

January 2008

Oklahoma: A Tax and Budget Assessment



Oklahoma Council
of Public Affairs

Executive Summary

Oklahoma imposes a relatively low tax burden: total state and local tax revenues are 9.0% of total state personal income. Nationally, the average state and local tax revenues are 11.0% of total state personal income. Very low property tax burdens are an important reason Oklahoma's overall tax burden is so low.

Not surprisingly, Oklahoma's relative economic growth compares very favorably to the nation's. Per capita personal income in 2006 grew by 7.8% in Oklahoma compared to 5.6% for the nation as a whole.

While Oklahoma's relatively low state and local tax burden provides a competitive advantage for the state, there are some concerns. Oklahoma's marginal tax rates on personal income, corporate income, and capital gains are relatively high—especially compared to those of neighboring Texas and Colorado. High marginal tax rates on income and capital gains diminish economic incentives to produce, save, and invest in Oklahoma. On the spending side, the recent acceleration in expenditures is also troubling, as the higher expenditures, if not curtailed, will negatively impact Oklahoma's positive economic growth environment.

Oklahoma's experience since the 1970s illustrates the importance of establishing a strong pro-growth tax environment. Historically, when Oklahoma's state and local tax burden was rising compared to the national average, economic growth in the state lagged overall national economic growth. The reverse has occurred when Oklahoma's state and local tax burden was declining relative to the national average. This real-world experience is precisely what the theory of pro-growth tax policies predicts.

Based on the theory of pro-growth tax policy, OCPA reviewed Oklahoma's tax system. Our analysis indicates that, while overall Oklahoma's tax system is good, there are several key areas for improvement, especially in comparison to neighboring Texas and Colorado. Specifically:

- Oklahoma's low overall state and local tax

burden and low property tax burden are important competitive advantages for the state, which should be maintained.

- Oklahoma's top marginal personal income and corporate income tax rates are too high—especially compared to neighboring Texas and Colorado. Tax reforms should lower these top marginal tax rates to bring them closer in line with neighboring Texas and Colorado.
 - Oklahoma's personal income tax has seven tax brackets, which is progressive. In general, progressive tax structures add significant complexity to the tax code, while the higher top marginal income tax rates tend to diminish pro-growth incentives throughout the economy. In Oklahoma, the top marginal personal income tax rate becomes effective at \$8,700 for a single filer, which is less than the annual salary for a full-time minimum wage worker. The low income threshold for the top marginal income tax in Oklahoma creates an additional argument for eliminating the progressive income tax structure in Oklahoma and replacing the complex structure with a simpler flat-rate tax.
 - Oklahoma imposes a relatively high capital gains tax rate. This rate should be reduced and, at a bare minimum, brought into line with the capital gains taxes that are imposed in neighboring states.
 - While Oklahoma's spending record has traditionally been competitive from a national perspective, overall spending has been growing at a troubling pace as of late. Furthermore, spending per capita in the state has been above several key neighbors, including Texas and Colorado. In order to enhance the effectiveness of the pro-growth tax reforms suggested above, the per capita spending of state and local governments should be brought into line with Texas and Colorado.
- Ideas for restraining spending in Oklahoma are not wanting. For instance, OCPA annually presents detailed spending budgets which limit government growth.

Oklahoma's tax and spending policies have a large and significant impact on the state's overall economic performance. When Oklahoma's state and local tax burden is increasing, Oklahoma's economic performance is less than the national average. Conversely, when Oklahoma's state and local tax burden is decreasing, Oklahoma's economic performance exceeds the national average.

On the surface, the trade-off between low taxes and economic growth appears to imply a trade-off between economic growth and adequate revenues for the state and local governments. In reality, the reverse is true. The optimal tax system for Oklahoma ensures adequate and stable revenues for state and local governments over the long term while simultaneously ensuring strong economic growth for the state and its citizens. This paper will discuss the importance of establishing pro-growth fiscal policies and illustrate that implementing pro-growth tax reforms with sound budget practices will maintain the strong economic performance as of late, while maximizing Oklahoma's long-run economic growth potential and providing a solid and stable revenue source for state and local governments.

Before we apply the lessons of past fiscal policies to Oklahoma, it is useful to review the history and theory of pro-growth tax policies. The first half of this paper reviews the theories and lessons from past tax policy changes. With this background, the second half of this paper reviews Oklahoma's tax and spending history, applying the lessons of the past to Oklahoma's future.

The Theory Behind Low, Broad-Based Taxes

Excessive taxation is detrimental to labor and capital, poor and rich, men and women, and old and young. Excessive taxation is an equal opportunity tormentor. In the short run, higher taxes on labor or capital lower after-tax earnings. In the longer run, mobile factors "vote with their feet" and leave the state, while immobile factors (such as low-wage workers and land and property) are left to suffer the tax burden. The principals of Arduin, Laffer & Moore Econometrics have produced decades of research demonstrating that states where taxes are high and/or increasing relative to the national norm experience declining relative income growth, declining relative popula-

tion growth, rising relative unemployment, and declining housing values.

The mode of taxation is as important as the amount of taxation, as noted by 19th century American economist Henry George:

The mode of taxation is, in fact, quite as important as the amount. As a small burden badly placed may distress a horse that could carry with ease a much larger one properly adjusted, so a people may be impoverished and their power of producing wealth destroyed by taxation, which, if levied in any other way, could be borne with ease.¹

While the world is dynamic and many of its ups and downs are outside the control of state government, there are a number of criteria for judging the efficacy of a state's tax system. These were summarized well by Henry George:

The best tax by which public revenues can be raised is evidently that which will closest conform to the following conditions:

1. That it bear as lightly as possible upon production—so as least to check the increase of the general fund from which taxes must be paid and the community maintained.
2. That it be easily and cheaply collected, and fall as directly as may be upon the ultimate payers—so as to take from the people as little as possible in addition to what it yields the government.
3. That it be certain—so as to give the least opportunity for tyranny or corruption on the part of officials, and the least temptation to lawbreaking and evasion on the part of the taxpayers.
4. That it bear equally—so as to give no citizen an advantage or put any at a disadvantage, as compared with others.²

The theory of incentives provides the basis for establishing an optimal tax policy. Incentives can be either positive or negative. They are alternately described as carrots and sticks or pleasure and pain. Whatever their form, people seek positive incentives and avoid negative incentives. The principle is simple enough: If an activity should be shunned, a negative incentive is appropriate, and vice versa.

In the realm of economics, taxes are negative

High marginal tax rates on income and capital gains diminish economic incentives to produce, save, and invest in Oklahoma.

incentives, and government subsidies are positive incentives, subject to all the subtleties and intricacies of the general theory of incentives. People attempt to avoid taxed activities—the higher the tax, the greater their attempt to avoid. As with all negative incentives, no one can be sure how the avoidance will be carried out.

Changes to marginal tax rates are critical for growth because they change incentives to demand, and to supply work effort and capital. Firms base their decisions to employ workers, in part, on the workers' total cost to the firm. Holding all else equal, the greater the cost to the firm of employing each additional worker, the fewer workers the firm will employ. Conversely, the lower the marginal cost per worker, the more workers the firm will hire. For the firm, the decision to employ is based upon gross wages paid, a concept which encompasses all costs borne by the firm.

Workers, on the other hand, care little about the cost to the firm of employing them. Of concern from a worker's standpoint is how much the

worker receives for providing work effort, net of all deductions and taxes. Workers concentrate on net wages received. The greater the net wages received, the more willing a worker is to work. If wages received fall, workers find work effort less attractive and they will do less of it. The difference between what it costs a firm to employ a worker and what that worker receives net is the tax wedge.

Tax Policy Matters for Economic Growth

Rising tax burdens are detrimental to economic growth. States that have high and/or increasing taxes relative to the national average experience relative declines in income, housing values, and population, as well as rising relative unemployment rates.

Consistently, economic growth rates in the states with the highest tax burdens lag the economic growth rates in the states with the lowest tax burdens. Table 1 summarizes the latest results.

Economic growth in the 10 states with the lowest tax burden, defined as total state and local taxes as a percentage of personal income,

Table 1
State and Local Tax Burden vs. 10-Year Economic Performance

(2006 state and local tax burden vs. economic performance between 1996 and 2006, unless otherwise noted)

	2006 S&L Tax Burden	Personal Income Growth	Population Growth	Net Domestic In-Migration as a % of Population	Non-Farm Payroll Employment Growth	Unemployment Rate, 2006
South Dakota	\$87.40	76.0%	5.2%	-1.8%	14.5%	3.2%
Tennessee	\$88.99	63.6%	11.9%	4.3%	9.6%	5.2%
Alabama	\$90.44	61.6%	6.1%	0.8%	8.0%	3.5%
New Hampshire	\$90.51	73.0%	13.2%	6.0%	15.9%	3.4%
Colorado	\$94.00	88.5%	21.9%	5.1%	19.5%	4.4%
Missouri	\$98.48	56.6%	7.8%	1.3%	7.3%	4.8%
Texas	\$99.49	87.2%	20.6%	2.1%	20.8%	5.0%
Oklahoma	\$100.21	70.1%	7.2%	0.1%	13.8%	3.9%
Oregon	\$101.10	65.0%	14.3%	4.7%	16.0%	5.4%
Georgia	\$102.50	78.1%	23.8%	6.4%	15.7%	4.7%
10 States With Lowest Tax Burden	\$95.31	72.0%	13.2%	2.9%	14.1%	4.4%
10 States With Highest Tax Burden	\$132.31	59.5%	5.5%	-2.3%	12.9%	4.4%
Connecticut	\$119.41	61.6%	5.6%	-3.1%	5.6%	4.3%
Wisconsin	\$121.73	59.8%	6.8%	0.6%	10.3%	4.7%
West Virginia	\$123.38	46.3%	-0.4%	-0.5%	8.2%	4.8%
Rhode Island	\$125.32	60.5%	5.8%	-1.9%	11.8%	5.3%
Alaska	\$131.39	52.6%	9.8%	-3.9%	19.4%	6.8%
Hawaii	\$133.05	46.9%	6.5%	-6.5%	16.5%	2.6%
Maine	\$134.56	62.6%	6.3%	3.7%	13.1%	4.6%
Wyoming	\$140.43	86.0%	5.0%	-2.0%	23.9%	3.2%
Vermont	\$143.29	64.9%	5.8%	1.0%	11.9%	3.5%
New York	\$150.52	53.8%	3.9%	-10.1%	8.3%	4.5%

Sources: U.S. Bureau of Economic Analysis, U.S. Census, U.S. Bureau of Labor Statistics, and ALME calculations

exceeds the economic growth in the 10 states with the highest tax burdens. Overall economic growth, as measured by total economic activity (state GDP) or residents' total personal income, has been significantly higher in the low-tax states.

Not surprisingly, stronger economic growth has led to more jobs and lower unemployment rates—this despite the higher population growth in the low-tax states, as more and more people choose to relocate to the lower-taxed states. Similar to the experience of the low-tax states, economic growth in the states with no personal income tax exceeds economic growth in the states with the highest personal income tax burdens. Table 2 illustrates this relationship.

Further substantiating the relationship between personal income taxes and economic growth, we examined the top marginal state and local personal income tax rates and compared them to each state's overall economic growth for 2006. While there is some dispersion in the results, due in part to other factors that will impact state

economic growth, there is a definite negative relationship between a state's top marginal personal income tax rate and the economic growth rate in the state—the higher the top marginal personal income tax rate, the lower the expected economic growth rate.³ This relationship is not unique to 2006 either. Since 1999, the states with higher marginal income tax rates tend to have slower state personal income growth, except for the recession year of 2001.

Voting With Their Feet: A Hypothetical Example

Each state in the U.S. is analogous to a country with open borders. Just as the U.S. competes with other countries for the location of economic activity, states compete with each other for the location of factories, offices, and jobs within the U.S. This competition is seen through tax-cutting battles between neighboring states and targeted tax incentives to encourage corporate relocation. As states seek to hold companies and workers within their borders and attract new ones, the winners and the losers will be separated by their

Table 2
Relationship between 2006 State Personal Income Growth and Top Marginal Personal Income Tax Rate (State and Local)

	Top PIT Rate	GDP by State Growth	Personal Income Growth	Personal Income Per Capita Growth	Population Growth	Net Domestic In-Migration as a % of Population	Non-Farm Payroll Employment Growth	Unemployment Rate, 2006
Alaska	0.00%	70.2%	52.6%	39.6%	9.8%	-3.9%	19.4%	6.8%
Florida	0.00%	94.0%	83.9%	46.4%	22.4%	8.9%	30.4%	3.2%
Nevada	0.00%	123.7%	120.1%	44.6%	52.7%	20.5%	52.9%	4.1%
New Hampshire	0.00%	73.9%	73.0%	55.2%	13.2%	6.0%	15.9%	3.4%
South Dakota	0.00%	71.0%	76.0%	62.1%	5.2%	-1.8%	14.5%	3.2%
Tennessee	0.00%	66.3%	63.6%	46.9%	11.9%	4.3%	9.6%	5.2%
Texas	0.00%	96.9%	87.2%	54.6%	20.6%	2.1%	20.8%	5.0%
Washington	0.00%	72.7%	70.6%	49.5%	14.7%	3.1%	18.6%	5.0%
Wyoming	0.00%	101.5%	86.0%	74.8%	5.0%	-2.0%	23.9%	3.2%
9 States With No PIT	0.00%	85.6%	79.2%	52.6%	17.3%	4.1%	22.9%	4.3%
9 States With Highest Marginal PIT Rate	9.12%	62.1%	59.6%	49.5%	7.6%	-1.8%	12.1%	4.6%
Kentucky	8.20%	49.6%	61.0%	51.0%	7.4%	1.7%	10.4%	5.8%
Hawaii	8.25%	49.2%	46.9%	38.1%	6.5%	-6.5%	16.5%	2.6%
Maine	8.50%	57.8%	62.6%	55.2%	6.3%	3.7%	13.1%	4.6%
Ohio	8.87%	47.3%	45.0%	44.4%	2.3%	-2.8%	3.0%	5.4%
New Jersey	8.97%	59.1%	63.3%	51.2%	7.9%	-4.2%	12.1%	4.8%
Oregon	9.00%	81.8%	65.0%	44.0%	14.3%	4.7%	16.0%	5.4%
Vermont	9.50%	69.2%	64.9%	58.7%	5.8%	1.0%	11.9%	3.5%
California	10.30%	80.1%	74.1%	53.3%	14.0%	-3.5%	17.7%	4.8%
New York	10.50%	64.4%	53.8%	49.6%	3.9%	-10.1%	8.3%	4.5%

Sources: U.S. Bureau of Economic Analysis, U.S. Census, U.S. Bureau of Labor Statistics, and ALME calculations

ability to understand the competitive environment in which they exist and take steps to enhance their own state's appeal. Since monetary policy and federal fiscal policy are basically the same for all of the states, and inherent state advantages and disadvantages (such as climate, natural resources, distances to desirable areas, etc.) remain fairly constant over time, state and local fiscal policies are far and away the most important factors determining changes in the competitiveness and, hence, relative economic growth rates among the states.

The overall level of taxation in a state is also critical. Overtaxed states *per se* restrain growth, while states—even if they currently aren't overtaxed—that raise taxes inhibit growth. A reduction in tax rates reduces the cost of doing business in a state. This increases demand for the now less-expensive goods and services produced within the state. The higher demand for the state's goods and services will result in an increased profitability for businesses located within the state. Business failures will decrease in states with declining relative tax burdens, and business starts will rise. If all else remains the same, a reduction in tax rates increases the return to capital and work effort, leading to increases in the supplies of capital and labor within the state.

Symmetrically, every state that raises its relative tax burden will find it difficult to retain existing facilities and attract new businesses and workers. In tax-raising states, new business starts will decline, and business failures will increase.

Competition among the many states results, in large part, from the ability of mobile factors of production to "vote with their feet" and relocate to political jurisdictions pursuing more favorable economic policies. Changes in tax rates have the greatest impact on the supplies of factors of production that are highly mobile. For example, a worker who is prepared to relocate to achieve a higher standard of living will be extremely sensitive to a change in his state's tax rates. By contrast, the supplies of immobile factors of production and/or real estate will be affected only slightly by tax rate changes. For example, capital in the form of a new manufacturing plant, as in

the case of the example below, is highly immobile. Its operating level initially will be relatively unaffected by an increase in a state's tax rates. The major impact of state tax rate changes will be on the plant's after-tax profits and, ultimately, whether to close down or to remain open. The implication of this analysis is that taxes levied on mobile factors will be passed on to the immobile factors located within the state. Thus, the burden of state and local taxes may very well be different from its initial incidence.

Consider two hypothetical manufacturing companies with production plants located within just miles of each other. One is located in Oklahoma, and the other, virtually identical to the first, is located just across the border in Texas. Since we assume both companies sell virtually identical products in the U.S. market, competition will force them to sell their products at approximately the same price. Because each company's plant is separated by just a thin and invisible state line, both have to pay the same interest cost on borrowings, the same after-tax wages to their employees, and the same prices to their suppliers.

Now, consider what would happen if Oklahoma were to put through a large corporate income tax increase, while Texas held constant or lowered its corporate income tax rate. Because the market for the companies' product is highly competitive, the Oklahoma company would not be able to pass the tax hike forward to its customers in the form of higher prices. Likewise, the Oklahoma company would not be able to pass the tax hike backward onto its suppliers or employees. The Oklahoma firm would have to absorb the tax increase through lower after-tax profits. This drop in profits would be reflected by a fall in the Oklahoma company's stock price. Clearly, the identical competitor in Texas would benefit.

Whether the price of a commodity or factor of production is equilibrated across states on a pretax or after-tax basis depends on each item's mobility. This means that changes in tax rates will have two general effects. First, they will change the quantity and pretax price of mobile factors within the state and leave their after-tax rates of

President Kennedy understood that tax reduction 'sets off a process that can bring gains for everyone, gains won by marshalling resources that would otherwise stand idle.'

return unchanged. Second, they will change the rate of return of factors of production that cannot leave the state and leave the quantity within the state unchanged.

As time horizons lengthen following tax increases or tax cuts, the process of adjustment will incorporate the movement of capital and labor into or out of the state. This migration of factors of production will continue until after-tax returns for mobile factors within the state are equalized with after-tax returns for their counterparts elsewhere in the economy. The returns of state-specific immobile factors will reap the benefit or bear the burden of the result of the tax change.

The Dynamic Effects of Lower Marginal Tax Rates

It is always difficult to project the dynamic effects of supply-side policy changes. Estimating what will happen as a consequence of a tax increase or tax cut is precarious to say the least. But failing to estimate the dynamic consequences of tax changes will always be wrong. With incredible clarity, none other than John Maynard Keynes described these difficulties:

When, on the contrary, I show, a little elaborately, as in the ensuing chapter, that to create wealth will increase the national income and that a large proportion of any increase in the national income will accrue to an Exchequer, amongst whose largest outgoings is the payment of incomes to those who are unemployed and whose receipts are a proportion of the incomes of those who are occupied, I hope the reader will feel, whether or not he thinks himself competent to criticize the argument in detail, that the answer is just what he would expect—that it agrees with the instinctive promptings of his common sense.

Nor should the argument seem strange that taxation may be so high as to defeat its object, and that, given sufficient time to gather the fruits, a reduction of taxation will run a better chance than an increase of balancing the budget. For to take the opposite view today is to resemble a manufacturer who, running at a loss, decides to raise his price, and when his declining sales increase the loss, wrapping himself in the rectitude of plain arithmetic, decides that prudence requires him to raise the price still more—and who, when at last his account is balanced with nought on both sides, is still found righteously declaring that it would

have been the act of a gambler to reduce the price when you were already making a loss.⁴

There are several major tax changes that have occurred at the state and federal levels. Each one of these case studies illustrates the positive economic impact pro-growth tax reform can have.

California's Proposition 13

In 1978, a force that had been building strength for several years finally brought a huge and dramatic change to the California economy. The public's frustration with high and rising state and local (particularly property) taxes found expression in the passage of Proposition 13—an initiative to limit state and local spending and taxation. In June 1978, Proposition 13 roiled the entrenched political establishment. Proposition 13 was a state constitutional amendment that (1) set property taxes not to exceed 1% of a property's value (down from the 3.5% rate that existed at the time), (2) rolled assessed property tax values back to their 1976 levels, (3) allowed the base value to grow no more than 2% per year unless the property changed hands, and (4) required that all new or increased taxes be voted in by a supermajority of the electorate. Proposition 13 won in a landslide.

Following on Proposition 13's heels was an elimination of the state's inheritance tax, an indexing of the state's income tax, and an elimination of the state's business inventory tax. In 1979, Proposition 4 passed, locking the tax gains into place by requiring (1) spending to grow no faster than the sum of population growth and inflation and (2) all surplus revenues to be returned to the taxpayers.

Prior to the passage of Proposition 13 in March of 1978, Arthur Laffer wrote an economic analysis which was used by the United Organization of Taxpayers, detailing support for the passage of Prop 13.⁵ This analysis included forecasts of what the initiative's effects would be, and almost all were spot on. In the aftermath of this tax revolt the previously chronically depressed California enjoyed a remarkable economic resurgence, outperforming the nation in nearly every conceivable measure. Naturally, the state's high tax burden fell like a stone, from \$124.57 to \$95.19 just one year later.⁶ In 1977, California per capita personal income was 15% above the national average.⁷ Three years later, it was 18% above the national average.⁸ California's unemployment rate was 1.2 percentage points higher than the U.S. rate in 1977; in 1980 the California rate was

lower than the national rate by 0.4 percentage points.⁹ Between 1978 and 1988 the number of jobs in California increased by 32%, twice the 16% increase in jobs nationwide.¹⁰ The population in California increased by 24% from 1978 to 1988, over twice the national increase of 10.7%.¹¹

Housing prices in the state soared. There is perhaps no better barometer for changes in the after-tax rate of return on assets than the price of the ultimate immobile factor: housing. In the second quarter of 1978, right before Proposition 13's passage, the median home price in California was \$70,677, which was 7.4 times per capita personal income in the state and 21% more expensive relative to the U.S.¹² Over the decade of the 1980s absolute and relative housing prices in California took off and never looked back. In the third quarter of 1981, the median home price in California was \$108,455, or 8.1 times per capita personal income and 42% more expensive relative to the U.S. By the end of the decade, per capita personal income-adjusted housing prices in California were nearly double those for the U.S.¹³

Prop 13 did what it was advertised to do. The historical record also shows that Proposition 13 did not have any long-term deleterious effect on the finances of the state's various levels of government. The Great California Tax Revolt more than paid for itself.

The private sector of the economy fared beautifully in the aftermath of Proposition 13, but opponents questioned whether this private sector success might have come at the expense of the public sector. They feared that post-Proposition 13 revenues would be absolutely gutted, forcing expenditure cuts well beyond the elimination of wasteful spending. Vital services, they said, would suffer; schools would have to close; fire and police protection would no longer be adequate. But the fears of citizens concerned about maintaining adequate levels of state and local government services were allayed very soon after the changes were enacted.

First looking at revenues, Proposition 13 passed on June 6, 1978, one month prior to the end of FY1978. State and local property tax revenues fell

\$5.0 billion, from \$11.0 billion in FY1978 to \$6.0 billion in FY1979, far short of the static revenue loss forecasts of \$7 billion. In addition, this drop was largely offset by higher revenues in every other major tax category. Total state and local revenues fell by only \$1.1 billion that first year.¹⁴

Looking at the bigger picture, the combined state and local tax burden per \$1,000 of personal income fell from \$124.57 in FY1978 to \$94.93 in FY1982, a 24% reduction.¹⁵ Yet, in spite of the precipitous fall in the state's average tax rate, state and local revenues did not fall proportionately. In fact, total tax revenue grew by 19% from \$27.4 billion in FY1978 to \$32.5 billion in FY1982.¹⁶ The tax base expanded more than enough to offset the reduction in tax rates. Even after adjusting for inflation, which can distort economic data

during this high inflationary period, tax revenues fell much less than the reduction in the state and local tax burden.

Economic expansion and higher property values led to healthy property tax growth over the following years, and by FY1985 property tax collections were

back to their FY1978 \$11.0 billion level.¹⁷ The disruptive shortage of funds so widely anticipated never materialized.

Turning our attention to spending, total state and local direct general expenditures were not slashed between FY1978 and FY1979 as skeptics had predicted; in fact, expenditures increased 1.6% from \$36.9 billion to \$37.5 billion over this period.¹⁸ The tax reduction which had invigorated the state's economy so profoundly did not impose any significant reduction in government services.

The state's balanced budgets during this period reflect the remarkable success of combining lower tax rates and increased output, employment, and production with restrained spending. California's experience following Proposition 13 exemplifies the types of pro-growth dynamics that follow sound tax reform. These effects have been experienced at the federal level as well.

The Harding/Coolidge Tax Cuts

In 1913, the federal progressive income tax was put into place with a top marginal rate of 7%. Thanks in part to World War I, this tax rate was quickly increased significantly and peaked at

The real-world experiences of California's Prop 13—as well as the Harding/Coolidge, Kennedy, and Reagan tax cuts/reforms—illustrate the power of reducing marginal income tax rates.

77% in 1918. Then, through a series of tax-rate reductions, the Harding/Coolidge tax cuts dropped the top personal marginal income tax rate to 25% in 1925.

While tax collection data for the National Income and Product Accounts (from the U.S. Bureau of Economic Analysis) do not exist for the 1920s, we do have total federal receipts from the U.S. budget tables. During the four years prior to 1925 (the year the tax cut was fully enacted), inflation-adjusted revenues declined by an average of 9.2% per year. Over the four years following the tax-rate cuts, revenues remained volatile but averaged an inflation-adjusted gain of 0.1% per year. The economy responded strongly to the tax cuts, with output nearly doubling and unemployment falling sharply.

Perhaps most illustrative of the power of the Harding/Coolidge tax cuts was the increase in GDP, the fall in unemployment, and the improvement in the average American's quality of life over this decade. Table 3 demonstrates the remarkable increase in American quality of life, as reflected by the percentage of Americans owning items in 1930 that previously had only been owned by the wealthy (or by no one at all).

Item	1920	1930
Autos	26%	60%
Radios	0%	46%
Electric lighting	35%	68%
Washing machines	8%	24%
Vacuum cleaners	9%	30%
Flush toilets	20%	51%

Source: Stanley Lebergott, *Pursuing Happiness: American Consumers in the Twentieth Century* (Princeton: Princeton University Press, 1993), pp. 102, 113, 130, 137.

The Kennedy Tax Cuts

During the Depression and World War II the top marginal income tax rate rose steadily, peaking at an incredible 94% in 1944 and 1945. The rate remained above 90% well into President John F. Kennedy's term in office, which began in 1961. Kennedy's fiscal policy stance made it clear he was a believer in pro-growth, supply-side tax measures. Kennedy said it all in January of 1963 in the Economic Report of the President:

Tax reduction thus sets off a process that can bring gains for everyone, gains won by mar-

shalling resources that would otherwise stand idle—workers without jobs and farm and factory capacity without markets. Yet many taxpayers seemed prepared to deny the nation the fruits of tax reduction because they question the financial soundness of reducing taxes when the federal budget is already in deficit. Let me make clear why, in today's economy, fiscal prudence and responsibility call for tax reduction even if it temporarily enlarged the federal deficit—why reducing taxes is the best way open to us to increase revenues.¹⁹

Kennedy further reiterated his beliefs in his Tax Message to Congress on January 24, 1963:

In short, this tax program will increase our wealth far more than it increases our public debt. The actual burden of that debt—as measured in relation to our total output—will decline. To continue to increase our debt as a result of inadequate earnings is a sign of weakness. But to borrow prudently in order to invest in a tax revision that will greatly increase our earning power can be a source of strength.²⁰

President Kennedy proposed massive tax-rate reductions which passed Congress and went into law after he was assassinated. The 1964 tax cut reduced the top marginal personal income tax rate from 91% to 70% by 1965. The cut reduced lower-bracket rates as well. In the four years prior to the 1965 tax-rate cuts, federal government income tax revenue, adjusted for inflation, had increased at an average annual rate of 2.1%, while total government income tax revenue (federal plus state and local) had increased 2.6% per year.²¹ In the four years following the tax cut these two measures of revenue growth rose to 8.6% and 9.0%, respectively.²² Government income tax revenue not only increased in the years following the tax cut, it increased at a much faster rate in spite of the tax cuts.

The Kennedy tax cut set the example that Ronald Reagan would follow some 17 years later. By increasing incentives to work, produce, and invest, real GDP growth increased in the years following the tax cuts, more people worked, and the tax base expanded. Additionally, the expenditure side of the budget benefited as well because the unemployment rate was significantly reduced.

Testifying before Congress in 1977, Walter Heller, President Kennedy's Chairman of the Council of Economic Advisors, summed it all up:

What happened to the tax cut in 1965 is

difficult to pin down, but insofar as we are able to isolate it, it did seem to have a tremendously stimulative effect, a multiplied effect on the economy. It was the major factor that led to our running a \$3 billion surplus by the middle of 1965 before escalation in Vietnam struck us. It was a \$12 billion tax cut, which would be about \$33 or \$34 billion in today's terms, and within one year the revenues into the Federal Treasury were already above what they had been before the tax cut.

Did the tax cut pay for itself in increased revenues? I think the evidence is very strong that it did.²³

The Reagan Tax Cuts

In August of 1981, Ronald Reagan signed into law the Economic Recovery Tax Act (ERTA, also known as Kemp-Roth). ERTA slashed marginal earned income tax rates by 25% across the board over a three-year period. The highest marginal tax rate on unearned income dropped to 50% from 70% immediately (the Broadhead Amendment), and the tax rate on capital gains also fell immediately from 28% to 20%. Five percentage points of the 25% cut went into effect on October 1, 1981. An additional 10 percentage points of the cut then went into effect on July 1, 1982, and the final 10 percentage points of the cut began on July 1, 1983.

Looking at the cumulative effects of ERTA in terms of tax (calendar) years, the tax cut provided a reduction in tax rates of 1.25% through the entirety of 1981, 10% through 1982, 20% through 1983, and the full 25% through 1984.

As a provision of ERTA, Reagan also saw to it that the tax brackets were indexed for inflation beginning in 1985.

To properly discern the effects of the tax-rate cuts on the economy, we use the starting date of January 1, 1983, given that the bulk of the cuts were in place on that date. However, a case could be made for a start date of January 1, 1984, the date the full cut was in effect.

These across-the-board marginal tax-rate cuts resulted in higher incentives to work, produce, and invest, and the economy responded. Between 1978 and 1982 the economy grew at a 0.9% rate in real terms, but from 1983 to 1986 this growth rate increased to 4.8%.²⁴

Prior to the tax cut, the economy was choking on high inflation, high interest rates, and high unemployment. All three of these economic bellwethers dropped sharply after the tax cuts. The unemployment rate, which had peaked at 9.7% in 1982, began a steady decline, reaching 7.0% by 1986 and 5.3% when Reagan left office in January 1989.²⁵

Inflation-adjusted revenue growth dramatically improved. Over the four years prior to 1983, federal income tax revenue declined at an average rate of 2.8% per year, and total government income tax revenue declined at an annual rate of 2.6%. Between 1983 and 1986 these figures were a positive 2.7% and 3.5%, respectively.²⁶

The most controversial portion of Reagan's tax revolution was the big drop in the highest marginal income tax rate from 70% when he took office to 28% in 1988. However, Internal Revenue Service data reveal that tax collections from the wealthy, as measured by personal income taxes paid by top percentile earners, increased between 1980 and 1988 despite significantly lower tax rates.

Lessons for Oklahoma's Tax Policy

The real world experiences of California's Proposition 13 or the Harding/Coolidge, Kennedy, and Reagan tax cuts/reforms at the federal level illustrate the power of reducing marginal income tax rates. In Oklahoma, reforms to the state tax code should heed the lessons from the previous major tax reforms.

All tax changes create two primary economic effects. Economists deem these the income effect and the substitution effect. The income effect examines the changed behavior that directly arises from changes in income or wealth. For example, people will tend to increase the amount of consumption in response to an increase in income. The substitution effect examines the changed behavior that arises from changes in the relative costs of different goods or activities. For example, a switch in tax policy that reduces the costs of one good compared to another will provide incentives for people to consume more of the former at the expense of the latter.

Any proposed tax reform will have both income and substitution effects. The tax reform should

Tax and spending reforms should be implemented that leverage the lessons from Oklahoma's state tax policy history.

reduce the penalty from additional work, savings, and investment and subsequently encourage increased

- Work effort
- Work demand (and, subsequently, wages)
- Savings
- Investment (and, subsequently, greater capital accumulation)

For any economic decision (i.e., work effort, saving, or investing) the marginal tax rate on the next dollar earned is crucial. To see why the marginal tax rate matters, imagine the work or investing incentives a person would face if the marginal tax rate on the next dollar earned was 100.0 percent. Under this scenario, every extra dollar a person earns would go straight to the government. Regardless if the tax rate on the previous dollar earned was zero, there is very little incentive for anyone to work, save, or invest under such a punitive tax rate. Now imagine the work or investing incentives a person would face if the marginal tax rate on the next dollar earned was zero. Under this scenario, the investor or worker would get to keep the full value of the income or return that they earned. Obviously, the second scenario is more favorable to the worker or investor than the first.

The proposed tax reforms should increase the after-tax income for the next dollar earned, raise the reward to work, and thereby increase the cost of leisure—the cost of leisure can be measured by the amount of other consumption goods that people could purchase (e.g., sending the kids to a better school or purchasing a high-definition TV) with the extra work effort. This opportunity cost to leisure increases following a decrease in the marginal income tax rate. Whenever a good's cost increases, rational people will economize on its use. These incentives are encapsulated by the aforementioned substitution effect that induces people to work more. Because the substitution effect captures the trade-off between work and leisure, it is the marginal tax rate (the amount of extra consumption that a person must give up by not working) that is the appropriate incentive driver.

Government revenues are not immune from the incentive drivers either. Tax collections are a game of cat and mouse—the individual wants to maximize his return on labor (after-tax income) and the government wants to maximize revenues it receives from the working individual. It is clear that the government will raise no revenue by

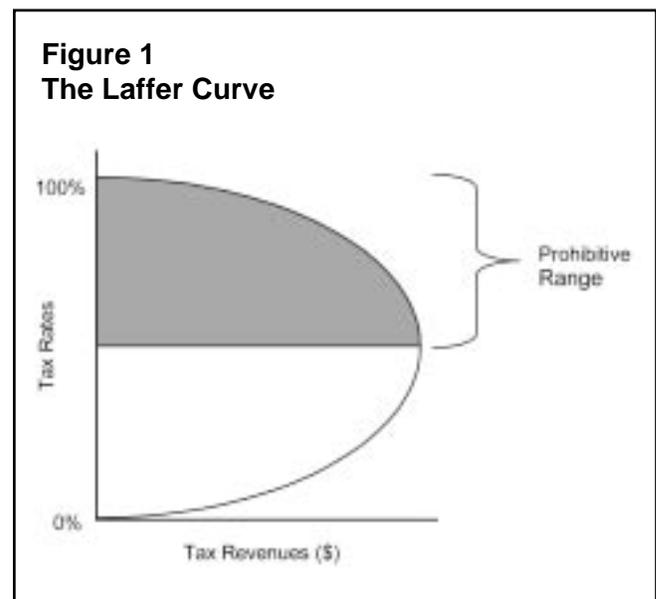
levying a zero percent tax on income; the government takes none of the income earned, so government revenues are zero. Similarly, the government can expect to raise no revenue by levying a 100.0 percent tax on income; there is no incentive for anyone to work, so taking 100 percent of nothing is still nothing. This effect (i.e., the Laffer Curve Effect) incorporates the economy's dynamic realities and importantly illustrates that government revenues are not always raised when the marginal tax rate is increased (see Figure 1).

Government revenues can be significantly enhanced when tax reforms lead to positive growth-enhancing incentives that grow the tax base. The government will, consequently, share in the beneficial growth impacts. The resulting growth in the economy, and consequently the consumption base, will lead to a larger tax base and even larger revenues over the aforementioned static estimates.

Pro-Growth Fiscal Policy Criteria

The following economic policy "checklist" contains general rules that summarize what's been learned from historical experiences which will guide the recommendations that follow:

- During prosperous times, life is relatively easy in the state legislatures, as high levels of economic activity result in abundant tax revenues and spending that often grows unrestrained with few consequences; it is during the bad times that flaws are exposed. Bad times expose fiscal flaws, spending flaws, pension flaws, and, yes, flaws in the tax codes.



- There is never truly a good time to raise taxes, but raising taxes during difficult times is especially bad. Tax increases serve to only worsen economic downturns. By raising taxes during depressed economic conditions, employers and employees face additional impediments just to keep from moving backwards. It makes no sense to raise taxes on the last three people working. People don't work to pay taxes, nor do businesses locate their plant facilities as a matter of social conscience. People work to earn what they can—after all taxes. During tough times after-tax earnings are depressed naturally, which is why unemployment rates are so high. Piling on more taxes only exacerbates the problem. Businesses locate their plant facilities to make after-tax returns for their owners. During depressed times, businesses are often desperate to reduce costs because of a shortfall in revenues. Increased taxes in one location can be the final straw leading to businesses relocating to more tax-friendly locations or to make the ultimate decision to close down operations.
- Raising tax revenues is far from cost free. Obviously, when tax rates on an activity are raised, the volume of that activity shrinks, leading to a revenue offset. There are also substantial collection costs to both the government and the taxpayer from raising taxes, which result in less money being collected than is paid. To the extent taxpayers seek to avoid or evade taxes, or otherwise shelter and hide their taxable income, the amount of additional revenues is also greatly reduced and can, in fact, end up costing the government money directly as a consequence of raising taxes. Capital flight and labor flight, along with companies going out of business, are classic responses to increased taxation at the state and local levels. In many of these cases the state and local governments actually lose revenues when they raise taxes.

Figure 2
Average Growth in State GDP
Oklahoma Compared to U.S. and Neighbors, 1997 – 2006

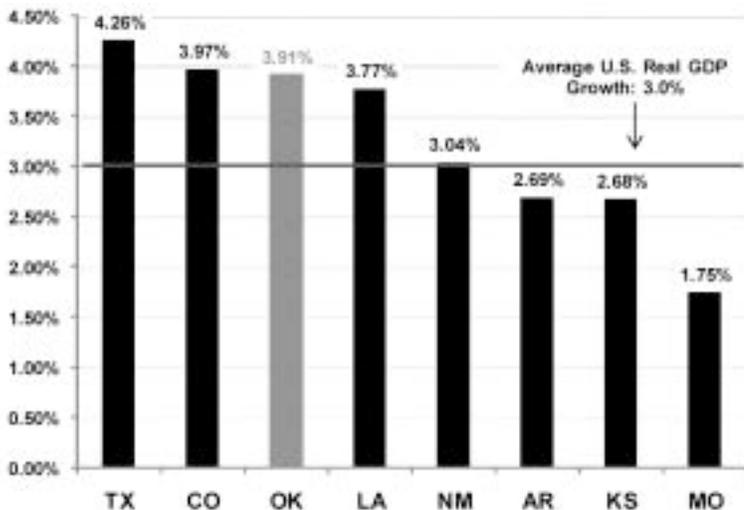
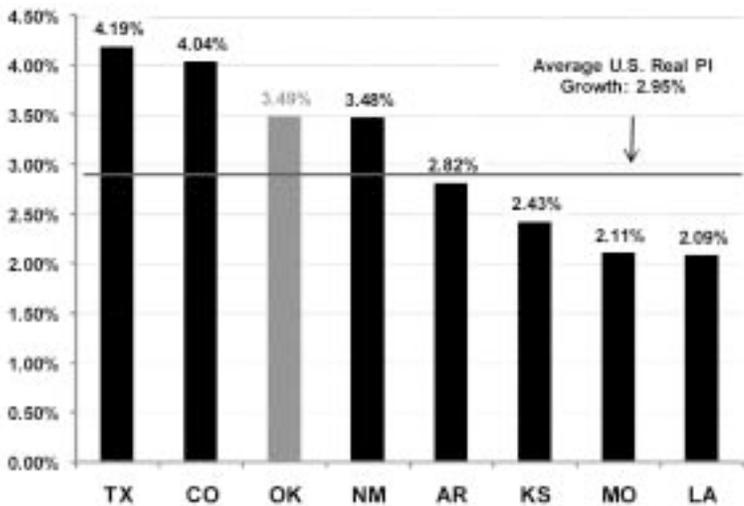


Figure 3
Average Growth in State Personal Income
Oklahoma Compared to U.S. and Neighbors, 1997 – 2006



- If raising taxes were actually to improve a state's fiscal circumstances, it would do so by worsening the fiscal circumstances of those it governs. No phrase is more important for government to adhere to than *primum non nocere* (first of all do no harm). Balancing the government's budget by unbalancing its citizens' budgets is contrary to the tax policy goals

of promoting growth and fairness.

- Almost without exception, states underestimate revenues during good times and overestimate revenues during bad times. As a result of overestimating revenues during bad times, politicians believe their fiscal circumstances are less severe than they actually are, leading to spending above and beyond revenues or delays in implementing spending cuts when they are desperately needed. Then, when deficits later appear, state legislators often turn to higher taxes, which in turn result in deeper declines in the economy, revenues again falling short of expectations, and a continuation of the spend-and-tax cycle.
 - Raising tax rates, especially during difficult times when tax increases are most frequently considered, virtually always deludes politicians into believing that more revenues will materialize than actually do. Cutting tax rates does the opposite. Static revenue estimates always assume that no one's behavior will change, and therefore a 10% tax increase will increase tax revenues 10%. In fact, this is never true. The dynamic effects of slower growth, reduced profitability, higher unemployment (and its associated costs), and tax evasion and avoidance, just to name a few, combine to ensure that actual revenues fall short of forecasted revenues.
 - A tax system—such as a flat single rate tax system without deductions—that avoids excessive revenues during good times will not tempt politicians to build up expensive spending programs that in turn will be unaffordable during tough times. It is the volatility of spending, whereby spending actually is cut during bad times, that causes so much hardship among those most vulnerable. A flat tax with modest rainy day provisions may well be the most moral as well as the most productive tax structure.
- It is important to keep these points in mind. An understanding of the relationship between state

Figure 4
Average Growth in State Employment
Oklahoma Compared to U.S. and Neighbors, 1997 – 2006

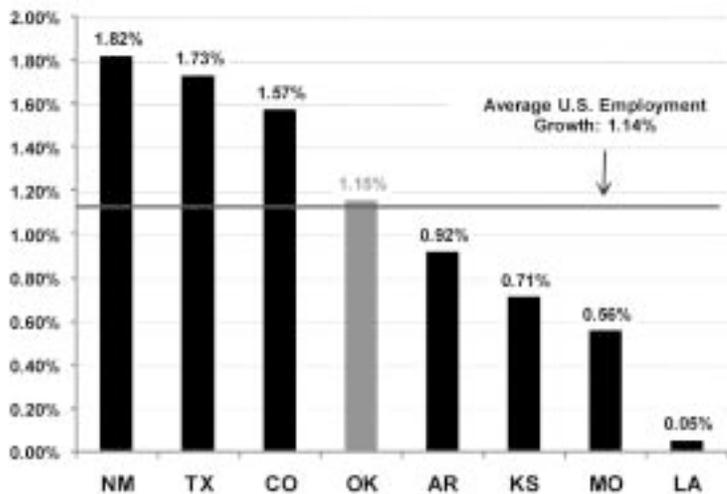
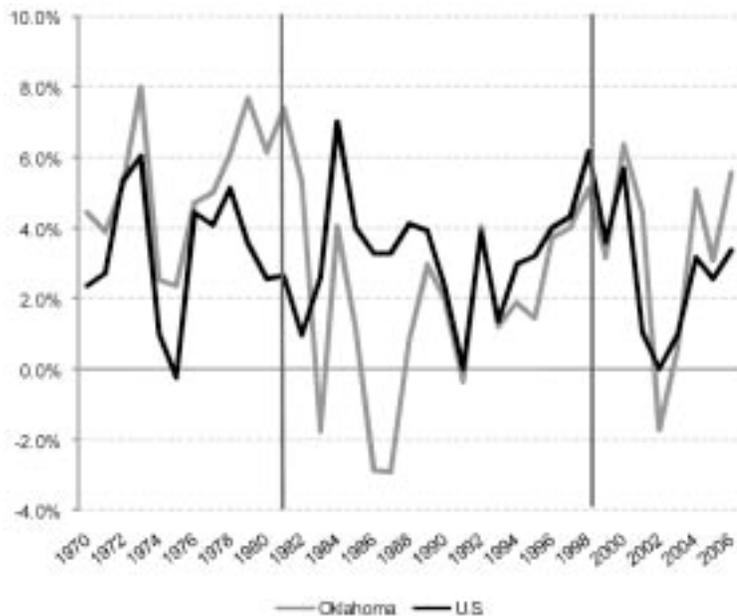


Figure 5
Average Growth in State Personal Income
Oklahoma versus the U.S., 1970 – 2006



Source: Bureau of Economic Analysis, National Income and Product Accounts, www.bea.gov

policies, economic performance, and asset values is vital.

Applying the Pro-Growth Lessons to Oklahoma

As of late, Oklahoma's economic record has been strong. Since 2002, Oklahoma's economy has been the sixth fastest growing state economy

in the nation. This fact holds true whether economic performance is measured by overall economic activity (state GDP) or by income growth of residents (personal income). These trends are presented in Figures 2 and 3.

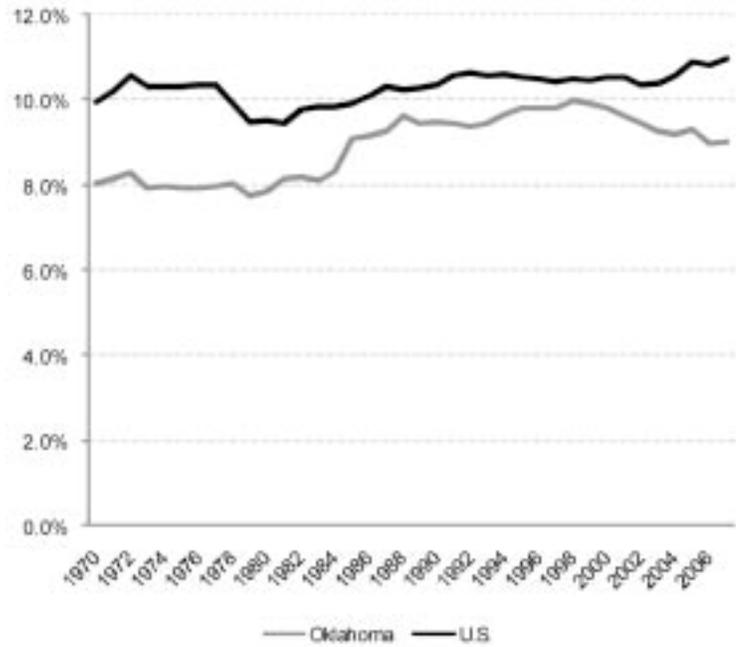
When it comes to jobs (growth in non-farm employment), Oklahoma's relative performance slackens compared to overall economic and income growth. As illustrated in Figure 4, overall employment growth in Oklahoma has barely outpaced the average employment growth in the country. From a jobs perspective, Oklahoma can do better.

Oklahoma's relative economic performance has not always been as stellar as it has been recently; for many years, economic growth in the state lagged overall economic growth in the country (see Figure 5).

According to the Tax Foundation, Oklahoma's residents have always faced a relatively smaller state and local tax burden (measured by total state and local tax revenues divided by total state personal income). However, as Figure 6 illustrates, there are three distinct trends regarding Oklahoma's relative tax burden. Between 1970 and 1980 Oklahoma's relative tax burden is stable and below the U.S. average. Beginning in 1981, Oklahoma's state and local tax burden began to rise consistently, at a much faster pace than the nation as a whole, and almost reached the national average in 1998. Beginning in 1998, the overall state and local tax burden began falling in Oklahoma, while it has been rising for the nation as a whole.

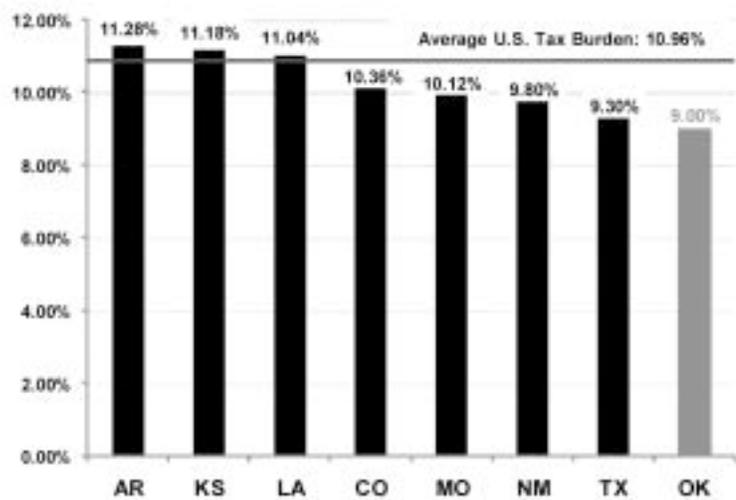
Figure 5 takes a longer-run view of Oklahoma's relative growth in personal income compared to overall personal income growth in the U.S. The two vertical lines in Figure 5 divide the 1970 to 2006 into three distinct time periods. Oklahoma's personal income growth exceeded overall personal income growth in the U.S. between 1970 and the early 1980s. Between 1982 and 1998, the reverse occurred—Oklahoma almost universally grew slower than the rest of the

Figure 6
Average State and Local Tax Burden
Oklahoma versus the U.S., 1970 – 2006



Source: U.S. Census Bureau, State and Local Government Finances, www.census.gov

Figure 7
Total Tax Burden as a Percentage of Personal Income
Oklahoma Compared to U.S. and Neighbors, 2007



country. Beginning around 1999 this trend reversed itself again (although the 2001 recession and its aftermath had a particularly large impact on the state), and Oklahoma is once again growing faster than the nation as a whole.

Oklahoma's relative economic performance

over the past 37 years has not been random. As the theories described above illustrate, states that impose rising tax burdens experience declining economic growth, and states that reduce tax burdens experience increasing economic growth. Oklahoma exemplifies this relationship since 1970.

Combining the results of Figures 5 and 6, the three distinct periods evident in Figure 5 are aligned with the three distinct periods in Figure 6. When Oklahoma's tax burden is rising relative to the national average, the state's economy is underperforming the national average; conversely, when Oklahoma's tax burden is falling relative to the national average, the state's economy is outperforming the national average. Going forward, tax and spending reforms should be implemented that leverage these lessons from Oklahoma's state tax policy history.

From an overall perspective, compared to other states' tax and regulatory policies, Oklahoma's tax policies are solid. However, there are areas for improvement. Addressing these areas will help ensure the positive economic outcomes that Oklahoma has been experiencing continue, as opposed to reversing to the poorer economic performance of the past.

Oklahoma's Tax Burden

While Oklahoma's tax system has been improving, and its tax burden as a percentage of state income has fallen, there are a variety of concerns. Additionally, other states in Oklahoma's region (especially Texas) have very competitive tax systems. In consequence, it is important to see how Oklahoma's tax system stacks up in its region and nationally.

As Figure 6 illustrates, Oklahoma imposes a relatively small state and local tax burden on its citizens. According to the Tax Foundation, total state and local taxes comprised 9.0% of total personal income in 2007, which is the sixth smallest tax burden in the nation and substantially smaller than all of Oklahoma's neighbors (see Figure 7).²⁷

Top Marginal Personal Income Tax Rate

While Oklahoma's overall tax burden is very competitive, the state's top marginal income tax rate is less so. Compared to Oklahoma's neighbors, four states (Arkansas, Kansas, Missouri, and Louisiana) have higher top marginal income tax rates, but three states (New Mexico, Colorado, and Texas) have lower top marginal income tax rates (see figure 8). Oklahoma's top marginal income tax rate is also higher than the average top

marginal income tax rate in the nation by over 0.16 percentage points or \$1.60 in higher taxes for every \$1,000 earned.

Top marginal income tax rates are not necessarily comparable. For instance, California's top rate does not apply until an income of \$1 million, while Pennsylvania imposes a flat income tax of 3.07%. The median top bracket becomes effective once an income of \$25,000 has been reached.

Ideally, states will tax the largest possible tax base at the lowest possible tax rate. Personal income tax codes often fall far short of this economic ideal. Despite the fact that both might generate a similar revenue stream, the tax structure of a state which imposes a low flat-rate tax on a broad range of personal income provides greater economic efficiency and growth incentives, and subsequently experiences greater economic performance than the tax structure of a state with a narrow, highly progressive personal income tax.

Oklahoma's top bracket becomes effective at \$8,700 of income. Since that's below the annual salary for someone earning minimum wage, most people face a flat 5.65% marginal income tax for most of their income earned.

Sales Tax Rate and Burden

Due to the differences in state sales tax bases and the complexity that local sales taxes add, we compare Oklahoma's sales tax burden using two different measures: state and local sales tax rates, and state and local sales tax revenues per \$1,000 of personal income. Table 4 compares Oklahoma's state and local sales tax rate to its neighbors based on the lowest combined state and local sales tax rates, as well as the highest combined state and local sales tax rates.

Table 4
Minimum and Maximum State and Local Sales Tax Rates
Oklahoma Compared to U.S. and Neighbors, 2007

	Minimum State and Local Sales Tax Rate	Maximum State and Local Sales Tax Rate
Arkansas	6.00%	11.50%
Colorado	2.90%	9.90%
Kansas	5.30%	8.30%
Louisiana	4.00%	10.75%
Missouri	4.28%	8.98%
New Mexico	5.13%	7.88%
Oklahoma	4.50%	10.50%
Texas	6.25%	8.25%
U.S. Average	5.00%	7.01%

When the areas with the minimum state and local sales tax rates are compared, Oklahoma's minimum state and local sales tax rate of 4.50% compares favorably both to the average U.S. rate and to its neighbors—the only neighbors that have lower minimum state and local sales tax rates are Colorado, Louisiana, and Missouri. However, when comparing those localities with the highest state and local sales tax rates, Oklahoma looks less favorable. Oklahoma's localities with the highest combined state and local sales tax rates (10.5%) are above the national average, and only two states (Arkansas and Louisiana) have a higher maximum combined state and local sales tax rate.

Total sales tax revenue per \$1,000 of personal income provides a measure of the pervasiveness of the low versus high combined state and local sales tax rates. Figure 9 compares the sales tax burden per \$1,000 of personal income in Oklahoma to its neighbors, as well as the U.S. average.

Figure 9 illustrates that Oklahoma and its neighbors impose a relatively high sales tax burden compared to the country as a whole. However, Oklahoma's overall tax burden is well below the states with the highest burdens—Louisiana, Arkansas, and New Mexico. **Combination Tax Rate**

The above review of the main state tax revenue sources—individual income taxes and sales taxes—does not provide an immediate answer with respect to which state has a more competitive tax system. In order to grasp this more fully we have constructed a "combination" tax index in Tables 5 and 6. The combination tax index shows the marginal tax bite for the major tax systems (personal income and sales taxes) combined.²⁸

The combination tax would be appropriate for a wage earner or someone who is receiving income that does not pass through the Oklahoma (or other states) corporate income tax system. In Oklahoma, a person earning above \$8,700 a year would confront a 5.65% top marginal income tax

Figure 8
Top Marginal Personal Income Tax Rate
Oklahoma Compared to U.S. and Neighbors, 2007

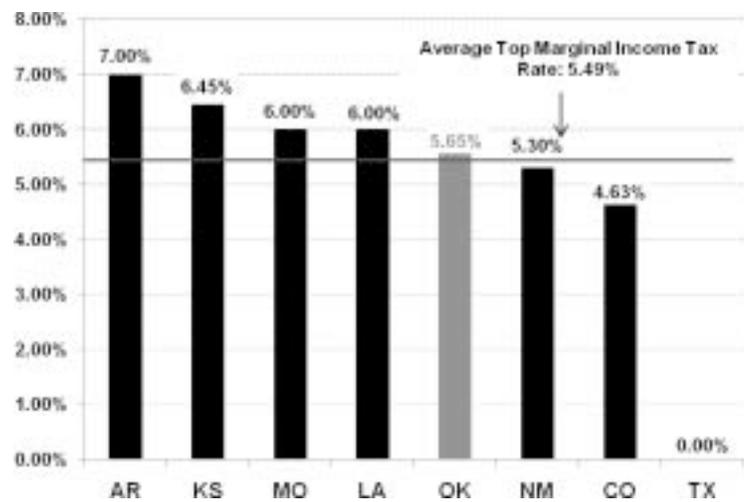
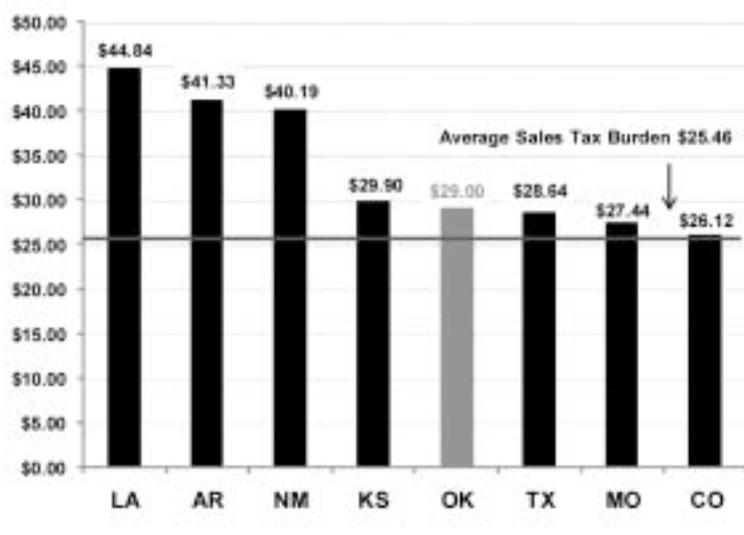


Figure 9
State and Local Sales Tax Burden per \$1,000 of Personal Income,
Oklahoma Compared to U.S. and Neighbors, 2007



rate, and when this after-tax income is consumed, would have to confront the state and local sales taxes between 4.50% and 10.50%. According to the Tax Foundation, the weighted average local tax rate in Oklahoma is 2.39%, for a total state and local sales tax burden of 6.89%. The rates for Oklahoma and its neighbors are summarized in Table 5.

Based on the values in Table 5, we calculate the combination tax. The combination tax

calculates the amount of money that the state and local income and sales taxes take for every \$100 of earnings in the respective states, assuming that the income earnings face the highest state marginal income tax rate. The average state and local sales tax rate is adjusted because not all income is spent on goods and services that pay a state and local sales tax, and this percentage varies by state. Total state sales tax rates are adjusted based on each state's sales tax base as a percentage of GDP. For instance, in Oklahoma, the 4.5% state sales tax rate raised \$1.8 billion in 2006.²⁹ This implies a sales tax base of \$40 billion. Total state GDP in Oklahoma was \$134.7 billion in 2006. Consequently, the sales tax base was 29.7% of total state GDP. The 29.7% figure is applied to the combined state and local sales tax rate to account for the 70% of all income in Oklahoma

that is not part of the state sales tax base.

The results of the personal combination tax are summarized in Table 6. In Oklahoma, when a person facing the top state marginal income tax rate earns \$100, he must pay the personal income tax of 5.65%, or \$5.65 in income taxes. This leaves the person with \$94.35 of income (disregarding the effect of federal taxes). The 6.89% state and local sales tax (applied to 29.7% of all income) subtracts another \$1.92, leaving \$92.42 in after-tax income for the individual.

Oklahoma ranks in the middle of the region taking 7.58% of each marginal dollar earned through income and sales taxes, based on the combination tax rate. Perhaps more troubling, Oklahoma's combination tax is very uncompetitive compared to Texas and Colorado. Additionally, according to the personal combination tax, Oklahoma exceeds the national average by 0.09 percentage points.

Entrepreneurs, as opposed to locating in Oklahoma, could settle in Texas, where the combination marginal tax rate is significantly less than the tax rates they would face in Oklahoma. Or our entrepreneurs could settle in Colorado, where the combination tax rate is about 24% smaller. The comparison of Oklahoma's combination tax rates indicates that the state should lower these costs in order to induce more businesses and economic activity into Oklahoma.

Top Marginal Corporate Income Tax Rate

As opposed to the top personal income tax rate, Oklahoma imposes a top marginal corporate income tax rate that is below the national average. However, compared to its neighbors, Oklahoma's

	Personal Income Tax Top Rate	Weighted Average State and Local Sales Tax Rate
Arkansas	7.00%	7.37%
Colorado	4.63%	3.83%
Kansas	6.45%	6.84%
Louisiana	6.00%	8.03%
Missouri	6.00%	7.17%
New Mexico	5.30%	5.97%
Oklahoma	5.65%	6.89%
Texas	0.00%	6.69%
U.S.	5.49%	5.94%

	Starting Personal Income	Personal Income - Personal Income Tax	Personal Income - Personal Income Tax - Sales Tax Burden	Personal Combination Rate
Arkansas	\$100.00	\$93.00	\$89.55	10.45%
Louisiana	\$100.00	\$94.00	\$90.65	9.35%
Kansas	\$100.00	\$93.55	\$91.25	8.75%
Missouri	\$100.00	\$94.00	\$91.81	8.19%
New Mexico	\$100.00	\$94.70	\$92.11	7.89%
Oklahoma	\$100.00	\$94.35	\$92.42	7.58%
Colorado	\$100.00	\$95.37	\$94.22	5.78%
Texas	\$100.00	\$100.00	\$98.36	1.64%
U.S.	\$100.00	\$94.51	\$92.51	7.49%

Source: ALME Calculation

top marginal corporate income tax rate is less competitive, with three neighbors having lower top marginal income tax rates (see Figure 10).

Capital Gains Taxes

Oklahoma taxes capital gains (whether they are short-term or long-term) at 5.65% (see Figure 11). Compared to Oklahoma’s neighbors, four states have higher capital gains taxes, and three states have a higher capital gains tax on long-term capital gains. Nationally, Oklahoma’s capital gains taxes are around 16-20 percent higher than the average state capital gains tax.

Capital gains taxes discourage investment and, due to their volatility, lead to significant revenue swings for the state. Additionally, income, sales, and severance taxes account for nearly 85% of total state tax revenues. As a consequence, the minimal amount of revenue that Oklahoma raises from capital gains taxes come at a high economic cost.

Property Tax Burden

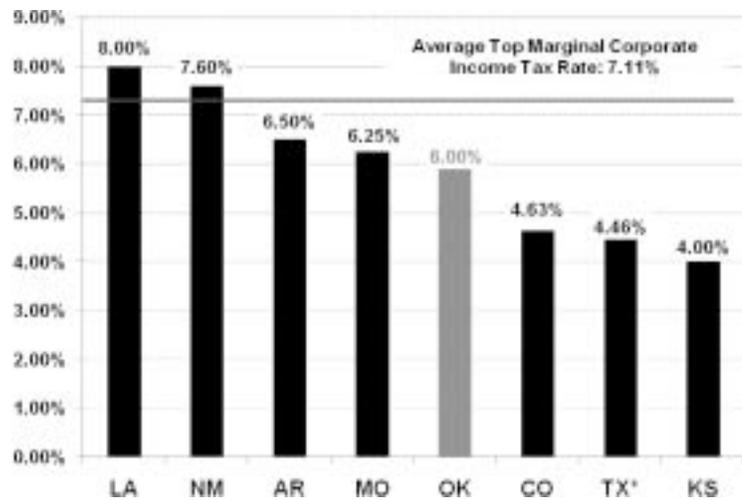
In 2006, Oklahoma’s property tax burden is \$17.06 per \$1,000 of personal income (see Figure 12). Compared to the nation as a whole, this is the fourth smallest property tax burden, and Arkansas is the only neighbor that has a smaller property tax burden than Oklahoma. However, most of Oklahoma’s neighbors have low property tax burdens. The exceptions are Texas and Kansas, which have higher than average property tax burdens.

Oklahoma’s low property tax burden has played an important role in keeping Oklahoma’s overall tax burden below the national average. As such, the property tax burden is a significant competitive advantage both nationally and compared to the majority of its neighbors.

Regulatory Burdens

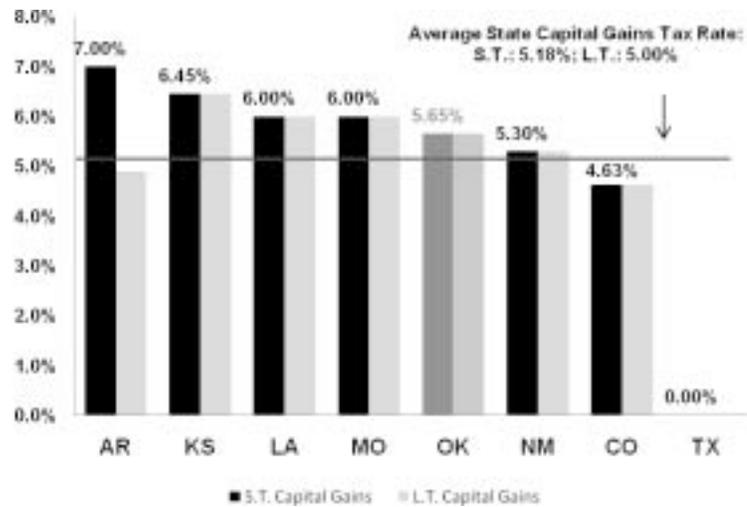
Regulatory burdens can also create positive or negative economic incentives. Burdensome regulations that increase business costs excessively will tend to reduce overall economic incentives, while the opposite will tend to increase overall economic incentives. In this examination,

Figure 10
Top Marginal Corporate Income Tax Rate
Oklahoma Compared to U.S. and Neighbors, 2007



*Texas imposes a 1.0% tax on the gross receipts on all companies (GRT). To put this rate on a comparable basis, we scaled the Texas’ GRT up by the ratio of national income to total corporate profits, proprietor’s income and rental income.

Figure 11
Short-term and Long-term Capital Gains Tax Rates
Oklahoma Compared to U.S. and Neighbors, 2007



we focus on four regulatory-type costs that tend to have important impacts on a state’s overall economic competitiveness: the state liability tort system, state minimum wage, worker’s compensation costs, and whether the state is a “right to work” state. Overall, Oklahoma ranks below average with respect to the regulatory costs the state imposes on businesses due to the additional

costs of its tort system and higher-than-average worker's compensation costs.

In order to assess Oklahoma's state tort system, ALME relied upon a tort system survey performed by the U.S. Chamber of Commerce. Based on this study, the Laffer Associates study ranks Oklahoma 38th (out of 50). This below-average rank indicates that Oklahoma's tort liability system adds greater than average costs to businesses that operate in Oklahoma, compared to businesses that operate in other states. This places Oklahoma at a distinct competitive disadvantage when it comes to attracting businesses and jobs to the state.

Worker's compensation costs impose additional costs on employers in Oklahoma. When employers consider hiring additional workers, it is the total cost from increasing employment that is relevant, which includes all salaries, benefits, taxes, and regulatory costs. Worker's compensation increases the costs of employing additional workers; consequently, these regulations increase overall unemployment and decrease a state's potential economic growth. Oklahoma again ranks 38th (out of 50) with respect to the additional costs it imposes on employers due to worker's compensation. Along with the higher tort liability costs, the worker's compensation costs are another barrier to business and job creation in Oklahoma.

On the positive side, Oklahoma mandates that businesses in the state meet only the federal minimum wage standard. Minimum wage laws can have only one of two effects: either the minimum wage is below the wage that would be paid to any employee and is irrelevant, or the minimum wage law raises the wage costs for employers, leading to greater unemployment. By imposing the federal minimum wage, Oklahoma is not unnecessarily increasing employer costs. In so doing, business flexibility is increased, and overall employment in the state is enhanced.

Oklahoma is also a "right to work" state. This law prohibits trade union membership from being

Figure 12
Property Tax Burden per \$1,000 of Personal Income
Oklahoma Compared to U.S. and Neighbors, 2007

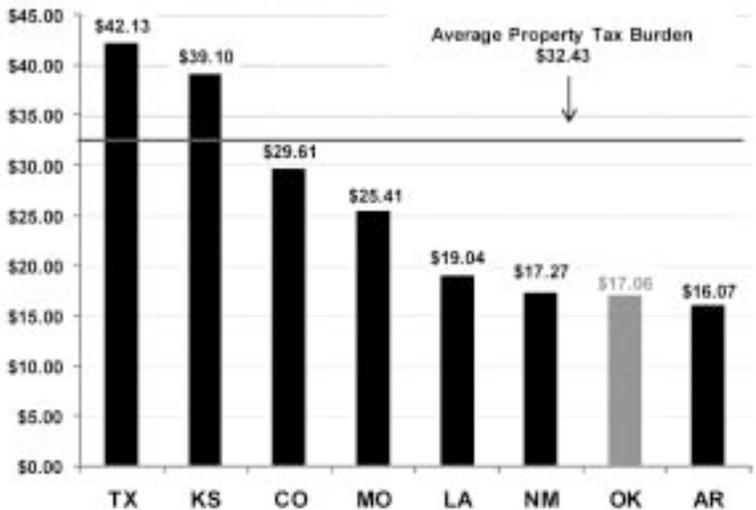
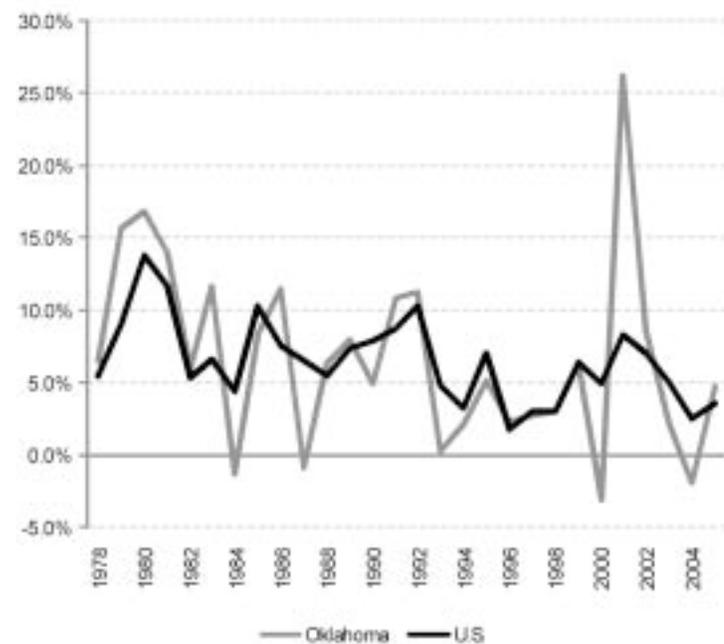


Figure 13
Growth in State Spending Per Capita
Oklahoma Compared to U.S., 1978 – 2005



a prerequisite for employment, which, if allowed, would adversely affect overall employment and economic growth.

Spending Discipline

Lastly, fiscal discipline in Oklahoma compared to the national average has been competitive,

when compared over a long time period. Figure 13 traces out the growth in spending per capita in Oklahoma compared to the average state spending growth. As Figure 13 shows, per capita spending growth in Oklahoma between 1978 and 2001 had been generally around the average state growth in expenditures per capita, and sometimes even below average.

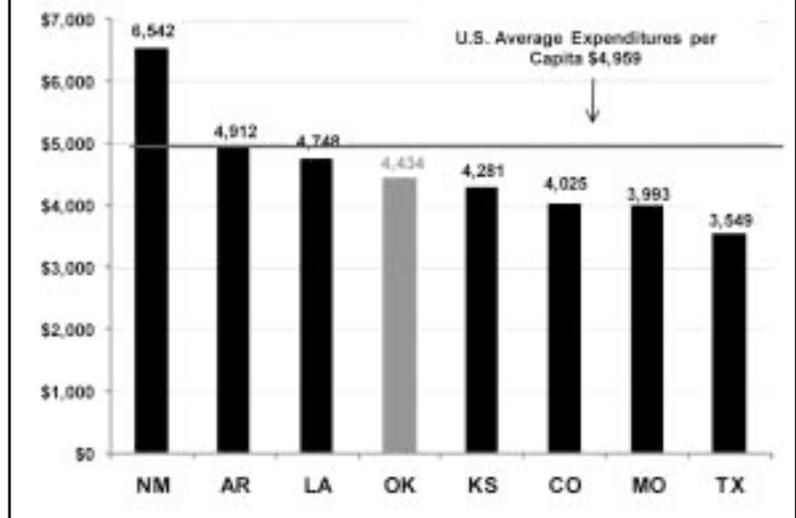
However, expenditures in 2001 spiked, both in absolute and relative terms. According to the U.S. Census, the driver of this spending spike was an increase in public welfare expenditures that increased from \$911 million in 2000 to \$2.7 billion in 2001. Since the spending spike in 2001, per capita spending has appeared to return to its typical pattern for state and local spending; however, state spending has been generally above trend. Overall, state spending in Oklahoma grew 8.1% between 2000 and 2005, compared to 6.3% for the average state in the nation.

Through 2005, Oklahoma's total expenditures per capita (\$4,434) were below the national average of \$4,959 (see Figure 14). While such an expenditure level is competitive on a national basis, it is above average compared to several of Oklahoma's neighbors—especially Colorado, Missouri, and Texas.

The spending discrepancy with Texas and Colorado is especially disconcerting. Except for Oklahoma's lower property tax burden, Texas and Colorado have lower capital gains tax rates, lower top marginal corporate income tax rates, and a lower combination tax rate (top personal marginal income tax and sales tax). Increasing overall tax competitiveness vis-à-vis these states is enhanced by implementing increased spending control that brings overall spending per capita in line with Texas and Colorado—the two neighbors that have tax systems that are more competitive and pro-growth than Oklahoma.

Additionally, the expenditure data from the U.S. Census is only current through 2005. Since 2005, the spending record of Oklahoma has worsened, making the imperative to control spending more urgent. Based on the 2006 Comprehensive Annual Financial Report, total expenditures in 2006 accelerated, growing 10.1% in 2006 compared to

Figure 14
Average Expenditures per Capita
Oklahoma Compared to U.S. and Neighbors, 2005



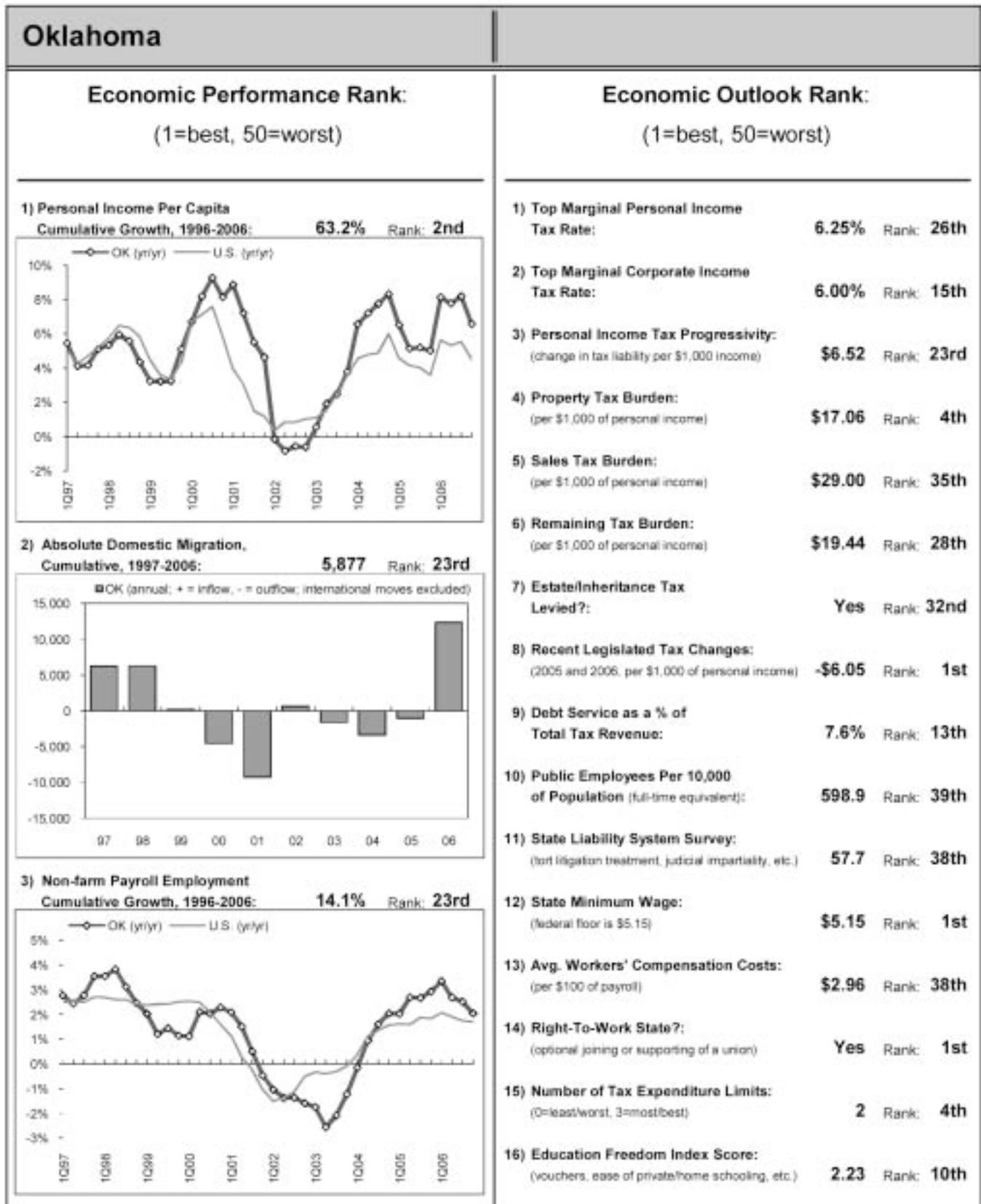
2005.³⁰ Such expenditure growth worsens Oklahoma's disadvantage, compared to neighboring Texas and Colorado, and reduces the state's competitiveness vis-à-vis the remainder of the country. Consequently, controlling state spending is an important step for ensuring a continuation of Oklahoma's recent strong economic performance.

Ideas for restraining spending in Oklahoma are not wanting. For instance, the Oklahoma Council of Public Affairs presented a detailed spending budget for FY2007 that would limit spending to a 4.2% increase (inflation plus population growth in Oklahoma).³¹ This proposal represents large potential savings that could significantly help increase Oklahoma's economic competitiveness.

Tax Reform Suggestions

Figure 15 summarizes Oklahoma's relative economic performance and environment for 16 key policy variables—which include many of the tax and regulatory policies discussed above. As shown in Figure 15, Oklahoma's fiscal and regulatory policies are competitive nationally in certain areas—especially the property tax burden and recent tax reductions. However, as discussed in more detail above, there are areas for improvement. Combining the theory of pro-growth tax policies with our review of Oklahoma's tax system provides several observations with respect to tax reform. These observations include:

Figure 15. Oklahoma Fiscal and Economic Performance and Rank, 2007



- Oklahoma's low overall state and local tax burden and low property tax burden are important competitive advantages for the state, which should be maintained.
- The state's top marginal personal income and corporate income tax rates are too high, especially compared to neighboring Texas and Colorado. Tax reforms should lower these top marginal tax rates to bring them closer in line with neighboring Texas and Colorado.
- The personal income tax has seven tax brackets, which is progressive. In general, progressive tax structures add significant complexity to the tax code, while the higher top marginal income tax rates tend to diminish pro-growth incentives throughout the economy. In Oklahoma, the top marginal personal income tax rate becomes effective at \$8,700 for a single filer, which is less than the annual salary for a full-time minimum wage worker. The low income threshold for the top marginal income tax in Oklahoma creates an additional argument

- for eliminating the progressive income tax structure in Oklahoma and replacing the complex structure with a simpler flat tax rate.
- Oklahoma imposes a relatively high capital gains tax rate. This rate should be reduced and, at a bare minimum, brought into line with the capital gains taxes that are imposed in neighboring states.
- While Oklahoma's spending record has, traditionally, been competitive from a national perspective, overall spending has been growing at a troubling pace. Furthermore, spending per capita in the state has been above several key neighbors, including Texas and Colorado. In order to enhance the effectiveness of the pro-growth tax reforms suggested above, the per capita spending of state and local governments should be brought in line with Texas and Colorado.

—This study was conducted for OCPA by the firm
 Arduin, Laffer & Moore Econometrics
 (arduinlaffermoore.com).

Footnotes

¹George, Henry. *Progress and Poverty*.

²Ibid.

³Based on 2006 data across all 50 states, every 1.0 percentage point increase in the top marginal income tax rate was associated with a reduction in total economic growth of 0.08%, on average.

⁴Keynes, John Maynard (1972). *The Collected Writings of John Maynard Keynes*. London: Macmillan Cambridge University Press.

⁵Laffer, Arthur B. (1978). *Revitalizing California's Economy: A Discussion of the Impact of Proposition 13*. United Organization of Taxpayers. March 22.

⁶ALME calculation based on data from the U.S. Census, State and Local Government Finances, www.census.gov, and Bureau of Economic Analysis, www.bea.gov.

⁷Bureau of Economic Analysis, www.bea.gov.

⁸Ibid.

⁹Bureau of Labor Statistics, www.bls.gov.

¹⁰Bureau of Labor Statistics, www.bls.gov.

¹¹U.S. Department of Census, www.census.gov.

¹²U.S. Bureau of Economic Analysis; Housing prices from California Association of Realtors, National Association of Realtors and the Office of Federal Housing Enterprise Oversight.

¹³Ibid.

¹⁴U.S. Census Bureau, State and Local Government Finances, www.census.gov.

¹⁵Ibid.

¹⁶U.S. Census Bureau, State and Local Government Finances, www.census.gov.

¹⁷Ibid.

¹⁸Ibid.

¹⁹The White House (1963). *Economic Report of the President: Together With the Annual Report of the Council of Economic Advisors*. January.

²⁰Kennedy, John F. (1963). *Special Message to the Congress on Tax Reduction and Reform*. January 24.

²¹Bureau of Economic Analysis, National Income and Product Accounts, www.bea.gov.

²²Ibid.

²³Heller, Walter (1977). *Testimony before the Joint Economic Committee, U.S. Congress*; quoted in Bartlett, Bruce (1978). *National Review*, October 27.

²⁴Bureau of Economic Analysis, National Income and Product Accounts, www.bea.gov.

²⁵Bureau of Labor Statistics, www.bls.gov.

²⁶Bureau of Economic Analysis, National Income and Product Accounts, www.bea.gov.

²⁷Tax Foundation, <http://www.taxfoundation.org/taxdata/>.

²⁸The combination tax rate does not account for corporate income, dividend, and capital gains taxes. Nor does the combination tax incorporate property taxes, which are exceptionally low in Oklahoma. As designed, the combination tax provides a means to compare the marginal tax rates across states for the personal income and sales tax only.

²⁹State Government Tax Collections Data, U.S. Census, www.census.gov.

³⁰Henry, Brad (2006). 2006 Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2006. Office of State Finance.

³¹The Oklahoma Council of Public Affairs provides perspective on the problems and consequences of excessive spending growth in Oklahoma and provides a detailed budget that allocates budget authority across departments while maintaining the overall 4.2% expenditure cap; see Anderson, Steve, Brandon Dutcher, and Grant Gulibon (2007). *OCPA State Budget: A State Budget That Respects Your Family Budget*. Oklahoma Council of Public Affairs.

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