Action Items for Oklahoma

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Tax Reform

Create a 21st Century Revenue System
for a 21st Century Economy

This is the first of a seven part series by Oklahoma Policy Institute to propose public policy action items for the state of Oklahoma. These recommendations are aimed at improving the shared prosperity of all Oklahomans while maintaining a fiscally responsible state budget. Future installments will focus on criminal justice, education, energy, financial security, health care, and jobs.

Action Items for Oklahoma

Tax Reform

Create a 21st Century Revenue System for a 21st Century Economy

To prosper in the 21st century, Oklahoma needs a well-educated workforce, functioning infrastructure, healthy families, and secure communities. Reaching these goals requires a tax system capable of generating enough revenue to fund the core public services on which our prosperity depends.

Our current state tax system is poorly equipped for the task. It has become increasingly outdated, inefficient and unfair. Oklahoma's tax code is riddled with loopholes that reduce revenue collections and place a greater share of the tax load on a narrower base of taxpayers.

As we look further ahead, we see that growing funding obligations and ever-larger holes in our tax system are creating a fiscal gap, or structural budget deficit, between revenue collections and rising costs. Inadequate revenue is already straining the public institutions that educate our children, protect our streets, and take care of our family members and neighbors in need. In the not-distant future, the aging of the Baby Boom generation will drive up the cost of health care, social services, and corrections. The state faces price tags in the tens of billions to cover unfunded pension liabilities, repair crumbling roads, bridges and public buildings, and protect our drinking water and waste water systems.

For too long, Oklahoma has not had a sensible debate on tax policy. In the mid-2000s, the state approved deep, permanent tax cuts that were only fully phased in after the economy faltered. Recent proposals have focused narrowly on cutting the top personal income rate, with wildly optimistic promises that this will lead to massive economic growth.

There is another way. Through key reforms to Oklahoma's tax code, we can ensure that we will have adequate revenues to perform the essential functions of state government while making the tax code fairer for Oklahoma families and businesses.

Action Items

- Modernize the income tax by eliminating inefficient tax credits, limiting itemized deductions, adopting combined corporate reporting, and taxing less income at the top rate.
- Modernize the sales tax by taxing selected services, eliminating sales tax exemptions, collecting tax on online sales and eliminating the sales tax on groceries.
- Strengthen the gross production tax by eliminating unnecessary exemptions.
- Make sure that future tax and spending proposals are affordable and sustainable by adopting PAY-GO requirements.

Modernize The Income Tax

The personal income tax is an indispensable part of the state tax system for several reasons:

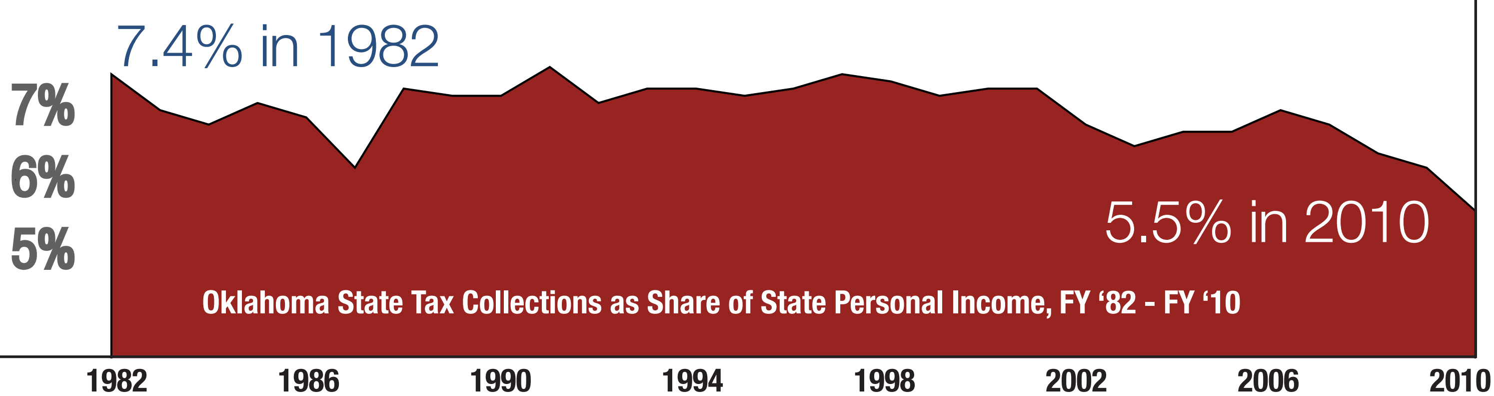
- It is the single largest source of funding for state services in Oklahoma, bringing in $2.2 billion in FY 2010 and accounting for just under one-third (31.4 percent) of all state tax dollars[i];
- It is a dynamic tax, performing better than the sales tax and other taxes in growing to meet the increased cost of providing public services;
- It is the only major component of our tax system based on ability to pay. The income tax partly offsets highly regressive sales and property taxes within the overall state and local tax system.

Preserving and strengthening the income tax is vital to restoring public services after the cuts of recent years and to meeting the challenges that lie ahead. Several reforms would improve the adequacy and fairness of Oklahoma's income tax:

- **Eliminate inefficient tax credits:** Oklahoma has enacted many income tax credits to encourage and subsidize various economic activities. While some have spurred investment and job growth, others provide inadequate transparency and accountability, impose large and uncertain costs, and fail to create many jobs. The Legislature should subject all existing and future credits to strict criteria and eliminate those that are inefficient.
- **Limit itemized deductions:** Oklahoma allows taxpayers who claim itemized deductions on their federal income tax return to claim the same deduction on their Oklahoma tax return. Low-income families receive virtually no benefit from these deductions, while the greatest benefits go to already wealthy families who need them the least. Oklahoma should repeal itemized deductions while increasing the standard deduction available to all families. Alternately, the state should disallow the deduction for state tax payments that is carried over from federal returns.
- **Adopt combined corporate reporting:** Oklahoma could stop abusive tax-avoidance strategies and promote a level playing-field for business by adopting combined corporate reporting. Under combined reporting, multi-state corporations are prevented from hiding profits earned in Oklahoma by sending them to a subsidiary located in a no-tax state. Combined reporting has been adopted by more than half of all states that assess a corporate income tax and by every Western state except New Mexico.
- **Tax less income at the top rate**: Oklahoma's failure to index its income tax brackets to inflation means that over time a growing share of income is taxed at the top rate. Currently, Oklahomans hit the top rate at $8,500 of taxable income for an individual or $17,000 for a family. Any comprehensive tax reform proposal should ensure that fewer Oklahomans fall into the top bracket by increasing the personal exemption or stretching out the lower brackets.

We're Paying a Historically Low Share of Our Income in State Taxes

Lawmakers passed large cuts to Oklahoma's personal income tax in the mid 2000s, reducing the top personal income tax rate from 6.65 percent to 5.25 percent. Due to these cuts and growing loopholes in the tax base, tax collections as a share of state personal income have reached 30-year lows.



Modernize The Sales Tax

The sales tax is the largest single revenue source for state and local government combined in Oklahoma. However, this tax is increasingly falling short for three main reasons:

- The percentage of purchases on which sales tax is levied is declining as the US moves from an economy dominated by consumption of tangible goods to a service-driven economy;
- A growing number of purchases are made online, where collecting taxes is difficult;
- Revenue has been eroded by a growing array of sales tax exemptions.

The cumulative effect is that just 35.7 percent of all sales in Oklahoma in 2003 were subject to the sales tax, compared to 52.0 percent in 1990.[ii]

A number of measures could modernize the sales tax:

- **Taxing selected services:** Oklahoma exempts more services from the sales tax than most states; Oklahoma currently charges sales tax on just 32 of 168 potentially taxable services. Expanding the sales tax to selected services would make the sales tax more economically fair and rational and help maintain its long-term adequacy.
- **Enhancing tax collection of online sales:** While taxes are owed on purchases made from online retailers who lack a physical presence in Oklahoma, states are prohibited from requiring such retailers to collect the tax. Congressional action is needed to fully address this loophole, which costs Oklahoma over $150 million annually.[iii] However, Oklahoma could follow the lead of other states to enhance collection of taxes on Internet sales by defining affiliate programs like those run by Amazon as sufficient for meeting the 'physical presence' test, and by requiring remote sellers to provide their customers with an annual tab of their purchases.
- **Curtailing sales tax exemptions:** Oklahoma grants nearly 150 exemptions from the general sales tax. While some exemptions have a strong economic justification or identifiable social purpose, many lack a clear rationale. The exemptions should be carefully reviewed and curtailed,

As part of sales tax modernization, Oklahoma should eliminate the sales tax on groceries. Taxing groceries places a particular burden on low- and moderate-income families that do not qualify for food assistance programs. Of 45 states with a general sales tax, 38 exempt groceries or tax them at a lower rate.[iv]

Many Common Household Services Are Not Taxed in Oklahoma

Veterinary Services	Horse Boarding/Training	Pet Grooming
Landscaping/Lawn Care	Self Storage	Marina Services
Residential Electricity	Residential Gas	Investment Counseling
Barber Shops/Salons	Carpet/Upholstery Cleaning	Dating Services
Diaper Service	Garment Alteration/Repair	Health Clubs
Laundry/Dry Cleaning	Personal Instruction	Shoe Repair
Swimming Pool Cleaning	Tuxedo Rental	Exterminating
Auto Washing	Auto Road Servicing/Towing	Auto Maintenance/Painting
Parking Lots/Garages	Auto Rustproofing	Pari-mutuel Racing Admission
Amusement Park Admission	Bowling Alleys	Cable TV
Cultural Event Admission	Professional Sports Admission	Circus/Fair Admission
Private Club Membership	Private Limo Service	Installation Charges
Labor Charge, Auto Repair	Labor Charge, Remodeling	Extended Service Contracts
	Exempt from Sales Tax: 29	**Subject to Sales Tax: 10**

Source: Michael Mazerov, Expanding Sales Taxation of Services: Options and Issues, Center on Budget and Policy Priorities, August 2009

Strengthen The Gross Production Tax

The oil and gas industry is a vital driver of Oklahoma's economy, accounting for nearly 9.5 percent of gross state product and 4.6 percent of the nonfarm labor force.[v] Revenue from oil and gas production is also a vital part of Oklahoma's tax system. In FY 2010, the state collected $744 million in gross production taxes on oil and gas, which represents 10.5 percent of all tax collections.[vi] Gross production taxes are the state's third largest revenue source, behind only the personal income tax and the sales tax.

Oklahoma assesses a 7 percent gross production tax on the extraction of oil and gas, except when prices fall below a certain floor. However, several forms of production, including horizontal drilling and deep well drilling, benefit from tax incentives that lower the tax rate to just 1 percent for horizontally-drilled wells and 4 percent for deep wells, regardless of the price of oil or gas. As oil and gas production has shifted increasingly towards horizontal and deep well drilling, the cost of these tax breaks has skyrocketed.

From FY 2010 to FY 2012, the state paid out or accrued $688 million in gross production tax breaks.[vii] With horizontal and deep wells now accounting for the lion's share of Oklahoma drilling activity, the cost of these credits is poised to grow even greater in coming years. Yet research and experience show that state tax incentives are largely irrelevant to a company's decisions on whether to drill or to a well's profitability.

Oklahoma should eliminate or curtail its tax preferences for horizontal and deep well drilling in favor of more uniform tax treatment that allows energy producers to operate profitably while ensuring that the state can fund the core services that allow our families, communities and businesses to prosper.

Ensure Fiscal Sustainability By Adopting A PAYGO Requirement

With core services absorbing deep cuts in recent years and enormous fiscal challenges in the years ahead, it would be irresponsible and unsustainable to erode our revenue base further. One promising approach to ensure that we do not bankrupt the state is for Oklahoma to adopt a pay-as-you-go, or PAYGO, requirement.

During last year's tax debate, state Treasurer Ken Miller stated:

> *Budget writers should adopt a "pay-as-we-go" approach to reducing taxes. To responsibly finance tax cuts, policymakers should eliminate one dollar of spending or credits for every dollar cut in taxes.*
>
> *This can be accomplished with fiscal discipline, better spending prioritization and a refined approach to budgeting.*[viii]

PAYGO would require policymakers to maintain a responsible balance by identifying up-front how they will pay for any reduction in revenues or expansion of services. Payment could take the form either of an offsetting revenue increase or specific cuts to services. The undesirable alternative is to cut taxes or increase services and then throw the whole budget into disarray because the money isn't there. If, for example, the Legislature wanted to devote more funding to road repair, it could do so by increasing gas taxes or tolls or by cutting some other service (such as new road construction).

Oklahoma's recent history is full of examples where budget decisions were made without regard to the long-term health of the state's finances or the impact on other state services. PAYGO would would only allow such diversions if "paid for" by additional revenue or specific cuts in other programs. In addition to PAYGO, Oklahoma should adopt multi-year forecasting and a current services budget, which would inform lawmakers and the public of the cost of maintaining today's level of services and put us on a more sustainable fiscal course.

NOTES

i US Census Bureau, 2010 Annual Survey of State Government Finances; http://www.census.gov/govs/state/

ii Iris J. Lav, Elizabeth McNichol and Robert Zahradnik, Faulty Foundations: State Structural Budget Problems and How to Fix Them. Center on Budget and Policy Priorities, October 2005; http://www.cbpp.org/5-17-05sfp-states.htm

iii Wayne Greene, "Officials, merchants push to collect online taxes", Tulsa World, September 26, 2011; http://bit.ly/138xmxd

iv Center on Budget and Policy Priorities, "Which States Tax the Sale of Food for Home Consumption in 2009?", March 2009; http://www.cbpp.org/cms/?fa=view&id=1230

v Calculated from Bureau of Economic Analysis data

vi See note 1 above

vii Oklahoma Policy Institute, Unnecessary and Unaffordable: The Case for Curbing Oklahoma's Oil and Gas Tax Breaks, Issue Brief, October 2012; http://okpolicy.org/unnecessary-and-unaffordable

viii Ken Miller, "Building better budgets," Oklahoma Economic Report, February 2012; http://www.ok.gov/treasurer/documents/OER_2-28-12.pdf

See these Oklahoma Policy Institute publications to learn more:

Create a 21st Century Revenue System for a 21st Century Economy

- Online Budget Guide; http://okpolicy.org/resources/online-budget-guide

Modernize The Income Tax

- Oklahoma Income Tax Basics, Fact Sheet, August 2011; http://okpolicy.org/files/income-tax-basics.pdf
- What the Income Tax Pays For, Fact Sheet, March 2012; http://okpolicy.org/files/what_the_income_tax_pays_for.pdf
- Let There Be Light: Making Tax Expenditures More Transparent and Accountable, Issue Brief, March 2010; http://okpolicy.org/shining-the-light-on-tax-breaks
- Limiting itemized deductions would improve the fairness and adequacy of the state income tax, Blog Post, March 2010; http://okpolicy.org/limiting-itemized-deductions-would-improve-the-fairness-and-adequacy-of-the-state-income-tax/
- Interview with Michael Mazerov: Oklahoma can put an end to abusive corporate tax shelters, Blog Post, October 2011; http://okpolicy.org/interview-with-michael-mazerov-oklahoma-can-put-an-end-to-abusive-corporate-tax-shelters/

Modernize The Sales Tax

- Fixing the Sales Tax: Options for Reform, Issue Brief, February 2011; http://okpolicy.org/fixing-the-sales-tax
- Boosting the Grocery Tax Credit Would Give Targeted Help to Struggling Families, Policy Brief, October 2008; http://okpolicy.org/files/grocerytax_brief.pdf

Strengthen The Gross Production Tax

- Gross Production Tax, Fact Sheet, April 2011; http://okpolicy.org/gross-production-tax-fact-sheet
- Stand back, we don't know how big these things may get, Blog Post, March 2012; http://okpolicy.org/stand-back-we-dont-know-how-big-these-things-may-get
- Unnecessary and Unaffordable: The Case for Curbing Oklahoma's Oil and Gas Tax Breaks, Issue Brief, October 2012; http://okpolicy.org/unnecessary-and-unaffordable

Ensure Fiscal Sustainability By Adopting A PAYGO Requirement

- Pay-go is a promising approach to fiscal responsibility, Blog Post, March 2012; http://okpolicy.org/pay-as-you-go-is-a-promising-approach-to-fiscal-responsibility/
- Stop Flying Blind: Three sensible reforms to help us chart a stable fiscal course, Blog Post, November 2011; http://okpolicy.org/stop-flying-blind-three-sensible-reforms-to-help-us-chart-a-stable-fiscal-course/

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