ISSUE BRIEF

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The Case For The Income Tax

By Gene Perry

The income tax is a vital tool for providing public services that all Oklahomans depend on. It is the single largest source of support for education, health care, transportation, public safety, and other necessities. Some state leaders have proposed repealing or reducing the state income tax. This issue brief explains why that policy is ill-advised.

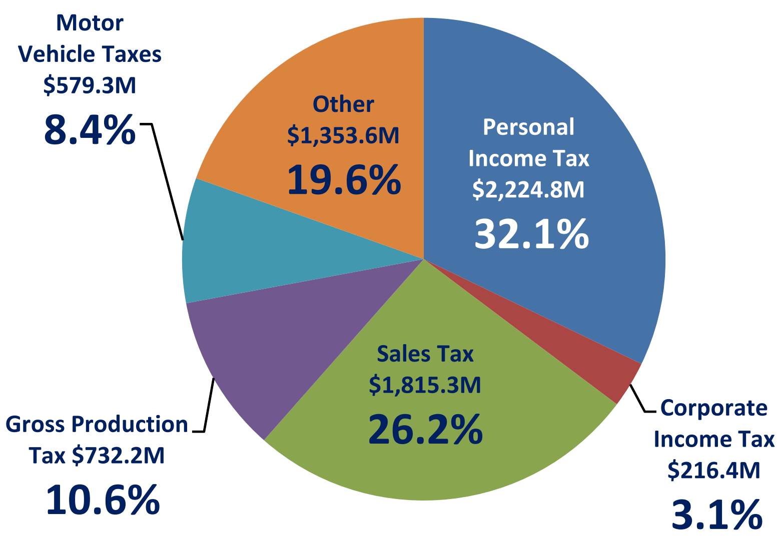
Oklahoma's income tax rates are not a hindrance to the state's business climate or a spur for people to move out of state. In fact, shifting to greater reliance on other taxes would disadvantage local business, create more risk of revenues not being adequate to needs, and put a disproportionate burden on low- and moderate-income Oklahoma families. The brief also shows that Oklahoma is already out-competing most states that lack an income tax.

The state could not provide basic, essential services without income tax revenue unless other taxes were drastically increased. Before the economic downturn, the income tax brought in more than $2.5 billion a year. In FY 2010, it made up about one-third of all state tax collections.

Collections have fallen in recent years due to tax cuts and the economic downturn. Oklahoma had comparatively low taxes even before lawmakers approved the largest tax cut package in state history in the mid 2000s. The most significant of these cuts was a reduction in the top income tax rate from 6.65 percent to 5.25 percent.

Today, after three years of repeated cuts to the state budget, the state has fallen further behind in funding teacher salaries and benefits, staffing our prisons and juvenile facilities, and ensuring the safety of children at risk of abuse and neglect, among other vital functions. We face growing obligations to fund our public pensions, protect our water system, repair our crumbling infrastructure, and take care of an aging population. In this context, cutting the income tax is the wrong priority for Oklahoma's future.

Total State Tax Collections, FY '10



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What Does Oklahoma's Individual Income Tax Pay For?

The individual income tax accounts for about one-third of all state tax collections. It supplies revenue that helps support every core function of government and public services.

When income tax revenues are collected by the state, a set amount is taken off the top each year for specific priorities: OHLAP college scholarships for low- and moderate-income Oklahomans ($63.2 million this year) and the ROADS fund for maintenance of highways and bridges, as well as two much smaller funds for public transit ($255.7 million). ROADS is the cornerstone of Governor Fallin's plan to fix the state's more than 700 structurally deficient bridges by 2019.

Remaining individual income tax revenues are divided between the General Revenue Fund (85.66%); 1017 Fund for Common Education (8.34%); Teacher's Retirement Fund (5.00%); and Ad Valorem Reimbursement Fund (1.00%).

Based on that apportionment, as well as the typical division of General Revenue appropriations between agencies, we calculate that in FY 2012, income tax revenue will go to state agencies as follows:

Our Income Taxes Pay For...

17,000 classroom teachers

19,000 Oklahoma's Promise scholarships

Incarceration costs for 9,300 inmates

Health care for 430,000 children

And more.

- **$743.4 million to the State Department of Education** — Without this revenue, the state would be unable to afford salaries and benefits for almost 17,000 teachers (41 percent of all public school classroom teachers in the state).[i]
- **$141.1 million to the Department of Corrections** — This revenue is needed to cover the expense of incarcerating more than 9,300 inmates, or about 36 percent of the state's entire prison population.[ii]
- **$268.2 million to the Oklahoma Health Care Authority** — This revenue provides the state match for the health care expenses of more than 430,000 low-income children enrolled in SoonerCare.[iii]
- Remaining income tax revenues provide $261.8M to the State Regents for Higher Education, $149.7M to the Department of Human Services, $63.1M to Mental Health and Substance Abuse Services, $44.9M to Career & Technology Education, $33.0M to the Office of Juvenile Affairs, $29.2M to the Department of Public Safety, $20.5M to the Department of Health, and $192.3M to other agencies.

i Based on Oklahoma's average classroom teacher salary and fringe benefits of $44,285, as reported by the National Education Association.
ii Based on the Oklahoma Department of Correction's average direct per-prisoner costs of $15,103 per year.
iii Based on a 35 percent state match and the average cost per child (under 21) TANF member served of $1,771, according to the Oklahoma Health Care Authority FY 2010 Annual Report.

The Business Climate Myth

The frequently heard claim that eliminating the income tax will make businesses more likely to locate in Oklahoma is not supported by real-life experience. Extensive research on economic development makes it clear that investment decisions are driven more by the presence of a well-trained, productive workforce and strong public infrastructure than by state and local tax rates. Dr. Robert Lynch, a professor and chair of the Department of Economics at Washington College, reviewed hundreds of credible economic studies and found that "state and local taxes, at their current low levels, may be largely irrelevant to business investment decisions."[1]

A national survey of business leaders found that they ranked tax rates last among factors relevant to location decisions. Far more important were access to skilled labor, nearby markets, public safety, and transportation infrastructure — most of which require public investments made possible by the income tax.[2]

Rank of Relevant Factors in Location Decisions	
1	Labor Productivity
2	Skilled Labor Supply
3	Labor Costs
4	Distance to Major Market/Access
5	Crime Rates/Safety
6	Highway Access
7	Quality Heath Care Facilities
8	Red Tape – Regulatory Climate
9	Public Schools
10	Corporate Tax Rate

Source: Louisiana Business Image Survey

The Oklahoma business community agrees. At an October 2011 meeting of the state legislative task force on tax reform, representatives from the Ardmore, Tulsa Metro, and State Chambers of Commerce all cast serious doubt on the idea that cutting the income tax is the path to prosperity.

Wes Stuckey, Ardmore Chamber President and a long-time economic development officer, told the task force: "For 24 years, I've been conducting interviews with executives of companies that we tried to recruit to Ardmore that ended up locating elsewhere. ***Not once in all those years did a company that rejected Ardmore base its decisions on taxes.***"

This makes sense, because state taxes make up a very low percentage of the cost of doing business, and high-quality public services are necessary for becoming a good state to do business. Studies have identified serious damage done to economic development from combining tax cuts with spending cuts, especially when the cuts were to higher education or basic infrastructure.[3]

Oklahoma is already a comparatively low tax, low services state. Only ten states collect less in state and local taxes as a share of personal income, and government spending per capita is 18 percent less than the national average.

In 2006, the legislature approved the largest tax cut package in state history. Since then, we have cut almost every state agency by 10 percent or more, with many cut by as much as 20 percent. Oklahoma continues to struggle with one of the least healthy workforces in the nation, and we face large, continuing costs just to maintain our transportation and water infrastructure. Common sense tells us even if jobs might be gained by cutting taxes, they would be more than offset by damage to the business climate from cuts to public services.

As former House Speaker Chris Benge, who now represents the Metro Tulsa Chamber of Commerce, said at the October meeting, "If our ability to educate and train employees for a 21st century economy is damaged through lack of funding, if we can't maintain our roads and bridges, strong health care system, robust research and technology infrastructure, safe streets, etc., then the benefits of a reduction in the income tax rates may be limited."[4]

The Migration Myth

Income tax opponents frequently claim that states with low or nonexistent income taxes attract more residents and businesses from other states. But this, too, turns out to be a myth. The most rigorous studies have found either no effect from state and local taxes on individual migration or business location decisions or so little impact that it is far outweighed by the significant revenue the taxes produce for essential services.[5]

An extensive study of New Jersey's 2004 tax increase on households making more than $500,000 found that migration of this group after the tax increase was no different from that of households in the next lowest, whose taxes did not go up. The study estimates that at most, 70 tax filers might have left New Jersey between 2004 and 2007 because of the tax increase. This migration cost the state an estimated $16.4 million — which was far eclipsed by the revenue gain from the tax increase of nearly $3.8 *billion*.[6]

Migration between states at any time is low. Between 2001 and 2010, just 1.7 percent of U.S. residents moved from one state to another per year, and only about 30 percent of Americans change states over their entire lifetime.[7]

Migration that does occur is much more likely to be driven by cheaper housing than by lower taxes. The difference in housing costs between states is many times greater than the difference in taxes. Net migration in Florida and California (which are often cited as examples of states gaining or losing population because of their tax policy) is vastly more affected by changes in housing prices than tax rates.

Florida has no personal income tax, but the state's net migration over the last decade varied dramatically, booming in the early part of the decade and then slowing dramatically. By 2008, more people were leaving the state than moving in. Florida's tax policy did not change over this time. The Center on Budget and Policy Priorities explained what really happened:

> Florida's housing prices rose sharply during the mid-2000s, narrowing opportunities for Northeasterners to "trade up" on their expensive homes. Many decided either not to move or to move to states like Georgia or South Carolina, which have income taxes but also have cheaper housing and a mild climate. Then Florida's economy collapsed in the severe recession, dispersing Floridians to other states in search of work.[8]

Oklahoma is often compared to Texas, which lacks an income tax and has experienced high population growth in recent years. But high birth-rates among Hispanics and a welcoming immigration policy are the real explanation for this growth – Hispanics accounted for 65 percent of the state's growth since 2000, while the population of non-Hispanic whites grew by just 4.2 percent.[9]

Oklahoma Already Does Better Than Most States With No Income Tax

Nine states have no personal income tax: Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. Those seeking to eliminate Oklahoma's income tax often claim that doing so will help us compete with these states, but there is no evidence that lack of an income tax sets them apart in any significant way.

In fact, Oklahoma already out-competes most of these states on two important measures of economic prosperity: unemployment and personal income growth. As of August 2011, Oklahoma has a lower unemployment rate than six out of nine of the states with no income tax. In the last decade, per capita personal income grew more in Oklahoma than in six out of the nine states with no income tax, including Texas.

Unemployment Rate, September 2011

South Dakota	4.6%
New Hampshire	5.4%
Wyoming	5.8%
Oklahoma	**5.9%**
Alaska	7.6%
Texas	8.5%
Washington	9.1%
Tennessee	9.8%
Florida	10.6%
Nevada	13.4%

Source: Bureau of Labor Statistics

Per Capita Personal Income Growth, 2000-2010

Wyoming	53.3%
South Dakota	49.9%
Alaska	44.9%
Oklahoma	**43.9%**
Texas	32.3%
Florida	31.4%
Washington	31.4%
Tennessee	31.0%
New Hampshire	27.8%
Nevada	19.2%

Source: Bureau of Economic Analysis

The Texas Comparison

As our most populous neighbor, Texas is commonly looked to as a model and major competitor for jobs. It's true that Texas has experienced high population growth in the last decade, and with more people the number of jobs has naturally increased. Yet before Oklahoma rushes to copy Texas, we should note two facts:

1) Numerous factors contributed to Texas's population growth other than taxes. These include high birth-rates among Hispanics and a welcoming immigration policy, low housing prices due to insulation from the housing bubble, abundant oil and gas wealth, and a strong energy industry base in Houston.

2) More people does not mean greater prosperity. Texas's unemployment rate is well above Oklahoma's. In addition, the jobs that Texas has added are predominately low-income. Texas has the highest share of workers earning minimum wage or lower (9.5 percent [10]), the most people without health insurance (26 percent [11]), and the eighth highest poverty rate in the nation (17.2 percent [12]). Oklahoma out-performs Texas on each of these indicators.

The Income Tax is Vital to a Balanced Revenue System

Most states depend on a mix of three major revenue sources: income tax, sales tax, and property tax. Over-reliance on any one of these taxes is inadvisable, because each performs better or worse in different economic climates. Balance helps provide adequate and stable revenue for essential public services over time.

State budgets are affected by two types of deficits: **cyclical deficits** are caused by recessions, and can be mediated by saving during good times with a Rainy Day Fund; **structural deficits**, on the other hand, occur when the state is unable to meet its basic obligations even during periods of full employment. Structural deficits tend to get worse over time, as poorly maintained infrastructure and unaddressed economic and social problems send the state into a downward spiral.

In any shift away from income tax that maintains the same level of total revenue, Oklahomans will pay more taxes. That's because taxpayers can deduct the state income taxes they pay from their federal tax liability. If we eliminate or reduce the state income tax, Oklahomans will lose some or all of that deduction. Therefore some part of any income tax cut will go to the federal government.

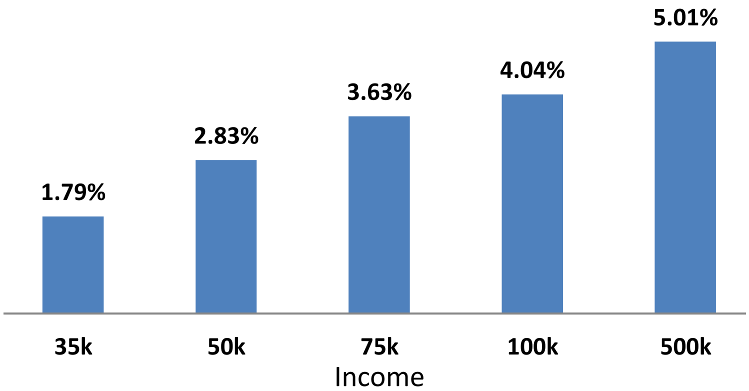
Structural deficits are best prevented with adequate income tax, because it is the only tax that grows as quickly as personal income and keeps pace with economic growth. That's one of the reasons why a report by the National Center for Public Policy and Higher Education found that eight out of nine states without an income tax were in the bottom fourteen of all states for having the worst projected structural deficits.[13]

Oklahoma can guard against volatility and cyclical deficits without giving up on the positive aspects of income taxes. We do this by relying on a mix of different types of taxes, including sales and excise taxes, to reduce the likelihood that all fall simultaneously, as well as setting revenues aside in the Rainy Day Fund when collections are rising.

Another important feature of the income tax is that, unlike sales and property taxes, it is based on the ability to pay. The more money a household makes, the higher the proportion of their income they pay in income tax. Sales and property taxes are just the opposite: families with lower incomes pay a higher share of it in those taxes. To help even things out, Oklahoma offers several income tax credits for low and moderate-income families: low income property tax credit, sales tax relief credit, and the earned income tax credit.

A proposal by Governor Fallin's economic development task force would pay for a reduction in the state income tax rate for the highest earning households by eliminating tax credits and exemptions, including these important supports for low and moderate-income working families.[14] The result could not be fairly described as a tax cut, but rather a tax *shift* that provides the greatest benefit to the wealthiest Oklahomans by increasing taxes on those already struggling to get by. That in turn increases costs by creating higher demand for public services as more families are pushed into poverty and reliance on government assistance.

Effective State Income Tax Rates for Married Joint Filers with Two Children, Standard Deduction



Shifting to More Reliance on Sales Tax Will Harm Oklahoma's Economy

Another suggestion from lawmakers has been to make up for lost income tax revenues by increasing consumption taxes, but this would be counterproductive. The nation's economy is driven to a great extent by the sale of goods to consumers. If consumption drops due to increasing sales taxes, many businesses will have to cut back on hiring and salary increases to stay afloat, sending a ripple effect through the economy.

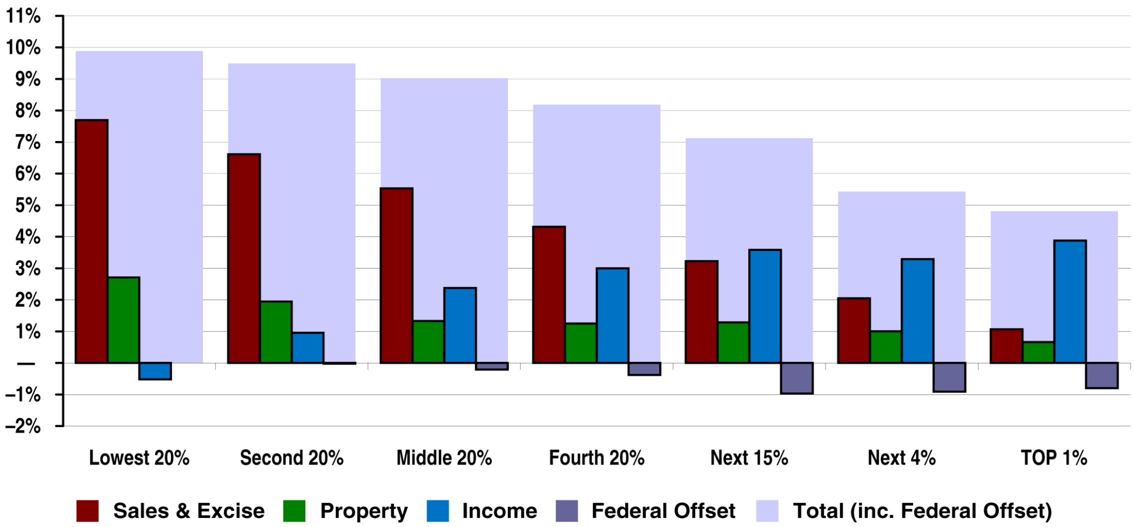
Oklahoma's sales tax is already relatively high – our combined state and local sales tax rate (based on calculating the average local sales tax) is 8.66 percent, the 5th highest rate in the nation.[15] In addition to the 4.5 percent state sales tax rate, cities may levy sales taxes between 1 and 5 percent and counties may add sales taxes of up to 2 percent. If the state raises the sales tax an additional 1 percent, Oklahoma's combined sales tax rate would be the highest in the nation.

A high sales tax harms local businesses' ability to compete. After all, most people wouldn't move their family to Texas to avoid the income tax, but some will drive to Kansas or shop on the Internet to avoid a sales tax. Untaxed Internet sales already cost our state and local governments $185 to $225 million annually, according to the Oklahoma Tax Commission.[16]

Shifting to more reliance on sales taxes will hit average people hardest. Sales and property taxes take a higher share of income from low- and moderate-income Oklahomans than from the wealthy. As shown in the chart below, income tax is our main tool to balance the overall regressivity of state taxes. In Texas, over-reliance on sales and property tax means that while Texas as a whole ranks 41st in state and local taxes as a share of income, the poorest 20 percent of non-elderly Texans pay the 5th highest taxes in the nation. The next 20 percent of Texans, with average incomes of $24,500, pay the 17th highest taxes.[17]

Oklahoma State & Local Taxes in 2007

Shares of family income for non-elderly taxpayers



Source: Institute on Taxation and Economic Policy. 2009. "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States." http://www.itepnet.org/whopays3.pdf

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