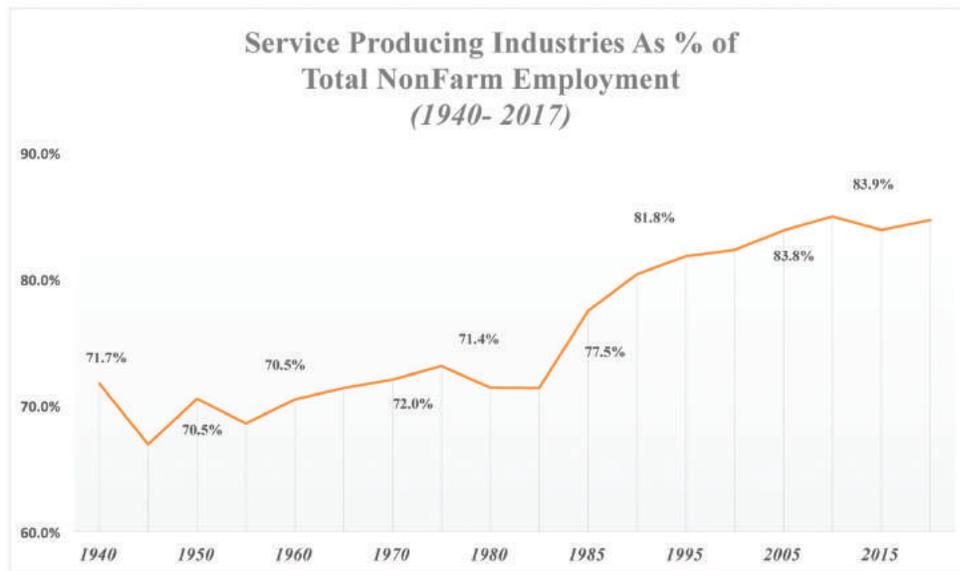
We've included several articles from some of Oklahoma's most prominent economists, covering both historical to current perspectives and issues on Oklahoma's economy. One of the things that had intrigued me over the many years that I tracked Oklahoma's economy was not just the importance of energy (Mining category) but Transportation and Warehousing. Energy is a function of being in the right place (formations) and today, the application of technology to more effectively and efficiently extract oil and natural gas (coal as well). One of the biggest selling points the Department of Commerce used to tout as an advantage — and I presume still does — is Oklahoma's "central location." We are at the



crossroads of two major interstate systems, north and south, and, thanks to Senator Kerr have the McClelland-Kerr Arkansas River Navigation System, originating at the Tulsa Port of Catoosa. This allows access to the Mississippi, thus New Orleans and ports around the world. The interstates and the Arkansas River move both cargo and passengers, we have an extensive pipeline transportation system with a hub in Cushing, and with our central location and relatively inexpensive land, a strong warehousing and storage infrastructure.

As I wondered how much had changed in Oklahoma over time, I sought the help of both OESC (employment) and BEA (Output \$\$) to take a look back. While I could look back to the 1940s with employment, I could only look from 1997 forward in terms gross domestic product by state. Gross domestic product measures the value of economic activity within a country or state. Using an Indexed time series, where all industries are indexed at 100 in 1997, we graphed “goods-producing” industries, service-providing” industries, and all levels of government . . . all against the total amount of output of all private industries. The first graph should come as no surprise: Mining (O&G output) is a significant positive outlier, demonstrating the volatility it is well known for . . . but a strong contributor even in weak times relative to other industries.

The one that surprised me was the strong contribution that Transportation and Warehousing has made relative to all private industries and competing industries. With a 2016 index value of 338.8, the T&W industry is significantly higher than the all Private Industries value of 226.7. All other industries have tracked within a fairly narrow range over the past 20 years, again with the notable exception of Mining (Index Value of 506 in 2016). The transportation/warehousing surge that has taken place in recent years is significant and is largely traced to the pipeline sector - primarily oil and gas transportation. GDP from pipelines surged from less than \$500 million annually in 2007 to more than \$4 billion annually since 2015.



On the employment side, the last two graphs are essentially an inverse of one another. Economists tracked goods producing activity because of its importance to expanding exports (capital importation) and its relatively high-waged status. Goods-producing is comprised of the construction, manufacturing, and mining industries for this analysis; agriculture is also considered a goods-producing industry but the employment data set being used is non-agricultural employment industries only. What we have seen in Oklahoma (nationally as well) is a significant decline in the contribution goods-producing industries. Because machines/technology allow a smaller workforce to produce more tangible goods, the service functions of distribution, sales and finance have become more important. Notwithstanding, the hourly wage rates for goods-producing are \$27.02, versus the service-providing hourly rate of 22.76, or 18.7% lower.

The last item was referenced before: exports. Export growth is important because of its effect on economic stability. Even more than that, the rate of economic growth and the distribution of income and wealth are closely related to export growth. In 2017, Oklahoma had \$5.4 billion in exports, or 0.3% of total us exports. Oregon, ranking just ahead of us in population, had exports of \$21.9 billion, ranking it 20th from the top of all states. In addition, both their per capita personal income and gross state product numbers/ranking well above ours. As an aside, Texas and California combined represent almost 30% of all exports nationally. When measured including service industries that function as export industries (e.g. Federal government) we rise closer to the midpoint of the states. The recent gains in exports of crude oil and natural gas have boosted the numbers as well. Notwithstanding, in an increasingly global economy, such trends in Oklahoma are disheartening.

Notes

**This is a resource document for you to use.
Take notes, highlight, use as a text book.**

Section 2
State Tax Systems

Principles for Evaluating State Tax Sources

Tax Policy Handbook for State Legislators, NCSL, Third Edition, February 2010

In 1991, a bipartisan group of state legislators, legislative staff, and other public and private sector representatives identified nine principles to evaluate the quality and effectiveness of state revenue systems. Seven of these nine principles are especially appropriate for evaluating individual tax sources within the state revenue mix, while the remaining two—complementary state and local financial systems and balanced revenue sources—address the interrelationships of tax systems within the state revenue system as a whole.

This handbook evaluates major state revenue sources by the seven principles—reliability, equity, compliance, administration, responsiveness to interstate and international competition, economic neutrality, and accountability—that are appropriate for evaluating individual tax sources. These seven principles are described below; two of them—compliance and administration—are discussed together.

Reliability

Reliability has three primary components:

- Stability
- Certainty
- Sufficiency

Stability implies that revenues are relatively constant over time and not subject to unpredictable fluctuations. Certainty means that the number and type of tax changes are kept at a minimum to allow businesses and individuals to plan for the future. Sufficiency requires that revenue sources provide the revenue growth necessary to finance the desired rate of spending growth.

The reliability of different types of tax sources varies greatly, depending on the type of activity being taxed. States can improve the reliability of their tax systems by imposing a balanced mix of taxes. The reliability of a tax also depends on its elasticity. Elasticity here refers to how much revenues expand or contract when there is a change in the activity being taxed.

In *The Income Elasticity of State Tax Systems: New Evidence*, Steven Gold provides a definition and explanation of tax elasticity in terms of income:

“The income elasticity of a tax relates the growth of the revenue it produces to the change in personal income. For example, if revenue increases 15 percent when personal income rises 10 percent, the elasticity is 1.5. If revenue increases only 4 percent in response to a 10 percent rise in personal income, the elasticity is 0.4.”

Elasticity varies among the different taxes, with income taxes generally more responsive to changes in income than

sales taxes:

“The personal income tax usually has a relatively high elasticity, nearly always more than 1. Excise taxes as a group usually have an elasticity considerably less than 1. The sales tax has an elasticity in between these extremes.”

It is important to consider the effect of both sides of elasticity on the revenue stability of the tax system. When incomes are rising, tax collections on income increase at a greater magnitude. However, when incomes fall, personal income tax revenue falls further.

Equity

Equity has two primary components—horizontal equity and vertical equity. Horizontal equity means that taxpayers with similar economic circumstances have similar tax burdens. Vertical equity refers to the distribution of tax burdens among taxpayers with different economic circumstances. In a progressive tax system, the share of income paid in taxes increases as income rises. In a regressive tax system, the share of income paid in taxes is greatest for low-income taxpayers and falls as income rises. Because states rely on many consumption tax sources that are regressive by nature, it is difficult to design a progressive state tax system. However, many tax policy experts believe that, at a minimum, a fair state tax system minimizes both regressivity and the tax burden on low-income households.

Compliance and Administration

A quality tax system facilitates taxpayer compliance by minimizing the time and effort necessary to comply with the law. It also minimizes the cost of the state administrative apparatus necessary to collect revenue, enforce the law, and audit to ensure compliance with the law. Complex taxes that are expensive to enforce reduce the yield of the tax system and result in wasted taxpayer resources.

Responsiveness to Interstate and International Competition

A state tax system does not operate in a vacuum—lawmakers must recognize that the tax policies of surrounding states can limit the revenue potential of some taxes. Businesses that sell in a national or global marketplace can relocate if state business taxes are too burdensome. Individuals may choose to shop in neighboring states if specific state consumption tax differentials are high.

Economic Neutrality

Taxes, by their very nature, are not economically neutral. Tax policy can encourage or discourage consumption of goods and services, influence decisions to save and invest, and affect fundamental business decisions about the use of

labor and capital. A quality tax system tries to minimize the effect of the tax system on the allocation of resources in the economy. When lawmakers decide to use the tax system to make budget decisions or influence behavior, these decisions should be explicit and subject to frequent evaluation and review. Taxes with broad bases and low rates, spread across a wide range of sources and economic activities, reduce the effect of taxation on economic decisions.

Accountability

The essence of accountability is that tax burdens should be explicit, not hidden. This principle can be applied to state taxes in two ways. First, credits and exemptions in the tax code should be minimized and reviewed frequently to determine their cost (in lost revenue) and to determine whether they are unfairly benefiting some taxpayers at the expense of others—“picking winners and losers,” as it is often described by critics. Second, taxes that are designed to be “passed through” to consumers provide less accountability than taxes that are paid directly and openly by taxpayers and should likewise be minimized.

State Taxes in Principle

Personal Income Tax

The personal income tax is one of the largest sources of state tax revenue, providing around a third of total collections since 1990. Forty-one states, the District of Columbia and Puerto Rico levy broad-based personal income taxes. Two others (New Hampshire and Tennessee) tax interest, dividends and capital gains, but do not collect taxes on wages and salaries.

Reliability

The personal income tax is a fairly reliable source of state revenue. Most long-term estimates of the responsiveness of the income tax to economic growth show that income taxes tend to increase more quickly than state personal income. Like other state revenue sources, the growth of personal income tax revenues declines during recessions. However, personal income taxes are “elastic” over the entire business cycle—that is, a 1 percent change (increase or decrease) in personal income produces more than a 1 percent change in tax collections.

The responsiveness of the income tax also makes it more volatile and vulnerable to economic downturns, especially due to its heavy reliance on high-income earners. Yet this same responsiveness to economic growth helps explain why state income tax reliance has increased over time. Consumption taxes, particularly excise taxes, tend to grow more slowly than the economy. Lawmakers must pass rate increases to ensure that consumption tax revenues keep pace with economic growth. The political process is biased toward revenue sources that produce revenue growth without lawmakers voting to increase the tax rate or expanding the base to keep revenues growing at the same rate as the economy. In the late 1990s, however, states across the

country experienced consecutive years of surplus revenues. In response, state legislatures reduced personal income taxes, offsetting some of the automatic growth in personal income tax revenues that comes from economic expansion.

Equity

The personal income tax scores well on horizontal equity because income taxes are levied based upon a standard set of rules that apply to all taxpayers. Although tax credits, deductions and exemptions may erode horizontal equity somewhat, the income tax is widely recognized as reinforcing horizontal equity in state tax systems. An increasingly important exception to this evaluation is the exemption of people over age 65 from income taxes.

The personal income tax is also generally accepted as promoting vertical equity. The underlying assumption for this judgment is that progressive taxation promotes vertical equity. This is a widely, though not universally, held assumption. The personal income tax is the only state tax that is progressive by design, so inclusion of personal income taxes in the overall mix of state taxes is seen as reducing the regressivity of the system.

Income taxes achieve progressivity either through a graduated rate structure or with a flat rate structure that includes personal exemptions and standard deductions that remove low-income taxpayers from the tax rolls or reduce their burden vis-à-vis higher earners. In addition, about half the states have earned income tax credits—provisions targeted toward low-income working taxpayers—that offset income tax liability and actually may provide refunds in excess of tax liability.

Compliance and Administration

Most state income tax systems are closely linked to the federal tax code. States that link their personal income taxes closely to the federal code gain efficiency in administration. They also reduce compliance costs because taxpayers are already required to maintain records and calculate figures for federal tax forms. State administrative costs are reduced through joint federal/state audit programs that allow the Internal Revenue Service to share the results of audits and enforcement actions with states.

Although there are benefits to linking to the federal tax code, states also lose a measure of control over their income tax systems because any changes in federal law that increase or decrease federal revenue also will affect state revenues. States may choose to decouple from the federal code to avoid such changes.

Interstate and International Competition

The personal income tax is a factor in interstate competition for retirees and corporate headquarters. Some states have reduced income taxes on retirement income to compete for retirees with states such as Florida, Nevada and Texas that do not levy a personal income tax. Some executive recruiting firms also claim that businesses seeking to relocate corporate headquarters look closely at the top marginal income

tax rate (the rate on the last dollar of income earned), which is of concern to highly compensated executives.

Interstate competition requires states to consider whether their taxes are out of line with neighboring or competing states. Corporate recruiters suggest it is most appropriate to examine the effect of the entire state-local revenue system—not just a single tax—on the cost of doing business. Since firms do not pay personal income tax, this is more a concern to senior executives than a direct factor in the cost of doing business.

Economic Neutrality

Like other taxes, the personal income tax is not economically neutral. The very existence of the tax, in theory, can influence individual decisions about whether and how much to work, save and invest. The higher the marginal rate, the stronger the work disincentive provided by state income taxes. High capital gains tax rates also can discourage investment. However, the effect of state income taxes on work and investment decisions is dwarfed by the federal income tax. State income taxes may be a factor in decisions about work effort, but they probably are not the deciding factor for most taxpayers. In addition, over the years a number of states have reduced their highest marginal rates.

Most state income tax preferences are specifically designed to not be economically neutral. Some state policymakers favor using the income tax code to provide incentives for certain behavior (saving for retirement or college) and disincentives for other behavior. Massachusetts has a higher tax rate on short-term capital gains, but the tax rate falls as assets are held for longer periods of time. The provision discourages short-term, speculative gains, while rewarding investors who hold assets over a longer period. Other states have exempted interest earned in college savings plans from state income taxes to encourage taxpayers to participate in such plans.

Accountability

The personal income tax is one of the most visible taxes paid by individuals. Unlike consumption taxes and business taxes that may be concealed in the price of products, taxpayers know exactly how much they pay in income taxes each year because they are required to file a tax return that specifies the tax paid. The high visibility of the income tax makes it a popular target for tax reductions by lawmakers who want to reduce the tax burden.

Additional Issues

During times of inflation, states with progressive income taxes tend to experience automatic growth in income tax revenues over time as the cost of living goes up, even when wages are increasing more slowly than inflation. To address bracket creep—the effect of inflation pushing taxpayers into higher tax brackets—a number of states index their personal income tax brackets to some measurement of inflation. Although inflation has been relatively low for some time, this was a major concern in the late 1970s when

double-digit inflation was prevalent.

State income taxes paid can be claimed as an itemized deduction on the federal form 1040 for taxpayers who itemize deductions. This deduction can reduce the effective state tax rate significantly for taxpayers in the highest federal tax bracket. Prior to 2004 when Congress also made the sales taxes deductible, the deductibility of state income taxes was an important consideration in states that were examining major tax shifts. Even so, states tended to cut income taxes and raise sales taxes, which suggests that taxpayer preference—and, perhaps, a goal of equalizing reliance on the two kinds of taxes—is more important than deductibility.

Sales and Use Taxes

Mississippi adopted the first state sales tax in 1932. Since then, this tax has become one of the most important taxes in state revenue systems, consistently contributing approximately one-third of total state own-source revenues. Forty-five states, the District of Columbia and Puerto Rico levy a sales tax. Designed to tax consumption, sales taxes are levied on general retail sales transactions and, to a lesser extent, purchases of services.

Every state that taxes sales also imposes a state use tax at the same rate. The use tax was designed to capture revenues on purchases that are not subject to the state sales tax; namely, purchases from out-of-state vendors who are not responsible for collecting tax on interstate transactions. Most states impose a use tax on the storage, use or consumption of tangible personal property within the state upon which sales tax has not been paid. The state collects the use tax from out-of-state vendors that are registered with the state or from the purchaser in the state. As one might expect, collection of the use tax can be difficult. Furthermore, the increase in remote sales as a result of the Internet and expansion of electronic commerce has focused more attention on the problem of collecting use taxes and the resulting foregone revenues.

Reliability

The sales tax has been a stable state revenue source, although rate increases have been necessary to preserve its share of the state revenue mix. Since it is levied as a percentage of the retail sales price, the sales tax provides some automatic revenue growth as general price levels rise. However, most states have been slow to broaden the sales tax base to include services. Therefore, as personal consumption expenditures continue to shift toward services, the sales tax captures a smaller share of the total consumption dollar.

The elasticity of the state sales tax depends greatly on what is included in the tax base. A sales tax that includes services tends to be more elastic because many services are discretionary and changes in consumption correlate to changes in income. State estimates of the elasticity of the sales tax range from 0.65 to 1.23, with most estimates between 0.9

and 1.1.

The stability of the sales tax is improved if food and other necessities are included in the base. States that exempt services but tax food have the most revenue stability but are likely to have less revenue growth over time. States that exempt food but tax services will be most susceptible to revenue shortfalls during economic downturns but will likely enjoy strong revenue growth during economic expansions. States that tax both food and services are likely to enjoy both stability and revenues that grow commensurately with personal income growth.

Equity

Three primary issues dominate the debate over the equity of the sales tax. The first is regressivity. Sales taxes claim a larger share of low-income taxpayers' incomes than those of higher-income taxpayers, especially if food is included in the tax base. The second issue involves whether exemptions for certain goods and services make the sales tax inequitable, and the third issue is the limit on government's ability to collect sales taxes from out-of-state sellers, particularly Internet retailers.

Sales taxes are regressive. Taxpayers with lower incomes tend to spend a higher proportion of their incomes on consumption. These taxpayers also spend a larger share of their income on goods rather than services, and services tend not to be taxed in many states. As a result, low-income taxpayers pay a higher proportion of their incomes in sales taxes than do middle- and upper-income taxpayers.

In an attempt to reduce the regressivity of the sales tax, some states have adopted specific exclusions for necessities, such as groceries and prescription drugs. Although food exemptions lessen the regressivity of the tax, food is the largest component of the sales tax base, and food exemptions produce large state revenue losses.

States face a trade-off when they attempt to reduce the regressivity of the sales tax. Removing grocery food and other necessities from the sales tax base can significantly reduce state revenues and make the sales tax less stable through the business cycle. Many economists also argue that a food exemption benefits the wealthy proportionately more than the poor because they consume more expensive food items. Some states that tax food have tried to mitigate the effect on the poor through special rebates. Another mitigating factor is a federal prohibition on state sales taxes on food items that are purchased with food stamps.

Another equity issue concerns the disparate treatment of goods and services in many state sales taxes. The sales tax is designed to tax consumption, yet a growing share of the consumer expenditure dollar is spent on services that may not be subject to taxation. The shrinking relative share of the consumer dollar spent on goods has forced states to raise the rate to maintain the sales tax share of state tax revenues. However, four states that tried to dramatically ex-

pand the sales tax to services—Florida and Massachusetts in the 1980s, Michigan in 2007, and Maryland in 2008—were met with such political resistance that the laws were repealed soon after enactment or before they took effect.

States vary significantly in identifying taxable and exempt transactions. A handful of states have historically taxed services much more than the rest of the states. This is because these states each impose a unique version of the sales tax that was more widespread from 1900 to 1930—a gross receipts tax—where taxes are imposed on businesses for the privilege of doing business in the state. As a result, services are implicitly included in the tax base.

The third equity issue is proliferation of electronic commerce and the tax treatment of on-line sales versus sales in traditional retail stores. Under current law, many on-line retailers are not required to collect taxes on remote sales, which may give them a competitive advantage over Main Street retailers. This issue is discussed in greater detail below.

Administration and Compliance

From the state perspective, sales tax administration is straightforward—much of the administrative burden is shifted to the vendor. The vendor collects the tax from the consumer, and the vendor is responsible for knowing what is taxable and what is tax-exempt. Given advances in technology, administrative burdens on most retailers are not as great as they were before use of Universal Product Code scanners became widespread. Compliance is relatively easy to monitor, since taxes are based on sales transactions and sales records are maintained by vendors. States typically provide a vendor compensation allowance to retailers, allowing them to retain a percentage of the revenue collected as compensation for their administrative costs. When dealing with large budget shortfalls, some states have eliminated the vendor allowance

The use tax, on the other hand, is much more difficult to monitor because transactions take place across state lines, and states where items are consumed may not have administrative authority over vendors. Clearly, the use tax is the weak link in sales tax enforcement. Under a line of U.S. Supreme Court cases, states can legally impose a use tax on purchases made in another state. For practical and political reasons, states have chosen to focus enforcement efforts on vendors instead of on consumers. However, they cannot require the out-of-state retailer to collect and remit the sales tax unless the retailer has a physical presence, or nexus, in the taxing state. This restriction, however, can be reconsidered due to a collaborative effort by the private sector and state and local government officials. Representatives from these groups began meeting in 2000 to develop measures to design, test and implement a sales and use tax system that radically simplifies sales and use taxes so that remote collection is less burdensome. Their recommendations—published in the Streamlined Sales and Use Tax Agreement—may eventually be realized.

Streamlining State Sales Taxes

In November 2002, 35 states, known as the Streamlined Sales Tax Implementing States, ratified the terms of an interstate agreement that combines uniform administration procedures with simplification measures. Taken collectively, the Streamlined Sales and Use Tax Agreement attempts to address the undue burden on interstate commerce cited by the U.S. Supreme Court in establishing the physical presence test for sales tax nexus. The agreement does not require any action by states; rather, states that choose to join the agreement would simplify the process and move significant burdens of collection from the retailer to the state. Currently, a number of states are considering modifications to their present structure to meet the requirements of the agreement. For states to require remote sellers to collect sales or use taxes on items shipped into the state, either Congress or the Supreme Court must find that the system imposes no undue burdens on remote sellers and grant mandatory collection authority to states that have adopted this agreement.

Another state policy issue is whether to impose a sales tax on energy, raw materials and services—or inputs—used or consumed in the manufacturing process. In a competitive interstate and international marketplace, states that tax business inputs may put firms at a competitive disadvantage. The prices for many agricultural commodities, for example, are set by the world marketplace, so producers may not be able to pass to consumers sales taxes on machinery and supplies in the form of higher prices. A major argument against extending sales taxes to services is the extent to which producers employ other services in the production process. Many economists argue that inputs in the production of goods later sold at retail should not be taxed because the sales tax is intended to be a tax on final consumption. Taxes on inputs cause pyramiding—the imposition of taxes on goods where the retail price already has taxes embedded in it (a tax on a tax).

Economic Neutrality

The disparate treatment of goods and services affects the economic neutrality of the sales tax. For example, states that exempt labor repairs but tax new purchases may affect decisions about whether to fix a machine or buy a new one. The higher relative price of durable goods resulting from sales taxes may affect the mix of goods and services purchased by consumers if services continue to be excluded from sales taxes. Also, states that tax services may disproportionately burden small businesses because larger firms may provide services (legal, accounting) in-house. In addition, Internet retailers may have an advantage over local stores if they are able to sell their goods tax-free.

Accountability

Most states require the sales tax to be separately stated on the receipt, making the tax burden per purchase explicit. However, the total burden of sales taxes over a longer pe-

riod of time is less obvious to most taxpayers. Other taxes that are paid quarterly or yearly can easily be compared to income, thus demonstrating the overall burden of the tax. With sales taxes, knowing how much one pays over months or years requires record keeping for every purchase that most individual taxpayers are not likely to maintain. (Exceptions to this are those who itemize and deduct state and local sales taxes paid for their federal income taxes—see below.)

In addition, many state tax incentive programs for certain businesses include deductions or abatements of sales tax requirements. This selective application also affects the accountability of the sales tax.

Additional Issues

In 2004, federal tax law was enacted that allowed taxpayers to choose whether they wanted to deduct state sales taxes paid instead of state income taxes paid as an itemized deduction on federal form 1040. The amount of the deduction is calculated in one of two ways: 1) calculating the actual amount of sales tax paid during the year, or 2) using the IRS optional \state sales tax tables. The sales tax deduction is particularly beneficial for residents of states that impose a state sales tax but not an income tax (e.g., Florida), as well as low-income \residents who have no income tax liability; however, it is beneficial only if they choose to itemize. Historically, low-income households are not likely to do so.

Corporation Income and Franchise Tax

The corporation net income tax generates the least revenue of the major state tax categories, although it is a major revenue producer in a few states. Forty-seven states, the District of Columbia and Puerto Rico impose corporate income taxes. Most states use either net income as the exclusive basis for levying the tax or a combination of net income and net worth as the base for determining tax liability.

Most states levy the corporation income tax at a flat rate, although a number of states impose a graduated corporation income tax. States that use capital stock or net worth as a portion of the tax base typically levy the tax at a flat share of capital stock outstanding or net worth. A few states use gross receipts as the basis for taxing corporations. New Hampshire taxes corporations using a value-added tax, which imposes taxes on the capital, entrepreneurial profit and labor inputs that add value to products in the production process.

States offer a wide variety of tax credits and deductions that are designed to provide incentives for business expenditures in certain areas. Common credits include investment in machinery and equipment, research and development, employee training and investments in enterprise zones (economically distressed areas that have been targeted for redevelopment through favorable public policies and financial incentives).

Reliability

Corporation taxes are one of the most volatile state revenue sources. Corporate profits are highly vulnerable to national economic cycles, not only due to the nature of business operations but also because corporation income taxes use accounting procedures that allow firms to carry losses forward against future profits. States that use capital stock or value added in the tax base can mitigate fluctuations inherent in corporation taxes that are levied solely on net income.

Equity

Considerations of vertical equity typically do not apply to corporation taxes. However, horizontal equity is affected by tax abatements, exemptions and preferences that some states grant to lure new businesses and to promote economic development generally. For example, many state and local governments have waived taxes and provided large subsidies for specific industries such as manufacturing plants or for professional sports teams, creating inequities with businesses in the same neighborhoods that did not receive preferential treatment.

Corporations have long complained that taxation of both corporation income and dividends (through the personal income tax) is unfair. Firms argue that taxation of both dividends and profits amounts to double taxation because dividends are paid from profits that already have been taxed.

Some economists note that corporation taxes really are paid by individuals, in one of three ways: by firm owners, in the form of reduced profits; by firm employees, in the form of lower wages; and by consumers, in the form of higher prices. How this shifting occurs depends upon the nature of the business taxed. Firms that sell products in highly competitive global markets or in commodity markets may not be able to pass taxes along through higher prices. However, firms that sell services in local markets or in monopoly or oligopoly markets can more easily shift taxes to consumers.

The primary argument in favor of corporation taxes is called the benefit principle of taxation (those who benefit the most should pay the most). Businesses benefit from the educational system (skilled workers), infrastructure and other services financed by state governments. Other public services that are particularly important to businesses are the judicial system and public safety. Without these, businesses could not function. The corporation income tax helps ensure that firms share part of the costs of services that benefit them directly.

A key equity question for corporation taxes is whether to levy taxes only on net income, or to use a value-added or a capital stock component in the tax base. Firms that are taxed only on net income are not required to pay corporation taxes in years when they are not profitable, while the other tax bases create tax liability even when firms lose money. The benefit principle would favor value-added taxes or capital stock taxes, since firms benefit from public

services regardless of profitability. However, some firms argue that such taxes exacerbate losses in bad years and are inequitable.

Administration and Compliance

Forty-six states, the District of Columbia and Puerto Rico tax corporate income. Almost all of them use the federal income tax code as a starting point in calculating state liabilities. Despite this fact, however, complying with state corporation taxes is a complex undertaking for firms that operate in more than one state.

First, even though most states conform to the three-factor apportionment formula (described below) designed to provide uniformity in how multi-state firms apportion their income among the states, state definitions vary on what types of income are included in the formula. Second, firms that have intangible property such as copyrights or patents face different state rules governing whether such property should be included in the apportionment formula. Third, states have different rules about whether corporate subsidiaries must file separate returns or combined returns. Finally, a multitude of state rules govern when returns must be filed, when estimated payments are due, and what types of income are reported.

This complexity leads to high compliance costs for businesses. It also requires that state departments of revenue spend a disproportionate share of their resources on compliance audits and other administrative tasks.

Interstate and International Competition

The proliferation of tax incentives, credits and abatements reflects states' heightened concern about the role of taxes in business decisions about where to locate operations. States are competing with each other as well as with other nations for facilities and jobs. However, for many firms—particularly manufacturing firms with high capital requirements—the corporation income tax is less onerous than local property taxes and sales taxes on machinery and equipment.

Businesses that specialize in helping firms with location decisions report tax rates that are out of line with neighboring states can be a disqualifying factor in business location decisions. However, as long as overall state tax burdens (income, sales, property and other taxes combined) are not excessive compared to other states, taxes are rarely as important as labor, energy and transportation costs.

Economic Neutrality

One common complaint about corporation taxes is their disparate effect on businesses that have different capital structures. Firms can deduct interest payments from net income but cannot deduct the cost of equity financing, so the tax code provides an incentive for firms to use debt financing. Accountability The corporation income tax is a cost of doing business that is embedded in the cost of goods and services, just like energy and other production or operating costs. Consumers do not know the proportion of the price

of a good or service that is attributable to the corporation income tax. By this measure, the corporation income tax is not accountable to the public.

Additional Issues—Apportionment Formulas

Another business tax issue is the apportionment of corporate income for firms operating in more than one state. For firms that do business in only one state, determining how much of their income the state can tax is fairly straightforward. Similar to most individual income tax calculations, the taxable income of a corporation is the amount that remains after adjusting gross income for tax deductions and credits. That taxable income is then multiplied by the state's corporate income tax rate, and the result is the firm's tax liability.

In the case of multi-state corporations, state corporate income taxes are more complicated. This is because the corporation's gross income is the aggregate of business done in various states. The question then becomes, "What portion of a multi-state corporation's total income should be taxed by each of the states in which it operates?"

States use apportionment formulas to answer that question. A number of states still follow a method developed in the 1950s that focuses on three factors of a company's operations in a state—sales, payroll and property. The idea is to arrive at a number representative of the amount of a company's total (or gross) income that comes from business in the state in question.

The formula involves first calculating the ratios of how much of the company's total values in each category (sales, payroll and property) come from the state in question. That is, a state considers how much of the company's total sales come from sales in that state, how much of the company's total payroll comes from employment in that state, and how much of the company's total property is located in that state.

These three separate ratios (or percentages) of in-state to total (multi-state) company operations are added and divided by three. The result is a final ratio of in-state to total business operations. This ratio represents the portion of a company's total income derived from the state, and hence subject to taxation.

The ratio then is applied to the company's total income. The resulting amount (the company's taxable income) may be further adjusted with state tax deductions or credits, and the remainder is then multiplied by the state's corporate income tax. The final amount after any adjustments is the amount a multi-state company must pay in the state's corporate income taxes.

An apportionment formula with equal focus on the three parts of a company's operations described above (sales, payroll and property) is referred to as "three-factor apportionment." About one-third of the states use this formula.

More states have moved to other apportionment formulas that give added weight to a company's sales in the state. The method is similar to that described above where the in-state to total ratios of sales, payroll and property are added together for a final ratio that is then applied to total income. In double weighted sales apportionment, however, the in-state to total sales ratio is included twice in the arithmetic: sales+sales+payroll+property, rather than sales+payroll+property.

Even further emphasis on sales in determining corporate income tax liability is applied in the states that use a single sales factor formula. In this case the only ratio or portion considered is how much of a company's total sales are derived from sales in the state in question. That ratio then is applied directly to the firm's gross income to calculate taxable income. Single sales apportionment also simplifies the state corporate tax codes.

Increased emphasis on sales in apportioning corporate income may make a state more attractive for business expansion or relocation if property and payroll factors are not used to calculate corporate tax liability.

Motor Fuel Excise Taxes

The motor fuel excise tax is the primary funding source for state highway and other transportation programs. The tax typically includes gasoline, diesel fuel and blended motor fuels and is imposed in all 50 states, the District of Columbia and Puerto Rico. The motor fuel tax has been a traditional source of transportation funding; 48 states adopted the tax before 1929. All states earmark motor fuel tax revenues to highway or transportation trust funds.

As is the case with most selective sales taxes, the motor fuel excise tax is assessed on a per-unit basis. Revenue is dependent upon gallons consumed, which is influenced by oil prices, motor vehicle fuel efficiency, alternative fuel sources and consumer driving patterns. Following the oil price hikes of the 1970s and early 1980s, states increased their motor fuel excise tax rates to offset the decline in motor fuel consumption.

Reliability

The motor fuel tax is an inelastic state revenue source—that is, collections fail to keep pace with inflation and economic growth at a given tax rate. States must periodically increase tax rates to generate the revenue growth required to keep pace with highway maintenance and construction needs. The problem is exacerbated by increased fuel efficiency of cars and trucks, which has prevented fuel tax collections from keeping pace with the number of miles driven. Reductions in miles driven in reaction to high gasoline prices, particularly in 2008, likewise undermine the reliability of revenue generation from motor fuel taxes.

One way states have addressed the inelastic nature of the motor fuel tax is by indexing the tax rate. Indexing motor

fuel tax rates annually to changes in the consumer price index, total fuel consumption or vehicle miles traveled may provide the revenue growth needed to meet transportation maintenance demands. States that do not use indexing must periodically raise motor fuel excise tax rates to meet higher material and construction costs for highway and transportation systems.

Equity

The motor fuel tax is a benefits tax—gasoline consumption is used as a proxy for highway use—and every state earmarks tax revenues for highway maintenance, repair and construction. The benefits of motor fuel taxes are widely accepted by the public, and opposition to motor fuel tax increases typically is less vociferous than for other state taxes.

Some experts argue, however, that drivers of passenger automobiles pay a disproportionately large share of highway costs compared to their contribution to highway wear and tear. Equity in motor fuel taxation would require that taxes be distributed according to costs generated, with relatively higher tax burdens on users that generate higher costs. Several studies argue that motor fuel taxes violate this definition of equity because heavy trucks generate a disproportionate share of highway maintenance costs. Truckers argue that all consumers benefit from the current system because higher taxes on the industry would be passed to consumers through higher prices on consumer goods.

The motor fuel tax is a regressive tax, particularly in poor rural areas where residents must commute longer distances to work, shopping and other necessary activities. The poor pay a much larger percentage of their incomes in motor fuel taxes than do middle- and upper-income taxpayers.

Administration and Compliance

Motor fuel excise taxes generally are easier to administer and collect than other state taxes because the point of taxation may be limited. Depending on the size of the state, fuel tax collection may be limited to a dozen refiners or to a few hundred certified distributors.

All states except Alaska and Hawaii participate in the International Fuel Tax Agreement (IFTA). The agreement was mandated by Congress in 1991 to make uniform the administration of motor fuel use taxation laws with respect to motor carrier vehicles that operate across state lines. Under the agreement, states can cooperate in administration and collection of motor fuel use taxes. This essentially allows motor freight carriers to base their operations in one state and report their taxable activities on one fuel tax report in that state, rather than file separate reports in each state in which they operate. Fuel tax collections are allocated to states based upon miles traveled.

Interstate and International Competition

IFTA has helped alleviate tax avoidance problems caused by differentials in state tax rates as applied to the trucking

industry. However, the potential still exists for taxpayers in private vehicles to purchase gasoline in neighboring states where rates are lower.

Economic Neutrality

Gasoline, gasohol and diesel are not the only motor fuels state governments tax. Others include alternative motor fuels such as methanol, ethanol, compressed natural gas (CNG), liquid natural gas (LNG) and liquefied petroleum gas (propane). States often provide preferential taxes for nonpolluting or “clean” fuels to encourage consumers to use them, sometimes in conjunction with state or regional air quality programs.

An issue regarding the taxation of alternative fuels is that in many cases, they may be a more expensive option than gasoline. Although alternative fuels often burn more cleanly, some vehicles use more than a gallon of alternative fuel to achieve the same energy output as a gallon of gasoline or diesel. Thus, some states have given preferential treatment to alternative fuels. States also are examining substitute methods (i.e., vehicle permit fees) for collecting revenue from alternative fuel powered motor vehicles.

Accountability

As with other excise taxes, motor fuel taxes are not separately stated on customer receipts. Although motor fuel retailers in some states post information on the pumps about the amount of state and federal taxes paid, most consumers are unaware of the total annual gasoline tax burden imposed. Unlike taxes that accrue to the state general fund, most motor fuel excise taxes are deposited in state transportation funds. In terms of expenditure accountability, most state taxpayers realize their motor fuel taxes are used for highway maintenance and other transportation needs.

Tobacco Taxes

All states, the District of Columbia and Puerto Rico impose excise taxes on cigarettes, chewing tobacco, cigars, snuff and other tobacco products. Most cigarette and tobacco taxes were adopted before 1950; only 10 states have adopted such taxes since 1951. States also can impose sales taxes on retail sales, but these revenues are included in sales tax figures rather than in excise tax figures.

Proponents of increasing tobacco taxes argue that they improve the efficiency of the free market by including the social costs of smoking—public health care costs, for example—in the price of tobacco products. However, some in the public health community believe that any rational tax strategy should be based on the relative risks of the various tobacco products. Opponents argue that smokers and tobacco users already pay their fair share of these costs, and that excise taxes are a highly regressive form of taxation that single out one class of citizens for punitive taxation.

Reliability

Cigarette taxes are not a stable source of revenue. Like other excise taxes, they are levied on a per-unit basis that does not automatically provide revenue growth in response

to price increases. The decline in per capita cigarette consumption since 1970 and the failure of tax rates to keep pace with inflation have led to a significant decline in the share of state revenues attributable to cigarette taxes.

Taxes on other tobacco goods usually are levied as a percentage of the product price. Generally, when the price goes up so does the tax revenue. High tax rates, however, provide a significant incentive for consumers to shift to lower priced—and thus lower taxed—products. In addition, other tobacco products make up a small share of total tobacco sales. A popular trend in recent years has been to earmark tobacco tax revenues for health-related programs. Even if tax rates go up, however, tobacco taxes are not a growth revenue source in the long run. Any program that relies on tobacco taxes will likely see future revenues decline.

Equity

Cigarette and tobacco taxes are highly regressive. In fact, studies show that these taxes are the most regressive of the major excise taxes; households with incomes below \$30,000 contribute about 47 percent of total tobacco taxes paid. This is because low-income taxpayers statistically are more likely to use tobacco than are upper-income taxpayers.

Tobacco tax proponents argue that the tax is equitable because it helps recoup some of the social costs of smoking that are not included in the market price of tobacco products. They contend that using taxes as a way to include public health costs in the price of tobacco products actually leads to a more economically efficient market outcome by reducing consumption levels below a no-tax level.

Administration and Compliance

States typically levy the cigarette tax at the wholesale level. In nearly all states, wholesalers must affix a tax stamp to each pack of cigarettes, proving that the tax has been paid. The small number of wholesalers minimizes direct administrative and compliance costs for states. Stamping is an expensive process, however, and states reimburse wholesalers for some of their compliance costs by allowing them to retain an administrative fee (similar to the vendor collection allowance on the sales tax).

The tobacco products tax is paid by the wholesaler and levied on cigars, snuff, pipe tobacco and chewing tobacco at a percentage of the wholesale price. The varying size and composition of this wide range of tobacco products makes administrative compliance difficult.

Interstate and International Competition

Tobacco taxes vary greatly among the states. This makes interstate competition and bootlegging an important issue, especially in states that share populated border areas. Complicating the issue is the possibility that, when consumers cross state lines to buy cigarettes, other goods also might be purchased and the economic loss will be spread beyond lost

tobacco product sales. Geography becomes less relevant, however, as on-line sales of tobacco products increases.

The Supreme Court has ruled that states cannot tax the sale of tobacco products on Indian reservations if they are sold to residents of the reservation. Sales on reservations to non-Indian customers are taxable; however, it is difficult for states to require Indian retailers to segregate sales to Indian and non-Indian customers. Some states, such as Arizona, have reached cooperative agreements with tribes that respect the legal exemptions for sales to tribal members and provide for voluntary tax collections from non-Indian customers. Other states, however, still face significant problems with regard to tobacco tax evasion. The Internet and growth of on-line tobacco sales has exacerbated this problem. Evasion also is a problem on military bases; base sales are not subject to state sales taxes.

Economic Neutrality

As with other excise taxes, tobacco taxes are deliberately designed to violate the principle of economic neutrality. Tobacco taxes single out specific products for higher tax rates to influence consumer consumption choices. For tobacco products taxed as a percentage of wholesale prices, the lack of economic neutrality is even more pronounced because identical products may carry different tax burdens based solely on price differences.

Accountability

Tobacco excise taxes are hidden in the price of a pack of cigarettes or a can of snuff. Although most taxpayers know tobacco taxes are levied, most probably do not know how much of the price of a tobacco product is tax and how much they pay in taxes annually. Accordingly, tobacco taxes may not score high on the principle of accountability.

Alcoholic Beverage Taxes

All 50 states, the District of Columbia and Puerto Rico tax alcoholic beverages. Most states have imposed excise taxes on alcoholic beverages since the 1930s. Alaska and Oklahoma, in 1959, were the last states to impose the tax.

Excise taxes on alcohol are intended to generate revenue and discourage consumption by increasing prices to the consumer. Proponents argue that alcoholic beverage excise taxes improve the efficiency of the free market by including the social costs of drinking in the price of the product, while opponents argue that alcoholic beverage taxes are a highly regressive form of taxation.

States fall into two categories in taxing of alcoholic beverages. About two-thirds are license states that allow licensed private retailers to sell liquor, beer and wine. For these states, revenues are generated through wholesale excise taxes.

In the other states, government-owned stores sell liquor at retail, and licensed stores sell beer and wine at retail. State revenues are generated through a retail markup on liquor and an excise tax on beer and wine. Markups in

these control states are categorized as “other revenue” by the Census Bureau, and excise taxes are counted as taxes. This makes tax comparisons difficult between license and control states.

Reliability

Alcoholic beverage tax collections have been declining relative to other state taxes for two primary reasons. First, like some other excise taxes, per-unit taxes fail to generate additional revenue when prices increase. Rates must be increased legislatively to keep revenues on par with inflation and economic growth. Second, per capita consumption of alcoholic beverages has been stable or declining since 1970, further eroding tax productivity.

Equity

Alcoholic beverage taxes are regressive; beer taxes are the most regressive of the three major categories. Lower-income households pay a larger share of their incomes in taxes than do higher-income households, assuming the same level of consumption. Price elasticity estimates show that beer consumption is least responsive to price changes, while wine consumption is most responsive. This suggests that beer taxes may have the least effect on reducing consumption and, therefore, would most affect low-income beer consumers. Excise taxes also tend to impose higher tax burdens on low-income taxpayers because they are levied at flat rates, instead of on the sales price. Taxpayers pay the same excise tax on a \$100 bottle of wine as on a \$5 bottle because the volume is the same.

Alcoholic beverage tax proponents argue that the taxes help recoup some of the social costs of drinking that otherwise are not included in the price, and that including these social costs in the price of alcoholic beverages reduces consumption and leads to a more economically optimal level of consumption. However, there is no agreed-upon methodology for social cost accounting, nor any movement to apply social cost tax adjustments consistently for products thought to have social costs.

Administration and Compliance

Excise taxes typically are levied on the manufacturer, distributor or importer of alcoholic beverages. Markups are determined by state liquor control agencies. States have been shifting from a payment system that requires sellers to affix tax stamps to each bottle of liquor to a report system that allows sellers to remit taxes based upon reported sales. The report system significantly reduces compliance costs for businesses but may increase the likelihood of tax evasion. From the state perspective, administrative costs are low because the tax is collected monthly from a limited number of wholesalers, importers and distributors instead of from a large number of retailers. However, states may provide collection allowances that reduce the tax yield.

Interstate and International Competition

Although differentials in state tax rates can be significant, the weight and volume of alcoholic beverages and state

regulations on direct shipping of alcohol make large-scale smuggling much more difficult than for tobacco products. However, states where prices are significantly higher than neighboring states, with higher taxes contributing to the price differential, may experience reduced sales at border locations. In addition, once consumers make the choice to purchase alcohol in a neighboring state, it is possible that other goods also will be purchased, and the economic loss will be spread beyond lost alcoholic beverage sales.

Economic Neutrality

Some policymakers argue that alcoholic beverage taxes should be designed to reduce consumption. This perspective violates the principle of economic neutrality. In practice, however, alcoholic beverage taxes rarely have been raised on the basis of this perspective. States typically have raised these taxes when revenues have dropped during national recessions. Federal tax increases have followed a similar pattern. For instance, beer taxes were levied for the first time to raise funds to pay for the Civil War and in modern history have been increased only to help pay for the Korean War and to raise revenues during the 1990-1991 national recession.

Accountability

Alcoholic beverage excise taxes and markups are embedded in the price of products sold at retail. Although most taxpayers are aware that taxes are levied, the exact amount of the sales price that represents taxes is not known to most consumers. Alcoholic beverage taxes may not score well on the principle of accountability.

Electric Utility Taxes

States vary greatly in how they tax electric utilities. In addition to property taxes, most states tax utility profits under their general corporation income tax or franchise tax statutes. Furthermore, most states levy additional taxes based upon the gross receipts of electric utilities, and a few impose a tax based upon kilowatt hours of electricity generated.

Legislative and regulatory changes in the early 1990s injected competition into the electric power industry that were designed to give customers a choice of power providers. By 2002, nearly half the states had laws to open power markets to retail competition. The competition has yet to materialize, however, at least on the retail side, although wholesale power markets have become more competitive.

Of the states that levy gross receipts taxes on electric utilities, taxes in at least 10 are designed to recover the costs of regulatory agencies. These taxes typically are levied at rates lower than 1 percent of gross receipts and are levied either at variable rates set by public utility commissions annually to cover costs (subject to statutory maximum rates) or at a rate fixed in statute. Other states levy gross receipts taxes at rates higher than 1 percent, and revenue from the taxes contribute not only to public utility commission costs but also to the state general fund.

States can tax only the gross receipts earned from sales within their borders or levy kilowatt-hour taxes based upon electricity consumed within state borders. In cases where utilities operate across state lines, gross receipts must be allocated to the respective states.

Reliability

Electricity consumption is closely correlated with the strength of the overall economy, because large industrial customers add to demand during economic expansions. Therefore, electric utility tax collections are subject to cyclical fluctuations in the economy.

Equity

Electricity gross receipts taxes are a regressive form of taxation, particularly given electricity pricing structures. Many utilities provide declining marginal electricity rates for large industrial customers as an incentive to keep them from fuel switching. Many residential customers pay among the highest electricity rates per kilowatt-hour. Gross receipts taxes, therefore, most significantly affect residential customers; low-income customers pay a larger share of their incomes for utility bills. Some states use revenue from gross receipts taxes or kilowatt-hour taxes to provide subsidies for low-income customers, however.

Another equity issue involves the tax treatment of investor-owned utilities, municipal utilities and member-owned cooperatives. In some states, municipals and co-ops are exempt from income and property taxes, while investor-owned utilities are not. Differential taxation can place investor-owned utilities at a competitive disadvantage.

Administration and Compliance

One of the major strengths of electric utility taxes is the low cost of administration and compliance. States typically have a small number of utilities, which means few tax returns are filed and only a small administrative staff is necessary to process them. From the perspective of the regulated utility, taxes are a cost of doing business that regulators allow to be passed directly to customers in the form of higher rates. Calculating gross receipts is straightforward, so compliance costs are minimal.

Interstate and International Competition

With the electric industry moving toward competition, interstate competition and competitiveness are becoming major issues. In the former, regulated environment, utilities could sell only within their service territories and customers could buy only from their local utility. Differentials in state tax rates and policies were irrelevant because industrial customers could not purchase cheaper power from out-of-state utilities. The only options available to reduce power costs were to relocate to another state or switch fuels.

The federal Energy Policy Act of 1992 and subsequent regulatory changes opened the marketplace for wholesale competition in power sales and gave states the opportu-

nity to open the retail marketplace for competition. Large industrial users now can contract with utilities outside their immediate area for cheaper power, and the local utility is required to transmit this power to the customer. In this new marketplace, state tax policies that place local utilities at a competitive disadvantage can have a major effect on the utility market.

Economic Neutrality

Economic neutrality has become a more important concern in the taxation of electric utilities with the advent of wholesale and retail competition. State tax policy should treat in-state and out-of-state generators equally in a competitive marketplace. Gross receipts taxes are levied on the electricity supplier, not on the end user. Companies that buy power from out-of-state generators may receive a price break because the state gross receipts tax cannot be applied to out-of-state companies. States will need to reconsider any tax policy that imposes different tax burdens on firms in the same industry.

Accountability

Electric utility taxes are hidden in the final cost of power and, therefore, are not accountable to taxpayers. In some states, utilities are prohibited by statute from separately stating the tax on customers' bills.

Other Issues

Gross receipts taxes are well-suited for utilities that operate in monopoly markets. They are simple to collect and administer, are stable and are hidden from taxpayers. Regulated monopolies can pass taxes directly to consumers without affecting shareholder returns. In a competitive market, however, gross receipts taxes may create horizontal inequities by placing in-state firms at a competitive disadvantage. Competition also may provide incentives for utilities to restructure so that it is difficult to impose the gross receipts tax. For example, if a utility divests its generation capacity and retains only transmission and distribution, its gross receipts may include only the charge for transmitting power from generators to end-users.

For this reason, states that plan to deregulate the retail energy marketplace may shift from gross receipts taxes on producers to taxes on consumers. Taxes levied on the end-user treat generators equally and avoid nexus problems. Such taxes could include a sales tax on electricity sold at retail or a kilowatt-hour tax imposed on end-users.

Competition has forced states to reexamine their electric utility tax policies because taxes can influence where, when and if companies build new power plants. In 2001, the nation experienced generation shortages and bottlenecks in the power delivery system. During that time, it became clear that new infrastructure investments in power plants were desperately needed simply to meet demand. State policymakers began to examine how they could use their tax systems to encourage new investment.

Inheritance, Estate and Gift Taxes

Commonly referred to as “death taxes,” these taxes are imposed on the transfer of accumulated wealth at death or in anticipation of death. States levy three types of death taxes: inheritance, estate and gift. Inheritance taxes are levied on the person receiving the bequest, while estate taxes are levied on the estate of the deceased person before assets are distributed to heirs. Gift taxes are imposed on transfers of wealth from living donors.

Inheritance taxes typically are levied at graduated rates, based upon the amount of the bequest and upon the relationship between the deceased and the beneficiary. Rates typically are lower for immediate family members (spouse and children) and highest for unrelated beneficiaries. Estate taxes also are levied at graduated rates, based upon the value of the estate. However, the tax rates are imposed on the estate as a whole and typically do not vary based upon the relationship of the beneficiary to the donor.

Death taxes are designed to prevent the extreme and permanent accumulation and concentration of wealth. Critics of death taxes argue that they can cause the breakup of family-owned businesses and provide disincentives for savings and investment. Proponents argue that exemptions and credits included in most state statutes allow all but the wealthiest citizens to avoid tax liability. Another concern about death taxes is that many wealthy individuals can legally avoid the tax through estate planning.

Reliability

Death tax collections often fluctuate, especially in small states where the death of one very wealthy person can dramatically affect collections. Therefore, the estate tax is notoriously difficult to forecast. Most forecasters conservatively estimate revenues and treat large collections from a single estate as a windfall. Since estate taxes represent only a small percentage of state tax collections, the lack of stability in collections exposes the state to minimal risk. Using long-term averages, death taxes provide a reasonably steady flow of income to the state treasury.

Equity

The equity of death taxes is subject to considerable debate. Proponents of these taxes argue that they promote vertical equity by preventing excessive accumulation and concentration of wealth. This is especially important in the United States, where—in contrast to other industrialized nations—federal and state income tax rates are low and individuals retain a significant portion of their earnings.

Death taxes create problems of horizontal equity because of an increase in estate planning and legal avenues for avoidance. Most death taxes exempt bequests to charitable institutions, for example. In many instances, wealthy individuals bequeath money to colleges and universities or create charitable foundations rather than pay the tax. Therefore, depending upon the estate planning techniques used, two estates with similar assets may pay dramatically

different taxes.

Opponents also charge that death taxes are unfair because they sometimes prevent family farms, small businesses and other closely held firms from being passed to family members.

Compliance and Administration

The probate system for disposing of assets at death requires an accounting of the decedent’s assets. Therefore, death taxes cause few additional administrative burdens on the state. The tax imposes a relatively small paperwork and reporting burden on taxpayers and does not require an extensive state bureaucracy to administer.

Taxpayers may argue that significant compliance costs are incurred in estate planning activities. Taxpayers, however, choose to incur these costs to avoid tax liability—they are not mandated by state law or administrative rules.

Interstate Competition

One main cause for the trend to eliminate or reduce state death taxes is the role of interstate competition. Wealthy taxpayers can easily avoid state estate, inheritance and gift taxes by establishing residence in a state where tax laws are more favorable. Death taxes can legally be imposed on real and tangible property located within a state, even if the taxpayer lives in another state. However, much of the value of a wealthy person’s estate is typically intangible property—stocks, bonds and cash—that is taxable to the state of residence.

Interstate competition limits the revenue that states can generate from death taxes. If these taxes are significantly lower in other states, taxpayers easily can change legal residence. Some experts argue that high death taxes can harm a state’s economy if wealthy citizens leave, because they no longer consume goods and services that generate other types of tax revenue.

Economic Neutrality

Death taxes can discourage owners of family businesses from investing in the business as they approach old age because any equity added to the business becomes taxable upon their death. The additional debt that sometimes is necessary to pay estate taxes also can jeopardize the viability of privately held businesses. This may put these firms at a competitive disadvantage compared to publicly owned companies.

Accountability

Death taxes are a key consideration in the settlement of large estates. Wealthy taxpayers know about the tax and its consequences, giving rise to a thriving estate planning industry. Like the income tax, filing returns allows taxpayers to know the exact amount of their tax liability. Therefore, death taxes measure very well on the accountability yardstick.

State Property Taxes

The property tax is one of the oldest forms of taxation, both in the United States and worldwide. It was the primary revenue source for state and local governments until the Depression era, when most states abandoned the property tax in favor of excise, sales and income taxes. The property tax is the primary revenue source for local governments, and remains a modest source of revenue to the few states that levy a statewide property tax.

Reliability

The property tax can be the most stable and reliable tax used by state and local governments. Property is generally categorized as real (land and all things attached to it) and personal (property owned by an individual or business that is not affixed to or associated with the land). Property values tend to be stable in the short-term, and when changes in value occur, it typically can be several years before they take effect in the property valuation process. Changes in taxpayers' income or consumption patterns do not affect property tax liability, and most types of taxable property cannot be moved to avoid tax liability.

However, as seen in the recession beginning in late 2007, dramatic fluctuations in real property values do occur. The effects of these fluctuations on property tax revenues can create serious fiscal challenges for states, and especially for local governments.

Equity

Horizontal and vertical equity both are major concerns with the property tax. Property taxes have the potential to be regressive because tax liability is not dependent upon income. A family at the poverty level and a middle-income family pay the same amount of tax on a \$100,000 home, regardless of their incomes. However, income and property wealth tend to be correlated, so families with different income levels are not likely to live in homes of the same value. Leading economists disagree about whether the property tax is regressive or proportional (imposes an equal burden on everyone, regardless of income). This uncertainty about vertical equity is primarily due to differing assumptions about how much of the property tax burden is shifted from landlords to renters.

Another concern is horizontal equity. Property taxes depend upon subjective decisions about how market trends affect property value. In some instances, similar properties in the same region can have different valuations for tax purposes, allowing taxpayers in similar circumstances to be treated differently. This is particularly true in states where property valuation cycles are very long.

Another issue arises in states such as California that base assessed value on the purchase price and provide for very little increase in property taxes over the time one owner retains the property. California has a cap of 2 percent per year. In these cases, identical properties can be assessed at greatly differing amounts over time. These measures do not

seem to have generated the public backlash that other property tax issues have, however, and seem to help preserve older housing stock.

Issues of horizontal equity are particularly important in a statewide property tax because, with one statewide rate, variations in the quality of assessment directly affect whether property owners in different parts of a state pay their fair share of the tax.

Compliance and Administration

The administrative costs of a statewide property tax are low. States typically use valuations provided by county or municipal assessors, and many states already have divisions within their revenue departments that review the accuracy of local valuations for the sake of equitable education funding.

Business and individual taxpayer compliance costs also are low compared to other types of taxes. Many residential property taxes are included in standard mortgage payments.

Businesses usually are required to self-report their personal property using information that already is maintained for accounting purposes. The assessment appeals process usually is available to taxpayers so they need not hire legal experts.

Interstate and International Competition

The effect of property taxes on businesses varies dramatically by the type of business and by the type of property taxed. In addition to land and buildings, businesses may pay taxes on machinery and equipment, vehicles and inventories. The type of property taxed under a statewide property tax usually is the same as that subject to local property taxes. Heavy manufacturers that use expensive machinery and equipment in the production process bear a much higher property tax burden than do service and knowledge-based firms.

Statewide property taxes can exacerbate or alleviate the tax burdens on businesses, depending upon how they are structured. A statewide property tax that replaces some or all local school property taxes will create a more uniform business tax burden statewide; businesses in high tax localities pay less, and firms in low tax localities pay more.

Economic Neutrality

One significant and growing problem with the property tax is the disparate treatment of intangible property. Traditional manufacturing firms that invest heavily in plants and equipment face a much higher property tax burden than do service firms that derive their value from intellectual property such as a skilled labor force, patents and copyrights. As knowledge-based businesses grow and become more important in the national economic mix, the amount of property tax collected decreases. In addition, the relative burden of the tax on manufacturing firms increases.

Another issue is the use of classification systems in several states. Classification systems set the taxable values of property at different percentages of market value, depending upon the type of property in question, such as residential or commercial. In Alabama, for example, the taxable value of residential property is 10 percent of market value, while the taxable value of commercial and industrial property is 20 percent of market value. Telecommunications and utility property are taxed at 30 percent of market value.

Classification systems can create disparities in industries that are shifting from regulated monopolies to competition. For example, some states tax the property of traditional telephone companies at a higher percentage than that of cellular telephone companies. This also is becoming an issue in the electric industry, where some states are providing for retail competition. In some instances, generating plants owned by traditional, regulated utilities are taxed at a higher rate than similar plants owned by competing companies that sell power at wholesale.

Accountability

Like income taxes, property taxes are accountable to taxpayers because bills are determined annually and taxpayers know the exact amount of their bills. The high visibility of the property tax, combined with the fact that it is not directly linked to income, makes it unpopular and a frequent target for tax reductions by lawmakers who want to ease the tax burden.

Other Issues

Taxpayers who itemize deductions can claim the property tax on federal form 1040, which can significantly reduce the effective rate of the property tax. As discussed earlier, deductibility is an important issue in states that are considering major tax shifts. This also can affect the equity of a state's tax system because higher-income taxpayers usually itemize deductions.

Severance Taxes

Severance taxes are excise taxes levied when natural resources are severed from the soil or water of a state. These revenues are intended to compensate a state and its citizens for depletion of their natural resource wealth, and to mitigate social and environmental effects. Severance taxes usually are associated with oil, natural gas, coal and ores, which generate the greatest portion of severance tax revenues. They also are applied to other natural resources including salt, timber, fish, phosphates, sulfur, clay, sand, gravel and cement compounds.

Severance taxes can be considered as a substitute for property taxes on the mineral value of a section of real property. Ownership titles to mineral rights (and thus taxation) often are separate from titles to surface property rights. Names given to the taxes vary from state to state—production, license, conservation, mining or specific severance taxes.

Reliability

Severance taxes potentially can produce significant revenue, but they are less reliable than most other taxes for financing recurring expenses. Collections fluctuate in response to price changes in world markets. Individual state conditions and production also can translate into widely different changes in revenue from year to year.

In addition, resources may become depleted or more difficult to extract, mines may close due to high costs or management problems, or a new development may make a resource obsolete. When collections drop, state budgets may face shortfalls, forcing policymakers to cut services or raise other taxes.

The bulk of severance tax collections depends upon a cyclical combination of worldwide prices and production levels, making them an unstable revenue source. The volatility in oil prices from 2007 to 2009 is an obvious example. Crude oil prices were approximately \$48 per barrel in mid-January 2007. A year later, the price had almost doubled to approximately \$93 dollars per barrel. Crude oil prices peaked seven months later in July 2008 at \$137 per barrel. By December 2008, the price had plummeted to \$43 dollars per barrel.

Severance tax-reliant states cope with the effects on budgets of fluctuations in worldwide markets by using risk-adjusted revenue forecasts (intentionally reducing revenue estimates by a risk factor), forward funding (using the previous year's revenues to fund the next year's expenditures), revenue-indexed budgeting (establishing minimum state appropriations using relatively certain revenues), and establishing rainy day funds (accumulating money during booms to be used during busts). In anticipation of ultimate resource depletion, some states have created resource revenue-based trust funds.

Equity

Generally, severance taxes are based on the value of the resource extracted or produced, with the tax imposed as a fixed percentage of the value (usually market) of the products severed. When based on the production quantity, taxes are imposed at a flat rate per unit of measure. Taxes can be graduated according to product value or volume of production. Some states use gross value, while others use net value or net proceeds. Taxing net proceeds can help distinguish between profitable and marginal operations and is consistent with taxing according to ability to pay. Customary measures of equity, based on a person's annual or lifetime income, are not applicable to severance taxes.

The opportunity to export taxes rather than impose personal taxes on a state's residents is attractive if it is technically feasible and if it can be justified as offsetting social costs generated by out-of-state residents. Severance taxes can be exported because they fall upon resource owners rather

than on a state's citizens as a whole. They have allowed Alaska, Texas and Wyoming to forgo imposition of a personal income tax and have supported Montana's choice to forgo a sales tax. Some states split severance tax receipts between the state and local governments, which bear the burden of expanding public facilities and providing public services to the extractive industries.

Compliance and Administration

In theory, a severance tax should be imposed at the earliest possible point, thus minimizing the effect of the tax on ensuing stages of use. A few states require first purchasers to pay the tax, but it usually is payable by the producer. The determination of what constitutes production may require allocation to a product's value at each stage of production, e.g., separation, refining or finishing. Over time, however, most states have developed complicated severance tax collection systems that require frequent reports, and their administration and compliance are highly specialized.

Interstate and International Competition

As previously mentioned, the world market sets resource prices. States compete with one another and with other nations for energy resource expansion and development investment. Since energy prices are set by world markets, state taxes will not affect selling prices, but will affect decisions about whether a resource can be commercially exploited at any given time. Tax increases cannot be passed to consumers, but are borne by resource owners whose royalties (property or mineral income) are reduced by taxes on production.

Economic Neutrality

Severance tax revenues may allow resource-rich states to provide additional services or to keep other major taxes low relative to neighboring states. Producers argue that high severance taxes discourage resource exploration and jeopardize the nation's energy independence. In response to this concern, many oil-producing states passed tax incentive legislation in the early 1990s to encourage oil production. State and local severance tax laws may distort investment allocation within and between states, but most likely will not have long-term effects. Regional disparities in wealth were a source of concern during the 1980s, but have not proven significant in the long run, since prices and the corresponding highs and lows in state severance tax revenues leveled.

Accountability

The citizen taxpayer is unlikely to be aware of severance taxes, and would be unable to determine their effect. Resource companies report the extraction and production activities upon which severance taxes are based, but there does not appear to be an effective method to evaluate the tax benefits received against the social and environmental costs.

Sources for More Information on State Tax Rates and Policies

Annual summaries of state tax actions <http://www.ncsl.org/default.aspx?tabid=18038> .

State personal income taxes on pensions and retirement income <http://www.ncsl.org/default.aspx?tabid=12657>

Tax backgrounders - six articles that provide a data-driven overview of state tax systems <http://www.ncsl.org/default.aspx?tabid=17151>

States with a legislative supermajority requirement to raise taxes <http://www.ncsl.org/?TabID=17421>

State tax and expenditure limits <http://www.ncsl.org/default.aspx?tabid=12633>

State personal income tax rates http://www.taxadmin.org/fta/rate/inc_inc.html and federal income tax starting points http://www.taxadmin.org/fta/rate/inc_stp.html

State corporation income tax rates http://www.taxadmin.org/fta/rate/corp_inc.html and apportionment of corporate income http://www.taxadmin.org/fta/rate/corp_app.html

State sales tax rates and exemptions for food and prescription drugs <http://www.taxadmin.org/fta/rate/sales.html> and vendor discounts http://www.taxadmin.org/fta/rate/sale_vdr.html

State sales tax holidays http://www.taxadmin.org/fta/rate/sales_holiday.html

State sales taxes on services <http://www.taxadmin.org/fta/pub/services/services.html>

State motor fuel tax rates http://www.taxadmin.org/fta/rate/motor_fl.html

State cigarette tax rates <http://www.taxadmin.org/fta/rate/cigarette.html> and state taxes on other tobacco products <http://www.taxadmin.org/fta/rate/otp.html>

State taxes on distilled spirits <http://www.taxadmin.org/fta/rate/liquor.html>, wine <http://www.taxadmin.org/fta/rate/wine.html> and beer <http://www.taxadmin.org/fta/rate/beer.html>

State real estate transfer taxes <http://www.taxadmin.org/fta/rate/Realtytransfer.html>

State and local tax burdens <http://www.taxadmin.org/fta/rate/burden.html>

(Corporate Tax- 9; Individual Income Tax- 38; Sales Tax- 36; Unemployment Insurance Tax- 1; and Property Tax- 15)

Characteristics of an Effective Tax System

Oklahoma Policy Institute, Online Budget Guide

A good tax system should meet five basic conditions: fairness, adequacy, simplicity, transparency, and administrative ease.

Although opinions about what makes a good tax system will vary, there is general consensus that these five basic conditions should be maximized to the greatest extent possible.

Fairness, or equity, means that everybody should pay a fair share of taxes. There are two important concepts of equity: horizontal equity and vertical equity.

Horizontal equity means that taxpayers in similar financial condition should pay similar amounts in taxes.

Vertical equity is just as important, however. Vertical equity means that taxpayers who are better off should pay at least the same proportion of income in taxes as those who are less well off. Vertical equity involves classifying taxes as regressive, proportional, or progressive.

•**Regressive tax:** A tax is regressive if those with low incomes pay a larger share of income in taxes than those with higher incomes. Almost any tax on necessities, such as food purchased at a grocery store, is regressive because lower income people must spend a larger share of their income on these necessities and thus in taxes. Oklahoma's sales tax is one example; lower-income residents pay a much larger share of their incomes for groceries and other necessities than higher income ones, so the sales tax takes more of their income.

•**Proportional tax:** A tax is proportional if all taxpayers pay the same share of income in taxes. No taxes are truly proportional. Property taxes often come closest since there is typically a close relationship between a household's income and the value of the property in which they live. Corporate income taxes often approach proportional because one rate applies to most corporate income.

•**Progressive tax:** A progressive tax requires higher-income individuals to pay a higher share of their income in taxes.

The philosophy behind progressive taxes is that higher income people can afford and should be expected to provide a bigger share of public services than those who are less able to pay. The federal income tax is the best example of a progressive tax; the Internal Revenue Service reports that the top one percent of taxpayers by income paid 38 percent of federal income taxes in 2012.



While no system of taxes is perfect, it is important to seek horizontal equity because taxpayers must believe they are treated equally. It is just as important to seek vertical equity so government does not become a burden to low-income residents.

Adequacy means that taxes must provide enough revenue to meet the basic needs of society. A tax system

meets the test of adequacy if it provides enough revenue to meet the demand for public services, if revenue growth each year is enough to fund the growth in cost of services, and if there is enough economic activity of the type being taxed so rates can be kept relatively low.

Simplicity means that taxpayers can avoid a maze of taxes, forms and filing requirements. A simpler tax system helps taxpayers better understand the system and reduces the costs of compliance.

Transparency means that taxpayers and leaders can easily find information about the tax system and how tax money is used. With a transparent tax system, we know who is being taxed, how much they are paying, and what is being done with the money. We also can find out who (in broad terms) pays the tax and who benefits from tax exemptions, deductions, and credits.

Administrative ease means that the tax system is not too complicated or costly for either taxpayers or tax collectors. Rules are well known and fairly simple, forms are not too complicated, it is easy to comply voluntarily, the state can tell if taxes are paid on time and correctly, and the state can conduct audits in a fair and efficient manner. The cost of collecting a tax should be very small in relation to the amount collected.

Systematic Thinking For State Tax Reform

Kent W. Olson, State Policy and Economic Development in Oklahoma: 1986

When the Oklahoma Legislative convenes in 1987 it is likely that tax reform will figure prominently on the legislative agenda. The objective of this essay is to offer some guidelines for thinking systematically about this issue. It begins with an outline of the major sources of concern and a brief development of the principles of tax system design which reflect these concerns. Then these principles are used to evaluate several reform proposals. No conclusions are reached; that is not the point of this analysis. Rather, the purpose is to provide a framework that will be helpful in making more informed choices regarding the tax system.

SOURCES OF CONCERN

Tax reform is normally undertaken in response to perceived problems with existing tax systems. In Oklahoma, there are five concerns that seem important enough to spark reform efforts in the near future:

- (1) an apparent instability in revenue collections,
- (2) the perception that the tax burden is not distributed fairly,
- (3) the concern that state and local taxes may adversely affect business investment and economic growth,
- (4) the recognition that state government may be assuming too large a share of the burden of financing local government activities and
- (5) the growing possibility of a need to reduce government spending in Fiscal Years 1987 and 1988 in the face of a revenue shortfall.

The awareness of each of these issues has been heightened by recent events. First, a remarkable drop in oil prices has precipitated a steep plunge in gross production tax revenues, producing a clear reminder of how dependent the state still is on the energy sector. Second, the passage of historic tax reform legislation at the federal level, primarily to achieve greater fairness in the application of the federal tax code, has focused attention on fairness in state taxes, as well. Third, the recent growth record of the state's economy has caused a searching reappraisal of many alleged barriers to growth, including the burden imposed by state taxes, fourth, revenue shortages for state programs have forced a recognition and reexamination of the state's generous support for local school districts and county roads. Fifth, the disappointing flow of tax revenues already in Fiscal Year (FY) 1987 has raised the possibilities that the state will not be able to fully fund the FY 87 budget, and that the budget for FY 88 will be smaller in the absence of new revenue sources.

A conjunction of these events is likely to force tax reform onto the agenda for the next legislature, and that there will be a search for ways to; (1) improve revenue stability, (2) make the tax system fairer, (3) enhance state economic growth, (4) relieve the state of some of the burden of financing local schools, and (5) increase the level of tax

collections. If so, some additional explanation of each of these tax reform objectives is in order. The stability objective will be discussed first.

To economists, a stable tax is one which provides a predictable, smooth yield over time. Taxes that produce constant or declining collections, and taxes characterized by fluctuating collections, are both undesirable. Taxes with collections that are relatively insensitive to economic growth fail to provide revenues needed to finance growing demands for government services. Taxes that are sensitive to fluctuations in economic activity create unplanned expenditure revisions and may even lead to painful mid-year budget adjustments of the type already experienced twice in Oklahoma in the 1980s.

Oklahoma's tax system is unstable in both ways. The primary source of past and prospective instability is the state's heavy reliance on revenue from the gross production tax on oil and gas. Revenue from this tax varies directly with both prices and production of these commodities. In the recent past, large changes in prices have been the primary factor behind the rapid growth and decline of tax collections from this source. In the long run, declining production will make collections from this tax less sensitive to growth in the state's economy than they have been in the past.

The gross production tax is not the only source of tax instability, however. Oklahoma depends also on a general sales tax which is partly a levy on consumer expenditures and partly a tax on producer purchases. The latter component of this tax is somewhat sensitive to fluctuations in economic activity. In addition, the general sales tax is marked by collections that are relatively insensitive to economic growth. The latter is a general characteristic of most state sales taxes, but it is exacerbated in Oklahoma's case by the exemption of consumer purchases of services—an exemption that will become more and more important in the future as the Oklahoma economy shifts toward a more service-oriented economic structure.

The short-run instability of the gross production tax is rivaled by that of the Corporation Income Tax— not in terms of the absolute magnitude of tax collections, but in terms of the annual percentage change in tax collections around the long-run trend. This occurs because the base of the corporation income tax, net corporation income, is quite unstable over the course of the business cycle.

These facts suggest that greater stability can be achieved by reform of taxes other than the gross production tax. In fact, reform of the latter, alone, would not remove an significant causes of tax instability from the system. There is a need for a revenue structure that is not so dependent on the oil and gas industry. However, there is also a need for a

tax structure which responds well to economic growth and long-run changes in the structure of the economy.

Fairness in taxation is also a two-dimensional concept. The principle of fairness, or equity, applied most often by economists is that people should contribute to the cost of government according to their ability to pay. Taxation according to this principle calls for people with equal abilities to pay, to pay equal amounts in taxes, and for people with greater ability to pay, to pay more taxes than people with lesser ability to pay. The former principle is that of horizontal equity, and the latter the principle of vertical equity.

Recent evaluations of Oklahoma's major taxes indicate the presence of many features that violate these dimensions of equity. Historically, the individual income tax has been a source of horizontal inequity because of the non-uniform applicability of deductions, exemptions, and credits. The impact of these features can be reduced significantly with passive acceptance of the changes imposed in the Federal Individual Income Tax by the Tax Reform Act of 1986.

The state's general sales tax is also an important source of inequity. It produces horizontal inequity, largely through exemptions granted specific commodities and consumer expenditures for services. This tax produces vertical inequity insofar as the tax is shifted to lower income consumers in the form of higher prices.

These facts suggest that much of the inequity associated with the individual income tax may have been reduced by recent actions of the U.S. Congress. However, there is still an unfinished equity agenda for the state sales tax.

Is there an unfinished economic development agenda for state taxes? It has long been claimed by business interests that taxes are an important determinant of business investment. Economists have long been skeptical of this claim because business taxes are such a small part of total business costs, and because many empirical studies failed to find a strong relationship between business taxes and investment spending or economic growth.

In the past few years, however, the authors of several studies have found a more significant relationship between business taxes and regional economic growth. If they are right this may be good news for Oklahoma because it has a low business tax burden relative to neighboring states,

Oklahoma's ability to compete for business investment may be reduced somewhat, however, by the presence of certain "sore thumbs", e.g., specific features of specific taxes that business investors interpret as anti-business in nature. At issue here primarily are two tax features: (1) the nominally progressive rate structure associated with the use of Method II in determining individual income tax liability, and (2) sales taxes on business purchases.

There is another side of the relationship between taxes

and economic development however, Business investment seems to be attracted to areas with excellent social infrastructure and high quality educational institutions. Since both items require large government expenditures, higher taxes are often associated with higher state growth rates, provided that these taxes are linked closely to the provision of such services.

The higher taxes required for better elementary and secondary schools (and to a lesser extent, county roads) have been coming increasingly from the state government. In FY 1984, local revenue accounted for only 29 percent of the local schools' budget in Oklahoma, while state government provided 49 percent of local school finance through appropriations from the General Revenue Fund and 15 percent from earmarked state taxes. In FY 1961, local revenues made up 53 percent of the total local schools' budget, and state appropriations accounted for only 25 percent.

This virtual reversal of the roles of state and local government is due to changes in both state and local government finance. At the local level, the property tax base—the main source of local revenues—has been narrowed four times in the past 20 years, and school districts wishing to raise more money from this source have run up against a constitutionally mandated maximum on millage levies. At the state level, the relatively rapid growth of state revenues during the decade, 1973-82, provided the means to pick up the slack created by these constraints on the property tax. The means of continuing to do so have been greatly circumscribed by the pressure on the General Revenue Fund since then, and the conflict between state support of local schools and state support of state programs has been posed in much starker terms. It is not surprising that people are beginning to suggest that local communities should shoulder a larger share of the burden of financing local schools.

It is too early to tell whether the recent downward trend in tax revenues will be reversed somewhat in FY 1988; however, the early warning signs are not hopeful. Tax collections so far in FY 1987 are running below expectations and no bullish forecasts of the state's economy have yet appeared. In fact, it seems likely that the state government will start FY 1988 with reserve funds exhausted, and if oil prices do not revive, the state will lack the means of replacing these reserves and of funding even a stand-still budget without additional tax revenues. Since 1987 is not an election year, this is likely to lead to a number of proposals for increasing tax revenues. The legislature will be interested, in any event, in the effect on tax revenues of the various tax reform proposals that are likely to engage their attention.

TAX CHOICES

Ideally, the next step in this analysis would be to apply the five tax criteria suggested above to choices that will actually be debated in the next legislative session. It cannot be predicted what these will be, however. Instead these criteria will be applied to alternatives identified and evaluated in recent studies of Oklahoma's tax system. In doing so,

attention will be focused on some alternatives that deserve broader exposure than they have received up to now.

The various alternatives can be divided into three categories: (1) reforms of existing taxes, (2) substitution of new taxes for old taxes, and (3) substitution of local taxes for state taxes.

Reforms of Existing Taxes

It is not feasible, within the confines of this essay, to evaluate all the options for reforming existing taxes which have been identified. Table 1, located on the next page, contains a summary of an evaluation of most of the major options for the principal state taxes, as well as the local property tax. Each of these options was examined for its impact on revenue stability, horizontal and vertical equity, economic growth, and revenues collected.

Individual Income Tax

Significant reform of the Oklahoma Individual Income Tax will take place automatically if the legislature does nothing to offset the provisions of the recently-enacted Federal Tax Reform Act of 1986. The Oklahoma Individual Income Tax is coupled to the Federal Individual Income Tax in two ways: (1) Adjusted Gross Income (AGI) on the federal tax return is the base of the Oklahoma tax, and (2) itemized deductions claimed on the federal tax form are also used as itemized deductions in figuring Oklahoma tax liability. It follows that Oklahoma tax liability will increase if there is an increase in federal AGI, or if federal itemized deductions fall. Since the Tax Reform Act of 1986 produces both of these changes in the federal tax, an increase in Oklahoma income tax collections is certain. Estimates for the Advisory Commission on Intergovernmental Relations (ACIR) indicate an increase as large as 13-15 percent of current revenues, or more than \$100 million. The same study does show, however, that this increase will be more than offset by a reduction in federal individual income taxes paid by Oklahomans.

In addition to the positive effect on state tax revenues, federal tax reform will have a positive effect on horizontal equity, as a result of the elimination of several exemptions and deductions, and the elimination of favorable tax treatment of capital gains. These changes will produce a more equal tax burden for individuals at the same income level, and they will be passed through automatically via the existing coupling to the federal and state income taxes.

The effect of federal tax reform on vertical equity will probably be negative in the absence of explicit state action to imitate new federal provisions which provide tax relief to the poor. Estimates done for ACIR indicate that, in the absence of these provisions, individuals in higher income brackets would get larger percentage tax breaks than individuals in lower income brackets, making the federal tax less progressive. Given the close relationship between the federal and Oklahoma income taxes, there should be a similar impact on the Oklahoma tax-*ie.*, it will become less

progressive.

Vertical equity would be improved by providing state tax relief to the poor. This could be done by adopting the new federal levels for personal exemptions and standard deductions. When fully phased-in, federal personal exemptions will be \$2,000 per person (up from \$1,080), and the standard deduction will be \$3,000 (up from \$2,480) for single taxpayers, \$5,000 (up from \$3,670) for married taxpayers filing joint returns, and \$4,400 (up from \$2,480) for taxpayers filing as a head-of-household.

Although such a policy would provide the poor with virtually complete protection against paying state income taxes, it would produce a significant revenue loss because it would provide greater tax relief for all taxpayers, especially the non-poor. To avoid this, the state could adopt an earned income tax credit similar to the Federal Earned Income Tax Credit. This provision of the federal tax code provides tax relief at the federal level largely for the poor, at about only one-tenth the cost of higher exemptions and only one-fifth the cost of higher standard deductions. Similar revenue savings should be realized at the state level.

Imitation of the Federal Government's increases in the personal exemption and the standard deduction would probably increase horizontal equity. The higher standard deduction would surely reduce the advantage now enjoyed by itemizers in the same income class.

An alternate way to improve horizontal equity would be to eliminate the state's exclusion from taxes of one-half of military pay and the up-to-\$100 (\$200 for joint filers) in interest received from Oklahoma financial institutions by individuals claiming less than this amount as a dividend exclusion on their federal returns. This would have a positive impact on revenues, as well, although it would be small, given that the amount of income of these types not now taxed is rather small. Not enough is known about the distribution of military pay by income class to determine the effect on vertical equity, and there may be a negative, although very small, impact on economic growth as a result of the reduction in the rate of return after taxes on money placed in Oklahoma financial institutions.

Another possible reform is the elimination of the low income tax credit now provided for property tax relief. Holmes has pointed out that the real beneficiaries of this relief are the heirs who inherit the property free of tax liens. He proposes that property taxes be deferred by placing a lien on the property of low income households, such lien to be payable when the property is transferred to heirs. This would impose a higher relative burden on higher income families, improving vertical equity. Some increase in tax revenues at both the state and local levels would be realized.

There are few things that can be done to increase the stability of the individual income tax; in fact, little needs to be

TABLE 1
Effects of Tax Reforms on Tax Objectives

Reform Options	Effect On				
	Revenue Stability	Horizontal Equity	Vertical Equity	Economic Growth	Revenues Collected
Individual Income Tax					
a. Accept federal reforms	?	+	—		+
b. Imitate federal increase in personal exemption and standard deduction		+	+		—
c. Adopt earned income tax credit			+		—
d. Eliminate exclusion of military pay and interest from OK. financial institutions		+	?	—	+
e. Substitute tax deferral for low income property tax credit			+	+	
f. Index rates, personal exemption, standard deduction	+			+	—
g. Eliminate Method II			—	+	+
Corporation Income Tax					
a. Accept federal reforms	+			—	+
General Sales Tax					
a. Tax all consumption	+	+	+	+	+
b. Exempt all business purchases				+	—
c. Substitute low-income tax credit for exemptions			+		+
Gross Production Tax					
a. Allocate share of revenues to (1) stabilization and (2) permanent funds	+				—
b. Adopt loss-offset tax credit	+	—	—	+	+
Motor Fuels Taxes					
a. Make gasoline tax a user fee					+
b. Adopt ad valorem motor fuels taxes, with minimum per unit levy	+				+
c. Index tax rate to construction costs	+				+
Property Tax					
a. Equalize assessment ratios by location		+			?
b. Adopt "greenbelt laws"		+			+

Note: A plus (+) sign indicates the likelihood of a positive effect, a negative (-) sign the likelihood of a negative effect, the absence of a sign indicates "no effect," while a question mark (?) indicates that it is not possible to determine the sign of an effect with available information.

done. However, if Oklahoma were to imitate the Federal Government by indexing tax rates, the personal exemption, and the standard deduction, Oklahoma Individual Income Tax revenues would be more stable over the course of the business cycle. Indexing would produce some loss in revenues to economic growth, but it may have a positive effect on economic growth by reducing Oklahoma's effective tax rates relative to those in neighboring states.

The final provision of the Oklahoma Individual Income Tax that has attracted attention is the Method II option. Under the Oklahoma tax code there are two ways to calculate tax liability. Method I imposes rates ranging from 0.5 percent to 6.0 percent of taxable income. Method II imposes rates ranging from 0.5 percent to 17.0 percent of taxable income less federal taxes paid. Individual taxpayers figure taxes by both methods and pay the lesser of the

two amounts.

Method II actually provides tax relief to individuals with taxable income below the median income. Individuals with above average income will pay taxes according to Method I which are less than if determined by Method II.

There appear to be many people, however, who believe that higher income individuals actually pay higher taxes because of Method II. Insofar as prospective taxpayers believe this, it may discourage some business executives from moving to Oklahoma. If Method II were eliminated, then, it may have a positive effect on economic growth. However, elimination of Method II would place a higher burden on lower income taxpayers and have no real effect on higher income taxpayers. Thus, there would be an unambiguous reduction in vertical equity and an increase in tax revenues.

Corporation Income Tax

The Corporation Income tax has received little attention from tax reformers in Oklahoma, and there appears to be little enthusiasm for altering its features. However, some of its key features have already been changed by the Federal Tax Reform Act of 1986, and the Oklahoma Legislature must decide if it wishes to endorse these changes.

A simple endorsement requires no action by the Oklahoma Legislature, because the principal changes at the federal level have a direct impact on federal taxable income, which serves as the base for determining Oklahoma taxable corporation income. Since the federal reform increases federal taxable income, Oklahoma collections from the state's corporation income tax will increase directly as a result of this reform. This may negatively affect state economic growth by widening the gap between business taxes in Oklahoma and other states, but the impact is likely to be quite small. Federal reform also broadens the base of both the federal and state versions of the corporation income tax, producing a positive effect on revenue stability for the latter.

General Sales Tax

The sales tax is an important source of both state and local government revenue in Oklahoma. At the state level, 3.25 cents is collected on each dollar of taxable sales—two cents of which goes into the Human Services Fund, and 1.25 cents into the General Revenue Fund. The former fund is used primarily to finance the Department of Human Services, and the latter fund provides money for the other important functions of state government, principally education, highways, and corrections.

It is commonly believed that the various sales taxes imposed throughout the country, as well as in Oklahoma, are levies on consumer expenditures. In reality, the sales tax in most states, including Oklahoma, is levied on both consumer and producer expenditures. Thus, the Oklahoma sales tax is both a consumption tax and a business tax.

However, it is neither a general consumption tax nor a general business tax; the tax is applied to only part of consumer and producer expenditures. The part of consumer expenditures not taxed consists primarily of services and tangible goods specifically excluded by statute. Producer expenditures which are not taxed are concentrated heavily in manufacturing and agriculture.

One reform would be to convert this tax to one based solely on consumption. If this were done, the sales tax would conform to the following guidelines:

- (1) only consumer expenditure items would be taxed.
- (2) all consumer expenditures would be taxed.
- (3) only sales to final (nonbusiness) consumers would be taxed.

This conversion would promote economic growth by encouraging consumers to save more and by reducing the tax burden on business. A tax on all consumption would

be a fairer tax because: first, the taxation of services would make the sales tax more progressive, and second, people at the same income level would have more equal sales tax burdens than they do now. The taxation of services and elimination of business purchases would also make collections more stable over the course of the business cycle, and a truly broad-base consumption tax would yield more revenue than the current sales tax at today's rate of 3.25 percent.

The primary additions to the tax base would be:

Services purchased by final consumers from brokers, investment counselors, banks and other financial intermediaries, insurance companies, lawyers, accountants, employment agencies, advertisers, hospitals, physicians, dentists, repairmen, educational institutions, barbers, beauticians, dry cleaners, and personal transport carriers.

Goods purchased by final consumers that are currently exempt from sales taxes: new residential dwellings, motor fuels, electricity, natural gas, water, prescription drugs, magazines and newspapers, purchases from government agencies and non-profit organizations, and food purchased in school and college cafeterias.

The primary deletions from the tax base would be:

Business purchases currently taxed: building materials purchased by businesses or by contractors on their behalf, oil field machinery, equipment and supplies not used or consumed directly in manufacturing by manufacturers, and equipment and supplies used by non-manufacturing businesses and non-profit organizations.

Since the sales tax currently places a burden on low income consumers, and a broader base would increase this burden, tax relief could be provided through a tax credit or tax rebate for such consumers. This method would cost far less in terms of revenue foregone than the current convention of excluding certain items (e.g., prescription drugs, water, electricity, and natural gas) from the tax base. A tax credit or rebate would be confined largely to low-income households, while exemptions are given to every household, regardless of income.

Gross Production Tax

Oklahoma's gross production tax (GPT) is principally a levy on the value at the wellhead of crude oil and natural gas. During the period, 1973-1983, it was the state's fastest growing source of revenue; in the past three years it has been the fastest declining source. This trend is attributable largely to the remarkable growth and decline in the price of crude oil. Natural gas prices grew even faster, but there is little doubt that they were pulled up by rising oil prices. Fortunately, they have not fallen in concert with oil prices, nor are they likely to, given the long-term contracting which characterizes the market for this commodity.

These relationships impart somewhat greater downside instability to GPT revenues from crude oil than to GPT revenues from natural gas. Eighty-four percent of the for-

mer and 29 percent of the latter are dedicated to the state's General Revenue Fund. Fifty-six percent of GPT revenues from natural gas are earmarked for state retirement funds (with the first \$125 million of this portion dedicated to the Teachers' Retirement Fund), and 14 percent of total GPT revenues are split evenly between school district and county roads. These allocations and the greater instability of collections from crude oil production combine to introduce a significant risk of revenue shortfall to the General Revenue Fund and the school district and county road funds.

Hopefully, the decline in oil prices is over, but there is no assurance that it is, or that there will be a significant price reversal in the near future. In the longer run Oklahoma faces the prospect of slow, but inevitable, depletion of oil reserves. The long-run picture for natural gas production may be brighter, given the state's enormous reserves. However, long-run trends do not favor substantial increases in the price of natural gas.

Given these factors, it may be prudent to take the initial steps toward reducing the state's dependence on the gross production tax revenues. In doing so, it would be unwise to reduce the current tax rate; much of the tax is exported to non-residents, and it can be defended, furthermore, as *quid pro quo* for social costs associated with instability in energy production.

Unfortunately, Oklahoma is not allocating its GPT revenues in a manner which would promote stability. It may be time to do so by following the lead of other resource-dependent states in establishing stabilization funds financed by gross production taxes. In the case of Oklahoma this could be accomplished by dedicating a percentage of the tax to two funds: (1) an Energy Price Stabilization Fund, and (2) an Energy Depletion Fund. The former would be used to accumulate revenues during periods of rising prices for appropriation during periods of falling prices. The latter would be used as a savings account for future generations: i.e., to provide an annuity which replaces the government's income from oil and gas just as a private annuity replaces income from earnings upon an individual's retirement.

The state's recent economic experiences may have created a window of opportunity for such a reform package. If it has, the state needs to devote sufficient resources to carefully designing these funds. If these funds were established there would be a reduction in government revenues for existing programs, of course.

Another problem with Oklahoma's energy sector is the relatively small margin of profitability on small volume oil wells. Since the gross production tax is a levy on revenues, rather than profits, from resource extraction, a reduction in price eventually drives profits below zero on some wells, forcing the owner to halt production.

One way to give tax relief to the owners of such wells is to provide for a credit against the gross production tax, or oth-

er taxes equal to losses sustained on these wells. Revenues would fall as a consequence, but by less than if no credit were granted and the wells were shut down-especially if the shutdown is followed by plugging of the well. Thus, the net effect on revenues is positive in a long-run context.

This alternative would have a more positive impact on revenues than the frequently-discussed alternative of exempting all low volume wells from the gross production tax. Such an exemption would probably exempt many wells that would remain profitable.

Provision of a loss-offset credit would lend greater stability to tax collections during periods of falling prices and increase the state's ability to compete for investment in oil and gas development. It is likely, however, that this type of tax relief would go disproportionately to higher income individuals, thus reducing vertical equity. Since not everyone at the same income level would receive this kind of relief, there would be a negative effect on horizontal equity, as well.

Motor Fuels Taxes

Oklahoma levies a 10 cent per gallon excise tax on gasoline and a 10 cent per gallon use tax on diesel fuel. About 5.5 cents from each gallon is allocated to the state highway fund; the remainder goes into country and city road funds. In the case of state highways, money from these taxes is supplemented by appropriations from the state's General Revenue Fund and matching grants from the Federal Government.

The state's ability to get federal matching grants for highways has been hampered in recent years by the failure of the General Revenue Fund to grow, and by the State Legislature's decision to cut appropriations for highways as a means of protecting funds for other purposes. The core of the problem, however, is the failure of the motor fuels tax to produce enough revenue to meet highway needs in the first place.

One factor which contributes to this dilemma is the state's unwillingness to acknowledge fully that it is appropriate to finance roads and highways primarily by levies on users. Such a philosophy apparently guided the establishment of the tax on diesel fuel, but it played a smaller role in establishing the tax on gasoline. Legislative affirmation of the philosophy that users should pay for road use in proportion to all fuels used for highway travel would create a better climate for choosing a tax rate which truly funded highway needs.

Adoption of the user fee philosophy of highway finance would also require that the state eliminate exemptions for users representing schools, cities, counties, and towns. Alternatively, it would require that fuel exemptions be granted where they are not now granted for all off-road uses of motor fuels, especially for diesel fuel used in agriculture, fuel used in aviation, and gasoline used for a variety of off-road purposes. The net effect of these changes on revenues is

uncertain.

The other principal problem with the Oklahoma motor fuels taxes is the failure of collections to grow as economic activity, population, and road construction costs grow. This is the inevitable result when a per unit tax is levied on a commodity for which units sold are sensitive to rising prices, as were gasoline and diesel fuel during the booming decade from 1973-1983. The state was able to meet growing highway needs during this time only by providing large appropriations for this purpose, and when the General Revenue Fund leveled off the legislature was forced to raise the amount per unit to provide adequate revenues. To avoid this problem in the future, and to fully implement the user fee philosophy, the state could switch to an ad valorem tax, i.e., a tax rate specified as a percent or the price per gallon. It may also be appropriate to index this rate to a measure of need, such as the highway construction cost index. These changes would certainly improve the long-run stability of this tax.

There is always the danger with an ad valorem fuels tax that declining prices will reduce tax collections. Serious revenue declines could be avoided by prescribing an amount below which the tax per gallon cannot fall, adding another element of stability.

Finally, it is apparent that high quality social infrastructure is an important input in the growth process. To the extent that higher revenues underwrite better infrastructure in the form of roads and highways, there is an automatic offset to the negative effects of higher taxes.

Property Tax

It is widely believed that the local property tax in Oklahoma is in need of substantial reform. The biggest source of concern is the great variation in property assessment, within and across counties: and within and across types of property. One proposed cure for this problem is the enforcement by the state of equalized assessment ratios and periodic revaluation of property. This would produce an improvement in horizontal equity, but it would have an unknown impact on revenues. The statewide equalization rate could be set to achieve an increase, a decrease, or no effect on property tax revenues.

Another problem is created by the imposition of the property tax on agricultural land on the basis of use value rather than market value. This feature of the tax which produces a relatively low tax burden on owners of agricultural land, has also provided low taxes for developers of the urban fringe. They acquire agricultural land for future projects but pay taxes based on current use value. One remedy for this practice is the passage of a so-called "greenbelt law" which provides for the payment of back taxes for five years on the difference between market value and use value for a parcel converted to nonagricultural use. Such a measure would provide increased revenues and greater horizontal equity, as well.

New Taxes For Old

The second general alternative in the tax reform arena is the replacement of existing taxes, either partially or wholly, by new taxes. Although the number of potential replacements is large, only two have received much attention in studies of Oklahoma's tax system; one is to substitute the value-added tax for the corporation income tax; the other is to substitute a net proceeds or a property tax for the gross production tax on oil and gas.

The Value Added Tax

The value-added tax (VAT) has been advocated as a source of revenue for state governments by many state and local finance experts. While it is widely used in Europe, Michigan is the only state which levies this tax in the U.S.

The VAT is imposed on the value a firm (a corporation, as well as a partnership or a sole proprietorship) adds to goods and services produced by and purchased from other firms. There are three types of VAT. In the gross product variant of the VAT, value added is the difference between annual sales and purchases, except for capital goods purchases. In the income variant of the VAT, value added is the difference between annual sales and purchases with the annual depreciation of capital goods included in purchases. In the consumption variant, value added is the difference between annual sales and purchases, including the full purchase cost of capital goods in the year purchased (with depreciation added to the tax base in subsequent years). The consumption variant provides the most favorable treatment of capital goods, and is the one most often proposed for adoption. The Michigan VAT is one of this type. The base of a consumption VAT corresponds closely to personal consumption expenditures. It is similar, therefore, to a retail sales tax on all consumption.

The VAT has two dear advantages over an equal yield corporation income tax in terms of the tax criteria used in this study. First, although the current state corporation income tax may have little adverse impact on investment, a consumption VAT, if it had any impact on investment, would work to increase it rather than to decrease it. This is a particularly appealing feature for a state seeking to grow through diversification of its economic base.

Second, a consumption VAT would be more cyclically stable than the corporation income tax. The biggest component of the tax base for the former is labor income, a relatively steady source of income over the course of the business cycle. The corporation income tax base, net income, is notoriously unstable.

The consumption VAT also poses some difficulties. Two, in particular, seem to dominate the policy discussion: (1) the regressivity of the tax, and (2) its questionable political feasibility.

There is some question as to whether or not a consumption VAT would be shifted entirely to consumers in the form

of higher takes, However, there is greater likelihood that a larger proportion of this tax will be borne by consumers than the likelihood that a larger proportion of the corporation tax will be shifted to consumers.

Regressivity the VAT has led European users to exempt certain necessities from the tax base, such as food, housing, and medicine. However, this is not the only solution to this problem. Regressivity at the lower end of the income scale could be offset, instead, by the granting of general tax credits or tax rebates, much as several states do currently to offset the regressivity of the general sales tax.

The problem of political feasibility is probably more important, however. The threat of a consumption VAT would almost certainly generate opposition by a larger political constituency than the one currently opposing the corporation income tax. However, the Michigan experience shows that such opposition can be overcome in the US.

Alternative Taxes on Oil and Gas Production

If the problems created by reliance on the gross production tax cannot be solved through reform of this tax, can they be solved by substituting other taxes for this tax? There are several possibilities, but two taxes seem particularly promising: a net proceeds tax, and a state property tax.

The net proceeds tax is a tax levied on the mineral deposit, *per se*, rather than on the general business of the developer/exploiter of the deposit. The tax base is gross receipts less expenses on the specific parcel. It is found in Nevada, Idaho, and South Dakota, and seems to be growing in favor among resource economists.

The property tax prescribed as an alternative is one levied on the present value of the resource deposit. This type of property tax has not been employed widely because it is difficult to estimate; however, Arizona uses a method that seems adaptable by other states. In this method, the present value of the deposit is based on estimates of reserves and production, which are combined with a profit-margin formula to convert the extraction profile into an income stream. The profit, margin formula is based on the average margin for five preceding years to minimize the influence of short-run fluctuations.

Insofar as any of the three (GPT, net proceeds, property) taxes would not be exported, they would fall principally on property and dividend income. Thus, the burden of each would be distributed progressively, and there is little basis for distinguishing between them in terms of vertical equity. All three taxes are not horizontally equitable, because each falls only on a portion of total income; however, there is no basis for believing that one is more inequitable than the other.

It is clear that the property tax has better potential for short-run stability than the gross production tax because it is tied to an estimate of longer run profitability rather

than to current year prices. The net proceeds tax would be more stable than the gross production tax in the sense that it would automatically exclude from taxation nonprofitable wells even when revenues are positive. The net proceeds tax would reflect changes in current prices to a greater degree than the property tax, however, and be less stable than that tax as a result.

In the short-run, the property tax has little impact on production, simply because it cannot be avoided by changing the production decision. The same verdict holds for the net proceeds tax, but for a different reason; it would not be profitable to change the output plan in order to avoid this tax. The gross production tax is clearly the worst in terms of this criterion because it does lead to the closing of marginal wells. However, some of this effect may be curable through tax credits, as pointed out earlier.

Unfortunately, all three of these taxes can potentially reduce investment. A study by The Rand Corporation indicates that this effect is quite small for the gross production tax. It is not known how this compares to the impact on investment of the other taxes, however.

State Taxes Versus Local Taxes For Local Schools

The final set of choices to be examined is that of state or local taxes to fund programs of local government. Here the overwhelmingly important issue is the degree to which the state government should fund Oklahoma's elementary and secondary, or "local" schools. As noted earlier, the state has shouldered an increasing share of the costs of local schools, up from 41 percent in 1960-61 to 64 percent in 1983-84. This fact, coupled with the recent pressure on the state's General Revenue Fund, has led many analysts to advocate that local government share a larger part of these costs.

In his study of this problem, Holmes proposes more local funding for local schools.²⁰ He argues that an equalized, frequently revalued property tax base is an essential precondition for such an increase. To accomplish the latter, he proposes that the Oklahoma Constitution be changed to give local interests the right to establish their own maxima on millage levies.

In addition, Holmes recommends the elimination of the "hold harmless" provision of Oklahoma's formula which determines the level of state aid to local school districts. This provision provides that a district shall receive no less than its previous level of aid, even if the formula indicates that a reduction is in order, say, because of declining enrollment. This provision cost Oklahoma State Government over \$66 million in FY 86.

Finally, Holmes recommends the consolidation of small districts, both as a means of improving educational quality and of saving money. If adopted, these changes would probably result in increased local revenue and reduced state aid for local

schools. The effect on economic growth would depend partly on what the state did with the state money no longer used by local schools, and partly on the degree to which educational quality was improved. It is not difficult to construct a scenario in which both of these elements would make a positive contribution to state economic growth.

CONCLUSIONS

As stated, there are not conclusions herein in terms of identification of the best alternative for state tax reform. There is, however, a framework for systematic consideration of the tax issues, and many of the alternatives, that are imminent in Oklahoma.

ENDNOTES

See: Kent W. Olson, Alexander Holmes, Ansel M. Sharp, Charles Register, Michael Bresson, *Oklahoma State and Local Taxes: Structure, Issues, and Reforms, A Report to The Kerr Foundation Inc. (Stillwater OK: Office of Business and Economic Research, Oklahoma State University, 1984)*; Alexander Holmes, Kent W. Olson, Ansel M. Sharp, Larkin Warner, *Oklahoma's Tax System, Research Report Volume I for Oklahoma Academy for State Goals (Available from Alexander Holmes, Research Director, Oklahoma Academy for State Goals, Department of Economics, University of Oklahoma, Norman, 1986)*.

See the assessment of this issue by Alexander Holmes. "New Tax Initiatives for Economic Development," in *State Policy and Economic Development in Oklahoma: 1985, a report to Oklahoma 2000, Inc., December 1985*, pp. 31-39

See, for example: Leslie Papke, *The Measurement and Effect of Interstate Business Tax Differentials on the Location of Capital Investment (West Lafayette, Indiana: Center for Tax Policy Studies, Purdue University, 1986)*; Michael Waslenko, and Therese McGuire, "Jobs and Taxes: The Effect of on States' Employment Growth Rates," *National Tax Journal*, December 1985; L. Jay Helms, "The Effect of State and Local Taxes on Economic Growth: A Time Series-Cross Section Approach," *The Review of Economics and Statistics*, 1985: 574-582,

This is one of the principal findings of Helms (1985).

Alexander Holmes, "Oklahoma's Property Taxes. Problems and Solutions," In *Oklahoma's Tax System (1986, p. 204)*.

Olson , et al., *Oklahoma State and Local! Taxes; Holmes, et al., Oklahoma's Tax System*.

Carolyn D. Lynch, "Tax Reform and Federal Individual Income Tax Liabilities," *intergovernmental Perspective*, Winter/Spring 1986, 30-33,

State Policy Reports, October 10, 1986, pp. 8-10.

Kent W. Olson, *The Burden of Taxes on the Poor in Oklahoma, A Report to the Oklahoma Conference of Churches, Oklahoma City, 1986*.

Ansel M. Sharp, "The Oklahoma Individual Income Tax: Features, Issues, and Options," In Holmes, et al., *Oklahoma's Tax System (1986, p. 40)*

Alexander Holmes, "Oklahoma's Property Taxes: Problems and Solutions," (1986, p. 201).

It has been estimated that adoption of this alternative could raise an additional \$384 million in taxes. See Kent W. Olson. "The Okla-

homa General Sales Tax," In *Oklahoma's Tax. System (1986, p.284)*

Kent W. Olson, "The Oklahoma General Sales Tax," in *Oklahoma's Tax System (1986, p. 287)*

Such as in Alaska, Wyoming, North Dakota, Montana, and New Mexico.

Over 70 percent of Oklahoma's oil production comes from stripper wells, which produce less than 10 barrels per day. There is considerable variation among these wells in terms of the cost of getting oil to the surface.

See: Alexander Holmes, "The Oklahoma Motor Fuel Taxes; An Interstate Comparison," in *Oklahoma's Tax System (1986, pp. 97-100)* .

See : Alexander Holmes, "Oklahoma's Property Taxes: Problems and Solutions," (1986, pp 196-205).

See: Kent W. Olson, "State Taxation of the Oklahoma Oil and Gas Industry," in *Oklahoma's Tax System (1986, pp. 249-254)*

F. Camm, C.W. Myers, R.Y. Arguden, S.J. Bell, and T Jacobssen, *Effects of a Severance Tax on Oil Produced in California (Santa Monica, CA: The Rand Corporation, 1982)*.

Alexander Holmes, "Elementary and Secondary Education Expenditures in Oklahoma," In *Oklahoma's Expenditure System, Research Report Volume II for Oklahoma Academy for State Goals (Available from Alexander Holmes, Research Director, Oklahoma Academy for State Goals, Department of Economics, University of Oklahoma, Norman, 1986)*.

What follows are summaries of three additional articles from the State Chamber's "Oklahoma 21st Century Studies." The completes studies can be found at <https://www.okstatechamber.com/issues/state-chamber-research-foundation-publications>. We have highlighted what we felt were key statements under each of the major headings. This was done to keep the overall document from being too voluminous.

(c. 95%)

Attitudes of Oklahomans Toward State and Local Taxes and Expenditures

Chapter III, State Policy and Economic Development in Oklahoma: 1994

The objective of this study is to examine the likely future course of public expenditure and revenue pressures in Oklahoma. To obtain greater insight into the probable future, the research team surveyed the Oklahoma populace.

State Question 640 now virtually mandates a “survey,” of the grand sort, of voter attitudes for practically every tax increase, with the will of the majority ruling. This ominous fact is the primary impetus for an in-depth exploration of citizen attitudes on public finance issues.

There are other reasons, however, for conducting survey research on citizen attitudes. Among them is a need to better understand the attitudes of Oklahomans in regard to the public sector. There is a need, as well, to gauge the intensity of reaction to possible future courses of action: just how strongly is the electorate opposed to new revenue sources? Survey research is also a useful tool for assessing the extent of citizen knowledge of public sector issues. Voters, it could be argued, have taken on new responsibilities with passage of State Question 640, greatly increasing their need for informed judgments.

Surveys are useful, too, in exploring general levels of satisfaction of Oklahoma citizens with state and local government. Is widespread dissatisfaction with the services government provides a root cause of discontent? Finally, there is a need to “get inside the heads” of Oklahoma taxpayers to see what they want from government and to check for inconsistencies and conflicts in goals. Fiscal constraints are such, at present, that government may be called on for more than it can hope to provide.

Following careful review of the literature on the design of state and local government surveys and a review of hundreds of questions asked in previous efforts, we defined five types of information needs: (1) national benchmarks; (2) perceptions of value and knowledge indicators; (3) attitudes toward specific government programs; (4) attitudes toward sources of revenue; and (5) the citizen psyche—an exploration of voter values, beliefs, and attitudes. The survey was conducted over the period September 9 through October 5, 1993. Responses were obtained randomly from 1,091 adults, providing an error rate of slightly better than plus or minus three percentage points. The following sections present the survey’s major findings.

National Norms

The researchers took two questions directly from a national survey administered by the Advisory Commission on Intergovernmental Relations (ACIR). The comparisons given below contrast Oklahoma respondents’ answers to results of the 1991 ACIR survey.

- The Oklahoma citizen regards local government much more favorably relative to national benchmarks (44 percent versus 31 percent) as the level of government from which the most is gained for the money. The federal and state governments are regarded about equally favorably in comparison

with national norms. A much lower proportion of Oklahoma respondents than national respondents said they didn’t know or provided no definite answer (11 percent versus 22 percent).

- A much larger percentage of Oklahomans regard the federal income tax as the least-fair tax compared to other forms of taxation (38 percent versus 26 percent in the national poll). The property tax ranks second among Oklahomans, with 26 percent of respondents stating that it is the least-fair tax. The state income tax and the state sales tax scored similarly in relation to national norms.

Perception of Value and Knowledge Indicators

- Several questions addressed voter perceptions regarding the value of state and local government and awareness of state revenue issues. The results were mixed. Oklahomans strongly believe that they do not receive good value from state and local government. More than three-fifths responded negatively to the statement “Oklahomans generally receive good value for the state and local tax dollars they pay.” Only about one-third said that they agreed with this statement and only 2 percent said that they strongly agreed.

- Respondents appeared somewhat knowledgeable about comparative reliance on various forms of taxation at the state and local level. Oklahoma’s state income and sales taxes are generally higher than those in many other states, and about two-fifths responded that this is so. In addition, 31 percent responded correctly that property taxes are lower. Those responding that they did not know ranged from 10 to 20 percent for these questions.

- Respondents were also asked whether Oklahoma has a state constitution. Sixty-two percent said that it did; only 6 percent said that it did not. The remaining 32 percent said that they did not know. The percentage who know that their state has a constitution may seem astonishingly low, but Oklahomans actually compare quite favorably with a national norm. In the ACIR survey, 52 percent responded affirmatively; 11 percent negatively; and 37 percent did not know.

Attitudes Toward Specific Programs

Because voters are likely to face decisions regarding specific services, the survey attempted to distinguish among attitudes about various services. For example, the survey asked respondents to “suppose government funding is limited and a decision must be made whether to reduce services or raise taxes. Would you favor or oppose additional taxes for the purpose of supporting the following activities?” For various categories of public spending, there were some notable differences. The responses were as follows:

- Education: strong support was shown. For education in kin-

dergarten through grade twelve, 73 percent favored additional taxes to provide support. For higher education, 63 percent indicated favor.

- Social problems: strong to moderate support was shown. In terms of health care for the elderly, handicapped, and poor, 74 percent would favor additional taxes. For drug education and treatment, 60 percent favored; for health and social services for children, 56 percent favored higher taxes over reduced services. For assistance for the poor and homeless, 56 percent favored, while in the area of crime prevention and prison facilities, 58 percent would choose additional taxes rather than reduce services.

- Physical infrastructure: varying support was recorded. Sixty-one percent favored more support for maintenance of roads and bridges. Yet, 71 percent opposed higher taxes for new highway construction. Sixty-two percent would support higher taxes for water and sewage treatment, while 66 percent opposed increased taxation for public transportation.

- Other activities also met with varying support. Additional taxes for parks and recreation facilities) wildlife preserves, and tourism were opposed by 61 percent of survey respondents. For environmental regulation and cleanup, 50 percent opposed. For economic development, including location incentives, 49 percent opposed. These results indicate moderately strong support for government programs, especially in view of the question's wording, which asked whether the citizen would prefer more taxes in support of these functions instead of service reductions. Many of the unfavorable responses bordered on the 50 percent mark. Very few programs or services were strongly opposed.

Attitudes Toward Sources of Revenue

In probing attitudes toward sources of revenue, the survey asked respondents: "If the state needed additional money for a program that voters have approved, would you favor or oppose increases in each of the following revenue sources?" The ordering of the responses by the percentage opposing increases in the corresponding source of revenue is shown in Table III-1.

Only two tax sources—on games such as bingo and on tobacco and liquor—were favored by a majority of respondents. Sale of state assets had the blessing of slightly more than one-half the respondents, and fees to users of government services scored near the 50 percent mark.

With the exception of these minor sources of revenue, however, survey respondents decisively indicated opposition to tax increases. Results even reveal opposition to expansion of the sales tax base to services. Services constitute a growing proportion of household consumption expenditures, and thus, a growing proportion of consumption expenditures escapes sales taxation.

The Citizen Psyche

As noted, the researchers asked a series of questions of respondents in order to assess citizen thinking on a variety of issues related to state and local government taxes and expenditures. Sixteen questions were submitted to each respondent and, while the ordering of the questions was random, the questions fell nat-

TABLE 111-1
Rank Ordering of Various Revenue Sources
by Percent Opposed to Increases

Taxes on utilities	86%
Taxes on residential property	83%
State personal income tax	82%
Taxes on molar vehicles	79%
State sales tax rate increases	73%
Gasoline tax	71%
Sales taxes on services	71%
Oil and gas production taxes	69%
Taxes on businesses and corporations	55%
Fees to users of government services	45%
Sale of state assets	40%
Tobacco and liquor taxes	33%
Taxes on games such as bingo	19%

urally into five categories: (1) state and local intergovernmental relations, (2) the role of government, (3) tax burdens on higher-income families and corporations, (4) attitudes toward politicians and government workers, and (5) other tax and budget issues. For each question, respondents were asked whether they strongly agreed, agreed, disagreed, strongly disagreed, or did not know or have an opinion. An example of detailed responses to the other tax and budget issues questions is provided in Table III-2.

State and Local Intergovernmental Relations

In the questions on intergovernmental relations, 85 percent of the respondents agreed or strongly agreed that the state should be involved in funding and quality assurance of local public education. This result is in contrast to a virtually equal plurality (86 percent) who believe that state government provides too much support to local government functions. Almost 90 percent believe that local governments should be free to set their own sales and property tax rates, presumably free from any encumbrances on that process from the state government.

Role of Government

The tabulations on questions related to the role of government reveal strong and consistent preference by Oklahomans for an activist role for state government. For example, one-half of the respondents agreed or strongly agreed that state government should aggressively seek to improve the quality of life, the environment, educational attainments, and the economic vitality of Oklahoma. Only 31 percent disagreed or strongly disagreed.

In a similar vein, respondents believe that government should not be limited to provision of just basic services, defined in the questionnaire as education, transportation, and crime prevention. The desire for an activist role extends to health care. Fifty-eight percent think that state government should provide a minimum level of health insurance for all citizens. In addition, respondents indicated that the state should provide financial incentives for businesses to locate in Oklahoma. The state also has a responsibility to provide financial assistance to families in need, said 71

TABLE 111-2
Detailed Survey Results
Other Tax and Budget Issues
(In percent)

Other Tax and Budget Issues	Strongly Agree	Agree	Disagree	Strongly Disagree	Don't Know
Taxes should not be increased unless linked to specific government programs.	27	63	7	1	3
Balancing the state budget is a first priority, even if we must reduce services.	28	47	18	4	3
Revenue problems in Oklahoma government are matters of serious concern.	6	37	30	2	26

percent of those surveyed, but that support is highly constrained: almost 93 percent of the respondents stated that people are on public welfare much too long.

Tax Burdens

Respondents were split on the question of whether higher-income families pay their fair share of state taxes; 48 percent agreed and 44 percent disagreed. Fifty-seven percent believe that corporations and businesses are paying their fair share.

Attitudes Toward Politicians and Government Workers

Respondents apparently do not hold politicians in high esteem, according to their responses to the statement “Politicians are, for the most part, in public life for their own financial gain.” Over three-quarters of respondents agreed with this statement. Government workers were perceived by 88 percent of those surveyed as having done better in job security and pay increases than workers in the private sector.

Other Tax and Budget Issues

Almost 90 percent of respondents strongly believe that taxes should not be raised unless they are linked to specific government programs. Furthermore, three-fourths of the sample favored balancing the state budget as a first priority, even if it means that services must be reduced. Differences were found among Oklahomans on whether revenue problems are matters of serious concern in the state. A slightly higher percentage of the sample agreed than disagreed, but of special note is the one-fourth of respondents who did not know or have an opinion on this issue.

Conclusions

State Question 640 gives the voter new power over state taxes. These survey results indicate that the tax sources preferred by Oklahomans are those that are unlikely to yield significantly higher revenues. Opposition is uniform and strong across the full spectrum of major tax sources.

Problems of state and local finance are likely to be made more

difficult by the high expectations that citizens have of government. Citizens apparently want more education, better health care, more public welfare, a higher quality of life, a cleaner environment, improved physical infrastructure, and a myriad of other government programs. However, these wants will certainly clash with unwillingness to pay for programs. Indeed, the survey results show that the demand for public services bears little or no relation to willingness to pay,

Oklahomans are divided when it comes to locally provided government services. Local government is viewed as the level of government offering the most value, and citizens want to have control over taxes at the local level. However, there is strong opposition to relying more heavily on the property tax- a principal source of local revenue. Only one in seven Oklahomans favors higher property taxes as a means of financing approved programs, in spite of the fact that citizens know that this source is underrepresented as a source of revenue in Oklahoma in comparison to other states.

Oklahoma citizens want state government involved in local education, yet a high proportion believes that state government provides too much support for local government functions. Oklahomans believe that government should provide financial assistance to the poor, but nearly unanimously agree that people are on welfare much too long. These views suggest either that poverty is viewed as a transitional phase, rather than a permanent problem, or perhaps that the respondents believe that the poor can do more to help themselves after they have received a boost from the state.

Although the survey results show that the Oklahoma voter is not likely to favor significant tax increases in a State Question 640 election, they also show that voter preferences for services are inconsistent with this rigidity. Perhaps the Oklahoma voters have not yet reconciled the inherent conflict between tax rigidity and its implication for levels of state services.

Read the full report at <https://www.okstatechamber.com/sites/www.okstatechamber.com/additional/21stCentury/Reports/1994.pdf>

Tax Incentives for Oklahoma Business Firms: Issues in Accountability, Targeting, and Evaluation

Kent W. Olson, State Policy and Economic Development in Oklahoma: 2002

Tax Incentives and Tax Expenditures

Tax incentives consist of tax exclusions, exemptions, deductions and credits that reduce taxes paid by taxpayers or, what is the same thing, revenues collected by government. Tax incentives have become so numerous, and revenues foregone so large, that many state and local governments have produced lists containing estimates of revenue foregone because of tax incentives. These lists are normally called “tax expenditure budgets”.

The term “tax expenditure” is used to convey the idea that, from the government’s perspective, tax incentives represent prospective revenues that are “spent” for specific purposes or programs. The ideal tax expenditure list would include all state tax incentives and all local tax incentives that are subject to design by state government. It would include federal tax expenditures, as well, if the amount enjoyed by state taxpayers could be changed by unilateral actions of state government. It would indicate the current year revenue reduction attributable to each tax expenditure, and projected revenue reductions for several years. The latter is an important feature because tax expenditures are like entitlements.

We know of no state tax expenditure list that conforms perfectly to this ideal. The Oklahoma Tax Commission produces a Tax Expenditure Report on a biennial basis that lists all of the exemptions, deductions, credits, and exclusions codified in state statutes.⁷ According to the 1999- 2000 report, Oklahoma law provided for 415 tax incentives, 210 of which appear to be related directly to business income, sales, purchases, or assets.

Policy Implications

The reader who has persevered to this point will have already encountered a host of policy implications. The purpose of this section is to provide a summary of them and to provide further discussion of those that appear to be more important.

Basic Data Needs

The Oklahoma Tax Commission prepares a Tax Expenditure budget every two years. The information it provides is useful, but incomplete as a basis for determining the importance of business tax incentives provided by the state or local governments.

Effects on Resource Allocation

States, Oklahoma included, go to great pains through the provision of business tax incentives, to reward certain industries, firms of certain sizes, certain kinds of business inputs, certain kinds of sales, and certain locations. This is likely to alter the distribution of resources in the economy. The payoff question is whether it increases gross state product. Studies need to be conducted to determine if this is the case.

Targeting

States often favor certain industries in a deliberate attempt to “target” their incentives in the hope of stimulating the expansion of what they conceive are, or are likely to become, the fastest growing industries. Or they are often trying to stimulate the expansion of industries they believe will have bigger net impacts on the state’s economy. The underlying target is usually the expansion of basic industries. Basic industries are usually identified as those that export a large part of their output to other states or countries.

There is nothing wrong with trying to pick basic industries, but the criterion normally used to do so - the percentage of sales out of state - is not an accurate test. The ideal targets are those that promise the greatest difference between social benefits and costs. If a Benefit-Cost Analysis (BCA) is not conducted, the best targets are the fastest-growing net exporters. These are the industries with the largest expected differences between future sales out-of-state (exports) and future purchases of inputs from out-of-state (imports). The best targets, that is, are the industries that achieve the largest differences between exports and imports, not the industries that generate the largest exports (the usual “basic industry” criterion). Any incentives should go, moreover, to the industries with the best prospects for exports in excess of imports and long-run growth in output.

A study based on this test should be conducted to determine if the state needs to change the target industries favored by current legislation. The industries of the new economy should also be examined through the same lens.

Effectiveness

It bears repeating that money that would have been spent anyway is not necessarily a waste (cost); it is not, if it results indirectly in spending for jobs or investment or decreases in product prices. We also need to be aware that

private firms often have very short pay-back periods in mind when they make new investments. If they do, then some of the long-run benefits from incentives may be discounted heavily. If they are, then shortening the length of time over which benefits are provided could improve the effectiveness of the incentives.

Benefit-Cost Analysis

A lot can also be learned about the wisdom of what we are doing or planning to do by conducting benefit-cost analyses. We should probably start with the largest programs and determine exactly what benefits they are likely to produce and the costs they are likely to impose. These analyses would be done using accurate measures of benefits and costs, many of which have been discussed above. We don't know the likely results, but they may reveal that measures such as jobs created, "good" jobs created, and dollars invested can be misleading performance indicators. In fact, we may find that subsidizing lower-wage/lower skill jobs has a higher payoff in many instances than subsidizing higher wage/higher-skill jobs. Remember, the key is not the level of the wage for the job created; it is the difference between this wage and the wage that would have otherwise been earned. Moreover, it is the wage that might have been earned in Oklahoma that counts, so business expansions that rely more heavily on using imported labor may have a relative advantage (although they may also be the source of extra costs of providing government services). In the final analysis, this factor may also impart an advantage to high-tech firms, but only additional study will tell.

One option that deserves attention is BCAs that compares current incentives for private investment and government investment of the same funds. Both should be held to the

same standards, of course.

Interstate Comparisons

The final, and to some the most important, issue is whether tax incentives induce businesses to migrate from one state to another. Our view is that the surest way to find out is to construct representative firms for each state that vary by size, location, and other attributes relevant to eligibility for tax incentives, and to endow them with the tax incentives of the various states. Variations across states in tax incentives will then show up in variations in rates of return or costs, depending on firms' locations.

When Fisher and Peters did this for 16 representative firms "located" in 24 different states, they found that variations in the basic tax system were more important determinants of variations in net income than were variations in economic development tax incentives." They also found no evidence that economic development tax incentives nullify differences in basic tax loads.

States still insist on competing in terms of incentives instead of overall tax burdens. If Fisher and Peters are right, however, more attention needs to be paid to the overall burden of the tax system on business and less attention needs to be focused on exceptions.

To read Olson's full article or the State Policy and Economic Development in Oklahoma: 2002, it can be viewed at <https://www.okstatechamber.com/sites/www.okstatechamber.com/additional/21stCentury/Reports/2002.pdf>

Notes

**This is a resource document for you to use.
Take notes, highlight, use as a text book.**

Oklahoma's Structural Budget: Hard Choices Ahead

Kent W. Olson, State Policy and Economic Development in Oklahoma: 2007

State governments have traditionally made tax and expenditure decisions with long-run consequences based on relatively short-term fiscal information. Oklahoma is a case in point; in fiscal years 2004, 2005, and 2006, the legislature passed, and the governor approved, the largest series of tax cuts in Oklahoma history, apparently without analyzing the long-run implications of their actions. The results of such an analysis are reported in this chapter.

State governments also have often slashed taxes while ignoring unfunded employee pension system liabilities. Again, Oklahoma is a case in point; it has one of the nation's most severely under-funded pension systems. Accordingly, we also examine the 2004-06 tax cuts in the context of a budget that recognizes the need to fully fund the state's public employee pension systems.

The analysis in this study revolves around projections of the state's structural budget. This involves projecting tax receipts generated by the existing tax system and expenditures required to continue providing state residents the currently provided (current services expenditures). Ideally, the state would project a structural budget annually. At a minimum, it should project a structural budget when it makes a major new commitment, such as a large tax cut or expenditure increase. If the projection indicates a structural budget deficit, then the state will know in advance that it is about to make a commitment that it cannot fully fund, unless it is willing to find new revenues or reduce current services.

The structural budget in this study recognizes the unfunded liability of Oklahoma's public employee pension systems by treating the cost of amortizing these liabilities as a budgeted expenditure. This requires a budget window that is at least as long as the period recommended by the Governmental Accounting Standards Board for amortizing unfunded liabilities, or 30 years. Thus, the structural budget in this study compares the cost of maintaining current services plus the cost of amortizing the unfunded accrued actuarial liability of the public employee pension systems with projected revenue in the context of a 30-year budget window.

Don Boyd has made 8-year projections of structural budget balances for all 50 states in a study commissioned by the National Center for Higher Education Management Systems. He estimated that Oklahoma will have a structural deficit equal to 4.3 percent of revenues by 2013. Boyd's estimate, however, is likely to be an underestimate of Oklahoma's structural deficit because: (1) his projection does not include the effects of the 2004-2006 tax cuts, (2)

the length of his projection period is too short to capture the full impact of these tax cuts, and (3) he makes no provision for unfunded pension system liabilities. The projections in this study correct for these omissions in Boyd's analysis.

Boyd is not the only one who has recognized the possibility of a structural budget problem for Oklahoma. David Blatt, Director of Public Policy for Tulsa's Community Action Project, argues in a recent *Budget Brief* that Oklahoma faces a significant risk of long-term deficits, citing Boyd's study, an analysis by the Center for Budget and Policy Priorities, and a 2006 study in which this author developed 75-year projections of the state's fiscal imbalance.

This is not a study in which a hypothesis is formulated and tested, but we can venture a guess at the probable result. On the expenditure side of the budget, Oklahoma faces Medicaid outlays expected to increase relative to state income, as well as unfunded pension system liabilities. On the revenue side, the legislature reduced the revenue-generating potential of the state tax system by concentrating its recent tax cuts on the individual income tax, and recent record increases in the state's gross production taxes on natural gas and crude oil are not likely to be sustainable. Thus, we expect to find structural deficits; i.e., an excess of projected expenditures over projected revenues.

Our projections do indicate that Oklahoma state government faces significant and sustained structural budget deficits, even without funding the pension systems' unfunded liabilities. We project a surplus of 5 percent of tax receipts in 2007. After that, however, structural budget deficits begin and increase steadily, reaching 18.3 percent of tax receipts in 2036. In fact, Oklahoma would have experienced structural budget deficits even without the 2004-06 tax cuts, but they would have started later and been much smaller. The problem is even worse when the costs of amortizing the pension systems' unfunded accrued actuarial liabilities are included in the structural budget. In that scenario, we project a deficit that is equal to 6.5 percent of tax receipts in 2007 and increases steadily to 25.2 percent of tax receipts in 2036.

Our analysis indicates, moreover, that these are more likely to be underestimates than overestimates of future structural budget deficits. To paraphrase David Blatt, we are speeding towards a train wreck. Thus, the state will have to make some hard budget choices very soon. Unfolding events will force the government to decide among future tax increases, alternative ways to pay for government services, expenditure reductions, and alternative ways to ration government

services. How these choices are made could have a significant effect on the state's prospects for economic development and other dimensions of economic welfare. It is well beyond the scope of this study to suggest what these choices should be; that will require much additional study and debate. The purposes of this study will have been fulfilled if it increases awareness of the problem, induces a serious response to it, and increases the likelihood that significant future changes in taxes (and expenditures) will be analyzed for their long-run effects before they are adopted.

Budget deficits are prohibited by the Oklahoma Constitution, so we can be reasonably certain that they will not occur as projected. Some hard choices will have to be made, however, to avoid the deficits we project. The consequences of what we project, then, depend on the actions taken to deal with this problem.

The problem, per se, is not trivial. The deficits we anticipate are both large and sustained. The problem Oklahoma faces is similar in some respects to the budget problem faced by the 19 federal government. Baseline projections indicate that the federal government is looking at a future of sustained budget deficits, as is Oklahoma. Federal deficits are largely a consequence of projected growth in expenditures for health care and social security that are much greater than projected growth in baseline revenues. Oklahoma's deficit also reflects projected growth in health care expenditures and its unfunded PEPS liabilities are similar to those faced by Social Security.

At the federal level, keeping promises to the elderly will require either unprecedented tax increases or drastic reductions in other programs. Oklahoma is a little more fortunate. As noted above, the Oklahoma deficit problem could be solved with tax increases that would actually put the state back on a trajectory that would be less burdensome than the trajectory it followed for most of the past quarter century. This observation should not be construed, however, as an endorsement of a tax increase. For one thing, we don't know the best way to do that if that's what we wanted to do. On the other hand, we are not endorsing cutting any particular expenditure, even those that are destined to grow the fastest, such as Medicaid.

What is needed is a thorough consideration of a large variety of tax and expenditure options, informed by careful analysis. We suggest the following, at a minimum.

In considering the possibility of a tax increase the most certain way to avoid sustained budget deficits appears to be a change in the tax structure that produces revenue growth that more closely matches the growth in state expenditures. This could involve increasing the top marginal rate of the individual income tax or broadening the base of the general

sales tax to include consumer purchases of services. But we don't know whether that is the best approach. Moreover, we want the tax system to achieve other objectives, as well. We should also consider the effects of any proposed tax increases on economic growth, on equity, on economic efficiency, and on revenue stability. In effect, if we take the tax increase approach, we should use it as an opportunity to improve the tax system. And, every aspect of the tax structure should be on the table, including tax preferences.

State taxes are not the only way to pay for government services, however. Thus, our list of options to be considered includes greater use of local property taxes to pay for local schools and different ways for students to pay for higher education, such as income-contingent loans. Again, it is not possible to make rational choices without a thorough consideration of the effects of these options on revenue growth, revenue stability, efficiency, economic growth, and equity.

We should also begin a consideration of whether, and if "yes," how, to best cope with rising Medicaid expenditures, ranging from restricting access to rationing. In addition, we need to identify options that would reduce commitments to the PEPS or increase revenues for that purpose.

Revenues and expenditures will not grow in the smooth fashion indicated by our projections. We know from experience that this is especially likely to be the case for the gross production taxes. The income-contingent taxes, such as the individual income tax and the general sales tax, will also fluctuate with the business cycle. At the same time, we're confident that the underlying trend will be that of increasingly larger deficits in the structural budget. So there is a need to work on the design of a rainy day fund that helps deal with both short cycles and long trends.

In general, there is a need for an analytical effort that parallels the one going on right now in Washington to inform the debate about options for solving the federal government's long-run budget problems. This effort has resulted in some studies that might provide guidelines, such as those evident in the Brookings Institution's Restoring Fiscal Sanity series. The important thing is to get on with it.

Finally, at the very least, we hope that the analysis in this chapter will move the Oklahoma Legislature toward the construction and analysis of long-run budget projections before any more permanent tax cuts (or significant expenditure increases) are adopted.

To read Olson's full article or the State Policy and Economic Development in Oklahoma: 2007, it can be viewed at <https://www.okstatechamber.com/sites/www.okstatechamber.com/additional/21stCentury/Reports/2007.pdf>

2018's Most & Least Federally Dependent States

John S Kiernan, WalletHub, March 20, 2018

One big point of difference among state economies is the tax burden of the average citizen. This number varies greatly. But what are the reasons behind why some states tax their residents more or less?

If a state can afford not to tax its residents at high rates, there are multiple explanations. One is that their economic policies are sound and the state economy is doing well. But another is that the state gets disproportionately more funding from the federal government than states with harsher tax codes.

Americans have looked at federal assistance programs with growing scrutiny. According to a 2018 Rasmussen report, 61% of American adults think there are too many people receiving government financial aid. On the other hand, only 9% think not enough people are receiving funds. Regardless of overall trends, though, it is true that some states receive a far higher return on their federal income-tax contributions than others.

Just how big is this difference? And to what extent does it change our perception of state and local tax rates around the country? WalletHub sought to answer those questions by comparing the 50 states in terms of three key metrics. Read on for our findings, commentary from a panel of experts, and a detailed explanation of our methodology.

Methodology

In order to determine the most and least federally dependent states, WalletHub compared the 50 states across two key dimensions, “State Residents’ Dependency” and “State Government’s Dependency.”

We evaluated those dimensions using three relevant metrics, which are listed below with their corresponding weights. Each metric was graded on a 100-point scale, with a score of 100 representing the highest level of federal dependency.

We then determined each state’s weighted average across all metrics to calculate its total score and used the resulting scores to rank-order our sample.

State Residents’ Dependency – Total Points: 50

Return on Taxes Paid to the Federal Government: Triple Weight (~37.50 Points)

Note: This metric was calculated by dividing federal funding in U.S. dollars by IRS collections in U.S. dollars. Share of Federal Jobs: Full Weight (~12.50 Points)

State Government’s Dependency – Total Points: 50

Federal Funding as a Share of State Revenue: Full Weight (~50.00 Points)

Note: This metric reflects the proportion of state revenue that comes from the federal government in the form of intergovernmental aid.

Most Federally Dependent States

Rank (1 = Most Dependent) ↓	State ↓	Total Score ↓	'State Residents' Dependency' Rank ↓	'State Government's Dependency' Rank ↓
1	New Mexico	83.22	3	5
2	Kentucky	78.96	5	4
3	Mississippi	75.84	8	2
4	Alabama	71.86	4	13
5	West Virginia	67.83	6	16
6	South Carolina	67.81	2	29
7	Arizona	67.22	11	3
8	Alaska	64.16	9	10
9	Montana	63.80	15	6
10	Louisiana	58.91	34	1
11	Indiana	58.89	7	22
12	Oregon	54.35	25	7
13	Tennessee	54.30	21	8
14	Maine	53.70	14	18
15	Vermont	50.96	18	15
16	Missouri	49.23	31	9
17	Maryland	47.82	12	33
18	South Dakota	47.22	23	14
19	Wyoming	44.95	22	20
20	Oklahoma	44.75	19	26
21	Idaho	44.49	20	27
22	Arkansas	44.06	39	11
23	Pennsylvania	42.78	17	34
24	Georgia	42.57	32	17
25	Michigan	42.15	30	19
26	North Dakota	40.90	1	50
27	Ohio	40.56	47	12
28	Florida	39.79	26	25
29	Iowa	37.99	29	28
30	Texas	37.81	42	21
31	Rhode Island	37.75	38	24
32	Wisconsin	36.98	16	41
33	Washington	36.33	27	32
34	North Carolina	36.03	36	30
35	New Hampshire	35.57	37	31
36	New York	35.25	44	23
37	Nevada	34.17	33	36
38	Hawaii	33.65	10	48
39	California	31.44	43	35
40	Nebraska	28.09	46	37
41	Virginia	27.99	13	49
42	Connecticut	27.78	24	45
43	Utah	27.06	28	44
44	Colorado	26.55	35	43
45	Minnesota	25.28	40	42
46	Massachusetts	24.34	45	39
47	New Jersey	23.35	49	38
48	Illinois	22.53	48	40
49	Kansas	18.57	41	47
50	Delaware	14.97	50	46

Ask The Experts: Making Sense of Funding Disparities

For further clarity on the problems contributing to federal-funding disparities, we talked to a panel of economics and public policy experts. Click on the experts' profiles to read their bios and responses to the following key questions:

1. Should Federal resources be allocated to states according to how much they pay in federal taxes or should some states subsidize others?
2. What programs should be a state/local responsibility and what should be a federal responsibility?
3. What is the fairest way to redistribute federal resources back to the states?
4. Will the new tax code have a positive effect on the economy?

Robert R. Preuhs

Associate Professor in the Department of Political Science at Metropolitan State University of Denver

Should Federal resources be allocated to states according to how much they pay in federal taxes or should some states subsidize others?

While on its face, it may seem reasonable to simply return the amount of discretionary spending to a state in proportion to federal taxes paid, a number of issues arise that simply make this impractical, or unreasonable, to do so. States have diverse needs relative to federal expenditures. From military bases to transportation infrastructure and even national laboratories or national parks, not to mention social welfare and educational needs, the variation in federal projects and programs across the states results in some redistribution of resources, which presumably reflects the preferences of the citizens and benefits the national as a whole. Moreover, if we simply allocated resources based on how much states pay in taxes, the federal budget essentially becomes a pass-through vehicle to return funds to the states and undermines the potential for more efficient distributions based on national priorities.

What programs should be a state/local responsibility and what should be a federal responsibility?

While the Constitution provides guidelines for which types of programs the federal government and/or the states may pursue, the interpretation of those powers is debated and often decided by the courts. Outside of the legal constraints, arguments based on efficiency and effectiveness play a role in determining what types of policies should be the responsibility of each level of government. One basic principle is that if a program's effects reach beyond a state's border, such as air pollution control or transportation of people and goods, then the federal government should be the responsible entity.



Robert R. Preuhs

Federal responsibility should also emerge when the desire is to provide equity in policy provisions for all U.S. citizens regardless of the state of residence, such as protecting basic civil rights and liberties. When these considerations do not hold, states can often more closely match programs to their citizens' preferences and objective needs, and even provide laboratories for new policies before more widespread adoption.

What is the fairest way to redistribute federal resources back to the states?

It may be impossible to devise an objectively fair way to redistribute federal resources. States will find a way to feel slighted regardless of the outcome. In short, as my father used to say, "Fair is where you buy popcorn and cotton candy." With that said, perhaps the best way to mitigate claims that allocations are unfair is to be transparent in the process of allocation and base the expenditures on objective criteria of effectiveness, efficiency, or equity, in light of clearly defined federal goals, without consideration of the taxes paid by each state's residents. However, with such a large variety of federal programs that require vastly different resources, one state's fair outcome will always seem inequitable to another.

Will the new tax code have a positive impact on the economy?

The new tax code should boost the economy in the short run, at least. More dollars in the pocketbooks of individuals may spur consumption, particularly at the mid- to lower-end of the income spectrum. Corporate tax cuts should also boost bottom lines for many businesses, freeing up capital for investment in future growth. In the long run, the picture is not as clear. Spurring growth in an already growing economy comes with risks, including inflation, which erodes corporate bottom lines. Moreover, if government revenues fall short of optimistic projections, budget cuts and/or ballooning deficits may offset any short-term benefits. For the states, budget cuts would mean a greater fiscal burden as they attempt to take up the slack from reduced federal spending. In short, it is a mixed bag, and much depends on attributes of the national and global economies beyond the influence of federal fiscal policy.

Ask the Experts

George DeMartino

Professor of International Economics and Co-Director of the MA Program in Global Finance, Trade and Economic Integration at the University of Denver

Should Federal resources be allocated to states according to how much they pay in federal taxes or should some states subsidize others?

A key piece of the social contract that unifies a democratic country like the U.S. entails shifting resources to places where the need is greatest and the purpose is most pressing. We see this most dramatically in the wake of natural disasters, but in fact, it is a normal, appropriate pattern in any civilized society.



George DeMartino

What programs should be a state/local responsibility and what should be a federal responsibility?

There is no fixed answer to this question. Some things are handled adequately at the local, state, or national level for long periods of time -- and then, circumstances change, such that the same functions need to be centralized. When most pollution sources had only local effects, for instance, it might have been appropriate for pollution regulation to occur primarily at the local or state level. Now that so many pollutants have national and even global effects, minimum environmental standards need to be set and enforced at the national, and even international levels. This shouldn't preclude local jurisdictions (like states) from raising their standards above those minima -- it requires only that national government takes the lead in regulating pollutants with wide impacts. The same can be said of labor rights protections. In the wake of economic globalization with increasing international trade and investment, labor rights now need to be harmonized across national borders.

What is the fairest way to redistribute federal resources back to the states?

Policies that ensure that all citizens are entitled to basic protections, paid for by income taxes. A single-payer health care system, for instance, can achieve this. The issue isn't "should New York subsidize Louisiana?" The issue is, should all residents of the country be provided with access to those goods and services that are fundamental to living a good human life, regardless of where they live?

Will the new tax code have a positive impact on the economy?

The new tax code is apt to provide a short-term bump in economic activity at a time when we don't need further stimulus, but at the expense of long-term economic problems, such as rising inequality and fiscal cutbacks that will be proposed to pay for the rising deficit in the years ahead.

John Donahue

Raymond Vernon Senior Lecturer in Public Policy at Harvard Kennedy School

Should Federal resources be allocated to states according to how much they pay in federal taxes or should some states subsidize others?

It would be difficult or impossible to balance resource flows to and from Washington. That's because there are at least three major categories of resource flows to the states. The most obvious is money that goes from the federal government to be spent by state governments. I am confident that this is no large share of the total. Another category is money that goes to serve the needs of individuals and institutions within states, but not through the intermediary of state government. This is huge -- Social Security, Medicare, public pensions and (though some would dispute this) tax preferences, like health care and mortgage deductions. The third category is money that goes to buy goods and services to meet federal goals: military salaries, procurement contracts, R&D spending, etc.



John Donahue

What programs should be a state/local responsibility and what should be a federal responsibility?

It's a balancing act. The more a program deals with conditions and preferences that vary across locales, the stronger the case for state or local control. And the more a program's impacts spill across borders, the stronger the case for national responsibility.

Will the new tax code have a positive impact on the economy?

My guess is that it will have a mild positive effect in the short run and a mild-to-moderate negative effect in the longer run.

Ask the Experts

Kenneth Chilton

Associate Professor in the Department of Public Administration at Tennessee State University

Should Federal resources be allocated to states according to how much they pay in federal taxes or should some states subsidize others?

No, federal resources should not be allocated to states based upon how much federal taxes are paid. Some states are poorer than others and lack robust tax bases. Historically, we've typically followed the model of redistributing tax revenues to bolster the public good. School funding formulas in states, for the most part, are based on this model. Urban districts have larger tax bases than rural districts. State legislatures direct funds from more affluent districts to less affluent districts to promote funding equity. The same general principle applies to states. Cities often complain of "leaked" revenue to states, but this neglects the fact that a new transportation corridor in Eastern Kentucky might make interstate commerce more efficient and generate new revenues and trade opportunities for states. Without subsidies, some regions of the U.S. would be unable to fund schools, build infrastructure, pay teachers or promote economic development.

What programs should be a state/local responsibility and what should be a federal responsibility?

There are multiple schools of thought on the issue. We are currently in a situation that pits federalists against anti-federalists. The anti-federalists have been trying to undo FDR's New Deal since the 1930s. They want low taxes and little government intervention in markets. They oppose federal mandates such as Obamacare and argue that states should design their own systems. Others would argue for a strong federal role in funding education, enforcing environmental protections, mandating health care access for all, subsidizing mass transit and so on. The old models are fraying and that is manifested in the current environment of political chaos. Folks are seeking certainty and nostalgia for the way things used to be. But, our tax system has not evolved. Many of the programs and policies enacted that drive current debates about the proper role of government



Kenneth Chilton

were implemented during the industrial era.

The mechanisms we have to capture revenues are not compatible with a digital knowledge economy. We try to retrofit our old legacy tax system when states impose taxes on Amazon and other online retailers. While most "anti-federalists" promote the idea of local control, they contradict themselves in many cases. For example, when more politically progressive regimes in cities try to impose affordable housing mandates or minimum wage increases, more rural state legislatures nullify those local initiatives. Or, businesses fight attempts by localities to raise local revenues. Local leaders in Williamson County, Tennessee, one of the wealthiest counties in the U.S., implemented fees on new development to help offset the costs of residential growth. A group of developers have sued the county, and none of the money from the impact fees can be allocated to public projects that would help build roads and schools until after the lawsuit is settled.

What is the fairest way to redistribute federal resources back to the states?

I'm not sure there is a "fairest" way to allocate resources back to the states. Every state thinks their projects are the most important. State legislatures across the country -- Wisconsin, Kansas, Kentucky and many others -- continue to cut budgets. The federal government has cut taxes and will cut programs, except military spending. This will require localities to be more creative in terms of revenues. Ultimately, individuals will continue to be burdened by increased costs for health care, education, and retirement. We're all free agents now without a "nanny state" to protect us from the whims of the market.

Will the new tax code have a positive impact on the economy?

It's too early to say how the new tax code will affect the economy in the long term. In the short term, it could fuel increased consumer spending. But, the majority of the benefits go to those who are already doing quite well. Wages have been sticky for decades and there was some evidence prior to tax reform that wages were starting to rise. My biggest concern is that the new cuts will exacerbate existing debt problems and will be used to justify future cuts to Medicaid, Medicare, federal/state pensions and social security. This is the long game that anti-federalists have played. They want to starve the beast (big government) and then say "see, government doesn't work."

Ask the Experts

Kenneth Kickham

Professor of Public Administration at the University of Central Oklahoma

Should Federal resources be allocated to states according to how much they pay in federal taxes or should some states subsidize others?

Our federalist system of sharing power among the states and the national government has strengths and weaknesses, each of which depends to some degree on one's political preferences. Those favoring a strong national government might justify such a preference on the basis of the national government's capacity for smoothing out disparities across states, in things like quality of life, justice, equality, etc. States' rights advocates, on the other hand, might instead emphasize how innovation can begin in one state, and spread to others, in which case letting the states have as much autonomy as possible makes more sense.



Kenneth Kickham

I have been teaching federalism for 20 years, and the idea of some sort of injustice arising from some states subsidizing others has never been a significant part of the discussions I have had. It has always simply been a fact that any system of federal taxes and expenditures inevitably leads to redistribution not only across households, but also across states. From my perspective, that's part and parcel of, or maybe even the whole point of, becoming "a union of states." A federation is a collective, and thus, collectivism in fiscal policy makes perfect sense.

What programs should be a state/local responsibility and what should be a federal responsibility?

In theory, responsibilities should locate at the "lowest" level of government that can handle said responsibility. In practice, however, we live in a complex world that doesn't fit its component responsibilities nicely into our preconceived templates. Distinctions between state and federal, or among public, private and nonprofit sectors, are fluid, reflecting our rapidly changing needs and differential capabilities, both geographically and organizationally. Current federalism and management theories speak of policy-centered networks cutting across these arbitrary lines, so that real problems in society can be addressed in the best way possible.

We don't get caught up so much in the sorting out of

responsibilities, but strive to cobble together collaborative networks and arrangements that leverage our available resources efficiently and effectively. Institutional boundaries are less important than finding ways to address problems. There have been attempts to sort responsibilities by level of government, such as Reagan's "Big Swap" proposal (the idea was for the federal government to take responsibility for Medicaid and the states to take responsibility for income maintenance), but people actually running public and nonprofit programs tend to see that line of reasoning as less productive.

What is the fairest way to redistribute federal resources back to the states?

If you accept that the whole point of collectivizing states, which federalism does, is to redistribute resources to make the whole nation stronger, then obviously, "need" is the basis for redistribution. Most intergovernmental programs are funded this way. Formulas take account primarily of population, resources (i.e., capacity) and need. That is how it has always been done.

Will the new tax code have a positive impact on the economy?

No one knows, of course, because it was written and passed in such a haphazard and hurried manner that we really don't even know what all is in there. Congress is now considering how it will repair the many glitches and unintended consequences of that process. When they used reconciliation to get around working with the opposition party, the GOP bypassed a valuable check on their own work. My experience tells me not to expect positive impact on "the economy" from the tax overhaul. A better question, in my opinion, is how the tax overhaul will affect different groups differently.

Akheil Singla

Assistant Professor in the School of Public Affairs at Arizona State University

Should Federal resources be allocated to states according to how much they pay in federal taxes or should some states subsidize others?

It is important not to think of federal resources as a single pot of money from which certain states draw more and other states draw less. Though one can work out how much federal spending ends up going to one state versus another, the actual process



Akheil Singla

Ask the Experts

of allocating federal dollars does not work that way. Congress allocates money to particular programs that in turn benefit different people. And because states have differing demographic compositions, some states benefit more from certain programs than others.

Whether federal dollars going into a state should be dependent on the federal tax revenues being extracted from that state depends on the nature of the program in question. Medicaid, for instance, provides access to health care for low-income individuals. The federal government funds between 50 and 80 percent of Medicaid spending; states with lower per capita incomes receive more Medicaid funding because they have a larger share of low-income residents and, by extension, have more Medicaid-eligible residents. If Medicaid funding was based on state contributions to federal tax revenue, states with more low-income, Medicaid-eligible residents would effectively be punished, receiving a smaller pool of money to be spread across a greater number of people than wealthier states with lower numbers of qualifying residents. This, of course, defeats the purpose of the program.

On the other hand, federal programs that are not targeted toward providing aid to lower-income populations may not suffer from the same issues. Highway funding, for instance, is largely about building and maintaining the network of roads; ideally, this determination would be made based on some objective measure of need. Given that no such measure exists, program allocations tied to state contributions to federal taxes may make some level of sense, as states with higher per capita incomes likely have more economic activity that requires increased use of infrastructure.

In practice, most of federal spending goes toward some form of social assistance (e.g., Medicaid, Medicare, Social Security, TANF, SNAP). As a result, federal allocations do not correspond with state-level contributions to federal revenues.

What programs should be a state/local responsibility and what should be a federal responsibility?

Richard Musgrave argued that there are three major functions of government: economic stabilization, income redistribution, and resource allocation. Economic stabilization mostly focuses on things like unemployment, price stability (e.g., low inflation), and economic growth. Income redistribution covers much of what we would consider social policy, wherein resources are allocated toward ensuring people do not fall below a socially-defined floor. And resource allocation covers the provision of public goods, or things that markets fail to provide in socially-optimal amounts. These categories are useful to address this question.

Economic stabilization, both in theory and in practice, is best handled at the federal level. State and local governments are constrained from borrowing to finance their operations, which means in the event of a recession, they are forced to cut spending when revenues invariably fall. The federal government, on the other hand, engages in counter-cyclical spending due to its

ability to borrow. It also controls macroeconomic policy via the Federal Reserve, which is far better suited to manage the potentially opposing forces of price stability and economic growth as a singular entity than 50 state-level banks would be.

Income redistribution, in theory, also ought to be conducted at the federal level. The theoretical wisdom suggests that allowing state and local governments to set their own redistribution policies will encourage higher-income individuals to leave communities that allocate more resources to those ends and attract lower-income individuals who benefit from them. This is known as a welfare magnet. In practice, however, communities see a different effect: though there is evidence of a “welfare magnet” effect, it is diluted, because low-income individuals aren’t typically very mobile. More broadly, most people do not make relocation decisions based on the generosity of social policy in their jurisdiction; indeed, there is evidence that most citizens have no idea what differences there are in the policies of different states or municipalities. As a result, the federal government and states tend to share the responsibility of income redistribution programs (e.g., Medicaid, TANF, SNAP).

Resource allocation, or the provision of public goods, does not allow for such easy distinctions. Instead, here we need to consider how the benefit of a particular program accrues to society. In the case of something like national defense, the benefits extend to all residents of the nation, so it should be provided federally. On the other hand, police and fire services typically only benefit people within a small geographic area; they are correspondingly provided at the local level. K-12 education receives funding from all three levels of government, with the states and municipalities covering about 90 percent of the cost. This implies that most of the benefit of a K-12 education system accrues to the school district and the state it resides in. To the extent it is possible to do so, funding for public goods should account for the benefits that accrue to higher or lower levels of government.

What is the fairest way to redistribute federal resources back to the states?

The source of funding should be based on the nature of the services being provided. Providing health care is different than building roads or educating children, and the funding for those services should reflect those differences. If the federal government chooses to expand the social safety net, this will invariably mean poorer states will receive larger shares of federal resources. Ultimately, this question is based on what the federal government chooses to allocate resources toward, which is more of a political question than anything else.

Will the new tax code have a positive impact on the economy?

The University of Chicago’s Booth School asked 42 senior economists this same question. Only one of them suggested the new tax code was likely to spur economic growth. Nothing I have seen has given me cause to disagree with those scholars.

A Better Tax System (Assembly Instructions Included)

N. Gregory Mankiw, The New York Times, January 21, 2012

It's that time again. Start filing all those W-2s, 1099s and scraps of paper you'll need for your annual tax return. No doubt, this isn't your favorite activity. At some point, you may ask yourself whether there's a better way.

There is. Economists who study public finance have long agreed with William E. Simon, the former Treasury secretary, who said that "the nation should have a tax system that looks like someone designed it on purpose." Here are four principles of tax reform that most of those economists would endorse:

BROADEN THE BASE AND LOWER RATES

The United States tax code is filled with deductions and exclusions that shrink the basis of taxation. The smaller base in turn requires higher tax rates to raise the revenue needed to fund government. The starting point of reform is to reverse this process.

This principle was endorsed both by President George W. Bush's tax reform commission in 2005 and by President Obama's deficit reduction commission in 2010. Neither report had much impact, because eliminating deductions and exclusions is politically treacherous. Yet each made a good case on the merits.

Consider the deduction for mortgage interest. The policy is politically popular, but economists have long thought it has little justification. Because of this provision, among others, our tax system gives a better treatment to residential capital than it does to corporate capital. As a result, too much of the nation's saving ends up in the form of housing rather than in business investment, where it could have increased productivity and wages.

This efficiency cost might be worth bearing if the deduction had a benefit from the standpoint of equality, but it fails there as well. Subsidies to homeowners are, in effect, penalties on renters — after all, someone has to pick up the tab. But there is nothing wrong with renting. And once one acknowledges that renters are poorer, on average, than homeowners, the mortgage interest deduction becomes even harder to justify.

TAX CONSUMPTION RATHER THAN INCOME

Almost four centuries ago, the philosopher Thomas Hobbes suggested that taxes should be based on consumption, not income. Income measures a person's contribution of labor and capital to society's production of goods and services. Consumption measures the quantity of those goods and services he gets to enjoy. Hobbes reasoned that because consumption better reflects the benefits a person receives as a member of society, it is the proper basis of taxation.

Much modern economic theory confirms that conclusion. In standard models, a consumption tax allows the economy to achieve the best allocation of resources over time, whereas an income tax needlessly discourages saving, investment and economic growth.

Moving to a consumption tax might seem to require wholesale reform of our current system. But such a politically difficult step isn't necessary. In fact, as our tax system has evolved over many years, legislators have come to appreciate the logic of taxing consumption, if only implicitly.

The United States now has an income tax, or at least that is what it is called. But because many Americans do most of their saving through tax-preferred accounts, such as I.R.A.'s and 401(k) plans, they in effect pay taxes based on how much they consume. Tax reform could expand and simplify the availability of such tax-preferred savings accounts. In this way, our progressive income tax could further evolve toward a progressive consumption tax.

TAX BADS RATHER THAN GOODS

A good rule of thumb is that when you tax something, you get less of it. That means that taxes on hard work, saving and entrepreneurial risk-taking impede these fundamental drivers of economic growth. The alternative is to tax those things we would like to get less of.

Consider the tax on gasoline. Driving your car is associated with various adverse side effects, which economists call externalities. These include traffic congestion, accidents, local pollution and global climate change. If the tax on gasoline were higher, people would alter their behavior to drive less. They would be more likely to take public transportation, use car pools or live closer to work. The incentives they face when deciding how much to drive would more closely match the true social costs and benefits.

Economists who have added up all the externalities associated with driving conclude that a tax exceeding \$2 a gallon makes sense. That would provide substantial revenue that could be used to reduce other taxes. By taxing bad things more, we could tax good things less.

KEEP IT SIMPLE, STUPID

This engineering aphorism is based on the timeless insight that complex systems are more likely to break down, often in ways the designer failed to anticipate. It applies with force to tax systems.

Indeed, unlike engineering systems, complex tax systems go awry because an army of highly paid accountants and tax lawyers is ready to take advantage of any loophole it can find. Remember when President Obama's stimulus plan

offered tax credits for electric cars? Suddenly, the sale of golf carts took off.

To be sure, any tax system will be subject to gaming, which is why we will always need the Internal Revenue Service. But the more we use narrowly targeted taxes and tax breaks, the more gaming there will be.

Filling out tax returns will never be a delight. But if reform included simplification, the task might become a bit less onerous. And if a few accountants and tax lawyers were induced to become engineers and doctors instead, society will have moved a big step in the right direction.

Notes

This is a resource document for you to use.

Take notes, highlight, use as a text book.

Modernizing Taxes: How Can Governments Improve Revenue Collection?

Justin Marlowe, *Governing*, June 18, 2015

“Tax modernization” was a trending topic in this year’s state legislative sessions. It joins “tax efficiency” and “tax fairness” as the latest benign-sounding way to talk about the thorny issue of who will pay for state and local government.

Modernization is tricky because different sides of tax policy debates deploy it to mean different things. To some, it means state and local governments should collect taxes more efficiently. To others, it means we should apply the taxes we have in new ways. A third group equates a modern revenue system with one that enlists lots of different types of taxes. Each of these groups envisions a unique tax system, but you need them all on board to get meaningful policy change. Tax modernization is a nice way to tie all three perspectives together.

But here’s the problem: When you look at the evidence, you see that only one of these three perspectives has a chance.

Liberals and conservatives alike agree that tax systems can be much fairer and far more efficient. We can automate tax bill payment systems. We can streamline how governments collect and manage taxpayer data. We can build in sophisticated data-tracking systems to detect fraud. When these changes happen, taxpayers are more likely to get the correct tax bill, to pay their fair share and to know their neighbors are paying their fair share. Chicago, Hawaii, West Virginia and many other governments have recently taken up this style of modernization. The criticism, of course, is that without the right kind of transparency, this new technology can actually obfuscate who’s paying which taxes.

Others believe tax modernization means applying the tax instruments we have in new ways. Most state and local tax systems were designed for a 19th-century manufacturing economy. They don’t work for today’s service-driven, electronic, global economy. So how do we update those

systems? By applying the sales tax to the services and “intangible” sectors of the economy. By phasing out taxes that are expensive to collect but don’t produce much revenue. By adopting the Streamlined Sales Tax and other reforms that make sales tax systems more uniform across states. Tennessee Gov. Bill Haslam’s proposed Revenue Modernization Act is probably the best recent example of a reform package tailored mostly to this notion of modernization.

It’s hard to make this argument resonate with voters. This might be because tax systems were outmoded long before the advent of the information economy. Connecticut was the last state to adopt a tax on earned income, in 1991. Vermont was the last to adopt a statewide sales tax, in 1969. Most local governments added sales taxes prior to 1985. State and local revenue systems have been remarkably staid, despite big changes in the broader economy.

Diversification also seems lost on voters. In fact, state and local revenues are remarkably undiversified. According to recent Census data, about 75 percent of local governments get more than 75 percent of their tax revenue from two revenue sources, usually property and sales taxes. States are just as dependent on sales taxes and income taxes, but not for lack of trying. Oregon has put a statewide sales tax to voters nine times since 1933. Countless other states and localities have also tried and tried again to diversify. Voters in those states seem OK with putting their proverbial revenue eggs in one or two baskets.

So if past is prologue, tax modernization has a chance, but only if it’s defined to mean making the system we have work efficiently. Folks on the right can stop calling revenue modernization efforts “tax increases.” Those on the left who want to grab new revenue can stop calling it “modernization.” Instead, maybe we can all agree that the future is really about making the system we’ve always had as efficient and transparent as possible.

“Liberals and conservatives alike agree that tax systems can be much fairer and far more efficient.”

(d. Council on Bond Oversight)

Section 3
Sources of State Revenue

2017 State Business Tax Climate Index Ranks and Component Tax Ranks

Tax Foundation, September 28, 2016

	Overall Rank	Corporate Tax Rank	Individual Income Tax Rank	Sales Tax Rank	Unemployment Insurance Tax Rank	Property Tax Rank
Alabama	32	14	22	48	14	16
Alaska	3	27	1	5	29	22
Arizona	21	19	19	47	13	6
Arkansas	38	40	29	44	30	24
California	48	33	50	40	16	15
Colorado	16	18	16	39	42	14
Connecticut	43	32	37	27	21	49
Delaware	19	50	34	1	3	20
Florida	4	19	1	28	2	10
Georgia	36	10	42	33	35	21
Hawaii	26	11	31	23	24	17
Idaho	20	24	23	26	46	2
Illinois	23	26	10	35	38	46
Indiana	8	23	11	10	10	4
Iowa	40	47	33	21	34	40
Kansas	22	39	18	30	11	19
Kentucky	34	28	30	13	48	36
Louisiana	41	36	27	50	9	30
Maine	30	41	25	8	44	41
Maryland	42	21	46	14	26	42
Massachusetts	27	37	13	18	49	45
Michigan	12	8	14	9	47	25
Minnesota	46	43	45	25	28	33
Mississippi	28	12	20	38	5	35
Missouri	15	5	28	24	7	7
Montana	6	13	21	3	19	9
Nebraska	25	29	24	12	8	39
Nevada	5	34	1	41	43	8
New Hampshire	7	46	9	2	41	43
New Jersey	50	42	48	45	25	50
New Mexico	35	25	35	42	17	1
New York	49	7	49	43	32	47
North Carolina	11	4	15	19	6	31
North Dakota	29	16	36	34	15	3
Ohio	45	45	47	29	4	11
Oklahoma	31	9	38	36	1	12
Oregon	10	35	32	4	33	18
Pennsylvania	24	44	17	20	45	32
Rhode Island	44	31	39	22	50	44
South Carolina	37	15	41	31	37	26
South Dakota	2	1	1	32	40	23
Tennessee	13	22	8	46	23	29
Texas	14	49	6	37	12	37
Utah	9	3	12	17	22	5
Vermont	47	38	44	16	20	48
Virginia	33	6	40	11	39	28
Washington	17	48	6	49	18	27
West Virginia	18	17	26	15	27	13
Wisconsin	39	30	43	7	36	34
Wyoming	1	1	1	6	31	38
District of Columbia	47	31	43	33	27	47

Note: A rank of 1 is best, 50 is worst. Rankings do not average to the total. States without a tax rank equally as 1. D.C.'s score and rank do not affect other states. The report shows tax systems as of July 1, 2016 (the beginning of Fiscal Year 2017).

Source: Tax Foundation.

To read the full report of the Tax Foundation's 2017 State Business Tax Climate Index, <https://files.taxfoundation.org/20170302120920/TF-SBTCI-2017-Final1.pdf>

Government Reports and Analysis

Craig Knutson

Government Functions	2017		2007		2017:2007	1997		2017:1997
	Total	% of Total	Total	% of Total		Total	% of Total	
Taxes	8132	46.27%	7974	54.40%	158	4964	62.46%	3168
Licenses, Permits, Fees	711	4.05%	290	1.98%	421	167	2.10%	544
Interest and Investment Rev	655	4%	638	4.35%	17	112	1.41%	543
Federal Grants	6696	38.10%	5007	34.16%	1689	2326	29.27%	4370
Sales and Services	222	1.26%	185	1.26%	37	102	1.28%	120
Other Revenues	759	4.32%	367	2.50%	392	191	2.40%	568
Other Financing Sources:		0.00%						
Transfers	82	0.47%	80	0.55%	2	73	0.92%	9
Bond/Note Proceeds	266	1.51%	107	0.73%	159	3	0.04%	263
Other	53	0.30%	10	0.07%	43	9	0.11%	44
Total Revenue	17576		14658		2918	7947		9629
	17576		14658			7947		
Millions of \$\$								

The two tables on this page are from three Comprehensive Annual Financial Reports, years 2017, 2007, and 1997. Under the title of “Governmental Functions,” the first table, pictured above, includes all state revenues and other funding sources for those three years. The “% of total” column reflects the contribution each makes to the total revenue collected. Taxes and Federal Grants account for the largest amounts in all three years of comparison.

While Taxes was the primary contributor in each of the selected years, its contribution has declined over time. From 1997 - 2017, the Taxes portion of total revenue rose 64%. However, the Federal Grants portion rose a significant 188% and currently represents over 38% of total state revenue.

The second table, pictured to the right, shows a 31-year history of budgetary general revenue fund comparisons, itemized estimates vs. actual collections. The values in red indicate years in which the actual collections failed to match or exceed itemized estimates. As the table reflects, that has occurred 14 times overall and in five of the last eight years.

	Est.	Actual		Act:Estim
2016	5746	5205	-541	90.6%
	5857	5727	-130	97.8%
2014	5889	5627	-262	95.6%
	5601	5604	3	100.1%
2012	5236	5564	328	106.3%
	4889	5138	249	105.1%
2010	5415	4622	-793	85.4%
	5981	5544	-437	92.7%
2008	5845	5981	136	102.3%
	5708	5966	258	104.5%
2006	5149	5715	566	111.0%
	4545	4957	412	109.1%
2004	4396	4613	217	104.9%
	4725	4186	-539	88.6%
2002	4829	4413	-416	91.4%
	4456	4693	237	105.3%
2000	4271	4354	83	101.9%
	4186	4148	-38	99.1%
1998	3866	4009	143	103.7%
	3531	3778	247	107.0%
1996	3614	3705	91	102.5%
	3515	3513	-2	99.9%
1994	3399	3342	-57	98.3%
	3365	3259	-106	96.8%
1992	3214	3161	-53	98.4%
	3034	3110	76	102.5%
1990	2661	2735	74	102.8%
	2500	2601	101	104.0%
1988	2320	2398	78	103.4%
	2167	2070	-97	95.5%
1986	2457	2271	-186	92.4%
31 yr avg	4269.90	4258.35		99.7%
				45.2%

The following two tables are from The Annual Report of the Oklahoma Tax Commission, fiscal years 1999, 2008, and 2017. From the table entitled “Comparative Statement of all Tax Collection of the Past Two Years,” the Table shows the top nine revenue-producing sources for six fiscal years, in alphabetical order. The row at the bottom of the tables shows the share those nine sources make up of all revenue. Since 1998, the share has ranged from a low of 90% to a high of almost 95%.

Oklahoma Tax Collections						
"Comparative Statement"	FY17	FY16	FY08	FY07	FY99	FY98
Cigarette Tax	174304.9	176346.8	183747.4	175105.9	57609.9	59093
Diesel Fuel Tax	132245.1	108759.8	128724.3	125489.1	139056.8	133703
Gasoline Tax	308079.3	330415.6	287351.1	282451.5	294625.5	295453.2
Income Tax Corporate	400748.7	526993	488231.1	628192.9	261550.4	270669.1
Income Tax Individual	3524360.2	3596680.3	3402323.9	3413561.5	2347002.4	2162874.3
Motor License Agent Remittances	725294.7	730144.9	607530.2	586395.2	554728.8	532160.3
Sales Tax	2226863.9	2288638.2	1972101.5	1820605.1	1304901.4	1250691.6
Severance Tax	429814.5	355906.2	1249985.3	987972.3	249405.3	355203.7
Use Tax	238518.8	235107	179998.2	169913.8	89066	85676.4
SubTotal	8160230.1	8348991.8	8499993	8189687.3	5297946.5	5145524.6
Grand Total	8789362.8	8963894.1	8957722	8625945.5	5889606.1	5691369.9
Subtotal/Grand Total	0.928	0.931	0.949	0.949	0.900	0.904

The second table comes from this table “Apportionment of Statutory Revenues,” the various funds receiving the overall tax revenue. This table is sorted on the funds receiving the most:least, looking at only the top 23 funds. Those funds for 2017, as the last row reflects, account for 95.4% of all revenue collected. If a “cell” is blank it is because that particular fund had not been created.

Apportionment of Statutory Revenue						
	FY17	FY16	FY08	FY07	FY99	FY98
General Revenue Fund	4756.5	4955.1	5621.3	5621	3890	3747.9
Education Reform Rev. Fund	544.1	577.9	522.4	540.6	349	332.5
Rebuild OK Access & Driver Safety Fund	508.7	441	137.5	50		
School Districts	342.4	345.1	335.4	315.5	236.7	230.6
OK Teachers Retirement Fund	275.7	287.4	263.1	239.8	106.3	133.5
Counties for Roads	233.7	228.9	239	224.1	161.5	164.3
State Transportation Fund	216.8	217.3	191.5	198.7	195.4	194.3
County Improvement Road & Bridge Revolving Fund	120	120	29.9			
Tribal Trust Account 1695T	58.5	57.3	13.7	8.3		
Okla. Health Care Authority	49.9	48.6	49.3	45		
Multiple Injury Trust Fund	49.4	56.1	20	28.8		
Turnpike Authority Trust Fund	46.4	46.1	42	40.8	32.7	31.7
Health Employee and Economy Improvement	41.7	40.6	41.2	37.6		
Cities and Towns	39.4	40.3	33.8	33.1	29.6	28.6
OK Building Bonds Sinking F.	38.9	39.4	41	38.9	57.6	59
Higher Education Capital Fund	38.4	33.9	47.4	45	1.7	
Common Ed. Technical Fund	38.4	33.9	47.4	45	1.7	
OK Student Aid Revolving Fund	38.4	33.9	47.4	45		
Ok Tax Commission Fund	32.2	25.3	21.8	19.8	13.2	12.7
Ad Valorem Reimbursement F.	30.5	32.5	31.4	33.4	22.5	21
SubTotal	7500	7660.6	7776.5	7610.4	5097.9	4956.1
Grand Total	7860.7	7997.1	8053.4	7856.2	5248.7	5102.6
SubTotal/Grand Total	0.954	0.958	0.966	0.969	0.971	0.971

FY 2019 Appropriations by Revenue Source

Oklahoma Policy Institute

Figure 5: FY 2019 Appropriations by Revenue Source

Total Appropriations:
\$7,567 M

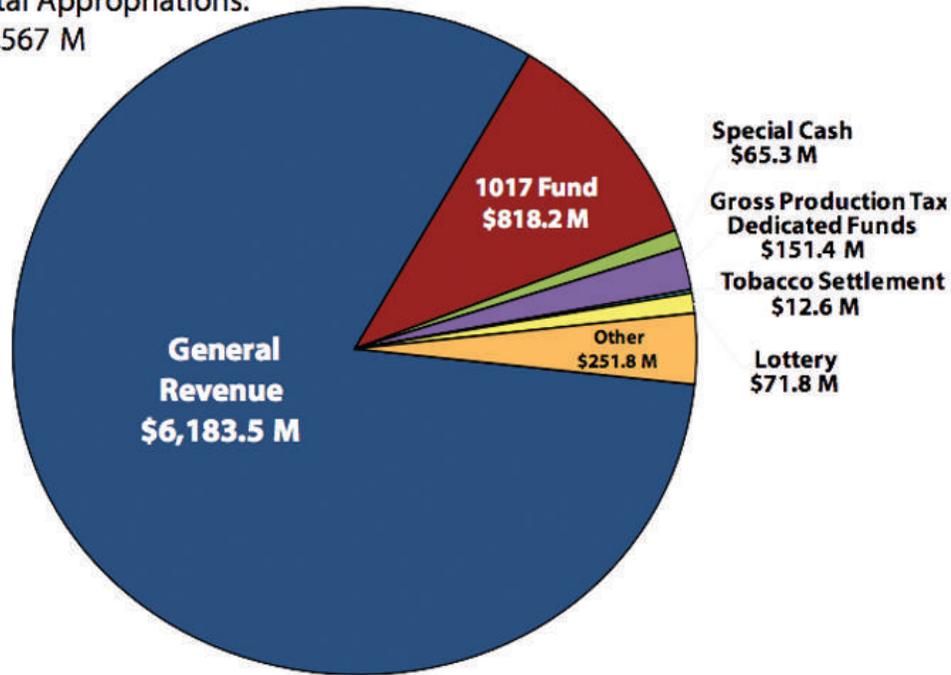


Table 1: Revenue Increases Approved in Special Session

Special Session Revenue Increases	
Gross Production Tax - 5% Initial Rate (HB 1010xx)	\$158,510,872
Cigarette tax increase - \$1 per package (HB 1010xx)	\$144,470,300
Taxing little cigars as cigarettes (HB 1010xx)	\$906,300
Gas tax increase - \$0.03 per gallon (HB 1010xx)	\$49,380,169
Diesel tax increase - \$0.06 per gallon (HB 1010xx)	\$50,353,325
Itemized deductions cap (HB 1011xx)	\$83,347,438
Online commerce sales tax extension (HB 1019xx)	\$19,600,000
Total New Revenue	\$507,568,404

All dollar amounts represent the FY 2019 appropriations authority for each revenue measure, which in most cases 95 percent of the total projected revenues from these measures in FY 2019.

Top 21 Tax Generators by Tax Type

Annual Report, Oklahoma Tax Commission, June 30, 2017

*(Five taxes equal 83.6% of collections; the top ten taxes equal 94.1% of collections;
and 15 taxes equal 96.9% of all taxes collected by the Oklahoma Tax Commission)*

<u>TAX CATEGORY</u>	<u>FY 2016</u>	<u>FY 2017</u>	<u>Cumul.</u>
Income Tax- Individual	3,596,680,344	3,524,360,201	40.337%
Sales Tax	2,288,638,150	2,226,863,948	25.487%
Motor License Agent Remittances	730,144,851	725,294,747	8.301%
Severance Tax	355,906,162	429,814,536	4.919%
Income Tax- Corporate	526,992,993	400,748,717	4.587%
Gasoline Tax	330,415,610	308,079,273	3.526%
Use Tax	235,106,981	238,518,802	2.730%
Cigarette Tax	176,346,772	174,304,850	1.995%
Diesel Fuel Tax	108,759,839	132,245,058	1.514%
State/Tribal Compact Stamps	65,504,126	68,039,637	0.779%
Tobacco Products Tax	53,138,058	55,363,659	0.634%
Mixed Beverage Gross Receipts Tax	53,091,198	54,351,062	0.622%
Franchise Tax	52,909,719	50,127,533	0.574%
Alcoholic Beverage Tax	40,292,200	41,532,214	0.475%
Electric Co-op Tax	40,425,146	41,061,080	0.470%
Motor Fuel Special Assessment Fee	33,569,324	32,915,031	0.377%
Beverage Tax	23,043,817	22,377,241	0.256%
Tribal Cigarette/Tobacco Payments	21,482,657	22,303,924	0.255%
Horse Track Gaming	20,841,405	20,688,308	0.237%
Documentary Stamp Tax	17,874,363	19,505,340	0.223%
Computer Enhancement Fund	18,603,015	18,612,332	0.213%
Sub-total: Top 21	8,789,766,730	8,607,107,493	0.985%
Total Tax, Lic., Fee, Permits	8,906,723,846	8,737,310,349	
Sub-total: Top Ten	8,414,495,828	8,228,269,769	0.941%
Sub-total: Top Five	7,498,362,500	7,307,082,149	0.836%
All Other Tax Collections	116,957,116	130,202,856	
Miscellaneous Accounts	57,170,206	52,052,495	
Grand Total Collections	8,963,894,053	8,789,362,844	

(Licenses, Permits, and Fees- 4%; Federal Grants- 38.1%; and Taxes- 46.3%)

2018 Facts and Figures

The Tax Foundation and Craig Knutson

State Rankings: Tax Foundation							
	ARK	COLO	KANS	MO	NM	OK	TX
COLLECTIONS							
State-Local Tax Burden/State Income	17	35	23	29	37	40	21
State Tax Collections per Capita	13	37	22	44	29	38	48
State&Local Tax Collections per Capita	34	22	25	41	27	39	28
State Individual Income Tax/Capita	29	14	33	25	37	34	
State&Local Indiv. Income Tax/Capita	31	18	34	27	38	33	
State Corporate Income Tax/Capita	19	27	24	43	42	37	
State&Local Corp. Income Tax/Capita	23	30	24	41	32	38	
State General Sales Tax/Capita	8	44	7	41	20	39	5
State&Local Gen. Sales Tax/Capita	11	18	12	29	6	16	9
State&Local Excise Tax/Capita	30	36	41	44	42	38	18
State&Local Property Tax/Capita	48	26	22	35	47	49	13
State Debt/Capita	44	27	34	26	25	37	42
State&Local Debt/Capita	43	11	15	27	31	47	12
Federal Aid as a % of State General Rev.	11	43	47	9	5	26	21
Income/Capita	43	14	23	36	48	37	41

Interpretation of Data

The Tax Foundation published its first Facts & Figures in 1941 “to meet the challenge presented by the broad problems of public finance.” The Tax Foundation is guided by the following principles of sound tax policy: Simplicity, Transparency, Neutrality, Stability, No Retroactivity, and Broad Bases and Low Rates.

We have assembled the most current tax information for Oklahoma and our regional states. With over forty table of information, using the same words through “source.” Substitute “In all cases . . .” with Please note “The Interpretation of Rankings” below the preceding table. The URL for all tables is listed at the end of this summary

Oklahoma’s population ranking is 28th from the top, just ahead of Connecticut and just below Oregon. Texas, Missouri, and Colorado have populations larger than ours; the remaining states have populations lower than ours. We mention that because on a per capita basis, many of our key tax rankings fall in the mid-30s and 40s, suggesting our tax burden, on a per capita basis, is less onerous.

On the “high end” of the rankings, Oklahoma receives more than its fair share of federal dollars (Federal Aid as a % of State Revenue). On the “low end,” Oklahoma, relative to our regional competitors, has very little debt.

While our state and local sales tax rates are quite high (16th from the top), our state and local property tax collections are the second lowest in the country (49th). In terms of Income per capita, we rank (37th) very close to our population ranking, just below Missouri but outpacing three of our regional counterparts.

For a complete copy of the report see <https://taxfoundation.org/facts-figures-2018/>.

Estimates show potential for e-retail taxes in Oklahoma

David Dishman, *The Oklahoman*, June 23, 2018

An analysis of increased Oklahoma tax collections following an agreement with Amazon.com could lend insight into how much the state stands to gain following a U.S. Supreme Court decision Thursday.



Robert Dauffenbach

Robert Dauffenbach, director of the Center for Economic and Management Research at the University of Oklahoma, showed what could be in store for Oklahoma after the Supreme Court ruled states could make laws for the collection of online sales taxes from internet retailers.

Dauffenbach estimates Oklahoma could eventually expect to see \$5.6 billion in online sales in the coming years. At that level of sales, with a state sales tax rate of 4.5 percent, it would yield \$253 million in revenues.

This estimation could take several years to reach, Dauffenbach added, and it will require legislation to be passed within Oklahoma.

“The magnitudes may eventually be a lot larger than they are originally,” Dauffenbach said. “States are going to be writing their laws in terms of who has to pay. Depending on how the law is written, and who has to pay, can make the ultimate difference.”

The Supreme Court decision is widely regarded as a victory for states and municipalities, as well as local retailers. For years, brick-and-mortar retailers across the country have felt the sting of competing with online retailers who don’t always collect sales tax on their goods.

If an online consumer purchases an item sans sales tax, the tax is still owed but the customer bears the responsibility of reporting the amount. Many do not report the taxes and states have felt millions in potential revenues are lost.

Amazon.com entered into an agreement with the state of Oklahoma to collect and remit sales taxes beginning in 2017. The internet retail titan left a noticeable impact on online sales tax collections in their first full year of collections.

Oklahoma saw an increase of about \$26 million in online

sales tax collections from the last full year before the Amazon deal, June 2015 to May 2016, to the first full year after the deal, June 2017 to May 2018.

Oklahoma City saw an increase of about \$4 million and Tulsa saw an increase of about \$2.4 million in the same period.

Online sales continue to grow, having risen from about 3.6 percent of retail sales in 2008 to about 9.5 percent today. Some estimate that number will increase to about 20 percent of

retail sales in the next decade, Dauffenbach said.



“It is unfair and unjust to those competitors, both local and out of state, who must remit the tax; to the consumers who must pay the tax; and to the states that seek fair enforcement of the sales tax — a tax many states for many years have considered an indispensable source for raising revenue,” Justice Anthony M. Kennedy wrote in South Dakota vs. Wayfair.

The history and future of the retail sales tax

Vivien Lee and David Wessel, The Brookings Institution, July 16, 2018

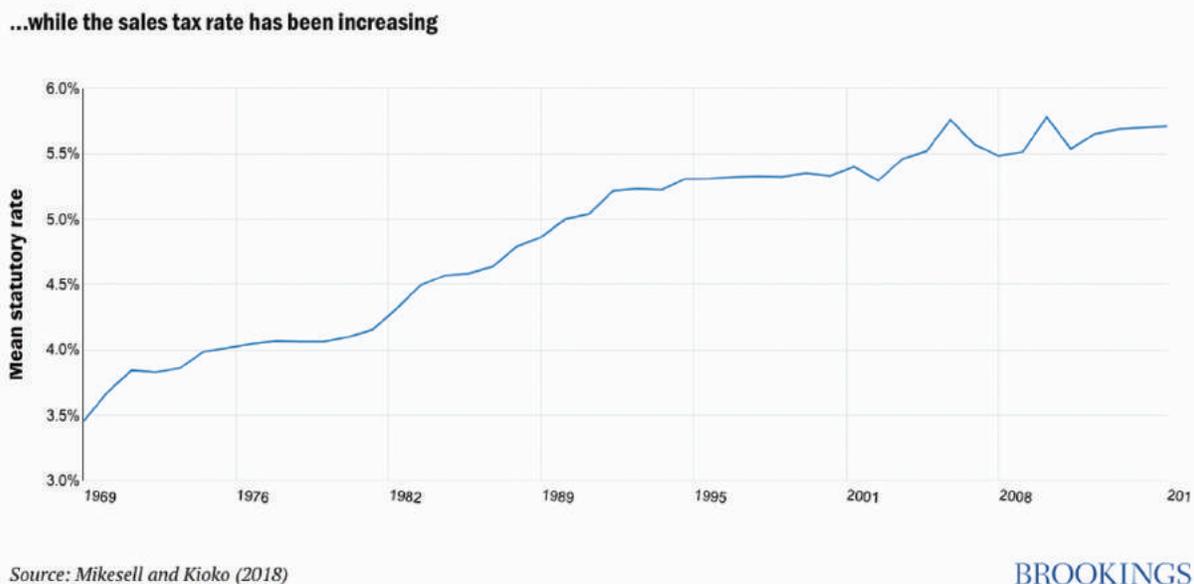
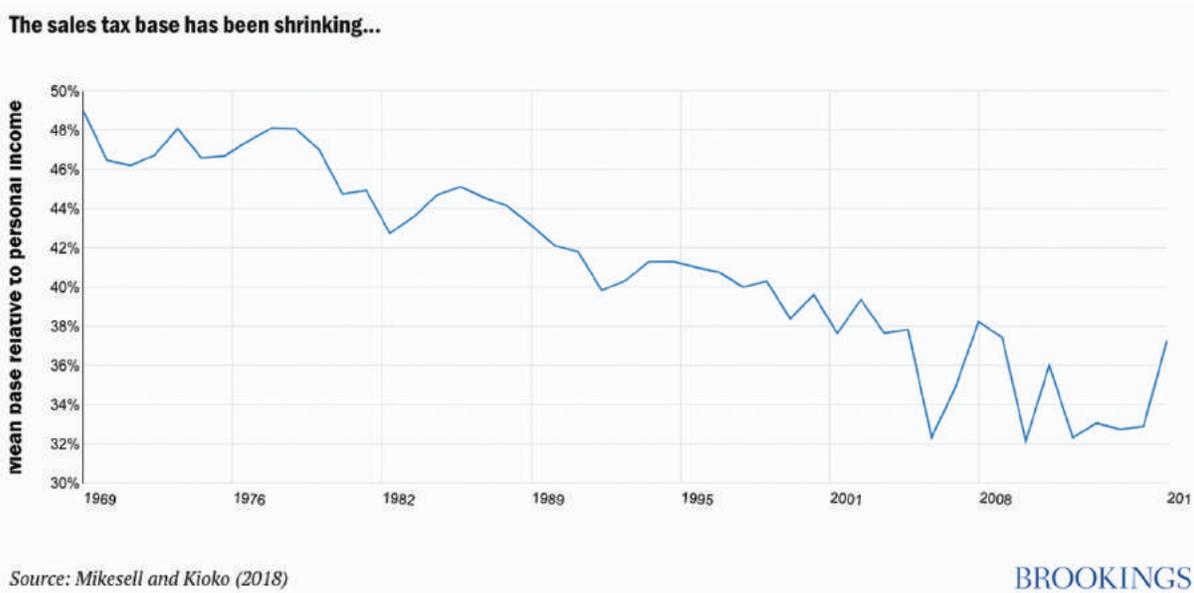
Retail sales taxes are inefficient, inequitable, and hard to administer, according to “The Retail Sales Tax in a New Economy,” a paper to be presented at the 2018 Municipal Finance Conference at Brookings this week.

The retail sales tax was first enacted during the Great Depression, and became the largest single source of tax revenue for states in 1947. Across the 45 states with a current retail sales tax, sales tax revenue made up on average 34 percent of all state tax revenues in 2016 – slightly higher than 32 percent in 1970. But the tax base has been shrinking since the 1970s, and states have increased retail tax rates in order to maintain those revenues, say John Mikesell of Indiana University and Sharon Kioko of the University

of Washington.

Tax revenues depend on the size of the tax base (the stuff that’s taxed), and the rate (how much that base is taxed). The sales tax base as a share of the economy has been shrinking over time, which decreases revenues as a share of a state’s personal income. The retail sales tax base includes purchases of tangible, personal property, but only selectively includes services. Because services are a growing share of economic activity, states are losing out on an increasing amount of potential revenue.

Using the Bureau of Economic Analysis’s calculations for tax bases from 1970 to 2016, the authors compare the typical retail sales tax base, as a share of personal income,



under three scenarios: 1) the base at present, 2) what the base would be if it included all services excluding health and education, and 3) what the base would be if all services were taxed. They show that the tax base, relative to personal income, has decreased by 20 percent since 1970; if services other than health and education were included, the base would have decreased by only 8 percent. Taxing all services would have increased the base by 11 percent relative to the 1970 level, they find.

Further, many categories of goods—for instance, food for at-home consumption and prescription medicines—are exempt from the retail sales tax in many states. Such exclusions decrease the tax base, make the tax harder to administer, decrease compliance, discriminate according to household preferences, and reward narrow political interests, the authors argue. These exemptions are often seen as a way to lighten the burden on lower-income families for purchases of essential goods. A better approach, the authors say, would be to give lower-income families a rebate or a tax credit.

Mikesell and Kioko suggest that the retail sales tax may overreach in one dimension. The initial intent was to tax household purchases of finished products, making the retail sales tax a tax on consumption. This is not always the case in practice: on average, 40 percent of retail tax revenues come from intermediate goods that businesses purchase, the authors say. Thus, the taxes on these intermediate purchases are incorporated into the prices charged by businesses, so consumers doesn't realize that are paying that tax. "While hidden taxes may be popular with legislatures," the authors write, "they conflict with the idea that the population ought to have a clear idea of what they are paying for government." Another unwelcome consequence is that tax adds a cost on capital investment and other purchases associated with economic expansion, potentially hindering economic growth. In this sense, the retail sales tax encompasses too broad a tax base. Exempting all business input purchases would be more efficient and less distortionary than the

current policies, the authors say.

In the face of a declining tax base, states have increased tax rates in order to maintain tax revenues, the authors find.

The average tax rate among states that levy a retail sales tax was 5.7 percent in 2015 compared to 3.5 percent in 1970. Existing literature suggests that tax rates above 10 percent are almost impossible to administer due to low compliance. The authors note that tax rates have been drifting upwards since the 1970s, with many states already above 7 percent, and warn that retail sales tax compliance may become a challenge in the future.

In the face of a declining tax base, states have increased tax rates in order to maintain tax revenues, the authors find.

The authors note that one change in the economy that creates difficulties for the retail sales tax is the rise of internet commerce. States have yet to devise an effective mechanism to enforce the sales tax on sales from remote vendors with no in-state physical presence. (In *South Dakota v. Wayfair*, decided June 2018, the Supreme Court ruled that states may charge sales tax on out-of-state purchases, even if the seller does not have a physical presence in the taxing state.) Another challenge is that the shared economy (where peer-to-peer transactions of goods or services are facilitated by online platforms like Airbnb and Uber) makes tax administration more complicated.

Mikesell and Kioko note that that a considerable share of the challenge to state retail sales taxes is within the control of state lawmakers, and some states have had modest success at restructuring. "The sales tax future much depends on the design of strategies to enact identified solutions to structural, behavioral, and administrative threats. None are impossible," they conclude.

“The sales tax future much depends on the design of strategies to enact identified solutions to structural, behavioral, and administrative threats. None are impossible.”

The Inevitable, Indispensable Property Tax

Josh Barro, The New York Times, July 4, 2015

If you're a homeowner, you probably don't like paying property taxes. But economists like property taxes for the same reason taxpayers hate them: They're hard to avoid.

A 2008 study by researcher at the Organization for Economic Cooperation and Development looked at a number of countries and found that taxes on real property caused the least drag on gross domestic product per dollar of revenue raised. Next came sales taxes, personal income taxes and corporate income taxes. In other words, property taxes were the best way to collect revenue without hurting the economy too much.

As the economist Greg Mankiw wrote in this space three years ago, "A good rule of thumb is that when you tax something, you get less of it." That idea helps explain why property taxes do relatively little economic damage.

The main way taxes harm the economy is by causing people to change their behavior. Raising the income tax can cause people to work less; a higher sales tax can make people spend less. But the only way to avoid a property tax increase is to sell your property, and even then, you have to find a buyer who's willing to take on the tax burden you're giving up.

Real property is an excellent tax base because it can't be moved and it lasts a long time. In the case of land, it usually lasts forever. We, as economic actors, cannot respond to a higher tax on land by reducing the amount of land that exists. We may change what buildings to construct and where, but once a building exists, it's not likely to move in response to tax changes.

In rare cases, property taxes can get so high that they encourage people to abandon their property (see Detroit). But in general, property taxes simply lead to an efficient transfer of wealth from property owners to the government. That's not necessarily lovely for property owners, but we need to finance government somehow, and it's best for the economy that the manner be an efficient one.

So from an economist's perspective, it's a bit of a problem that Americans have fought so strongly against property taxes for the last 40 years. Since the 1970s, most states have significantly restricted how high local property taxes can go. The main effect has been not to restrict the growth of government but to push government to rely on less economically efficient taxes.

Property taxes declined to 24 percent in 2007 from 31 percent of local government revenues in 1977. Even as property taxes were restricted, local government grew as a share of the economy, driven by a combination of higher sales and income taxes and greater aid from state governments.

Increased reliance on these taxes has brought problems, and not just because they cause people to change how much they work or where they spend:

- Sales tax, which falls disproportionately on the poor, is what economists call regressive. Property tax is often perceived as regressive, but because wealthy people own much more

property than poor people do, it is more progressive than sales tax, though not as progressive as income tax.

- Sales tax receipts are suppressed by several trends. Online sales have cut into the sales tax base, and the economy has shifted over time away from goods toward services, which most states don't subject to sales tax. States have responded to this base erosion by raising sales tax rates over time, increasing the extent to which the sales tax damages the economy.

- The shift toward sales and income tax has led to an erosion of local control. Sales and income taxes are often levied across a large geographic area (lest people simply shop across municipal borders to get a better sales tax rate). The shift away from property tax has meant that local governments have had to depend on state governments to collect taxes and send them aid. This structure is fairer to poor cities and towns with weak property tax bases, but it also leaves local officials responsible for providing services without control over the revenue sources to fund them.

- Sales and income taxes are volatile. It's their biggest problem. State and local income tax receipts fell 12 percent from 2007 to 2009, igniting budget crises around the country. In past recessions, sales tax held up much better than income tax, but not this time: Sales tax receipts fell nearly as much, 9 percent, over the same period.

The federal government deals with revenue volatility by borrowing money. But states and cities are supposed to balance their budget every year. Governments were caught off guard as the recession hit. Half of states missed their revenue projections by more than 10 percent in 2009, forcing large midyear budget cuts.

Property tax was the only major state and local government tax that held up well in the Great Recession. In most states, property tax collections are devised to grow in a stable, steady manner, with the tax rate falling when property values spike and rising when they fall.

Indeed, property tax has grown as a share of total state and local government receipts since 2007. In 2012 it was 27 percent, up from 24 percent in 2007, not because governments have re-evaluated their choice to de-emphasize property tax, but because sales and income taxes have been so extraordinarily weak in the recession and its aftermath that property tax has grown by comparison.

That growth serves as a reminder of the virtue of property tax: In good times or bad, it provides a stable, efficient source of revenue.

The Upshot provides news, analysis and graphics about politics, policy and everyday life. A version of this article appears in print on July 5, 2015, on page 6 of the New York edition with the headline: The Inevitable, Indispensable Property Tax.

County Funding 101

Chris Schroder, Association of County Commissioners

Counties were created under Article 17 of the Oklahoma Constitution to provide local governmental services such as public safety and road maintenance. County government is, in many respects, an arm of state government. County government executes state laws; it does not create new ordinances. Tax rates and fees are set by the constitution and state legislature. Many counties are experiencing a lack of revenue growth while the demand for services has increased. This lack of growth may be attributed in part to the fact that counties have no authority to increase revenues. The primary sources of revenue for the counties can be broken down into the general fund, highway fund and cash funds.

The general fund is the primary fund for county government in which the annual budget is adopted. It funds courthouse operations of the elected offices, general governmental activities of assessment, land records, purchasing, banking, collection of taxes, the county jail, county fairgrounds, emergency management, District Attorney's office and many other services. Tax collection is not only for the county itself but also for the schools, career techs, county health departments, and others. The majority of funding in the county general fund consists of ad valorem (property taxes), sales tax and use tax.

The Oklahoma Constitution authorizes property taxes. Both the use of a property tax and the number of mills levied are described in Article 10 of the Oklahoma Constitution as an ad valorem tax. For counties, up to 15 mills is guaranteed without a vote of the people. No less than 5 mills from the amount levied must be allocated to the common school districts within the county. The remaining 10 mills is apportioned by the County Excise Board. So, in practice, all 15 mills are levied and 10 mills of the total 15 mills are typically apportioned to the county general fund to support the services provided by county government. The Oklahoma Constitution and Statutes guide the county excise board to appropriate a portion of the 10 mills for the county general fund to finance various services and programs. In most instances, all 10 mills are needed to operate the general fund. In many counties, the historical foundation for financing county services – the ad valorem or property tax - has not kept up with rising prices. Inflation and the increasing cost of various mandates (such as jail standards) have compelled counties to find additional funds, and in many cases, a county sales tax is the most viable vehicle.

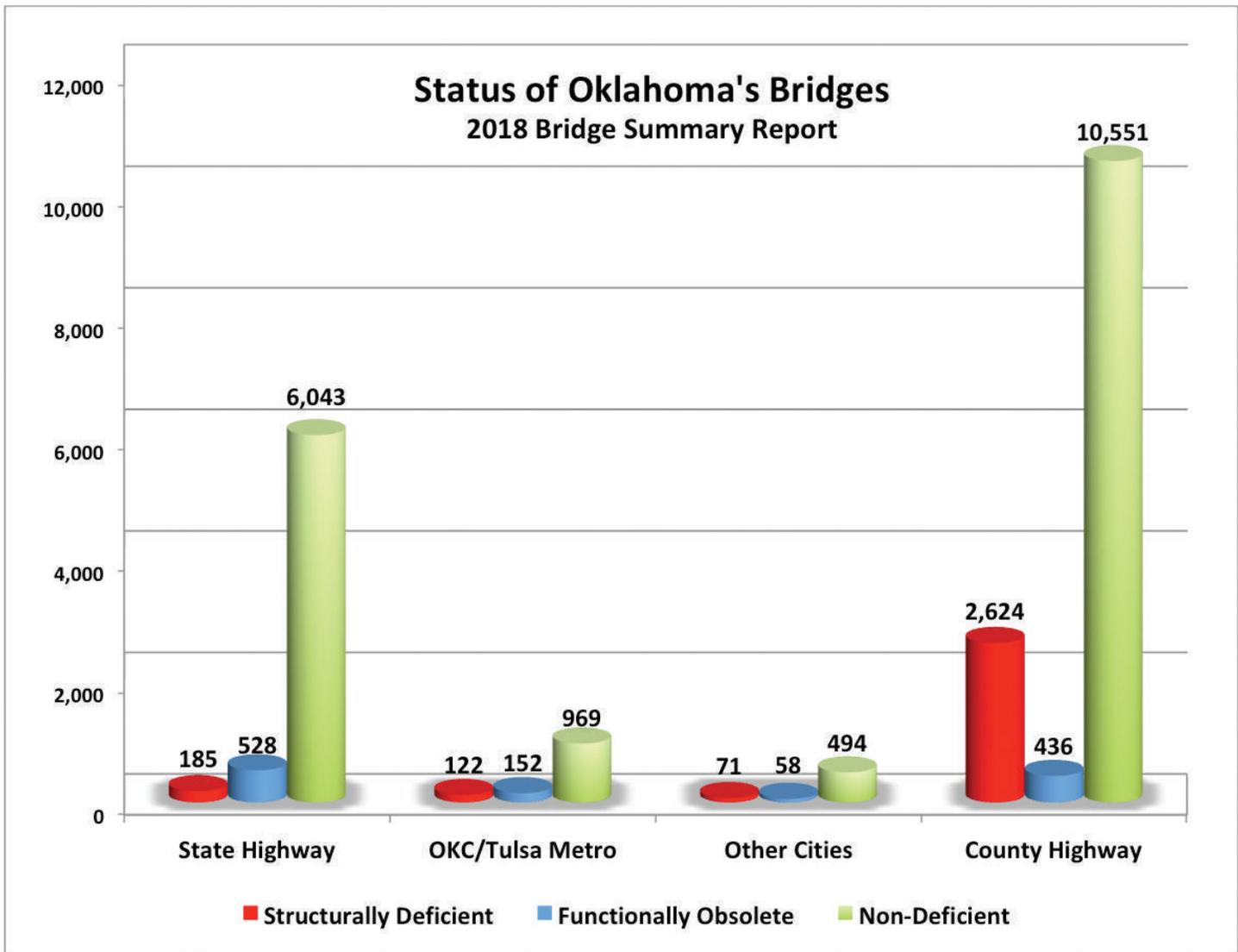
County governments gained access to the sales tax in 1984 and in increasing numbers adopted (by vote of the people) a county sales tax to bolster sagging revenue streams for county government services. As of 2018, 76 counties employ it with Oklahoma County being the one exception.

Historically, county governments relied heavily upon ad valorem taxes and transportation user fees (fuel taxes, motor vehicle license and registration taxes) set by the state constitution and statutes. In many cases, revenues from these sources have not grown as quickly as rising costs and the increasing demand for services. Therefore, the only viable option whereby a county may raise a significant amount of additional money to continue current activities or to expand county government services is the adoption of a county sales tax. Counties have the authority to adopt a 2% county sales tax by vote of the people. Sales tax dollars must be designated for a particular purpose, which the county shall identify when the ballot is presented to the voters. In some counties the sales tax is dedicated to roads but in most counties the tax is used for county jails, hospitals, fairgrounds, rural fire departments, among other things.

Use tax is essentially the same as sales tax, but applied to purchases from out-of-state vendors. The use tax is supposed to be collected on mail, telephone order, and internet purchases from merchants who have no physical presence in Oklahoma. In 1998, the state Legislature adopted House Bill 1816, allowing counties to begin collecting the use tax. The Board of County Commissioners sets the use tax rate, but they can only set it at a rate up to the county sales tax rate approved by vote of the people. Collectively, sales and use tax now generate as much or more than ad valorem in many counties.

The highway fund is funding for county road and bridge construction, improvement, and/or maintenance. The vast majority of county road funding typically comes from three state excise taxes: fuel taxes, gross production taxes, and motor vehicle license and registration fees. Motor fuel taxes are a specified amount per gallon defined by state statute. Hence, motor fuel tax collections vary according to the number of gallons sold. The gross production tax is a certain percentage of the total value of production. The amount of gross production tax generated depends on both the amount of production and the price per unit, such as price per barrel of oil or price per thousand cubic feet of natural gas. Motor vehicle license and registration fees depend upon the type, age, use, and value of the vehicle.

These taxes are collected by the Oklahoma Tax Commission (OTC) and apportioned according to state statute. Each county receives a set proportion of the gross production tax generated within its borders. The reasoning the majority of gross production goes back to the county it was generated in is to help the county pay for road damage that is caused as a result of drilling wells. The motor fuel and vehicle excise taxes are apportioned to counties for county roads according to formulas that take into account



the number of miles of county roads, the land area of the county, and population.

Challenges:

- Contrary to public opinion, property taxes do not pay for road maintenance (except on rare occasions in those counties that find themselves in a position to do so). Fuel taxes, motor vehicle fees and gross production taxes primarily support maintenance of county roads and bridges.

- Fuel taxes are based off of volume sold. With the increase in fuel-efficient vehicles and alternative fuel vehicles, fuel tax growth has been minimal and outpaced by the increase in construction costs.

- Many of the counties funding sources are maxed out allowing little room for revenue growth. Ad Valorem is maxed out at 10 mills according to the constitution. In recent years, motor vehicle fees have been capped by the legislature. And as mentioned above, fuel tax growth has been limited as a result of being based on volume sold.

- Counties maintain 82,755 miles of roads, 75% of all state

roads/highways. This includes 4,827 city street miles in 511 towns and cities.

- Counties maintain 13,611 bridges, 60% of all state bridges. Of these bridges, 2,624 are deficient. (See graph above)

- Counties are required to house county inmates and many were forced to construct new jails at a time when the State also needed more space for State inmates. Jail standards have greatly increased, resulting in increasing costs of construction and operation.

Recommendations:

- Remove caps on the motor vehicle taxes to return road user fees back to where they belong, on the roads.

- Road user fees (fuel taxes, motor vehicle license and registration taxes) should be dedicated strictly to roads and bridges.

(Notie Lansford of the OSU County Training Program contributed to this article)

The Need for Municipally Minded Tax Reform in the 21st Century

Mike Fina and Daniel McClure, Oklahoma Municipal League

The mantra of governments throughout Oklahoma in recent memory has been the theme of doing more with less. This concept is even more applicable in municipal governments where they have to do more with less while the deck is stacked against them. This is because state policy makers have effectuated a broken tax system that has continued to erode the municipal tax options. Municipally minded comprehensive tax reform must be implemented to continue sustainable and effective municipal governments into the 21st century.

Municipal governments are the foundation of what Oklahomans expect out of their government. Municipalities in Oklahoma insure safe and affordable water is available for residential consumption as well as supporting Oklahoma's agricultural sector. Over 60 municipalities provide reliable and affordable electric services to over 400,000 residents and keep the lights on and the doors open at businesses across the state. They also ensure that when Oklahomans are in peril, professional and capable emergency response services are available through police, fire, and emergency response services.

Municipal Success

Oklahomans have a relationship built on trust with their municipal governments. Since municipal policy makers have limited taxation options, municipal leaders have been forced to take taxation issues to a vote of the people. If municipalities fail to deliver, voters reject tax proposals. But, municipalities are not failing to deliver. This is evidenced by the continued voter support for municipal governments across Oklahoma. In a state whose voters are inherently 'anti-tax', many communities' voters have passed taxes to provide for infrastructure, community projects, economic development, and more.

Examples include the success of the dedicated sales tax of the Oklahoma City MAPS projects, as well as recently approved revenue packages including a bond for infrastructure and public improvements in Sand Springs; the 'Move Midwest City Forward Initiative' for streets, water, parks and public safety funding; the "Build our Future BA" plan which was the largest municipal bond package ever to improve streets, utilities, and parks in Broken Arrow; as well as a host of others this election cycle throughout the state. Voters approve these types of projects for one simple reason –because overwhelmingly municipalities deliver what they promise.

However, there are limits to this type of taxation strategy and many communities are reaching the cap for the types of funding they are utilizing. For example, Oklahoma is the sixth highest sales tax state in the country, so providing for

increased expenses and citizen requested services is limited through this route. Also, many communities have reached the upper threshold of their bond capacities. What works in one municipality may not work in them all, nor will all communities embrace differing taxation systems. However, Oklahomans deserve the right to choose their preferences, and the choice to tax or not should be determined locally as much as possible. Policy makers should consider substantive taxation reform that improves online sales tax collection systems, allows for equitable taxation and public safety districts to fund vital municipal public safety services, and implements reasonable taxes on services taxed in neighboring states.

A Broken Tax System

Oklahoma is the only state in the union where cities and towns are almost entirely dependent on sales tax for general operations. The state prohibition on allowing local voters to allocate ad valorem taxation for municipal purposes is inexplicably rare and ineffective to say the least. Another policy decision that is detrimental to municipal revenue is the decrease in the local share of motor vehicle fees (MVs). In 1933 cities and towns received 15% of MVFs. That number plummeted and today sits at a lowly 3.1%. Given the fact that 41% of state highways alone are driven through municipalities, the municipal proportion is lagging.

Over subsequent decades Oklahoma leaders have implemented policies that have contributed to the erosion of municipal revenue options. For example, today 76 counties across Oklahoma have a sales tax option (Oklahoma County does not have a county sales tax). When combined with the steep competition between municipalities for retailers, this effectively caps sales tax rates in a number of communities. This is due to the fact that cities are forced to choose between increasing the tax rate and the detrimental effects of citizens taking their business outside of city limits to save money. As a state, we have to do better.

Online Sales Tax Policy

Over the past few decades the states economy has undergone incredible changes. Specifically, the online shopping economy is vibrant and has continued to grow. With this changing economy, policy makers have had to modify the tax code to collect taxes on these new transactions. In 1991, the United State Supreme Court decision in *Quill Corp. v. North Dakota* implemented an in-state nexus requirement for states to collect a tax on sales in their taxing jurisdiction. This was a case regarding what has become an antiquated business system – ordering items from catalogs.

While some would argue *Quill* was wrongly decided from

the beginning, fitting the online economy into this ‘catalog economy’ has been difficult and burdensome. This year, the United States Supreme Court has overruled *Quill* in *South Dakota v. Wayfair*. The Court concluded an out of state business need not have a physical presence in a state for that state to place a tax on sales occurring within their jurisdiction. This decision is huge for state and local governments in regard to taxation, and policy makers must act swiftly to ensure they are prepared.

While the state has implemented a number of online sales tax policies, more work is still needed in this area. Specifically, municipalities have concerns with the zip code reporting system used in online transactions. If an online seller uses a 5-digit zip code during their transaction, the remittance may or may not find its way to the appropriate taxing jurisdiction. It’s important to be mindful that Oklahoma has 514 municipalities and 76 counties with unique sales tax jurisdictions. Many times, this involves one side of the street having one sales taxing jurisdiction with another right across the street. Further, even those vendors using effective tax reporting systems run into issues when the buyer uses a 5-digit zip code rather than the “zip +4” which more accurately places the point of sale.

For example, the western portions of Midwest City are addressed with a 5-digit zip code of 73110. This address is serviced by a branch of the Oklahoma City Post Office. The mailing address often shows up as an Oklahoma City address. Utilizing the “zip+4” zip code however will place the sale in Midwest City’s taxing jurisdiction. When taxes are incorrectly sent to the wrong taxing jurisdiction, municipalities have to expend tax-payer dollars and staff resources to resolve the issue. Municipal governments that spend these funds have to find ways to reimburse them so they can be sent to the appropriate taxing jurisdiction.

Requiring sales tax remittance systems to utilize the ‘zip+4’ solves this problem and appears to be low-hanging fruit in regards to easily implemented taxation reform.

Public Safety Districts

The League has advocated for the implementation of Municipal Public Safety Districts. This is a concept that allows local voters the option to utilize local ad valorem taxes to support police and fire services in their communities. This is consistent with locally minded taxation systems, and allows for voters to have the say in their own taxation and services provided in their community. This concept is vitally important in light of the changing landscape of the state. As communities grow and additional residences are built outside municipal boundaries, the need for police, fire, and medical services increases while the additional tax revenue required to provide these services does not necessarily correspondingly increase.

A recent survey of Oklahoma Municipalities shows that at least 154 municipalities provide fire, police, or medical services outside their municipal boundaries. A number of these

runs are the difference in life and death. Municipal governments are proud of the services they provide to save lives and provide medical care throughout the state. However, the antiquated tax model that funds these services does not keep up with the costs to provide them. On average municipalities are already spending 39% of their non-utilities expenditures on public safety.

Many of the municipalities responding to calls outside their boundaries receive no funding for the calls for service. As a result, municipal tax revenues have to fund calls for services within municipal limits, as well as subsidize out of municipal limits service calls. Allowing local voters a say in their public safety funding is important, and relinquishing Oklahoma’s super-minority status in allowing access to ad valorem funding is an important step to modernize tax policies. This will ensure that that adequate, life saving municipal public safety systems are available for Oklahoma’s statewide.

Sales Tax on Services

Another opportunity to consider is methodically rolling out sales taxes on services. This concept was introduced by Governor Fallin and met overwhelming opposition. Her approach at taxing 164 services may have been too large for an initial attempt. Sales taxes on services can be effective and make sense. Worth noting, at least some types of tax on services are in state tax codes in all of Oklahoma’s border states. However, a minimal and strategic approach to this taxation model makes sense. For example, Colorado, Illinois, Massachusetts, Nevada and Virginia have taxes on services, but tax fewer than twenty services total according to a 2015 report. This limited approach provides food for thought. By allowing a measured and systematic approach into this concept can bring important tax revenue without biting off more than the state can chew.

Call to Action

Oklahoma is poised to move forward as a state with an abundance of resources and talent throughout the state. Implementing a comprehensive tax reform package is imperative for providing essential municipal services moving forward. If policy makers implement municipally minded tax reforms, we can ensure Oklahoma’s cities and towns are prepared for the changes facing them. Public safety districts and locally implemented ad valorem taxation, ensuring the effective collection of online tax revenue, and implementing strategic taxes on services are three necessary components of a successful tax reform package that can move Oklahoma’s cities and towns into the 21st century confident of the opportunity for success.

(d. 99.7%)

FUNDING THE GAP: Strong Cities, Strong State

Oklahoma Municipal League, February 16, 2016

When addressing taxation in Oklahoma it is important to analyze the situation from a macro perspective. Understanding the complex and unique outlooks at every level of government will provide policy makers the information they need to make qualified and informed decisions. Cities and towns provide a plethora of services to residents of Oklahoma, and their contribution to the state's quality of life and growing economy are often overlooked.

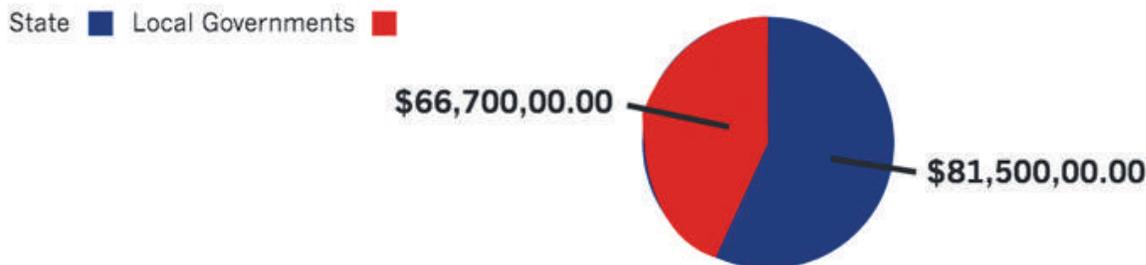
A BROKEN TAX PLAN

When your state is 1 out of 50 states to do anything you are either leading or lagging. Oklahoma's place as the only state in the union where cities and towns are almost entirely dependent on sales tax for general operations may not be putting us on the leading end of governmental taxation systems. Over subsequent decades Oklahoma leaders have implemented policies that have contributed to the erosion of municipal revenue options. For example, today 76 counties across Oklahoma have a sales tax option. When combined with the steep competition between municipalities for retailers, this effectively caps sales tax rates. This is due to the fact that cities are forced to choose between increasing the tax rate and the detrimental effects of citizens taking their business outside of city limits to save money. Another policy decision that has contributed to the erosion of municipal revenue is the decrease in the local share of motor vehicle fees (MVF's). In 1933 cities and towns received 15% of MVF's. That number plummeted and today sits at a lowly 3.1%. Given the fact that 41% of state highways alone are driven through municipalities, that municipal proportion is lagging.

SOMETHING'S GOTTA' GIVE: THE INTERNET TAX HAVEN

The "internet tax haven" has created additional burdens for municipalities. As technology made it easier for online purchases, governments did not keep laws ahead of the curve, and as a result we now see more and more consumers avoiding sales tax altogether. Many would argue this is a "new tax" and fail to see that it is just the enforcement of existing taxes. Recently, Rep. Jason Chaetz (R-UT) introduced the Remote Transactions Parity Act, which would regulate how states can enforce sales taxes for online purchases. This plan, or one like it, is a step towards balancing the playing field and directing sales tax revenue to the state, county, and municipal governments that need it.

Oklahoma Revenue Lost to Online Purchases in 2015



PROBLEMS WITH SALES TAX

Consumers switching to untaxed Internet sales results in a loss of \$81.5 million to the state and \$66.7 million loss to local entities in 2015.

Volatile source of revenue.

Municipal sales tax earmarked for local schools, hospitals, economic development, and colleges.

Combined state/county/city rates can crowd out the ability for cities to increase sales taxes.

(54 Cities with combined rates at 10%+).



Places Impacted

- Municipal Complexes
- Hospitals
- Churches
- Schools
- Public Arts Facilities
- PWA's
- Nutrition Centers
- Tribal Facilities
- Community Centers
- Parks
- Public Cemeteries

Types of Work

- Mowing
- Weed eating
- Painting
- General maintenance
- Street repair
- Janitorial
- Auto Repair
- Plumbing
- Sanitation
- Specialty trades
- Meal Preparation
- Storm Cleanup

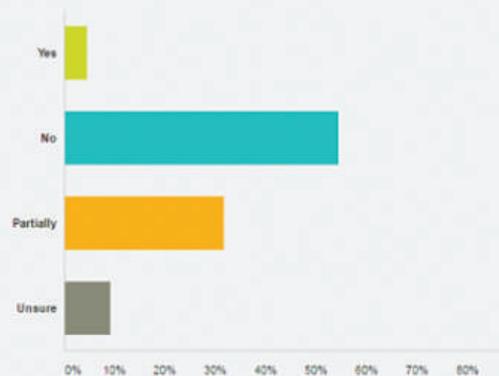


PA\$SING THE BUCK

Municipalities will bear the load for DOC work center closures

The recent announcement that the Oklahoma Department of Corrections will close work centers statewide will have a tremendous impact on municipalities. Initial assessments show the loss on just **33** of Oklahoma's 586 cities and towns is estimated to exceed **\$11,934,012***

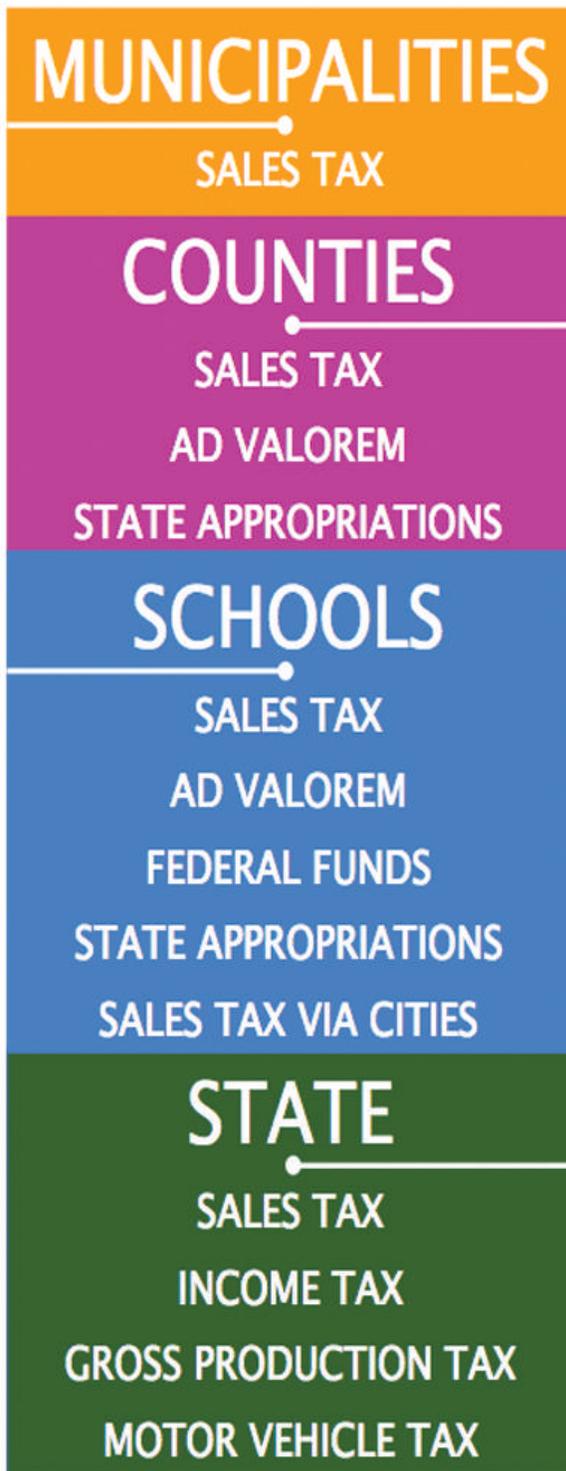
Does your municipality have revenue to hire outside contract labor to fill the gap the DOC work center closures will create?



*7/2016- Respondents that provided ranges were calculated using the median number.

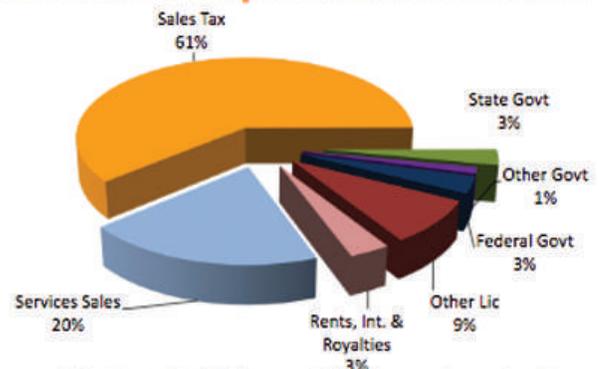
Funding the Gap

*Strong Cities, Strong State
A look at Municipal Revenue*



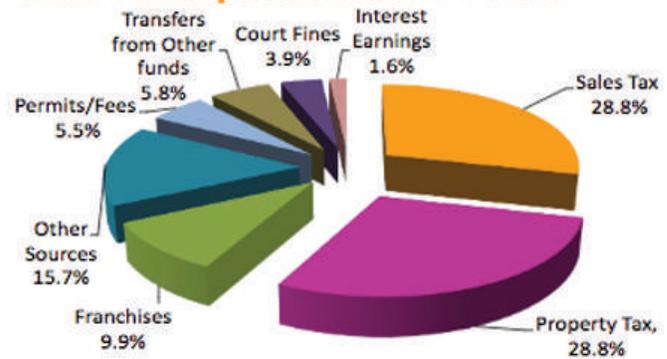
Oklahoma is the only state in which municipalities are almost entirely dependent on sales tax for general operations

Oklahoma Municipal Revenues FY 2014



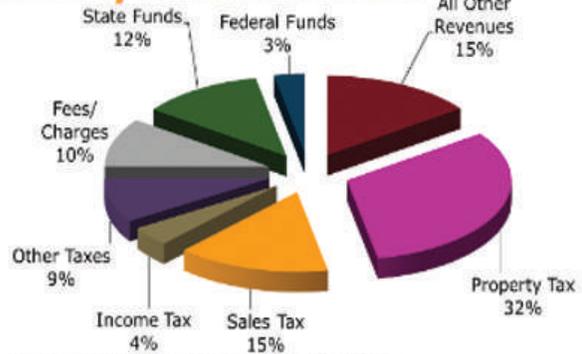
Source: FY 2014 SA&I forms, Oklahoma State Auditor

Texas Municipal Revenues FY 2010



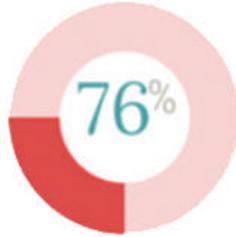
Source: Texas Municipal League

U.S. City Revenues FY 2010



Source: National League of Cities

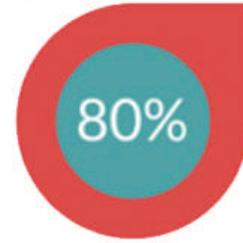
Cities and Towns Manage Infrastructure, Support New Businesses, Spur Innovation, and Attract Talent & Investment



76% of Oklahomans live in Municipalities



91% of STATE sales tax is generated from sales within Municipalities



80% of Oklahoma citizens & businesses receive water from Municipal Water Sources

Issues In Municipal Revenue

- Oklahoma is the “only” state where cities and towns do not receive “ad valorem” money for general operations
- 150 sales tax exemptions currently on the books with new ones introduced every legislative session
- Internet/Catalog “Tax Haven”: \$81.5 million loss to the state and \$66.7 million loss to local entities in 2015
- Sales tax is a volatile source of revenue
- Now Counties have sales tax option (76 of 77)
- Municipal Sales tax earmarked for local schools, hospitals, economic development, colleges
- Consumers switching to untaxed Internet sales

Motor Vehicle Fees

32.5%* of miles driven in Oklahoma are within municipalities, yet cities and towns only receive 3.1% of the motor vehicle fees.



For every \$1.00 in motor vehicle fees



Municipalities receive just over \$.03

* DOT 2016

“I certainly believe the people should have an opportunity to voice their opinion about using alternative revenue streams other than sales tax exclusively. It is just too vulnerable a source. I would like to see the state constitution amended to allow people to at least vote on it.”

“Internet sales have had a serious impact on our cities’ ability to grow our sales tax in order to maintain necessary services. We cannot change that without the federal government’s blessing to Oklahoma’s legislators to allow Internet sales tax to be collected.”

-Mayor Dewey Bartlett, Tulsa

“Cities shouldn’t be so reliant on sales tax. It affects our planning. If you see a Wal-Mart on this side of the street or that side of the street, it greatly affects a particular municipality. We’re going to get to a point here where the municipalities that have a Wal-Mart are going to make it and the ones that don’t are not going to make it.”

“When you see that we spend two-thirds of our tax dollars on police and fire service, it becomes a public safety issue. Oklahoma cities are too reliant on sales tax. We need a way to figure out some sort of revenue neutral, I am not saying we need more money, I am just saying it needs to be derived from different sources.”

- Mayor Mick Cornett, OKC



Champions For Effective Local Government

Updated November 10, 2015

Sales Tax on Services Makes Sense

Howard G. Barnett, Jr., President Oklahoma State University – Tulsa

In 2002, I co-chaired, with Dr. Don Davis (then President of Cameron University and a former legislator), a task force known as the Legislative and Citizen Task Force on Tax Reform. This task force was created by the joint action of Governor Frank Keating, Senate President Pro Tem Stratton Taylor and Speaker of the House Larry Adair. In addition to Don and



myself (I was then Chief of Staff to Governor Keating), the task force was composed of 8 legislators, 4 from each house, 2 of which were from each party, appointed by their respective legislative leaders. These legislators came from across the political spectrum from the most liberal (e.g. Senator Cal Hobson and Representative Debby Blackburn) to the most conservative (e.g. Senator James Williamson and Representative Forest Claunch).

In addition there were 20 private citizens from across the state representing our large cities (e.g. Russell Perry from Oklahoma City and Jody Parker from Tulsa) as well as our rural communities (e.g. Ford Drummond from Pawhuska, Jimmy Harrell from Elk City and John Massey from Durant). My examples also show the geographic dispersion of the members of the Task Force. And, needless to say, they also represented a cross section of businesses, from banking to accounting to car dealers.

Our charge from the three leaders was as follows: "...your task is to determine whether or not the State's tax policy can be modified in such a way that would stimulate economic growth while still maintaining the current level of revenues, and if so, to recommend specific modifications that would accomplish that goal."

The ultimate focus of our report, delivered to the legislature and the Governor on April 12, 2002, after many meetings and significant input from the public (all of our meetings were open to the public and each meeting allotted time for comments from the audience), was on low-

ering the income tax rate which was determined to be a burden on economic progress, particularly the fact that our full then 7% income tax rate fell on capital gains which the task force believed led to significant capital flight (this problem has been mostly taken care of by the elimination of state capital gains tax on Oklahoma based property that has been held for a specific pe-

riod of time). But what is important today is that the task force unanimously agreed that the state sales tax could be extended to certain services without materially impacting economic growth and our state's prosperity

These are admittedly different times. As mentioned above, one of the drivers of the task force proposals was the state capital gains tax, which has been largely done away with on Oklahoma based property, which was the concern then (I note, however, that a recent study claimed that this has had little positive economic impact and there is a move to eliminate this exemption. I am skeptical as our task force members were adamant and came with many examples of capital flight). Also, our proposal lowered the income tax to 4.5%, so today's 5% rate is not materially different from where we wanted to go. However, the elimination and lowering of these taxes has not been offset by either new revenue streams or the hoped for economic growth that they were intended to stimulate. Thus, it is my view that reconsidering the proposals of the task force that the cuts in income taxes must be offset by new revenue streams seems particularly relevant today.

In one sense, what the legislature has done since our report was issued is adopt many of the tax cuts we recommended without adopting the revenue raising measures we also recommended. Now is the time to rectify that problem.

While it may be coincidence, the taxes the task force recommended raising were similar to those being dis-

cussed in the legislature and by the Governor today. While the numbers are different, we recommended offsetting the revenue lost from lowering the income tax rate (plus eliminating a few other taxes such as the corporate franchise tax – but the big number to be replaced came from the lower rates on income and capital gains), with higher taxes on motor fuels and cigarettes (which was done last session) as well as the extension of the sales tax to certain services.

In looking at what services to tax, we adhered to several principles which I believe are still appropriate today:

1. Services primarily consumed by higher income individuals should be the primary ones charged to individuals. It is almost axiomatic that the consumption of services increases as income increases. Some obvious examples are lawn care services, home cleaning services and dry cleaning services (I am not privy to what if any of the services I mention here might already have been taxed by subsequent legislatures and I offer these only as examples).

2. Services delivered in connection with the sale of goods that are already subject to sales tax could be taxed. The best example of this might be car repairs where the replacement parts are subject to sales tax but the labor to install them is not (again, this was as of 2002). To the consumer this is one transaction.

3. Services consumed primarily by businesses where appropriate. In today's political environment I would add that a better approach might be to tax services consumed by business where the service is a very small part of a larger project (such as engineering services for the construction of a building) and, thus, the demand for the service should be unaffected, or where the demand for the service is otherwise inelastic such as credit reporting services.

4. The sales tax would exempt exported services and government purchases and a use tax would be imposed on imported services. We assumed that most imported services would be those consumed by business (since most of the individual ones would likely be local in

nature as with the examples above) and businesses are always better at paying use taxes than individuals.

5. The legislature was urged to be precise in defining the services to be taxed to ensure that an intended exempt service is not inadvertently included with one subject to tax, which can occur when multiple services are bundled in one transaction.

6. While we recognized the additional burden this might put on some small businesses, we noted that small retailer now collect and remit sales taxes and the technology today is even easier than in 2002.

For the tax on individuals, it was important that we recognize that for many of the services the task force recommended for taxation, people have a choice on the timing of those purchases or even to not pay for the service and choose to do the work themselves. I highly recommend that you read the entire report and review the extensive list of services listed in Appendix B to get a feel for these issues. A copy of the full report of the task force can be found at: <http://digitalprairie.ok.gov/cdm/ref/collection/stgpub/id/395328>.

I would note that extending sales taxes to services could allow municipalities to vote to extend their own sales taxes to some or all of the services taxed by the state (I would recommend that it require a vote of the people in the town or county) and this could go a long way toward relieving some of the financial stress on local governments.

In conclusion, I firmly believe that if Oklahoma does not recognize that we have a revenue problem (as many legislators did last session) and not a spending problem (I do not claim that state government – particularly higher education where I live – is the most efficient in the world or that more savings can't be rung from the system, but after five or more successive years of budget cuts, it is certainly significantly more efficient than it was and additional savings though efficiencies are harder and harder to find). Personally, I see the sales tax on services as being truly low hanging fruit that can be harvested without a significant impact on our economy or our citizens.

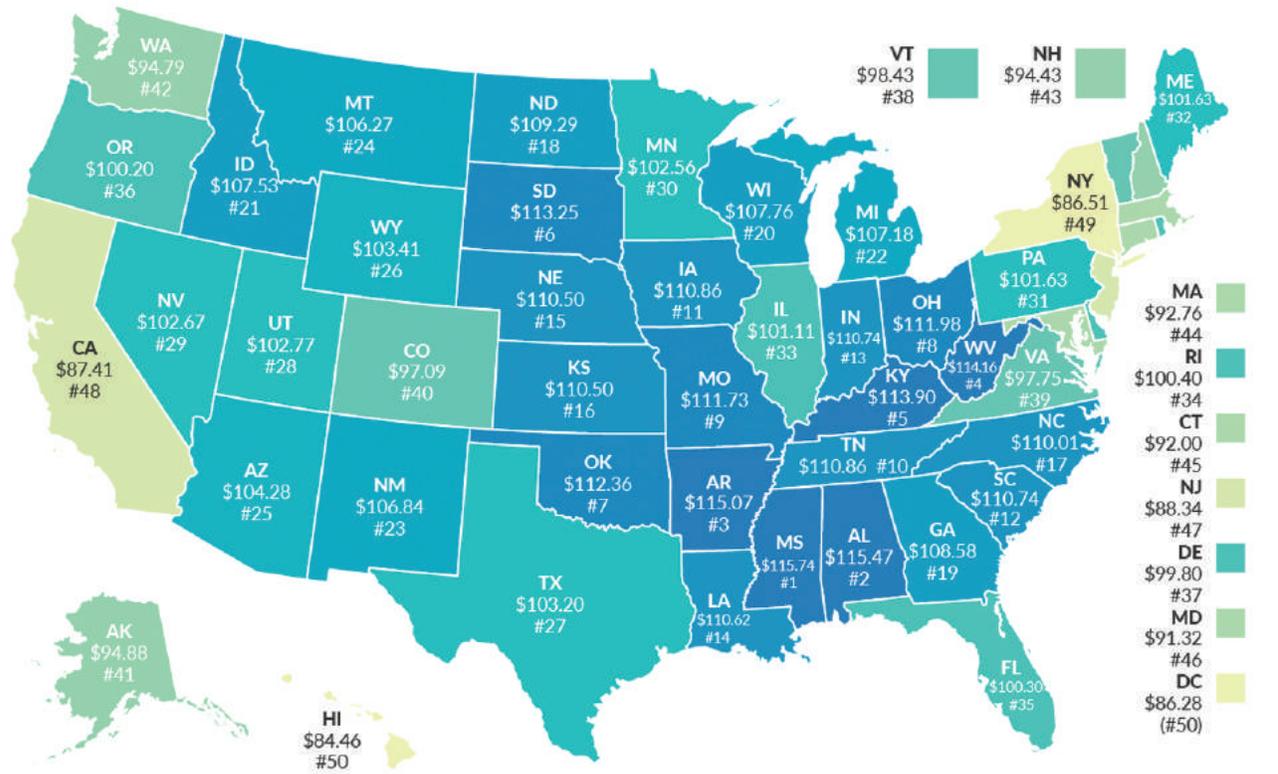
(b. 14)

What Is the Real Value of \$100 in Your State?

Erica York, The Tax Foundation, August 15, 2018

The Relative Value of \$100

Which State Offers The Biggest Bang For Your Buck?



Notes: Numbers represent value of goods that \$100 dollars can buy in each state compared to the national average. The Bureau of Economic Analysis has developed a methodology using Personal Consumption Expenditure and American Community Survey data to estimate average price levels in each state for household consumption, including rental housing costs. D.C.'s rank does not affect states' ranks, but the figure in parentheses indicates where it would rank if included. Data is as of 2016.

Source: U.S. Bureau of Economic Analysis, *Regional Price Parities*.



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This map shows the real value of \$100 in each state. Prices for the same goods are often much cheaper in states like Missouri or Ohio than they are in states like New York or California. As a result, the same amount of cash can buy you comparatively more in a low-price state than in a high-price state.

The U.S. Bureau of Economic Analysis has been measuring this phenomenon for three years now; it recently published its data for prices in 2016. Using this data, we have adjusted the value of \$100 to show how much it buys you in each state.

For example, South Dakota is a low-price state. There,

\$100 will buy you goods that would cost \$113.25 in a state at the national average price level. You could think of this as meaning that South Dakotans are, for the purposes of day-to-day living, 13 percent richer than their incomes suggest.

The states where \$100 is worth the most are Mississippi (\$115.74), Alabama (\$115.47), Arkansas (\$115.07), West Virginia (\$114.16), and Kentucky (\$113.90). In contrast, \$100 is effectively worth the least in Hawaii (\$84.46), the District of Columbia (\$86.28), New York (\$86.51), California (\$87.41), and New Jersey (\$88.34). See the table at the bottom of this post for a ranking of all 50 states.

Regional price differences are strikingly large; real purchasing power is 34 percent greater in Mississippi than it is in New York. In other words, by this measure, if you have \$50,000 in after-tax income in Mississippi, you would need after-tax earnings of \$67,000 in New York just to afford the same overall standard of living.

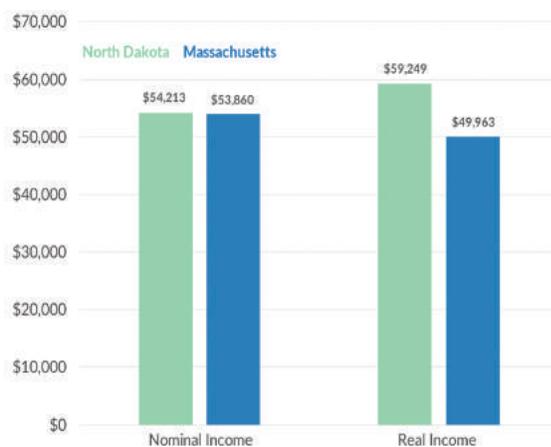
It's generally the case that states with higher nominal incomes also have higher price levels. This is because in places with higher incomes, the prices of finite resources like land get bid up. (This is especially true in cities.) What is also true is that places with high costs of living pay higher salaries for the same jobs. This is what labor economists call a compensating differential; the higher pay is offered in order to make up for the low purchasing power.

This relationship is important, although it does not always hold true. Some states, like North Dakota, have high incomes without high prices. Adjusting incomes for price level can substantially change our perceptions of which states are truly poor or rich.

For example, residents of Massachusetts and North Dakota earn approximately the same amount in dollars per capita, but after adjusting for regional price parity, North

North Dakota Has Higher Average Income than Massachusetts after Adjusting for Purchasing Power

Real Purchasing Power of Per Capita Personal Income in North Dakota and Massachusetts.



Note: Real incomes are in chained 2009 dollars and adjusted for regional price parity. Source: U.S. Bureau of Economic Analysis, Regional Price Parities.

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Dakotan incomes can buy more.

This has substantial implications for public policy, which is often progressive with respect to income. Many policies—like minimum wage, public benefits, and tax brackets—are denominated in dollars. But with different price levels in each state, the amounts aren't equivalent in purchasing power.

Regional Price Parities by State, 2016

State	Relative Value of \$100	Rank
Mississippi	\$115.74	1
Alabama	\$115.47	2
Arkansas	\$115.07	3
West Virginia	\$114.16	4
Kentucky	\$113.90	5
South Dakota	\$113.25	6
Oklahoma	\$112.36	7
Ohio	\$111.98	8
Missouri	\$111.73	9
Iowa	\$110.86	11
Tennessee	\$110.86	10
Indiana	\$110.74	13
South Carolina	\$110.74	12
Louisiana	\$110.62	14
Kansas	\$110.50	16
Nebraska	\$110.50	15
North Carolina	\$110.01	17
North Dakota	\$109.29	18
Georgia	\$108.58	19
Wisconsin	\$107.76	20
Idaho	\$107.53	21
Michigan	\$107.18	22
New Mexico	\$106.84	23
Montana	\$106.27	24
Arizona	\$104.28	25
Wyoming	\$103.41	26
Texas	\$103.20	27
Utah	\$102.77	28
Nevada	\$102.67	29
Minnesota	\$102.56	30
Maine	\$101.63	32
Pennsylvania	\$101.63	31
Illinois	\$101.11	33
Rhode Island	\$100.40	34
Florida	\$100.30	35
Oregon	\$100.20	36
Delaware	\$99.80	37
Vermont	\$98.43	38
Virginia	\$97.75	39
Colorado	\$97.09	40
Alaska	\$94.88	41
Washington	\$94.79	42
New Hampshire	\$94.43	43
Massachusetts	\$92.76	44
Connecticut	\$92.00	45
Maryland	\$91.32	46
New Jersey	\$88.34	47
California	\$87.41	48
New York	\$86.51	49
District of Columbia	\$86.28	(50)
Hawaii	\$84.46	50

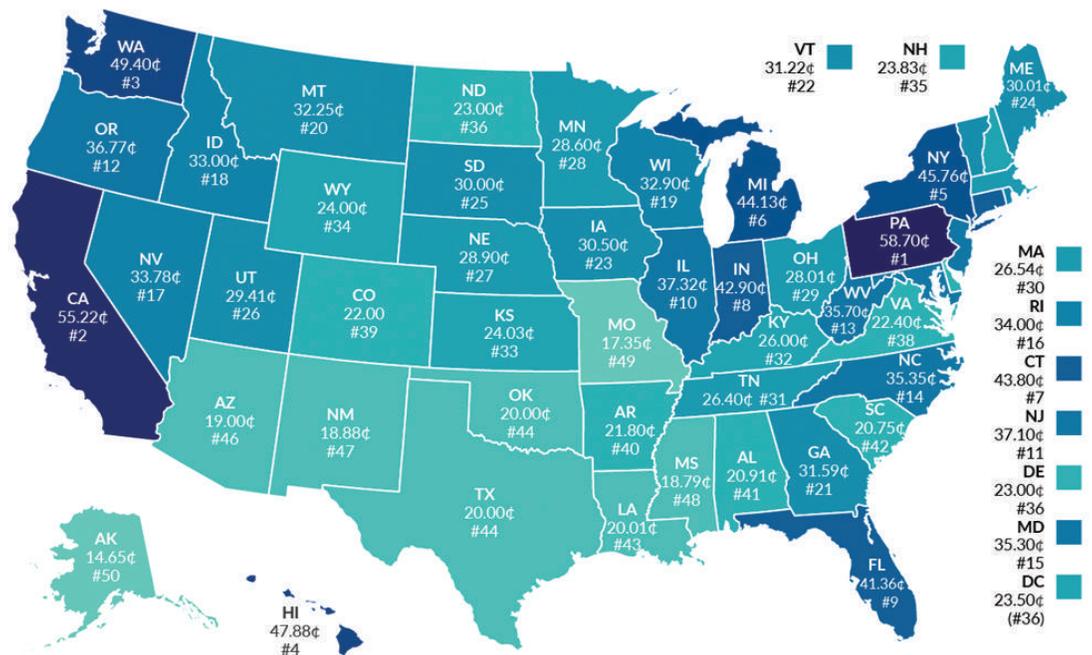
Source: U.S. Bureau of Economic Analysis Note: D.C.'s rank does not affect states' ranks, but the figure in parenthesis indicates where it would rank if included.

State Gasoline Tax Rates as of July 2018

Katherine Loughead, The Tax Foundation, August 8, 2018

How High Are Gas Taxes in Your State?

Total State Taxes and Fees on Gasoline, as of July 2018 (cents per gallon)



Notes: These rates do not include the 18.40 cent/gallon federal excise tax on gas. The American Petroleum Institute (API) has developed a methodology for determining the average tax rate on a gallon of fuel. Rates may include any of the following: excise taxes, environmental fees, storage tank taxes, other fees or taxes, and general sales tax. In states where gasoline is subject to the general sales tax, or where the fuel tax is based on the average sale price, the average rate determined by API is sensitive to changes in the price of gasoline. States that fully or partially apply general sales taxes to gasoline are California, Connecticut, Georgia, Illinois, Indiana, Michigan, and New York. D.C.'s rank does not affect states' ranks, but the figure in parentheses indicates where it would rank if included.

Source: American Petroleum Institute.



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Today's map shows gasoline tax rates in each state as of July 2018, using recently released data from the American Petroleum Institute.

States levy gas taxes in a variety of ways, including per-gallon excise taxes collected at the pump, excise taxes imposed on wholesalers and passed along to consumers in the form of higher prices, and sales taxes that apply to the purchase of gasoline. The American Petroleum Institute has developed a methodology to account for these different approaches and calculate the average tax rate on a gallon of gasoline in each state. These rates vary widely from state to state and are shown in the map.

Pennsylvania's gas tax rate is highest at 58.7 cents per gallon, followed by California (55.22 cpg) and Washington (49.4 cpg). The lowest gas tax rate is found in Alaska at 14.65 cents per gallon, followed by Missouri (17.35 cpg) and Mississippi (18.79).

While gas taxes tend to be politically unpopular, they are a

relatively good embodiment of the "benefit principle," or the idea in public finance that the taxes a person pays should relate to the benefits received. In general, drivers benefit from the government services that are funded by their gas tax dollars, including road construction, maintenance, and repair. By connecting the costs of road upkeep with the act of driving, gas taxes incentivize efficient road use, which helps mitigate congestion and wear and tear attributable to overuse.

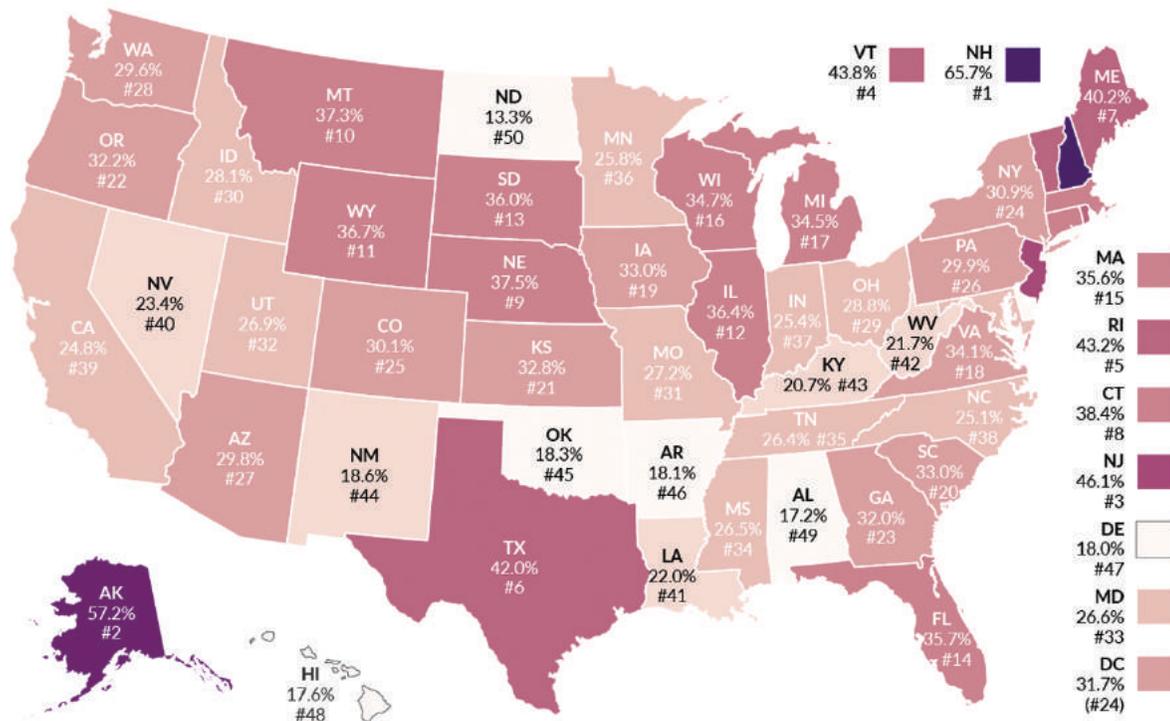
Because they adhere to the benefit principle, gas taxes and other user taxes and fees are the revenue tools most suitable for generating the funds needed to maintain and repair public roads over time. One of the primary issues with federal and state gas taxes, however, is that they are not indexed for inflation, meaning the nominal value of revenue generated from the gas tax isn't keeping pace with infrastructure funding needs across the country. Indexing gas taxes for inflation is one of the most important actions states can take to create a more stable source of revenue to fund infrastructure maintenance and repair needs for years to come, and to avoid leaning on less suitable taxes to maintain roads and bridges.

To What Extent Does Your State Rely on Property Taxes?

Ben Strachman and Katherine Loughead, *The Tax Foundation*, June 20, 2018

To What Extent Does Your State Rely on Property Taxes?

Property Tax Collections As a Percent of Total State and Local Tax Collections, FY 2015



Source: Census Bureau; Tax Foundation calculations.



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Property taxes represent a major source of revenue for states and localities. In fiscal year 2015, the latest year of data available, 31.1 percent of total U.S. state and local tax collections came from property taxes, more than any other source of tax revenue. In the same year, 25 states and the District of Columbia raised the greatest share of their tax revenue from property taxes.

A variety of local political subdivisions have authority to set property tax rates, including counties, cities, school boards, fire departments, and utility commissions. While most tax jurisdictions levy property taxes based on the fair market value of a property, some base the property tax rate on income potential or other factors. In addition, some states place limits on the extent to which property tax rates may increase per year or impose rate adjustments to achieve uniformity throughout the state.

In FY 2015, New Hampshire and Alaska relied most heavily

on property taxes, at 65.7 percent and 57.2 percent of their tax collections, respectively, while North Dakota and Alabama raised the smallest portion of their state and local tax revenue through property taxes, at 13.3 percent and 17.2 percent, respectively.

It is important to note that a heavy reliance on property taxes does not necessarily indicate a high overall tax burden in any given state. For example, while Alaska is among the states that rely most heavily on property taxes, it is also among the states with the lowest state and local tax collections per capita.

At the same time, states and localities that generate less revenue through property taxes tend to depend more on general sales taxes, individual and corporate income taxes, excise taxes, and others. For example, North Dakota derives much of its tax revenue from severance taxes while generating relatively little revenue from property taxes.

State and Local Sales Tax Rates, Midyear 2018

Jared Walczak and Scott Drenkard, *The Tax Foundation*, July 16, 2018

Retail sales taxes are one of the more transparent ways to collect tax revenue. While graduated income tax rates and brackets are complex and confusing to many taxpayers, sales taxes are easier to understand; consumers can see their tax burden printed directly on their receipts.

In addition to state-level sales taxes, consumers also face local sales taxes in 38 states. These rates can be substantial, so a state with a moderate statewide sales tax rate could actually have a very high combined state and local rate compared to other states. This report provides a population-weighted average of local sales taxes as of July 1, 2018, in an attempt to give a sense of the average local rate for each state. Table 1 provides a full state-by-state listing of state and local sales tax rates.

Combined Rates

Five states do not have statewide sales taxes: Alaska, Delaware, Montana, New Hampshire, and Oregon. Of these, Alaska allows localities to charge local sales taxes.

The five states with the highest average combined state and local sales tax rates are Tennessee (9.46 percent), Louisiana (9.45 percent), Arkansas (9.42 percent), Washington (9.19 percent), and Alabama (9.15 percent). The five states with the lowest average combined rates are Alaska (1.43 percent), Hawaii (4.35 percent), Wyoming (5.39 percent), Wisconsin (5.44 percent), and Maine (5.50 percent).

State Rates

California has the highest state-level sales tax rate, at 7.25 percent. Four states tie for the second-highest statewide rate, at 7 percent: Indiana, Mississippi, Rhode Island, and

Tennessee. The lowest non-zero, state-level sales tax is in Colorado, which has a rate of 2.9 percent. Five states follow with 4 percent rates: Alabama, Georgia, Hawaii, New York, and Wyoming.

Only Louisiana changed its state rate since January, reducing the rate from 5.0 to 4.45 percent. The former 5.0 percent rate was the product of a temporary one percentage point rate increase, due to expire (bringing the rate to 4.0 percent) at the end of fiscal year 2018. In special session, lawmakers voted to extend a portion of what is known in the state as the “clean penny,” resulting in a new state rate of 4.45 percent. High local rates yield a combined rate of

9.45 percent in the state, with the 0.55 percentage point reduction in the state rate and an 0.03 percentage point reduction in the local rate just enough to drop Louisiana below Tennessee (9.46 percent combined rate) for the highest combined rate in the country.

Local Rates

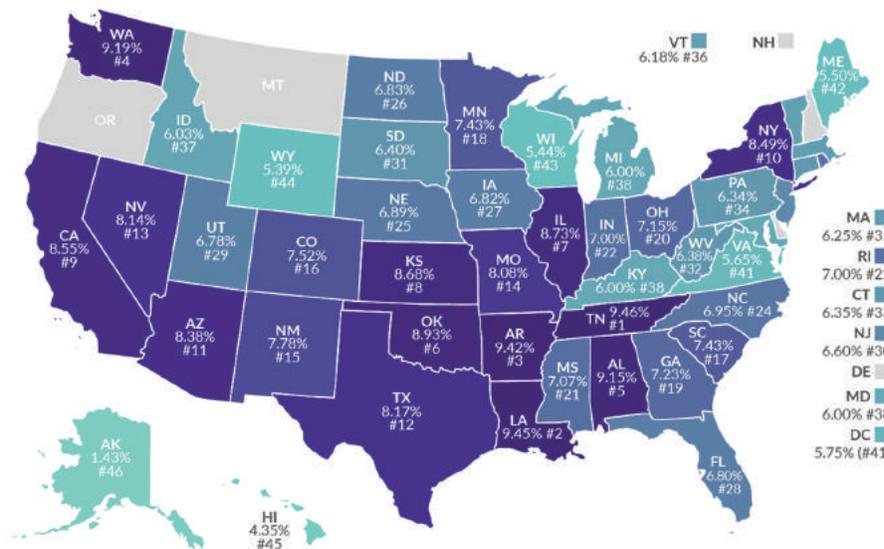
The five states with the highest average local sales tax rates are Alabama (5.15 percent), Louisiana (5.00 percent), Colorado (4.62 percent), New York (4.49 percent), and Oklahoma (4.43 percent). Average

local rates rose the most in California, led by a one percentage point increase in the sales tax rate in Santa Barbara County in April, along with rate increases in other local jurisdictions. In Alaska, where only local governments may impose sales taxes, several additional localities implemented a tax.

It must be noted that some cities in New Jersey are in “Urban Enterprise Zones,” where qualifying sellers may collect and remit at half the 6.625 percent statewide sales

How High Are Sales Taxes in Your State?

Combined State & Average Local Sales Tax Rates, July 1 2018



Note: City, county, and municipal rates vary. These rates are weighted by population to compute an average local tax rate. Three states levy mandatory, statewide, local add-on sales taxes at the state level: California (1.25%), Utah (1.25%), and Virginia (1%); we include these in their state sales tax. The sales taxes in Hawaii, New Mexico, North Dakota, and South Dakota have broad bases that include many services. This map does not include sales taxes in local resort areas in Montana. Salem County is not subject to the statewide sales tax rate and collects a local rate of 3.3125%. New Jersey's average local score is represented as a negative.

Source: Sales Tax Clearinghouse, Tax Foundation calculations, State Revenue Department websites

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tax rate (3.3125 percent), a policy designed to help local retailers compete with neighboring Delaware, which forgoes a sales tax. We represent this anomaly as a negative 0.03 percent statewide average local rate (adjusting for population as described in the methodology section below), and the combined rate reflects this subtraction. Despite the slightly favorable impact on the overall rate, this lower rate represents an implicit acknowledgment by New Jersey officials that their 6.625 percent statewide rate is uncompetitive with neighboring Delaware, which has no sales tax.

The Role of Competition in Setting Sales Tax Rates
Avoidance of sales tax is most likely to occur in areas where there is a significant difference between two jurisdictions' sales tax rates. Research indicates that consumers can and do leave high-tax areas to make major purchases in low-tax areas, such as from cities to suburbs. For example, evidence suggests that Chicago-area consumers make major purchases in surrounding suburbs or online to avoid Chicago's 10.25 percent sales tax rate.

At the statewide level, businesses sometimes locate just outside the borders of high sales-tax areas to avoid being subjected to their rates. A stark example of this occurs in New England, where even though I-91 runs up the Vermont side of the Connecticut River, many more retail establishments choose to locate on the New Hampshire side to avoid sales taxes. One study shows that per capita sales in border counties in sales tax-free New Hampshire have tripled since the late 1950s, while per capita sales in border counties in Vermont have remained stagnant. The state of Delaware actually uses its highway welcome sign to remind motorists that Delaware is the "Home of Tax-Free Shopping."

State and local governments should be cautious about raising rates too high relative to their neighbors because doing so will yield less revenue than expected or, in extreme cases, revenue losses despite the higher tax rate.

Sales Tax Bases: The Other Half of the Equation

This report ranks states based on tax rates and does not account for differences in tax bases (e.g., the structure of sales taxes, defining what is taxable and nontaxable). States can vary greatly in this regard. For instance, most states exempt groceries from the sales tax, others tax groceries at a limited rate, and still others tax groceries at the same rate as all other products. Some states exempt clothing or tax it at a reduced rate.

Tax experts generally recommend that sales taxes apply to all final retail sales of goods and services but not inter-

mediate business-to-business transactions in the production chain. These recommendations would result in a tax system that is not only broad-based but also "right-sized," applying once and only once to each product the market produces. Despite agreement in theory, the application of most state sales taxes is far from this ideal.

Hawaii has the broadest sales tax in the United States, but it taxes many products multiple times and, by one estimate, ultimately taxes 105.08 percent of the state's personal income. This base is far wider than the national median, where the sales tax applies to 34.25 percent of personal income.

Methodology

Sales Tax Clearinghouse publishes quarterly sales tax data at the state, county, and city levels by ZIP code. We weight these numbers according to U.S. Census Bureau 2010 population figures in an attempt to give a sense of the prevalence of sales tax rates in a particular state.

It is worth noting that population numbers are only published at the ZIP code level every 10 years by the Census Bureau, and that editions of this calculation published before July 1, 2011, do not utilize ZIP code data and are thus not strictly comparable.

It should also be noted that while the Census Bureau reports population data using a five-digit identifier that looks much like a ZIP code, this is actually what is called a ZIP Code Tabulation Area (ZCTA), which attempts to create a geographical area associated with a given ZIP code. This is done because a surprisingly large number of ZIP codes do not actually have any residents. For example, the National Press Building in Washington, D.C., has its own ZIP code solely for postal reasons.

For our purposes, ZIP codes that do not have a corresponding ZCTA population figure are omitted from calculations. These omissions result in some amount of inexactitude but overall do not have a palpable effect on resultant averages because proximate ZIP code areas which do have ZCTA population numbers capture the tax rate of those jurisdictions.

Conclusion

Sales taxes are just one part of an overall tax structure and should be considered in context. For example, Tennessee has high sales taxes but no wage income tax, whereas Oregon has no sales tax but high income taxes. While many factors influence business location and investment decisions, sales taxes are something within policymakers' control that can have immediate impacts.

State and Local Sales Tax Rates as of July 1, 2018

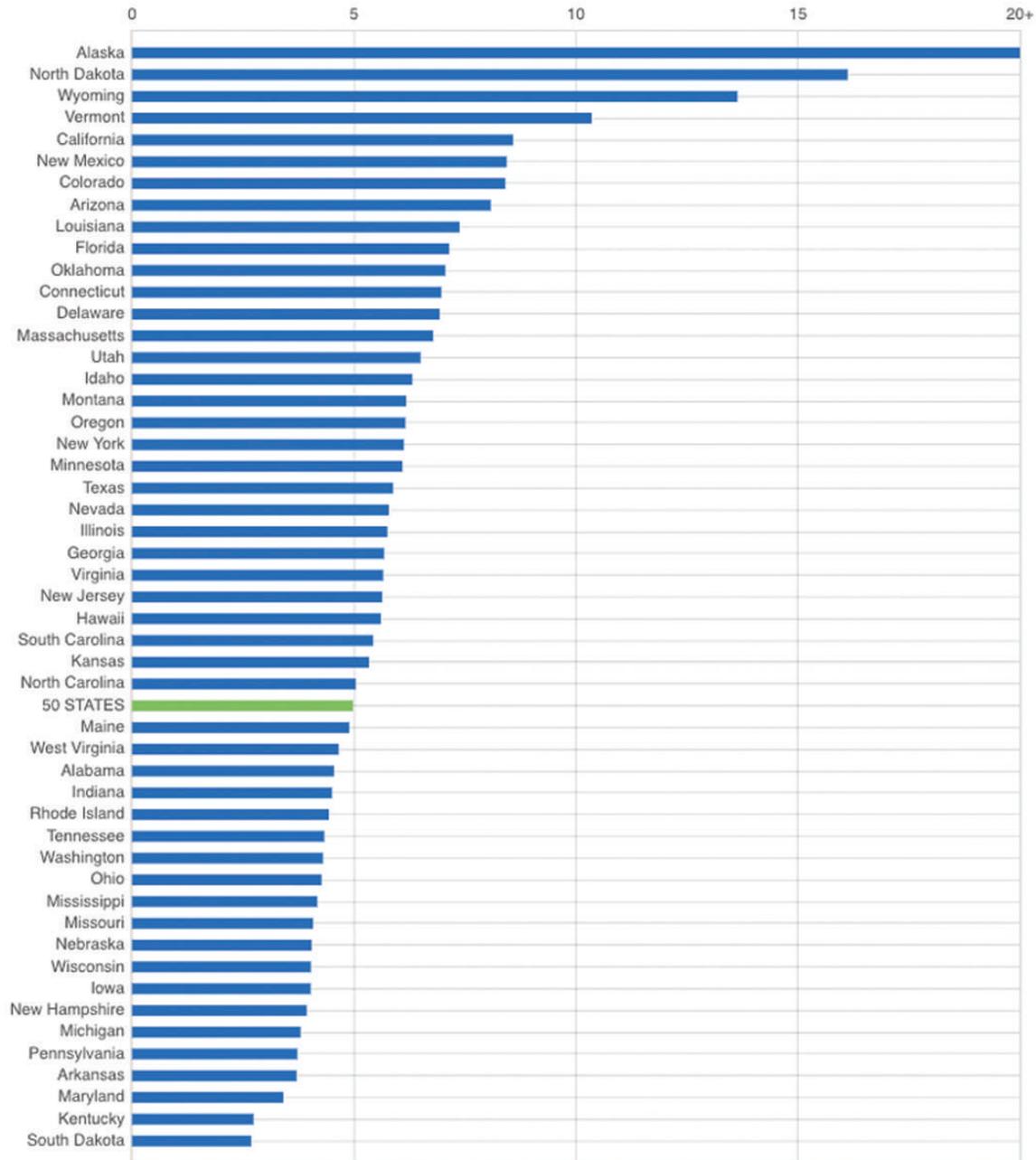
State	State Tax Rate	Rank	Avg. Local Tax Rate (a)	Combined Rate	Combined Rank	Max Local Tax Rate
Alabama	4.00%	40	5.15%	9.15%	5	7.50%
Alaska	0.00%	46	1.43%	1.43%	46	7.50%
Arizona	5.60%	28	2.78%	8.38%	11	5.60%
Arkansas	6.50%	9	2.92%	9.42%	3	5.13%
California (b)	7.25%	1	1.30%	8.55%	9	2.50%
Colorado	2.90%	45	4.62%	7.52%	16	8.30%
Connecticut	6.35%	12	0.00%	6.35%	33	0.00%
Delaware	0.00%	46	0.00%	0.00%	47	0.00%
Florida	6.00%	16	0.80%	6.80%	28	2.00%
Georgia	4.00%	40	3.23%	7.23%	19	4.90%
Hawaii (c)	4.00%	40	0.35%	4.35%	45	0.50%
Idaho	6.00%	16	0.03%	6.03%	37	3.00%
Illinois	6.25%	13	2.48%	8.73%	7	4.75%
Indiana	7.00%	2	0.00%	7.00%	22	0.00%
Iowa	6.00%	16	0.82%	6.82%	27	1.00%
Kansas	6.50%	9	2.18%	8.68%	8	4.00%
Kentucky	6.00%	16	0.00%	6.00%	38	0.00%
Louisiana	4.45%	38	5.00%	9.45%	2	7.00%
Maine	5.50%	29	0.00%	5.50%	42	0.00%
Maryland	6.00%	16	0.00%	6.00%	38	0.00%
Massachusetts	6.25%	13	0.00%	6.25%	35	0.00%
Michigan	6.00%	16	0.00%	6.00%	38	0.00%
Minnesota	6.875%	6	0.55%	7.43%	18	2.00%
Mississippi	7.00%	2	0.07%	7.07%	21	1.00%
Missouri	4.225%	39	3.86%	8.08%	14	5.45%
Montana (d)	0.00%	46	0.00%	0.00%	47	0.00%
Nebraska	5.50%	29	1.39%	6.89%	25	2.00%
Nevada	6.85%	7	1.29%	8.14%	13	1.42%
New Hampshire	0.00%	46	0.00%	0.00%	47	0.00%
New Jersey (e)	6.625%	8	-0.03%	6.60%	30	3.31%
New Mexico (c)	5.125%	32	2.65%	7.78%	15	4.13%
New York	4.00%	40	4.49%	8.49%	10	4.88%
North Carolina	4.75%	35	2.20%	6.95%	24	2.75%
North Dakota	5.00%	33	1.83%	6.83%	26	3.50%
Ohio	5.75%	27	1.40%	7.15%	20	2.25%
Oklahoma	4.50%	36	4.43%	8.93%	6	6.50%
Oregon	0.00%	46	0.00%	0.00%	47	0.00%
Pennsylvania	6.00%	16	0.34%	6.34%	34	2.00%
Rhode Island	7.00%	2	0.00%	7.00%	22	0.00%
South Carolina	6.00%	16	1.43%	7.43%	17	3.00%
South Dakota (c)	4.50%	36	1.90%	6.40%	31	4.50%
Tennessee	7.00%	2	2.46%	9.46%	1	2.75%
Texas	6.25%	13	1.92%	8.17%	12	2.00%
Utah (b)	5.95%	26	0.83%	6.78%	29	2.65%
Vermont	6.00%	16	0.18%	6.18%	36	1.00%
Virginia (b)	5.30%	31	0.35%	5.65%	41	0.70%
Washington	6.50%	9	2.69%	9.19%	4	3.90%
West Virginia	6.00%	16	0.38%	6.38%	32	1.00%
Wisconsin	5.00%	33	0.44%	5.44%	43	1.75%
Wyoming	4.00%	40	1.39%	5.39%	44	2.00%
D.C.	5.75%	(27)	0.00%	5.75%	(41)	0.00%

Tax Revenue Volatility Varies Across States, Revenue Streams

Mary Murphy, Akshay Iyengar & Alexandria Zhang, *The Pew Charitable Trusts*, August 29, 2018

Tax Revenue Volatility, FY 1998-2017

Higher values indicate greater volatility.



Pew's calculation of volatility scores is based on data from the U.S. Census Bureau's *State Government Tax Collections historical data series for 1997 to 2017*, accessed June 27, 2018, and the National Conference of State Legislatures' "State Tax Actions" reports for 1997 to 2016, accessed in April 2018.

Swings in energy prices in recent years have contributed to greater tax revenue volatility in several states. Tax revenue fluctuations are often greatest in natural resource-dependent economies, but occur to varying degrees in all states, creating unpredictability that can confound lawmakers' efforts to balance budgets. Over the past two decades, Alaska faced the greatest tax revenue volatility, and South Dakota the

least, not counting changes caused by tax policy. Revenue volatility differs across states because each relies on a unique mix of tax streams. Individual tax streams experience different fluctuations from year to year, contributing to a state's overall revenue volatility. Between fiscal years 1998 and 2017, severance taxes on oil and minerals and corporate income taxes were consistently more vola-

tile than other major state taxes, such as those on personal income and sales of goods and services.

Although states can raise or lower tax revenue by changing tax policies, the underlying volatility of individual tax streams is often driven by a variety of factors, many outside policymakers' control. These include economic factors—such as the mix of industry, natural resources, workforce, and population growth—as well as federal budget changes and unforeseen events, such as natural disasters. For example, seesawing energy prices led to more volatile severance tax revenue in fiscal 2017 among seven of the nine states where it was a major levy.

In this analysis, The Pew Charitable Trusts removes the estimated effect of state tax policy changes to calculate a volatility score for the underlying trends in each state's overall tax revenue and major taxes—those that account for at least 5 percent of its tax revenue on average over the past decade. The scores measure the variation in year-over-year percent changes between fiscal 1998 and 2017, based on a calculation of standard deviation. A low score means that revenue levels were similar from year to year, and a high score indicates that revenue grew or declined more dramatically.

Nationwide, overall state tax revenue had a volatility score of 5.0 for the 20 years ending in fiscal 2017, unchanged from 2016's score. This means that total tax revenue across the states typically fluctuated 5.0 percentage points above or below its overall growth trend. Tax revenue was more volatile than the national benchmark in 30 states and less so in 20 states.

State highlights

- The highest volatility occurred in Alaska (37.6 percentage points), North Dakota (16.1), and Wyoming (13.6).
- Kentucky and South Dakota saw the lowest volatility (both 2.7). Both states rely on relatively stable tax streams for over half of their revenue—sales for South Dakota, and sales and personal income for Kentucky.
- Volatility scores rose in 23 states for the 20-year period through fiscal 2017, compared with scores based on the period from fiscal 1997 to 2016, though many of the increases were small enough to be obscured by rounding. North Dakota and Wyoming experienced the greatest increases, driven by large swings in severance tax collections.
- Severance tax, which is highly dependent on global energy prices, was the most volatile revenue source in eight of the nine states where it accounted for enough revenue over the past decade to be considered a major tax. West Virginia was the exception. Volatility scores for severance tax ranged from 19.1 in West Virginia to 47.7 in Alaska. Severance tax volatility scores rose in seven states from 2016: Louisiana, Montana, New Mexico, North Dakota, Texas, West Virginia, and Wyoming.
- Corporate income tax revenue seesawed more than any other tax stream in 18 of the 22 states where it was a major tax. Volatility scores for this tax ranged from 10.5 in New Hampshire to 47.2 in Delaware.

- Broad-based personal income tax, collected in 41 states, and sales tax, collected in 45 states, were relatively less volatile revenue sources. Volatility scores ranged from 4.7 in West Virginia to 16.4 in North Dakota for personal income tax, and from 2.6 in Kentucky to 14.3 in Wyoming for sales tax.

In general, two factors work in tandem to influence a state's overall revenue volatility: how dramatically each tax stream changes from year to year and how heavily a state relies on each revenue source. Smaller tax streams can be highly volatile. But the more minor the tax source, the less of an impact it has on a state's overall revenue volatility.

For example, the three states with the highest overall scores—energy-rich Alaska, North Dakota, and Wyoming—collected the greatest share of their tax dollars over the past 10 years from highly volatile severance taxes. Yet Texas, the largest oil producer in the nation, ranked close to the middle of states for overall revenue volatility even though its severance tax revenue was more volatile than any but Alaska's. The crucial difference is that severance tax accounted for less than 10 percent of Texas' total tax collections over the past decade, compared with 67.3 percent of tax revenue in Alaska, 42.3 percent in North Dakota, and 37.6 percent in Wyoming.

Similarly, in the 22 states where corporate income tax was a major source of tax revenue, it was the most volatile major source in 18. However, its average share of total tax revenue was under 10 percent in 20 of these states.

Although volatility complicates the already difficult tasks of revenue forecasting and budgeting, it is not inherently bad. When receipts are higher than anticipated, states can improve roads and bridges, pay down debt, or build up reserves. But periods of unexpectedly high revenue may just as easily be followed by years of unanticipated low revenue that prompt spending cuts or tax increases to make ends meet.

By studying volatility, policymakers can better determine their own budgetary risk and put in place evidence-based savings strategies that harness tax growth in good years to cushion the lean years. These strategies include depositing one-time or above-average revenue into a rainy day fund and dedicating these balances to explicit, narrowly defined spending purposes. States can also reduce fiscal uncertainty by restricting spending from particularly volatile tax streams. Revenue from these streams could instead be deposited in longer-term savings accounts or sovereign wealth funds, as several natural resource-rich states do. These policies can help stabilize budgets and aid policymakers in planning for the long term.

Analysis by Mary Murphy, Akshay Iyengar, and Alexandria Zhang

(c. Sales Taxes)

Federal Revenue: Where Does the Money Come From

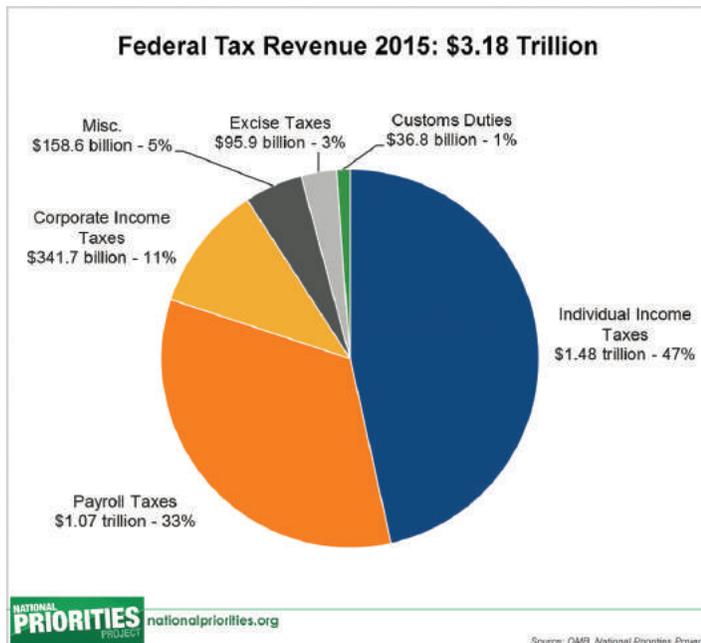
Federal Budget 101, Institute for Policy Studies

The federal government raises trillions of dollars in tax revenue each year, though a variety of taxes and fees. Some taxes fund specific government programs, while other taxes fund the government in general. When all taxes for a given year are insufficient to cover all of the government's expenses - which has been the case in 45 out of the last 50 years - the U.S. Treasury borrows money to make up the difference.

In 2015, total federal revenues in fiscal year 2015 are expected to be \$3.18 trillion. These revenues come from three major sources:

1. Income taxes paid by individuals: \$1.48 trillion, or 47% of all tax revenues.
2. Payroll taxes paid jointly by workers and employers: \$1.07 trillion, 34% of all tax revenues.
3. Corporate income taxes paid by businesses: \$341.7 billion, or 11% of all tax revenues.

There are also a handful of other types of taxes, like customs duties and excise taxes that make up much smaller portions of federal revenue. Customs duties are taxes on imports, paid by the importer, while excise taxes are taxes levied on specific goods, like gasoline. This pie chart below shows how much each of these revenue sources is expected to bring in during fiscal year 2015.



Once they are paid into the Treasury, income taxes and corporate taxes are designated as federal funds, while payroll taxes become trust funds. Federal funds are general revenues, meaning Congress and the president can decide to

spend them on just about anything when they conduct the annual appropriations process (see our explanation of the federal budget process). Unlike federal funds, trust funds can be used only to pay for specific programs. The vast majority of trust fund revenues pay for Social Security and Medicare.

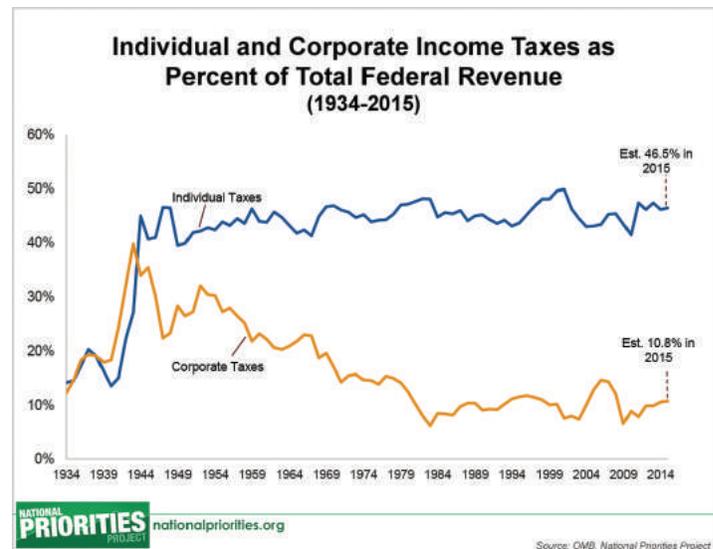
Income Taxes

The U.S. Constitution (Article I, Section 8) grants Congress the power to collect taxes. Early federal taxation was mostly in the form of excise taxes on goods such as alcohol and tobacco. Although an income tax existed briefly during the Civil War, it wasn't until 1913, with the ratification of the XVI Amendment to the Constitution, that income taxes became permanent. At that time fewer than 1 percent of people with the highest incomes paid income taxes.

Nowadays, more than 100 million American households file a federal tax return each year, and those income taxes make up the federal government's single largest revenue source. The income tax system is designed to be progressive. That is, the wealthy are meant to pay a larger percentage of their earnings than middle- or low-income earners. Due to the complexity of the tax code, however, this is not always the way it works out.

Corporate Taxes

Corporations pay income taxes similar to those paid by workers. Depending on how much profit a corporation makes, it pays a marginal tax rate anywhere from 15 to 35 percent. The top marginal tax rate for corporations, 35 percent, applies to taxable income over \$18.3 million. As you can see in the line chart below, individual income taxes make up a much larger share of all federal tax revenues than corporate taxes do, in part because the wages and salaries of all Americans are much larger than profits of all



U.S. corporations. The share of federal tax revenue paid by corporations has also declined substantially over time.

While the official tax rate for most corporations is 35 percent, the effective tax rate - that's the percentage of profits a corporation actually pays in taxes - varies enormously from one corporation to the next. That variation is the result of incredible complexity in the tax code as well as corporations' varying exploitation of "loopholes" to avoid tax liability. Loopholes refer to provisions in the tax code that exempt certain activities from regular taxation. For example, multinational corporations can allocate profits to overseas operations and reduce their tax liability by doing so. (For more about tax loopholes, see *The Big Money in Tax Breaks*.)

Payroll Taxes

While individual and corporate income taxes are designated as federal funds, as described above, payroll taxes are designated as trust funds. Trust funds can be used only for very specific purposes - mainly to pay for Social Security and Medicare. Social Security, officially called the Old Age, Survivors, and Disability Insurance program, is meant to ensure that elderly and disabled people do not live in poverty. Medicare is a federal program that provides health care coverage for senior citizens and the disabled.

Taxes to finance Social Security were established in 1935 as a payroll deduction - these are the payroll taxes you see taken directly out of your paycheck, labeled on pay stubs as Social Security and Medicare taxes or as "FICA," an abbreviation for the Federal Insurance Contributions Act. That's the law that mandates funding for Social Security by means of a payroll deduction.

The deductions from your paycheck are only half the story

of payroll taxes. Employees and employers each pay 6.2 percent of wages into Social Security and 1.45 percent into Medicare. That means your employer deducts 7.65 percent of your wages from your paycheck to contribute to those programs, and then your employer contributes an equal amount, though you never see documentation of your employer's contribution.

Borrowing

In most years, the federal government spends more money than it takes in from tax revenues. To make up the difference, the Treasury borrows money by issuing bonds. Anyone can buy Treasury bonds, and, in effect, lend money to the Treasury by doing so. In fiscal year 2015, the federal government is expected to borrow \$583 billion to make up the difference between \$3.18 billion in revenues and \$3.8 trillion in spending. Borrowing constitutes a major source of revenue for the federal government. Down the road, however, the Treasury must pay back the money it has borrowed, and pay interest as well. In 2015, the federal government will pay \$229 billion in interest on the national debt. For more on this topic, see *Federal Budget 101: Borrowing and the Federal Debt*.

Endnotes

Office of Management and Budget, Historical Table 1.

Office of Management and Budget, President's Budget for 2. Fiscal Year 2016, Budget Authority.

Internal Revenue Service, "Data Book 2014"

Internal Revenue Service, "Publication 542: Corporations," 14 Nov. 2013.

Citizens for Tax Justice, "The Sorry State of Corporate Taxes," February 2014.

Notes

**This is a resource document for you to use.
Take notes, highlight, use as a text book.**

(c. Diesel Fuel Tax)

REPORT: City budgets in an era of increased uncertainty

Michael A. Pagano and Christopher W. Hoene, Metropolitan Policy Program, July 18, 2018

Cities in the United States are likely to shoulder additional responsibilities during the Trump administration, as federal leaders seek to cut the federal budget and workforce and reduce regulatory authority in Washington. Yet cities' revenue sources and budgetary constraints vary greatly, shaping their ability to carry out new mandates or raise additional revenues. Some, like Atlanta and Miami, primarily raise revenues through property taxes, while others, like Kansas City and Philadelphia, are authorized by their state governments to collect sales and income taxes as well. Cities in Virginia and Vermont face no property tax or expenditure limitations, while cities in Colorado and California face severe limitations on both tax collections and expenditures. And state funding comprises more than a quarter of municipal budgets in states like Nebraska and New York, but less than seven percent of municipal budgets in Oklahoma and Texas. In other words, given their unique fiscal positions, cities will not respond uniformly to structural shifts—and potential devolution—within American federalism.

To better understand the variation in cities' fiscal outlooks, this report defines and assesses cities' fiscal policy space, surveying 100 large cities across four factors:

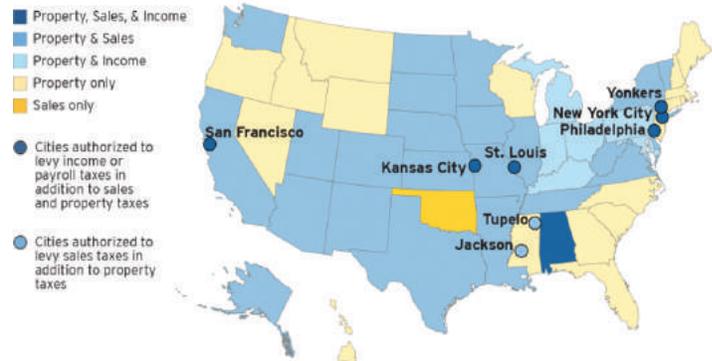
- **Tax authority**, the number of general taxes (property, sales, or income taxes) a city is authorized by its state to use;
- **Taxation and expenditure constraints**, measured by the difference between a city's legal maximum property tax rate and its actual rate;
- **Fiscal base alignment**, which measures how aligned a city's economic base is with its tax structure; and
- **Demand for services**, measured by partisanship, housing affordability, and union density within a city, which correlate with higher demand for municipal expenditures and lower fiscal flexibility.

Key findings are as follows:

Most states authorize cities to levy one or two general taxes. Some states, particularly concentrated in the Northeast, South, and Mountain West, authorize cities to levy only property taxes to raise revenue, as seen in the map below. Many others authorize cities to levy both property and sales taxes. A number of states in the Great Lakes region authorize cities to levy property and income taxes, but not sales. And a handful of large cities, as well as cities within Alabama, can levy all three general taxes. Generally, more than half of cities within the United States rely primarily on a blend of property and sales tax, in addition to non-tax fees, for revenue.

Most states authorize cities to levy one or two general taxes

Municipal general taxing authority by state



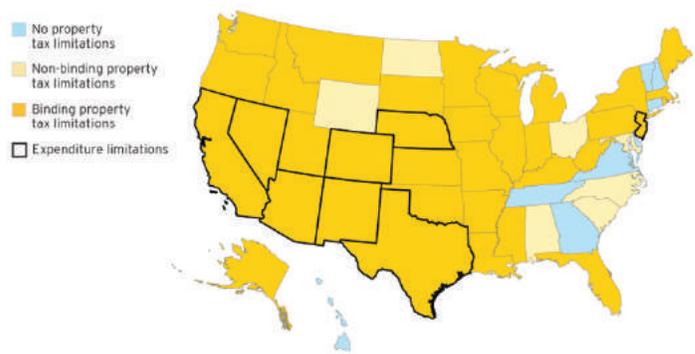
Note: the City and County of San Francisco currently levies a local payroll tax that is being phased out in 2018 in parallel with phasing in a local gross receipts tax on businesses.

Source: Authors' analysis

Most states impose binding property tax or expenditure limitations on cities. Property tax limitations for municipalities, which are enacted by state governments or via ballot referenda, can be considered either “binding” or “non-binding,” depending on the extent of the restrictions. As seen in the map below, a handful of states, including Vermont, New Hampshire, Connecticut, Virginia, Tennessee, and Georgia, impose no property tax limitations. Others, including North Dakota, Nebraska, Maryland, North Carolina, South Carolina, and Alabama, have “non-binding” tax limitations on municipalities. Nearly all of the remaining states impose “binding” property tax limitations, which prevent municipalities from raising rates above a defined threshold. Additionally, many states in the Southwest and West, as well as New Jersey, set strict expenditure limitations on municipalities, capping their total budgets and severely restricting their fiscal positions.

Most states impose binding property tax or expenditure limitations on cities

Municipal tax and expenditure limitations by state

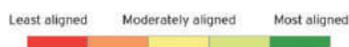


Source: Fiscal Policy Space project and Michael A. Pagano, “The Success and Challenges of the US Federal System: State-Local Finances,” in GianCarlo Pola, ed. *Principles and Practices of Fiscal Autonomy* (Ashgate Publishing, 2015), p. 83

Cities with economies that align with their tax structures have stronger fiscal positions. Municipal budgets are strongest when they have diversified revenue streams and when cities' taxation system aligns with their economies. A city with high overall property values should ideally have a taxation structure that collects a sizable amount of property tax revenue, just as a city with high rates of retail sales should collect a sizable amount of sales tax. To measure fiscal diversification and alignment, this report scored cities on a scale from 0 to 2 for each of the three general tax categories of property, sales, and income tax. Cities with above-average property values or sales receipts and above-average shares of property tax and sales tax revenue—such as Raleigh and Austin—scored highly. Cities with below-average property values and property tax revenue and that didn't have authorization to levy sales or incomes taxes—such as Milwaukee and Las Vegas—scored lower. The following chart indicates the highest- and lowest-scoring cities on fiscal base alignment.

Cities whose economies align with their tax structures have stronger fiscal bases

Cities' fiscal base rankings according to 2010 property, sales, & income tax alignment



Most-aligned cities				
City	Property tax alignment	Sales tax alignment	Income tax alignment	Composive fiscal base score
1 Birmingham, Ala.	0.5	2	2	4.5
2 New York City, N.Y.	1	0.5	2	3.5
3 Raleigh, N.C.	2	1.5	0	3.5
4 Austin, Texas	1.5	1.5	0	3
5 Baltimore, Md.	1	0	2	3
6 Fort Wayne, Ind.	1	0	2	3
7 Greensboro, N.C.	1.5	1.5	0	3
8 Huntsville, Ala.	1	2	0	3
9 Kansas City, Mo.	0	1	2	3
10 Louisville-Jefferson, Ky.	1	0	2	3

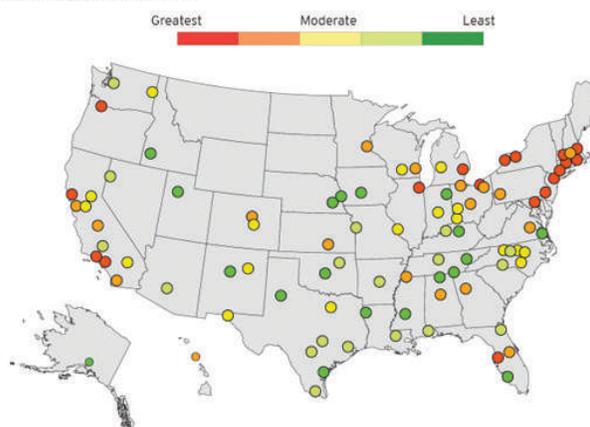
Least-aligned cities				
City	Property tax alignment	Sales tax alignment	Income tax alignment	Composive fiscal base score
1 Chicago, Ill.	1	0	0	1
2 Des Moines, Iowa	1	0	0	1
3 Hartford, Conn.	1	0	0	1
4 Jackson, Miss.	1	0	0	1
5 Las Vegas, Nev.	1	0	0	1
6 Milwaukee, Wis.	1	0	0	1
7 Orlando, Fla.	1	0	0	1
8 Providence, R.I.	1	0	0	1
9 Rochester, N.Y.	1	0	0	1
10 Springfield, Mass.	1	0	0	1

Note: See Appendix A for methodology.
Source: Authors' calculations

Cities with greater rental unaffordability, higher shares of Democratic voters, and larger public unions face greater fiscal pressures. Past research has correlated these three factors with greater demand for municipal services. As a result, cities with these characteristics are more likely to have experienced expansionary pressures on their budget, and therefore are more likely to have less fiscal space to raise rates further. By contrast, cities with comparatively more

rental affordability, conservative voters, and smaller public unions face less expansionary pressure, and—hypothetically, at least—have more fiscal space to raise rates when given additional responsibilities. Assessing sample cities along these three characteristics reveals that cities with the greatest demand for public services tend to be more populous and located in the Northeast, Midwest, or West Coast, as can be seen in the map below. Cities with the least demand for public services tend to be mid-sized and located in the South, Great Plains, and Mountain West.

Cities with greater rental unaffordability, higher shares of Democratic votes, and larger public unions face greater fiscal pressures
Index of city service demand



Source: Authors' calculations

The Great Recession provides insight into how cities with different fiscal positions may respond to increased responsibilities and pressures under the Trump administration. Through seven case studies of cities ranging from most to least fiscally constrained, this report explores how city leaders responded in times of fiscal pressure. Milwaukee, a severely constrained city, increased its property tax rates as much as possible during the Great Recession, but still faced major budget shortfalls due to declining property values and state funding. The city was forced to undergo hiring freezes and cuts to municipal employee benefits and raise fees for water filtration, parking permits, and other services; the city also received a much-needed infusion of \$203 million from the federal stimulus package in 2009. On the other end of the spectrum, Dallas, a less constrained city, raised its property tax rate to counteract a decline in sales and property tax revenues and increased fees for a range of municipal services. The city coupled these revenue adjustments with relatively small cuts to public expenditures and was able to stabilize its budget relatively quickly.

This analysis of cities' fiscal policy space carries implications for federal, state, and local leaders.

- **Federal leaders** should recognize that municipalities face varying fiscal constraints, and therefore will have

different capacities to respond to federal initiatives and programs (such as an infrastructure initiative that leverages private capital and local revenues). Officials might consider altering existing funding formulas to even out disparities in municipal fiscal constraints or penalizing states that impose particularly onerous fiscal constraints on their local governments.

•**State leaders** should consider how existing regulatory constraints and funding formulas affect cities’ abilities to serve as partners in advancing shared economic and social priorities, including infrastructure investment, education, and public safety. States with regulatory frameworks that disadvantage city governments by constraining their authority to levy taxes or establish stable fiscal bases would do well to update them.

•**City leaders** should think critically about how their fiscal infrastructure fulfills the needs of their city and its constituents. A city whose primary sources of economic growth do not contribute their fair share to public services may want to adjust tax rates accordingly. Tailoring public investments that enhance both private sector economic growth and fiscal returns to those investments is a critical public policy challenge for cities. Additionally, while expanding municipal tax authority is a difficult

process, it can be done, either by petitioning state legislators to change state laws or, for some cities, asking city councils or voters to support rate hikes or new taxing authority. City leaders should consider how their existing tax base supports their efforts to deliver high-quality public services to their constituents, and advocate for reforms if needed.

In conclusion, the policy pathways suggested by the fiscal policy space framework—providing greater municipal fiscal autonomy, encouraging cities to better align their tax structures with their underlying economic systems, and reconciling the public’s demand for services with their willingness to pay for them—are not “easy fix” solutions. In fact, these policies would require the reversal of trends that have acted to limit cities’ fiscal policy space over the past several decades. But if cities are to successfully design, fund, and implement policies that provide high-quality educational opportunities, safe streets and neighborhoods, modern transportation networks, affordable housing options, and economic opportunities for all residents, they will need significant fiscal resources and flexibility. This imperative is particularly salient in an era of federal devolution of power and responsibility. Ultimately, expanding the fiscal policy space of cities will serve to increase economic growth, prosperity, and inclusion for the nation as a whole.

Notes

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Take notes, highlight, use as a text book.**

(d. 45th)

Who Pays? A Distributional Analysis of the Tax Systems in All 50 States

The Institute on Taxation and Economic Policy, Who Pays: 5th Edition, January 2015

The 2015 *Who Pays: A Distributional Analysis of the Tax Systems in All Fifty States* (the fifth edition of the report) assesses the fairness of state and local tax systems by measuring the state and local taxes that will be paid in 2015 by different income groups as a share of their incomes. The report examines every state and the District of Columbia. It discusses important features of each state's tax system and includes detailed state-by-state profiles that provide essential baseline data to help lawmakers understand the effect tax reform proposals will have on constituents at all income levels.

The report includes these main findings:

- Virtually every state tax system is fundamentally unfair, taking a much greater share of income from low- and middle-income families than from wealthy families. The absence of a graduated personal income tax and over reliance on consumption taxes exacerbate this problem.
- The lower one's income, the higher one's overall effective state and local tax rate. Combining all state and local income, property, sales and excise taxes that Americans pay, the nationwide average effective state and local tax rates by income group are 10.9 percent for the poorest 20 percent of individuals and families, 9.4 percent for the middle 20 percent and 5.4 percent for the top 1 percent.
- In the 10 states with the most regressive tax structures (the Terrible 10) the bottom 20 percent pay up to seven times as much of their income in taxes as their wealthy counterparts. Washington State is the most regressive, followed by Florida, Texas, South Dakota, Illinois, Pennsylvania, Tennessee, Arizona, Kansas, and Indiana.
- Heavy reliance on sales and excise taxes are characteristics of the most regressive state tax systems. Six of the 10 most regressive states derive roughly half to two-thirds of their tax revenue from sales and excise taxes, compared to a national average of roughly one-third. Five of these states do not levy a broad-based personal income tax (four do not have any taxes on personal income and one state only applies its personal income tax to interest and dividends) while four have a personal income tax rate structure that is flat or virtually flat.
- State personal income taxes are typically more progressive than the other taxes that states levy (e.g. property, consumption). Sales and excise taxes are the most regressive, with poor families paying almost eight times more of their income in these taxes than wealthy families, and middle income families paying five times more. Property taxes are typically regressive as well, but less so than sales and excise taxes.
- Personal income taxes vary in fairness due to differences in rates, deductions, and exemptions across states. For example, the Earned Income Tax Credit improves progressivity in 25 states and the District of Columbia, while nine states undermine progressivity by allowing taxpayers to pay a reduced rate on capital gains income, which

primarily benefits higher-income households.

- State consumption tax structures are highly regressive with an average 7 percent rate on sales and excise taxes for the poor, a 4.7 percent rate for middle-income people, and a 0.8 percent rate for the wealthiest taxpayers. Because food is one of the largest expenses for low-income families, taxing food is particularly regressive; five of the ten most regressive states tax food at the state or local level.
- Taxes on personal and business property are a significant revenue source for both states and localities and are generally regressive in their overall effect, particularly for middle-income households. A homestead exemption (exempting a flat dollar or percentage amount of property value from a property tax) lessens regressivity. A property tax circuit breaker that caps the amount a property owner pays in property taxes based on their personal income can also reduce regressivity; none of the 10 most regressive states offer this tax break to low-income families of all ages.
- States commended as "low tax" are often high tax states for low- and middle-income families. The 10 states with the highest taxes on the poor are Arizona, Arkansas, Florida, Hawaii, Illinois, Indiana, Pennsylvania, Rhode Island, Texas, and Washington. Seven of these are also among the "terrible ten" because they are not only high tax for the poorest, but low tax for the wealthiest.

Economists have widely discredited trickle-down economic theories espoused for more than three decades, but that hasn't stopped new generations of supply-side theorists from repackaging those philosophies and pushing for lower state tax rates for wealthy individuals, businesses and corporations. In fact, recent years have brought tax proposals and changes in multiple states that would overwhelmingly benefit the highest income households under the guise of stimulating economic growth. This report doesn't seek to rebut ideological claims; rather it is an in-depth analysis of all taxes that all people pay at the state and local level.

This study assesses the fairness of each state's tax system by measuring state and local taxes paid by non-elderly taxpayers in different income groups in 2015 as shares of income for every state and the District of Columbia. The report provides valuable comparisons among the states, showing which states have done the best — and the worst — job of providing a modicum of fairness in their overall tax systems. The Tax Inequality Index measures the effects of each state's tax system on income inequality and is used to rank the states from the most regressive to the least regressive.

The bottom line is that every state fails the basic test of tax fairness. The District of Columbia is the only tax system that requires its best-off citizens to pay as much of their in-

comes in state and local taxes as the very poorest taxpayers, but middle-income taxpayers in DC pay far more than the top one percent. In other words, every single state and local tax system is regressive and even the states that do better than others have much room for improvement.

Overall, effective state and local tax rates by income group nationwide are 10.9 percent for the bottom 20 percent, 9.4 percent for the middle 20 percent and 5.4 percent for the top 1 percent (see chart below). This means the poorest Americans are paying two times more of their income in taxes than the top 1 percent.

There are moral and practical reasons to be concerned about this. Unfair tax systems not only exacerbate widening income inequality in the short term, but they also will leave states struggling to raise enough revenue to meet their basic needs in the long term.

In fact, a September 2014 Standard and Poor’s (S&P) study concludes that rising income inequality can make it more difficult for state tax systems to pay for needed services over time. The more income that goes to the wealthy, the slower a state’s revenue grows. Digging deeper, S&P also found that not all states have been affected in the same way by rising inequality. States that rely heavily on sales taxes tend to be hardest hit by growing income inequality, while states that rely heavily on personal income taxes don’t experience the same negative effect.

Averages for All States in 2015

Total State and Local Taxes Imposed on Non-Elderly Residents

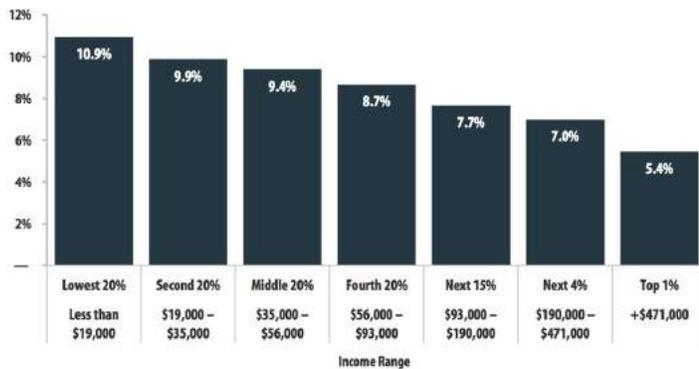


Figure represents 50 state (and District of Columbia) average for total state and local taxes paid as a share of 2012 income, post-federal offset

THE 10 MOST REGRESSIVE STATE AND LOCAL TAX SYSTEMS

Ten states — Washington, Florida, Texas, South Dakota, Illinois, Pennsylvania, Tennessee, Arizona, Kansas, and Indiana — are particularly regressive. These “Terrible Ten” states tax their poorest residents — those in the bottom 20 percent of the income scale — at rates up to seven times higher than the wealthy. Middle-income families in these states pay a rate up to three times higher as a share of their income as the wealthiest families.

What characteristics do states with particularly regressive tax systems have in common? Looking at the ten most regressive tax states, several important factors stand out:

ITEP’s Terrible 10 Most Regressive State & Local Tax Systems

Taxes as shares of income by income for non-elderly residents

Rank	State	Taxes as a % of Income on			Ratio of	
		Poorest 20%	Middle 60%	Top 1%	Poor to Top 1%	Middle to Top 1%
1	Washington	16.8%	10.1%	2.4%	686%	412%
2	Florida	12.9%	8.3%	1.9%	666%	429%
3	Texas	12.5%	8.8%	2.9%	435%	307%
4	South Dakota	11.3%	7.9%	1.8%	616%	431%
5	Illinois	13.2%	10.9%	4.6%	289%	238%
6	Pennsylvania	12.0%	10.1%	4.2%	286%	241%
7	Tennessee	10.9%	8.4%	3.0%	365%	280%
8	Arizona	12.5%	9.5%	4.6%	272%	207%
9	Kansas	11.1%	9.2%	3.6%	310%	258%
10	Indiana	12.0%	10.6%	5.2%	231%	204%

Note: States are ranked by the ITEP Tax Inequality Index. The ten states in the table are those whose tax systems most increase income inequality after taxes compared to before taxes. See page 134 for a full description of the Index. Total taxes as a share of income are post-federal offset.

- Four of the ten states do not levy a personal income tax — Florida, South Dakota, Texas, and Washington. An additional state, Tennessee, only applies its personal income tax to interest and dividend income.
- Five states do levy personal income taxes, but have structured them in a way that makes them much less progressive than in other states. Pennsylvania, Illinois and Indiana use a flat rate which taxes the income of the wealthiest family at the same marginal rate as the poorest wage earner. Arizona has a graduated rate structure, however there is little difference between the bottom marginal rate and top marginal rate. Kansas’ graduated rate structure only has two brackets, applying the top rate starting at \$30,000 for married couples.
- Six of the ten most regressive tax systems — those of Washington, South Dakota, Tennessee, Texas, Arizona and Florida — rely very heavily on regressive sales and excise taxes. These states derive roughly half to two-thirds of their tax revenue from these taxes, compared to the national average of 34 percent in fiscal year 2011-2012.

THE LEAST REGRESSIVE STATE AND LOCAL TAX SYSTEMS

Just as the combination of flat (or non-existent) income taxes and high sales and excise taxes leads to very regressive tax systems, the least regressive tax systems have highly progressive income taxes and rely less on sales and excise taxes. For example:

- Vermont’s tax system is among the least regressive in the nation because it has a highly progressive income tax and low sales and excise taxes. Vermont’s tax system is also made less unfair by the size of the state’s refundable Earned Income Tax Credit (EITC) — 32 percent of the federal credit.
- Delaware’s income tax is not very progressive, but its high reliance on income taxes and low use of consumption taxes nevertheless results in a tax system that is only slightly regressive overall. Similarly, Oregon relies highly on income taxes and very little on consumption taxes. The state also offers a refundable EITC and has a fairly progressive personal income tax rate structure. Montana also relies very little on consumption taxes (like Oregon, the state does not have a sales tax).

•The District of Columbia and Minnesota each achieve a close-to-flat tax system overall through the use of generous refundable EITCs and an income tax with relatively high top rates and limits on tax breaks for upper-income taxpayers. California has one of the least regressive tax systems due to its heavy reliance on a very progressive income tax.

It should be noted that even these least regressive states fail to meet what most people would consider minimal standards of tax fairness. In each of these states, at least some low- or middle-income groups pay more of their income in state and local taxes than wealthy families. In other words, every single state and local tax system is regressive and even these states that do better than others have much room for improvement.

	Personal Income Tax			Low Use of Sales & Excise Taxes
	Very Progressive	High Reliance on PIT	Use of Refundable Credits	
California	✓	✓		
Delaware	✓	✓		✓
District of Columbia	✓	✓	✓	✓
Minnesota	✓	✓	✓	
Montana				✓
Oregon	✓	✓	✓	✓
Vermont	✓		✓	

THE KIND OF TAX MATTERS

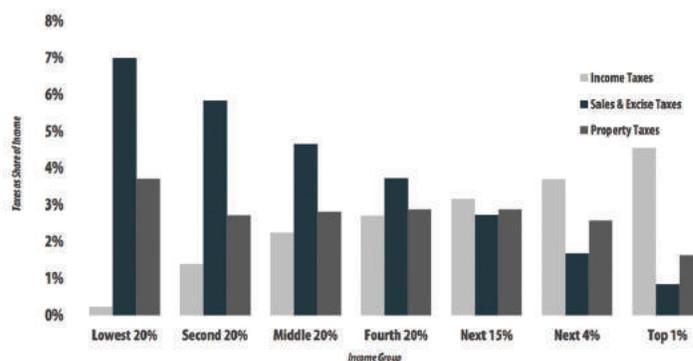
State and local governments seeking to fund public services have historically relied on three broad types of taxes — personal income, property, and consumption (sales and excise) taxes. (States also rely on non-tax revenue sources such as user fees, charges, and gambling revenues. A few states rely heavily on non-traditional tax sources, such as severance taxes on the extraction of natural resources, which are not included in this analysis. See Appendix C for trends in both tax and “non-tax” revenues as shares of total state and local own-source revenues.)

As ITEP’s analysis of the most and least regressive tax states shows, the fairness of state tax systems depends primarily on how heavily states rely on each tax. Each of these taxes has a distinct distributional impact, as the table on this page illustrates:

- State income taxes are typically progressive — that is, as incomes go up, effective tax rates go up. On average, poor families pay only a tenth of the effective income tax rate that the richest families pay, and middle-income families pay about half of the effective rate of the well-off. Of the three major taxes used by states, the personal income tax is the only one for which effective tax rates rise with income levels.
- Property taxes, including both taxes on individuals and business taxes, are usually somewhat regressive. On average, poor homeowners and renters pay more of their incomes in property taxes than do any other income group — and the wealthiest taxpayers pay the least.
- Sales and excise taxes are very regressive. Poor families pay almost eight times more of their incomes in these

taxes than the best-off families, and middle-income families pay more than five times the rate of the wealthy.

Comparing Types of Taxes: Averages for All States by Tax
(before federal offset)



A state’s tax fairness is only partially determined by the mix of these three broad tax types. Equally important is how states design the structure of each tax. Some personal income taxes are far more progressive than others, simply because lawmakers chose to design them that way. The same is true, to a lesser extent, of property and sales taxes; while any state that relies heavily on these taxes is likely to have a regressive tax structure, lawmakers can take steps to make these taxes less regressive. The overall regressivity of a state’s tax system, therefore, ultimately depends both on a state’s reliance on the different tax sources and on how the state designs each tax.

For example, California’s level of reliance on each of the three major tax types is fairly typical. But the state income tax is more progressive than most — and this makes California’s tax system one of the least regressive in the country.

Delaware, on the other hand, is one of the most progressive tax states not because any one of its taxes is exceptionally progressive, but because it relies so heavily on a modestly progressive income tax and relies very little on regressive sales and excise taxes.

ECONOMIC CASE FOR TAX FAIRNESS

Putting basic moral concerns aside, creating more fair state tax systems is an economic imperative. Over the last four decades the share of income and wealth accruing to those at the top of the income scale has skyrocketed, while wages and income for working and middle-class families have stagnated; today, the top 20 percent of Americans as a group earn more income than the bottom 80 percent combined. As a result, states that rely on regressive sales, excise and property taxes rather than income taxes have experienced faster revenue decline than states with more progressive tax structures according to *Income Inequality Weighs on State Tax Revenues*, a September 2014 report from Standard and Poor’s.

The vast majority of states allow their very best-off residents to pay much lower effective tax rates than their

middle- and low-income families must pay — so when the richest taxpayers grow even richer, these exploding incomes hardly make a ripple in state tax collections. And when the same states see incomes stagnate or even decline at the bottom of the income distribution it has a palpable, devastating effect on state revenue. A recent Standard & Poor's report found that the more income growth goes to the wealthy and incomes stagnate or decline at the bottom, the slower a state's revenue grows, especially if the state relies more heavily on taxes that disproportionately fall on low- and middle-income households. Hitching your state's funding of investments to those with a shrinking share of income is not a path to a sustainable, growing revenue stream.

Moreover, shrinking revenues and over reliance on regressive taxes prevent states from investing in the priorities that will bolster the prospects of low- and middle-income residents: education, workforce development, infrastructure improvements, and adequate healthcare. State tax structures that rely on trickle-down theories of economic growth, balance budgets on the backs of working families rather than asking the wealthy to do more, and fail to improve the wellbeing of the majority of that state's residents will fail to be competitive in the long run. Shortsighted tax cuts can be a long-term drag on development.

WHY THE SCOPE OF THE STUDY IS LIMITED TO NON-ELDERLY TAXPAYERS

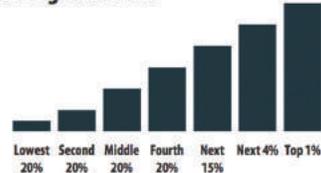
The analyses contained in this report show the tax incidence of singles and couples, with and without children who are under the age of 65. State tax structures are notorious for treating elderly families very differently from other families and these differences cloud the incidence of state tax structures.

Virtually every state conforms to at least one of the federal government's elderly tax breaks. All 41 states and the District of Columbia that levy broad-based income taxes follow the federal exemption for Social Security benefits, with many states exempting them altogether. Ten states allow their seniors to claim the same higher federal standard deduction.

But most income tax states go beyond these tax preferences

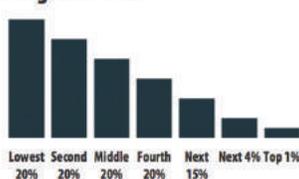
Progressive, Regressive, or Proportional?

A Progressive Tax



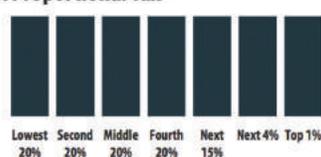
A progressive tax is one in which upper-income families pay a larger share of their incomes in tax than do those with lower incomes.

A Regressive Tax



A regressive tax requires the poor and middle-income to pay a larger share of their incomes in taxes than the rich.

A Proportional Tax



A proportional tax takes the same percentage of income from everyone, regardless of how much or how little they earn.

inherited from federal income tax rules to allow special elderly-only tax breaks of their own. Thirty-six states allow an exemption for private or public pension benefits. These range from fully exempting all pension benefits for adults above a certain age (three states — Illinois, Mississippi, and Pennsylvania) to only exempting very specific benefits such as those for military veterans. Twenty-one states allow senior citizens an extra personal exemption or exemption credit, allowing these taxpayers to shelter twice as much of their income from tax as similar non-elderly taxpayers can claim.

For example, Illinois exempts all pension and retirement income from their tax base which costs the state more than \$1 billion annually. If retirement income were taxed, the middle twenty percent of Illinoisans would see a tax increase equivalent to 0.2 percent of their income on average. Those in the next quintile would see their taxes increased by 0.3 percent of their income. Because so many states offer special consideration for elderly taxpayers, including elderly families in the Who Pays analysis would not give an accurate depiction of how the tax structure treats the majority of taxpayers.

CONCLUSION

The main finding of this report is that virtually every state's tax system is fundamentally unfair. The over reliance on consumption taxes and the absence of a progressive personal income tax in many states neutralize whatever benefits the working poor receive from low-income tax credits. The bleak reality is that even among the 25 states and the District of Columbia that have taken steps to reduce the working poor's tax share by enacting state EITCs, most still require their poorest taxpayers to pay a higher effective tax rate than any other income group.

The results of this study are an important reference for lawmakers seeking to understand the inequitable tax structures enacted by their predecessors. States may ignore these lessons and continue to demand that their poorest citizens pay the highest effective tax rates. Or, they may decide instead to ask wealthier families to pay tax rates more commensurate with their incomes. In either case, the path that states choose in the near future will have a major impact on the well-being of their citizens — and on the fairness of state and local taxes.

Tribal Economic Impact in Oklahoma

Southeastern Oklahoma State University, Native American Leadership Articles, September 1, 2017

As tribal nations begin to flourish with productive economic policies, they are starting to have significant impact, both within their communities and on the states in which they reside. As economic recovery moves across the United States, there will be greater presence within market segments from tribal nations. With a decrease in reliance on federal funds for their infrastructure and community services, tribal nations are becoming self-reliant and competitive within the marketplace. A recent study done by the National Congress of American Indians revealed that the three dozen tribal nations in Oklahoma, for instance, support more than 85,000 jobs — upward of 5 percent of all jobs in Oklahoma — and have an financial impact of more than \$10 billion.

Gaming Is Big Business

In 1988, the Indian Gaming Regulatory Act allowed tribal nations to operate casinos on their sovereign territories, as long as these casinos contributed a portion of their revenue to the state government. In the twenty years that followed, gambling revenue skyrocketed from \$100 million to more than \$16 billion annually.

Oklahoma is second only to California for total gambling-related revenue. Three dozen of its native tribes operate more than 120 casinos that generated \$4 billion in 2014. In 2015, the state of Oklahoma received over \$125 million in revenue-sharing proceeds from tribal casinos.

The revenue from these casinos has enabled tribal nations to provide essential services to their communities that were otherwise insufficient or severely lacking. More schools have been built. Water and electricity reach far more communities than they did several decades ago, and tribal elders have been able to preserve important cultural traditions.

Tourism Is on the Rise

While the relative growth of the gambling industry is fairly static, tourism is now starting to show a significant increase in revenue, as tribal nations are developing destination-driven economic opportunities in addition to more slot machines and other gambling activities. The Chickasaw Nation, for instance, has recently acquired the formerly state-run Lake Texoma Lodge and Resort, with plans to reopen the lodge as a tourist destination and business retreat center. The nearby town of Kingston will also benefit from an increase in local jobs as well as revenue from tourists seeking to stay at the rustic lodge on Lake Texoma.

In fact, cultural tourism provides more than just the opportunity to educate non-natives about the rich heritage of any of the more than three dozen tribes that currently reside in Oklahoma. As tribal tourism flourishes, it provides opportunities for the young people within a tribe to reconnect and engage with their own heritage in a way that sustains their

lineage and cultural identity. These young people become more invested in their tribal communities, which leads to further engagement with their heritage, resulting in a richer cultural experience for those who are merely passing through as sightseers.

There are numerous tourist destinations in Oklahoma that showcase the state's vibrant Native American history. The Cherokee Heritage Center in Tahlequah provides physical re-creations of indigenous history, including a full-scale Cherokee village from the 18th century. The Red Earth Art Center in Oklahoma City is home to over 1,400 pieces of native art from more than fifty different tribes. The Gilcrease Museum in Tulsa sits on 475 acres and showcases an incomparable collection of American Indian and Western art. Finally, the Spiro Mounds Archaeological Center is the only remaining site of a mound-building culture that flourished more than 500 years ago.

The Chickasaw Cultural Center in Sulphur has seen more than two hundred thousand visitors since it opened less than a decade ago, and those visitors have come from more than 17 countries. In addition to the Center, the Chickasaw Nation runs the Chickasaw Motor Inn in Sulphur and regularly conducts a national advertising campaign, enticing visitors to come explore its rich cultural heritage.

The Choctaw Nation, with a presence across ten counties in Oklahoma, accounted for more than \$300 million in tourism dollars, according to a recent survey of tourist spending within Oklahoma. As the Choctaw Nation seeks to improve that revenue stream in coming years, it will have to create more jobs and more opportunities for local residents and businesses.

Brand Visibility

Commercial businesses devote resources and marketing efforts to managing their brand within the marketplace, and the distinct Native American tribes in Oklahoma are approaching the preservation of their cultural heritage in a similar way. By providing opportunities for education at various tourist destinations, the tribes are enriching the national conversation about the history of these lands prior to the founding of the United States.

While the lucrative aspect of gambling can't be dismissed, the infrastructure necessary to run and service it can devour a significant portion of the gross proceeds. Building cultural centers and creating educational opportunities in a region help pave the way for lasting economic improvement. Providing opportunities for people of other cultures and races to experience the deep history and rich cultural legacy of Native American tribes will have an indelible impact on society and culture in general.

The Economic Impact of the Cherokee Nation

Russell R. Evans, Ph.D., and Kyle Dean, Ph.D., Fiscal Year 2016 Impact Report, April 3, 2017

The Cherokee Nation's economic growth in northeast Oklahoma has grown to more than \$2.03 billion, according to the Cherokee Nation Economic Impact Report.

The report, commissioned by the Cherokee Nation and produced by Dr. Russell Evans, principal of the Economic Impact Group and assistant professor of economics at Oklahoma City University, states Annual operations by the Cherokee Nation now support more than \$2 billion in local production of goods and services, ranging from retail purchases to new construction and manufacturing to new demand for local health care and education. Production of the \$2 billion of local goods and services requires support from 17,788 local jobs generating labor income payments of \$786 million. The economic importance of the Cherokee Nation to northeast Oklahoma continues to grow with the expanding economic footprint of Cherokee operations.

Since the fiscal year 2014 report, Cherokee Nation direct output (Cherokee Nation production plus Cherokee Nation purchases from local vendors) increased by 23 percent, Cherokee Nation direct employment increased by 5 percent and Cherokee Nation direct income payments to local labor increased by 12 percent.

The following is a direct economic footprint the tribe has in each county located in the Cherokee Nation:

Adair County

Economic impacts in Adair County support nearly \$68 million in county production of goods and services while supporting 902 jobs and \$37 million in local income payments. Cherokee Nation government and business operations directly support 491 jobs in the county and purchase more than \$17 million in goods and services from county vendors.

Cherokee County

Cherokee County is home to the Cherokee Nation's largest employment base, with direct government and business operations supporting 3,580 jobs and \$168 million in labor compensation payments. Cherokee Nation operations directly produce \$89 million in goods and services while directly purchasing \$79 million in additional goods and services from Cherokee County vendors. In Cherokee County the Cherokee Nation reportedly supports \$276 million in local production, 5,910 jobs and \$221 million in local labor income.

Craig County

Cherokee Nation operations directly support 149 jobs, \$7 million in labor income and nearly \$2.5 million in local production and directly purchase another \$6 million in local goods and services from local vendors. Regional economic



Cherokee Nation Principal Chief Bill John Baker announces the tribe's more than \$2 billion economic impact on the state of Oklahoma.

linkages generate multiplier effects sufficient to support total Craig County activity of \$14 million in output, 273 jobs and \$10.5 million in labor income.

Delaware County

Delaware County enjoys a significant Cherokee Nation presence, with operations directly accounting for \$147 million in county production and supporting 1,039 jobs. Additionally, Cherokee Nation entities directly purchase more than \$18 million from Delaware County vendors. In total, Cherokee Nation operations support \$186 million in county output, 1,372 jobs and \$56 million in local labor income.

Mayes County

Mayes County economic impacts continue to grow with Cherokee Nation business expansion in the county. Cherokee Nation operations now directly support 245 jobs, \$11 million in labor income and nearly \$121 million in local production. Including multiplier, spillover and feedback effects, total economic impacts total \$163 million in county goods and services production, 781 jobs and \$25 million in local labor compensation.

McIntosh County

While not home to direct Cherokee Nation operations, McIntosh County nonetheless enjoys a small economic impact by virtue of purchases from local vendors and county residents spending a portion of their Cherokee Nation income in their home county. In total, Cherokee Nation impacts support nearly \$2 million in county production, 13 jobs and nearly \$700,000 in local labor income payments.

Muskogee County

Muskogee County experiences economic benefits both from a direct Cherokee Nation presence in the county as well as from direct vendor purchases from local suppliers. Cherokee Nation operations directly produce more than \$53 million in local goods and services while directly purchasing nearly \$22 million in additional goods and services from local vendors. The direct operations support 373 jobs while the vendor responses and feedback effects support an additional 358 jobs in the county. Including local household spending, feedback and spillover effects, Muskogee County enjoys an economic impact of \$113 million in local production, 952 local jobs and \$40 million in local labor income payments.

Nowata County

Nowata County impacts have increased significantly with the expansion of Cherokee Nation operations in the county. Current reports indicate Cherokee entities directly account for 212 jobs, \$9 million in local labor income and nearly \$22 million in county production. Additionally, Cherokee Nation businesses and government operations purchase \$2 million in locally produced goods and services. In total, Cherokee Nation operations, purchases and local household spending changes support 263 jobs, \$10 million in county income and \$26 million in county production of goods and services.

Ottawa County

While not home to direct Cherokee Nation activity, Ottawa County nonetheless feels the economic influence of the Cherokee Nation by way of \$1.5 million in local vendor purchases and local spending of Cherokee Nation employees residing in Ottawa County. Total Ottawa County economic impacts support more than \$3 million output, 53 jobs and nearly \$1 million in county income.

Rogers County

A strong Cherokee Nation business and employee presence in Rogers County continues to complement significant vendor purchases and exert a significant economic influence in the county. Cherokee Nation operations directly employ 2,159 jobs associated with \$117 million in labor income and more than \$328 million in local production. Combined with nearly \$22 million in local vendor purchases, household spending and all multiplier effects, Cherokee Nation activity in Rogers County supports \$386 million in local output, 2,923 local jobs and \$135 million in local income.

Sequoyah County

Cherokee Nation activities directly account for 825 Sequoyah County jobs associated with \$38 million in local labor income and the local production of nearly \$107 million of goods and services. Cherokee Nation business and government operations combine to purchase an additional \$16.5 million from local vendors. The vendor response, local household spending, feedback effects and outside county spillovers combine to support a significant multiplier process. In total, Cherokee Nation operations support 1,200 Sequoyah County jobs, nearly \$50 million in local income and \$152 million in county production of goods and services.

Tulsa County

Tulsa County benefits from its status as a regional trade center, enjoying significant spillover impacts from activities that originated in outside counties in addition to their local impacts. Cherokee Nation operations are estimated to directly account for 265 jobs in the county, supporting \$30.5 million in local income payments and \$229 million in output. Tulsa also experiences a concentration of vendor purchases of more than \$131 million. In total, Tulsa County economic impacts from Cherokee Nation operations support \$593 million county output, 2,626 local jobs and \$181 million in local labor income payments.

Wagoner County

Wagoner County economic impacts are the result of more than \$1 million in local vendor purchases and significant local household spending of county residents from Cherokee Nation income earned in other counties. Impacts from all sources support 48 jobs, more than \$1 million in labor income and nearly \$7 million in county output.

Washington County

Cherokee Nation operations in Washington County directly support 213 jobs, nearly \$10 million in labor income and \$30 million in local production. Cherokee Nation entities combine to purchase more than \$8 million in output from Washington County vendors, while Cherokee Nation payrolls provide a significant source of household income to be spent in the local economy. The combined influence of Cherokee Nation operations, vendor purchases and household spending patterns support a total of 475 jobs, \$17 million in local labor income and \$49 million in Washington County output.

You can read the full report at http://www.cherokeemnationimpact.com/images/economic_impact_report_2016.pdf

(a. Individual Income Tax; b. Corporate Income Tax)

Choctaw Nation's economic impact passes \$1.8 billion

Charlie Clark, Bryan County Patriot, September 5, 2018

Chief Gary Batton reported on Labor Day the economic impact made by the Choctaw Nation to be a healthy \$1,868,451,097.

“That’s a \$1.8 billion with a B, impact made on the State of Oklahoma,” said Chief Batton. “Total tribal assets are \$2.4 billion.”

The Fiscal Year 2016 figure, the most recent available, but still growing, lit up a power point presentation in Chief Batton’s 2018 State of the Nation address at the Choctaw Nation Labor Day Festival. The Monday morning, Sept. 3 event closed out the five-day festival held each year at Tvshka Homma, the historic Capitol of the Chahta.

“The economic impact made by the Choctaw Nation is accelerating opportunities for growth and prosperity for the tribe and the State of Oklahoma,” Batton said. What that translates to, he said, are 8,358 direct jobs supported in 2016 (the 2018 figure has jumped to 10,346 employees) and 12,161 total jobs supported, making direct income payments \$518,000,000.

“Everyone wants to know where the money comes from,” Batton said, posting a pie chart behind him and on other screens, some outside the amphitheater for the overflow crowd to see. “The largest amount, about 58 percent, comes from the business operations of the tribe; 24 percent from federal and state grants; 12 percent from Medicare and third-party insurance; 3 percent, general government revenue; and 2 percent, housing.”

Another pie chart showed “Where the Money Goes.” It displayed 67 percent goes to services to tribal members, 21 percent to capital projects, and 12 percent to the permanent fund.

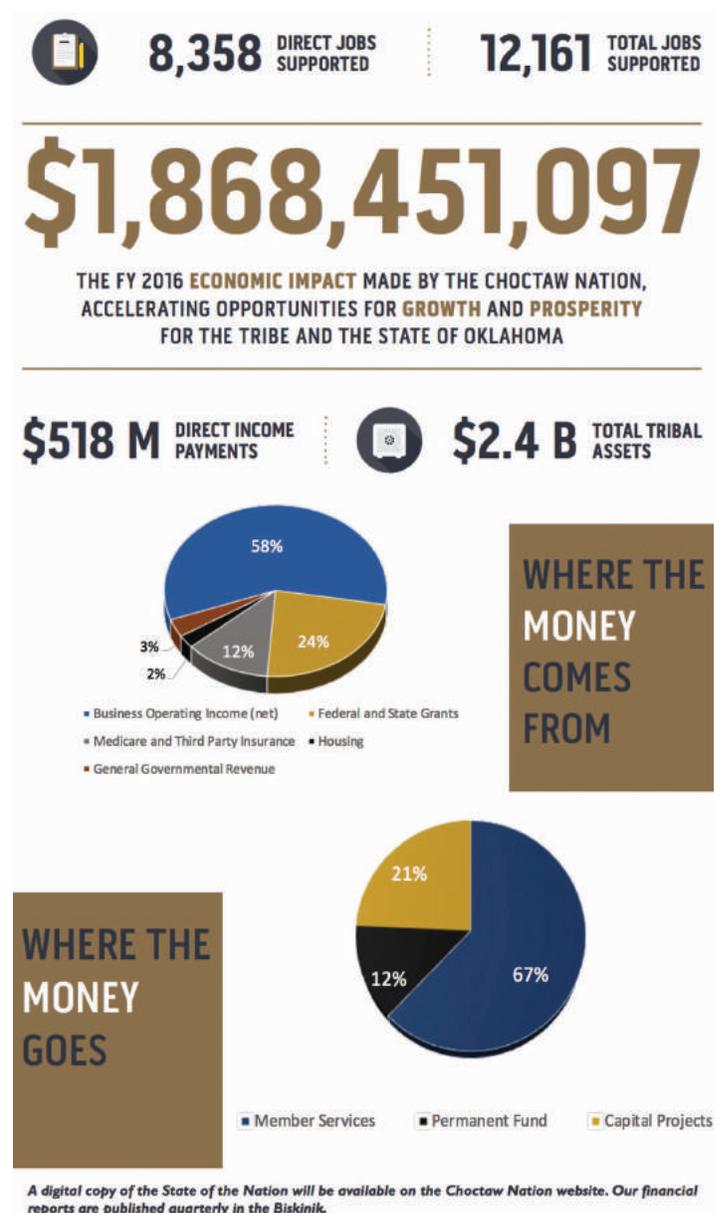
Chief Batton explained that there were large building projects completed in the past year including, in Durant, the new Choctaw Nation Headquarters and Regional Medical Clinic. Also he listed the Choctaw Casino & Resort expansion in Grant; Wellness Centers in Poteau and Durant, Community Center in Broken Bow and Head Start in Wright City. The Housing Authority’s lease-to-purchase program, LEAP, also opened 10 new brick homes each in Atoka, Cameron, Coalgate, Heavener and Hugo. By the end of the year 10 new homes will be in each of the 12 districts of the Choctaw Nation.

Future projects scheduled for openings in the coming months, he said, include more homes in other communities and the new Choctaw Nation Judicial Center.

Chief Batton praised the Tribal Council and noted among

their accomplishments, the passing of a new Election Ordinance and a new state of transparency with the Code of Ethics and streamlined reporting.

All programs, for education, youth, social and elder services and more, Chief Batton explained, showed increases in numbers of tribal members served. Some were substantial. In health, outpatient visits went from 107,563 to 364,857; surgeries performed went from 2,688 to 3,514. Households assisted with home repairs jumped from 154 to 548. Home ownership, assisted by the Choctaw Nation, grew from 158 to 240.



(d. Between FY1996 and FY2016, Rainy Day funds were used 12 out of 20 years)

Study Shows Chickasaw Nation's Contribution and Impact on Oklahoma's Economy Exceeds \$2.4 Billion

Business Wire, July 9, 2012

The contribution and impact of the Chickasaw Nation on the economy of Oklahoma exceeds \$2.4 billion dollars according to an economic impact analysis released today by the Steven C. Agee Economic Research & Policy Institute at Oklahoma City University. The report, "Estimating the Oklahoma Economic Impact of the Chickasaw Nation," was funded in part by the Oklahoma Department of Commerce and several Native American tribal governments to quantify the impact of tribal activities on the economy of the state of Oklahoma.

"The results are nothing short of impressive, and they show that the Chickasaw Nation's economic activities and enterprises strongly bolster the state economy. In fact, the analysis indicates the Chickasaw Nation's business enterprises generate \$1.39 billion in annual revenue and support over 16,000 direct and indirect tribal and non-tribal jobs, many in rural Oklahoma where steady quality jobs are not as plentiful," said Kyle Dean, Ph.D, associate director and research economist at the Oklahoma City University Meinders School of Business. "For this study, we employed a methodology designed to estimate the contribution of an existing industry to the local economy by analyzing expenditure flows between households and industries and capturing the reliance of one industry's output on other industries. Through its diversified enterprises, the study underscores that the Chickasaw Nation has become an integral part of Oklahoma's overall economy and is now among the top employers and purchasers of goods and services in the state."

In addition to the \$1.39 billion generated from tribal business activities, which include manufacturing, banking, tourism, energy, healthcare, hospitality and entertainment, the study found that the Chickasaw Nation contributes to the Oklahoma economy in multiple ways. The additional economic contributions include \$318 million in direct payroll contributions and \$119 million to Oklahoma entities for the purchase of goods and services. The Chickasaw Nation's government expenditures amounted to \$129 million in 2011. These expenditures funded programs and services in pursuit of increased medical care access, educational advancements, social services and economic development opportunities for Chickasaw Nation citizens in Oklahoma. The study also reported that the Chickasaw Nation employs over 10,000 people and supports 16,000 jobs in Oklahoma, producing annually \$525 million in payroll revenues.

"The reinvesting of revenues earned by the Chickasaw Nation in ventures is creating jobs and business opportunities across multiple sectors of Oklahoma's economy as well as insulating the state from downturns in the national economy," Dean noted.

Oklahoma's Secretary of Commerce, Dave Lopez, said, "The economic impact analysis shows that the Chickasaw Nation, as well as the other Oklahoma tribal governments, has a significant and beneficial impact on Oklahoma's economy. As made evident by the results in the study, the Chickasaw Nation's business ventures are creating positive economic activity and producing new jobs."

"Long term thinking guides our various business enterprises along with our goal to have a positive social and economic impact throughout the 13 counties comprising the Chickasaw Nation in south-central Oklahoma, as well as across all of Oklahoma," commented Bill Anoatubby, governor of the Chickasaw Nation. "Our economic activities are part of the economic fabric of the state, and the revenues generated through our various business enterprises allow us to invest in programs and services for the benefit of Chickasaw Nation and Oklahoma citizens, such as our \$150 million medical center in Ada as well as new health facilities in Ardmore and Tishomingo. The tribe's hospital and clinics average more than 350,000 patient visits each year."

Bill Lance, chief executive officer of the Chickasaw Nation's Division of Commerce, which oversees more than 60 businesses owned and operated by the Chickasaw Nation, said, "We are focused on growing our existing businesses and investing in new ventures with strong revenue and growth potential. To that end, we are committed to operating our diversified business enterprises in a responsible and sustainable manner to make sure we continue to strengthen our state's economy through sound investments and job creation."

"The economic impact analysis shows that the Chickasaw Nation, as well as the other Oklahoma tribal governments, has a significant and beneficial impact on Oklahoma's economy."

(a. 27.4%)

Statewide Economic Impacts from Oklahoma Tribal Government Gaming

Oklahoma City University Center for Native American and Urban Studies and Klas Robinson
Q.E.D, 2016 Annual Impact Report, September 5, 2018

Tribal Government Gaming in Oklahoma began several decades ago with simple bingo halls situated in retrofitted buildings including gymnasiums, community centers, double-wide trailers, and even Quonset huts located on Tribal lands.

Pursuant to Congressional authorization, today 31 Tribes in Oklahoma currently operate almost 130 gaming operations with approximately 72,850 electronic games, almost 5,300 bingo seats, and other games. There are 20 Tribal Gaming Operations with hotels/resorts in Oklahoma with a combined total of more than 5,000 rooms and almost 500,000 square feet of meeting, function, and entertainment space.

Other related ancillary facilities and amenities include almost 200 restaurants and bars, nine golf courses with a total of 126 holes, five spas, seven RV parks with almost 375 sites, and more than 50 gas station/convenience stores, as well as destination and convenience retail, several bowling centers, laser tag, and a movie complex.

Oklahoma has the second largest Native American population in the United States, behind only California. According to the 2010 Census, 482,760 Oklahomans identified as Native American alone or in combination with other races. Oklahoma Native Americans do not live on traditional reservations as in other states; rather, they live throughout the State with Tribal Government Operations and Services limited to jurisdictional areas. Due to Federal government requirements that casinos operate on Indian Land, exist-

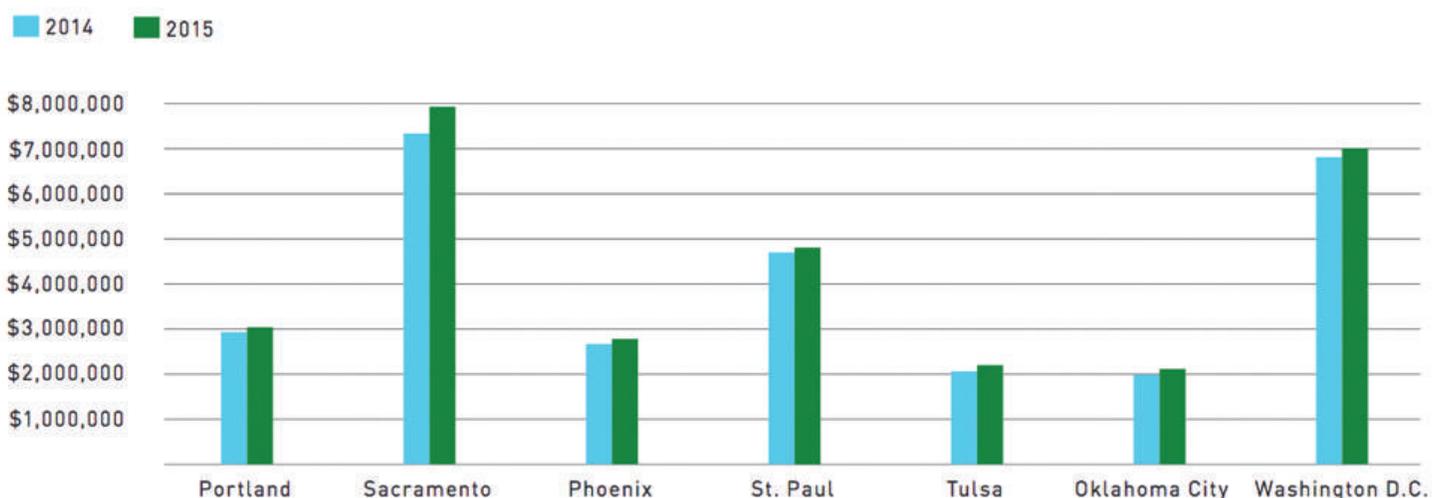
ing casinos are located in or near longstanding Federally Recognized Tribal Jurisdiction Areas. As shown in the map on the next page, Tribal Jurisdiction Areas belonging to the 38 Federally-Recognized Oklahoma Tribes cover most of the State except for the northwest quadrant. With no Tribal jurisdiction in the northwest, there are currently no Tribal Gaming Operations in this area.

The citizens of the State of Oklahoma passed the Oklahoma State Tribal Gaming Act in 2004, establishing a pre-approved gaming compact model for Federally-recognized Tribes. The compact covers one-time startup costs and monthly exclusivity payments from the operating Tribes to the State. Additionally, the compact defines the audit and regulatory framework for operation in conjunction with the National Indian Gaming Commission (NIGC) and in compliance with the Indian Gaming Regulatory Act (IGRA).

Since inception, Oklahoma Tribal Governments have paid more than \$1.123 billion in exclusivity fees to the State. Total construction cost for the existing gaming, hotel, and related ancillary facilities since inception is estimated to equal over \$3.6 billion since the beginning of Tribal Government Gaming in Oklahoma.

While the exclusivity payments are well known to state authorities, the annual impacts resulting from ongoing Tribal Government Gaming are not. This report seeks to quantify the annual production, employment, and payroll impacts of Tribal Government Gaming in Oklahoma.

Tribal Government Gaming Revenues 2014–2015



Source: National Indian Gaming Commission

Revenues

According to the National Indian Gaming Commission (NIGC), Tribal Government Gaming revenues were up sharply in Oklahoma during 2015. Nationally, revenues increased by 5.0 percent while the Oklahoma City Region, which encompasses western Oklahoma, exhibited the second largest increase of any of the regions at 6.7 percent.

The Tulsa Region, which includes the eastern portion of the State, grew by 6.5 percent, the third largest increase of any of the regions. Using the Oklahoma Tribal Survey data and the NIGC revenue release, we estimate that Oklahoma revenues were \$4.75 billion in 2015.

Output

Direct production, or output, from Tribal Government Gaming is derived from reported or estimated revenues less the wholesale value of goods sold in retail outlets. We estimate that Tribal gaming output was \$4.5 billion in 2015. This direct impact represented 3 percent of private production in the 2015 Oklahoma economy.

Exclusivity Fees

Oklahoma has 33 Tribes with gaming compacts. Per the terms of the State-Tribal Gaming Compacts, Compacted Tribes pay a monthly exclusivity fee to the State of Oklahoma for the exclusive right to operate Compacted Gaming. The fees are calculated as follows:

Electronic Covered Games:

- 4 percent of the 1st \$10,000,000 of annual Adjusted Gross Revenues (AGR),
- 5 percent of the next \$10,000,000 of AGR, and
- 6 percent of AGR over \$20,000,000

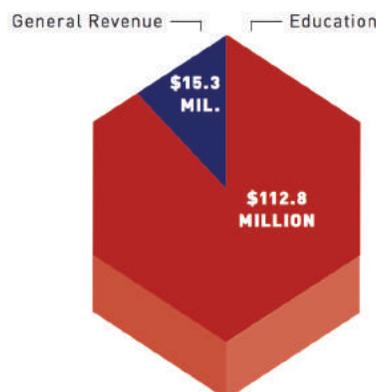
Non-House Banked Games:

- 10 percent of the Monthly Net Win

Oklahoma Tribes have paid the State \$1.123 billion in total exclusivity fees.

By statute, exclusivity fees go to the Education Reform Revolving Fund (HB 1017 Fund), the General Revenue

Where the Money Goes



Exclusivity Fees Paid by Oklahoma Tribes

Fiscal Year*	Total Exclusivity Fees
2016	\$132,035,000
2015	\$128,378,000
2014	\$122,622,000
2013	\$128,098,000
2012	\$123,872,000
2011	\$122,238,000
2010	\$118,214,000
2009	\$105,587,000
2008	\$81,424,000
2007	\$46,824,000
2006	\$14,234,000
Total	\$1,123,526,000

* Fiscal Year ending June 30th

Source: Oklahoma Gaming Compliance Unit Annual Report Fiscal Year 2016

Fund, and the Department of Mental Health and Substance Abuse Services (ODMHSAS). According to the Oklahoma Gaming Compliance Unit, ODMSAS receives \$250,000 annually, with 88 percent of the remaining fees going to the 1017 Fund and 12 percent to the General Revenue Fund.

Employment

During 2015 Oklahoma Indian casinos, along with their hotels and related ancillary facilities, had an annual average employment of 27,944. Of these employees, 76.6 percent were full-time, 55.8 percent of employees were women and 43.2 percent of employees were Native American including 22.3 percent of Tribal employees working for their respective Tribes.

An estimated 18,470 of Tribal gaming employees — more than 66 percent of total employees — worked at rural gaming facilities, while an estimated 9,474 of Indian gaming employees — almost 34 percent of total employees — worked at urban gaming facilities. At the same time, there is a greater percentage of full-time employees working at urban Tribal casinos in Oklahoma.

Private employment provided 1.32 million jobs in Oklahoma in 2015. As discussed previously, the average employment at Tribal Gaming and related ancillary facilities was 27,944. Tribal Government Gaming in Oklahoma, as a combined employment industry category, would rank as the 14th largest industry employer in the State of Oklahoma.

To put this into context, approximately 2.1 percent of all jobs in Oklahoma exist at Tribal Gaming and ancillary facilities — that equates to one in every 47 jobs.

Wages and Benefits

Workers earned \$1.37 billion in wages and benefits at casinos and ancillary facilities in 2015. Like public corporations, the Tribes provided healthcare, dental, insurance, and other benefits with healthcare accounting for the most significant cost at \$320 million.

Employees at Rural Indian casinos in 2015 were paid over \$975 million in wages and benefits more than 71 percent of total wages and benefits paid by Indian casinos in Oklahoma. This compares to urban casinos which paid employees over \$393 million almost 29 percent of the statewide total.

Payroll and Related Taxes

Oklahoma Tribes paid out almost \$325 million in State and Federal payroll taxes from workers employed in gaming and related activities in 2015. The Tribes withheld over \$33 million in income taxes for the State of Oklahoma.

Additionally, Tribal Government Gaming provided \$176 million in payments to Social Security and Medicare through employer and employee contributions. This is of particular importance as the State and Nation continue to age, relying more heavily on the current working population to fund current benefits.

During 2015 Tribal Gaming and related hotel and ancillary facilities had total annual visits of almost 46 million, including almost 18.5 million from out of state. This compares to 2014 with total annual visits of over 38 million, including an estimated 14.6 million from out of state.

Visitation

During 2015 Tribal Gaming and related hotel and ancillary facilities had total annual visits of almost 46 million, including almost 18.5 million from out of state. This compares to 2014 with total annual visits of over 38 million, including an estimated 14.6 million from out of state.

Rural and urban Tribal casinos in Oklahoma attract approximately the same amount of in-state resident visitors — around 13.5 million rural and 13.5 million urban. At the same time, rural Tribal casinos attract over 15.7 million visitors from outside of the state, more than five times that of urban casinos. Accordingly, Tribal gaming in Oklahoma, particularly those facilities located in rural areas, have created a tourism export for the State of Oklahoma, attracting millions of out of state visitors each year.

It is important to note that these visitors don't just spend money at Tribal Gaming Operations in Oklahoma, but at other businesses and attractions as well. Furthermore, the more time visitors spend at Tribal Gaming Facilities in Oklahoma, the greater the amount of money spent at area businesses, particularly by those visitors residing outside of Oklahoma.

Impact from Operations

Indirect output includes increases in production and/or sales

at area businesses due to the increased demand generated by Tribal Gaming and related ancillary facilities in Oklahoma, as well as at businesses impacted by the providers of goods and services to the Tribal Gaming and related ancillary facilities in Oklahoma. Indirect impacts are derived from casino expenditures within the Oklahoma economy. In total, gaming and ancillary facilities spent \$1.07 billion with other businesses in 2015, of which \$593 million was spent within the State. This \$593 million accounts for the first round of indirect, or business-to-business impacts attributable to Tribal Government Gaming. When coupled with additional business spending from related industries to support Tribal Government Gaming, business-to-business spending topped \$797 million in 2015. This is the total statewide indirect impact of Tribal Government Gaming. The rural areas accounted for 59 percent of the initial statewide expenditures and 57 percent (\$456 million) of the total indirect impacts within the State.

Tribal Gaming workers and workers in businesses supporting the industry spent an additional \$1.06 billion in Oklahoma from their employment earnings. This is the induced impact from Tribal Gaming. The total induced and indirect impact on the economic output on the State of Oklahoma as a whole is estimated to equal almost \$1.9 billion annually.

Adding the direct impact on output from Tribal Gaming and related ancillary facilities in Oklahoma to the indirect and induced impact yields a total estimated annual impact on output of almost \$6.3 billion for the State of Oklahoma. Rural impacts accounted for 60 percent (\$3.8 billion) and urban impacts represented 40 percent (\$2.6 billion) of the statewide impacts from operations.

Earnings

Indirect and induced earnings include increases in earnings at area businesses due to the increased demand generated by Tribal Gaming and related facilities in Oklahoma, as well as at businesses impacted by the providers of goods and services to the Oklahoma Tribal Gaming Operations. The total induced and indirect impact on personal income from Indian casinos and related ancillary facilities on the State of Oklahoma is estimated to equal more than \$606.2 million annually — 51 percent (\$307.3 million) rural, and 49 percent (\$298.9 million) urban. Adding the direct impact on earnings from the Tribal Gaming Operations to the indirect and induced impact yields a total estimated impact on personal income of almost \$2 billion annually for the State of Oklahoma as a whole — 65 percent (\$1.3 billion) rural and 35 percent (\$692 million) urban.

Annual Capital Expenditures

In addition to normal operations, Tribal Governments regularly undertake construction projects to build, maintain or expand gaming facilities and connected infrastructure. These construction projects require significant Tribal expenditure(s) within the local economy and serve as an additional source of indirect impact. In 2015, participating Tribes reported spending over \$534 million on construc-

tion of facilities and roads, of which 68 percent was spent in rural areas. Since capital expenditures vary greatly by Tribe and by year, we did not attempt to extrapolate these numbers across all Tribes. Thus, the capital expenditures reported here are likely a conservative estimate of the total actual expenditures in 2015.

Output Due to Capital Expenditures

As previously discussed, during 2015 Tribes in Oklahoma spent an estimated \$533.3 million on new and expanded gaming and ancillary developments and another \$1.1 million on road construction directly related to Tribal Gaming Operations. Combined, during 2015, Oklahoma Tribal Government Gaming spent over \$534.4 million on capital improvements directly related to Tribal Gaming Operations.

Indirect and induced output includes increases in production and/or sales at area businesses due to the increased demand generated by capital expenditures by Tribal Gaming and related ancillary facilities in Oklahoma, as well as at businesses impacted by the providers of goods and services to the Tribal Gaming Operations and related ancillary facilities in Oklahoma. The total induced and indirect impact on the economic output due to capital expenditures by Tribal Gaming Operations on the State of Oklahoma as a whole is estimated to equal over \$362.6 million annually, of which 46 percent occurred in rural areas. Adding the direct impact on output from capital expenditures by Tribal Gaming and related ancillary facilities in Oklahoma to the indirect and induced impact yields a total estimated annual impact on output of over \$897 million for the State of Oklahoma. These impacts were felt throughout the state with \$531 million (59 percent) in the rural areas and \$366.2 million (41 percent) in the urban areas.

DIRECT IMPACT SUMMERY

- Oklahoma Tribal Government Gaming output was \$4.75 billion in 2015, representing 3 percent of private production in the Oklahoma economy.
- Oklahoma Tribes have paid the State a total of \$1.123 billion in Exclusivity Fees since 2006.
- Tribal Government Gaming Operations and Related Facilities supported 27,944 ongoing jobs in 2015 of which 76.6 percent were full-time positions. 18,470 of these jobs (66.1 percent) were located at Indian casinos in rural counties while 9,474 of these jobs (33.9 percent) were located at Indian casinos in urban counties in Oklahoma.
- Annual wages, salaries, and tips of almost \$1.05 billion in 2015.
- Annual employee benefits of almost \$320 million including healthcare, dental, life insurance, and retirement plans.
- In 2015, Oklahoma Tribal Gaming Operations and their employees paid almost \$325 million in payroll related taxes including more than \$33 million in income taxes to

the State of Oklahoma.

- Oklahoma Tribal Gaming Operations had almost 45.9 million visits in 2015, including more than 18.7 million visits from out of state. In 2015, rural Tribal Government casinos in Oklahoma accounted for 29.3 million visits (63.9 percent of total visits) including over 15.7 million visits from out of state (almost 84.0 percent of total out-of-state visits).

- In 2015 alone, Oklahoma Tribal Gaming Operations spent \$534 million on capital improvements, creating an estimated 3,948 jobs and earnings of almost \$193 million in the construction industry.

MULTIPLIER AND TOTAL IMPACT

- Induced and indirect impact on the economic output on the State of Oklahoma, from both construction and operations, is estimated to equal just over \$2.2 billion annually, giving a total economic impact of \$7.2 billion from annual operations and construction, of which 60 percent occurred in rural areas.

- Induced and indirect impact on employment in the State of Oklahoma from both construction and operations is estimated to equal 17,050 ongoing jobs, giving a total employment impact of 48,942 jobs from annual operations and construction, of which 64 percent occurred in rural areas.

- Induced and indirect impact on earnings in the State of Oklahoma from construction and operations is estimated to equal more than \$713 million annually, giving a total earnings impact from annual operations and construction of \$2.3 billion, of which 64 percent occurred in rural areas.

To read the full 2016 Statewide Economic Impacts from Oklahoma Tribal Government Gaming, visit <https://oiga.org/wp-content/uploads/2018/01/OIGA-Impact-Report-2016.pdf>



Tribal gaming's
direct impact
represented 3
percent of private
production in the
2015 Oklahoma
economy.

(d. 3.9%)

Notes

**This is a resource document for you to use.
Take notes, highlight, use as a text book.**

Section 4
Tax Restrictions

How Oklahoma government got in a hole and why it can't seem to get out

Randy Krehbiel, *Tulsa World*, November 5, 2017

How, a caller asked last week, did Oklahoma's state government get into such a financial fix, and how do we get out of it?

Simple question. Not so simple answer.

First we have to accept the premise that the state is in a financial pickle. Not everyone does. They believe the rough patch of the past few years is just that, and that Oklahoma will soon grow its way out of the current difficulties. They also believe there is still a lot of money to be squeezed from revolving funds and wrung from the bureaucracy.

They may be right. There always seems to be another cookie jar at the Capitol. Prevailing thought, though, seems to be that, at the very least, the way Oklahoma funds state government needs some adjustments.

This week's phone call prompted me to begin a list of things heard and observed concerning state government. They are offered here for discussion purposes only:

1. Economy. Oklahoma's overly reliant on commodities — chiefly petroleum and agriculture — and doesn't produce enough "value-added" end products such as manufactured goods and computer software. We're better than we used to be, but we're not there yet.

2. Revenue system. Oklahoma's is becoming increasingly outdated. We depend mostly on income tax and sales tax. Income tax is OK as long as it doesn't become too burdensome, but sales tax is being collected on a smaller and smaller share of the economy. This is particularly hard on municipalities — which in turn puts more pressure on counties and the state for things like social services and roads.

The best models are low-rate, broad-base. With sales tax, we're getting caught in a high-rate, narrow-base situation.

Oklahoma's property taxes are among the lowest in the nation, and some people, including conservatives, have suggested higher property tax rates, especially on agricultural property. There is also some discussion of raising or eliminating the 3 percent annual valuation cap.

Property taxes go entirely to schools and local govern-



Senators find their seats before the proposal of a resolution on the budget at the Oklahoma State Capitol on Oct. 26. IAN MAULE/*Tulsa World*

ments, so they do not have a direct impact on state finances. But there is an indirect effect. For instance, the amount of local money going to schools affects how thinly state school funding is spread.

3. Tax cuts. Some say the tax cuts (and tax preferences, which amount to tax cuts) of the past 25 years are getting too much blame for the current situation. Taken individually, that may be true. Some probably more than pay for themselves.

Lawmakers overstate the possible savings from eliminating tax incentives for the simple reason that some of the bigger ones won't — and for all practical purposes can't — be done away with. These would be things like the mortgage interest deduction and the sales tax exemption for manufacturing.

Taken together, though, tax preferences distort the tax system and chisel away at the tax base. Again, it becomes a matter of relying on a smaller and smaller share of the economy for the resources to run state government.

4. State Question 640. Love it or hate it, the constitutional amendment approved by voters in the early 1990s makes governing more complicated. It requires a vote of the people or a three-fourths vote of both the House and the Senate to pass a tax increase.

Before 640, tax rates rose and fell every few years depend-

ing on circumstances. We eliminated the state property tax in the 1930s and replaced it with a state sales tax.

The supermajority requirement gives legislative minorities outsized influence. There's no getting around that. And protecting legislative minorities has a history in American democracy most evident in the U.S. Senate's filibuster rules.

But the three-quarters requirement is well-nigh impossible for the 101-seat House to achieve anything of significance. Currently there are three broad factions in the House — the Democrats, the Republicans and the other Republicans. Two of the three must agree on revenue measures, and that isn't close to happening.

The advantage of a supermajority requirement is that it makes it harder for lawmakers to take the easy way out. They can't just soak the group least able to defend itself — smokers, in the current scenario — and go home.

But Oklahoma's "super supermajority" encourages minority factions to overreach and demand more than is realistic. One Republican lawmaker compared House Democrats' opening demand for 350 percent increase in certain gross production tax rates to the equivalent of someone asking for a 350 percent raise and then compromising at a doubling in pay.

5. Poor health. Many Oklahomans are sick and disabled, which in turn means they have less income, generating less economic activity and less in taxes. I had a story about a month ago about Oklahoma having one of the lowest workforce participation rates. So we get less tax revenue and have more demand for services. Some percentage of these people are no doubt just malingerers, but I couldn't say what that percentage is.

6. Efficiency. There are always things that can be done to make an operation more efficient. The current situation at the Department of Health seems to be an example.

School consolidation is a favorite efficiency measure, though I personally question how much would ultimately be saved. Every consolidation of any size results in another layer of administration. And anyway, consolidation should be based on what's best for students.

One of the biggest problems for the state is that improving efficiency requires some upfront investment in technology and people. Not necessarily more people, but better trained and more capable people. Those usually cost more. State government has a very high turnover rate presently, which generally means the best people or at least the most promising are leaving to go elsewhere.

Notes

**This is a resource document for you to use.
Take notes, highlight, use as a text book.**

(b. 4.5% for state GDP but only 1.5% annually for state tax revenue)

All About Tax Credits, Deductions and Exemptions

Gene Perry (OK Policy), Jonathan D. Buxton (State Chamber), and Russell Evans, (OCU)

Oklahoma's tax expenditures are allowed to play by different rules than other state spending

by Gene Perry, Director of Strategy and Communications, Oklahoma Policy Institute

Beginning in fiscal year 2010, we can see a clear inflection point for Oklahoma's state budget. Prior to that year, the state budget reliably increased alongside inflation, population growth, and a large state economy. Although the growth could be disrupted by recessions from time to time, in good years it would return to the trend and keep pace with the increasing needs of a larger, more developed Oklahoma.



Gene Perry

From 2010 on, that picture looks very different. Revenues and state appropriations plummeted during the Great Recession, and they never returned to anywhere near the pre-recession trend. Even after the economy began to grow again, state agencies faced year after year of flat funding or cuts.

Some have called the flattened budget a “new normal.” This new state of affairs has several causes, and Oklahomans may differ over how much we should be concerned about it. But whatever we think about the “new normal,” we should note that one major category of state spending carried on under the “old normal” — the growth of tax expenditures in Oklahoma continued uninterrupted. There are more than 400 tax credits, deductions, and exemptions on the books in Oklahoma, with costs ranging from zero to hundreds of millions of dollars every year. Some of these benefit large swaths of the state — such as the personal exemption that all Oklahoma households can claim on their tax return. Others subsidize very specific activities or industries.

For example, take the “Credit for Employers in the Aerospace Sector,” which was claimed on 33 tax returns and cost Oklahoma \$1,989,000 in fiscal year 2016. The credit pays employers in the aerospace industry up to \$12,500 per engineer that they hire, plus another credit of up to fifty percent of any tuition they reimburse for their employees. A separate tax credit pays up to \$5,000 to the aerospace engineers directly; it was claimed on 1,504 returns for a cost of more than \$5 million in fiscal year 2016.

Under any fair assessment, these tax credits are state spending by another name. Although implementation of these credits happens through the tax code, the effect is that Oklahoma is directly using money collected through general taxation to subsidize a specific activity — in this case, providing tuition assistance and hiring aerospace engineers.

Between incentives like the Aerospace tax credit, the Quality Jobs program, the Investment/New Jobs credit, and others, reimbursing the payroll costs of private businesses has become a major destination for taxpayer dollars — one that is tens of millions larger than the entire appropriation for the state CareerTech system, which provides vocational training to students at public schools and technology and skills centers.

However, these tax expenditures operate under very different rules from other state spending. For example, the CareerTech system must operate within the annual budget appropriated by lawmakers each year. That budget has been cut more than 21 percent since FY 2009.

As a result, the agency has cut employees through layoffs and buyouts and eliminated much of the administrative oversight over their programs, which CareerTech officials say threatens to result in “inconsistent teaching/administration practices, loss of quality program content, and improper data reporting.”

This example illustrates the stark contrast between two kinds of state spending with very similar missions to promote workforce development and economic growth within the state. Over the same time as funding for CareerTech was slashed, spending on the Quality Jobs program, Investment/ New Jobs credit, and aerospace tax credits have more than doubled. Because these programs award tax credits to any qualifying company that applies, our spending on them continues to grow without oversight by lawmakers or the general public. We never know how much they will cost until we get the bill.

It is clear that growing tax expenditures are shifting money away from CareerTech and other services. We may debate whether it is better for Oklahoma to grow our economy by directly subsidizing private sector jobs versus investing in public workforce training programs. Unfortunately, Oklahoma lawmakers have not even acknowledged that they are making this tradeoff.

For example, when the Legislature voted in 2014 to extend the sunset date for the aerospace tax credit, the analysis provided by legislative staff claimed that “there is no additional fiscal impact due to extending the sunset date.” In another example, when lawmakers voted in 2015 to allow chicken egg producers to receive Quality Jobs subsidies, the bill's summary claimed that spending this money would not cost money “due to the revenue neutral features” of the Quality Jobs Program.

The revenue neutrality of tax expenditures is highly suspect, especially when contrasted with our very different treatment of appropriated spending programs. We have decided Quality Jobs doesn't cost money because the spending leads to economic growth that increases tax revenues. However, CareerTech isn't allowed that convenience when lawmakers decide its budget. Neither is Common Education, Transportation, or Public Safety,

despite these agencies' clear importance for ensuring a stable, growing economy.

This approach prevents an honest examination of how best to use Oklahoma taxpayer dollars. Oklahoma has made some progress with reforms that will require new tax breaks to be regularly assessed based on a measurable goal — however, as we saw with the Tax Incentive Evaluation Commission's rejection of an expert recommendation that the Oklahoma's Capital Gains Tax Break was not paying off in economic growth, in some cases lobbying power and wishful thinking still take precedence over responsible fiscal management.

We must do more. A good step would be to require a sunset date be added to all tax expenditures, so lawmakers have to regularly return to them and assess if they should continue. Tax breaks should also be capped with an annual spending limit to reduce the risk that lawmakers could severely underestimate how much they will cost. Estimates of how much the state is currently liable for in tax credits vary widely and credits can be used years after they are issued, so we never know exactly what the impact will be until the bill comes due.

These reforms would bring some much needed accountability by taking Oklahoma's tax expenditures off auto-pilot. Fundamentally, we need a shift in perspective among Oklahoma lawmakers and the public to recognize tax expenditures for what they are and to exercise the same scrutiny over them that we do for all other forms of state spending.

The Business Perspective on Tax Credits, Deductions and Exemptions

by Jonathan D. Buxton, former Senior Vice President of Government Affairs, State Chamber of Oklahoma

In order for any endeavor to thrive, investment must be made. Tax credits, deductions and exemptions allow the state to invest, via the tax code, in creating a thriving and diverse economy in Oklahoma.



The state of Oklahoma has been blessed with abundant natural resources and an enterprising spirit in her people. However, a lot of other states have a very similar set of raw materials and we compete with them every day. Unless the state provides a fertile field of growth, these resources will not be utilized. This will result in Oklahoma being outpaced by our neighboring states.

Historically, Oklahoma has relied heavily on the agriculture and energy sectors of the economy. These industries remain vital to the future of our state, but recent growth in other sectors has diversified the Oklahoma economy. As we have seen in the past, when we rely solely on agriculture and oil and gas commodities, our state revenues suffer from the fluctuations in those markets. There is a value in diversifying Oklahoma's economy, and the

primary tool in the toolbox of state government is a reduction in the tax burden imposed by the state to achieve specific goals.

Unfortunately, the term "tax credit" has become more of a pejorative than a description of a tool. The problem arises when people fail to recognize that these credits are reductions in the burden of the taxpayer. Perhaps better terms are "targeted tax cuts" or "economic development programs."

It is important to note that the assumption of the tax code at both the state and the federal level is that all income, from businesses and individuals, belongs to the government and the government simply allows taxpayers to keep some of that income. Thus, tax credits are reported by the government as tax expenditures. This shift in ownership of income allows legislators to claim that tax credits are handouts and cost the state money. Nothing could be further from the truth.

Businesses create jobs and make capital investments in the state. These investments make the state attractive to new talent while also helping the state government better weather recessions and economic downturns. Attracting new industries and businesses within existing industries through the use of tax credits helped the state move away from solely depending on one or two industries subject to the ebbs and flows of the markets.

The state should examine the return on these investments, and the business community welcomes fair minded evaluations of all credits, exemptions and deductions. The creation of the Incentive Evaluation Committee by House Bill 2182 last session is an excellent opportunity to evaluate these economic development programs. The business community looks forward to sharing the stories of how these programs have provided an opportunity for their industries and the growth of all of Oklahoma.

The Impact of Tax Credits, Deductions, and Exemptions on the Oklahoma Budget

By Russell Evans, Director, Economic Research and Policy Institute, Meinders School of Business, OCU

While the focus of this town hall gathering is on Oklahoma budget priorities, a focus of the impact of credits, deductions, and exemptions on the state budget omits from consideration important features of these programs. Credits issued against a tax liability, deductions offered to reduce a taxable base, and exemptions from taxable coverage all have an unambiguous negative effect on the state budget. In a static world (considering credits, deductions, and exemptions in a vacuum and ignoring dynamic economic impacts across time), every credit, deduction, and exemption reduces what would otherwise be available to the state budget. But we do not live in a static world, and these tax programs are implemented in recognition of this reality with the explicit intent to alter economic activity. The real question is



Russell Evans

whether or not the positive impacts to economic behavior offset the costs of foregone state revenue.

As an example, consider the federal mortgage interest deduction. The deduction has an unambiguously negative impact on federal budgets as a nearly \$70 billion tax expenditure (one of the largest federal tax expenditures and the subject of much recent reform debate).

When implemented, the intent was to encourage home ownership by decreasing the real costs of buying a home. In theory, renters may be more inclined to transition to homeowners if they know the increase in monthly living expenses (mortgage principal and interest payments, property taxes, homeowner's insurance, utilities, etc.) would be at least partially offset by a smaller tax burden.

The belief being that homeownership is associated with a host of positive economic spillovers on the community including increased likelihood of voting in local elections, decreased likelihood of criminal activity, increased likelihood of participation in local education, etc. Indeed, the federal mortgage interest deduction was seen as an integral part of the strategy to promote the American dream.

More recently, economists have wondered if the community benefits still outweigh the fiscal costs as it increasingly appears to have little effect on homeownership decisions and only offers significant tax savings to a small segment of the population – high income earners with large housing expenses (east coast, west coast, and select high cost of living metro areas). One Nobel economist, Robert Shiller, went so far as to note sarcastically that the deduction incentivized the uniquely American dream of being heavily leveraged in a singularly undiversified asset portfolio!

Returning to the state discussion, the remaining commentary will focus on the role of credits, deductions, and exemptions in determining the location of economic activity (successful economic development).

In a terrifically insightful paper published nearly twenty years ago entitled *State Tax Policy and Economic Development: What Should Governors Do When Economists Tell Them That Nothing Works?* by Dick Netzer, he poses and answers the following question:

“What do we really know about the effects of state tax policies on the location of economic activity? The answer to this first question is dismayingly inconclusive. It would be absurd for governors to act on the conviction that location is entirely indifferent to state-local taxes, but equally absurd for them to accept the proposition that there is usually a big bang for the buck. Ordinarily, it will cost a great deal in tax revenue to get strong economic effects and, in some circumstances, even a very costly tax change may have negligible effects (except perhaps in the very long run). But there are conditions in which strategic tax actions can

have a strong impact. Those conditions relate to geography, a state's economic structure and the specific features of its tax system.”

The preceding paragraph highlights at least two important points worth considering. First, tax credit, deduction, and exemption programs must be evaluated on a case-by-case basis to determine if their implementation improves social welfare. As before (see the previous article by this author), there is no sweeping answer to the issue that reveals the exact combination of taxes and tax expenditures that are optimal for a state. Instead, careful and considered analysis on a case specific basis is required to determine if the policy advances or impedes the public good. The second point is a little more subtle and is found in the recognition that the intent of these programs is to advance social welfare. The ability of the state to provide basic public sector support (the state budget) is certainly a component of social welfare, but so too is the level and growth of economic activity, private household consumption, environmental and natural resource quality, and many other arguments. All too often discussion of credits, deductions, and exemptions focus almost exclusively on the question of “does the program pay for itself” to the exclusion of other potential avenues of benefits.

In this light, the focus becomes less on the impact on the state budget, but more broadly, the impact on the state. In the interest of time and space, the following bullet point thoughts may prove useful in considering the role of credits, deductions, and exemptions.

- Credits, deductions, and exemptions are a complement to effective local government in regional economic development; there is likely no tax expenditure program or local incentive that can overcome the negative development effects of a community that has a culture of contention between local levels of government or the public and private sector; for regional economic development, a culture of success is more important than the specifics of a credit, deduction, or exemption incentive;
- A natural tendency to adopt and duplicate the programs of other regions is misplaced; successful programs must be complements to a region's existing economic geography, economic structure, and resource base;
- Credits, deductions, and exemptions should be evaluated on a case by case basis; sweeping assertions of their effectiveness or wastefulness are more likely to reflect a philosophical rather than an empirical analysis;
- The above bullet points combined suggest that a regular review of tax expenditure programs is beneficial, as the program may be stagnant against a changing geography, structure, and resource base;
- The effectiveness of a tax expenditure program should be evaluated using a set of metrics more broad than simply

evaluating if the program pays for itself by generating more tax revenue than it foregoes in tax expenditures

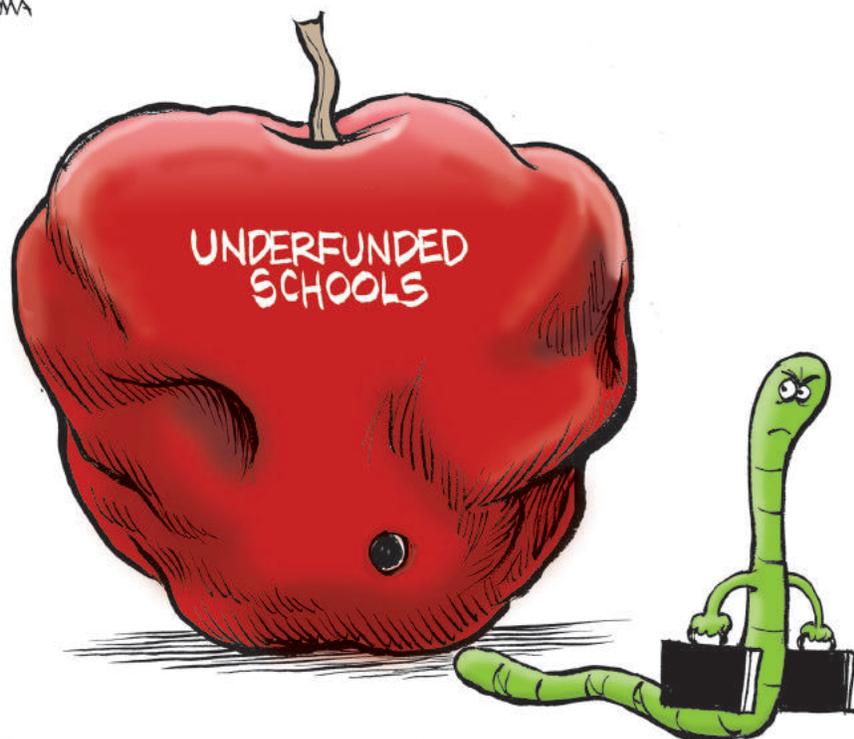
Netzer summarizes the above discussion nicely while underscoring the need for careful analysis rather than sweeping change. He notes that "...a careful reading of the evidence leads to a much more agnostic type of advice: there are indeed conditions in which tax policy changes that are not enormously costly can make a difference.

Don't expect miracles, however.

To get a big bang will take a lot of bucks, more often than not, and the scene is littered with examples of a lot of tax relief or reduction bucks producing no economic development bang at all."

Evaluating state tax credits, deductions, and exemption is certainly an important piece of the budget prioritization process, but a singular focus on budgetary impacts does a disservice to the broader aspiration state prioritization at the heart of this town hall gathering.

PLATE FOR OKLAHOMA ACADEMY



(a. \$40 sales tax credit on income tax)

Revenue Raising Options Given SQ 640

Craig Knutson and Kent Olson, PhD

The following are excerpts from an article Dr. Kent Olson wrote for the State Policy and Economic Development: 2000 publication, entitled “State Question 640: Fiscal Effects and Economic Growth.” The complete article can be found at the State Chamber’s Research Foundation website (www.okstatechamber.com).

This is presented for educational purposes and provides a thoroughly researched perspective about what impacts the law might have on the state’s budget and overall economic development. Keep in mind that 15 years have passed since this was authored, so the relative importance of sources of revenue might have changed.

“Oklahoma voters approved State Question 640, amending article 5, Section 33, of the Oklahoma Constitution in March, 1992. This amendment requires majority approval by voters of all revenue bills that pass either the House of Representatives or Senate with less than a three quarters majority.

Although SQ 640 reduces the probability of tax increases, it does not eliminate them entirely. Given the ultimate requirement of voter approval, however, legislators will tend to favor increases in the taxes most likely to be approved by the voters. These taxes will become relatively more important.

In the long run, SQ 640 will affect the sources of state government funds in four principal ways; by (1) reducing the total tax burden, (2) changing the relative importance of specific taxes, (3) increasing income from fees, and (4) increasing government borrowing.”

At the time of passage, “the prevailing view in the electorate appeared to be that the tax burden (taxes as a share of income) had increased too much, too fast, and that a measure making it more difficult to secure future tax increases would lead to a lower tax burden as state income continued to grow.”

The table below shows per capita personal income (PCPI) trends, for the U.S. and Oklahoma, in five year increments. 2012 is the most current PCPI data by state. The last column uses Tax Foundation Data for Oklahoma Total State & Local Taxes Per Capita, divided by PCPI, to calculate the ratio. The first entry in the last column is actually 2011 Data.

IMPACTS OF OKLAHOMA SQ 640

	US	OK	*OK/ US	Rank	**Tax/Inc
1992	\$20,799	\$17,269	83.0%	39th	9.4%
1997	\$25,654	\$20,866	81.4%	44th	9.7%
2002	\$31,481	\$26,185	83.2%	39th	9.4%
2007	\$39,506	\$34,329	86.9%	38th	9.1%
2012	\$42,693	\$39,006	91.4%	32nd	8.5%

*PCPI Ratio

**Oklahoma Total State & Local Per Capita Taxes divided by OK Per Capita Personal Income

While the trend suggests a lowering of tax burden relative to income, there is no way to determine correlation or causation due to one action (passage of SQ 640). As with most events being studied, the number of independent variables and their level of explanation are numerous.

“Although we expect the tax burden to fall as a result of SQ 640, we also expect changes in the relative importance of specific taxes. A tax becomes important over time if revenues from the tax increase as a percentage of total tax revenues.

The five largest taxes in Oklahoma, in order of amount normally collected, are the individual income tax, the general sales tax, the motor vehicle license tax, the motor fuels excise tax, and the severance tax on oil and gas production.

Fees are an important source of revenue for state government, surpassed in size only by the individual income and general sales taxes. SQ 640 does not appear to apply to fee increases. Thus, we expect discretionary increases in the future.

Borrowing, or the issuance of debt, is a widely used means of financing state and local government expenditures, especially for expenditures for durable capital goods. Given that debt financing is not subject to provisions of SQ 640, it will probably become a more frequently used source of funds.”

Dr. Olson’s article concludes with a qualitative assessment of SQ 640’s impact on future state economic growth, stating that “there’s no compelling reason to believe that SQ 640 will ultimately have a positive effect on state economic growth. In fact, a negative impact on economic growth is much more likely.”

Despite having been very active in economic development circles at the time of the passage of SQ 640, I am uncertain what the stated purpose(s) of the bill was/is . . . but I believe we have only had two state questions presented to the voters of Oklahoma that called for tax increases since 1992; one passed (SQ 713) and one failed (SQ 723). If the intent was to help improve sustained economic growth over the past twenty three years, the claims become less certain and, as Dr. Olson opined, “could be determined only after extensive research.”

This summary was sent to Dr. Olson for review and his comments follow:

“I think that SQ 640 has made/will make it very difficult (hopefully, not impossible) to mitigate/reverse the tax cuts of 2004-2018. Though I know of no direct evidence to date, I believe that the combination of the two has significantly reduced the state’s growth prospects by forcing the legislature to “pay” for these tax cuts with reductions in a host of government programs, especially K-12 and higher education.” - Dr. Kent Olson

Economic Incentives 101

State Chamber of Oklahoma Research Foundation, March 2015

Economic incentives play an important role for states and localities in developing their position for capital investment and job creation. Economic Incentives are components of a government's toolkit designed to address various business needs in a competitive environment through promoting job creation, job retention, and capital investment. Different incentive models have been designed to add value for specific locations, creating a higher level of competition in the marketplace for investment. One component under economic incentives is tax incentive programs. Tax Incentive Programs influence business location decisions by improving the relative profitability of businesses investing at a particular site. Tax incentive programs affect competition, which makes communities more efficient in their effort toward improving their economic conditions.

Research that addresses capital investment outlines a clear theme: tax incentives influence capital investment. In this report, we outline the basics of tax incentives in economic development that influence business location decisions.

Historical Background

Historically, states under the most economic stress were the first to create tax incentive programs. State governments have offered economic incentives since 1791. For instance, particular southern states sought to lure industry to their communities through tax incentives, low interest loans, and subsidized plants and land.

In another example, New Jersey offered an out-of-state company a tax exemption to build an industrial park in-state. Other milestones in the tax incentive evolution that play major roles in economic development include:

- The Morrill Act (1862) provided each state Federal land to be sold, stipulating that the proceeds be used to fund public colleges focused on agriculture and mechanical arts. There were sixty-nine colleges funded from the act, some of which include Cornell University, Massachusetts Institute of Technology, and Oklahoma State University.
- Modern state economic bureaus were founded in Alabama, North Carolina, Florida, and Maine, established between 1923 and 1927.
- After World War II, many states tried to preserve economic bureaus devoted to encouraging industrial relocation.
- By late the 1970s and early 1980s, economic development agencies began to function with special interest toward commercial and industrial-site planning.

Purpose of Tax Incentives

Tax incentives assist states and localities in the development of incentive models. The sole purpose of tax incentives is to influence business location decisions by

improving the profitability of investing in a particular site. By program design, tax incentives benefit businesses by offsetting business cost and government by providing new jobs and thus increasing the tax base. An incentive program helps maximize the income from a business locating into a certain community.

Tax incentives are modeled with the purpose of maximizing income for new business. For example, Kentucky developed tax incentive programs to:

- Address Cost Disadvantages—reduce business costs for startup, expanding, or relocating businesses.
- Revitalize Distressed Local Economies—more generous incentives offered to businesses that choose to locate in communities with high unemployment and poverty rates.
- Encourage Beneficial Behavior—lowering environmental emissions or creating a new product.
- Targeted Industrial Policy—attracting industries with strong economic growth trends.

Overall, one sees the commitments toward achieving economic goals from both parties; however, governments have the greater challenge in offering something that otherwise would not have been attractive.

How Incentives Work

Incentive programs must be designed to ensure a community an increase in the rate of return on investment. From a business perspective, a company must assess the value of a tax incentive by analyzing the potential cost of locating at a particular site. When incentives include job training grants, loans, and jobs tax credits, costs in capital and operation are affected. Governments have the responsibility to understand how far businesses will go to take advantage of incentives because the incentive must go to the applicant who maximizes its full potential.

Governments must consider commitments that address return on investment in incentive program design:

- Assessment of Need**
- Some businesses apply for incentive programs without proving how strong their investment intentions are without incentives. Rarely do these businesses produce the net benefits and incentive program intentions governments would like to see in program yield.
- Screening Process**
- If screened, governments can learn if investors have received incentives from other jurisdictions. Governments must maximize an investor's full potential of economic impact, especially in the long-term. When governments know the investor's history pertaining to incentive program utilization, governments can make more

Emerging Trends

1. Money matters but services and responsiveness matter more. In the era of social media, texts, and instant messaging, saving time and “instant service” is as important as dollars. A state can make up for lack of dollars by great service.
2. Calibration and fine tuning of incentives toward specific state goals and strategies will become increasingly important.
3. Workforce and talent incentives have a greater influence than tax incentives due to the long term nature of the workforce issue.

informed decisions about state and local economic future.

•Expected Job Creation.

•Performance contracts set provisions toward guaranteeing the full potential of incentives. As an example, there are stipulations preventing businesses from hiring workers to satisfy program qualifications, then laying off workers once incentive funds have been received.

•Program Evaluation

•Guidelines of programs should call for evaluations in awarding incentives and for evaluating programs. Evaluation monitors incentive impact and comforts public opinion about incentive programs. The recipient of the incentive program should not evaluate the program it administers.

Incentives are good for Economic Development

Incentives expand local employment opportunities and provide a competitive edge toward business attraction in locations that otherwise wouldn't be competitive. Traditionally, businesses seek to maximize full profit potential in site selection. To realize full profit potential, businesses evaluate alternative sites based on product demand and the cost of production. The argument from states and localities is that incentive programs reduce the cost structure of operation and meeting product demand, thereby inducing attractive alternative locations.

Local economies benefit most from incentives due to results in employment expansion, personal income expansion, community income expansion, and expansion of community output (business revenues or sales). Once a new business facility has landed and become operational, money will be spent directly on certain items, including (1) payroll; (2) service contracts with local vendors; and (3) local purchases of supplies and equipment. After the new business has made such expenditures, it sets in motion a series of spending flows that affect many areas of a local economy. For example, purchasing of goods and services from local suppliers supports hiring of workers at those businesses and enables those businesses to make additional purchases from

suppliers. In this cycle, employees of local businesses begin to earn salaries and wages that will be spent on local goods and services from other businesses. The ripple effects of the activity are evident on three different levels:

•**Direct effects**—initial changes in employment, income, or output that trigger the first round of spending (i.e. the value of a firm's initial change in payroll or production).

•**Indirect effects**—changes in employment, income, or output in subsequent rounds of re-spending that arise through purchase from local supplier industries (inter-industry purchases).

•**Induced effects**—when payrolls increase and workers in affected industry sectors spend more on local goods and services (household spending effect).

Given the benefits incentive programs have on commerce, governments also see a great benefit by maintaining or expanding the tax revenue base from new spending, thereby offering improved services or updated services to residents. Incentive programs favor economic development because they allow disadvantaged communities to level the playing field for business recruitment. Incentive programs are an investment of public finances for community benefit, rather than a subsidy of private business activities.

Criticisms of Incentives

The most common criticism of incentive programs is that they are too generous. Lavish incentives can negatively impact a government's revenue base, requiring additional spending on public services (such as education and health-care) to support new business. Problems arise when incentive programs strain local infrastructure but fail to produce the jobs or revenue they promised.

Another criticism arises when lawmakers assume that historically profitable incentives will continue to generate revenue in the future, overlooking changes in the economy which affect the program. Failing to recognize economic trends put governments in a position to lose critical revenue

due to outdated incentive programs.

Urban/Rural Conflict on Tax Incentives

The conflict between urban and rural communities on tax incentives is not an “us vs. them” relationship; instead, the relationship is better described as a conflict about what communities serve a better purpose in using tax incentives. Generally, incentive-induced employment growth in a local labor market has potential positive long-term effects. Furthermore, employment growth in metro communities contribute toward more permanent drops in unemployment due to a more accessible labor force.

However, rural and poor communities have a greater need for incentive-induced employment growth. Business development inside rural, poor communities provides positive shocks (sudden growth) to local labor demand. Additionally, incentive packages that include financing toward workforce training will also provide positive shocks to the local economy.

The Rural Opportunity Initiative (ROI) in Tennessee is an example of a plan that addresses rural investment with incentives. Characteristics of rural communities are limited road access, lack of public infrastructure, and difficulty in matching labor skills to job requirements—all problems ROI addresses through tax incentives. The ROI program outlined below provides tax incentives for businesses locating or expanding in certain counties, allocated in a tier system based on the economic demand for that county:

- Tier 1 Enhancement Counties: \$4,500 per job tax credit with a \$500,000 capital investment in a 12 month period.
- Job creation minimum of 25 full-time jobs in a 12 month period
- Job tax credits may offset 50% of franchise and excise tax liability in 15 years carrying forward.
- Tier 2 Enhancement Counties: \$4,500 per job tax credit with a \$500,000 capital investment in a 12 month period.
- Job creation minimum of 25 full-time jobs in a 3 year period
- Job tax credits may offset 50% of franchise and excise tax liability in 15 years carrying forward
- Additional job tax credits of \$4,500 per job each year for 3 years to offset 100% of franchise and excise tax liability with no carry-forward
- Tier 3 Enhancement Counties: \$4,500 per job tax credit with a \$500,000 capital investment in a 12 month period.
- Job creation minimum of 25 full-time jobs in a 5 year period.
- Job tax credits may offset 50% of franchise and excise tax liability in 15 years carrying forward
- Additional job tax credits of \$4,500 per job each year for 5 years to offset 100% of franchise and excise tax liability with no carry-forward.

Which Tax Incentives are Most Beneficial? One Time Cash

Payments vs. Periodic Performance-Based Incentives

The central challenge for governments providing tax incentive programs is understanding how to make the most informed decisions about which program best applies to a specific business; however, the decision of where businesses decide to locate relies solely on how they can maximize their income. Also, the most beneficial tax incentive programs to a government may not always be the most beneficial to business locations decisions.

The research on “one time cash payments vs periodic performance-based incentives” indicates that there is more benefit for a government to provide periodic performance-based incentives, due to the low degree of risk involved. For a government to decide which tax incentive programs to use to attract business investment depends on how risk prone or adverse a government is. The research opinions lean toward periodic performance-based incentives because of low governmental cost and program effectiveness.

The effectiveness of performance based incentives is also based on investment requirements on behalf of the relocating businesses, such as:

- Corporate Tax Reduction**—tax incentives that reduce corporate income tax liability. The amount that businesses receive in tax credits is calculated as a percentage of the investment made by the participating business. Corporate Tax Reduction is essentially a matching tax incentive program.
- Transparency**—programs are funded by taxpayer dollars and transparency is essential for building public support toward economic development initiatives.
- Monitoring**—evaluation of companies receiving incentives is helpful for analyzing whether each incentive is delivering the intended result. If an incentive program is not meeting the prescribed criteria, then a state can take action and change the program or cancel it. If an incentive requires an outcome that cannot be regularly measured, then the incentive is not well designed.
- Non-Entitlements**—Businesses that qualify for economic development incentive programs without proving they would not have invested in the expansion or location without the incentive, will rarely produce net benefits to the state or local economy.

Relocating businesses must be monitored or commit a degree of investment before the benefits of incentive programs can be realized. One time cash payments can be a strong incentive toward business attraction into a community due to the opportunities that maximize income; however, it is clear that risk is involved, and especially so with taxpayer funding.

Sunset Functions and Business Planning

A sunset is the period of time when a tax incentive program expires. Sunsets play an important role in economic devel-

opment, especially how businesses plan. First, screenings in tax incentive programs are a best practice for governments evaluating incentive applicants. Screening applicants help understand a business' commitment to locating in a state, and whether they can plan around sunsets from a previous location.

Second, a large function in tax incentive planning for governments rests on sunset stages, where they can predict a business's investments to a community when incentives expire.

State and local governments that focus on understanding the cost and effectiveness of tax incentive programs build evaluation models and policies to keep tax incentive programs modern. The best practices for sunset planning are designing evaluation models. Evaluation models consist of joint committees, citizen's commissions and legislative bodies that assemble to discuss the effectiveness of incentive programs and whether the programs should be extended, modified or allowed to expire. Some examples of states that have used evaluation models are:

- Oregon**—Created a Joint Committee on Tax Credits to review expiring credits and propose changes on a six year cycle.

- The committee requests hearings to review evidence and hear testimony from key stakeholders.
- Committee recommendations are sent to the state Legislature for review and consideration toward modernizing incentive program policies.
- In 2011, the Legislature allowed some little-used credits to expire while extending or redesigning others, and made modifications to energy incentives that would save the state \$20 million over two years, all based on the Joint Committee recommendations 26

- Washington**—A Joint Legislative Audit and Review Committee is responsible for reviewing tax incentives on a 10 year cycle.

- The committee staff submits detailed evaluations with recommendation on whether to continue, modify, or end specific tax incentives.
- A citizen's commission considers the evaluations and holds public hearings to develop their own recommendations.
- The committee and citizen's commission together provide evidence and guidance to Legislative committees that vote on tax incentive issues.
- In 2013, Washington ended an incentive meant to support beef processors after the committee staff concluded that the industry was no longer experiencing consequences of a disease outbreak that prompted creation of the incentive program.

- Rhode Island**—A law in 2013 was approved to review tax incentives in the annual budget process.

- As of 2014, incentives are evaluated by the state tax office every three years.
- The Governor's budget proposal includes recommen-

dations on continuation, change, or ending tax incentive programs.

- Gubernatorial recommendations are the subject of legislative hearings, providing lawmakers with opportunities to review tax office evaluation results and consider tax incentives alongside other state spending.

Safeguards for states and localities – Caps and Clawbacks

State and local governments understand the risk involved with tax incentive programs being potentially harmful to economic growth due to reductions in funding to education and infrastructure.

Caps

A common principle of an incentive program is that businesses are financed based on verified performance, meaning no tax dollars are paid until job creation or capital investment numbers are audited and confirmed.²⁹

When governments decline to finance a business until job creation is confirmed, this is an example of an incentive cap.

- In Kentucky, businesses receiving incentives must meet criteria every year to continue to receive incentives. A sliding scale is used to evaluate performance. For instance, if a business is required to create 20 jobs, yet only creates 10, 50% of potential incentives would be the maximum incentive amount distributed for that year.
- In New York, periodic reviews are conducted to understand the purpose of the tax incentives, if the credit is still good policy, if the credit is still applicable to the credit's original goals, and where state budget consequences stand.
- In Florida, evaluating incentive programs occur on a rotating three-year basis, as proposed. The evaluations determine economic benefits of job creation, increase/decrease in personal income, and impact on state gross domestic product resulting from each incentive program. Also, the state's Department of Economic Opportunity must publish information on incentive programs awarded to businesses.
- In North Carolina, if a business receiving incentives does not maintain its contract to term, North Carolina can force the company to pay back all or a portion of the incentives received due to provisions related to clawbacks.

Clawbacks

Governments that make loans or grants to businesses with a contract for performance typically use "clawback" provisions. The clawback provision is used when a company doesn't meet its requirements and must pay the state back for a portion of the incentive received.

You can view the original report at <https://www.okstatechamber.com/sites/www.okstatechamber.com/files/EconomicIncentives101FINAL.pdf>

Tax Incentive Evaluation Commission

Senator Roger Thompson, Senate Appropriations Committee chair-designate

The Incentive Evaluation Commission was created by the Legislature in 2015 and became effective on November 1, 2015. The Evaluation Commission consists of: (1) A certified public accountant appointed by the Accountancy Board; (2) The president of the Oklahoma Professional Economic Development Council or his or her designee who is a member of the Oklahoma Professional Economic Development Council; (3) An auditor who is employed as an internal auditor by a company or who is employed by a private auditing firm appointed by the Governor; (4) An economist from an Oklahoma college or university appointed by the President Pro Tempore of the Oklahoma State Senate; (5) A lay person who is not an elected official appointed by the Speaker of the Oklahoma House of Representatives; (6) The Chairman of the Oklahoma Tax Commission or his or her designee who is also a member of the Oklahoma Tax Commission, which shall be an ex officio and nonvoting position; (7) The Director of the Office of Management and Enterprise Services or his or her designee who is an employee of the Office of Management and Enterprise Services which shall be an ex officio and nonvoting position; and (8) The Oklahoma Secretary of Commerce or his or her designee who is an employee of the Oklahoma Department of Commerce which shall be an ex officio and nonvoting position.



Sen. Roger Thompson

The Chairman of the Commission is Lyle Roggow, designee of the President of the Oklahoma Economic Development Council. Carlos Johnson, CPA is the Vice Chairman. Johnson is an appointee of the Oklahoma Accountancy Board. Commissioner Ron Brown is an appointee of the Speaker of the House of Representatives. Commissioner Jim Deaton is an appointee of the Governor. Commissioner Dr. Cynthia Rogers is an appointee of the President Pro Tempore of the Oklahoma Senate. Ex Officio Commissioner Steve Burrage is the Chairman of the Oklahoma Tax Commission. Ex Officio Commissioner Denise Northrup is the Director of the Office of Management and Enterprise Services. Ex Officio Commissioner Deby Snodgrass is the Executive Director of the Oklahoma Commerce Department.

The law stipulates that no person shall be appointed to the Commission who is employed by a company that receives any incentive or who holds a substantial interest in ownership in a company that receives any incentive. “Sub-

stantial interest is defined in statute. Statute also stipulates that no elected official can serve on the commission. The Commission shall ensure that each incentive is evaluated at least once every four (4) years unless the Commission determines that the incentive is exempt from evaluation. By December 15 each year beginning in 2016, the Commission shall provide the results of each incentive evaluation in a written report to the Governor, President Pro Tempore of the Senate and Speaker of the House of Representatives. For a complete statutory review see 62 O.S. 7001-7005.

Over a number of years, the legislature has authorized numerous incentives. Some of the incentives have been modified several times to reflect the desire of the legislature in a particular year. The discussion leading up to 2015 was to create an avenue to evaluate each incentive offered by the state to determine if the incentive was advantageous to the state. Questions surfaced centering on the value of each incentive as to whether or not the state was gaining an economic gain or losing taxpayers money supporting a business.

As set forth in statute, the commission was to report to the Governor, President Pro Tempore of the Senate and Speaker of the Oklahoma House of Representatives by December 15 of each year. The first report was submitted in 2016 and the recommendations were considered in the 2017 Legislative Session. The first year, the Incentive Review Commission examined eleven incentives and made recommendations. Three of the incentives centered on the Aerospace Industry. They included: (1) Tax Credit for Tuition reimbursement for Aerospace Employers; (2) Tax Credit for Aerospace Employees; and (3) Tax Credit for Compensation paid by Aerospace Employers. All three were set to sunset on January 1, 2018. The Commission recommended to retain all three incentives. Senate Bill (SB)120 extended the sunset date to January 1, 2026.

Certainly one of the more hot topics dealing with incentives is tax credit for electricity generated by zero emission facilities. The Commission recommended to reconfigure the program to cap program credits or accelerate the closing of the program. The sunset date was January 1, 2021. The Commission recommended accelerating the sunset January 1, 2018. The legislature approved House Bill (HB) 2298 which closed the window for any new incentives to July 1, 2017, therefore moving the sunset date to July 1, 2017. The Commission also recommended to allow non-wind generating zero emission facilities to continue to claim the credit until January 1, 2021. SB893, which will take effect on January 1, 2019, did not change the sunset date, but capped

the credits at \$500,000. The zero emission tax credits had grown from \$3,698,962 in 2010 to \$113,236,509 in 2014.

The Commission recommended the reconfiguration of the excise tax exemption on Aircraft sales to focus the exemptions on policy goals. The commented the goals were not identified and the data did not provide a ready method of determining the overall impact on the industry in the State. HB 2253 tightened the criteria for qualifying for the exemption.

The Five Year Ad Valorem Property Tax Exemption was recommended by the Commission for retention. However, they recommended the legislature to revise the program eligibility requirements that have been the same in some cases since the inception of the program. The legislature approved HB2351 which made a narrow change for applicants in the tax incentive district.

The Commission voted to retain the Historic Rehabilitation Tax Credit and the Oklahoma Capitol Investment Board. The Evaluation recommendation was to repeal the Industrial Access Road Program. The Commission disapproved the recommendation 5-0.

The recommendation to allow the sunset date of 2024 to occur for the Oklahoma Film Enhancement Rebate was approved on a 4-1 vote. The legislature approved HB 2344 that reduced the annual amount from \$5 million to \$4 million.

The final incentive reviewed was the Quality Events Program. The recommendation that the state should (1) eliminate the process of estimating the projected economic impact prior to the completion of the qualifying event; (2) create a standardized application template with clear guidelines; (3) designate a single point person or office to respond to applicant questions. The legislature approved SB 1252 which adopted the recommendations and also extended the sunset date from July 1, 2018 to June 30, 2021.

The 2017 Incentive Evaluation Commission addressed twelve incentives. The Commission recommended to retain the Quality Jobs Program with modifications: (1) require filing for incentive payments each quarter; (2) regularly review eligible industries; and (3) centralize the data tracking. They recommended to retain the Small Employer Quality Jobs Program with the same modifications as the Quality Jobs. The legislature approved SB 923 that becomes effective on November 1, 2018 to increase the maximum employment to participate from 90 jobs to 500 closing the gap between the Quality Jobs and Small Employer Quality Jobs Program. The 21st Century Quality Jobs Program was given the same recommendations. The legislature approved HB 3324 that became effective August 2018 requiring five (5) percent of all funds paid under these three to be deposit-

ed into the Governor's Quick Action Closing Fund.

The Commission recommended to repeal the High Impact Quality Jobs Program and the legislature acted by approving SB 897 repealing the program effective November 1, 2018.

What became one of the most talked about and heated discussions in the 2018 legislature was the Capital Gains Deduction. The recommendation to the Commission was to repeal it, however, they voted 3-1 to retain the incentive. According to the executive summary written by the Commission, one of the key findings emphasized the program has been a significant net cost to the State. From 2010 to 2014, the program is estimated to have reduced State tax revenue by \$474 million, while creating an estimated \$9 million in additional tax revenue. This results in a net cost to the State of \$465 million.

The Commission recommended to reconfigure the Home Office Tax Credit by tying the credit to job creation and collecting payroll data from companies receiving credits to improve future evaluations. They also recommended to reconfigure the Clean Burning Fuel Vehicle Credit by retaining the infrastructure credit while sunsetting the vehicle credit, structuring the program to phase out and improve the reporting on the credit. The legislature took no action. The Commission recommended to repeal the Ethanol Fuel Retailer Tax Credit. While there was much discussion about this in the 2018 session, there was no action taken.

The Commission recommended to repeal the Economically At Risk Lease Tax Rebate, the Production Enhancement Rebate (Gross Production) and the Re-Established Production Rebate (Gross Production). The legislature approved HB 2377 that changed the sunset date for each of these incentives, but left the incentives in statute.

The Commission was split on whether to repeal the Coal Credits. The legislature approved HB 1034XX that capped it at \$4 million annually.

This year the Commission is evaluating eleven additional credits. They are the Energy Efficient Residential Construction Tax Credit, Small Business Incubators-Sponsors, Small Business Incubators-Tenants, Incentives for Inventors, New Products Development Income Tax Exemption, Quick Action Closing Fund, Technology Business Finance Program, Technology Transfer Income Tax Exemption, Investment/New Jobs Tax Credits, Basic and Applied Research Loan/Grant, Oklahoma Health Research, Oklahoma Applied Research, Quality Investment Program and Affordable Housing Act 14.

(b. FY2001)

Tax Incentive Evaluation Report 2016

Incentive Evaluation Commission, IEC.OK.GOV, 2016

**The following five pages are the 2016 and 2017 Tax Incentive Evaluation Reports and the Aug. 23, 2018 Meeting Agenda from the Oklahoma Incentive Evaluation Commission. In 2015, HB2182 established the Oklahoma Incentive Evaluation Commission. It requires the Commission to conduct evaluations of all qualified state incentives over a four-year time frame. The law also provides that criteria specific to each incentive be used for the evaluation. The first set of 11 evaluations was conducted in 2016, followed by 12 evaluations in 2017. The Commission is conducting 11 evaluations in 2018.*



VOTING MEMBERS

LYLE ROGGOW
CHAIRMAN

CARLOS JOHNSON, CPA
VICE-CHAIRMAN

RON BROWN
COMMISSIONER

DR. CYNTHIA ROGERS
COMMISSIONER

JIM DENTON
COMMISSIONER

EX-OFFICIO NON-VOTING MEMBERS

COMMISSIONER DAWN CASH
OKLAHOMA TAX COMMISSION

DIRECTOR PRESTON L. DOERFLINGER
OFFICE OF MANAGEMENT & ENTERPRISE SERVICES

SECRETARY DEBY SNODGRASS
DEPARTMENT OF COMMERCE

Dear Governor Fallin, President Pro Tempore Schulz and Speaker McCall:

We would like to thank you for the opportunity to serve on the Incentive Evaluation Commission. As the five voting members with diverse backgrounds and qualifications, we've taken very seriously our duties and responsibilities as commissioners.

We selected 11 tax incentives for evaluation this year, and then hired as an independent consultant Public Financial Management Inc., a national firm specializing in public sector finances. PFM delivered its evaluations to the commission Nov. 1, 2016. We then scheduled a meeting to receive public comment regarding the consultant's recommendations.

Commissioners considered all the public comments received at the Nov. 22 meeting before voting to approve or disapprove of PFM's recommendations at subsequent meetings. We hope our votes, based on public comments and PFM's fact finding, assist you and the Legislature in making critical decisions.

Pursuant to the Incentive Evaluation Act of 2015, 62 O.S. § 7001-7005, the commission is providing this written report to the governor, president pro tempore and speaker. The report is also being made publicly available on the Oklahoma Department of Commerce website and at documents.ok.gov. Further, we'll post the full report at IEC.ok.gov.

Included in this packet you will find a commission action summation chart on the next page ; the PFM reports compiled after the firm spent several months in Oklahoma analyzing data and meeting with stakeholders; and written comments commissioners submitted on the evaluations and incentives. We hope that this information is helpful to you during the upcoming session.

Respectfully,

The Oklahoma Incentive Evaluation Commission

Read the full 385-page Tax Incentive Evaluation Report at <http://iec.ok.gov/sites/g/files/gmc216/f/Tax%20Incentive%20Evaluation%20Report%202016.pdf>

INCENTIVE EVALUATION COMMISSION ACTIONS

INCENTIVE	EVALUATION RECOMMENDATION	COMMISSION ACTION
Tax Credit for Tuition Reimbursement for Aerospace Employers	Retain.	5-0 to approve recommendation
Tax Credit for Aerospace Employees	Retain.	5-0 to approve recommendation
Tax Credit for Compensation Paid by Aerospace Employers	Retain.	5-0 to approve recommendation
Tax Credit for Electricity Generated by Zero Emission Facilities	Reconfigure the program to cap program credits or accelerate the closing of the program window (currently Jan. 1, 2021) to Jan. 1, 2018. Allow non-wind generating zero emission facilities to continue to claim the credit until Jan. 1, 2021.	4-0 to approve recommendation (Roggow abstained)
Excise Tax Exemption on Aircraft Sales	Reconfigure by focusing the exemptions around a policy goal.	5-0 to approve recommendation
Five Year Ad Valorem Property Tax Exemption	Retain but consider revising program eligibility requirements that have been the same in some cases since program inception.	5-0 to approve recommendation
Historic Rehabilitation Tax Credit	The project team recommends that Oklahoma retain the program and adopt an annual cap to ensure some measure of future budget predictability.	5-0 to approve recommendation
Oklahoma Capitol Investment Board	Retain within its current parameters to allow OCIB to complete its scheduled activities prior to its legislated sunset. There is no compelling conclusion related to reversing the sunset imposed by the Legislature, particularly given short-term budget issues facing the state.	3-2 to approve recommendation (Johnson and Roggow, dissent)
Industrial Access Road Program	Repeal .	5-0 to disapprove recommendation
Oklahoma Film Enhancement Rebate	Allow to sunset as scheduled in 2024.	4-1 to approve recommendation (Johnson, dissent)
Quality Events Program	Reconfigure . The state should (1) eliminate the process of estimating the projected economic impact prior to the completion of the qualifying event; (2) create a standardized application template with clear guidelines; (3) designate a single point person or office to respond to applicant questions.	5-0 to approve recommendation

Tax Incentive Evaluation Report 2017

Oklahoma Incentive Evaluation Commission, IEC.OK.GOV, 2017



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DR. CYNTHIA ROGERS
COMMISSIONER

JIM DENTON
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STEVE BURRAGE
EX-OFFICIO COMMISSIONER

DENISE NORTHRUP
EX-OFFICIO COMMISSIONER

DEBY SNODGRASS
EX-OFFICIO COMMISSIONER

The Honorable Governor Fallin, President Pro Tempore Schulz and Speaker McCall:

We would like to thank each of you for the opportunity to serve as members on the Incentive Evaluation Commission (IEC). As the five voting members with diverse backgrounds and qualifications, we have taken our duties and responsibilities very seriously as Commissioners.

In our second year, IEC reviewed 12 incentives during this evaluation process. We have continued our contractual relationship with Public Financial Management Inc. (PFM), who won the bid in 2016. They are a nationally recognized firm specializing in public sector finances. IEC members received draft evaluation reports on facts and findings on Sept. 29, 2017, with a formal presentation to the Commission Meeting on Oct. 12, 2017. As required in statute, a public hearing meeting took place on Nov. 3, 2017, to receive public comments regarding the consultant's recommendations.

The commission took into consideration all public comments received at the November meeting before deciding the final vote to retain, repeal or modify incentives under review. It is in hope that our votes, based on public comments and PFM's facts and findings, help in assisting each of you and the Legislature in making imperative decisions. This year, PFM made alternative recommendations for improvement on all incentives if IEC chose to not follow the final PFM report.

Pursuant to the Incentive Evaluation Act of 2015, 32 O.S. § 7001-7005, the commission is providing the honorable governor, president pro tempore and speaker with the 2017, year two report. The report will also be made publicly available on the Oklahoma Department of Commerce website and at documents.ok.gov.

Enclosed in the packet is a commission action summation chart immediately following the letter and the compiled reports by PFM. We hope the information provided you is helpful during the upcoming 2nd Session of the 56th Legislature.

Respectfully,

The Oklahoma Incentive Evaluation Commission

Read the full 385-page Tax Incentive Evaluation Report at <http://iec.ok.gov/sites/g/files/gmc216/f/IECFinalReport-2017.pdf>

(d. 7.04)

INCENTIVE EVALUATION COMMISSION ACTIONS

INCENTIVE	EVALUATION RECOMMENDATION	COMMISSION ACTION
Quality Jobs Program	Retain with modifications: 1) require filing for incentive payments each quarter; 2) Regularly review eligible industries; 3) Centralize data tracking.	4-0 to approve to adopt the recommendations, as modified by the Oklahoma Department of Commerce (Brown absent)
Small Employer Quality Jobs Program	Retain with modifications: 1) require filing for incentive payments each quarter; 2) Regularly review eligible industries; 3) Centralize data tracking.	4-0 to approve recommendation, inclusive of the recommendations as modified by the Oklahoma Department of Commerce (Brown absent)
21st Century Quality Jobs Program	Retain with modifications: 1) require filing for incentive payments each quarter; 2) Regularly review eligible industries; 3) Centralize data tracking.	4-0 to approve recommendation (Brown absent)
High Impact Quality Jobs Program	Reconfigure by decreasing the job creation requirement and increasing the benefit.	4-0 to repeal incentive (Brown absent)
Capital Gains Deduction	Repeal.	3-1 to retain incentive (Brown, absent; Rogers, against)
Home Office Tax Credit	Reconfigure by tying the credit to job creation and collecting payroll data from companies receiving credits to improve future evaluations.	3-1 to approve recommendation (Brown, absent; Johnson, against)
Clean-Burning Fuel Vehicle Credit	Reconfigure by retaining the infrastructure credit while sunsetting the vehicle credit; structuring the program to phase out; and improving reporting on credit.	4-0 to approve with modifications to not sunset the vehicle credit and retain it, and retain the infrastructure of the program (Brown absent)
Ethanol Fuel Retailer Tax Credit	Repeal.	4-0 to approve recommendation (Brown absent)
Economically At-Risk Lease Tax Rebate	Repeal.	4-0 to approve recommendation (Brown absent)
Production Enhancement Rebate (Gross Production)	Repeal.	4-0 to approve recommendation (Brown absent)
Re-Established Production Rebate (Gross Production)	Repeal.	4-0 to approve recommendation (Brown absent)
Coal Tax Credits	Repeal.	Split vote due to a member absent. (Brown, absent; Johnson, against; Roggow against).

2018 Incentive Evaluation Commission Regular Meeting Agenda

Oklahoma Incentive Evaluation Commission, IEC.OK.GOV, Aug. 23, 2018

**INCENTIVE EVALUATION COMMISSION
REGULAR MEETING
AUG. 23, 2018
1:00 p.m.
State Capitol Building, Room 419-C**

ITEM #1: Call to Order and establish a quorum. [Lyle Roggow, chairman]

ITEM #2: Approval of minutes from the April 26, 2018 meeting. [Lyle Roggow]

ITEM #3: Subcommittee reports. [Lyle Roggow]

- Vendor: Dr. Cynthia Rogers and Ron Brown
- Scheduling: Lyle Roggow and Carlos Johnson
- Criteria: Dr. Cynthia Rogers and Jim Denton

ITEM #4: Discussion and update on report of 2018 incentives (Year Three) by PFM Consultant, Randall Bauer. [Lyle Roggow]

- | | |
|---|---|
| 1. Energy Efficient Residential Construction Tax Credit | 6. Technology Transfer Income Tax Exemption |
| 2. Small Business Incubators (Sponsors & Tenants) | 7. Investment/New Jobs Tax Credits |
| 3. Incentives for Inventors | 8. Oklahoma Health Research |
| 4. Quick Action Closing Fund | 9. Oklahoma Applied Research |
| 5. Technology Business Finance Program | 10. Quality Jobs Investment Act |
| | 11. Affordable Housing Act 14 |

ITEM #5: New Business

ITEM #6: Announcements: [Lyle Roggow]

Upcoming meetings discussion:

- | | | |
|------------|------------|-----------|
| •Oct. 4th | •Nov. 1st | •Dec. 6th |
| •Oct. 18th | •Nov. 15th | |

ITEM #7: Adjournment. [Lyle Roggow]

Panel advises keeping capital gains exemption

Molly Fleming, The Journal Record, November 17, 2017

A panel recommended keeping the contested capital gains exemption, though there was much discussion on the progress it has spurred.

During its meeting Friday, the Incentive Evaluation Commission almost avoided making a recommendation on the exemption.

Philadelphia-based PFM Consulting Group LLC wrote in its report that there needed to be more data about the program.

The capital gains exemption started Jan. 1, 2005, for personal income and Jan. 1, 2006 for corporate income. It allows people who gain from selling Oklahoma-based property, stock, or ownership to deduct the amount from their state taxable income.

PFM's report showed that the state gained only about \$9 million from the program and lost \$474 million in potential revenue.

"I came up short in ways to look at this as an economic development incentive," said Commissioner Cynthia Rogers. "There's absolutely no way. Even with better data, it won't help to see if it works."

The commission debated whether the exemption was more of a tax policy than a true incentive. Department of Commerce Executive Director Deby Snodgrass recommended not taking an action because she considered it a tax policy. She doesn't have a vote in the commission, but two voting members also agreed it was a tax policy.

The committee considered approving the capital gains exemption with the recommendations from PFM. The analysts recommended that the program should target a specific industry, require the gains to be invested in Oklahoma, and improve the data collection.

But those modifications were not part of the approval. The recommendation will be heard by state legislators when they convene for the regular session in February.

The commission was formed in 2015 and has been evaluating all of the state's incentives annually. In 2016, the commission reviewed 11 incentives. This is the second round.

At Friday's meeting, the commission also recommended keeping Quality Jobs, Small Employer Quality Jobs, 21st Century Quality Jobs, and the Home Office Tax Credit. The commission recommended repealing the High Impact



Warren Vieth / Oklahoma Watch

State Incentive Evaluation Commission member Carlos Johnson questions consultants about proposed changes in business tax breaks.

Quality Jobs program. The companies that qualify for HIQJ could also get other incentives, so it seemed like a duplicate.

The Department of Commerce made recommendations to modify the Quality Jobs, Small Employers, and High Impact programs.

With the Quality Jobs provision, one recommendation from the department is to require all potential incentive projects to be reviewed by the Incentive Approval Committee. The IAC consists of the directors from the Commerce Department and the Office of Management and Enterprise Services, and a member of the Oklahoma Tax Commission.

Commerce Department spokeswoman Leslie Blair wrote in an email to The Journal Record that agency executives believe having the group examine at the company seeking the incentive will strengthen the program's integrity. The other recommendation was to have a company representative at the meeting.

The commission's recommendation to approve Quality Jobs included those recommended changes.

The panel rejected recommendations to repeal the capital gains exemption.

An Elected Official's Guide to Tax Increment Financing

Nicholas Greifer, Government Finance Officers Association, May 2005

Local economic development is a big business. Municipalities collectively spend billions of dollars for subsidies to encourage existing businesses to stay or new businesses to move in. They employ myriad techniques to accomplish this: building or replacing municipal infrastructure, reducing regulatory burdens, and providing tax incentives.

The Government Finance Officers Association (GFOA) has a long-standing interest in promoting sound financial management when pursuing municipal economic development. In 1990, GFOA issued a recommended practice concerning the use of economic development incentives (reproduced on page 58). A key element of the recommendation was the practice of establishing criteria to measure progress toward goals, and identifying remedial steps when goals are not being met.

This publication was written to familiarize elected officials with one of the most popular tools for local economic development, tax increment financing (TIF). Although much has been written about the pluses and minuses of using this financing method, less has been written about the practical steps that can be taken to prudently use and manage TIFs. The objective of this book is to lay out the steps for using TIF as well as identify and describe important financial management concepts integral to TIFs. A secondary goal is to help elected officials become conversant in TIF techniques, so as to better oversee the staff that administer TIF districts on a day-to-day basis.

The guide is organized into four sections. Section I introduces the fundamental concepts behind tax increment financing and the historical reasons for its growing use among city and county governments. Section II provides background on the mechanics and process of establishing and operating a TIF district. Section III discusses the impacts associated with tax increment financing, both positive and negative. Section IV discusses specific financing techniques used to fund TIF projects, including pay-as-you-go and bond issuance. Following the previously mentioned GFOA recommended practice, an appendix presents profiles of TIF districts in operation and a resource list.

FUNDAMENTALS

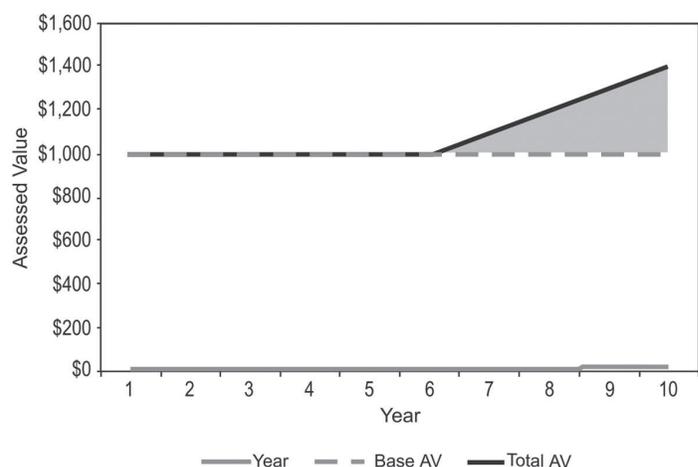
What is tax increment financing? Tax increment financing is a financial tool widely used by local governments to promote economic development and redevelopment. The TIF process splits tax revenue generated from properties within the TIF district into two components:

- Base revenues – This is the amount available before the TIF district is established; base revenues are shared among a mix of local governments that have the power to assess property taxes: schools, cities, counties, and special districts.
- Incremental revenues – These new revenues in excess of the base revenues are generated by development projects. Represented by the triangular area in Exhibit 1, these dollars are allocated to the government that sponsors the TIF project.

Although some states permit counties to use tax increment financing, in most cases the sponsoring government is a municipality.

By giving exclusive use of incremental revenues to the sponsoring government, the successful tax increment financing process generates a revenue stream to underwrite projects within the TIF district and to provide development subsidies to encourage growth.

Exhibit 1 • Assessed Value of Prototypical TIF District



GFOA RECOMMENDED PRACTICE Economic Development Incentives (1990)- pg. 58

Background. Economic development incentives are tools used by state and local governments to retain or attract jobs and/or tax base. There are expenditures and/or opportunity costs as well as potential or actual benefits associated with these incentives. These costs and benefits often do not clearly appear in a budget or financial statement, and if they do, the overall impact of these incentive costs and benefits often take place over many years.

Recommendation. The Government Finance Officers Association (GFOA) recommends that any jurisdiction's economic development incentives have specific goals and criteria that serve to define the economic benefit both the government and the entities receiving the incentives expect to gain from the incentives, the conditions under which the incentives are to be granted, and the actions to be taken should the actual benefits differ from the planned benefits. For any specific economic development incentive, it is recommended that the economic benefit to the government, as well as the cost of the incentive, be measured and compared against the goals and criteria that have been previously established.

The full 63-page guide can be found at <https://www.gfoa.org/sites/default/files/EOGTIF.pdf>.

Navigating TIFs has become a tool to grow economy

Brian Brus, The Journal Record, August 31, 2018

The amount of properties placed in tax increment finance districts statewide continued to grow last year, Tax Commission data shows.

By the end of fiscal year 2017, the captured tax assessment of those properties dedicated to special infrastructure projects was worth a total of \$539 million. That's nearly a tenfold increase since 2014 when the state total was \$54.6 million.

It also suggests that more local governments are figuring out how to get around tight tax revenues to develop blighted infrastructure and grow the economy.

"We have limited resources in supporting community and economic development," said Brent Bryant, Oklahoma City's economic program development manager. "I think TIF has been a very good tool for us to make things happen that would not have been possible otherwise."

Tax increment finance districts, often referred to simply as TIFs, have been around since 1990 with the passage of State Question 641. Under law, a TIF begins with a recommendation by a review committee comprising affected local jurisdictions within a city or county with an eye on improving infrastructure such as streets or utilities in troubled areas, thus providing an incentive for private investment.

If a TIF is passed by the governing entity, the current assessed value of all real and personal property within a defined boundary is established as a base figure, and any natural economic growth of assessed values beyond that base is diverted for the special projects within that boundary as defined by ordinance.

The participation of other taxing jurisdictions – school districts, in particular – is important because they cannot benefit from property tax growth as usual during the TIF's life span – up to 25 years, initially. Oklahoma City has worked around that potentially negative impact by sharing the diverted or captured increment, Bryant said.

"In some cases, development is going to be extremely difficult, so we can't afford to share," he said. "In the case of the Omni Hotel development (planned near the MAPS 3 convention center), the other taxing jurisdictions get 75 percent of the increment.

"In some cases, we've included line items so that the other taxing jurisdictions can apply for certain projects of their own – we've had it happen with the library system and with the Oklahoma City-County Health Department and numerous times with the school district."

Even with efforts toward public transparency and stakeholder engagement, TIFs don't always go over well. Stillwater's latest TIF, for example, is facing a petition drive calling for a citywide vote on whether to overturn it. The City Council there created the district in June to raise about \$32.5 million to improve the infrastructure connecting Main Street with the Oklahoma State University campus under the Stillwater (Re)Investment Plan. The petition went to court review on Friday.

However, in August officials in McAlester saw some of the positive response they hoped for when they launched a TIF there. The Marshalls retail chain announced it would anchor a new shopping center in the district. In that case, the TIF created an incentive: The developer behind the deal will get back up to \$5.5 million in sales tax collections during the five-year life of the TIF.

In Oklahoma County, Oklahoma City was responsible for more than half of the TIF increment recorded by the Tax Commission last year. The city has nine districts out of 11 still active; Bryant said the City Council authorized up to 25.

The next TIF to reach its sunset in 2020 in Oklahoma City has helped develop the Health Center corridor south of the state Capitol. The district was intended to promote development in and around the University of Oklahoma Health Sciences Center, spurring private investment by the health care, bioscience and technology industries. According to the state Tax Commission, that TIF increment last year totaled \$15.1 million.

"Without TIF, you wouldn't have the Skirvin Hotel," Bryant said, referring to the refurbishment of the dilapidated hotel downtown. "Without TIF, you wouldn't see work on the First National building now. ... It's a valuable tool that a lot of cities have made good use of."

Attorney Dan Batchelor at the Center for Economic Development Law said he can't tell whether TIF use will continue to grow, but it's obviously been recognized as a way to get things done. His center assists communities across the state in economic efforts.

"Tax increment financing is simply a tool," Batchelor said. "It's like asking whether mortgage financing is good. Well, if I make a good home choice and need financing, it can be very beneficial. But nothing ensures I'll make a good choice. ... Tax increment financing is a lot like that. It's very useful, but the benefits are generated by the quality of its use."

10 ways to end the TIF

Mack Burke, *The Norman Transcript*, September 9, 2018

With the arena TIF proposal now on the shelf, the city council has turned its attention back to the existing University North Park TIF and how to end it.

City Finance Director Anthony Francisco presented with the council with 10 options Tuesday on how to bring the tax increment finance district, which was created in 2006, to a close:

1. Do nothing — Maintain remaining project authorizations and tax apportionment methods.
2. Maintain remaining project authorizations but reduce sales tax apportionment rate to 5 percent.
3. Maintain remaining project authorizations but reduce sales tax apportionment rate to 10 percent.
4. Maintain remaining project authorizations but reduce sales tax apportionments to a fixed dollar amount.
5. Eliminate authorization for the lifestyle center costs project.
6. Eliminate authorization for the cultural center costs project.
7. Eliminate authorization for both the cultural center and lifestyle center cost projects.
8. End the UNP TIF by elimination of project authorizations to an amount less than the apportioned tax funds on hand.
9. Proceed with council recommendation to utilize authorized cultural center funding for a senior center within the UNP project area.
10. Expand UNP TIF project authorization by adding an additional project for a senior citizens center.

In Fiscal Year 2017-2018, about \$4 million was apportioned to the TIF fund, representing 60 percent of the sales tax collected within the district, after adjustments. Ending the TIF would bring about \$3.6 million in sales tax income back into the city's general fund and capital fund, potentially allowing the city to fund its 14 open positions or address other shortfalls.

Though council members expressed support for reallocating the funds, particularly in light of the budget crunch,



Mack Burke / The Transcript

City Finance Director Anthony Francisco explains options for reallocating TIF funds Tuesday at city hall.

closing the district could carry some negative consequences, depending on the route the council chooses to take.

At the current rate, Francisco said two and a half years would be enough time to generate enough revenue to not have to issue any more debt to complete project costs. Standing pat also would keep clawbacks and developer agreements in place.

Doing so would keep \$3.6 million in annual sales tax revenue out of the general fund until 2021.

Then, there's Norman Public Schools to consider. Keeping the TIF alive puts more state aid formula money into NPS' budget. Drastically reducing the TIF's allocation without closing it altogether has appeal to many council members because it would maintain NPS funding while bringing the bulk of those funds back into city coffers.

"It seems like there are quite a few advantages and not a whole lot of disadvantages to [keeping the TIF open] for a few more years," Mayor Lynne Miller said.

Ward 3 council member Robert Castleberry said lowering the allocation may be a good middle ground that "checks all of the boxes."

“Those are the boxes we’re trying to check,” he said. “Balance the general fund, check. Protect Norman Public Schools, check. Meet our legal obligations, check. Hold the developer responsible, check.”

Castleberry said there’s no need to continue appropriating 60 percent of the city’s sales tax in UNP if the city has no interest in finishing the remaining projects, but finding a way to shield NPS from a budget hit and keeping claw-backs in place binding developer University Town Center to pay roughly \$8 million, if it fails to achieve a lifestyle center, are good considerations.

Ward 5 council member Sereta Wilson said the council needs to be a good steward of public money and trust. Though she is concerned about NPS, she said it’s difficult to explain to her constituents why the city needs a storm-water utility when there is so much money going to the TIF fund.

While bringing those funds back into the fold would be impactful for the city’s general fund, Miller and Ward 4 council member Bill Hickman said it’s important to convey to the public that the city’s general fund still wouldn’t be in a position of strength with growing obligations, open positions and cuts on the table.

Francisco didn’t show his favor for one option in particular, but his broader assessment of the situation indicates he believes reallocating TIF dollars back into the general fund is prudent.

“The general fund is spending more money than it’s taking in each year right now,” he said. “The first thing I would suggest is getting the general fund back to square zero where you’re not drawing down the general fund balance and you’re paying for things that you’re doing.”

Like Miller and Hickman, Francisco said doing so still wouldn’t address the city’s big-picture budget issues.

“In the long term, the general fund is declining on an annual basis, and this slows that rate of decline,” he said. “I would just draw council’s attention back to those [stormwater] mandates that we have.

“I would also remind the council that [some] Public Safety Sales Tax expenditures are coming back into the general fund . . . We need to improve the status of the general fund, and this is one step toward doing that.”

With \$10.7 million in the TIF fund, and all outstanding loans paid off, the district is just \$14.3 million shy of the \$54.7 million total needed to pay for all of the project costs. Two projects remain: a cultural center and a lifestyle center.

Neither are close to breaking ground, and the city doesn’t necessarily have to follow through on those.

But unlike changing its sales tax allocation, which the city can do unilaterally, Francisco said changing the project plan — by adding or removing projects — would require renegotiating existing development agreements and approval from the city’s TIF partners through the TIF statutory committee.

If the city were to keep the lifestyle center project — envisioned as something similar to Utica Square in Tulsa — in the plan, and the developer failed to live up to its obligations, the city would stand to reap about \$8 million in clawback penalties. If the project came to fruition, he said the city has enough money available in the TIF fund to pay for its share without borrowing.

“I hate to say this, but the greatest thing would be if the lifestyle center didn’t happen,” Castleberry said. “Because if it doesn’t happen, we’d get \$8 million from the developer.”

As for the other outstanding project, the council could override the TIF statutory committee and use TIF funds to create a senior center, fulfilling the cultural center component (possibly at the risk of litigation), but the city has yet to secure the desired land from the University of Oklahoma.

The property, a swath of land near the Cleveland County Y, was the subject of an agreement between the university and the city that seemed to be all but finalized in December. That deal has since been on hold since the university opted to reevaluate the deal, and, as some council member’s believe, use it as a bargaining chip in the OU Foundation’s arena proposal negotiations.

Miller said the city will be eager to see what comes out of the OU Board of Regents meetings this week.

Though a decision could be made quickly on TIF reapportionment — Francisco said the entire process could take as little as 90 days — some council members believe the best course of action is to take a wait-and-see approach.

“We have so many balls up in the air right now that I want to be sure that we know what the lay of the land is before we make such a big decision,” Ward 1 council member Kate Bierman said. “I think Bill Hickman had it right. If the university moves forward with the land acquisition, then we have funds there to move forward [on a senior center].

“I think this is a worthwhile discussion to start now, but it’s not something I think we’ll make a decision on in the next 30 to 60 days.”

Some TIFs create reverse Robin Hood effect, critics say

Catherine Sweeney, The Journal Record, September 17, 2018

As tax increment financing districts become more popular, some residents are urging city government and economic development officials to consider all stakeholders – even those that don’t live nearby.

These special tax policies have garnered some critics who say the districts can have a reverse Robin Hood effect: take from poor districts to raise funding for rich ones.

“It encourages the districts to rob each other,” said Cynthia Rogers, an economics professor at the University of Oklahoma. “It’s a prisoner’s dilemma.”

Tax increment financing districts, often known by their nickname TIF districts, divert property tax revenue from their typical recipients so the money can be reinvested within that area. Those recipients include county governments, vocational technology centers and public schools. The policy is intended to encourage development in areas that otherwise would struggle to grow, such as blighted neighborhoods. The diversion is to take place for a certain amount of time, and once that ends, revenue is slated to return to its normal distribution.

Property taxes play a vital role in Oklahoma’s education funding. Budgets depend on a formula meant to equalize funding among affluent and low-income districts. For example, Edmond Public Schools sees about twice as much ad valorem revenue as its neighbors, Mid-Del Public Schools. However, the two see similar overall funding because Edmond gets less state money and Mid-Del gets more. The notoriously complicated formula takes several factors into account to determine how much to give to districts per student. Among them is property tax revenue. Districts lose state funding for each dollar they receive in local revenue. That type of funding, as well as other kinds that spur more money from the state funding formula, is known as a chargeable.

When local leaders implement TIFs and divert local money from school districts, those districts don’t see a decrease in overall revenue. State funding replaces that money. But some observers note that when the state replaces that revenue, it loses money that would otherwise go to school districts with no nearby TIF development. Although some rural areas have TIF districts, the majority of those developments are in Oklahoma City and Tulsa.

From 2014 to 2017, TIF revenues increased about tenfold, according to data from the Tax Commission, increasing from about \$55 million to about \$539 million. Again, that money would usually go to several governmental entities including counties and school districts. However, it’s difficult to determine what kind of impact that has had on



Daleaha Baig leaves John W. Rex Elementary School after a visit involving getting her child admitted to the downtown Oklahoma City school.
(Photo by Mark Hancock)

education funding, said Matt Holder, the vice superintendent of finance and federal programs for the Oklahoma State Department of Education. Records submitted to the state agency don’t detail how many dollars the school districts get in TIF funding because they aren’t considered chargeables.

“It’s like they don’t exist,” he said.

Some of those TIF districts allot money back to the schools. Officials sometimes give districts a one-time sum. Other times, they get a portion of property tax revenues similar to the way they would without the TIF. But that money is classified differently than property tax revenue and does not trigger a decrease in state funding. Critics say this policy incentivizes districts to participate in those TIF agreements to increase their own funding at the expense of other districts.

Shawn Hime is the executive director of the Oklahoma State School Boards Association. His organization’s staff has been talking with its members about TIFs often.

“We talk to school leaders, superintendents and board members regularly on the statutory requirement of TIFs and their role on the TIF committee,” he said.

Those talks help members determine whether a TIF would benefit the district. He said they need to consider whether

Notes

**This is a resource document for you to use.
Take notes, highlight, use as a text book.**

the TIF would be placed in an area that would otherwise struggle to develop. They should discourage them if they are in areas already seeing development or otherwise show the TIF isn't crucial. If that area is expected to see growth in retail or other industries that generate sales taxes as well as property taxes, education officials might push for sales taxes to also be diverted to shift some of the expense to the city, he said.

But officials on TIF committees need to consider how they are affecting not only their local school district but also the roughly 500 across the state that depend on the funding formula and state revenue.

"Generally, just overall, any money that is put into a TIF district is taken off of the ad valorem revenue for that local school, therefore taken from all the schools in the state," Hime said.

For example, he said, if Lawton implements a TIF that diverts \$10 million in education funding, Lawton Public Schools won't be the organization losing money.

"That's \$10 million that doesn't go to schools across the state," he said.

Oklahoma currently holds nearly 100 TIF districts, according to Oklahoma Tax Commission data. There are 25 in Oklahoma County, but those affect several school districts, including Mid-Del and Choctaw. There are 17 in Tulsa, most of which affect school districts in Jenks.

Those who craft the TIFs' terms have the option to share no money with other entities, but that isn't always what happens. It's relatively common for the district to share its revenue with other stakeholders, such as schools. For example, the TIF in Norman shares hundreds of thousands of dollars annually with its local school district. Again, even though the school gets that revenue, it still doesn't trigger the drop in state funding, so state formula funding is higher while the district gets TIF revenue.

Rogers, the OU economist, said she is critical of this practice because it encourages districts to take revenue from other districts. District officials and supporters want to ensure they maximize funding for their own students, she said, but current TIF laws allow those districts to essentially shelter some of their property tax revenue so they can receive more state funding.

"The system is set up to make schools like Norman want to do this, even though it hurts our neighbors in the rural schools," she said. "It's a dollar out of their pocket."

TIF development tends to occur in areas with higher rates of investment, she said, so more affluent districts tend to be the ones getting revenue increases from TIFs and the state. She said this undermines the funding formula's efforts to preserve equity in schools statewide.

Section 5
Recommended Changes

THE NEW YORK TIMES:

“A Better Tax System (Assembly Instructions Included)”

William Simon, former Treasury Secretary said, “The nation should have a tax system that looks like someone designed in on purpose.”

Here are four principles of tax reform:

BROADEN THE BASE AND LOWER RATES (including the elimination of deductions and exclusions!);

TAX CONSUMPTION RATHER THAN INCOME (consumption better reflects the benefits a person receives as a member of society, it is the proper basis of taxation);

TAX BADS RATHER THAN GOODS (the latter being hard-work, savings, risk-taking . . . the former might be gasoline due to the negative externalities associated with driving — congestion, pollution, accidents/deaths); and

KEEP IT SIMPLE, STUPID: Complex systems (e.g., the tax system) are more likely to break down and require an army of accountants and tax lawyers. And if a few accountants and tax attorneys were induced to become engineers and doctors instead, society will have moved a big step in the right direction.

2015's Most & Least Fair State Tax Systems

John S Kiernan, WalletHub, September 18, 2015

With summer ending, the 2016 elections are starting to heat up. And, as usual, tax policy is a hot-button issue, as political candidates from both sides of the aisle claim their plan is more “fair.” But what does a fair tax system look like? Which states actually have the fairest tax systems?

WalletHub analyzed and ranked the 50 states based on the fairness of their state and local tax systems — including income taxes, sales and excise taxes, and property taxes. To rank the states, WalletHub used the results of a nationally representative online survey of 1,050 individuals to assess what Americans think a fair state and local tax system looks like. Our analysts then compared public perception to data on the real structure of tax systems in all 50 states.

We believe this is the first ever ranking of state and local tax fairness that matches representative data on what Americans consider “fair” with real data on the structure of state and local tax systems.

State and Local Taxes: What's Fair?

What do Americans think is a fair amount to pay in state and local taxes? Results from our national survey, asking respondents from different income levels how much they think is fair to pay. Answers ranged from a low of 2.5 percent tax for households earning \$5,000 annually to a high of 16.36 percent tax for households making \$2.5 million per year. There is a clear upward trend: respondents think state and local tax systems are fair when higher-income households pay a greater percentage of their income in taxes than lower-income households.

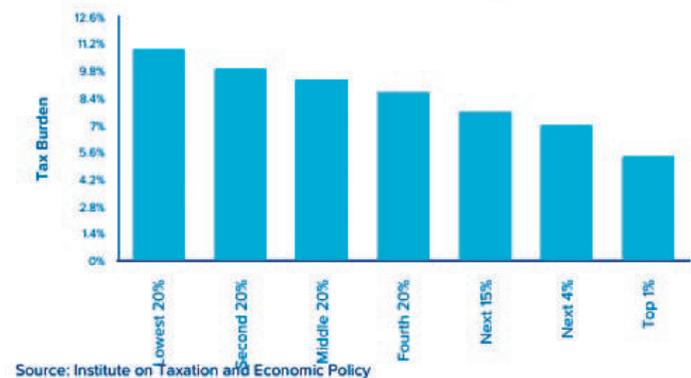
Data averaged from the full sample of respondents shows a strong preference for a progressive state and local tax structure. When examining the data by income of respondents, we find the same pattern: low-income, middle-income, and high-income respondents all assert that a progressive tax structure is most fair.

But what if we look by political ideology? Do economic liberals and conservatives feel the same way? Although conservatives appear to support higher taxes on the poor and lower taxes on the rich, the general trend is the same: all Americans believe a fair state and local tax system imposes higher tax rates on wealthy households than on lower- and middle-income households.



So how does the actual structure of state and local tax systems compare to what Americans consider “fair”? The chart below presents the average real state and local tax burden by income level across the 50 states, as estimated by the Institute on Taxation and Economic Policy (ITEP). The data show that the real relationship between household income and state and local tax burden is negative — that is, as income goes up, state and local tax burden goes down — the exact opposite of what Americans think is fair.

Average Real State and Local Tax Burden by Income Level



Methodology

The aim of this study is to determine what Americans think a fair state and local tax system looks like and use that information to rank the tax systems of the 50 states. To get an accurate picture of what Americans consider a fair state and local tax system to be, we conducted an original online survey of 1,050 Americans. The sample was designed to be nationally representative by age and sex and has substantial variation across income levels, racial and ethnic categories, and political beliefs.

Respondents were asked: “In thinking about the fairest possible tax system, what percentage of income do you think households at each income level should pay in state and local taxes?” Respondents were then presented with 10 different income levels ranging from \$5,000 to \$2.5 million and asked to enter a number between 0 and 25 corresponding to the percentage of income they think would be fair for that household to pay in state and local taxes. We then averaged

responses at each income level to determine the master “fair tax burden” at each income level for the overall sample.

To compare what Americans think is fair to the structure of real state and local tax systems, we used data from the Institute on Taxation and Economic Policy (ITEP). ITEP has estimates of the total state and local tax burden of households at seven different points in the income distribution of each of the 50 states (e.g., bottom 20 percent, top 1 percent, etc.). Because every state has a unique income distribution, the corresponding household income at each point in the distribution varies by state (e.g., top 1 percent earns more in Connecticut than in Mississippi). Using linear interpolation, we generated estimates of what Americans consider a fair tax burden at each of these unique income levels. This allowed us to compare the real state and local tax burden of households — including income taxes, sales and excise taxes, and property taxes — at different income levels relative to what Americans think is fair at various income levels for each of the 50 states:

$$Abs(\text{Survey Estimate of Fair Tax Burden} - \text{Real Tax Burden}) = abs(\text{Difference})$$

We then took the mean of the absolute value of the difference between the fair tax burden and the real tax burden for the five income quintiles for each of the 50 states. States were then ranked, with higher ranking corresponding to lower mean difference between fair tax burden and real tax burden.

(Sources: Data used to create these rankings were obtained from the Institute on Taxation and Economic Policy, U.S. Census Bureau and WalletHub survey data.)

Ranking	State/Local Tax Fairness: Overall Ranking	Ranking	State/Local Tax Fairness: Overall Ranking
1	Montana	26	Massachusetts
2	Oregon	27	Nebraska
3	South Carolina	28	Wyoming
4	Delaware	29	Oklahoma
5	Idaho	30	Louisiana
6	Minnesota	31	South Dakota
7	Utah	32	Rhode Island
8	Virginia	33	Alabama
9	Colorado	34	Kentucky
10	Maryland	35	Pennsylvania
11	Maine	36	New York
12	Nevada	37	Alaska
13	West Virginia	38	New Mexico
14	Connecticut	39	Tennessee
15	Wisconsin	40	Ohio
16	Vermont	41	Arizona
17	California	42	Indiana
18	New Jersey	43	Texas
19	North Dakota	44	Mississippi
20	New Hampshire	45	Florida
21	Michigan	46	Illinois
22	Missouri	47	Arkansas
23	North Carolina	48	Hawaii
24	Iowa	49	Georgia
25	Kansas	50	Washington

Overall Ranking	State	Dependency on Property Taxes (1=least)	Dependency on Sales & Excise Taxes (1=least)	Dependency on Income (Personal & Corp.) Taxes (1=least)	Dependency on Other Taxes (1=least)
1	Montana	42	4	28	46
2	Oregon	32	3	46	40
3	South Carolina	34	24	15	33
4	Delaware	2	2	42	48
5	Idaho	22	25	33	30
6	Minnesota	18	23	37	20
7	Utah	20	34	31	13
8	Virginia	33	8	38	28
9	Colorado	30	29	19	18
10	Maryland	16	10	45	21
11	Maine	45	15	25	16
12	Nevada	17	49	N/A	45
13	West Virginia	9	32	26	43
14	Connecticut	40	11	36	2
15	Wisconsin	41	14	34	9
16	Vermont	47	19	11	8
17	California	19	17	40	25
18	New Jersey	49	7	17	11
19	North Dakota	1	12	5	49
20	New Hampshire	50	5	6	26
21	Michigan	38	28	13	12
22	Missouri	21	30	29	19
23	North Carolina	13	26	39	17
24	Iowa	31	22	22	23
25	Kansas	28	35	21	6
26	Massachusetts	39	6	43	7
27	Nebraska	37	18	20	29
28	Wyoming	35	27	N/A	47
29	Oklahoma	3	37	16	44
30	Louisiana	11	46	7	34
31	South Dakota	36	45	1	39
32	Rhode Island	48	16	14	3
33	Alabama	6	40	18	37
34	Kentucky	10	31	41	22
35	Pennsylvania	24	20	32	35
36	New York	27	9	44	14
37	Alaska	4	1	4	50
38	New Mexico	8	42	9	42
39	Tennessee	12	48	3	38
40	Ohio	23	21	35	36
41	Arizona	25	41	8	4
42	Indiana	14	36	27	5
43	Texas	46	39	N/A	41
44	Mississippi	15	38	10	27
45	Florida	43	44	2	32
46	Illinois	44	13	30	15
47	Arkansas	7	43	23	10
48	Hawaii	5	47	12	24
49	Georgia	29	33	24	1
50	Washington	26	50	N/A	31

Ask the Experts

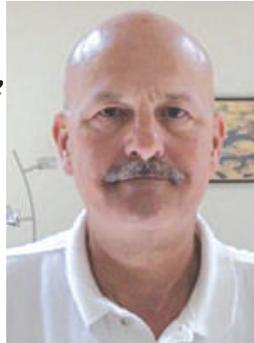
As our analysis reflects, public perception regarding taxation of various income levels is distorted when compared with hard data. For additional insight into such discrepancies as well as other tax-related issues, we turned to a panel of leading experts in such fields as economics and public taxes. Read their thoughts on the following key questions:

1. Why is there such a large difference between what people think is fair and the real structure of state and local tax systems?
2. How do state and local tax systems influence economic growth?
3. What policies should states and localities consider to increase tax fairness?
4. Have state and local tax policies become more or less fair since the start of the great recession?

Joseph Vonasek

Assistant Professor in the College of Liberal Arts at Auburn University

Why is there such a large difference between what people think is fair and the real structure of state and local tax systems? real structure of state and local tax systems?



Joseph Vonasek

The variance between taxpayer's opinions on fairness and the actual structures of state and local tax systems can often be attributed to what's referred to as "Miles Law." Miles, a career federal bureaucrat, coined a maxim that essentially says "where one stands on an issue depends upon where one sits." The taxpayer is, and should be, focused on their particular self-interest. As well, the legislative actors (both elected officials and "lobbyists") that are responsible for the actual shape of the structure, have their interests and the result is sometimes tax exemptions or "tax spending" (think about the reduction of taxable income allowed for home loan interest payments or tax-free interest earnings on government issued bonds). If you own a home or invest in tax-free municipal bonds, you might think of these as inherently good; enabling home ownership and lowering interest rates on borrowing by governments. If you do not, you might perceive these exemptions as increasing the level of other taxes that you pay in order to compensate for the loss of tax revenues that are providing a benefit to others.

How do state and local tax systems influence economic growth?

Taxes collected are often spent on infrastructure improvements that enhance the ability of business to be started or conducted which often results in employment growth. Alternatively, tax exemptions/tax spending have the ability

to make the establishment or location of businesses more attractive to their owners and managers because they can increase a firm's profitability while increasing employment opportunities for citizens of the area. Many state and local government have established economic development programs that work with private firms (and, in some cases, other public entities) to deliver time limited tax exemptions, necessary infrastructure (such as power grids, transportation system improvements, or port facilities), or technical skill training programs for an improved labor base. Benefiting firms not only provide employment opportunities but increase the local tax base and personal income levels (this provides a multiplier effect from the increased disposable income of citizens).

What policies should states and localities consider to increase tax fairness?

There are two basic principles of taxation: Ability to Pay and the Benefits Principle. The Ability to Pay principle considers whether those who are being taxed have the capacity to pay. The Benefits Principle holds that there must be some relationship between the amount paid and the benefits received. To accomplish this, the concept of Tax Equity must be observed. The Horizontal Equity of the taxes levied must be considered. This principle requires that individuals with the same capacity to pay, living at the same level within the same jurisdiction, should pay approximately the same level of tax. As well, Vertical Equity must be achieved. The "effective tax rate" of citizens at different economic levels can be used as a measure of whether the existing tax system is "progressive" (those with higher incomes pay a higher rate – like the US Income Tax rate structure), "proportional" (those of all income levels pay essentially the same rate), or "regressive" (those with lower incomes pay a higher rate – much like sales tax treats families of equal size in that the family with lower income pays a greater proportion of its total income for the same purchases). The Vertical Equity concept is often viewed in a macro sense, compiled from all means of taxation, rather than on the basis of individual taxes.

Ask the Experts

Have state and local tax policies become more fair or less fair since the start of the great recession?

I can only answer this based on my impression that the basic tax policies themselves have not significantly changed. In that personal consumption declined substantially in that period, it can be expected that where tax policies are more dependent upon regressive taxes for governmental revenues, they could be perceived as becoming less fair. However, the economic base of the various states and localities vary from one another, as do their respective tax structures. Thus, it's difficult to make a broad statement on "fairness." My expectation is that the individual taxpayer would evaluate this using "Miles Law."

Gary J. Krueger

Cargill Professor of International Economics at Macalester College

Why is there such a large difference between what people think is fair and the real structure of state and local tax systems?

Ever since Ronald Reagan stated "government is not the solution government is the problem." It has been all too easy to ridicule any form of government spending. We forget how valuable the FAA, NOAA, USGS CDC etc. are to the functioning of our economy. I was once on a Delta flight to Amsterdam and the flight attendant complained bitterly "government always screws things up." While we were taxing down the runway! Think where air travel would be without the NTSB or the FAA. No one would fly if planes were falling out of the sky. Think of how valuable it is to know that a hurricane will reach landfall 24-48 hours before it hits. 40 years ago this was impossible. I live on the Mississippi river and I have a boat dock and boat tied up there. The USGS water monitoring website is my go to web site when the river is in danger of overflowing. So my point is that people think they receive no value from their taxes, so they resent it.

How do state and local tax systems influence economic growth?

In a multitude of ways, obviously. Spending on safety (fire/police), infrastructure (public transportation/roads/airports), and education from taxes clearly helps growth. Tax policy alters behavior inducing people to invest where they might

not otherwise. For example the mortgage deduction leads to over-consumption of housing. Basically any tax policy that alters the relative prices of goods and services will change behavior. The cigarette tax among the more obvious.

What policies should states and localities consider to increase tax fairness?

Sales taxes tend toward regressivity, whereas a value added tax is a bit less regressive. Replacing sales taxes with a value added tax might help. In Minnesota we exempt food and clothing from sales tax. I consider property taxes a bit unfair as they are based on the accumulated value of your asset which might be unrelated to your income in a particular year.

Have state and local tax policies become more fair or less fair since the start of the great recession?

In Minnesota? No. We elected a Democrat in 2010 who increased the income tax and cut some local property taxes. In other states, especially red states, generally yes. They have moved to eliminate the income tax and rely more on sales taxes (Kansas, Wisconsin etc.). They have also increased college tuition and reduced funding for higher education. So I think there is an increasingly large schism between the Red and the Blue states.

Thomas Potiowsky

Director of the Northwest Economic Research Center in the College of Urban & Public Affairs at Portland State University

Why is there such a large difference between what people think is fair and the real structure of state and local tax systems?

Maybe most people have a Senator Russell Long view of taxes and tax reform: "Don't tax me. Don't tax you. Tax that fellow behind the tree." Your question is loaded with subjective interpretations: "fair" and "real". I think the main difference in being "fair" relates to the benefit-received principle of taxation. I hear people complain that they pay in all these taxes and don't receive anything in return. This is the extreme case of this feeling, but by degree I think this is the main conception. The other difference arises based on the ability-to-pay principle of taxation. This idea of "fair" is that higher income and wealth people



Gary J. Krueger



Thomas Potiowsky

Ask the Experts

should pay higher taxes, both absolute and relatively. Here the complaint is from people who feel the wealthy are not paying their “fair” share, and the wealthy who may feel just the opposite. So now I have just stated the case and not answered your “why”.

At the state and local level, the major sources of government revenue are income taxes, sales taxes, property taxes, payroll taxes, and licenses and fees levied on businesses and households (this is not ordered by importance). All these revenue sources have different degrees of “fairness”. And some, like property taxes, are a mystery to people as to how their tax is computed. So you have a combination of misunderstanding and mistrust as to how taxes are calculated and who pays and what are taxes used for by the government.

How do state and local tax systems influence economic growth?

There are books on this subject. One aspect of this question that people forget is that government budgets have two sides: tax revenue collected and tax revenue spent. We should not just look at how taxes impact economic growth, but we need to also look at how government spending impacts economic growth. And we have to recognize that the spending side can be either well or poorly designed. But your question is looking at one side of the coin: taxing. Now, I do have trouble talking only about taxes and not the spending side, for if you only tax and do not spend it, it will generally not help economic growth. So when you talk about property taxes, you need to talk about financing education, and an educated workforce will assist with economic growth. By the way, people sometimes confuse local tax systems with local building codes, which are not the same as building permit fees. Let me get back on the topic. To come to an end for this question, and looking at only one aspect (remember, there are books on this topic), state and local tax credits for business investments are one of the best uses of a tax policy to assist economic growth. Now, design is very important here and there have been terrible tax credits that give away the farm and do not result in more investments and more jobs. But this is an area where state and local tax systems can give a boost if you already have the other desirables in place: land availability, inexpensive energy, good transportation, educated labor force...

What policies should states and localities consider to increase tax fairness?

There are two main ways of looking at fairness or equity

in public finance: horizontal and vertical equity. Horizontal equity refers to “equal treatment of equals”. So people of the same income and/or wealth should be paying the same taxes. Vertical equity refers to people of higher income and/or wealth should pay higher taxes. Vertical equity is generally categorized as regressive, proportional, and progressive. Relative to one’s income or wealth, is the tax paid a declining proportion (regressive), the same proportion, (proportional), or an increasing proportion (progressive) as your income or wealth rises? Using these as criteria, state and local governments can compare their tax systems. For example, sales taxes are considered regressive since lower income households spend almost all their income while higher income households have more savings which the sales tax does not apply. The idea here is not absolute amount, but the proportion of tax payment. Should a state or locality get rid of their sales tax? No, but maybe look to see what is taxed and maybe certain goods and services that are a large portion of low income households expenditures should be exempt or a lower sales tax rate. “Fairness” is very subjective and people will always have their own interpretations. State and local governments could at least improve the debate and understanding by being more transparent about their tax systems.

Have state and local tax policies become more fair or less fair since the start of the great recession?

I have not really followed this. Many states and localities did nothing to their tax system, others raised taxes, others lowered, and others a combination. These changes were a reaction to the Great Recession and “fairness” was likely of secondary concern. Once again, depending on your definition of fairness, a rise in sales taxes would be deemed “less fair” while a progressive rise in income tax rates could be seen as “more fair”. Of recent interest is Ohio’s Commercial Activity Tax (CAT) passed before the Great Recession but fully implemented in 2010. The fairness of this gross receipts tax (only a handful of states have this) is open to debate but we should hear more about this as many states are presently looking at tax reforms with this tax in mind. Your tax system needs to consider the three “Es”: Effective, Efficiency, Equity. Effective refers to what services your citizens want from the government and do you have the amount of taxes coming in to finance the cost. Efficiency refers to reducing economic distortions from taxes. Equity refers to what we have been talking about in this email. These three criteria can be at odds with one another, and it is a public policy consideration to weigh their tradeoffs as to the structure of the tax system that fits best for your citizens.

Ask the Experts

Herbert I. Lazerow

Professor of Law at University of San Diego, School of Law

Why is there such a large difference between what people think is fair and the real structure of state and local tax systems?

It is not clear that there is a large difference. To the extent that there is, it probably derives from factors identified in a doggerel by the late Senator Russell Long, then Chairman of the Senate Finance Committee:

“Don’t tax you,

Don’t tax me.

Tax that feller

Behind the tree.”

How do state and local tax systems influence economic growth?

By themselves, state and local tax systems do not influence economic growth.

A state tax system can influence economic growth in comparison with another state’s system by luring enterprises to the state. In considering where to locate, state and local taxes are a factor, along with the available workforce, businesses and universities located there with which the business wants to interact, public amenities, and subsidies provided by state and local governments. Investment in a state will increase the number of jobs there, which in turn is likely to increase economic activity as the people who hold those jobs spend their salaries.

What policies should states and localities consider to increase tax fairness?

All states have property taxes. Most states have both sales taxes and income taxes. Income taxes tend to be progressive because they usually tax higher incomes at a greater percentage rate. Sales taxes tend to be regressive because they only apply to the purchase of goods and services, and they usually apply at a flat rate, so a person who spends a high percentage of his income on investments pays sales



Herbert I. Lazerow

tax of a lower percentage of his income than a person who spends his entire income on goods and services. Property taxes are assessed in theory assessed on the fair market value of the property (though many states have provisions like California’s proposition 13 that prevent certain property from being assessed at its fair market value). While the rates on property tax are neither progressive nor regressive, to the extent that the property a person owns roughly follows the person’s income, a wealthy person will pay more property tax than a person of moderate income.

It is fairer to rely on all three types of taxes than to rely on only two, as the application of three tends to average out the tax burden.

Have state and local tax policies become more fair or less fair since the start of the great recession?

Nationwide, probably neither more nor less fair.

Michael J. Waggoner

Associate Professor of Law at University of Colorado, Law School

Why is there such a large difference between what people think is fair and the real structure of state and local tax systems?

A major problem is that tax laws tend to be complicated but political discourse may need to be simple. Modern society also tends toward the complicated:

It may be expensive to get “law” created (whether by legislation, by administrative regulation, or by judicial decision), so one may limit one’s new “law” to those who are contributing to its being adopted. No point in benefiting free-riders. So the new law is narrow. A bunch of narrow laws will, in total, be complicated.

Courts only deal with the dispute the parties present to them, so their result may be more appropriate for that dispute than for that general area. A good result in that dispute may be unwise for that area, and a series of narrow “good results” are likely in total to be complicated.

My experience suggests that scholars are more likely to win recognition for declaring, “This area is really two or more areas, requiring different rules,” than for proclaiming



Michael J. Waggoner

Ask the Experts

“These two historically distinct areas are best treated as one.” Hence more complication.

How do state and local tax systems influence economic growth?

Taxes are of course necessary to pay for public benefits, but taxes may have serious costs beyond just the amount of tax collected: The taxes must be enforced and disputes about enforcement must be resolved. Costs.

People and organizations will incur costs to comply with taxes and to minimize taxes.

They will change their conduct, foregoing sensible activities to pursue less-well-advised ones, to secure tax benefits. Costs.

There will be political costs in deciding how to tax and how to spend, costs not just of campaigns but also of the log-rolling that inevitably occurs in legislative bodies in making decisions. Further, there are two sets on tax costs. First, tax payments are withdrawn from the economy, so not available for economic circulation (of course government spending tends to offset this cost). Second, the marginal tax rate changes people’s conduct by making certain choices more or less desirable. Foregoing desirable choices is a cost. Higher rates have greater impact. This second tax cost is usually made more severe because typically there will have been a choice to create exemptions from the tax, thus increasing the marginal rate on those not exempt.

Lucy Dadayan

Senior Policy Analyst in the Rockefeller College of Public Affairs & Policy at University at Albany, State University of New York

Why is there such a large difference between what people think is fair and the real structure of state and local tax systems?

In general, people don’t want to pay higher taxes but want to have access to more public services. However, state and local governments cannot provide public services without raising revenues through taxes. While state and local governments have to raise revenues, they are often unwilling to raise tax rates on income or sales taxes. Many politicians use various gimmicks to push costs off to the future. In the most recent years, the focus has been on the sin taxes, which is not a long-term solution to budgetary problems. It



Lucy Dadayan

is politically less challenging to raise taxes on cigarettes, legalize marijuana, and expand gambling activities. Reliance on sin taxes and less regressive taxes is not a good policy choice.

How do state and local tax systems influence economic growth?

Economic growth is usually a top priority for state and local officials. Elected officials often lower taxes and use various tax incentives to spur economic growth. However, history shows that the tax cuts and tax incentives are not the best tools for job and economic growth.

Politicians often argue that lower tax rates will attract more business firms due to lower costs and higher profits. In reality, state and local taxes do not represent a significant cost for firms. Business investment decisions are based not only on state and local taxes but on other, more crucial factors, such as the geography, the proximity to customers, the availability and quality of public services, the availability of qualified workforce, etc.

Enhancement of public services is the catalyst for economic growth.

What policies should states and localities consider to increase tax fairness?

Politicians are widely divided on the issue of tax fairness. Most liberals argue that tax fairness is embedded in progressive tax structures while most conservatives are in favor of flat tax rates. While tax fairness is important, it is not the only principle of good tax policy. Economists argue that good tax systems are based on the following principles: broader tax bases, relatively low rates, simplicity, equity, neutrality, revenue adequacy, competitiveness, and transparency. In reality, it’s hard, if not impossible; to achieve a tax system that meets all the principles of good tax policy. At very minimum, state and local governments should strive to have more progressive and broader tax bases. However, the bottom line is to have a balance between revenues and expenditures.

Have state and local tax policies become more fair or less fair since the start of the great recession?

States vary widely in terms of composition and structure of the tax portfolios. There have been no real substantial changes in state and local tax policies since the Great Recession with the exception of very few states. The most notable changes were individual income tax rate cuts in Kansas, North Carolina and Wisconsin. Cutting individual income taxes do not necessarily translate into fair tax systems. The motives for tax cuts are varied: political

Ask the Experts

gimmicks, claims for stimulating economy, job growth, etc. However, the tax cuts in these states were not necessarily fairer and led to less tax progressivity. Moreover, there is not enough evidence that the tax cuts boosted the economy or produced job growth. On the flip side, the revenue losses caused by the tax cuts were greater than anticipated.

In 2013, the governor of Kansas signed into law a tax-cut measure that reduced the number of income tax brackets from three to two as well as cut the rates. The tax rates were cut from 3.5 percent to 3.0 percent for the bottom bracket. The top two brackets were consolidated into a single bracket and the tax rates were reduced from 6.45 percent

and 6.25 percent to a single rate of 4.9 percent. Therefore, the tax cuts were more advantageous for higher income taxpayers as the income tax was cut by more for higher income taxpayers. The tax rates were dropped further in the subsequent years.

In North Carolina, the legislature replaced the three-bracket income tax rates of 6, 7 and 7.75 percent with a single rate of 5.8 percent in calendar year 2014.

Officials in Wisconsin also reduced the number of income tax brackets from five to four as well as cut the tax rates.

Notes

This is a resource document for you to use.

Take notes, highlight, use as a text book.

Five States Accomplish Meaningful Tax Reform in the Wake of the Tax Cuts and Jobs Act

Katherine Loughhead, The Tax Foundation, July 23, 2018

Many states' annual revenue projections have increased following enactment of federal tax reform last December. That is because the Tax Cuts and Jobs Act (TCJA) broadened the tax base—or expanded the sources of income that are subject to federal income taxation—and most states conform in large part with the federal income tax base.

Specifically, with respect to individual income taxes, most states use either federal adjusted gross income (AGI) or federal taxable income as the starting point for calculating a taxpayer's state income tax liability, so changes to certain federal deductions and exemptions flow through to state income tax returns and impact the amount of income that is subject to taxation.

Unless and until state lawmakers modify state tax codes to offset revenue gains from federal base broadening provisions, most states can expect to see a net revenue increase under the new law. Many states have quantified the amount of revenue they expect to gain or lose based on how their longstanding Internal Revenue Code (IRC) conformity statutes interact with the TCJA. We have compiled these revenue estimates on our website as they have been announced.

States that expect to see a net revenue increase have three options in deciding how to use new revenue; my colleague Jared Walczak has called them the “Three Rs of Tax Conformity”: Retain, Return, or Reform. States can retain the additional revenue, which amounts to an implicit tax increase; they can return the revenue to taxpayers by reducing rates or decoupling from federal provisions responsible for the additional revenue; or they can reform their tax codes, using the revenue gains to adjust rates and create a tax structure that is more conducive to economic growth.

During the 2018 legislative session, five states took the latter approach, using federal tax conformity legislation as an opportunity to enact state tax reform. These accomplishments are recapped below:

- Georgia: Anticipating a revenue increase of \$5.2 billion over five years, the legislature passed House Bill 918, tax reform legislation that was signed into law by Governor Nathan Deal (R) in March. This law reduces the top individual and corporate income tax rates from 6 percent to 5.75 percent in 2019 and doubles the standard deduction. In addition, this law outlines steps to further reduce both rates to 5.5 percent pending passage of a joint resolution ratifying such language in 2020.

- Idaho: Anticipating a \$97.4 million increase in revenue in fiscal year (FY) 2019 due in large part to the state's conformity with the federal personal exemption (which was eliminated in the TCJA), Idaho lawmakers realized that doing nothing would result in an unintended tax increase. As a result, the House and Senate passed House Bill 463, which was signed into law by Governor Butch Otter (R) in March. This law retains conformity with the TCJA's repeal of the personal and dependent exemptions, incorporates the TCJA's higher standard deduction, reduces the individual income tax rate by 0.475 percentage points across

all marginal income tax brackets, and reduces the corporate income tax rate by 0.475 percent.

- Iowa: The Iowa Department of Revenue projected \$188.3 million in increased revenue due to the TCJA. After initially weighing the idea of reducing rates without enacting substantive reforms, Iowa lawmakers ultimately opted for comprehensive tax reform, fully restructuring the state's tax code to better promote economic growth. In May, Governor Kim Reynolds (R) signed Senate File 2417 into law, bringing much-needed reform to a tax code that was previously one of the worse structured in the country. This tax reform package consolidates Iowa's nine individual income tax brackets into four and lowers the top rate from 8.98 to 6.5 percent. It also eliminates the alternative minimum tax (AMT) and fully conforms with federal itemized and standard deductions, among other changes. This law incorporates many of the reforms we recommended for the state in 2016, including an eventual repeal of the state's unusual deduction for federal taxes paid and a reduction of the highest-in-the-nation corporate income tax rate from 12 percent to 9.8 percent by 2021.

- Missouri: Governor Mike Parson (R) signed House Bill 2540 into law in July. This tax reform law reduces the top individual income tax rate from 5.9 to 5.4 percent in 2019 and includes triggers to reduce the rate to 5.1 percent subject to revenue availability. The law also partially phases out high earners' federal deductibility, which has historically allowed Missouri taxpayers to deduct a portion of their federal tax liability from their income when calculating state liability. Combined with legislation enacted earlier this year giving the state a 4 percent corporate tax rate, this conformity and tax reform package will help Missouri stand out among its peers.

- Utah: Utah adopted House Bill 293 in March, which reduced individual and corporate income tax rates slightly, from 5 percent to 4.95 percent, as well as increased the state's homeowner's and renter's tax credits. In a July special session, the state approved a \$30 million expansion of the state's child tax credit, which is expected to reduce families' income tax liabilities by approximately \$34 per dependent.

Georgia, Idaho, Iowa, Missouri, and Utah wasted no time capitalizing upon the TCJA's base broadening provisions to offset the cost of rate reductions, simplifications, and other sensible changes to the structure of their tax codes. While every state but Massachusetts has adopted a budget for fiscal year 2019, states that have not yet grappled with the new revenue from federal tax reform will have another opportunity to do so next year. Some have yet to conform to the new law's base-broadening provisions and may explore opportunities to reform their tax codes as they capture that new revenue. But even states that have already conformed may choose to return some or all of the additional revenue to taxpayers with the benefit of an additional year to consider options. Whether additional states use any new revenue for tax reform will be something to watch out for during the next legislative session.

States Make More Progress Rebuilding Rainy Day Funds

Barb Rosewicz, Jonathan Moody & Daniel Newman, *The Pew Charitable Trusts*, August 29, 2018

A decade after the Great Recession began, at least half of the states could cover a bigger share of spending with rainy day funds than before the downturn. But most still had a thinner cushion against budget shortfalls in their total balances, which count rainy day reserves plus general fund dollars left over at the end of a budget year.

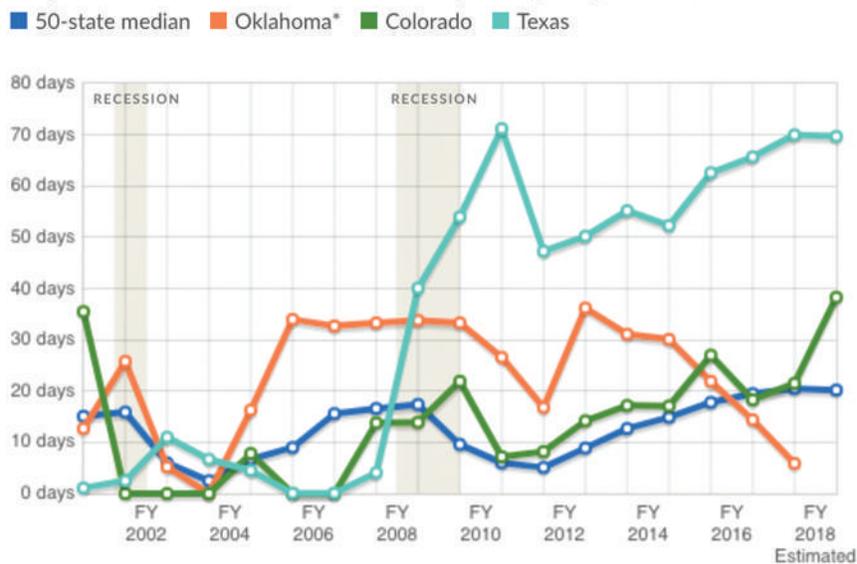
In fiscal year 2017, the 50-state total for rainy day funds increased for a seventh straight year to a record \$54.7 billion, enough to run government operations for a median of 20.5 days, also a new high. Early estimates showed savings at near-peak levels in fiscal 2018, which ended in June for most states. The results will probably rise once missing and final data are counted in a year in which higher-than-expected tax revenue led a number of states to increase savings beyond their earlier estimates.

Even with rainy day funds at today's peak levels, though, most states' total balances could cover a smaller share of government spending than they could have heading into the 2007-09 recession.

After tax revenue plunged in the downturn, states softened the blow to their budgets by tapping both components of total balances—rainy day reserves and ending balances in their budget's general fund, which functions as a state's main checking account. As they did after the 2001 recession, most states have used the current economic recovery to steadily replenish and expand their rainy day funds. However, slow tax revenue recovery and tight budgets have meant fewer dollars left over in year-end balances.

As a result, total balances have improved since their low point but still have fallen short of pre-recession levels, mainly because of smaller ending balances. States had enough in their total balances to fund government operations for a median of 30.3 days in fiscal 2017 and an estimated median of 31.4 days in fiscal 2018, compared with 41.3 days just before the downturn. For many states, though, even pre-recession levels were inadequate to plug huge budget gaps caused by the last recession.

Days Each State Could Run on Only Rainy Day Funds, FY 2000-18



* Oklahoma did not report rainy day fund data for FY 2018.

States use reserves and balances to help manage unexpected revenue shortfalls or spending demands, lessening the need for spending cuts or tax increases to balance their budgets. They are an important measure of how well-prepared states are for the inevitable next economic downturn. Because fiscal 2018 data are still subject to change, Fiscal 50's rankings of states' rainy day funds and total balances relative to spending are based on fiscal 2017 results.

Rainy day funds

Nationally, rainy day funds in fiscal 2017 held the greatest amount in both nominal dollars and as a share of government spending since at least 2000, according to data collected by the National Association of State Budget Officers (NASBO). The 50-state total of \$54.7 billion could cover a median of 20.5 days, or 5.6 percent of general fund spending. Estimates for fiscal 2018 were \$53.9 billion—a median of 20.2 days, or 5.5 percent of spending—but are likely to be revised higher with the inclusion of missing data for Georgia and Oklahoma as well as extra deposits made late in the budget year by states with unexpected surpluses. By comparison, states held \$29.9 billion in rainy day funds in fiscal 2007, the last full budget year before the downturn, with enough to cover a median of 16.6 days, or 4.6 percent of spending.

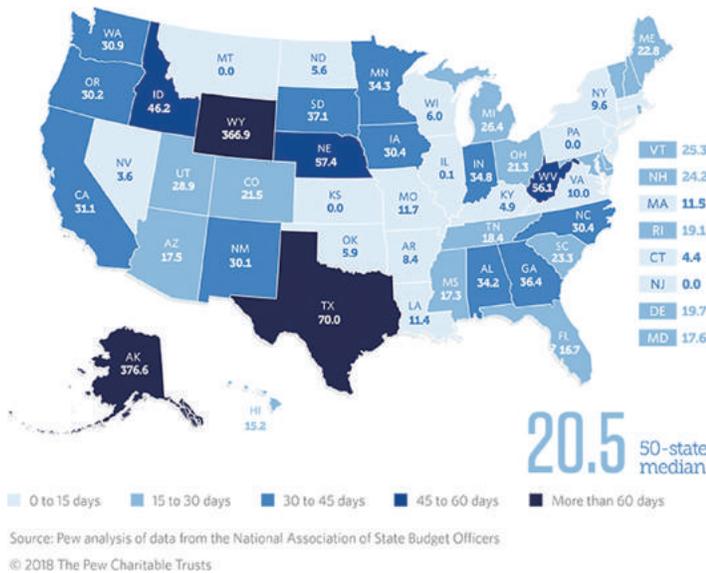
Despite budget pressure from slow tax revenue growth and pent-up spending demands following the recession, policymakers in many states have made efforts to set aside money in rainy day funds. At least 30 states expected to add to their savings in fiscal 2018, while only seven foresaw a drop, according to NASBO data. The trend extends into the current fiscal year, as 28 governors recommended making deposits into their state's rainy day fund in fiscal 2019, according to NASBO.

Although many factors determine how much each state should set aside in its rainy day fund, one gauge of states' progress in building their savings is a comparison with pre-recession levels. In fiscal 2017, at least 26 states had

saved enough to cover a greater share of government spending than in fiscal 2007.

Rainy day funds—also called budget stabilization funds—are the largest component of states’ financial cushions, accounting for more than 70 cents of every \$1 in total balances, compared with 44 cents of every \$1 just before the recession.

Days Each State Could Run on Only Rainy Day Funds in FY 2017



Rainy day fund highlights

States’ results for fiscal 2017 and estimates for fiscal 2018 show:

Alaska ended fiscal 2017 with the nation’s largest rainy day reserves as a share of operating costs (376.6 days), but five years of annual withdrawals to make up for recurring shortfalls in oil-related revenue was expected to bump it from first place. The state expected to end fiscal 2018 with an estimated 191.5 days’ worth of spending, enough for second place. Wyoming, the only other state with more than a year’s worth of operating costs (366.9 days), was expected to replace Alaska as the top state once figures are finalized for fiscal 2018.

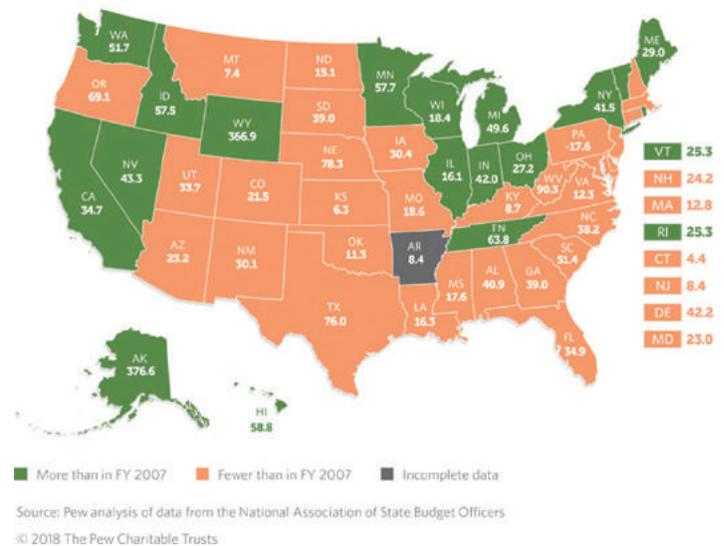
Nine states’ rainy day funds could cover more days’ worth of operating costs in fiscal 2017 than at any point since at least 2000: Alabama (34.2 days), Georgia (36.4), Hawaii (15.2), Idaho (46.2), Maine (22.8), North Carolina (30.4), Ohio (21.3), Vermont (25.3), and Washington (30.9). Among those, Alabama, Ohio, and Vermont anticipated adding to their savings in fiscal 2018.

Eight states had less than a week’s worth of operating costs in reserve in fiscal 2017: Wisconsin (6.0 days), Oklahoma (5.9), North Dakota (5.6), Kentucky (4.9), Connecticut (4.4), Nevada (3.6), Illinois (0.1), and Pennsylvania, with less than a tenth of a day. At least three—Connecticut, Oklahoma, and Pennsylvania—made deposits for the first time in several years at the close of fiscal 2018.

Three states had nothing in their rainy day accounts at the end of fiscal 2017: Kansas, Montana, and New Jersey. But Montana agreed to make its first deposit at the close of fiscal 2018. Kansas and Montana created their funds just a year ago.

Seven states expected a decrease in rainy day fund dollars in fiscal 2018, compared with 13 states that had decreases in fiscal 2017.

18 States’ Total Balances Surpass Pre-Recession Levels
Days each state could run on total balances, FY 2017



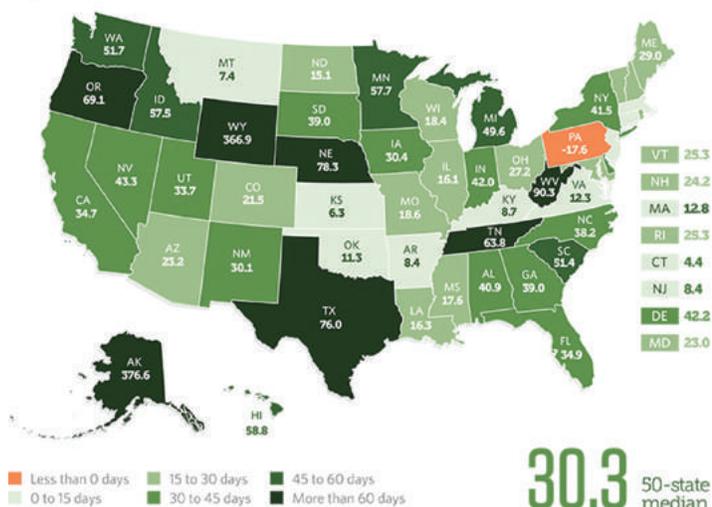
Total balances

States’ total balances stood at \$77.3 billion in fiscal 2017 and could have covered a median of 30.3 days, or 8.3 percent of spending. Amid more favorable budgetary conditions in fiscal 2018, estimates based on incomplete data showed an uptick to \$78.1 billion, with a median of 31.4 days, or 8.6 percent of spending. But states had a smaller financial cushion for both years than they had in fiscal 2007. Because states were spending less a decade ago, pre-recession total balances of \$67.9 billion could stretch further and cover a median of 41.3 days, or 11.3 percent of spending.

Only 18 states in fiscal 2017 could cover more days’ worth of operating costs with their total balances than they could before the recession. A surge in tax revenue, though, gave many states an opportunity to boost their reserves and balances in the budget year that ended in June for most states.

Most states have found it difficult to match their pre-recession benchmarks for total balances, largely because tight budgets have left fewer unspent dollars in ending balances. Because ending balances vary from year to year and do not accumulate, policymakers cannot count on them as cushions against future emergencies to the degree they can with rainy day funds, which are saved until policymakers decide to draw them down. Still, ending balances can be useful in a budget crunch and provide an additional source of fiscal flexibility.

Days Each State Could Run on Total Balances in FY 2017



Source: Pew analysis of data from the National Association of State Budget Officers
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Total balance highlights

States' results for fiscal 2017 and estimates for fiscal 2018 show:

Two states had total balances that could cover more than a year's worth of operating costs in fiscal 2017: Alaska (376.6 days) and Wyoming (366.9). But Alaska was expected to fall below that benchmark based on estimated results for fiscal 2018.

Less than a week's worth of operating costs were held by Connecticut (4.4 days) and Kansas (6.3) in fiscal 2017, but both anticipated their holdings would rise in fiscal 2018.

Pennsylvania (-17.6 days) ended the 2017 budget year with a negative total balance because of tax revenue shortfalls. Its fiscal 2018 budget resolved the deficit through borrowing and one-time revenue injections.

Montana's financial cushion has fallen to its lowest level since at least 2000: 7.4 days in fiscal 2017 and an estimated 9.2 days in fiscal 2018, although final figures could raise that.

Three states' total balances in fiscal 2017 could cover more days' worth of operating costs than at any point since at least 2000: Tennessee (63.8 days), Vermont (25.3 days) and Washington (51.7). Vermont and Washington expected their financial cushions to expand even further in fiscal 2018.

Why reserves matter

States use reserves and balances to manage budgetary uncertainty, deal with revenue forecasting errors, prevent severe spending cuts or tax increases when there are unexpected revenue shortfalls, and cope with unforeseen emergencies. Because reserves and balances are vital to managing unexpected changes and maintaining fiscal health, their levels are tracked closely by bond rating agencies. For example, S&P Global Ratings downgraded Massachu-

setts' debt rating in June 2017, citing its "failure to follow through on rebuilding its reserves." The state addressed the shortcoming in June by making a sizable deposit into its reserve fund.

Building up reserves is a sign of fiscal recovery, but there is no one-size-fits-all rule on when, how, and how much to save. States with a history of significant revenue or economic volatility may desire larger cushions. According to a report by The Pew Charitable Trusts, the optimal savings target of state rainy day funds depends on three factors: the defined purpose of funds, the volatility of a state's tax revenue, and the level of coverage—similar to an insurance policy—that the state seeks to provide for its budget.

Reserves and balances represent funds available to states to fill budget gaps, although there may be varied levels of restriction on their use. Rainy day funds are typically dedicated to provide budget stabilization during economic or revenue downturns but may also have restrictions on the fiscal or economic conditions in which they can be used. In addition, limits are often set on how much states can deposit into rainy day accounts in a given year when seeking to replenish their reserves.

General fund reserves and balances may not reflect a state's complete fiscal cushion. States may have additional resources to soften downturns, such as dedicated reserves outside of their general funds or rainy day accounts. In addition, some states undertake considerable spending outside of the general fund, so comparisons across states should be made with caution. One way to standardize the size of reserves and balances is to calculate how many days a state could run solely on those funds, even though it is highly unlikely that would ever happen.

Analysis by Barb Rosewicz, Jonathan Moody, and Daniel Newman

Oklahoma's Rainy Day Fund was created in 1985 after the oil bust for an emergency, to make up for a shortfall in fiscal year collections and to make up revenue if next year's general revenue fund collections are forecast to be less than the current year.

(d. 423.7)

The time is now for rainy day saving in Oklahoma

The Oklahoman Editorial Board, The Oklahoman, July 11, 2018

With Oklahoma's economy roaring out of the recession that started in 2014 and with record tax collections rolling in, lawmakers would do well to focus on putting more aside in the state's "rainy day" fund for the next downturn.

As things stand, Oklahoma government is ill-prepared for the future, and tax collections will undoubtedly fall again at some point.

In a recent report, The Wall Street Journal noted, "Measured as a share of spending, 21 states had smaller rainy day funds in 2017 than they did in 2008, according to data from the National Association of State Budget Officers compiled by the Tax Policy Center."

Oklahoma was singled out as among the worst states. The Journal said Oklahoma's Rainy Day Fund held enough money to cover 9.3 percent of expenditures in 2008, but could cover just 1.6 percent of expenditures by the 2017 budget year.

The situation has improved somewhat since then. In May, officials with the Office of Management and Enterprise Services announced Oklahoma state tax collections were on pace to provide a Rainy Day Fund deposit of more than \$300 million.

While that's an impressive amount, it would cover only a fraction of the more than \$1 billion single-year shortfall ultimately experienced after oil prices fell in 2014. Thus, lawmakers would do well to devote more money to the fund instead of automatically increasing government spending. Spending, coupled with a relatively small Rainy Day Fund, caused much of the fiscal dysfunction of the past few years.

Rather than increase savings, however, some political leaders have decried the fact that they cannot raid Oklahoma's Rainy Day Fund outside true financial shortfalls. (Despite political rhetoric to the contrary, lawmakers faced no shortfall at the start of the 2018 session and instead had hundreds of millions in growth revenue available.)

Such arguments are short-sighted. The problem in Oklahoma is not that lawmakers are too restrained in using rainy day money. The problem is they are instead too reluctant to make savings deposits aside from those strictly mandated by law. That needs to change for the state's future stability.

North Dakota is often cited as a model for Oklahoma to follow, because that state used its pre-2015 surge in energy tax revenue to boost school funding. Yet the Journal notes North Dakota went from having enough money in its rainy day fund to cover 16.6 percent of expenditures in 2008 to having enough for just 1.5 percent of expenditures by 2017. A better example may come from Texas, which *Governing Magazine* reports had enough money set aside to cover 19.3 percent of expenditures in 2017. There are several reasons the energy recession didn't impact Texas as severely as Oklahoma, but prudent savings surely played a role.

We have argued before that lawmakers should raise the cap on the Rainy Day Fund, which is set too low. That's still needed. But they must also realize that boom times are an opportunity to increase savings.

A politician's first instinct is to spend today, plan tomorrow. But this approach has not served Oklahoma well, and continuing with that model only promises greater pain in the future.

Notes

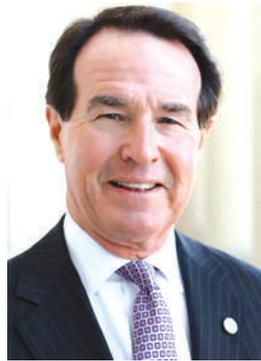
This is a resource document for you to use.

Take notes, highlight, use as a text book.

Morgan: A 21st-century tax system – Part II

Fred Morgan, *The Journal Record*, August 11, 2017

Last month, I posed a series of questions worth examining, particularly in light of Oklahoma’s ongoing budget shortfall. In many areas related to our business competitiveness and quality of life, Oklahoma is not measuring up to its potential. The State Chamber has launched OK2030, a vision plan for Oklahoma, to study what’s not working and present innovative ideas for moving our state forward.



Fred Morgan

My previous column dealt primarily with questions related to Oklahoma’s governmental structures and procedures. Many Oklahomans responded, sharing their ideas on how things could be improved. But that was just the beginning of the discussion that policymakers, business leaders and the general public should be having.

Based upon the state’s budget difficulties over the last few years, and in light of a very recent Supreme Court decision, it is becoming increasingly obvious we should conduct a thorough review of our entire taxation system and how we finance local, county and state government. Our basic tax code, despite numerous amendments and revisions, was

established almost 100 years ago. The world has dramatically changed since our code was enacted. Technological shifts in business and our personal lives have altered our society. Our economy has also radically changed from an agricultural, commodity and manufacturing based economy to a consumer-driven service economy.

It is time to ask serious questions about the tax system. Are we taxing the right things? Does our current tax system create more jobs and investment or hinder our growth potential? Will we be able to fund the core functions of state, county and municipal government adequately in the future? Is our current tax system fair and equitable to all of our citizens? What role should government have through its tax policies? Are there tax systems in other states that better serve the interests of their citizens? Can we reduce the cost of administering our own tax system?

These are but a few of the many questions we need to ask ourselves if we want a vibrant 21st-century Oklahoma.

No one enjoys paying taxes but they are an absolute certainty. In light of that, we must work together to develop the best tax system possible.

Fred Morgan is president and CEO of the State Chamber of Oklahoma.

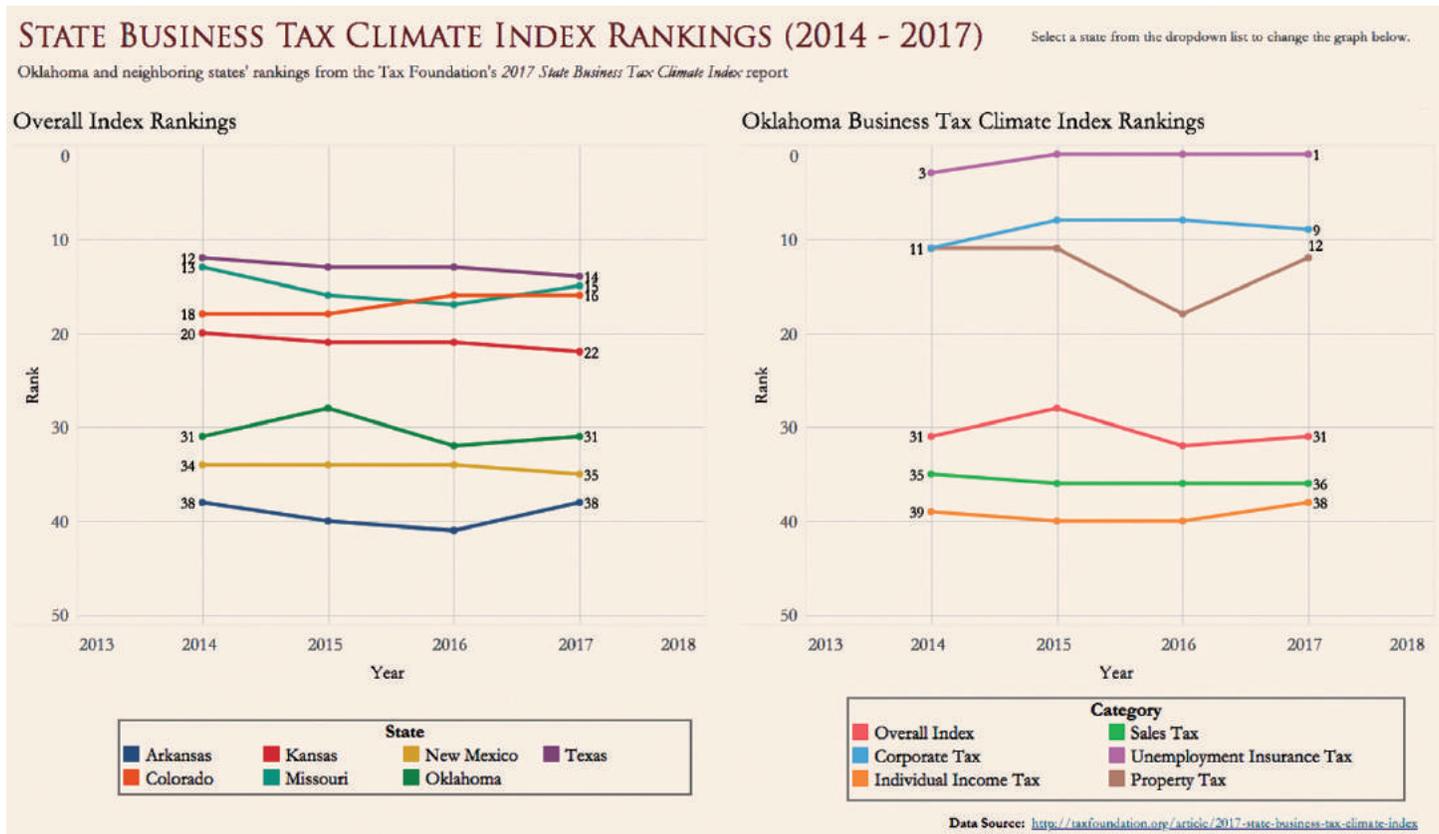


Chart found at State Chamber Research Foundation

OK2030: Moving Oklahoma Forward with Tax Reform

Jennifer Leopard, DrPH, Executive Director State Chamber of Oklahoma Research Foundation

A Business Perspective on the Need to Modernize Oklahoma's Tax Code

Tax Reform and the Oklahoma Business Community For years, Oklahoma has ranked poorly in key areas, including job growth, health and education. To shift the direction of our state, Oklahoma business leaders came together in early 2017 to begin developing a strategic vision plan to move our state forward. The result was OK2030, a business-led initiative of the State Chamber of Oklahoma Research Foundation to put Oklahoma on the top of national rankings by the year 2030. Ideas were collected from in-person interviews, surveys sent to thousands of Oklahomans, and regional forums held across the state. In each instance we asked, what must our state do to move to the top?

For many in Oklahoma, the answer was tax reform. Strong jobs and economic growth are directly impacted by tax policy, and a robust economy enables a state to better address its needs in areas such as education, health care and quality of life. OK2030 called for modernizing Oklahoma's tax code to provide a stable source of revenue and make Oklahoma more competitive for business. To ensure informed tax policy recommendations, we called on university researchers and economists to provide guidance on the direction our state should take. This

Largest Historical Annual Declines (% Change) in Total State Tax Revenue - Oklahoma

Fiscal Year	% Change
1983	-3.3%
1986	-0.8%
1987	-11.0%
1992	-2.5%
2002	-4.6%
2003	-2.4%
2009	-1.7%
2010	-13.5%
2016	-9.7%
2017	-3.3%

process resulted in several findings related to Oklahoma's current tax system as well as key takeaways for shaping a more modern tax structure.

Findings on Oklahoma's Current Tax Structure

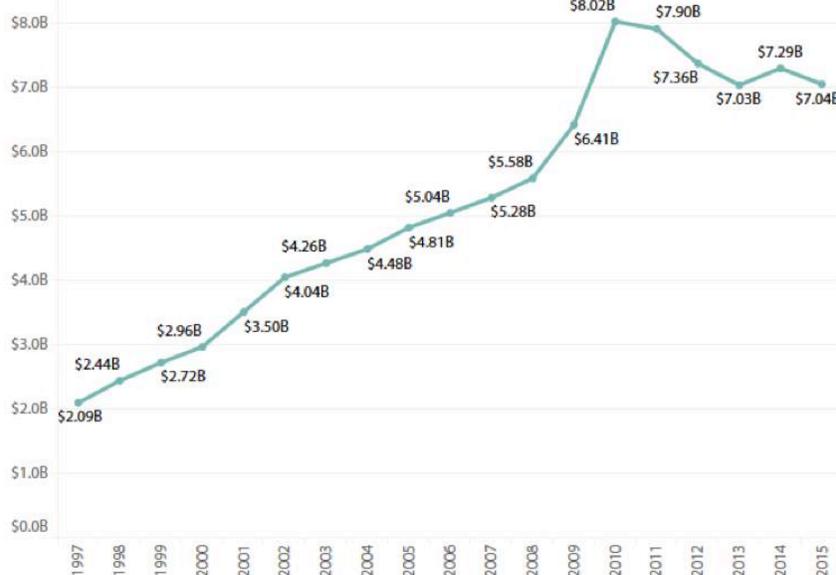
Not surprisingly, the research revealed that revenue from Oklahoma state taxes is extremely volatile. In fact, Oklahoma's year-to-year change in total state tax revenues is among the most volatile in the country. Since 1970, Oklahoma experienced the third highest tax volatility among all states, with two of Oklahoma's three largest single-year declines occurring within the past ten years (2010 and 2016).

What was surprising, however, was the role federal funding has played in recent years magnifying the effects of this volatility. Although Oklahoma's revenue performance was relatively strong during the national recession, Oklahoma received a sharp increase in federal funding from "stimulus" dollars under the American Recovery and Reinvestment Act. Federal funding of Oklahoma state government peaked at \$8.02 billion in 2010, then declined by \$1 billion through 2015. Unfortunately, significant declines in oil and natural gas prices would soon follow, leading to a sharp decline in both employment and state tax revenue in 2016 and 2017. This resulted in a 12.7% drop in state tax revenue on top of the loss of federal funds.

A review of total revenue sources also highlights the state's steadily increasing reliance on non-tax forms of state

revenue, such as user fees for state services. While total state revenue grew 4.5% between 1997 and 2015, this increase reflected a 5.2% growth in non-tax forms of state revenue combined with a much slower 3.5% growth in state tax revenue. Since many non-tax forms of revenue are not included in the General Revenue Fund (GRF) used for state appropriations, GRF balances have become an increasingly less accurate depiction of Oklahoma's true revenue picture.

Oklahoma State Revenue from Federal Government Transfers



Recommendations for Tax Reform

Given these findings, several recommendations began to emerge. First, while taxes have been the focus of recent

reform efforts, it is important to evaluate Oklahoma's tax structure within the context of the full set of revenue sources available to fund state government. In Oklahoma, state taxes only represent roughly one-third of total state revenues. Federal funding to the state makes up another third of total state revenues, and the remaining third is mainly comprised of non-tax state sources including fees for state services. All three sources present varying degrees of burden on Oklahoma individuals and businesses, and the effects must be balanced with the very real needs of state government.

But most importantly, we must separate the conversation about tax reform from the conversation about tax revenue. A discussion on whether our state spends an appropriate amount on state government is healthy, but it should not be confused with the need for a broader discussion on whether our state taxes its people or its businesses appropriately. Tax revenue growth has systematically trailed the rate of economic growth in the state in recent years by a ratio of three-to-one, highlighting the mismatch between a tax code built on a statehood-era economy and the realities of a modern, globally competitive marketplace. And finally, we must search for tools to address our state's natural propensity toward dramatic fluctuations in state tax revenue. In the most recent oil and gas price cycle, Oklahoma, Alaska, Wyoming, Louisiana and North Dakota all experienced significant declines in state tax revenue. Of these

top oil and gas producing states, only Oklahoma was left unprotected and without a strategic oil and gas investment fund. Oklahoma voters will have the opportunity to remedy this in November by voting on State Question 800, which would deposit a small percentage of existing tax revenues

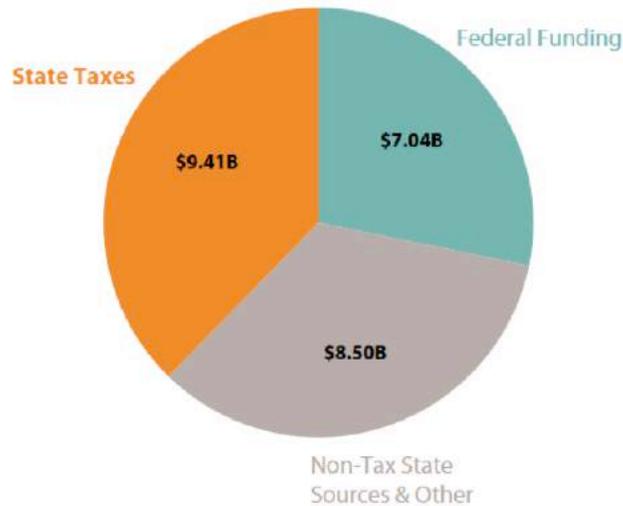
from oil and gas production into an investment fund called the Oklahoma Vision Fund. Managed by the Oklahoma State Treasurer, income from the fund would be placed in the state's General Revenue Fund to supplement the state budget and —without raising taxes— insulate our state budget to protect core services from the drastic budget cuts often levied in economic downturns.

Taxes for a 21st Century Economy

Of the nearly three dozen policy recommendations highlighted under the OK2030 strategic vision plan for Oklahoma, none may be more important — or more challenging — than

tax reform. Sound tax policies attract new jobs, promote economic growth and produce a more sustainable tax base for the state. In this way, tax reform can serve as a catalyst for improvements in nearly every other key policy area. If there is one silver lining to the state budget crisis that has hindered Oklahoma's progress in recent years, it is that it has called our attention to the importance of understanding Oklahoma's total revenue picture and how we can better align Oklahoma's tax structure with Oklahoma's 21st century economy.

FY 2015 Total State Revenues: \$24.95B



Notes

**This is a resource document for you to use.
Take notes, highlight, use as a text book.**

Tulsa Regional Chamber's legislative priorities for 2019

Mike Neal, President and CEO of the Tulsa Regional Chamber

We began the 2018 legislative session much as we have in prior years, calling for state legislators to produce a budget based on recurring, sustainable revenue that adequately funds core services such as education, transportation and health care. Thankfully, this year culminated in historic progress. The legislature began to address long-standing revenue and funding issues, and significant steps were taken to move our state forward in the areas of education and criminal justice reform. Legislators also continued their support of essential economic incentives. There is still much to do but this session showed us that large gains and bold investments are possible.



Mike Neal

Our legislators and teachers deserve praise for their work on behalf of education in Oklahoma. Their progress does not address every need, but it's a strong first step. The new revenue created to support common education – and for teachers, support staff and state employees – is a move forward. The voices of educators were heard, and we encourage them to continue the dialogue as northeast Oklahoma's OneVoice regional legislative coalition continues to advocate for adequate public school funding. We also applaud our state's legislators for the tough compromises they had to make along the way. They showed courage and leadership. We will continue to work hard to protect the progress made in this area, and we hope legislators will work in 2019 to further solidify funding for our state's schools. Restoring higher education should also be a high priority to meet workforce needs for key industries. Higher education absorbed more cuts than any other area of the budget in recent years.

Progress was also made this year on criminal justice reform, a long-time goal for the OneVoice coalition. Passage of the Oklahoma Justice Reform bills was a victory for

the coalition and its pro-growth, pro-business legislative agenda. These bills will set us on a path toward increasing workforce participation, alleviating strain on social programs and relieving the burden of overpopulated prisons on taxpayers. However, the significant steps forward still leave us as the No. 1 most incarcerated state in the country. That path remains unsustainable. We must follow up next year with more smart-on-crime policy. Rehabilitation is cheaper than incarceration and helps our long-term budgeting with more ex-offenders contributing to the economy. We've seen data that shows drug court graduates paid \$6.1 million in taxes over three years. Had they been incarcerated, the cost to the state would have exceeded \$190 million over the same time period.

We also must pursue funding diversification for municipalities. Cities provide many services to offset the state's shortcomings, but the legal requirements for cities to operate predominantly on volatile sales tax revenue hampers effective fiscal management. As a partner in making Oklahoma communities better places to live, the state must consider alternative funding solutions so cities can craft stronger budgets.

Last year we saw great success in securing economic incentives. The Quality Jobs Program has a significant positive economic impact on the state. Greater funding for this tool will assist in attracting high-quality jobs and industry to the state, which increases the economic opportunity and quality of life for Oklahoma residents. Economic incentives require protection and further investment next session.

Much remains for the years ahead. If we are to truly address all that needs to be done to maintain Oklahoma's national competitiveness, legislators on both sides of the aisle must work together to craft solutions. It is my pledge that the Tulsa Regional Chamber will join with our next Oklahoma governor, member companies, citizens and legislators who want a better future to continue our advocacy efforts into 2019 and beyond.

“We also must pursue funding diversification for municipalities. Cities provide many services to offset the state's shortcomings, but the legal requirements for cities to operate predominantly on volatile sales tax revenue hampers effective fiscal management.”

Think Tank Thoughts...

Jonathan Small, CPA, President, Oklahoma Council for Public Affairs, Oklahoma City

The views on taxes vary considerably. While many disagree on what and who should be taxed, and at what level, we all agree that we want government to have available revenue that provides for core government services in the least damaging way possible to the economy. Those who tend to think first of the revenue needs of government do so with a heart for those reliant on government services. Those who tend to think first of taxpayers and the burden taxpayers face do so with a heart for those who go without the fruits of their labor for government and concern for preserving opportunity for others. Both perspectives are valuable, and necessary, for deriving a tax system for the betterment of all Oklahomans.



Jonathan Small

Whether you think taxes should be raised or cut, it is clear that Oklahoma must change some of its tax system to be competitive and securely fund core services of government. The world is changing. Municipalities, counties, states and nations are making adjustments to their respective tax codes.

They know that they must attract wealth production in order to provide economic opportunities to their citizens and steady revenues for the government services citizens rely on. Portions of Oklahoma's current state tax structure resemble more the design of relics than one that is modernized and poised for the sustainability of Oklahoma.

What is the evidence that Oklahoma's tax system is currently destined to be a challenge for Oklahomans?

1. Government services in Oklahoma are too reliant on state taxes.
2. Municipal government services are almost entirely reliant on sales tax revenues.
3. Oklahoma is surrounded on its north, south and west borders by states that either assess no personal income tax or assess one lower than Oklahoma.
4. While other energy states such as Texas have diversified their economy and rely much less on oil and gas (severance) tax revenue because they are structured to grow their private sector, Oklahoma is heavily dependent on this volatile revenue source.
5. Oklahoma's state tax system, and data about it, is often analyzed in purely a static analysis - ignoring the reality of market response to government incentives and disincentives.

To move Oklahoma's tax system into the future we must recognize and value our strengths and work to remedy our weaknesses.

The great news for Oklahoma is that for more than a decade,

Oklahoma lawmakers have worked in bi-partisan ways to correct severe flaws in our weaknesses. Oklahoma eliminated its damaging death tax, cut its high personal income tax rate and income tax burden on millions of Oklahomans, permanently preserved competitive and low oil and gas taxes, prevented property taxes on intangible property, solidified taxpayer protections, and other positive measures. These have all led to significant growth in Oklahoma in measures of state and local tax collections, per-capita income increases, and declines in unemployment.

But Oklahoma cannot rest.

A review of Oklahoma's job growth since 2010 reveals that 66 percent of the growth was in the oil and gas industry. Oklahoma must strive to be attractive for growth across all sectors and make

Oklahoma economically attractive to all, including those looking to relocate from other states. Oklahoma can best do that by gradually phasing out its personal income tax. A study conducted in 2015 by The Oklahoma Council of Public Affairs, Americans for Prosperity-Oklahoma and academia from three Oklahoma universities found that this can be done over a 20-year period without reducing year-to-year revenue growth for the state. Including the gradual phase out of the state's personal income tax, Oklahoma must also reform its tax code in the following manner:

1. Amend the state constitution to allow local school districts to have greater discretion over the use of property tax dollars by removing the requirements that property tax dollars must be spent on certain expenditures
2. Amend the state constitution to specifically dedicate a portion of current property tax dollars to municipalities without increasing the property tax burden
3. For the future, focus on the gradual elimination of taxes that are deterrents to growth: the personal income tax, corporate income tax and the franchise tax - as opposed to specific targeted breaks for specific activity
4. Adopt dynamic scoring for any changes to the tax code proposed at the state or local level, this provides a fairer picture of proposed tax changes

If things remain as they are, when our children and Oklahoma's future generations are faced with the decision of where to go for opportunity, we will be forced to tell them that places like Dallas, Houston, Frisco, Lewisville, Abilene, Plano, Orlando, Fort Myers, and elsewhere hold better promise than Oklahoma City, Tulsa, Edmond, Broken Arrow, Enid, or Bartlesville. With these reforms, the state can ensure funds are available for core services while transitioning our economy into one that can't be easily surpassed. For the sake of future generations, and to unleash the full economic potential of all Oklahomans, let's eliminate damaging taxes and update the code to provide the utmost in flexibility and opportunity.

Three Tax Code Changes for the Middle-Class

Mickey Hepner, PhD, Austin Peay State University

No one likes paying taxes. So why do we? Because we know that the world would be much worse if no one paid any.

After all a world populated by uneducated, unhealthy people who travel down dirt roads overrun with criminals is not something anyone aspires to live in. So we pay taxes. We pay taxes to build better schools for our children. We pay taxes to provide better health care to the sick. We pay taxes to provide better roads for our businesses and families. And we pay taxes to make our communities safer.



Dr. Mickey Hepner

We pay taxes...and we grumble about it.

We grumble about how much we have to pay, and we grumble about what types of taxes we have to pay. And we believe (as if that all it takes to make it true), that we can provide higher quality government services and still pay less for them. Of course this is not new, nor is it something unique to Oklahoma. Somehow though, the effects in Oklahoma have been stronger.

In our state, a state that prides itself on being child friendly, only two states pay their teachers less. In our state, a state where law-and-order justice rules, our prisons are staffed at only 60% of what they should be. In our state, where the uninsured rate exceeds the national average, we've chosen to spurn billions in federal funds to help. And all of this can be traced to our low taxes.

The fact is that overall, Oklahoma is a relatively low-tax state. According to the nonpartisan Tax Foundation, the tax burden for Oklahoma's state and local tax burden is the 39th highest out of the 50 states — and lower than all but one of our neighboring states. When you couple our state's low tax rates, with our state's relatively low income, there is simply insufficient funding for our state to provide the education, health care, transportation, and public safety services that our citizens deserve.

Furthermore, the WAY we tax people, places too much of the burden on the wrong people. According to the latest data from the Institute on Taxation and Economic Policy (ITEP), the middleclass taxpayer in Oklahoma pays 9.4% of their income in state and local taxes. This is more than double the effective rate of 4.3% for the highest earning 1%.

Why the disparity? The answer comes back to all of that

grumbling. You see, in Oklahoma we tolerate the sales tax (the nickel-and dime tax), we dislike the income tax, and we absolutely hate the property tax. In response, we have a tax system with a high sales tax, a below-average income tax, and property taxes that are among the nation's lowest. In fact, according to ITEP's estimates, more than 60% of the tax burden a typical Oklahoma family faces, is due to our state sales taxes.

Furthermore, the Tax Foundation recently reported that Oklahoma's state and local sales tax rates are the 6th highest in the nation.

Unfortunately for Oklahoma's middle-class families, sales taxes (especially those that include groceries like in Oklahoma) tend to be more regressive than income taxes. Consequently, a state with relatively high sales taxes and relatively low income taxes, is effectively forcing the middleclass to shoulder a much greater burden for financing government services...making it feel to the typical family, that Oklahoma's taxes are much higher than they are in reality.

The good news though, is that this is fixable. Here are three ideas to make Oklahoma's tax code fairer for Oklahoma's families:

1. Tax Groceries

Less 38 states plus the District of Columbia exempt groceries from state sales taxes, or charge lower rates, while 5 other states do not even charge a state sales tax at all. Thus, only 7 states (one is Oklahoma) charge the same sales tax rate on groceries as other items. By reducing the state sales tax on groceries, the benefits to Oklahoma's families—those most in need of tax relief—are immense.

2. Tax Apps (Software) More

In Oklahoma if you buy software in a store on a CD-ROM, you must pay sales tax...but if you buy the exact same software and download onto your device, your purchase is exempt. From an economics perspective, such a discrepancy in taxing similar products is inefficient and effectively raises the overall sales tax rate (as the state must increase the rate to generate the same revenue with a smaller tax base). Currently, more than 35 states tax downloaded software. By taxing downloaded software, ebooks, and apps the same as canned software, Oklahoma could broaden the tax base and reduce its overall sales tax rate.

3. Impose a new 1% tax on all incomes above the poverty level to provide a dedicated funding source to increase teacher pay

Under this scenario, a family of four earning \$30,000/year would pay an additional \$57 in taxes per year, while

families earning \$250,000 annually would pay an additional \$2257 in taxes. This proposal does two things. First, it would enable Oklahoma to begin addressing one of its critical needs—low teacher pay. Second, by exempting income below the poverty level from the tax, this tax disproportionately falls on those who have the lowest tax burden. It's easy to see why people don't like to pay taxes. If one looks carefully though, one can also see how making the tax code fairer can simultaneously reduce the tax burden for Oklahoma's middle-class families while providing additional revenues to invest in Oklahoma's future. Not doing that... is something well worth grumbling about.

ENDNOTES

National Education Association Rankings and Estimates, "Average Salaries of Public School Teachers, 2011-12 (revised)".

Oklahoma Speaker of the House Jeff Hickman, as quoted in the Tulsa World on January 17, 2015. http://www.tulsaworld.com/news/government/house-speakerhickman-oklahoma-one-law-suit-away-from-federalintervention/article_fbaf56c1-1842-5089-bda6-3155b1e1bd82.html

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"Who Pays?" Institute on Taxation and Economic Policy, 2015. <http://www.itep.org/whopays/states/oklahoma.php>

"State and Local Sales Tax Rates, Midyear 2015", Tax Foundation. <http://taxfoundation.org/article/state-andlocal-sales-tax-rates-mid-year-2015>



Thoughts of a University Economist ...

Russell Evans, PhD, Oklahoma City University

Discussions of state revenues and expenditures are, at their essence, discussions of how and how much money governments should collect and how governments should spend their collections.

The double use of the word “should” is intentional and conveys at the outset that answers to these very important questions rely on a heavy dose of subjectivity. Two readers may see an identical data set and reach very different conclusions as individual preferences, shaped by life experiences, political philosophy, and moral attitudes leverage the data to reach very different policy conclusions. Perhaps the most important takeaway on this topic is a frank admission that there are not right answers – only answers that better reflect the attitudes and preferences of the constituents of the state. The intent of this paper is to advance the discussion with a little background information and commentary on some key principles worth considering. It would be disingenuous to suggest that anything about my education or profession makes clear an enlightened path left ill illumed for others.

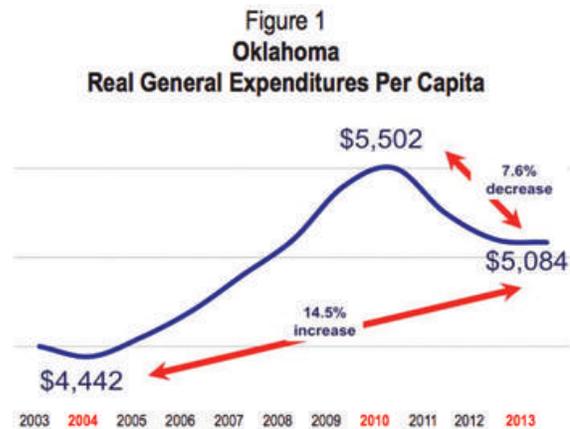
Table 1 compares tax collections by major categories for all states and for Oklahoma specifically. Oklahoma tax collections of \$9.1 billion represent 1.05% of total U.S. state collections of \$865.7 billion while Oklahoma’s 2014 gross state product of \$183 billion also represents 1.05% of the U.S. gross domestic product of \$17.4 trillion. That is, Oklahoma as a state is responsible for 1.05% of all economic activity in the nation and raises at the state level 1.05% of all state tax revenues. Oklahoma does not have a state property tax making it less reliant on the property base for state revenues that the nation as a whole.

Table 1
Tax Reliance: FY 2014 Tax Collections by Major Category
U.S. and Oklahoma (in thousands of dollars)

	United States		Oklahoma	
	FY 2014	Pct	F Y2014	Pct
Property Tax	\$14,232,835	1.6%	-	0.0%
Sales Tax	411,414,175	47.5%	\$3,989,358	43.8%
License Tax	51,120,024	5.9%	1,057,768	11.6%
Individual Income Tax	310,828,815	35.9%	2,962,128	32.5%
Corporate Income Tax	46,275,970	5.3%	397,290	4.4%
Severance Tax	7,780,808	2.1%	679,406	7.5%
Total Taxes	865,752,089	100.0%	9,103,302	100.0%

In contrast, Oklahoma’s status as an energy state lends itself to an increased reliance on severance tax collections. Compared to the national characteristics, Oklahoma is less reliant on sales, income (individual and corporate) but more reliant on license taxes (of which motor vehicle license fees are the largest component). After looking briefly at patterns of expenditures across time and category, we’ll return to the tax discussion with commentary of some principles of effective taxation.

Figure 1 illustrates the pattern of general state expenditures over time. Note that discussion of budget shortfalls in the media generally refer to the appropriate budget only. The appropriated budget accounts for just more than a third of total state expenditures as often tax dollars and collected and allocated by statute without passing through the formal appropriations process. Over the ten-year period from 2004 to 2013 real (inflation adjusted) state expenditures per person increased 14.5% from \$4,442.55 to \$5,084.73 for an average annual rate of real expenditure growth of 1.6%. Since peaking in 2010, real expenditures per person have decreased 7.6%.



State general expenditures are allocated across major categories including education, public welfare, health, and highways. Table 2 compares that allocation pattern of 2004 with that of 2013. The share of state general expenditures allocated to education fell from 43% in 2004 to 37.4% in 2013 while allocations to public welfare increased from 27.4% in 2004 to 32.0% in 2013. Over the same time period, allocations to both health and highways increased while allocations to corrections decreased.

Table 2
State General Expenditures by Major Function: 2013 and 2004
(in thousands of dollars)

	2,004	2,013	2004	2013
Education	\$5,547,702	\$7,321,724	43%	37%
Public Welfare	3,535,549	6,258,083	27%	32%
Hospitals	154,342	258,175	1%	1%
Health	495,409	861,552	4%	4%
Highways	1,064,245	1,802,547	8%	9%
Police Protection	102,790	233,623	1%	1%
Correction	501,001	569,140	4%	3%
Natural Resources	205,152	231,332	2%	1%
Parks and Recreation	77,230	81,657	1%	0%
Governmental Administration	419,205	747,200	3%	4%
Interest on General Debt	286,836	460,984	2%	2%
Other and Unallocable	504,089	753,082	4%	4%
Total	12,893,550	19,579,099	100%	100%

Having reviewed briefly how the state collects taxes (with reliance on sales, income, and severance taxes complemented by motor vehicle license taxes), how much the state collects and spends (\$5,084.73 inflation adjusted dollars per person compared to \$4,442.55 in 2004), and how the state spends those revenues (education, public welfare, health, and highways), we turn to one brief comment on public finance.

Nobel economist Kenneth Arrow argues convincingly that, subject to a reasonable set of constraints, it is impossible to combine the preference rankings of individuals using a rank order voting system to convert the individual preferences into a group-wide social welfare ranking. In short, it is not possible to combine the ranked preferences of all Oklahomans for public sector priorities and solve the problem budget prioritization in one pass. It was stated earlier that there wasn't a right answer but we see now that there is a right

answer – only that the right answer is unknowable to us!

Given that the right answer of how much to collect, how to collect it, and how to spend it is unknowable, we are left to grapple through trial and error to arrive at improved rather than optimal allocations. If it seems discussions of the optimal size and reach of government never end you may be intuitively attuned to the economic principle presented here. These conversations will never end. Changes in societal preferences will continually demand further grappling with the public sector as trial and error moves us (hopefully) in an improved direction.

Meetings such as this town hall gathering are an important component of the ongoing grappling process. Careful analysis of policy and funding alternatives is equally important if we are to be confident that our grappling, trial and error efforts are moving society to an improved condition.

Notes

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Take notes, highlight, use as a text book.

(b. 1)

Help from Our Friends: What States Can Learn from Tax Reform Experiences across the Country

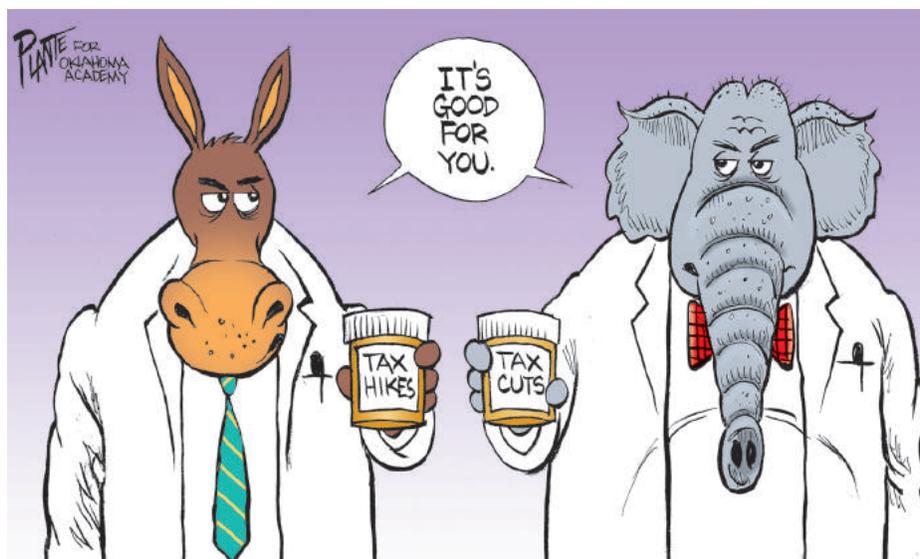
Nicole Kaeding and Jeremy Horpedahl, *The Tax Foundation*, May 15, 2018

Reforming and modernizing a state tax code is a herculean task, but states considering reform are not alone. They can learn from the lessons of other states. A number of states have developed and passed tax reforms in the last several years. This paper looks in depth at five recent state/jurisdiction tax reform efforts in: Utah, Indiana, North Carolina, the District of Columbia, and Kansas. The first four are generally considered to be successful examples of tax reform. While each approached the important questions differently, these four all broadened tax bases, lowered tax rates, and simplified their tax structures. North Carolina and Utah completed theirs in one large tax package, with smaller modifications later. Indiana completed a series of smaller reforms over a number of years, while the District of Columbia used a series of tax triggers to accomplish their goals.

Kansas is the unique state in this grouping, and instead, illustrates an unsuccessful example of state tax reform. Base broadening is an essential part of tax reform. Kansas's exempted a large part of income from its tax base, leading to tax avoidance.

Utah's Reforms Before (And During) The Great Recession In 2006 and 2007, Utah enacted a major reform of its tax code, first in a special legislative session in late 2006 and then in the 2007 general session a few months later. The major achievement of this tax reform was the creation of a flat-rate tax system for the individual income tax, which was passed in a 2006 special session. In the general session in 2007, Utah enacted several more tax changes, including a small decrease in the overall state sales tax rate, and a larger decrease in the sales tax on groceries.

Unlike North Carolina (discussed later in this paper), Utah began its tax reform efforts from a position of strength in its tax system. It already ranked well (18th) in the 2006 edition of the Tax Foundation's State Business Tax Climate Index. Today, in the 2018 edition of the Index, Utah has moved up even further, with the eighth best overall score and the 11th



best score for the individual income tax. And that eighth best overall score is actually the highest score among states that have all three major tax types. Utah started from a strong position, but its 2006-2007 reforms moved the state up to have one of the best business tax climates in the country.

Prior to the 2006-2007 reforms, Utah had a progressive income tax with six brackets. The brackets ranged from 2.3 percent up to 7 percent, and this specific set of brackets had been in place since 1997, though Utah had a multi-bracket income tax since its enactment in 1931. The top rate of 7 percent applied to married couples with taxable income above \$8,627 per year (or \$4,314 for single filers). The standard deduction and personal exemption are both tied to the federal standard deduction and personal exemption in Utah, and reforms converted these deductions into credits.

The big change was to move Utah from a six-bracket, progressive tax system to a flat-rate income tax of 5 percent. The initial reform passed in the 2006 special session created a dual-track system, where filers could either continue filing under the old progressive system, or the new flat rate. The flat rate was initially set at 5.35 percent, though this rate and the dual-track system only existed for tax year 2007. In 2007, the legislature lowered the rate to 5 percent and eliminated the six-bracket system, leaving only the flat rate system for all taxpayers.

Prior to the reform, a married couple would not be paying a 5 percent marginal rate until they were above \$5,177 in taxable income (the rate was 5.2 percent), so some taxpayers would have seen a net tax increase under this reform. To partially offset this tax increase, Utah made two changes to the sales tax rates, as well as one change to income tax credits. For the sales tax, first the general sales tax rate was lowered slightly from 4.75 percent to 4.65 percent. The tax rate on food was also lowered to 1.75 percent in two steps.

In the income tax, Utah added new income tax credits to help make whole those taxpayers who would see their rates

increase under a flat-rate income tax. Instead of taking the standard deduction and personal exemption to arrive at taxable income, the new tax system applied these as credits (equal to 6 percent of the total) after the tax is calculated. The credits are nonrefundable, and start to phase out above \$24,000 for married-filing-joint returns (this is adjusted for inflation, so it is almost \$28,000 today). Thus, high-income taxpayers will pay exactly 5 percent of their income in taxes, whereas low-income taxpayers will pay less than 5 percent (zero at some income levels), retaining some progressivity even within a flat-rate system.

These changes to the tax code did result in a net cut to state revenue. The individual income tax changes resulted in a roughly \$190 million revenue reduction, and the sales tax changes reduced state revenues by about \$160 million (most of that coming from the sales tax reduction on groceries).

Utah also had the unusual experience of its tax changes going into effect right as the Great Recession hit state budgets. But because Utah carried out its reforms in a prudent manner, they did not suffer additional adverse effects from the recession (other than the effects all states felt). By lowering rates, broadening the base, and making sure the overall package was roughly revenue-neutral, Utah demonstrated that good tax reform can work even in a rough business cycle.

Indiana's Consistent Path to Reform

Unlike Utah and North Carolina, which tackled the majority of their reforms in one legislative session, Indiana approached reform in smaller pieces. The state passed small reforms in multiple sessions, which, in combination, represent a far-reaching reform of the Hoosier State's tax code. By lowering individual and corporate tax rates, reforming the state's tangible personal property tax, and repealing its inheritance tax, the Hoosier State now ranks ninth in the State Business Tax Climate Index, the second-highest rank of a state with every major tax type (following only Utah).

Indiana's first step towards tax reform began in 2011. In that year, the state launched a bold strategy, lowering the state's corporate income tax rate from 8.5 percent to 6.5 percent by 2015. The rate would fall by 0.5 percent each fiscal year, slowly lowering the tax burden for Hoosier businesses.

The corporate rate reduction was financed in part by eliminating a tax credit for municipal bonds from other states. Indiana was unique in that it allowed credits for non-Indiana bonds. The state also eliminated net operating loss carrybacks after the 2011 tax year.

In 2013, the first year of then-Governor Mike Pence's (R) term, the state continued its tax reform. This tax package made several key reforms. First, it set the individual income tax on a set phasedown, to match the state's corporate income tax. When fully phased in, Indiana would have the

second lowest individual income tax, behind only Pennsylvania, of any state that taxes individual income in the country. The 2013 tax package also accelerated the elimination of the state's inheritance tax. The tax, originally slated for elimination in 2022, was repealed immediately. Finally, the plan retained the corporate income tax phasedown created in 2011.

Indiana continued its trend of tax reform in 2014, with further reductions in the state's corporate income tax. By 2022, the state's corporate income tax rate will be 4.9 percent, an impressive reduction from the state's 8.5 percent rate in 2011.

The state also made noteworthy changes to its local tangible personal property taxes in 2014. Tangible personal property taxes are local property taxes on inventory, machinery, and other capital investments of businesses. Indiana recognized the need to reduce and eliminate these taxes, but was concerned how to proceed given the local governments' reliance on the tax revenue. The state came up with a creative solution: local governments were granted significant authority to reduce these taxes. Local governments could first decide to exempt the small amounts, less than \$20,000, in tangible personal property value. Locals were also permitted to exempt new property purchases.

Never content on tax issues, the Hoosier state pushed forward again in 2015, eliminating its throwback rule for corporate income taxes. Throwback rules are complicated provisions that require businesses to add untaxed income, known as "nowhere income," from other states into another state's tax base. Multiple states try to claim this untaxed income, requiring firms to engage in a tangled web of calculations to determine their taxable income. Eliminating this rule further simplified the state's corporate income tax.

The state also furthered its tangible personal property reforms from 2014. While 2014's reform allowed localities the option to exempt up to \$20,000 in tangible personal property, in 2015, the state automatically exempted the amount statewide.

The state also created a taxpayer rebate program in 2011. If the state's rainy-day fund exceeded 10 percent (later revised to 12.5 percent) of the state's budget spending, the excess would be automatically refunded. Half the money would help to lower the unfunded liability within the teacher's pension program, while the other half would be refunded to Hoosier residents via an income tax credit. Hoosiers saw a \$111 tax refund in 2012, when the state had a \$2.5 billion surplus. The state continued to run surpluses, but future legislatures dedicated more of the surplus to education.

At the same time that all these reforms took place, the state also launched a nation-leading tax incentive review process. All tax incentives must be reviewed on a five-year basis by the state's Legislative Services Agency (LSA). And even more important, when cost-benefit analysis of the

“Tax reform means, Don’t tax you, don’t tax me. Tax that fellow behind the tree.” -Russell B. Long

incentives proved the provisions were ineffective, the state has seen fit to repeal them. In 2015, LSA’s research showed a program providing a tax deduction for solar-powered roof vents was not fruitful. According to the report, “The link between the solar-powered roof vent/fan deduction and taxpayers’ expenditures...is questionable and appears to be very weak, if at all present.” Eliminating these incentives allowed the state to finance other tax reforms.

Finally, in 2017, Indiana raised its gasoline tax as part of a package to create a long-term transportation funding plan. The 10 cents-per gallon increase is expected to generate \$1.2 billion annually and help fund a number of construction projects around the state. Approximately \$850 million would finance state construction projects, with \$350 million going to local infrastructure projects. This followed a transportation study committee identifying \$1 billion a year in funding projects. While raising a gas tax is often unpopular, aligning user fees, like a gas tax, with the associated spending projects, like road construction, is a sound financing approach for states. Recent polling further suggests that ensuring dedication of gas taxes in Indiana to road maintenance and construction has increased the popularity of what may appear on its face to be an unpopular tax hike.

Indiana has launched an aggressive campaign in the last six years to overhaul and reform its state’s code. Almost every year, since 2011, the state has passed tax reforms to improve the competitiveness of the state, including lowering its individual and corporate income tax rates, reforming tangible personal property taxes, and reforming corporate tax base rules. Indiana’s actions represent a responsible step forward, particularly for states concerned about enacting too many changes at one time.

North Carolina’s 2013 Tax Reforms

North Carolina’s tax code had long been uncompetitive before their recent tax reform. The state’s tax code was among the bottom 10 of states on the Tax Foundation’s State Business Tax Climate Index, ranking 46th in 2011, 45th in 2012, and 44th in 2013, the final score before their first comprehensive tax reform.

The list of issues with the state’s tax code was long. The state had the highest individual income tax rate in the Southeast at 7.75 percent, with a progressive rate structure with low rate kick-ins. Income above \$12,750 was taxed at 7 percent.

Business taxes were also high in North Carolina. The

corporate income tax in the Tar Heel State was the highest in the Southeast at 6.9 percent, and the state was plagued by a narrow corporate tax base. From 2003 to 2009, North Carolina provided more than \$6.7 billion in economic development incentives, such as tax credits, abatements, and special incentive packages, but the success of these packages was lackluster. North Carolina was one of only 20 states with a franchise tax, a tax on business assets, with the high rate of 0.15 percent of assets.

In 2013, the state undertook comprehensive tax reform, seeking to improve the state’s tax climate. The North Carolina legislature passed a dramatic, comprehensive overhaul of the state’s tax code. The plan broadened, flattened, and lowered the individual income tax, lowered a number of business taxes, and expanded the sales tax base, among other changes.

The first major change was a modification to the state’s individual income tax. The state consolidated its three income tax brackets, with a top rate of 7.75 percent, into a flat income tax with a top rate of 5.8 percent. It also included a further phasedown of rates to reach 5.75 percent in 2015.

To mitigate concerns about regressivity in this change, the state coupled its rate changes to changes with its tax base. The state increased its standard deduction from \$6,000 for married filers to \$15,000, while repealing its personal exemption of \$2,000. Combined, North Carolinians would see the first \$15,000 of their income being exempt from taxation, compared to \$8,000 prior to reform. The state also increased the amount of its child tax credit for lower-income households. The credit increased from \$100 to \$125, but the increase was limited to married filers below \$40,000 in income.

At the same time, the state limited a number of its individual tax expenditures to finance these tax changes. The total number of individual income tax expenditures fell from 40 to 17, and even for the retained expenditures, many were limited. The total itemized deduction for mortgage interest and property taxes paid was capped at \$20,000. The adoption tax credit decreased from 50 percent of the federal credit to 30 percent of the federal credit.

North Carolina also lowered its corporate income tax as part of its tax reform package from 6.9 percent to 6 percent in 2014 and 5 percent in 2015. Additionally, the state created a unique tax trigger to further lower the corporate rate if the state’s revenue hit specific targets. If revenues exceeded

\$20.2 billion in 2015, the corporate income tax rate would fall again to 4 percent in 2016, with another cut to 3 percent in 2017 if 2016 revenues exceeded \$20.975 billion. In both cases, the state achieved the revenue target, lowering corporate income tax rates.

Similar to the individual income tax, the state eliminated several corporate tax expenditures. The state's generous film credit was allowed to expire, and was subsequently replaced with a grant program. Credits for low-income housing, historic rehabilitation, and recycling oyster shells, among others, were allowed to expire.

Finally, the state made large changes to its sales tax structure as part of its tax reform package. North Carolina had two sales tax holidays. The first exempted clothing, school supplies, and computers, among other items, in early August each year for back-to-school purchases. The second, in November, exempted ENERGY STAR® home appliances, such as refrigerators, from the sales tax. The state eliminated both sales tax holidays as part of its tax reform package.

The state expanded its sales tax base to include several new purchases as well, though to a lesser degree than in several of the original proposals. For instance, bread and other bakery items sold at a bakery were no longer exempt from the sales tax. North Carolina also began charging sales tax on admission charges to entertainment events, such as live performances, movies, festivals, and museums. Finally, the state expanded its sales tax base to more fully tax manufactured and mobile homes.

North Carolina's tax reform was groundbreaking, becoming the first state to pass comprehensive tax reform in one legislative session since Utah in the mid-2000s. By broadening their tax bases, the state was able to dramatically lower their individual and corporate income tax rates, lowering tax burdens for individuals. Compliance costs were also lowered with the larger standard deduction. And finally, North Carolina's strategic use of a tax trigger ensured that the state had sufficient revenues to meet its spending needs. North Carolina's 2013 tax reforms are an excellent example of what is possible for a state to accomplish with tax reform.

North Carolina's 2015 Tax Reforms

Following passage of its comprehensive tax reform package in 2013, North Carolina made further modifications and reforms during its 2015 legislative session. These changes advanced upon principles of its 2013 reform. The state made further cuts to its individual income tax, lowering the rate from 5.75 to 5.499 percent in 2017. North Carolina also slightly increased their standard deduction from \$15,000 to \$15,500 for married filers. Finally, the state kept its corporate income tax rate trigger in place, which allowed rates to decrease to 4 percent in 2016 and 3 percent in 2017.

The state also expanded its sales tax base to include service contracts, such as services for "repair, maintenance, and

installation" services, and used the additional revenues to ensure equity among its local governments for their spending priorities.

North Carolina's 2017 Tax Reforms

In 2017, the state legislature continued to push forward with state tax reforms, even after the party in the governor's mansion flipped with the election of Democratic Governor Roy Cooper. The Republican-controlled legislature passed multiple tax reforms within its budget, and subsequently overrode the governor's veto of the changes.

The state's individual income tax rate is scheduled to be reduced again in 2019, from 5.499 percent to 5.25 percent. At the same time, the state's standard deduction will increase from \$17,500 to \$20,000 for married filers.

Businesses will also see additional tax cuts under the budget agreement. The corporate income tax will fall from 3 percent to 2.5 percent, also in 2019. At the same time, the franchise tax will be lowered for S corporations. Instead of 0.15 percent on all assets, S corps will pay a flat \$200 on their first \$1 million in capital value. Assets in excess of \$1 million will be subject to the 0.15 percent rate.

District of Columbia

In 2014, the District of Columbia passed a tax reform package that lowered individual income tax rates and business tax rates, increased the standard deduction and personal exemption amounts, and expanded the Earned Income Tax Credit for childless workers. Some of the changes took place right away, while many of the changes used a tax trigger, so they were not implemented until enough new tax revenue was available. As of January 2018, all the changes that required tax triggers have been enacted. In addition to the tax triggers, the tax changes were partially paid for by expanding the sales tax base to several personal services.

Many of the changes D.C. enacted came directly from the recommendations of a Tax Revision Commission, which held a series of meetings and public hearings over a 16-month period in 2012 and 2013. Some of the Commission's recommendations addressed ways that D.C. could be more competitive with neighboring Virginia and Maryland. For example, the District's business franchise tax rate (a form of a corporate income tax) was 9.975 percent prior to the reforms, while Maryland's was 8.25 percent and Virginia's was even lower at 6 percent. The Commission recommended lowering the rate to match Maryland, and the reform package put this change in place; much of the reduction was done in steps triggered by tax revenue surpluses.

The individual income tax was changed in two major ways. First the "zero bracket," the amount of income you can earn without owing any tax, was greatly expanded. This was done by increasing both the standard deduction and personal exemptions to match the amounts in the federal tax code. For example, a married couple with two children

now had \$27,800 of untaxed income, whereas before it was only \$10,800. Second, a new 6.5 percent tax bracket was added, lowering the rate for households between \$40,000 and \$60,000 of income (it had been 8.5 percent, which still applied to those over \$60,000). As with the changes to the business tax, these two changes to the individual income tax were done in steps through tax triggers.

While the tax reform package as a whole reduced revenue by about \$67 million, there was one major change that increased revenue: the expansion of the sales tax base to certain personal services. The services included in the base expansion were recommended by the Tax Revision Commission as well. The list of services included: construction contractors and other construction-related services, storage of household goods and mini-storage, water for consumption at home, barber and beautician services, carpet and upholstery cleaning, health clubs and tanning studios, car washes, and bowling alleys and billiards parlors. As would be expected, businesses in these industries opposed the idea of being included in the sales tax base, and health clubs even tried to name this a “yoga tax.” But despite the orchestrated fanfare, the sales tax base expansion was included in the final tax package.

The tax reform package in D.C. demonstrates a number of important tax reform principles in action. First, lowering rates by broadening the tax base can be done effectively, even when narrow interests object to being included in the base. Second, when structured correctly, tax triggers are a prudent means of implementing tax cuts, as we saw in North Carolina. Finally, tax cuts don’t necessarily have to diminish the progressivity of the overall tax code, as evidenced by the expanded zero bracket and earned income tax credit.

Kansas’s Missteps in Tax Reform

Unlike the states mentioned earlier in this paper, Kansas represents a case study in how not to approach state-level tax reform. Kansas passed large tax rate cuts, without accompanying base broadening, creating a large hole in the state’s budget. At the same time, the state completely exempted one type of income from the income tax, leading to tax avoidance.

In 2012, Governor Sam Brownback (R) proposed an aggressive tax package. It would have lowered the state’s individual income tax, with the top rate falling from 6.45 percent to 4.9 percent, while increasing the state’s standard deduction. A number of other deductions, such as mortgage interest, would be eliminated too. At the same time, nonwage income from pass-through businesses would be exempt. Overall, the plan would have been revenue-neutral.

However, the package actually passed by the legislature differed significantly from the original plan proposed by Governor Brownback. After several months of debate among the governor, House, and Senate, the House grew frustrated and sent the unresolved plan to the governor’s

desk. Many of the identified pay-fors in the governor’s plan were removed from the final package, representing a large net tax cut for the state. The governor decided to go ahead and sign the plan, and promised to sign a compromise bill to supplant it when the House and Senate ironed out the details. But negotiations balked, and the state was left with a tax cut with estimated annual costs of \$803 million by 2014.

The plan was also problematic for its complete exemption of nonwage income for pass-through businesses. Pass-through businesses, such as sole proprietorships and LLCs, are taxed through the individual income tax rather than the corporate tax. Owners of these businesses pay themselves a wage, but any additional income is taxed on Schedule C of their income tax return. Kansas’s tax plan dictated that all nonwage income would be exempt from taxation, creating an incentive for tax avoidance.

Reports of abuse of this provision quickly circulated within the state. Bill Self, head coach of the Kansas University men’s basketball team, had the majority of his income paid to an LLC in the state to help avoid Kansas income taxes. A study by several academic economists highlighted the tax avoidance caused by the provision. First, filers with pass-through income increased the amount of their nonwage income, to take advantage of the tax change. Second, they found “no evidence of increases in investment.” According to the authors, their research found “income shifting rather than real economic activity.” State estimates put the total loss of revenue from this provision at \$200 million to \$300 million a year.

In 2013, Kansas considered ways to again pass the base broadeners needed to finance its 2012 tax cuts. Again, “legislators stripped out the base broadening and kept the tax cuts,” arguing that “starving the beast” was the preferred approach. Many in the legislature refused to confront the issues they created the year before. Large tax cuts without revenue or spending offsets create large budget holes, impacting the provision of government services. The final package passed in 2013 did end up raising revenues, but it was still a large net tax cut. After all the changes, the state still passed an almost \$500 million tax cut for 2014, with the amounts increased further in later years. (By 2018, the cut was expected to be over \$900 million in annual revenue. For comparison, Kansas’s general revenue budget was \$6 billion.)

At the same time, the state continued to miss a number of its revenue projections, partly due to weak agricultural prices and partly due to the pass-through exemption. These missed projections added to the budget crunch, as the state continued to struggle for revenue to pay for spending programs.

As a result, the state faced a large budget crunch. Kansas had to drain its rainy-day fund, and issue furloughs for state employees, among other efforts. Finally, in 2015, the

state began a series of tax increases to finance the previous cuts. The sales tax rate was increased, and a number of deductions were eliminated, among other changes. Kansas passed another round of tax increases, including repeal of the state's pass-through exemption, in 2017, over Governor Brownback's veto, to help close the budget gap.

While the state's individual income tax in 2018 will still be lower than it was before tax reform efforts began in 2012, Kansas's story over the last five years illustrates the risks of cutting taxes without regards to sound tax policy or a state's spending priorities. By providing a wholesale exemption to pass-through income, the state encouraged individuals to simply reclassify their income. It was not an economic growth driver as some proponents promised. Additionally, the state's reckless slashing of revenues, without accompanying spending changes, risked the fiscal solvency of the state. By 2017, Kansas was one of only four states without budget reserves.

Tax reform is difficult, and Kansas's experience illustrates how states should not approach these difficult questions.

Concluding Insights from State Legislators Who Were There

In December 2017, the Arkansas Tax Relief and Reform Task Force invited legislators from Indiana, North Carolina, Oklahoma, and Kansas to share their thoughts and experiences on tax reform. Throughout the conversation, five key themes emerged.

First, tax reform is a process. Representative John Szoka (R) of North Carolina described tax reform as an "evolution, not a revolution." Second, cutting revenue cannot be the single goal. Representative Steven Johnson (R) from

Kansas discussed how Kansas's 10 percent revenue cut put the state at risk. Third, spending must be considered simultaneously. North Carolina Representative Bill Brawley (R) discussed that state's new high-way prioritization system, while Speaker Tim Moore (R) noted that North Carolina also reformed its education and unemployment insurance programs. Balanced budget requirements mean that states must consider spending changes as part of tax reform. Fourth, tax trigger

designs are critical. As discussed previously, North Carolina's tax trigger was a critical part of its tax reform efforts. Oklahoma Tax Commissioner Clark Jolley (R) spent a large part of his presentation discussing his state's challenging tax trigger.

But most importantly, all the presenters echoed that tax reform is worth the effort. Eliminating tax expenditures and handling trade-offs isn't politically easy, but in the end, the presenters reiterated that tax reform was worth the effort. Senator Brandt Hershman (R) of Indiana outlined the various accolades Indiana continues to receive for reforming its tax code, and how those changes are translating into greater economic opportunity for Hoosiers.

There are important lessons to learn from other state experiences with tax reform. While Kansas's troubled experience teaches us that reforms must be thoughtful and diligent, comprehensive reforms in Utah, Indiana, North Carolina, and the District of Columbia illustrate that smart, sensible tax reform is possible, and can dramatically improve a state's competitiveness.

First, tax reform is a process.

Notes

**This is a resource document for you to use.
Take notes, highlight, use as a text book.**

The Relationship Between Taxes and Growth at the State Level: New Evidence

William G. Gale, Aaron Krupkin, and Kim Rueben, National Tax Journal, December 2015

The effects of state tax policy on economic growth, entrepreneurship, and employment remain controversial. Using a framework that in prior research generated significant, negative, and robust effects of taxes on growth, we find that neither tax revenues nor top income tax rates bear stable relationships to economic growth or employment across states and over time. While the rate of firm formation is negatively affected by top income tax rates, the effects are small in economic terms. Our results are inconsistent with the view that cuts in top state income tax rates will automatically or necessarily generate growth.

The effects of state-level tax policy on states' economic growth and on related activity such as entrepreneurship and employment have proven to be perennial, controversial issues in academic and policy circles. Policy controversies have heated up in recent years as several states, hoping to stimulate long-term growth and new business activity, have cut taxes in various ways as their budgets have recovered following the Great Recession. Most prominently, Kansas cut taxes in 2012, eliminating its top income tax bracket, reducing other income tax rates, and abolishing state income taxation of pass-through entities. Several other states have enacted or proposed lower income taxes, sometimes in exchange for higher sales tax revenue. In contrast, some states, most notably California and New York, have maintained higher top marginal income tax rates that were originally introduced to address revenue shortfalls (Bosman, 2015).

A voluminous academic literature on taxes and state growth features widely varying methodologies and results. Major recent studies reach almost every conceivable finding: tax cuts raise, reduce, do not affect, or have no clear effect on growth. The effects of different taxes — income, corporate, property, and sales — vary dramatically within and across studies. Several factors complicate interpretation of the findings; the studies use different dependent variables, analyze different time periods, employ alternative measures of tax revenues and/or rates, include different measures of government spending, control for different independent variables, and use different control groups and identification methods. Additionally, state balanced budget requirements imply that revenues and spending should covary closely, making it more difficult to study independent influences of taxes or spending.

In this paper, we present new results on how state tax policy affects economic growth and entrepreneurial activity.

Using a framework that in prior work generated significant, negative, and robust effects of taxes on income growth, we nonetheless find that neither tax revenues nor top marginal income tax rates bear any stable relationship — and, indeed, often bear a positive relationship — to economic growth rates across states and over time. Consistent with these findings, we also find that tax revenues have unstable effects on employment over time and that marginal tax rates do not affect employment levels. While the rate of firm formation is negatively affected by top income tax rates, the effects are small in economic terms.

Because there are so many specifications already in the literature, our goal was to build on a previously existing model. In particular, we extend the model in Reed (2008), who uses five-year observations and consistently finds that tax revenue levels negatively affect the growth rate of real per capita personal income during the 1970–1999 time-frame under a wide range of specifications. Our goal is not to replicate Reed's results, though we do generate similar findings for a similar time period. Rather, the advantage of using this approach is that we can examine the robustness of results as the time period is updated or other specification details are altered. The disadvantage is that the identification method is not as strong as studies that compare the economic activity of neighboring areas located on opposite sides of a state line.

We essentially replicate Reed's original findings, using data from 1977 to 2001. We show, however, that the results are not robust to several extensions. First, simply extending the sample period by one five-year observation to 2006 (or two, to 2011, and thus including the Great Recession) greatly reduces the absolute value of the effects and eliminates their statistical significance. Given the sensitivity of the results to time period, our second extension is to test for parameter stability over 1977–2006. We find that the estimated impact of tax revenues on income growth changes sign over the first and second 15 years of the sample period. The effect is negative over the 1977–1991 period and positive over the 1992–2006 period.

Our third extension decomposes tax revenues into components. We show that different taxes have dramatically different impacts on growth, with property taxes exerting consistently negative effects and income and corporate taxes usually exerting positive effects. Statistical tests overwhelmingly confirm that it is inappropriate to aggregate the components of tax revenue into a single aggregate

revenue measure. We extend Reed's results in a fourth way, by including estimates of the top statutory state income tax rate and the top effective state income tax rate, that is, the top statutory rate adjusted for federal deductibility of state taxes. Inclusion of these variables does not change the results for tax revenues noted above, and generally the tax rate variables do not affect growth. All of our findings described above remain in place when we add controls for public spending categories and a variety of economic, social, and political variables.

To explore these effects further, we look at two main components of economic growth: firm formation and employment. We show that neither variable is consistently affected by tax revenue levels. Top marginal income tax rates have no effect on employment, but appear to reduce firm formation slightly. Raising the top income tax rate by 1 percentage point reduces the rate of firm formation by about 0.1 percent per year.

Section II reviews previous literature. Section III describes our methodology and data. Section IV examines the impact of taxes on real growth of personal income. Section V examines the impact on firm formation and employment. Section VI contains our concluding remarks.

The effects of taxes on state-level growth have been the subject of continuing controversy, with many conflicting and fragile results in the literature. In this paper, we present new results for the impact of tax revenues, marginal tax rates, and other variables on overall real personal income growth, firm formation, and employment.

We build on the model constructed by Reed (2008), who shows that tax revenues negatively and significantly impacted growth of real personal income from 1970–1999. After replicating his results for a slightly different time period, we show that the results are not robust to an extension of the time period through 2006 or 2011, that the effect of tax revenues on personal income growth differed dramatically between the 1977–1991 period (when

it was negative) and the 1992–2006 period (when it was non-negative and possibly positive), and that revenues from different taxes have different effects on personal income growth. These results undermine Reed's claim that there is a robust and consistent impact of tax revenues on personal income growth. We also show that including measures of the marginal tax rate do not affect the results for tax revenues and that marginal tax rates generally do not enter into the growth equations. Moreover, controls for government spending and other explanatory variables do not change any of these results. Consistent with these aggregate effects, we show that marginal tax rates generally have no impact on employment and statistically significant but economically small effects on the rate of firm formation.

Our results are not consistent with the view that cuts in top state income tax rates will automatically or necessarily generate significant impacts, or any impact, on growth. If anything, our study produces some evidence that property tax revenues are correlated with growth. Exploring that relationship, especially the connection between land values, property tax revenues, and growth, may well be worth additional research.

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DISCLOSURES

The authors have no financial arrangements that might give rise to conflicts of interest with respect to the research reported in this paper.

You can read the full paper at <https://pdfs.semanticscholar.org/6199/69eabc5c88113d396cfa44676ddef6417281.pdf>

(b. 1)

Sales Tax Holidays: Politically Expedient but Poor Tax Policy, 2018

Scott Drenkard and Joseph Bishop-Henchman, *The Tax Foundation*, July 17, 2018

Key Findings

- Seventeen states will hold a sales tax holiday in 2018, down from a peak of 19 states in 2010, and up from 16 states last year. Wisconsin created a sales tax holiday for the first time, New Mexico will hold an additional holiday for items purchased from small businesses, and Louisiana suspended its sales tax holiday program effective July 1, 2018.

- Sales tax holidays do not promote economic growth or significantly increase consumer purchases; the evidence (including a 2017 study by Federal Reserve researchers) shows that they simply shift the timing of purchases. Some retailers raise prices during the holiday, reducing consumer savings.

- Sales tax holidays create complexities for tax code compliance, efficient labor allocation, and inventory management. However, free advertising for what is effectively a paltry 4 to 7 percent discount leads many larger businesses to lobby for the holidays.

- Most sales tax holidays involve politicians picking products and industries to favor with exemptions, arbitrarily discriminating among products and across time, and distorting consumer decisions.

- While sales taxes are somewhat regressive, this does not make sales tax holidays an effective tool for providing relief to low-income individuals. In order to give a small amount of tax savings to those with lower incomes, holidays give a large amount of savings to higher-income groups as well.

- Political gimmicks like sales tax holidays distract policymakers and taxpayers from genuine, permanent tax relief. If a state must offer a “holiday” from its tax system, it is an implicit recognition that the state’s tax system is uncompetitive. If policymakers want to save money for consumers, then they should cut the sales tax rate year-round.

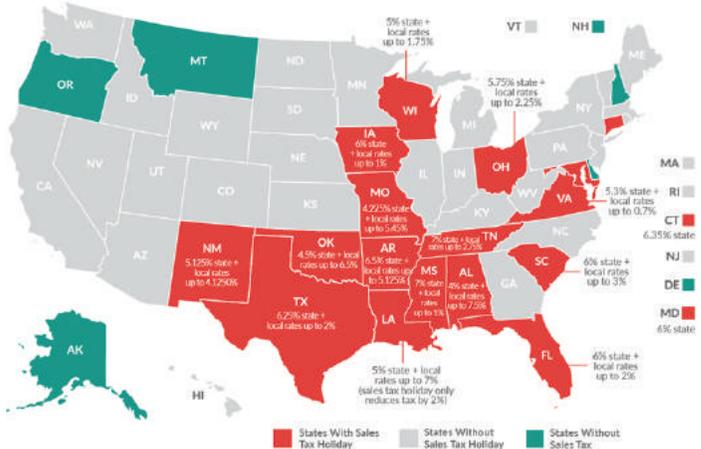
Executive Summary

Sales tax holidays are periods of time when selected goods are exempted from state (and sometimes local) sales taxes. Such holidays have become an annual event in many states, with exemptions for such targeted products as back-to-school supplies, clothing, computers, hurricane preparedness supplies, products bearing the U.S. government’s Energy Star label, and even guns. New York State, which is known for high state taxes, sparked the trend in 1997 as a way to discourage border shopping.

In 2018, 17 states will conduct sales tax holidays, down from a peak of 19 states in 2010. Wisconsin will hold a sales tax holiday for the first time this year, and New Mexico created an additional sales tax holiday for items purchased from small businesses. Louisiana suspended its sales tax holiday program

Does Your State Have a Sales Tax Holiday?

States with Sales Tax Holidays, 2018



State	Holiday Dates	Exempt Items
Alabama	February 23-25	Generators (\$1,000); Weather Preparedness Items (\$60)
Arkansas	August 4-5	Clothing (\$100); School Supplies (No Cap); Clothing Accessories (\$30)
Connecticut	August 19-25	Clothing (\$100)
Florida	June 1-7	Generators (\$750); Radios & Plastic Sheeting (\$50); Batteries & Coolers (\$30); Fuel Containers (\$25); Lights (\$20); Ice Packs (\$10)
Iowa	August 3-4	Clothing (\$100)
Louisiana	May 26-27	Hurricane Preparedness Items (\$1,500)
Maryland	February 17-19	Energy Star (No Cap)
Mississippi	July 27-28	Clothing (\$100)
Missouri	April 19-25	Energy Star (\$1,500)
New Mexico	August 3-5	Clothing (\$100); School Supplies (\$50); Computers (\$1,500); Software (\$350); Graphing Calculators (\$150)
Ohio	August 3-5	Clothing (\$75); School Supplies (\$20); School Instructional Material (\$20)
Oklahoma	August 3-5	Clothing (\$100)
South Carolina	August 3-5	Clothing (No Cap); School Supplies (No Cap); Computers (No Cap); Bedding and Bath Items (No Cap)
Tennessee	July 27-29	Clothing (\$100); School Supplies (\$100); Computers (\$1,500)
Texas	April 28-30	Generators (\$3,000); Hurricane Shutters and Emergency Ladders (\$300); Batteries, Fuel Containers, and Flashlights (\$75)
Texas	May 26-28	Air Conditioners (\$6,000); Refrigerators (\$2,000); Water-Conserving Products (No Cap)
Texas	August 10-12	Clothing (\$100); School Supplies (\$100); Backpacks (\$100)
Virginia	August 3-5	Clothing (\$100); School Supplies (\$20); Energy Star (\$2,500); Generators (\$1,000); Chainsaws (\$300); Chainsaw Accessories (\$60); Other Hurricane Preparedness Items (\$40)
Wisconsin	August 1-5	Clothing (\$75); School Supplies (\$75); Computers (\$750); School Computer Supplies (\$250)

Note: Figures in parentheses indicate dollar limits of items exempted. Louisiana’s May sales tax holiday reduced the state sales tax rate from 5 percent to 3 percent, but retained local sales taxes. In June 2018, the state legislature changed the sales tax rate, which was scheduled to drop from 5 percent to 4 percent, to 4.45 percent. As part of the sales tax changes, the state also suspended its sales tax holidays for 7 years, so the regularly scheduled August and September holidays will not occur in 2018. At time of publication, the Massachusetts legislature is considering legislation establishing a 2018 sales tax holiday. Source: Tax Foundation review of state statutes and revenue department websites.

TAX FOUNDATION @TaxFoundation

in June 2018 as a component of broader legislation. It has already held its May holiday, but its regularly scheduled August and September holidays will not occur. As of publication date, Massachusetts legislators are considering a sales tax holiday for 2018. In separate legislation, they have approved a sales tax holiday to take place from 2019 onward.

At first glance, sales tax holidays seem like great policy. They enjoy broad political support, with backers arguing that holidays are a highly visible form of tax cuts and provide benefits to low-income consumers. Politicians and other supporters routinely claim that sales tax holidays improve sales for retailers, create jobs, and promote economic growth.

Despite their political popularity, sales tax holidays are based on poor tax policy and distract policymakers and taxpayers from real, permanent, and economically beneficial tax reform.

Sales tax holidays introduce unjustifiable government distortions into the economy without providing any significant boost to the economy. They represent a real cost for businesses without providing substantial benefits. They are also an inefficient means of helping low-income consumers and an ineffective means of providing savings to consumers.

Principles of Sales Taxation

Sales taxes are a type of consumption tax, or a tax on spending on goods and services purchased by the end user. The principle underlying the use of sales taxes to fund government is that individuals should pay taxes in proportion to the benefit they receive from government spending; this idea is known as the benefit principle. Personal consumption is considered an appropriate proxy for the amount of government services consumed by an individual.

Thus, a tax on consumption is considered an equitable method of paying for government services. Consumption also has the advantage of being relatively easy to track, measure, and tax. Many economists also prefer a consumption tax over an income tax because consumption taxes do not tax (and thereby discourage) savings.

Sales taxes in the United States are consumption taxes, but they largely exempt certain transactions, such as higher education, housing, and health care. A properly structured sales tax, however, would tax all consumption by end users including services that are currently excluded.

Broadening the sales tax base while lowering the sales tax rate would mitigate both volatility in revenue collections and the economic harm caused by a high tax rate. A high tax rate increases distortions in the market and can inhibit growth by making a state less attractive for individuals and businesses.

Another important feature of good sales taxes is that they tax consumption once and only once. Business inputs, or business-to-business purchases that are used to create other products or services, should be excluded from the sales tax base. Otherwise, final products will be taxed multiple times: once (or more) during production and again when purchased by the end user. In practice, this multiple taxation unfortunately occurs in many states.

Sales taxes tend to be inherently regressive with regard to income, as low-income individuals tend to spend a greater percentage of their income in taxable sales than high-income individuals. In an effort to reduce this regressivity, items viewed as basic necessities, such as groceries, utilities, clothing, and prescription drugs, are often exempted from sales taxes in the United States. But these exemptions also benefit high-income taxpayers, while narrowing the base and necessitating a higher tax rate.

Ideally, sales tax reform would broaden sales tax bases while lowering sales tax rates, to produce a system that collects stable revenue with minimal economic distortion. Sales tax holidays are an example of the opposite—base narrowing—in that they

carve out exemptions for certain transactions during certain time periods.

The History of Sales Tax Holidays

Ohio and Michigan enacted the first sales tax holidays in 1980 when they offered one-time tax holidays for automobile purchases. But it was New York that sparked the modern trend, with the first sales tax holiday for clothing in 1997. New York's objective was to tackle cross-border shopping, the phenomenon of residents traveling to nearby states to take advantage of lower sales tax rates (particularly clothing purchases in New Jersey). The sales tax holiday gave hope of reducing border shopping without the need of actually having to reduce the state's sales tax rate.

While sales tax holidays are often defended on grounds of economic benefits, in reality, a key motivation has been attempting to stop cross-border shopping, and perhaps even lure shoppers from other states. In 2005, Massachusetts adopted an extremely generous weekend sales tax holiday applying to all goods up to \$2,500, attempting to stop Massachusetts residents from shopping in next-door New Hampshire, which has no sales tax. In 2009, Massachusetts temporarily abandoned the holiday as it raised its sales tax even further, from 5 percent to 6.25 percent.

Since the inception of sales tax holidays, many states have created them around certain products and industries. In 2018, 16 states will hold clothing sales tax holidays, 11 states will have school supplies sales tax holidays, six states will have computer sales tax holidays, and four states will have Energy Star products sales tax holidays. Altogether, 17 states will conduct a holiday, two fewer than in 2010.

A number of states have tried sales tax holidays and then canceled them, a trend that accelerated during the recent recession and related state government revenue downturn. Florida and Maryland canceled their holidays after 2007 (but have reinstated them since). Massachusetts canceled its 2009 holiday after it hiked its sales tax, but has a habit of reinstating it at the last minute most years since. In 2009, the District of Columbia, faced with declining revenue and a widening budget shortfall, announced the one-year suspension of its August sales tax holiday only weeks before it was scheduled to occur, later repealing it permanently. Meanwhile, Florida, having skipped holidays in 2008 and 2009, returned to having a tax holiday in 2010.

In July 2013, North Carolina approved legislation ending future sales tax holidays, using the revenue instead for broad-based tax relief. In 2016, Massachusetts canceled its sales tax holiday (traditionally held in August), citing a lack of revenue as reason for its hiatus. The state will hold a sales tax holiday permanently starting in 2019, but has not yet decided whether to hold one in 2018; legislation is pending in the Massachusetts legislature as of this report's publication. In June 2018, the Louisiana state legislature passed broad sales tax legislation which changed its state sales tax rate from 5 percent to 4.45 percent. As part of the sales tax changes, the state also suspended its sales tax holidays for seven years, so while the May holiday has already occurred, the regularly scheduled August and September holidays will

not occur in 2018.

Many other localities, counties, towns, and even individual vendors have opted out of their state's sales tax holidays. As noted tax scholar John Mikesell has put it, "State lawmakers are in the position of making a politically attractive decision with the cost of that decision being borne by someone else (local lawmakers), [a condition] ripe for poor policy choices."

Sales Tax Holidays Do Not Promote Economic Growth

Supporters claim that sales tax holidays stimulate the economy. They argue that, first, individuals will purchase more of the exempted goods than they would have in the absence of a holiday, and second, consumers will increase their consumption of nonexempt goods through "impulse" purchases, paying taxes that would otherwise not have been collected.

Rather than stimulating new sales, sales tax holidays simply shift the timing of sales. In 1997, the New York Department of Taxation and Finance studied its clothing sales tax holiday and found that while sales of exempt goods rose during the holiday, overall retail sales for the year did not increase. On the contrary, shoppers waited until the holiday to purchase exempted goods, thereby slowing sales in the weeks prior to and following the holiday. A University of Michigan study looking at computer purchases during sales tax holidays found that this timing shift "accounts for between 37 and 90 percent of the increase in purchases in the tax holiday states over [a] 30-week horizon," depending on price caps and particular products. Anecdotal evidence from other states supports these conclusions.

Other evidence suggests that sales tax holidays attracted cross-border sales only when other states did not have their own holidays, which is no longer the case. Peter Morici, an economist at the University of Maryland, told the Washington Examiner in 2006 that a sales tax holiday "has to be a novelty to be a measurable success and it's no longer." As the costs of squeezing a disproportionate number of sales into a short period of time have become clear, evidence suggests that fewer shoppers participate. For the vast majority of those who shop during sales tax holidays, the holiday simply provides a modest windfall, or unexpected benefit, for doing something they would have done anyway.

"Impulse" purchases occur whenever consumers shop, and if consumers merely shift their purchases into a tax-free period, as the evidence suggests, their "impulse" purchases during a sales tax holiday are likewise shifted from other time periods. The increase in tax revenue would be far outweighed by the lost revenue from the much larger amount of tax-free purchases. It is therefore unlikely there is a net revenue gain from additional "impulse" purchases. And even if the "impulse" argument were true and consumers essentially tricked into making extra unnecessary taxable purchases, that would contradict the argument that sales tax holidays are designed to provide a tax cut for consumers.

Job creation is a frequent argument in support of sales tax

holidays. But this argument suffers from the same problems as the argument based on general economic growth. Any increase in employment will be modest and temporary, limiting the benefits. Temporary increases in labor associated with sales tax holidays are costly for businesses, more so than an equivalent increase spread over the whole year, because of the fixed cost associated with hiring and training multiple temporary employees. By focusing on encouraging a few days of temporary employment during sales tax holidays, lawmakers lose sight of and undermine policies that promote long-term economic growth and job creation.

Recent budget difficulties have prompted some states and localities to cancel or opt out of their sales tax holidays. The District of Columbia Office of Taxation and Revenue estimated that it would save \$640,000 in tax revenue by canceling its sales tax holiday in 2009. After eight years of sales tax holidays, District tax officials found the holiday did not spur enough economic growth to offset the costs. North Carolina officials found that repealing their sales tax holiday in 2013 would save the state \$16.3 million the next year, and put those dollars toward individual and corporate income tax cuts. Other states would be wise to follow D.C.'s and North Carolina's lead and reevaluate the costs and benefits of sales tax holidays.

Sales tax experts and economists widely agree that there is little evidence of increased economic activity as a result of sales tax holidays. Politicians claim that sales tax holidays largely pay for themselves through increased economic activity and new collections. But experience shows that the claims of economic stimulus, increased revenue, and consumer savings are greatly exaggerated. States see little net economic activity as a result of sales tax holidays; the holidays instead represent a costly-to-administer revenue loss for the government.

Sales Tax Holidays Discriminate Arbitrarily among Products

Sales tax holidays usually apply only to a specific list of products, such as school supplies, sports equipment, clothing, or computers. The number of categories has expanded in recent years to include specific appliances, hurricane preparedness supplies, and even firearms. Restaurant owners in Massachusetts have even pushed for a prepared food sales tax holiday. These lists are a product of political forces. Politicians single out specific populations or industries and bestow targeted tax breaks on them. Such discrimination among products distorts consumer spending and reduces market efficiency by favoring certain products over others.

For example, the New Mexico sales tax holiday exempts computer microphones but not headsets, blank painting canvases but not dry erase boards, and backpacks but not duffel bags. Many states exempt backpacks during their "back to school" sales tax holidays even though students may prefer to purchase comparably priced messenger-style bags or duffel bags which accomplish the same functional goal but are not tax-exempt. The sales tax holiday raises the price of these items relative to backpacks and so students are influenced to purchase the backpacks. Though they save a little money on the purchases,

they end up with less suitable products that they may not have purchased in the absence of the holiday.

Likewise, a low-income elderly or childless couple may not have a need for school supplies, a computer, or sports equipment, but presumably they are as deserving of tax cuts as a consumer purchasing any of the exempt products. Using the tax code to discriminate among products can easily translate into discrimination among certain types of consumers, driving sales taxes further from the ideal policy based on the benefit principle.

While it is true that consumers always face these cost-benefit trade-offs in the market, tax policy should avoid adding unnecessary and discriminatory market distortions. In general, political efforts to manipulate the economy make markets less efficient by influencing consumers, retailers, and manufacturers to consume, sell, and produce more or less of a product than they otherwise would. While the economic costs of these distortions may be difficult to measure, they are real and economically damaging.

The fact that most sales tax holidays impose a price limit on the goods that are exempt only worsens the economic distortions. This encourages consumers to purchase cheaper goods over more expensive goods during sales tax holidays, even if they would prefer an item of better quality or suitability. Consumers should make consumption decisions for their individual economic reasons, not tax reasons.

Sales Tax Holidays Can Mislead Consumers about Savings

Large retailers are often the biggest supporters of sales tax holidays. Given that they are the beneficiaries of free marketing for what is essentially a modest 4 to 7 percent discount, and that the mad customer rush in a short time allows them to raise prices, this is not surprising. Policymakers should not be convinced that a sales tax holiday is a good idea just because retailers support it.

As weeks or months of sales cram into a weekend or a week, demand rises dramatically during sales tax holidays. Because the amount of inventory a retailer can have on hand is finite, many retailers understandably respond by raising prices rather than running out of stock too quickly. When lawmakers create sales tax holidays, the assumption is that the benefit will be passed on to consumers in the form of lower prices. In reality, retailers often absorb those benefits.

For example, assume a pair of shoes costs \$50, and with tax the total comes to \$53. During a sales tax holiday, the shoes are exempt from the sales tax, so the consumer would expect to pay \$50. But if the shoes are in high demand due to crowds turning out for the sales tax holiday, a retailer may have to raise the price or risk running out of stock too quickly. If the retailer raises the price to \$51 or \$52, the retailer absorbs a large share of the savings that are intended to go to the consumer.

Researchers at the University of West Florida studied the price effect of Florida's sales tax holiday in 2001. Using 10 types

of apparel across 10 retail locations, data was collected over a three-week period to analyze whether before-tax prices were comparable before, during, and after the sales tax holiday. Based on the prices observed in Pensacola before the sales tax holiday, it was expected that shoppers would save \$125.58 during the holiday on a representative basket of \$1,674.41 worth of consumer goods. Due to changes in the before-tax price of the various products, actual savings observed during the holiday were \$100.06. In short, retailers absorbed up to 20 percent of the benefit of a sales tax holiday, significantly reducing the benefit that consumers received. Their study is not conclusive for all tax holidays, but it strongly suggests uncertainty about how much consumers actually benefit from sales tax holidays.

There is even evidence that the prices consumers pay during holidays may exceed the prices during other times of the year, even after accounting for the tax savings. A reporter in Charlotte, North Carolina, found that consumer price savings were greater at six large stores in the week before the 2009 tax holiday than during it.

Indeed, this seems to be a perverse effect of sales tax holidays: the more consumers they turn out, the more demand goes up, and the more prices rise.

Sales Tax Holidays Cause Costly Complexity and Instability

Tax codes should be as simple as possible. Tax complexity means additional tax compliance costs. Because of their impacts on labor allocation and inventory management, sales tax holidays add complexity to sales taxes and are accompanied by administrative costs which can place a large burden on businesses. This extra burden represents a real cost to businesses, particularly small businesses, as valuable resources are diverted to pay for compliance with and implementation of sales tax holidays.

Businesses must reprogram their registers and computers to ensure they are in compliance with the temporary tax changes. Most states, for instance, prohibit stores from advertising that they will pay the sales tax on a purchase for the consumer; during a sales tax holiday, what is normally prohibited becomes mandatory. Lawmakers are likely to be under strong political pressure to provide ever expansive exemptions, and businesses are required to track and comply with these year-to-year law changes. These costs are especially high for small businesses without the overhead to dedicate employees to tracking these changes and ensuring compliance.

Sales tax holidays force businesses to operate under more than one set of sales tax laws each year. These include nonintuitive and sometimes absurdly minute regulations about the holiday's operation. For example, Mississippi's sales tax holiday regulations prohibit the sale of individual shoes (evidently done as a way to get under the holiday price cap), permit the use of coupons, prohibit layaway sales but permit rain checks, and exclude shipping costs from the holiday. Virginia's sales tax holiday permits layaway sales and rain checks, does not permit rebates to lower the sales price, and excludes shipping

but includes handling. South Carolina subjects layaway sales to tax during its holiday. Texas exempts layaway sales as well as shipping, handling, and even installation costs as part of its Energy Star product tax holiday.

Vermont's sales tax holiday for computer purchases in 2004 applied to keyboards and mice but not printers, unless purchased as part of a bundled package, with the enigmatic caveat that "(1) the package is sold for \$4,000 or less and (2) the most common selling price of items that would be taxed if charged separately is not more than \$250 or 15 percent of the selling price of the package, whichever is greater." Pennsylvania's 2000 holiday taxed computer accessories, but they became exempt for the 2001 holiday, even when not purchased with a computer.

Virginia's hurricane preparedness holiday is ostensibly to help consumers stockpile needed supplies, but the list there is arbitrary as well. Cell phone chargers are exempt, but laptop chargers are not. Duct tape is exempt but not masking or electrical tape. What some states include is somewhat unusual. South Carolina included "bath wash clothes, blankets, bed spreads, bed linens, sheet sets, comforter sets, bath towels, shower curtains, bath rugs and mats, pillows, and pillow cases" in its general sales tax holiday. Virginia includes "clerical vestments" in its definition of clothing, along with suspenders.

Besides the complexities of preparing for the sales tax holiday, businesses will have to deal with a distortion in consumer spending as shoppers shift their buying patterns to coincide with sales tax holidays. The increased activity during sales tax holidays may be accompanied by the need to hire temporary workers or pay their employees overtime compensation, as previously noted. But because this increase in consumption is largely a result of consumers shifting the timing of purchases, the result is simply a loss in efficiency for businesses without an overall boost in sales.

One retail establishment respondent in a 2015 survey of Massachusetts Retailers Association members said, "The sales tax holiday has created more problems than benefits for us. Business is nonexistent three weeks before and two weeks after. As a result, five weeks of business are crammed into two days, and the total amount of sales does not come close to five normal weeks of summer business."

Instability in tax law is costly to the economy not only because of complexity but also because it disrupts the plans and expectations of consumers and businesses. Not every state codifies its sales tax holiday in law; some instead pass a bill establishing it each year. Florida alternated from having a holiday, not having one, and now having one again. New York did the same. Even states that have codified them can suspend them. Washington, D.C.'s last-minute cancellation of its 2009 sales tax holiday created more costs and left everyone involved uncertain. The sudden change meant businesses had to change their pricing systems and registers yet again.

Lawmakers should avoid creating temporary tax laws like sales

tax holidays. From the perspective of a business trying to operate at maximum efficiency, the extra administrative and labor costs associated with a sales tax holiday are an unjustifiable burden, considering the unlikelihood that sales tax holidays increase overall sales. Instead of creating a subset of tax laws that apply only temporarily and then creating ambiguity about whether those very laws will even be implemented on a year-to-year basis, lawmakers should focus on enacting real and permanent tax relief.

Sales Tax Holidays Discriminate Across Time

There is little economic justification for why a product purchased during one time period should be tax-exempt while the same product purchased in another time period should be taxable. Experience with sales tax holidays shows that consumers will wait until a holiday to purchase the same goods they would have purchased earlier in the year, as outlined above. But purchases in one time period are no more beneficial to the economy, all else being equal, than purchases in another time period.

Time discrimination also has serious negative consequences for some consumers and businesses. Some consumers may be unable to shop during the sales tax holiday because they are working, out of town, or between paychecks. Presumably they are no less deserving of a tax break than consumers who can shop during the holiday, but the timing of the sales tax holiday excludes them from the tax relief.

A 2017 study by researchers at the Federal Reserve found "that sales-tax holidays are associated with significant shifts in the timing of purchases by consumers" and that "the patterns are suggestive that consumers adjust their spending behavior noticeably to take advantage of the temporarily lower prices." The study used credit transaction data gathered in the days before, during, and after the Massachusetts sales tax holidays in 2014 and 2015. Sales for high-priced durable goods, such as electronics or furniture items, more than doubled during the holiday compared to average daily sales. Sales of general merchandise also increased, suggesting the effects of the tax holiday on high exposure goods caused reciprocal spillover effects on the sales of non-holiday goods. The study did not find a corresponding drop in purchases in the days before or after the holiday, but noted that "some of the negative offsets in spending may have occurred outside the assumed time horizon. In particular, very long-lived durable goods such as furniture are likely purchased only intermittently, and these categories are where the spending response appears to have been concentrated."

Sales tax holidays result in government influencing consumers to change when they purchase goods, but in some cases, it might not be wise for consumers to put off the tax-free purchases until the holiday. (For example, it may not be the best idea to wait until the weekend before school begins to buy school supplies.) For others, it might be wiser to wait until after the holiday. For example, scholars Richard Hawkins and John Mikesell describe a working-class family that puts off repairing its only car so that it can take advantage of the holiday, or a single, low-income mother who runs up her credit card during

the August tax holiday to buy winter coats for her children.

Such government manipulation of consumer timing decisions is unwarranted and economically damaging. Experience shows that political decisions about holiday scheduling and product selection are often arbitrary and sometimes wholly unpredictable. Distorting consumer behavior with sales tax holidays is frequently not to consumers' benefit.

Sales Tax Holidays Are Not an Effective Means of Relief for Low-Income Consumers

Some supporters claim that sales tax holidays provide tax relief to the working poor. However, sales tax holidays are an inefficient way to achieve that goal. Because sales tax holidays only provide a benefit for a short time, low-income consumers who may not be able to shop during the designated time for cost, mobility, or timing reasons cannot enjoy the benefits of the holiday.

Sales tax holidays provide savings to all income groups, not just low-income individuals. People of every income level can and do buy goods during sales tax holidays. If the purpose of sales tax holidays is to make school supplies and clothes cheaper for low-income individuals, then a 4 to 7 percent price reduction for all consumers, but only for a brief period, is an odd and ineffective way of achieving that. It's an example of politicians using a fire hose when a garden hose will do a better job.

If the citizens of a state determine that there truly is a legitimate need to help low-income consumers obtain particular products, a more targeted and effective approach could be a rebate or voucher program. Such a program would be administratively similar to existing food stamp programs and would only be available to the needy, while avoiding a costly tax relief for higher-income consumers. A rebate or voucher would make benefits available to low-income consumers regardless of when they shop. The poor would receive real benefits, while consumers and retailers would avoid the economic distortions and burdens associated with sales tax holidays.

If policymakers genuinely want to save money for consumers, then they should cut the sales tax rate year-round. While the rate reduction may be modest, such a change would put the same money back in taxpayers' hands without the distortions and complications associated with a sales tax holiday. For example, in 2008, applying the revenue loss from a New Jersey tax holiday proposal would have reduced the state's sales tax rate from 7 percent to 6.6 percent year-round.

Sales Tax Holidays Are Not Real Tax Cuts and Distract Policymakers and Taxpayers from Tax Reform

Some advocates support sales tax holidays as a way of giving revenue back to taxpayers. However, if the ultimate policy goal is reducing government involvement in individual and market decisions, sales tax holidays are a poor choice due to their complexity, administrative burdens, distortions, and arbitrary government micromanaging. As scholars Hawkins and Mike-

sell put it, sales tax holidays are highly intrusive, going so far as to call them "a Soviet-style state-directed price reduction on items selected by the state."

Because states must balance their budgets, and because states rarely, if ever, cut spending to offset the revenue loss from sales tax holidays, the net result is that tax rates must rise elsewhere, now or in the future. Pushing for a sales tax holiday without associated spending cuts means that the government will have to raise revenue from other sources, creating even more complexity in the tax code.

Looking only at the amount of revenue raised provides an incomplete picture of the effects of sales tax holidays. One must also look at their broader consequences and the economic damage they cause, including the harmful effects of discrimination among different products and time periods, burdensome administrative and complexity costs on businesses, distortions of consumer behavior, and economically damaging uncertainty about tax policy. Real tax reform—broadening the sales tax base and lowering sales tax rates—can achieve desired revenue collection levels without these costs. Going further to eliminate the sales tax year-round for all consumers is another option to reduce negative effects.

Tax holidays are a political gimmick that distract policymakers and taxpayers alike from real, sustainable, and economically beneficial tax reform. They were created as a way to avoid addressing the negative effects of high sales taxes, while politicians often receive favorable media attention for pushing these short-sighted policies, denigrating the hard work of those who support genuine tax relief.

Conclusion

Sales tax holidays have enjoyed political success, but recently, policymakers have been reevaluating them. Rather than providing a valuable tax cut or a boost to the economy, sales tax holidays impose serious costs on consumers and businesses without providing offsetting benefits.

Taxes should raise revenue, not micromanage a complex economy by picking winners and losers in the market. Lawmakers should aim to raise the necessary revenue in the least economically distortionary and destructive way. To achieve this goal, sales taxes should be neutral toward products and timing decisions—all end-user goods and services should consistently be subject to the same sales tax. Narrowing the tax base, by contrast, will likely lead to higher and more damaging taxes elsewhere.

Sales tax holidays neither promote economic growth nor increase purchases. They create complexities for all involved, while inserting the political process into consumer decisions. By distracting high-tax states from addressing real problems with their tax systems, holidays undermine efforts to provide legitimate relief to consumers in general and low-income individuals in particular. Sales tax holidays are not sound tax policy.

Study cautions against relying strongly on ‘sin taxes’

Dale Denwalt, *The Oklahoman*, July 22, 2018

As Oklahoma prepares to collect taxes on marijuana, a new study from the Pew Charitable Trusts urges caution when relying too much on that money.

The report released Thursday highlights the history of “sin taxes,” or revenue collected from things like marijuana, gambling, tobacco and alcohol.

“Sin taxes can provide short-term revenue boosts, but because of a combination of factors, they may also drive budget challenges in the long term,” said Mary Murphy, project director for Pew’s state fiscal policy division. “And relied on for ongoing commitments, (they) can create structural budget challenges.”



Mary Murphy

State Question 788 set the tax on medical marijuana at 7 percent, which will be collected at the retail level based on the amount of money a customer spends. Other states tax product at the warehouse, and others set levies based on potency or the quantity of marijuana sold.

Tax revenue will first be used to regulate the industry. If there is a surplus of funds, 75 percent of it would be earmarked for public education and 25 percent will go to Oklahoma State Department of Health for drug and alcohol rehabilitation programs.

“Earmarking some of this revenue for specific purposes can prevent some of these volatile revenues from being baked into general fund spending. On the other hand, earmarks have their own challenges associated with them,” Murphy said.

That’s because there is no clear estimate of how much money that medical cannabis might raise for state coffers. She

offered the same warning for recreational marijuana, which could be placed on the statewide ballot in November.

State Question 797 campaigners are collecting signatures now and have almost enough to secure its place in the next election.

“Data on the demand for marijuana is still very limited, and prices are uncertain at best in a market where demand and supply is still in flux,” Murphy said.

Even if Oklahoma approves recreational marijuana, the Pew Charitable Trusts study shows that revenue from it might not solve state budget issues. There has been growth, but it’s also been inconsistent in states like Colorado, Oregon and Alaska, according to the report.

Any of these new or existing sin taxes are unlikely to be a silver bullet for larger budget issues...

In June 2017, Colorado collected about \$18 million from recreational marijuana compared with less than \$2 million in tax revenue from medical sales. Murphy said that estimating revenue in states with a new marijuana market is hazy at best, particularly for places like Oklahoma with its proximity to Colorado.

That’s because some of Colorado’s marijuana industry is driven by tourists coming from places like Oklahoma.

“Any of these new or existing sin taxes are unlikely to be a silver bullet for larger budget issues, especially when attempting to resolve some of the larger structural budget challenges that many states are facing,” said Murphy.

(b. 1)

Six Policies Economists Love (And Politicians Hate)

Theo Francis, NPR, Planet Money, July 19, 2012

Tuesday's show presented the common-sense, no-nonsense Planet Money economic plan — backed by economists of all stripes, but probably toxic to any candidate that might endorse it.

You can still listen to the show, but we've had some requests for a post with our six-step plan spelled out in brief.

So here they are, along with a few words about each of the economists who helped craft it:

— The proposals —

One: Eliminate the mortgage tax deduction, which lets homeowners deduct the interest they pay on their mortgages. Gone. After all, big houses get bigger tax breaks, driving up prices for everyone. Why distort the housing market and subsidize people buying expensive houses?

Two: End the tax deduction companies get for providing health-care to employees. Neither employees nor employers pay taxes on workplace health insurance benefits. That encourages fancier insurance coverage, driving up usage and, therefore, health costs overall. Eliminating the deduction will drive up costs for people with workplace healthcare, but makes the health-care market fairer.

Three: Eliminate the corporate income tax. Completely. If companies reinvest the money into their businesses, that's good. Don't tax companies in an effort to tax rich people.

Four: Eliminate all income and payroll taxes. All of them. For everyone. Taxes discourage whatever you're taxing, but we like income, so why tax it? Payroll taxes discourage creating jobs. Not such a good idea. Instead, impose a consumption tax, designed to be progressive to protect lower-income households.

Five: Tax carbon emissions. Yes, that means higher gasoline prices. It's a kind of consumption tax, and can be structured to make sure it doesn't disproportionately harm lower-income Americans. More, it's taxing something that's bad, which gives people an incentive to stop polluting.

Six: Legalize marijuana. Stop spending so much trying to put pot users and dealers in jail — it costs a lot of money to catch them, prosecute them, and then put them up in jail. Criminalizing drugs also drives drug prices up, making gang leaders rich.

There you have it, six major proposals that have broad agreement, at least among economists. Though we should note that there were some pretty significant quibbles about just how to implement the income-tax and carbon-tax proposals.



A marijuana cigarette in British Columbia. Our panel of economists agrees that criminalizing pot is a huge waste of resources. Jae C. Hong/AP

— The economists —

Dean Baker, co-director of the Center for Economic and Policy Research in Washington, D.C., and widely published blo “You could probably describe me as left of center. It'd be fair.”

Russ Roberts, George Mason University economics professor. “In the grand spectrum of economic policy, I'm a pretty hard core free market guy. I'm probably called a libertarian.”

Katherine Baicker, professor of health economics at Harvard University's Department of Health Policy and Management. We simply called her a centrist on the show.

Luigi Zingales, professor of entrepreneurship and finance and the University of Chicago's Booth School of Business. “What I like to say is that I'm pro-market, but not necessarily pro-business.”

Robert Frank, professor of management and economics at Cornell University's Johnson Graduate School of Management. “I'm a registered Democrat. I think of myself as a radical pragmatist.”

Note: This post was updated to make clear that the income tax would be replaced with a consumption tax. That's in the original show, but was inadvertently omitted from the summary above. Sorry for the confusion!

(d. \$10 billion)

Notes

**This is a resource document for you to use.
Take Notes, highlight, use as a text book.**

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2004- Oklahoma's Environment: Pursuing A Responsible Balance

Town Hall Chair: William R. McKamey, AEP Public Service Company of Oklahoma

2005- Drugs: Legal, Illegal... Otherwise

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2006- Strategies for Oklahoma's Future

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2015- Oklahoma Priorities: The Government & Taxes We Want

Town Hall Co-Chairs: Howard Barnett, OSU- Tulsa; and Dan Boren, Chickasaw Nation Department of Commerce

2017- Oklahoma Votes: Improving the Election Process, Voter Access & Informed Voter Engagement

Town Hall Co-Chairs: Dan Boren, Chickasaw Nation Department of Commerce; and John Harper, AEP Public Service Company of Oklahoma

2018- Aligning Oklahoma's Tax Code to Our 21st Century Economy

Town Hall Co-Chairs: Darryl Schmidt, BancFirst; and Dan Boren, Chickasaw Nation Department of Commerce

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