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FILLING THE BUDGET HOLE: OPTIONS FOR A BALANCED APPROACH

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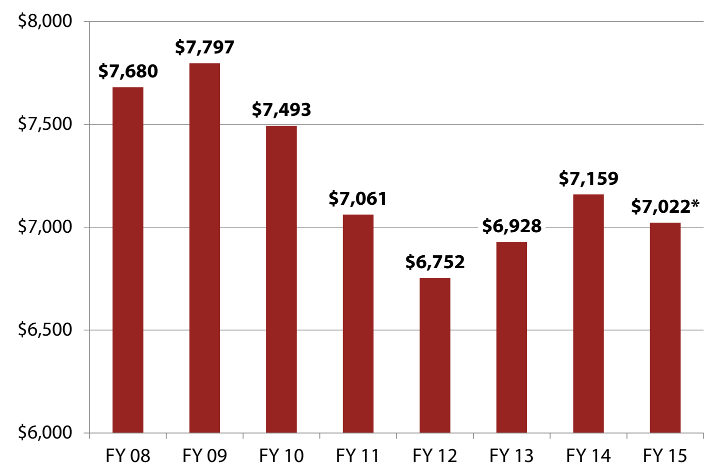
In 2009 and 2010, a national recession plunged Oklahoma and most other states into deep budget holes. Even as unemployment skyrocketed and millions lost their homes, states were forced to slash funding for education, health care, public safety, and most other services. Federal stimulus funds helped to cushion the blow, but a shrinking public sector still compounded and prolonged the effects of the recession on the entire economy.

Oklahoma's appropriations budget remains significantly below pre-recession years

2014 dollars adjusted using the Consumer Price Index, in millions



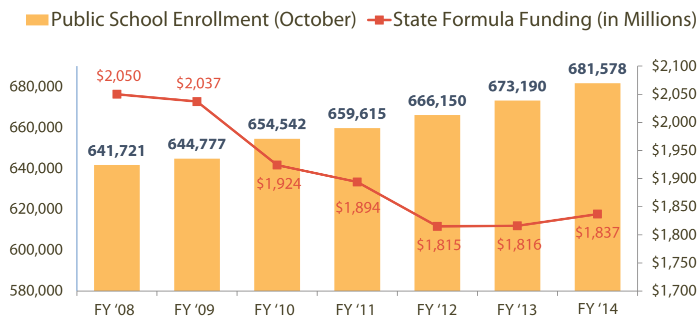
* Proposed in Governor Fallin's FY 2015 Executive Budget

Six years later, most states have emerged from the crisis and are rebuilding their core services. Revenues are exceeding forecasts or on target in 37 states.[1] Yet Oklahoma is headed in the opposite direction. The Board of Equalization has certified that we will have $188 million less available revenue for next year's budget compared to this year. That estimate is binding on the legislature as it prepares to develop the FY 2015 budget between now and May.

In her FY 2015 Executive budget, which was developed when the estimated shortfall was "only" $170 million, Gov. Mary Fallin proposed an overall cut of $137 million, or 1.9 percent, across all of state government. She recommended modest funding increases for a few agencies, but cut most budgets by 5 percent. Higher education, Medicaid, public health and juvenile justice were among the core areas of government dealt 5 percent cuts.[2]

The prospect of more budget cuts should be a grave concern for two main reasons. First, the state has never fully recovered from the prolonged budget crisis that accompanied the recession of 2009-10. Three years of budget cuts were followed by three years of modest increases or flat funding. This year's budget is 0.5 percent larger than that of five years ago in nominal terms, but is $638 million, or 8.2 percent, smaller when adjusted for inflation. Forty out of the 73 appropriated state agencies remain 20 percent or more below FY 2009 funding levels, adjusted for inflation.[3]

The impact of an incomplete budget recovery continues to be felt across state government. State support for K-12 education through the state aid formula remains more than $200 million below that of six years ago, while school attendance has grown by 40,000 students. Our prisons are at close to 100 percent of capacity, while staffing levels have fallen to under 70 percent. Overall, the state workforce has shrunk by 10 percent in the past five years, and we have 1,500 fewer classroom teachers. Meanwhile, waiting lists for programs like those serving individuals with developmental disabilities have grown to historically high levels.[4]



Second, not only are agencies facing a backlog of critical unmet needs, but many require substantial funding increases simply to maintain existing services. The Department of Education, for example, has requested over $50 million more in FY 2015 just for increased health care costs for teachers and support staff. The Department of Corrections needs $45 million to handle projected inmate counts and address critical staffing shortages. The Medicaid agency is facing a shortfall of over $100 million due to increased enrollment, rising health care costs, and declining federal support. The Department of Human Services is seeking a $33 million supplemental this year and an additional $57 million next year to implement court-ordered child welfare improvements. For these and other agencies facing rising costs and unavoidable obligations, even a flat budget could require painful cuts.[5]

In short, our agencies and schools are not in a situation where they can absorb budget cuts simply by tightening their belts and squeezing out greater efficiencies. Rather, at a time when additional funds are needed to recover from years of cuts and flat funding and to address the rising cost of maintaining core services, further cuts would inflict serious harm to the public institutions on which our health, safety, and economic well-being depend.

However, this outcome is not inevitable. Policymakers have the choice of adopting a balanced approach to filling the budget hole, one that includes new revenue sources in addition to targeted cuts and efficiencies. In this brief, we lay out a number of feasible proposals that should be considered as part of the budget discussions this session. Most of these proposals have been considered and endorsed previously by top elected officials or outside experts, and some are contained in measures currently before the legislature. While some involve one-time revenues, most would bolster state revenues over time and would help address the growing disconnect between the cost of providing basic services and the revenues we collect to pay for them. The proposals are not intended as an exhaustive list of the options that may be available, but they are ideas that would have a significant budget impact and enjoy some chance of winning legislative support.

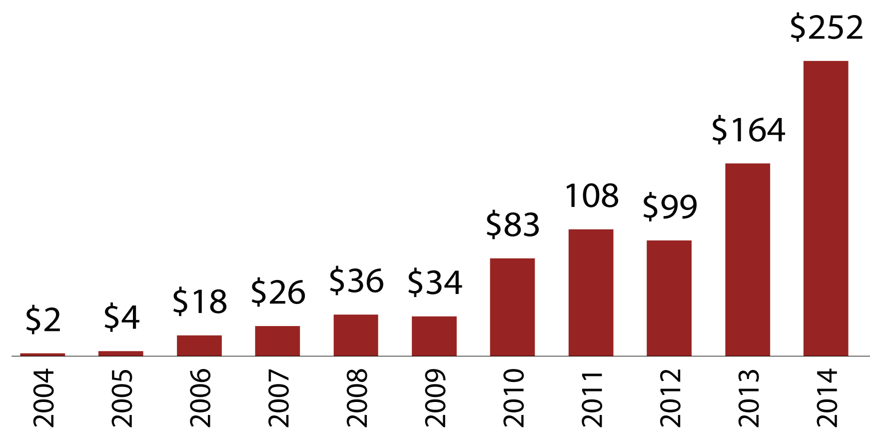
1. Curb the tax break for horizontal oil and gas production

Oklahoma imposes a severance tax (also known as a gross production tax) on extraction of oil and gas. The rationale for severance taxes are to cover the costs associated with drilling and mining, such as road wear and tear and environmental damage. They are also designed to compensate taxpayers for the loss of a nonrenewable resource within the state.

Oklahoma taxes oil and gas production at 7 percent of the value of the extracted fuels. However, the state has created various exemptions for production methods that were considered especially risky. The most generous tax break is for horizontal production, which is taxed at just 1 percent for the first 48 months without regard to the price of oil and gas and without any cap on the amount of the tax break.[6]

In recent years, a growing share of oil and gas production in Oklahoma and across the country has shifted to horizontal drilling. In 2013, 75 percent of completed wells in Oklahoma were drilled horizontally (through August), up from just 15 percent in 2007. Currently some 90 percent of all rigs operating in Oklahoma are drilling horizontally.[7]

Cost of the Tax Break for Horizontal Drilling (in millions)



Source: Oklahoma Tax Commission

The rapid shift in oil and gas production to horizontal drilling means that the cost of the tax break is skyrocketing. The state is expected to collect $237 million less in FY 2015 due to the 1 percent tax rate than if production were taxed at 7 percent. The horizontal drilling tax break is a major reason why state General Revenue collections remain below prior year peaks and why the state faces budget shortfalls. Without legislative action, the cost of the tax break could soon reach $400 - $600 million per year.[8]

As Finance Secretary Preston Doerflinger stated last summer, "Any fiscally responsible policymaker needs to seriously consider at what level government should incentivize something that is now standard practice. It's not responsible for government to give money away as an incentive if no incentive is needed." A recent study of state severance tax policies in Tax Analysts concluded that, "Oklahoma's policy of exempting production from horizontal wells for up to four years goes

way beyond encouraging innovation and reducing investment costs and exempts wells that oil and gas producers would drill and develop without the exemption." If Oklahoma were to tax horizontal production at the standard 7 percent rate, its effective tax rate would be similar to most peer-producing states and considerably lower than North Dakota's.[9]

> *Any fiscally responsible policymaker needs to seriously consider at what level government should incentivize something that is now standard practice. It's not responsible for government to give money away as an incentive if no incentive is needed."*
>
> -Oklahoma Finance Secretary Preston Doerflinger

The tax break for horizontal production is set to expire at the end of June 2015. Several proposals have been floated for reforming the gross production tax, some of which aim to be revenue-neutral by coupling a higher rate on horizontal production with a lower rate on traditional production. Policymakers should instead establish a 7 percent rate for all production. This would allow energy companies to continue to operate profitably while ensuring adequate funding for the schools, roads and bridges, public safety, and other public services that the energy industry and other businesses, families, and communities depend on.

2. Eliminate the double deduction of state income taxes

Among the many tax deductions allowed on the state income tax, the deduction for state income tax, also known as the 'double deduction', may make the least sense.

In Oklahoma, taxpayers who itemize their federal tax deductions can deduct state income taxes paid. Those deductions are then carried over the state tax return. Almost all states that allow taxpayers to carry over federal itemized deductions require them to add back the deduction for state income taxes. Oklahoma is one of just six states that still allows the deduction of state income tax on state tax returns. It is an unintentional fluke of the law that serves no rational purpose.

The deduction for state income taxes benefits only a minority of Oklahoma taxpayers who itemize their deductions, primarily higher-income households. A full 67 percent of the deductions for state income taxes claimed by Oklahomans in 2007 were claimed by the small minority of taxpayers (8 percent) with income over $100,000. Just 10 percent of the deduction went to households with income under $50,000, even though over 70 percent of taxpayers fall under the $50,000 income threshold.[10]

In recent years, there has been a push to do away with the deduction for state income tax. Its elimination was part of the final tax agreement between the Governor and legislative leadership in 2012 that ultimately failed to gain passage. This year, two bills that included doing away with the

state income tax deduction – SB 1246, authored at the time by Sen. Kyle Loveless, and SB 2011, authored by Sen. Ralph Shortey – passed out of the Senate Finance committee. During committee hearings, both authors referred to the deduction as "double dipping".[11] It should be noted that legislators supporting the repeal of the deduction have looked at it as a means to offset part of all of the lost revenue from a cut in the top income tax rate or other tax cuts.

By eliminating the deduction for state income taxes, the state would gain $101 million in additional revenue in Tax Year 2015, according to an analysis by the Institute for Taxation and Economic Policy.[12]

3. Adopt combined corporate reporting

One of the causes of Oklahoma's budget shortfall is a steep drop in corporate tax collections. The state is now projected to take in just $307.6 million from the corporate income tax in FY 2014, which is 36 percent less than was projected last spring and 32 percent less than what was collected last year. Through the first seven months of FY 2014, the state had paid out more than $75 million in corporate tax refunds, more than double the amount through January of last year ($31.4 million). Though there is no consensus on why we are seeing this drop in corporate collections and growth in refunds, a contributing factor may be states artificially shifting profits to out-of-state subsidiaries. Oklahoma could put an end to abusive tax-avoidance strategies and promote fairness between different kinds of businesses by adopting combined corporate reporting.[13]

A tactic that some corporations use to minimize their state tax liability is shifting profits between parent and subsidiary companies. A large multi-state company can use separate accounting to shift taxable profits to low-tax jurisdictions. These tax avoidance strategies take various forms – prominent examples include Wal-Mart's "captive REIT" tax shelter (featured in a front page Wall Street Journal expose) and the "Delaware Trademark Holding Company" shelter adopted by Toys R Us and many other retailers.

To put an end to these tax-avoiding strategies and ensure that multi-state corporations pay their fair share of taxes, just like local businesses, states can adopt a reform known as combined reporting. Under combined reporting, multi-state corporations must add together the profits of all their subsidiaries into one total. The state then taxes a share of that combined income based on a formula that takes into account the corporate group's level of activity in the state as compared to its activity in other states.

Combined reporting has been adopted by 24 of 45 states that assess a corporate income tax, including Texas, Kansas, and Colorado.[14] The 2011 Comprehensive Task Force on Tax Reform chaired by Sen. Mike Mazzei and Rep. David Dank recommended "that to minimize tax avoidance, corporations

be required to use the accounting practice known as 'combined reporting.'"[15] Combined reporting legislation has since been introduced but not enacted.

Based on a variety of fiscal notes from states that have considered combined reporting bills, plus analyses of actual tax return data, a conservative estimate is that adopting combined reporting would lead to a 10 -20 percent boost in corporate tax collections, or some $50 - $100 million for Oklahoma.[16]

4. Enhance Tax Collections from Online Sales

When purchases are made of taxable goods out-of-state – whether via the Internet, catalogs or other sellers – a companion to the sales tax called a "use tax" is still legally owed by the purchaser. However, as a result of US Supreme Court rulings, states are unable to require retailers who lack a physical presence in a state, or 'nexus', to collect and remit use tax owed to the state. This creates a differential tax treatment that puts "Main Street" Oklahoma retailers at a competitive disadvantage compared to online retailers of the same goods. It also leads to substantial lost revenue for state and local governments. The Oklahoma Tax Commission has estimated that Oklahoma state and local governments are losing $200 million every year when people buy products online and don't pay the required tax.[17]

The best approach to leveling the playing field is for Congress to take action to allow states to require the collection of taxes from all but the smallest online retailers. Federal legislation such as the Marketplace Fairness Act has gained support from a broad coalition of national and local trade associations, state and local government organizations, and businesses, but has so far failed to advance through Congress.

In the absence of Congressional action, states can and should do more to expand tax collections on online sales. The main approach adopted by a growing number of states is to pass so-called "Amazon laws." Under these laws, arrangements that provide compensation to state residents for linking their websites to a company such as Amazon's website (i.e. affiliate programs, or "click-throughs") are deemed to establish nexus and require tax to be collected. New York passed the first Amazon law in 2008; nine other states (Arkansas, California, Connecticut, Illinois, North Carolina, Pennsylvania, Rhode Island, Vermont and, most recently, Georgia) have followed suit.

In 2010, the Oklahoma Legislature adopted a few modest measures to encourage use tax collections, including requiring that remote sellers disclose that you may owe use tax on what you are buying and requiring paid tax preparers to remind clients of their use tax obligations.[18] Oklahoma should go further by adopting an "Amazon law" that would both boost state and local tax collections and help address the unfair competitive disadvantage hindering locally-based businesses.

5. Tap the Rainy Day Fund

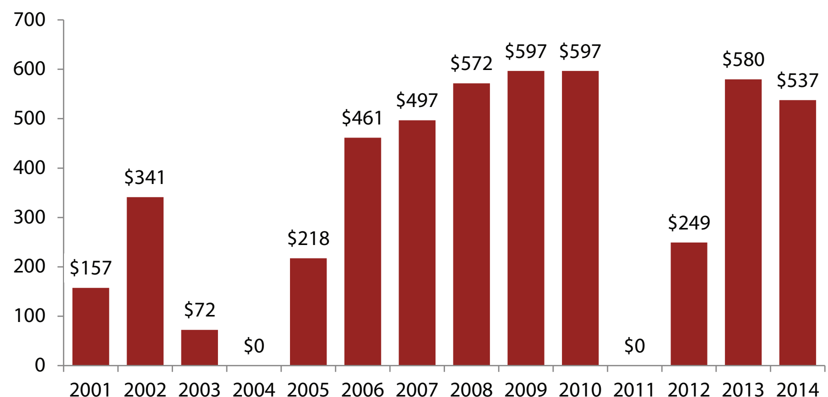
In FY 2012 and 2013, Oklahoma enjoyed large revenue surpluses that allowed for substantial deposits in the state's Constitutional Reserve Fund, or Rainy Day Fund (RDF). The RDF now has a balance of $537.4 million.

The State Constitution (Article X, Section 23) allows for the Rainy Day Fund to be tapped in three circumstances:

- Up to 1/4th may be spent upon declaration of an emergency, which requires a 2/3rds vote of the legislature if declared by the Governor or a 3/4ths legislative vote in the absence of a declaration by the Governor. Up to $134.35 million could be appropriated under the emergency provisions.

- Up to 3/8ths may be used in the budget for the next year if General Revenue collections are forecast to be less than the current year's collections. The Board of Equalization has certified $27.7 million less General Revenue for FY 2015 than what was certified for FY 2014; that amount could be appropriated from the Rainy Day Fund upon a simple majority vote of the legislature.

- Up to 3/8ths to make up for a revenue failure in current year collections. Although year-to-date collections are 4.8 percent below the estimate through February, that does not meet the threshold of a revenue failure, and so this portion of the RDF could not be tapped.

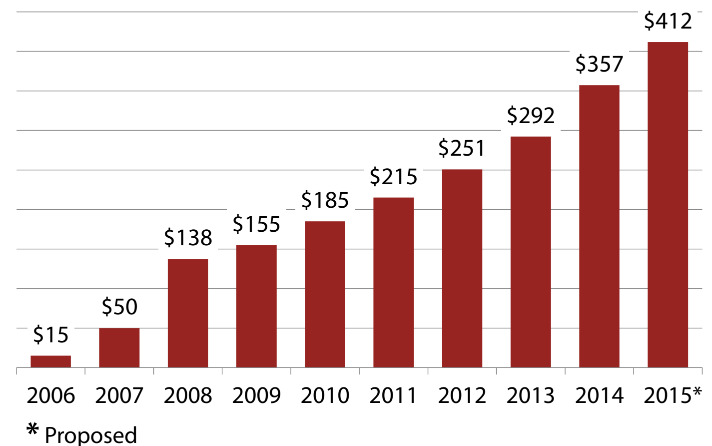


In total, $162.1 million could be appropriated to help balance the budget, which would leave $375.3 million in the fund to deal with future shortfalls. Since 2000, the average balance in the fund has been $335.1 million.

While tapping the Rainy Day Fund provides only one-time relief, its use should be considered if the alternative is cuts that would mean people losing health care coverage, teachers losing their jobs, steep tuition hikes, or other measures that would cause serious damage to the economy and to Oklahoma families and businesses.

6. Maintain Transportation Funding at Current Levels

Since the mid-2000s, Oklahoma has taken huge strides to address years of neglect of our state's roads and bridges. Each year since FY 2006, the amount of income tax revenue taken off the top for the ROADS fund has increased automatically based on a formula in statute. In FY 2015, the ROADS fund is scheduled to receive $416.8 million, an increase of $59.7 million from this year and of $166 million compared to FY 2012. The fund is set to grow by a similar amount over the next three years until it reaches a cap of $592 million in 2018. Lawmakers also redirected a portion of the motor vehicle tax, the fuel tax, and gross production tax to several transportation funds. This diverts about $21 million from General Revenue this year and $31 million in FY 2015.[19]



While investments in transportation are unquestionably important, it is worth asking whether it makes sense to allow these sizeable increases to take effect automatically each year if we are going to be cutting support for other vital services, such as schools, health care, and public safety. When the ROADS program was first enacted, annual increases were tied to a 4 percent revenue growth trigger, but this safeguard mechanism was since removed. In recent years, while transportation has received substantial increases, funding for other core government functions has been cut or frozen. Now those areas are on the chopping block again.

By putting automatic funding increases into statute, the legislature was intentionally taking the decision to decide funding priorities out of the normal appropriations process. But the legislature can still amend the statute and decide to suspend or limit the automatic $56.7 million increase scheduled for FY 2015 to avoid cuts in other critical areas.

As an alternative to diverting an increasing share of general revenue to roads and bridges, Oklahoma could alter how it assesses the gas tax. Oklahoma's gas tax was set at 17 cents per gallon in 1987 and has not been adjusted for inflation for the past 26 years, a period longer than every state except Alaska. Over that period, the tax has lost more than 45 percent of its value for meeting the state's transportation needs. Oklahoma could modernize the gas tax by making it a percentage of the purchase price, just like the general sales tax, rather than cents on the gallon. Virginia recently implemented a similar reform and saw prices at the pump decrease. Switching the gas tax to a percentage basis was a main recommendation of this year's Oklahoma Academy for State Goals Town Hall, which focused on transportation issues.[20]

7. Accept Federal Funds to Expand Health Coverage

The state's budget outlook is particularly dire for two major health care agencies, the Oklahoma Health Care Authority (OHCA) and the Department of Mental Health and Substance Abuse Services (DMHSAS). Due to a drop in the federal Medicaid matching rate, rising health care costs, increasing enrollment, and other factors, both agencies need substantial new money to maintain current services or else face painful cuts.[21] There is no single solution that will address this problem. However, Oklahoma has the opportunity to free up substantial state dollars if we agree to accept federal funds under the Affordable Care Act.

Between now and 2016, the federal government will assume 100 percent of the cost of providing health insurance to adults with incomes below 138 percent of the poverty level who are not currently eligible for Medicaid. After 2016, the federal share will phase down to 90 percent.

A 2013 study commissioned by the Oklahoma Health Care Authority and Governor Fallin estimated that over a ten-year period, accepting federal funds would provide net state savings of between $447 million - $486 million.

A 2013 study commissioned by the Oklahoma Health Care Authority and Governor Fallin conducted by the Leavitt Partners estimated that over a ten-year period (2014-2023), accepting federal funds would provide net state savings of between $447 million - $486 million. The study states, "While the proposal is expected to increase direct costs to the State over a 10-year period, the overall net effect is positive due to program savings and increased tax revenues." The net effect would be greatest over the next two years while the federal government would pick up the entire cost of coverage.[22]

Expanding coverage would assist the state budget in two primary ways. First, the state spends an estimated $47 million annually through the Department of Mental Health and Substance Abuse Services, Department of Corrections, and Health Department to provide health care to indigent adults. If Oklahoma accepts the federal dollars, these services currently being completely paid for by the state would be funded with 90-100 percent federal dollars, freeing up state funds.[23] Secondly, the state is now allocating $30 - $40 million annually as the traditional state Medicaid match to cover the 20,000 or so individuals in the Insure Oklahoma program. If Oklahoma follows the Leavitt Partners report and expands Insure Oklahoma in ways that conform with the Affordable Care Act, that population will also be paid for exclusively or primarily with federal funds.

Besides providing critical relief to the state's health care budgets, expanding coverage would provide a major economic boost to the state, help businesses by creating a healthier workforce, and address a situation where the lowest-income Oklahomans are left in a "coverage crater" without insurance options.[24]

Conclusion

The proposals contained in this brief are not intended as a comprehensive set of options to fill Oklahoma's budget hole and avert further cuts to state services. For example, in her FY 2015 Executive Budget, the Governor proposes transferring a portion of the cash balances in agency revolving funds to the General Revenue fund for appropriation. The Governor allocates $83 million – or 10 percent of total revolving fund balances – without specifying which funds are to be transferred. Where it can be determined that revolving funds have grown to unnecessary levels, and there are no statutory restrictions on how these funds can be spent, these balances should be used either to offset a decrease in an agency's appropriations or transferred to the General Revenue fund to help fund other areas of government. Legislators should also consider money in the Cash Flow Reserve Fund and other one-time money that could help address immediate needs.

Even if some combination of the proposals laid out in this brief are adopted, Oklahoma will still face challenging budget circumstances next year and beyond. However, the proposals outlined here show that we do have options to avoid cutting deeper into important services. Oklahoma's $188 million budget shortfall is not inevitable; it is a choice that we can avoid.

Lawmakers have a responsibility to consider all of the options to protect the services Oklahoma needs to be a prosperous and healthy state and to put our fiscal house back into order.

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Oklahoma Policy Institute (OK Policy) is a non-profit organization that provides information, analysis and ideas on state policy issues.

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