

**REVENUE-NEUTRAL TAX REFORM FOR OKLAHOMA:  
ISSUES AND OPTIONS**

**FINAL REPORT**

**A STUDY**

**FOR**

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## EXECUTIVE SUMMARY

This study is undertaken to determine the most promising revenue sources to replace revenues that would be lost if Oklahoma:

- eliminated the individual income tax,
- exempted grocery purchases from the state sales tax, and
- replaced the rates currently in the Oklahoma Estate Tax Code with rates equal to the maximum allowable credits under the Federal Estate Tax Code, making Oklahoma a so-called "pick-up" state.

Simulations of Oklahoma tax collections indicate that these changes would produce revenue losses of \$2.65 billion in 2002 and that these losses would grow steadily to \$4.16 billion by 2010. Ideally, the state would identify replacement revenues that:

- achieve revenue neutrality,
- improve the tax system according to well-known tax criteria, and
- minimize interference with existing tax institutions.

Revenue neutrality requires the attainment of a ratio of taxes to income with replacement revenues that is the same as the ratio of taxes to income provided by the current tax system. If this were done, there would be no effect of the replacement revenues on the size of government relative to the private sector.

According to tax criteria, the ideal change in the tax system is one that would:

- increase revenue stability,
- increase the percentage of the tax burden that is exported to residents of other states or countries,
- promote economic efficiency,
- improve equity or fairness in taxation, and
- minimize costs of administration, enforcement, and compliance.

A change in the tax system that minimizes interference with existing institutions is one that would:

- achieve intergovernmental revenue neutrality,
- minimize changes in existing tax bases, and
- minimize effects on state funding priorities.

Although the proposed revenue changes are substantial, revenue neutrality appears to be feasible. Four states - Florida, Nevada, Texas, and Washington - have neither an individual income tax nor a sales tax on groceries, but they have expenditure

patterns that are similar to those in other states and levels of expenditure per capita that would be expected, given their relative state incomes. Texas has made up for the lack of an individual income tax and no sales tax on groceries largely by collecting high property taxes. Florida, Nevada, and Washington rely more heavily on sales or sales-type taxes. Nevada gets significant taxes from casino gambling, while Washington also levies a gross receipts tax that is a major revenue producer.

In the search for replacement revenues, it is important to recognize that Oklahoma begins from a position relative to national averages of already having reduced one of the big-three sources of state and local revenue. Oklahoma's property tax burden is only about half of the national average and 40 percent of the property tax burden in Texas. Thus, there appears to be room for increasing property tax rates. There is considerable revenue potential in broadening the sales tax base to include additional services, both within the services sector and in construction, transportation, utilities, finance, insurance, and real estate. The largest potential tax base, however, is a gross receipts tax levied on producers in all sectors of the economy, except government. There is some leeway for increasing the tax on motor fuels, although the revenue potential of this source is small relative to the property tax, the sales tax, and the gross receipts tax. The revenue potentials of a lottery and taxes on alcohol and cigarettes are quite small; the lottery can also be ruled out on the grounds that the opportunity to establish a lottery was recently rejected by voters. A health care providers' tax is a potentially good source of revenue, but it was also rejected by voters.

There are literally an infinite number of ways that the state's tax system could be restructured to achieve revenue neutrality in the face of the proposed elimination of the individual income tax, exemption of groceries from the sales tax base, and modification of the estate tax. We construct five scenarios in this study that we believe are representative of the range of possibilities. The first three scenarios assume reliance on a single tax to take up the slack. Approaching the problem this way would require either a tripling of the property tax, a drastic expansion of the sales tax base along with a rate increase, or imposition of a broad-based gross receipts tax with a rate of 1.25 percent. The last two scenarios are hybrids, involving changes in more than one tax to achieve revenue neutrality.



It is far better, in our judgment, to rely on a mix of new revenue sources. We examine two such mixes in response to the elimination of the individual income tax, exemption of groceries from the sales tax, and modification of the estate tax. The first features reliance on an increase in the property tax burden, coupled with the imposition of the sales tax on services produced in the services sector and a low-rate gross receipts tax. The increase associated with each tax would be smaller, of course, than if each were relied upon exclusively. The second mixed or hybrid scenario features reliance on an increase in the property tax and the gross receipts tax, with no change in the sales tax. Some would advocate the first of these on the grounds that it is a more balanced approach and involves a smaller increase in the property tax. The second hybrid scenario levies a higher tax on property but taxes services at a lower rate.

Given overall trends in the economy, there is a need to reform Oklahoma's tax system in the direction of greater dependence on taxation of services. The traditional approach to doing this - by applying the sales tax to additional services - is not as promising a route, however, as that of applying a gross receipts tax to the output of businesses that produce services.

## I. INTRODUCTION

This study has been conducted in response to a request from Governor Frank Keating, Senate President Pro Tempore Stratton Taylor, and House Speaker Larry Adair. In a letter of April 26, 2001, they requested the development of “a draft reform program that accomplishes the following goals:

1. Elimination of the personal income tax;
2. Elimination of the sales tax on groceries;
3. Elimination of the capital gains tax;
4. Alteration of estate tax to make Oklahoma a “pick-up” state; and
5. Implementation of these tax changes accomplished in such a way that Oklahoma can still provide adequate funding to its existing programs and services.”

The purpose of this report is to outline a reform program that accomplishes these goals. It describes some options for changing the state’s tax system if the tax changes proposed above are actually made. It should not be interpreted as either an endorsement or rejection of the proposed changes. Our goal is to determine how the proposed changes can be made and to provide information that we hope will illuminate the choices

We appreciate the opportunity to be involved in examining such an important state policy issue and we understand that the political process often moves at a rapid pace. We do regret, however, the necessity of completing this study in such a short period of time. Although we have a lot of collective experience with various aspects of the issue, we would normally have gone through a lengthy process involving an exchange of ideas and drafts with other economists and with government officials in Oklahoma and the states from which we draw important lessons. We expect that this would have changed some of our findings, including our estimates of revenues potentially provided by changes in the tax code. In fact, the estimates of potential tax revenues should be viewed only as approximations. Additional research, and significant input from tax and legislative experts in state government, will be required to produce "certifiable" estimates.

## **II. A BRIEF RATIONALE FOR THE PROPOSED REFORMS**

The proposed changes are significant, but apparently feasible. State taxation of capital gains would be eliminated automatically with elimination of the individual income tax. Seven states have no individual income tax and two states have an individual income tax limited primarily to interest and dividend income. Thirty of the 46 states taxing sales have no sales tax on food for home consumption. Four states - Florida, Nevada, Texas, and Washington - have neither an individual income tax nor a sales tax on groceries. These states demonstrate that there are ways to accomplish what has been proposed.

Each of these four states, moreover, is growing more rapidly than Oklahoma. In fact, they are among the nation's fastest growing states. Some believe that a key to their relative prosperity is the lack of an individual income tax and that Oklahoma would enjoy faster growth if it eliminated this source of revenue. This is purportedly even more likely, given the absence of the individual income tax in Texas.

The states without an income tax depend more heavily on the sales tax as a source of revenue. Purchases of food for home consumption constitute a large share of the sales tax base, especially among low-income households. Many states, therefore, provide sales tax relief to low-income households by exempting purchases of food for home consumption. If Oklahoma were to eliminate the individual income tax, it would also have to depend more heavily on the sales tax. Under these circumstances, some believe that Oklahoma should provide similar relief.

Under the Federal Estate Tax Code, each taxpayer is allowed a credit for state estate taxes paid, up to a maximum credit set by Federal statute. Since the federal estate tax liability is reduced by the state tax credit dollar for dollar, states can impose estate taxes up to the maximum federal credit without costing their residents any additional taxes. This outcome has persuaded 28 of the 35 states with estate taxes to simply define the state estate tax as equal to the maximum allowable federal tax credit. These states are referred to as "pick-up" states. Seven states, however, have defined estate tax structures that impose a tax higher than the maximum allowable federal credit. In these states, some estates are subject to higher taxes than they would be in the states that have simply adopted, or "picked up" the federal maximum allowable credit as the basis for state taxes.

Oklahoma is one of the seven states that is not a "pick-up" state. Accordingly, some Oklahoma estates are subject to more taxes than they would be if the estate were subject to the tax laws of a "pick-up" state. Given Oklahoma's current estate tax rate structure, higher taxes are confined to net estates of less than \$4 million, but estates of this size account for most of the estates subject to taxation. Moreover, Texas is a "pick-up" state, and the fact that Oklahoma is not provides Texas with a tool to use in the competition for retirees.

### **III. PROSPECTIVE REVENUE LOSSES**

#### **INTRODUCTION**

The individual income tax is the largest single source of state tax revenue in Oklahoma. In calendar year 2000, net collections were \$2.2 billion, by far exceeding state sales tax revenues of \$1.4 billion, the second largest source. To gain an understanding of the implications of replacing the income tax in Oklahoma with other sources of revenue, one of the first questions to be asked is “What will be the revenue loss from zeroing out the individual income tax?” Obviously, for year 2000, we already know that answer. What about the coming year and years into the future? For fiscal year 2003, the revenue loss is estimated by the Oklahoma Tax Commission to be roughly \$2.5 billion. That number takes us somewhat into the future, but it does not take us far enough. Revenue neutrality, the general framework for conduct of this research, implies not only immediate revenue neutrality, but future revenue neutrality, as well.

A second question that needs to be addressed is “What is the potential for filling the revenue gap created by repealing the state income tax with other tax sources?” This gap could potentially be filled by, for example, expanding the base of the state sales tax, increasing rates on a variety of other revenue sources including the sales tax, or by creating new state revenue sources, such as a state property tax. A mix of strategies could be pursued. Whatever mix is chosen, it is clear that revenue estimates from that mix of choices are needed, now and into the future.

This section of the report discusses, in what we hope are understandable terms, the approach we have taken to estimating the revenue consequences of eliminating the individual income and other taxes. We review the methodology used, present point estimates of the responsive of various taxes to changes in personal income, and examine projections of revenue sacrificed by repealing the individual income tax and sales tax on groceries, and by adopting the federal framework for the estate tax (i.e., by becoming a “pick-up” state).

#### **THE ECONOMIST’S TOOLKIT**

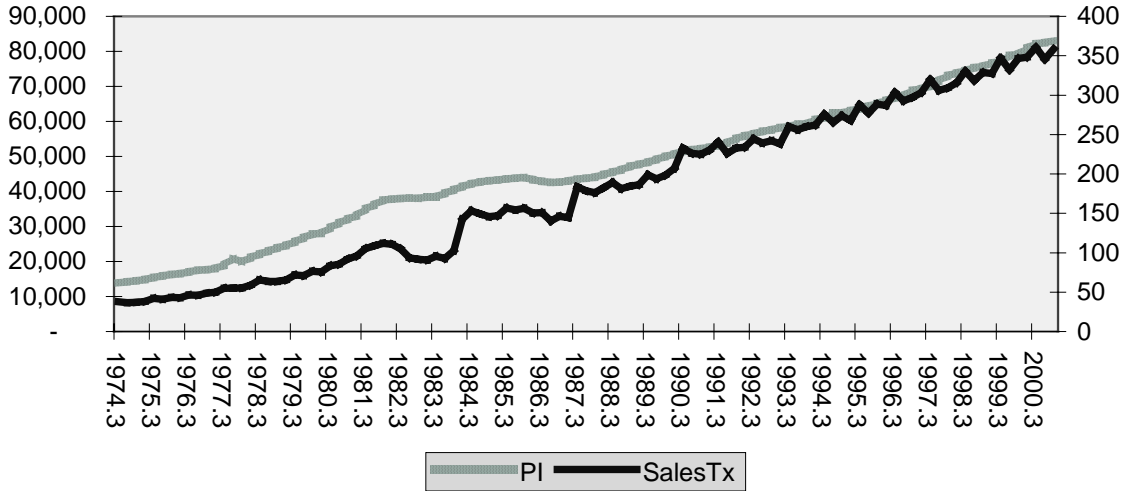
Public finance economists, following the path-breaking lead of researchers Groves and Kahn (1952), have developed a number of tools to assist them in analyzing the revenue

implications of tax changes. The principal strategy has been to relate tax receipts to personal income for a state or region. Taxes, especially those taxes paid by households, are obviously related to income, but some more closely than others. The amount of sales taxes a household pays is related to its level of household consumption, which in turn, is related to its level of income. The personal income tax, because it is based directly on household income from various sources, has an obvious connection to personal income. The value of houses is also positively correlated with income. The relationship may be somewhat loose in that people with equal incomes may choose to live in houses with widely varying values. Some people prefer to stretch, hoping for inflation to bail them out; others choose to live in houses of relatively low value in comparison to their incomes, reserving surplus dollars for other types of consumption. While the relationship between housing values and income is less direct, it is nonetheless present, thereby providing at least the expectation of a positive relationship between the property tax and income. Even motor fuels taxes are expected to grow with income; rising income allows people to indulge their tastes for larger, less fuel-efficient vehicles and more economic activity translates into more miles driven.

Over time, we would expect to see the values of a given tax and personal income trending positively for at least two reasons: growth (and possibly decline) and inflation. Real economic growth engenders increases in population, labor force, employment, output, and income, even without any change in the price level. Inflation increases current prices and, therefore, the nominal values of income and consumption. Inflation was particularly pronounced in the late 1970s and early 1980s, which should enhance the positive historical trend between taxes and income. Of course, there is another reason that taxes could change, and that is through changes in tax rates, which are for the most part only in one direction. All three factors tend to produce positive trends in tax collections and personal income.

Chart 1 illustrates the relationship between quarterly sales tax collections and personal income in Oklahoma from the third quarter of 1973 to the fourth quarter of 2000. While sales tax collections have an obvious seasonal component, owing principally to the Christmas season, there is an apparent closeness of the relationship between sales tax collections and (annualized, seasonally-adjusted) quarterly personal income, as reported by the US Bureau of Economic Analysis.

**Chart 1. Oklahoma Personal Income (PI) v. Sales Tax Trends**  
**Quarterly, 1973:3 -2001:1, \$Millions**



**Chart 2. Oklahoma Personal Income (PI) v. Individual Income Tax Trends**  
**Quarterly, 1978:3 -2001:1, \$Millions**

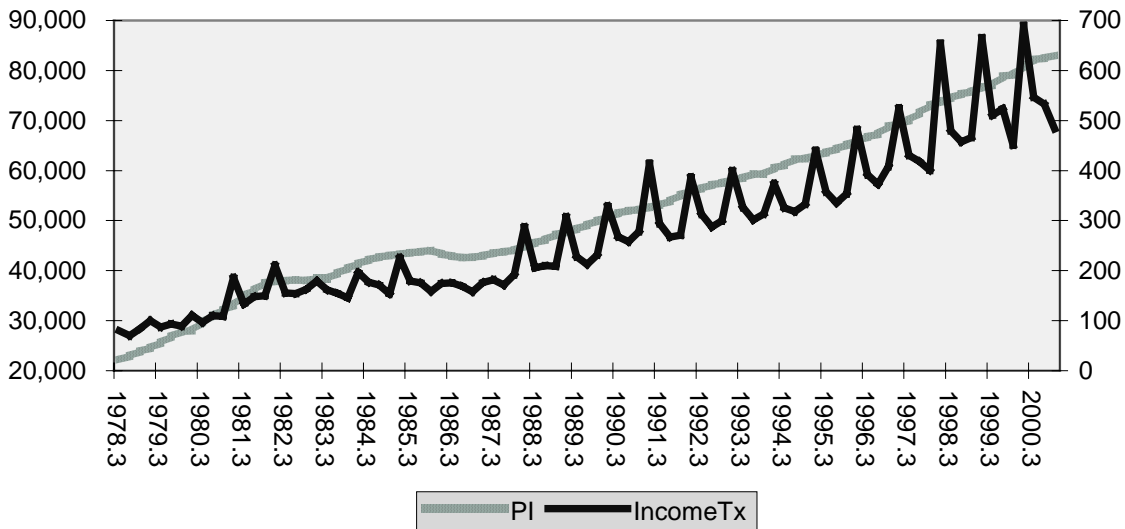
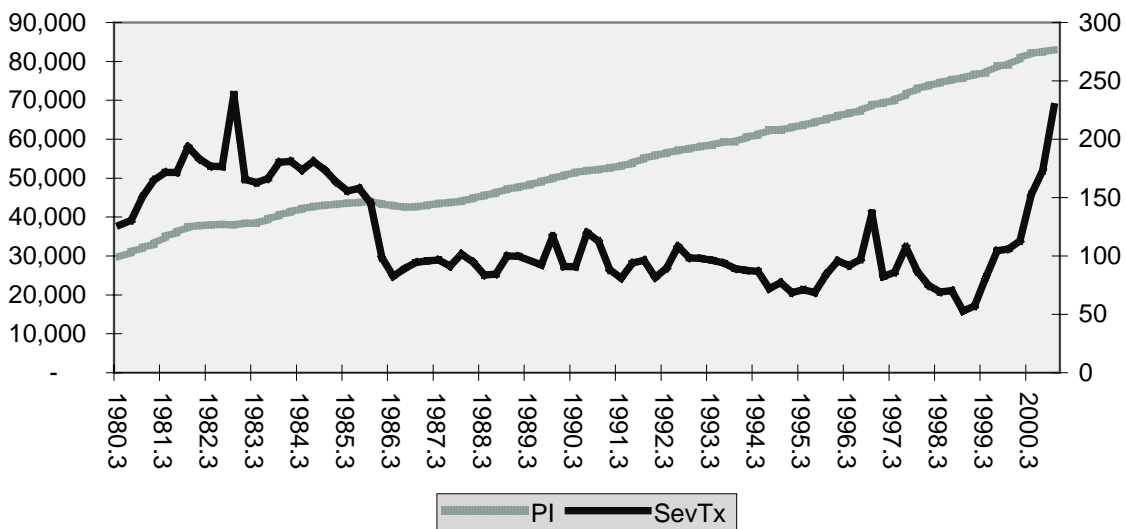


Chart 2 shows how Oklahoma individual income tax collections are related to income. This chart shows an obvious high degree of seasonal fluctuation, with peak values in the second quarter when tax returns are due. Despite the obvious high degree of seasonal variation, there is a clear positive relationship between the individual income tax and personal income.

Chart 3 illustrates a tax in Oklahoma that bears no consistent relationship to income levels: the gross production tax on oil and natural gas. Receipts from this tax, levied at seven percent of the value of production, bear an obvious relationship to the price of oil and natural gas. They bear no consistent relationship to personal income in Oklahoma. Charts for other tax sources are displayed at the end of this section.

**Chart 3. Oklahoma Personal Income (PI) v. Severance Tax Trends**  
**Quarterly, 1980:3 -2001:1, \$Millions**



There is, then, an apparent relationship between taxes and personal income that should be subject to measurement. Also in the economist’s toolkit is a set of mathematical and statistical procedures for estimating an underlying model of the tax-to- income relationship. The statistical and model building tools of this trade fill scores of textbooks and scholarly writings. This is not the forum for detailed presentation of the underlying theory and estimation procedures. Details are available to inquisitive minds, however. We are willing to supply the detailed econometric results to all who desire to see them. Suffice it for present to concentrate on the results, and, in



particular, on what is known as the *income elasticity of a tax*, the primary number we need to conduct simulations of the future course of tax receipts.

Economists use the term *elasticity* to reflect the responsiveness of one variable, the dependent variable, to change in a variable it is dependent upon. Responsiveness is measured in terms of percentage changes. To take a simple example in order to firm up this notion of elasticity, consider a movie theater owner thinking about raising the price of tickets. Now this theater owner, whether he or she knows it or not, is concerned with the *price elasticity* of demand for theater tickets. If the price goes up by 25 percent and the number of tickets sold falls by only 10 percent, the theater owner is obviously ahead of the game. Total receipts will have risen. However, if the price of tickets goes up by 25 percent and attendance falls by 35 percent, total receipts will actually decline.

There is obviously a relationship, then, between the change in total receipts and the degree to which ticket sales respond to price changes. The price elasticity of demand tells us how much sales change as price changes. In this example, it is measured as the percentage change in ticket sales divided by the percentage change in price. In the first instance the elasticity would measure  $-0.4$ . With an absolute value (ignoring the negative sign) less than one, the price elasticity is said to be inelastic, meaning that quantity demanded is not very responsive to price changes. Therefore, with quantity not very responsive, total revenue increases with a price increase. In the latter case, the price elasticity of demand measures  $-1.4$ . An absolute value greater than one indicates a high degree of responsiveness of quantity demanded to changes in price. Thus, with a price increase, quantity demanded falls more than proportionately, leading to a decrease in total receipts. If the elasticity value were close to  $-1.0$ , then very little change in revenue would occur if the price were changed. The negative sign shows that prices and quantities demanded move in opposite directions.<sup>1</sup>

## **INCOME ELASTICITY ESTIMATES**

It is clear that it would be a good idea for the theater owner to know the value of elasticity prior to changing the price of theater tickets. In a similar fashion, it would be a very good idea for the State of Oklahoma to know the value of the income elasticities of various taxes

prior to changing its tax structure. Thus, we have engaged in an extensive investigation of the personal income elasticities of various state revenue sources. These estimates appear in Table 1.

**Table 1**  
**Revenue Sources and Estimated Personal Income Elasticities**

<b>Revenue Source</b>	<b>Estimated Income Elasticity</b>
Sales Tax	1.06
Use Tax	1.45
Motor Vehicle Tax	1.00
Motor Fuels Tax	1.00
Individual Income Tax	1.30
Corporation Income Tax	1.20
Estate Tax	1.50
Gross Production Tax	0.20
Local Property Tax	0.73
Centrally-Assessed Property Tax	0.47
Franchise Tax	1.01

As a review of this table shows, four of the elasticity estimates are near the unit-elasticity value of 1.0; namely, those for the sales, motor vehicle, motor fuels, and franchise taxes. An income elasticity value equal to 1.0 indicates that a percentage change in personal income of, say, five percent, is matched by a percentage change in tax receipts of five percent.

Owing to its progressive nature, with the average tax rate increasing as income rises, the individual income tax has an estimated elasticity of 1.3. This estimate has been obtained by working with actual tax data distributed by income classes. The econometric (statistical) results were even higher, around 1.5, but we believe that estimate overstates the true future income elasticity of this tax. The highest bracket or marginal rate of 6.75 percent applies to taxable incomes starting at \$20,000 for married couples and at \$10,000 for taxpayers filing individually.

With inflation and growth in incomes, Oklahomans are pushed toward the highest marginal rate bracket. When this happens, there is an increase in taxes paid as a percent of income. After they reach the highest bracket, however, taxes paid as a percent of income fall as income rises. Thus, as the percentage of income taxed at the highest marginal rate grows, the overall progressivity of the tax will decline, along with its income elasticity. In 1998, 58 percent of Oklahomans reported Oklahoma Income After Adjustments (OIAA) of \$20,000 or higher. (Standard or Schedule A deductions and exemptions are subtracted from OIAA to determine Oklahoma taxable income.) Normal economic changes will increase this percentage and lead inevitably to a reduction in the income elasticity of the individual income tax.

The use, corporate, and estate taxes show fairly high-income elasticities, possibly owing to improved enforcement or compliance. A review of graphics at the end of this section provides evidence that these tax sources have been closely associated with personal income gains in recent years, but not historically. Of great significance is the small income elasticity of the local property tax and, especially, the public utilities property tax, which is centrally assessed. The inelasticity of these two tax sources bodes poorly for use of these sources as replacements for the income tax. The millage rate on property would have to rise every year in order to keep pace with a personal income tax with an elasticity of 1.3.

## **REVENUE SIMULATIONS**

Armed with the elasticity estimates, it is a fairly simple task to build a spreadsheet model of revenue projections for the various tax sources.<sup>2</sup> A simulation model has been built that utilizes a 4.5 percent growth rate of total personal income in Oklahoma to FY-2010. Alternative growth rates can be used. The 4.5 percent rate was chosen because it matches recent experience, roughly assuming about a 2.3 percent real rate of growth and a 2.2 percent rate of inflation. Coupled with the elasticity estimates, revenue projections can be made. Table 2 reports the revenue simulations resulting from repeal of the individual income tax, removal of the sales tax on groceries, and adoption of the federal framework for the estate tax.

**Table 2**  
**Baseline and Alternative Revenue Projections**  
**Repeal of Income Tax, Sales Tax on Groceries and Modification of Estate Tax**  
**(\$Millions)**

Fiscal Year	Baseline Projection	Alternative Projection	Revenue Shortfall	Baseline to Personal Income Ratio
FY-2000 (Actual)	6,832	6,832	-	8.65%
FY-2001	7,145	7,145	-	8.66%
FY-2002	7,475	4,826	2,649	8.67%
FY-2003	7,820	5,018	2,803	8.68%
FY-2004	8,183	5,218	2,965	8.69%
FY-2005	8,564	5,427	3,137	8.70%
FY-2006	8,965	5,645	3,320	8.72%
FY-2007	9,386	5,873	3,513	8.73%
FY-2008	9,828	6,111	3,717	8.75%
FY-2009	10,292	6,359	3,933	8.77%
FY-2010	10,780	6,619	4,161	8.79%

The baseline projection in this table reflects no changes in the current tax system. The alternative projection reflects the proposed tax changes. The difference between the two indicates that a considerable revenue shortfall would result from elimination of the individual income tax, exemption of the sales tax on groceries, and modification of the estate tax. Initially this shortfall would be approximately \$2.65 billion in FY-2002, rising to \$4.16 billion in FY-2010. The tax on groceries and the estate tax change have modest implications, however. The tax on groceries is estimated by the Oklahoma Tax Commission to result in about \$155 million in state sales tax revenue in 2002, net of reimbursements now made available. The sales tax on groceries also produces about \$99.7 million in tax receipts for cities and counties, the loss of which is not reflected in the estimates in Table II. The estate tax change would amount to about \$57 million in FY-2002. Although the losses from these sources will grow throughout the projection period, they are swamped by the losses owing to the repeal of the individual income tax.

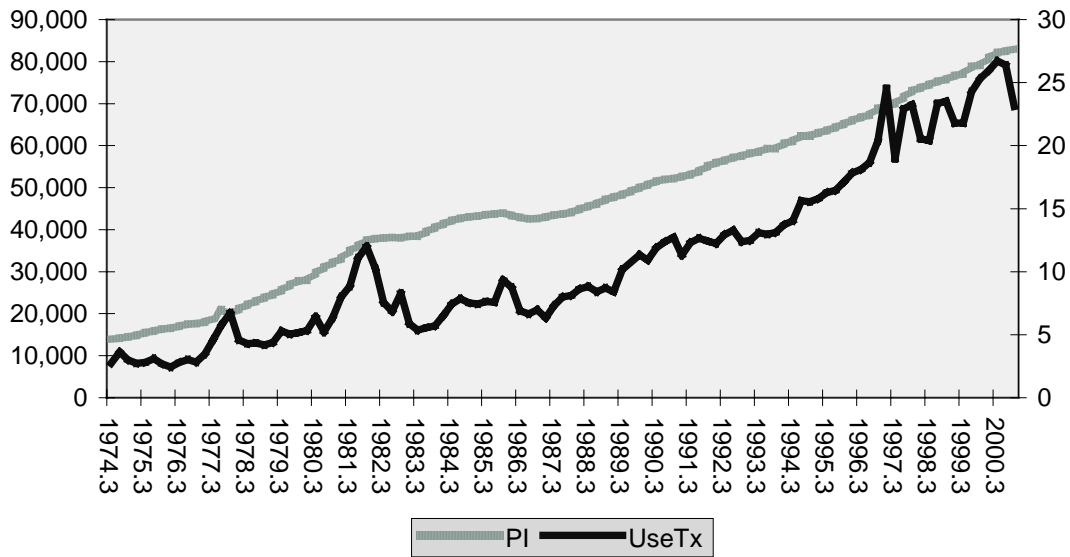
We note that the 11 taxes simulated in these projections represent 8.65 percent of personal income in FY-2000. In FY-2010, these 11 taxes would yield a small increase of the combined tax to income ratio of 8.79 percent in the absence of any changes in the tax structure. This increase in the ratio amounts to only \$15 million in additional revenue in FY-2010. Oklahoma's tax structure as it is constituted today will be barely able to keep pace with the growth in the economy.

## **CONCLUSION**

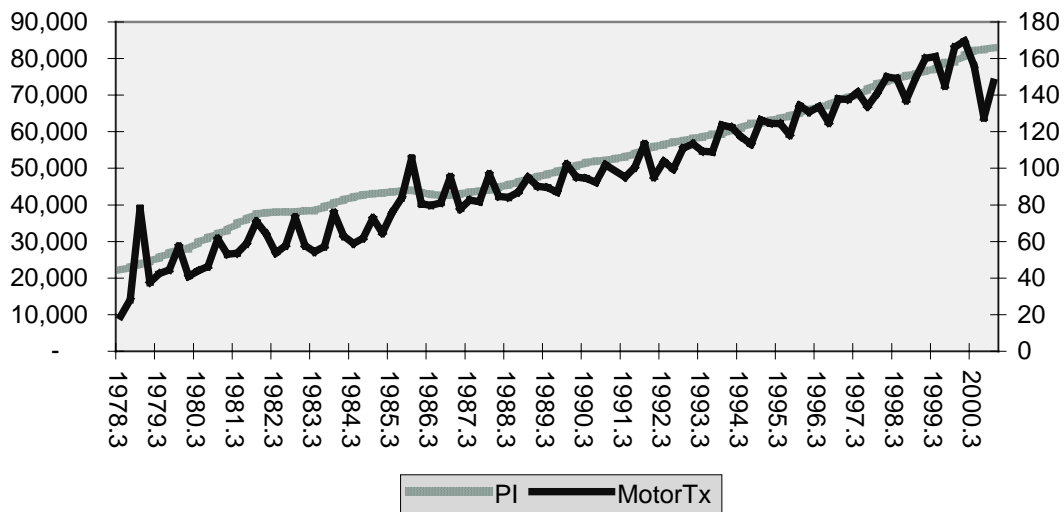
This section has attempted to provide the reader with insight as to how economists go about estimating the revenue implications of tax consequences. These estimates are subject to a variety of limitations; the largest being that this analysis is "static" in nature. For example, it might well be reasonably argued that elimination of the income tax would provide dramatic incentives to work effort and entrepreneurship in this state. Undoubtedly there would be economic growth consequences of such a dramatic change in Oklahoma tax law. We have captured such a scenario by raising the growth rate of personal income rising gradually by 25 percent to 5.6 percent (this would actually be a remarkable accomplishment by historical standards). In this scenario, the shortfall still amounts to \$3.8 billion in 2010, owing to the inelasticity of the property tax. Even if Oklahoman's growth in personal income were to rise immediately to 5.6 percent in FY-2002 and remain at that high level through FY-2010 (an even more remarkable accomplishment), the budget shortfall would still be \$3.6 billion. Thus, even with a substantial dynamic increase in the growth rate, most of the projected revenue shortfall remains.

The preeminence of the individual income tax in Oklahoma as a revenue source is clear from this analysis. The initial shortfall of 36 percent rises to 39 percent in the calculations. Removing the sales tax on groceries has a relatively minor effect, rising from \$189 million initially to \$274 million by FY-2010. Modification of the estate tax also has a minimal impact, \$57 million initially, rising to \$95 million. In any event, the state would have a substantial shortfall to make up. We analyze ways to do this in the next three sections and then present projections of tax receipts from alternative revenue sources in Section VII, using the techniques described above.

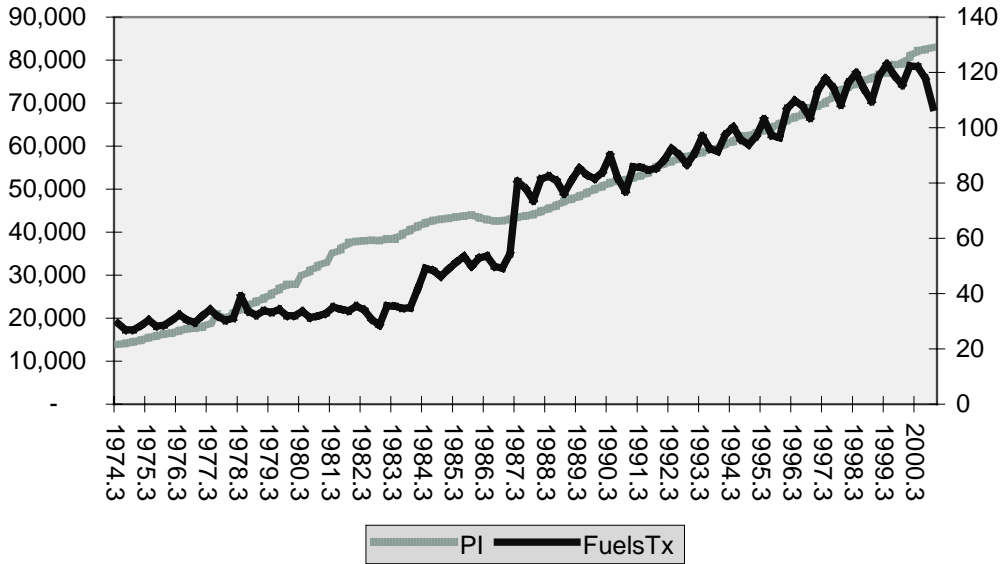
**Chart 4. Oklahoma Personal Income (PI) v. Use Tax Trends**  
**Quarterly, 1973:3 -2001:1, \$Millions**



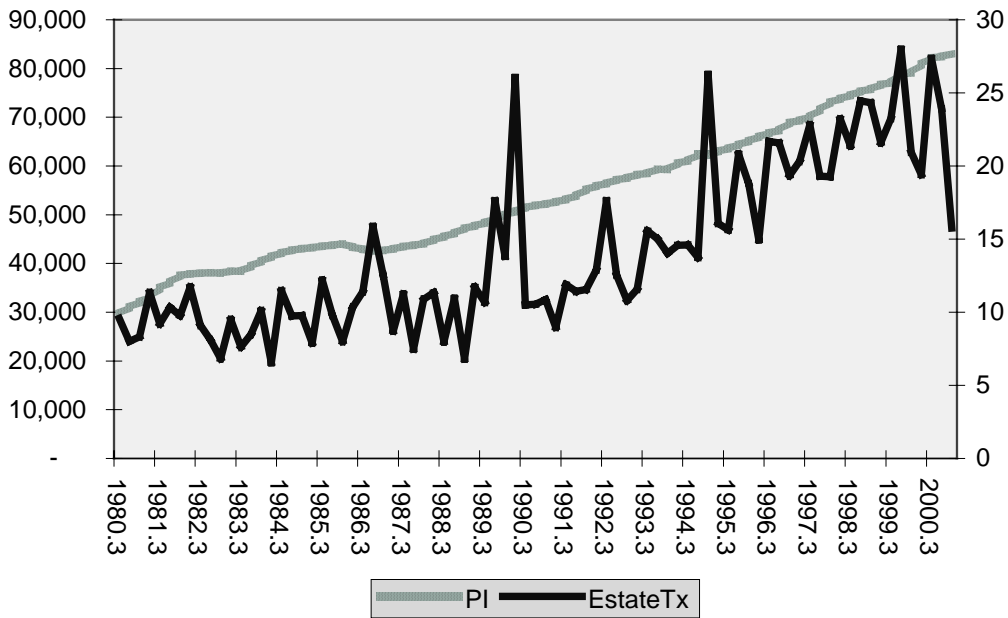
**Chart 5. Oklahoma Personal Income (PI) v. Motor Vehicles Tax Trends**  
**Quarterly, 1978:3 -2001:1, \$Millions**



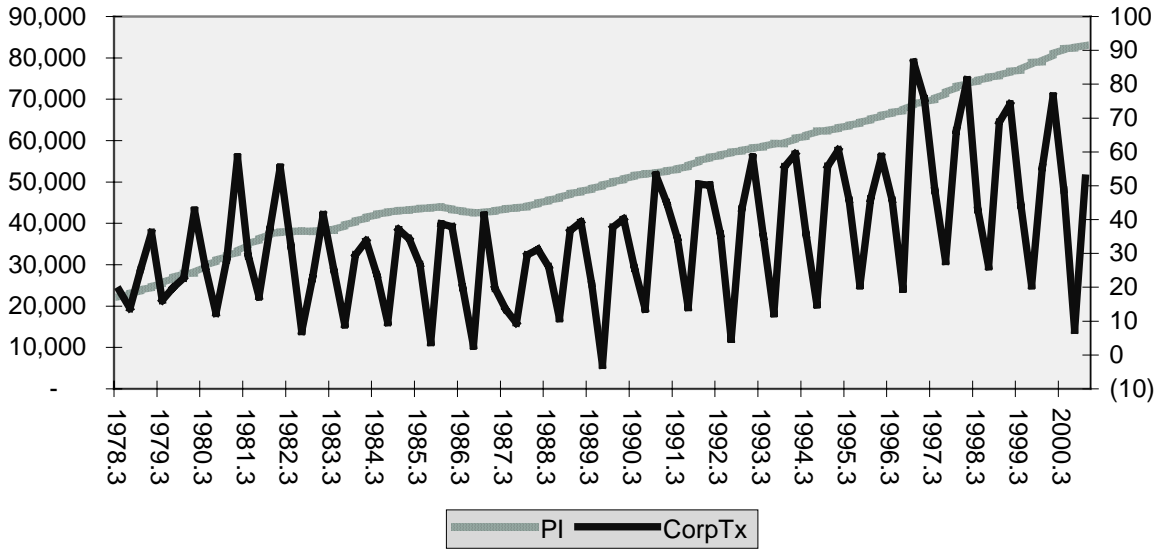
**Chart 6. Oklahoma Personal Income (PI) v. Fuels Tax Trends**  
**Quarterly, 1973:3 -2001:1, \$Millions**



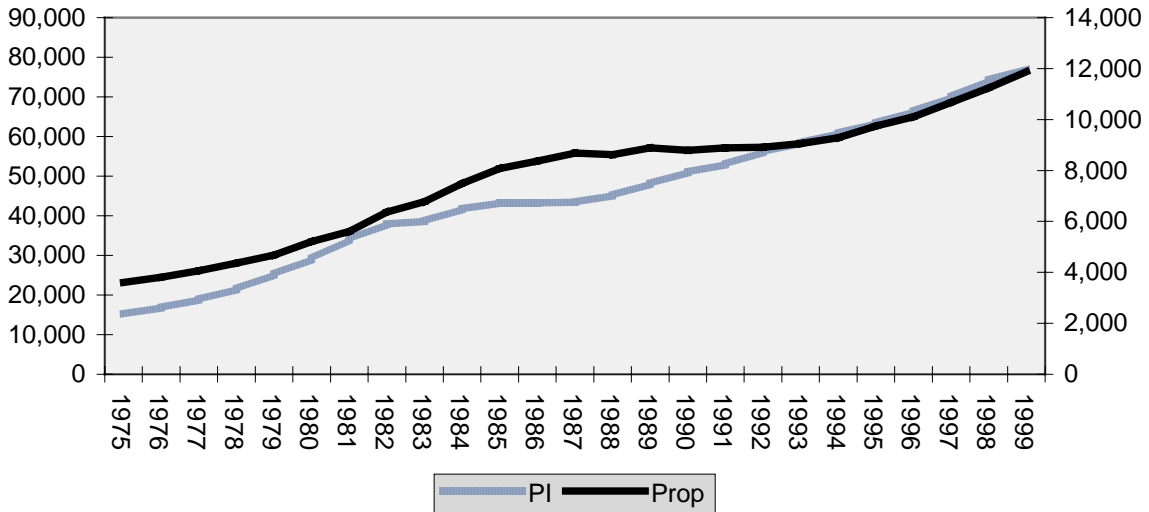
**Chart 7. Oklahoma Personal Income (PI) v. Estate Tax Trends**  
**Quarterly, 1980:3 -2001:1, \$Millions**



**Chart 8. Oklahoma Personal Income (PI) v. Corporate Income Tax Trends**  
**Quarterly, 1978:3 -2001:1, \$Millions**



**Chart 9. Oklahoma Personal Income (PI) v. Net Locally-Assessed Property**  
**Annual, 1975 -1999, \$Millions**





## ENDNOTES

<sup>1</sup>For readers wanting more discussion of the elasticity concept, any introductory economics textbook will provide a good discussion of this central topic. The reader might also can review discussion of elasticity on the Internet at a number of web sites. In particular, the web site at <http://www.amosweb.com> provides a good discussion of elasticity. This web site was produced by Professor Orley Amos, Department of Economics, Oklahoma State University.

<sup>2</sup>This spreadsheet, although copyrighted by the Center for Economic and Management Research, University of Oklahoma, is considered in the public domain. Requests for a copy of the spreadsheet and instructions in its use can be made by writing to Robert C. Dauffenbach, CEMR, 307 W. Brooks, University of Oklahoma, Norman, OK, 73019-0450, or by e-mailing to [Rdauffen@ou.edu](mailto:Rdauffen@ou.edu).

#### **IV. PRINCIPLES FOR EVALUATING CHANGES IN THE TAX SYSTEM**

As explained above, this study's sponsors have posed changes in the Oklahoma tax system that would:

1. eliminate the state personal income tax,
2. exempt the purchase of "groceries" from the state sales tax,
3. change Oklahoma's estate tax to a federally-based "pickup tax", and
4. maintain existing government services.

Given that changes 1-3 would reduce state and local government tax collections, either costs must be reduced or new revenue sources must be provided if government services are to be maintained. Although it may be possible to maintain existing government services to some degree by reducing costs, the prospective revenue reduction is so great that this is not a practical solution. The first requirement, then, is that the new sources replace revenues lost; i.e., that we achieve revenue neutrality. There are, however, many potential combinations of new sources that could provide revenue neutrality. Thus, we must choose among them. Ideally, the final choice would be the one that: (1) improves the tax system, while (2) honoring existing institutional constraints.

#### **REVENUE NEUTRALITY**

Revenue neutrality requires the replacement of revenues lost (at **both** the state and local levels) due to changes in existing taxes, both in the initial year the changes are made and in a longer-run context. Revenue neutrality is the key to the ability of state and local governments to fund existing programs and services. Analytically, the task is to project the revenues lost because of the proposed tax changes, both initially and in a longer-run context, and to find new revenues that are projected to replace revenues lost. Projections of revenues lost have been provided in Section III. Projections of new or replacement revenues are outlined Sections VI and VII.

In Table 2 of Section III we presented estimates of the baseline revenue projection, along with the ratio of taxes to income in the baseline projection (expressed as a percentage). Strict revenue neutrality means that the ratio of taxes to income will be the same after "replacement taxes" are levied as in the baseline scenario. This is a prescription for neither growing nor shrinking the government sector relative to what it would have been in the absence of the

proposed tax changes. Achievement of revenue neutrality in this sense will not necessarily result in revenue neutrality for individual taxpayers or even for broad classifications of taxpayers. There will undoubtedly be gainers and losers associated with particular revenue decreases and increases.

### **IMPROVEMENTS IN THE TAX SYSTEM**

The substitution of new revenue sources for revenue sources that are eliminated improves the tax system if it:

1. achieves greater revenue stability,
2. increases revenue exportability,
3. increases economic efficiency,
4. improves equity, and
5. reduces administration, enforcement, and compliance costs.

If these criteria are out of reach, then the substitution of revenue sources should minimize the degree to which these criteria are not met.

### **REVENUE STABILITY**

Revenue stability requires the maintenance of tax collections during cyclical upturns and downturns in the economy. Revenue stability facilitates the planning and implementation of government programs. Tax collections generally fluctuate directly with the business cycle. There are differences among specific taxes, however, in terms of how much collections vary over the business cycle. For example, receipts from the sales tax on groceries hold up better in a cyclical downturn than do receipts from the corporate income tax. By the same token, receipts from the sales tax on groceries do not grow as fast as receipts from the corporate income tax in a cyclical upturn. A tax system that featured the sales tax on groceries, then, would be more stable than one that featured the corporate income tax.

Oklahoma's Rainy Day Fund acts as a hedge against shortfalls in tax collections in a cyclical downturn and as a repository for unanticipated revenue windfalls in a cyclical upturn. It is doubtful, however, that we want to place the entire burden of stabilizing government revenues on this device when we also have the option of designing a tax system that shares this task.

## **EXPORTABILITY**

Tax exportability refers to the degree to which the burden of a tax can be exported or shifted to individuals or businesses residing in other states or countries. The higher the degree of tax exportability, the lower the cost of state (and local) government to state residents and businesses.

A state or local government may be able to export taxes in four ways:

1. by taking advantage of provisions in the federal individual income tax code for the deductibility of state and local taxes (for example, state income taxes are a deduction for federal income tax filers who itemize deductions),
2. by shifting taxes to consumers in other states or countries through higher prices of goods and services exported,
3. by taxing tourists and business visitors to the state (for example, by levying taxes on goods and services that tourists and business visitors buy while in Oklahoma), and
4. by shifting taxes to out-of-state owners of capital employed in the state (such as out-of-state owners of oil and gas property or office buildings) and land located in Oklahoma (such as out-of-state owners of farm property).

There are no readily available means of quantifying overall changes in tax exportability, but there are some significant differences in the exportability of alternative taxes that will be considered in evaluating proposed changes in Oklahoma's tax structure.

## **ECONOMIC EFFICIENCY**

Most taxes reduce economic efficiency by affecting decisions that would have been made in the absence of taxes. It is commonly alleged, for example, that state and local tax systems:

1. distort the location choices of individuals (especially high-income individuals) and businesses,
2. reduce household savings and business investment,
3. reduce individuals' work effort, and
4. distort the purchasing decisions of households (for goods and services) and businesses (for inputs, including both labor and capital).

The first three impacts are related to state economic growth. Taxes that discourage individuals and businesses from locating in the state, or that induce them to leave, will reduce growth. Taxes that reduce work effort, saving, or investment will also adversely effect the state's growth prospects.

There are no readily available means of quantifying overall changes in efficiency, but there are some significant differences in the degree to which alternative taxes influence economic decisions that will be considered in evaluating proposed changes in Oklahoma's tax structure.

## **EQUITY**

Equity in taxation refers to a "fair" distribution of the tax burden. One view is that the tax burden is distributed fairly if tax payments are distributed in proportion to benefits received from public goods and services – the benefit principle. An excise tax on gasoline is often cited as one that illustrates the benefit principle, in the sense that the tax is paid by those who benefit from the use of highways and the revenues from the tax are used for maintaining and expanding the highway system.

Another view is that the tax burden is distributed fairly if tax payments are distributed according to ability to pay – the ability to pay principle. There are two variants of equity according to the ability to pay principle: horizontal equity and vertical equity. Horizontal equity requires that tax payments be distributed so that people with similar abilities to pay have similar tax burdens. Vertical equity requires a judgment about how tax payments ought to be distributed as ability to pay increases. There are three possibilities: tax payments may be distributed regressively, proportionally, or progressively relative to ability to pay. A regressive distribution is one in which the ratio of tax payments to ability to pay falls as ability to pay increases. A proportional distribution is one in which the ratio of tax payments to ability to pay is constant as ability to pay increases. A progressive distribution is one in which the ratio of tax payments to ability to pay increases as ability to pay increases. There is no universal agreement on the most desirable distribution of the tax burden relative to ability to pay. There seems to be a lot of support, however, for changes that do **not** make the tax system **more** regressive (i.e., changes that reduce the ratio of tax payments to ability to pay as ability to pay increases).

Ability to pay is commonly measured in terms of current income. It may be measured also in terms of permanent income. The two measures may yield different estimates of the distribution of the tax burden, so both should be used as distributors if possible.

### **ADMINISTRATION, ENFORCEMENT, AND COMPLIANCE COSTS**

Taxes differ in terms of the costs imposed on government to administer and enforce the tax code, and on the private sector to comply with the tax code. Government should be interested in reducing these costs. There is, moreover, a significant literature to draw upon in making comparisons of these costs for a variety of alternative revenue sources.

### **INSTITUTIONAL CONSTRAINTS**

The principles of a good tax system discussed above are universally applicable to tax systems everywhere. We turn now to issues specific to Oklahoma. One of the most desirable features of the U.S. federal system of government is that it permits the citizens of state and local jurisdictions to determine for themselves, within wide limits, the nature of their governmental institutions, including their revenue raising systems. In Section V we examine some of these rich contrasts, focusing on lessons to be learned from the four states that have neither a grocery sales tax nor an individual income tax. However, throughout these comparisons, we will be reminded continuously that Oklahoma is not the same as Florida, Nevada, Texas, or Washington.

In the following discussion we develop some home-grown principles to be used in deciding how to replace revenues lost due to abolishing the sales tax on groceries and the individual income tax. These principles reflect our understanding of Oklahoma's institutional framework and of the need to rearrange the state's revenue system with as little disruption to this framework as possible. The following points summarize our position.

- As is the case with all states, the institutions of the state/local tax system of Oklahoma have evolved over time and reflect the preferences exercised by the citizens through direct and representative democracy.
- The institutional system includes tax rates, tax bases, the application of fees and charges, the allocation of revenue-generating authority between state and local jurisdictions, the

allocation of spending responsibilities across jurisdictions, and the administrative processes necessary to collect revenues.

- Changes in Oklahoma's tax system typically have operated *at the margin*—an increase in a rate here, an addition in exemptions there, sometimes a new tax, sometimes the abolition of an old tax. Such changes have been acceptable because they have not been unduly disruptive of the activities of households and businesses.
- The abolition of the state's individual income tax and the exemption of groceries from the sales tax are *not marginal changes*. Both of these major reductions will, *taken by themselves*, have significant positive impacts on Oklahoma's households.
- However, in order to make up for lost revenue from these tax sources in a revenue neutral manner, it will be necessary for other tax and/or non-tax sources to generate more revenue. Raising other sources of revenue *per se* is inherently painful to households and businesses. The expected overall net effect of new tax arrangements will ultimately be evaluated by the voters and their representatives.
- It is imperative that a minimum of adjustments be required to maintain an equivalent amount of state/local revenue in the face of the two major tax reductions. There should be as little revision as possible in Oklahoma's constitutional, statutory, and administrative revenue system. The basic structure of state/local government and the procedures involved in collecting revenues should remain essentially the same after as before the major tax cuts and the offsetting increases. The restructuring of revenues in a manner that automatically links certain revenues to certain expenditures should be avoided.

## **RESPECT HISTORY AND VALUES**

The tax system of every state at any point in time is the outcome of an evolutionary process. While the elements of a "good" tax system, as outlined above, are principles that can be generally agreed upon, just what emphasis is placed on each is the result of years of debate and compromise. All taxes are, after all, the outcome of a political process. As such, one expects that the citizens of the various states and their representatives may come to different conclusions on important tax and expenditure issues. They may differ, for example, in terms of the appropriate burden of the tax that should be borne by current taxpayers versus future taxpayers in choosing the level of debt issuance. Or in determining the appropriate relative burden of taxes borne by

different income classes. Or in the appropriate degree to which users of government services, such as college education and highways, should pay the cost of these services. Or, indeed, which services are appropriate for government provision and which should be in the domain of the private sector.

Just how a state organizes its government is a critical aspect of the tax system that emerges. Should the state delegate to localities the responsibility of providing some, most, or all government services? Oklahoma is fiscally centralized to a significant degree. Virtually all higher education government funding comes from the state treasury, for example. Many states delegate to local districts the responsibility of funding community colleges. County governments in Oklahoma are given limited ability to fund local services and as a result a significant share of county government budgets is in the form of state taxes passed through for the purpose of county road construction and maintenance. Other states have created often county governments with significant taxing authority and responsibility for providing a wide array of government services.

The funding of elementary and secondary education is one of the most critical functions of government as demonstrated by the large share of revenues spent for this purpose. Oklahoma has concluded that, regardless of local wealth, all school districts should have some minimal level of resources in school operating budgets. This decision has resulted in very low reliance upon the property tax within the context of the state's overall tax system. Other states have reached different conclusions concerning this important funding issue, resulting in tax systems that rely more heavily on the property tax.

Different states have through time responded differently to requests for tax relief from different groups. Agriculture is treated differently from other business activities within many states, and there are differences in the tax treatment of agriculture across states, as well. Some states exempt motor fuels used by agriculture from taxation, others do not; some exempt the purchase of agricultural machinery from the excise tax, others do not; all states use preferential property tax assessment methods for agricultural land. Some states, Texas for example, require the payment of back-taxes on property when agricultural land is converted to non-agricultural use; others do not.

Special tax considerations for specific groups are not confined to agriculture, however. States exhibit differential treatment of motor homes and motor vehicle licenses, non-producing



mineral resources, and sales and purchases by non-profit organizations. Each of these considerations is the result of the democratic process working its will in each of the states.

The source of state tax differences may also reside with differences in the natural resources with which states are endowed. Oklahoma and Texas have historically had an abundance of petroleum resources, thus they raise a larger amount of revenue from these resources. Florida has beaches and an almost season-less climate that attracts visitors, allowing the state to rely more heavily on taxes that tap the wealth of these visitors. These aspects of a state are not within the general control of policy makers. Other differences arise from conscious choices made through policy debate, often decades old. Nevada was the first—and long the only—state to promote the casino gambling industry.

State tax systems reflect important values of the citizenry. Of course, these values change over time, but the pace of change is slow. Thus, one should expect that institutions such as the tax system will accommodate only a limited amount of change in a short period of time.

We recognize the important role played by imbedded values and historical political processes in forming the Oklahoma tax system. The alternatives to the proposed tax changes that we analyze, therefore, are chosen to maintain to the greatest degree possible these values as expressed in the current tax system. Put simply, the alternative tax recommendations that we make will minimize effects on existing tax institutions and governmental structures. A number of these institutional constraints are discussed below.

#### **ACHIEVE INTERGOVERNMENTAL REVENUE NEUTRALITY**

As discussed above, we are seeking revenue neutrality in the sense of replacing lost revenues. This principle applies to each level of government. Local jurisdictions and the state government, taken by themselves, should continue to generate about the same amounts of revenue as before the elimination of the income and grocery taxes. The constraint of minimal disturbance to institutional structures implies that state governmental revenue generating and expenditure functions are not to be shifted to other levels of government, i.e. to school districts, cities, or counties. Under this constraint, Oklahoma's historical centralized governmental structure is maintained.

By contrast, the four comparison states that have no income tax and no sales tax on groceries are more decentralized. There is much greater reliance in these states on the local

property tax as a source of funds for elementary and secondary education and city government general operations. If changes were to be made in Oklahoma that would shift the tax burden to local units of government, while still maintaining aggregate state and local tax burden neutrality, new mechanisms would have to be created. For example, shifting the burden to school districts by forcing them to raise property tax revenues would require amending the state constitution to lift the millage caps. Further, some mechanism would have to be put in place to involve the voters more heavily in the tax rate setting process. This might take the form of school district elections as is done in Texas, or it might simply be a responsibility placed on the elected school board as is done in other states. Any of these changes would be a significant departure from the current structure of Oklahoma government and thus are rejected as policy options for this study.

Of course, some changes in intergovernmental relations will be necessary. Only those changes that have minimal effects are considered. Again, this principle will eliminate some options. It does, however, require a review of the tax competition issue between the state government and local units of government. This will be particularly important in all matters concerning the sales and use tax, a tax that is shared by state, county, and city governments in Oklahoma.

#### **MINIMIZE CHANGES IN TAX BASES**

As already noted, states differ in terms of both the absolute and relative burdens of various taxes. Clearly the impetus for the proposal that generated the need for this study lies with recognition of this fact. For a specific tax, statutory and constitutional definitions of the tax base vary across states. For example, both Oklahoma and Texas have a motor vehicle excise tax, however, the base of the tax differs between the two states. Until recently, Oklahoma imposed the tax on the suggested manufacturer's retail price while Texas imposes the tax on the price actually paid for the vehicle. This difference can create different tax burdens between the states for the same value automobile even if the same tax rate is imposed. It is important to recognize that *all* taxes may have different bases across states, and that some differences are more subtle than others.

As a principle governing the selection of tax system alternatives, changes to the existing tax base in Oklahoma will be minimized. In the face of the proposed elimination of one tax base

(individual income) and the proposed reduction of another (grocery sales), however, it is not feasible to fully honor this principle *and maintain revenue neutrality*. Thus, as will be explained later, it may be necessary to expand the sales tax base and create a new tax base, as well (gross receipts).

We stick with this principle rigidly, however, where the property tax is concerned. Thirty-nine states levy a state property tax. Three of the four states without an individual income tax and sales tax on groceries do so; Texas is an exception, but Washington gets 17 percent of state tax revenues come from this source. All four states have a local property tax and each has developed distinctive exemptions and administrative protocols. Each state provides for a homestead exemption and an exemption of property moving in inter-state transit. Each exemption differs to some degree, although when administrative differences in assessment ratios are accounted for these differences are often minimal.

We could choose any one of these states and imitate its property tax administration and exemption system, but the differences between that state and Oklahoma in the resulting property burden overall would be small. There are, however, significant specific differences that would have profound effects on particular taxpayers. Texas applies the property tax to non-producing minerals; Oklahoma does not. Utilities are centrally appraised in Oklahoma, Washington, and Florida. Texas and Nevada centrally appraise only a subset of utilities. This simple difference has significant effects on the final valuation of the property because central assessment normally results in appraised values much closer to market value than do appraisal practices used by local authorities. Oklahoma assesses public service property at a different rate of market value than all other states in the study group; the other states assess at 100 percent of market value for all property, Oklahoma assess at 22.85 percent for public service property and approximately 12 percent for all other property.

Oklahoma's constitution creates virtually all of the property tax exemptions and at least three sections of Article X speak directly to the assessment procedures. These institutional structures will be left in place; i.e., treated as a constraint on the choice of alternative tax systems. This decision will avoid revisiting the ad valorem exemption for new and expanding industrial property (something not universal to all states), the use value method of agricultural land appraisal, and other long-settled issues.

As a side benefit, it facilitates the projection of revenue estimates for proposed changes in property tax rates (the base is considered to be a more-or-less inviolable feature of the property tax; the rate is not). If both the base and the tax rate were to be changed to follow some combination of other states' exemptions it would not be possible to formulate accurate revenue estimates for Oklahoma in the time available for this study.

#### **MINIMIZE EFFECTS ON EXISTING STATE FUNDING POLICIES**

Some state taxes reflect the application of the benefit principle of taxation discussed above. One of the more important examples is the motor fuels tax. Most states, including Oklahoma, exempt off-road motor fuel consumption because the tax is designed to pay for the construction and maintenance of roads and highways. Most states eschew tax advantages for vehicles using diesel fuel because heavy trucks clearly "use" more highway resources per vehicle mile than do cars. Oklahoma is an exception; it applies a higher tax rate to gasoline than to diesel fuel - a clear violation of the benefit principle.

When taxes are imposed on the basis of the benefit principle, the revenues are normally apportioned to specific functions of government. This raises the difficult problem of disentangling the tax structure from the expenditure of tax revenues. The Oklahoma Department of Transportation receives all of the revenue from the motor fuels tax, except that transferred to counties for road functions. The ODOT, however, has also received some funding from the state's general revenue fund. Currently, highway "revenue" bonds are paid from the general revenue fund to the tune of nearly \$125 million per year. In short, the benefit principle is not a hard, binding constraint on setting funding priorities in Oklahoma, even in an area where it can be expected to be applied most completely. Nevertheless, historical links of tax revenue sources and funding cannot be ignored.

A second example of the link between revenue sources and funding policy is imbedded in the state aid funding formula for elementary and secondary education. As a matter of policy, Oklahoma has attempted to minimize the tie between local property wealth and ability to fund local education programs. The state aid formula ties local dollars, dependent on local wealth, to state aid dollars. Any changes in the local property tax would require a review and possible adjustment of the current state aid formula.

As a principle for choosing new tax sources, therefore, only those that minimize the impact on existing policies concerning funding priorities will be included. This is done with the belief that funding priorities, either directly through appropriation or indirectly through apportionment of tax revenues, are the province of the legislature acting in concert with the governor and should not be driven automatically by the structure of the tax system.

## V. LESSONS FROM OTHER STATES

This section explores the main characteristics of state and local government finances in the states that have no state personal income tax and that also exempt food for home consumption from their general sales tax. State/local finances in Florida, Nevada, Texas, and Washington are structured to function without these two significant tax sources. If Oklahoma were to also eliminate these two sources and continue to finance state/local jurisdictions at the same level in the initial year of change, it would have to turn to other revenue sources to make up for the loss of roughly a 15-17 percentage point share of its total state and local government general revenues. That is, if state/local government general revenue were viewed as a pie, then a slice equal to 15-17 percent of the pie would be removed and then replaced with a slice consisting of different revenue sources. The four states illustrate a variety of responses to the need to manage a state/local revenue system without the two tax sources.

It is also noted that no corporate income tax is levied in Nevada, Texas, and Washington. Unlike Oklahoma, all four comparison states are “pick up” states with respect to the estate tax. Neither the corporate income tax nor the estate tax receives special emphasis in this section. In the discussion that follows, we will elaborate on the following propositions:

- Comparative analyses must treat state and local governments as a single, unified system in each state.
- When it comes to delivering services to citizens, state/local government systems throughout the nation perform roughly the same functions in roughly the same proportions. Thus it is reasonable to compare governmental finances for states as diverse as Oklahoma, Florida, Nevada, Texas, and Washington.
- As it anticipates ending its personal income tax and sales tax on food for home consumption, the patterns within Oklahoma and in the other four states suggest that Oklahoma faces limited options as it turns to other revenue sources to replace lost revenue in a revenue-neutral manner.

In most of the analyses, the states will be compared for the 1996-97 fiscal year. Unfortunately, that is the latest year for which the U.S. Census Bureau has released data as part of its regular series of reports on government finances. There are no other comprehensive sources of state/local government finance data.

Before proceeding with the state-level analysis, a brief discussion of the use by the 50 states of the individual income tax and the general sales tax on groceries will place these two tax sources into a national perspective.

### **INDIVIDUAL INCOME AND SALES TAXES IN THE FIFTY STATES**

Seven states have no state/local individual income tax. These are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. Thirty states do not levy a general sales tax that applies to groceries. Four of those 30 states (Delaware, Montana, New Hampshire, Oregon) do not have any general sales tax at all.<sup>1</sup> The remaining 20 states apply their state/local general sales tax to food. A few of those 20 states provide for a reduced sales tax rate on food in comparison with a basic rate applied to other covered transactions. Louisiana will remove food from its general sales tax on July 1, 2002.

When the seven states without the individual income tax are compared with a list of the 30 states without a grocery sales tax, only Florida, Nevada, Texas, and Washington do not use either tax source. Alaska does not have a state general sales tax, but local jurisdictions do levy a sales tax that only exempts groceries being paid for through the federal food stamp or WIC programs. South Dakota and Wyoming do not exempt food.

Tennessee and New Hampshire both have individual income taxes, but the taxes apply to income from intangible assets only, i.e. certain interest and dividends.<sup>2</sup> Thus these states really do not have a standard individual income tax. Tennessee is viewed briefly because it has not ratcheted up its property tax, while New Hampshire is of interest because it also has no general sales tax.

### **STATE AND LOCAL GOVERNMENT FINANCE AS A UNIFIED SYSTEM**

State governments are granted substantial powers by the 10<sup>th</sup> Amendment to the U.S. Constitution. Although there are also other provisions of the U.S. Constitution affecting state taxes, the power to tax is an 'inherent attribute' of state authority.<sup>3</sup> Local jurisdictions gain their authority through state constitutions and statutes. Thus the allocation of taxing authority between state and local jurisdictions is a matter determined by state government policy. Oklahoma's state constitution, for example, prohibits state government from levying a property tax and sets forth

maximum rates for local property taxes. Washington, on the other hand, receives a significant flow of property tax revenue at the state level.

With access to a greater range of types of taxes and with efficiencies in administration, state governments' taxes tend to raise a larger share of state and local government general revenue than local taxes. State governments then provide various flows of intergovernmental payments to local jurisdictions. The most important of these flows in Oklahoma involves state aid to local school districts.

Given the typical dominance of state as opposed to local revenue generation, there is, however, substantial variation in the relative importance of state versus local governments across the fifty states. This variation is illustrated in a comparison between state/local tax revenue for Oklahoma and Texas in 1996-97. In Oklahoma, state government tax revenues were responsible for 71.0 percent of all state/local tax revenue; in Texas the state government share of the total was only 52.9 percent. Oklahoma operated a tax system that was much more fiscally centralized than in Texas.<sup>4</sup>

Given this variation in the degree of state centralization of revenue collection, any comparisons of either state finance alone or local finance alone will be misleading—particularly with respect to statements about tax revenues per capita or taxes relative to income. Moreover, it is impossible to consider major changes in the structure of state government taxes without examining the ramifications for local cities, counties, and school districts. For such purposes, all governments within a state must be treated as a single unified system.

## **STATE/LOCAL GOVERNMENT EXPENDITURE COMPARISONS**

Even though the four comparison states are quite different in scale, economic base, and income, it is still reasonable to make state/local government finance comparisons with Oklahoma. Within the U.S. federal system of government, state and local jurisdictions provide roughly the same mix of services to citizens everywhere. That being said, we still need to note some major differences between Oklahoma and the comparison states. First, we will examine contrasts in population, income, and state/local spending relative to population and income. Then we will observe how amazingly similar the states are with respect to the mix of services delivered.



## CONTRASTS IN POPULATION AND INCOME

Texas and Florida dominate the comparison group population figures in 2000.<sup>5</sup>

<i>Oklahoma</i>	3,450,654
Texas	20,851,820
Florida	15,982,378
Washington	5,894,121
Nevada	1,998,257

All four of the comparison states have per capita personal income levels that are substantially higher than Oklahoma. Here are the data for 2000:<sup>6</sup>

<i>Oklahoma</i>	\$23,517
Washington	31,528
Nevada	30,529
Florida	28,145
Texas	27,871

The percent of persons living below the federally determined poverty rate indicates that the two comparison states with the highest per capita personal incomes also had the lowest poverty rates (Washington: 9.2 percent and Nevada: 11.2 percent) on average during 1997-99. Oklahoma's poverty rate of 13.5 percent was virtually identical to Florida's 13.3 percent. The poverty rate in Texas of 15.6 percent is above what might be expected from the state's per capita personal income level.<sup>7</sup>

A relatively high incidence of poverty is often related to a relatively high degree of inequality in the distribution of an area's income. A recent report by the Center on Budget and Policy Priorities included a ranking of states in which the measure of income inequality compared the average income of the top 20 percent of a state's families with the average income of the bottom 20 percent during 1996-98.<sup>8</sup> Using this measure, Texas and Florida exhibited greater income inequality than Oklahoma, while Washington and Nevada had less inequality. Here are the calculations:

	Average income, <u>bottom fifth</u>	Average income, <u>top fifth</u>	Top-to-bottom <u>ratio</u>
<i>Oklahoma</i>	\$11,558	\$115,272	10
<i>United States</i>	12,986	137,485	10.6
Texas	11,200	130,302	11.6
Florida	11,847	125,204	10.6
Washington	15,123	138,787	9.2
Nevada	15,635	132,301	8.5

The income measures used in the above data are those of the Census Bureau's surveys of family income and apply before the payment of state and federal income taxes. The measures also do not include capital gains or non-cash government benefits such as food stamps and subsidized housing.

#### **CONTRASTS IN EXPENDITURES RELATIVE TO INCOME AND POPULATION**

The substantial differences in population size and per capita personal income are muted when comparisons of state/local government expenditures are normalized for income. Relative to its personal income, Oklahoma actually spent more on state/local government in 1996-97 than all of the comparison states except Washington. Here are state/local direct general expenditures per \$1,000 of total personal income for each of the states:

<i>Oklahoma</i>	\$174
Washington	192
Florida	168
Nevada	167
Texas	163

Even though Oklahoma's expenditure effort compared to its income was relatively high, the state apparently did not provide as much governmental service per person as the four comparison states. Oklahoma's relatively low expenditures per capita are primarily a reflection of the state's low per capita personal income. Washington and Nevada spent more per person than Oklahoma and the other two comparison states. Here are direct general expenditures per capita for 1996-97:

<i>Oklahoma</i>	\$3,675
Washington	5,148
Nevada	4,721
Florida	4,319
Texas	3,949

Washington in particular appears to have a high preference for state/local government services.

### **EXPENDITURE SHARES FOR VARIOUS GOVERNMENT FUNCTIONS**

Table 3 permits a comparison of relative shares of direct general expenditures for state/local governments for selected government functions in 1996-97. The data are for Oklahoma, the four comparison states, and the United States. Direct general expenditures include payments to employees, suppliers, contractors, beneficiaries, and other final recipients except for intergovernmental payments and payments of utilities and insurance trust operations.

Although the individual percentage shares for functions vary across Oklahoma and the four comparison states, the remarkable feature of Table 3 is the substantial similarity in the size of functional shares. For example, public school expenditures is the largest component for each state. There is also a strong pattern in which public welfare and highway expenditures have the same rank position among the functional shares.

The underlying forces driving this uniformity in functional shares reflect a nationwide consensus concerning the basic services expected from state and local governments. Because a mobile population can “vote with its feet,” it is inconceivable that any state would choose to cease supplying the core of services embodied in each of the functional areas of Table 3. State and local jurisdictions are in competition with each other. Think what would happen, for example, if Oklahoma ceased providing elementary and secondary education services! On the other hand, it is entirely feasible—and sometimes advantageous-- for a state to utilize a unique mix of sources of tax and other revenues including the total avoidance of certain taxes such as the individual and corporate income taxes.

**Table 3****Direct General Expenditure, State/Local Government  
1996-97 (percent)**

	<b>U.S.</b>	<b>OK</b>	<b>FL</b>	<b>NV</b>	<b>TX</b>	<b>WA</b>
<b>Total</b>	100.00	100.00	100.00	100.00	100.00	100.00
Higher education	8.50	11.23	5.99	6.76	10.16	9.44
Elementary and secondary education	23.62	26.56	22.46	22.89	28.66	23.02
Other education	1.47	1.43	1.09	0.61	0.92	1.55
Public welfare	16.03	13.90	12.51	8.94	14.56	14.04
Hospitals	5.46	7.68	5.86	6.06	6.68	4.79
Health	3.39	2.84	3.41	1.77	2.62	5.08
Highways	6.58	7.73	7.23	8.65	6.43	7.24
Police protection	3.82	3.30	5.09	4.71	3.61	3.00
Fire protection	1.56	1.88	1.97	2.28	1.41	1.79
Corrections	3.20	3.08	4.34	4.27	4.08	2.94
Natural resources	1.33	1.26	2.95	1.25	1.01	1.96
Parks & recreation	1.66	1.74	2.25	3.16	1.19	2.00
Housing & community development	1.86	0.90	1.38	1.42	1.08	1.94
Sewerage	2.06	1.68	1.80	1.94	1.95	2.26
Solid waste management	1.27	1.08	2.32	0.12	0.90	1.39
Financial administration	1.96	2.27	2.47	2.46	1.64	1.84
Judicial and legal	1.74	1.20	2.00	2.18	1.48	1.84
Interest on general debt	5.00	3.75	5.80	6.16	4.88	4.19
Other	9.50	6.53	9.07	14.38	6.74	9.68

Source: Census Bureau, *State and Local Government Finances, 1996-97*,  
www.census.gov/govs.

**STATE/LOCAL GOVERNMENT GENERAL REVENUE COMPARISONS**

General revenue includes all revenue except liquor store, insurance trust, and utility revenue. Taxes are the most important single source of state and local government general revenue—accounting for 56.5 percent of the total in 1996-97. In contrast to the relative uniformity in the pattern of expenditure shares, there is significant variation in the degree to

which states rely on different revenue sources. The following observations highlight some of the major contrasts between Oklahoma revenue sources and those of the four comparison states with emphasis on tax structures. Unlike Oklahoma, the four comparison states do not levy personal income taxes and do not apply their general sales tax to groceries.

**TAXES AND GENERAL REVENUE**

Table 4 contains a further reminder of the need to examine state and local government finances as unified systems. This table reports 1996-97 general revenue amounts for the United States, Oklahoma, and the four comparison states.

**Table 4  
State/Local Government General Revenue  
1996-97 (millions of dollars)**

	<b>U.S.</b>	<b>OK</b>	<b>FL</b>	<b>NV</b>	<b>TX</b>	<b>WA</b>
Total general revenue	1,289,217	12,840	63,758	7,659	78,655	28,179
Intergovernmental revenue, federal	244,607	2,263	9,248	966	14,841	4,565
Total state and local taxes	728,594	7,126	35,633	4,567	43,562	16,370
State taxes	444,197	5,061	20,985	3,045	23,025	11,202
Local property tax	208,524	1,095	11,543	937	16,349	3,283
Local general sales tax	31,333	852	445	93	2,529	967
Other local taxes	44,540	118	2,660	492	1,659	918
Charges and miscellaneous	316,016	3,452	18,876	1,603	20,252	7,244

Source: Census Bureau, State and Local Government Finances, 1996-97, [www.census.gov/govs](http://www.census.gov/govs).

More information is contained in Table 5, which reports detailed functional shares of revenues for state and local government, and in Table 6 which contains state-level only detailed data on tax collections.

**Table 5****General Revenue, State/Local Government, 1996-97 (percent)**

	U.S.	OK	FL	NV	TX	WA
Total	100.00	100.00	100.00	100.00	100.00	100.00
Intergovernmental revenue						
From Federal Government	18.97	17.62	14.51	12.62	18.87	16.20
General revenue from own sources	81.03	82.38	85.49	87.38	81.13	83.80
Taxes	56.51	55.50	55.89	59.63	55.38	58.09
Property	16.97	8.53	19.34	13.03	20.79	18.49
Sales and gross receipts	20.30	22.41	29.17	38.66	27.71	34.52
General	13.86	16.55	19.63	23.40	17.66	26.75
Selective	6.44	5.86	9.54	15.26	10.05	7.76
Motor fuel	2.18	2.71	3.08	3.71	3.03	2.43
Alcoholic beverage	0.31	0.44	0.87	0.19	0.55	0.49
Tobacco products	0.59	0.61	0.69	0.75	0.83	0.99
Public utilities	1.26	0.70	2.97	0.73	1.24	1.78
Other	2.09	1.41	1.92	9.88	4.40	2.07
Individual income	12.34	13.22	0.00	0.00	0.00	0.00
Corporate income	2.62	1.72	1.93	0.00	0.00	0.00
Motor vehicle license	1.09	4.27	1.32	1.28	1.31	1.22
Other taxes	3.19	5.35	4.13	6.66	5.58	3.87
Charges and miscellaneous general revenue	24.51	26.88	29.61	27.75	25.75	25.71
Current charges	14.78	19.12	17.94	18.55	14.67	17.60
Education	4.09	6.36	2.95	3.29	4.66	4.71
Institutions of higher education	3.43	4.84	1.94	2.45	3.82	3.99
School lunch sales (gross)	0.35	0.41	0.34	0.27	0.50	0.28
Hospitals	3.84	6.66	4.39	5.32	3.58	3.78
Highways	0.46	0.94	0.74	0.60	0.40	0.33
Airports	0.70	0.55	1.53	2.61	0.74	0.57
Parking facilities	0.09	0.06	0.11	0.03	0.03	0.04
Water transport and terminals	0.16	0.01	0.30	0.00	0.17	0.73
Natural resources	0.21	0.07	0.40	0.07	0.08	0.92
Parks and recreation	0.41	0.54	0.47	0.84	0.31	0.46
Housing and community development	0.30	0.25	0.17	0.14	0.17	0.35
Sewerage	1.71	1.35	1.93	2.32	2.16	2.62
Solid waste management	0.73	1.05	2.22	0.11	0.83	1.51
Other charges	2.06	1.28	2.73	3.23	1.54	1.59
Miscellaneous general revenue	9.73	7.76	11.67	9.19	11.08	8.11
Interest earnings	4.78	4.58	5.27	5.52	5.44	3.94
Special assessments	0.27	0.03	1.18	0.93	0.06	0.25
Sale of property	0.13	0.10	0.03	0.17	0.05	0.28
Other general revenue	4.56	3.05	5.18	2.57	5.53	3.64

Source: Census Bureau, State and Local Government Finances, 1996-97, [www.census.gov/govs](http://www.census.gov/govs).

**Table 6****State Government Tax Collections, 1996-97 (percent of total state taxes)**

<b>Tax Category</b>	<b>U.S.</b>	<b>OK</b>	<b>FL</b>	<b>NV</b>	<b>TX</b>	<b>WA</b>
Total Taxes	100.00	100.00	100.00	100.00	100.00	100.00
Property Taxes	2.32	0.00	3.74	2.02	0.00	17.20
Sales and Gross Receipts Taxes, Total	48.66	38.35	76.29	85.73	79.93	74.00
General Sales and Gross Receipts	33.18	25.15	57.25	55.99	49.35	58.67
Selective Sales Taxes, Total	15.48	13.20	19.04	29.75	30.59	15.33
Alcoholic Beverages	0.83	1.11	2.63	0.47	1.87	1.24
Amusements	0.49	0.27	0.00	16.26	0.10	0.00
Insurance Premiums	2.03	2.82	2.31	3.21	2.92	1.89
Motor Fuels	6.11	6.86	7.03	7.14	10.35	6.12
Parimutuels	0.10	0.07	0.31	0.00	0.06	0.03
Public Utilities	1.94	0.29	2.73	0.19	1.60	2.15
Tobacco Products	1.68	1.54	2.10	1.90	2.84	2.48
Other Selective Sales	2.31	0.24	1.94	0.59	10.83	1.41
License Taxes, Total	6.36	13.85	6.50	9.97	14.18	4.55
Alcoholic Beverage License	0.07	0.11	0.13	0.00	0.10	0.08
Amusement License	0.06	0.07	0.04	2.63	0.03	0.00
Corporation License	1.32	0.78	0.58	0.50	7.95	0.10
Hunting & Fishing License	0.24	0.24	0.07	0.01	0.28	0.26
Motor Vehicle License	2.91	10.78	3.84	3.24	3.41	2.18
Motor Vehicle Operators License	0.27	0.11	0.47	0.35	0.36	0.22
Public Utility License	0.10	0.00	0.13	0.00	0.06	0.10
Occupation & Business Licenses, NEC	1.30	1.75	1.19	3.12	1.86	1.34
Other Licenses	0.09	0.01	0.05	0.12	0.12	0.26
Other Taxes, Total	42.66	47.81	13.48	2.27	5.89	4.25
Individual Income	32.73	33.55	0.00	0.00	0.00	0.00
Corporation Net Income	6.89	4.37	5.85	0.00	0.00	0.00
Death & Gift	1.33	1.59	2.55	0.91	0.90	0.79
Documentary & Stock Transfer	0.61	0.14	4.72	0.08	0.00	2.73
Severance	1.04	7.98	0.36	1.28	4.98	0.73
All Other	0.06	0.18	0.00	0.00	0.00	0.00

Source: Census Bureau, *State Government Tax Collections, 1996-97*, [www.census.gov/govs](http://www.census.gov/govs)

Table 4 clearly indicates that state/local systems of taxation consist largely of taxes collected by state governments plus property taxes and general sales taxes collected by local jurisdictions. Here are the 1996-97 shares of total state/local tax revenue generated by these tax sources:

<i>Oklahoma</i>	<i>98.3 percent</i>
<i>United States</i>	<i>93.9</i>
Texas	96.2
Washington	94.4
Florida	92.5
Nevada	89.2

The above data emphasize that Oklahoma’s tax system, more than any of the comparison states, consists almost exclusively of state taxes plus local property and sales taxes.

**THE MATHEMATICS OF COMPARING REVENUE PERCENTAGE SHARES**

It is emphasized that given the fact of zero revenue shares for the personal income tax (and for the corporate income tax in Nevada, Texas, and Washington), it is a mathematical certainty that some of those states’ functional revenue shares will exceed their Oklahoma (or U.S.) counterparts. We have no way of knowing what share of general revenue a hypothetical personal income tax or a sales tax on food for home consumption would have generated in the four comparison states. We do know, however, that the four comparison states do not exhibit significantly low levels of state/local government spending as a result of these two tax practices; their outlays per capita are, in fact, higher than Oklahoma’s. This implies that the four states have somehow “made up” for the lost revenue from the two tax sources by generating revenue from other sources. In a rough way, their revenue patterns are suggestive of what Oklahoma might do if it were to eliminate the two tax sources while holding total state/local revenues constant. Our focus at this stage is on very large revenue sources because these are the most likely to be affected by large changes in the application of major taxes.

**Impact on User Charges**—Nationwide, charges and miscellaneous general revenue accounted for one quarter of the revenue of state/local governments in 1996-97. Without a personal income tax and without a grocery sales tax, it might be expected that a state would place



more emphasis on these non-tax charges and miscellaneous revenue sources. This response may be the case for Florida and Nevada, whose revenue shares for this broad category were 29.61 percent and 27.75 percent, respectively. However, such a response is not observed for Texas (25.75 percent) and Washington (25.71 percent), both of which are slightly less reliant on this category than Oklahoma.(26.88 percent).

**Significance of the General Sales Tax**—Other things being equal, exempting food for home consumption from a state’s general sales tax should decrease the relative importance of that tax source. However, in all four comparison states, the general sales tax is a relatively more important revenue source than in either Oklahoma or the whole nation. Aside from the mathematical point mentioned above, two explanations are suggested. As we examine these explanations, we are reminded that the revenue generated by any tax is the result of multiplying the tax rate times the tax base.

First, the combined state/local sales tax rates might be higher in the four comparison states. We know, for example, that the 2001 *state* general sales tax rates are higher than Oklahoma’s 4.5 percent (Florida: 6 percent; Nevada: 6.5 percent; Texas: 6.25 percent; and Washington: 6.5 percent). We do not have comprehensive data on average local sales tax rates for the comparison states, though local rates appear to be generally less than in Oklahoma. For example, county sales taxes in Florida are 0.5 percent to 1.0 percent; no sales taxes in Texas are greater than 2 percent; and no local rates in Washington exceed 1.9 percent. In Oklahoma there is no limit to the municipal sales tax and many cities charge between 2 and 4 percent. Oklahoma counties are limited to a 2 percent sales tax, though most of the 61 counties utilizing the tax have set their rates around 1 percent.

The Census data do permit a comparison of state versus local sources of general sales tax revenues. The local government shares of general sales tax revenues in 1996-97 were:

<i>Oklahoma</i>	<i>40.1 percent</i>
<i>United States</i>	<i>17.5</i>
Texas	18.2
Washington	12.9
Nevada	5.2
Florida	3.6

These data indicate low local general sales tax rates in the comparison states relative to Oklahoma and suggest that their larger general sales tax shares of general revenue are not due to higher combined state/local rates.

Second, in spite of exempting food for home consumption, the comparison states apparently maintain broader sales tax bases to apply to goods and particularly to services not subject to the Oklahoma general sales tax. This is a more plausible explanation for the significance of general sales tax revenues even without applicability to food for home consumption. The Federation of Tax Administrators prepared a report on number of services exempted from the general sales tax for the states in 1996.<sup>9</sup> Three of the four comparison states taxed a much larger number of services than Oklahoma.

<i>Oklahoma</i>	<i>32 services</i>
Washington	152
Texas	78
Florida	64
Nevada	11

One of the factors enabling Nevada to tax fewer services than the other states from its general sales tax is the fact that it levies a 10 percent selective sales tax on sales at casinos. It is also possible that the general sales tax bases of Florida and Nevada in particular are boosted by a high incidence of tourism. Florida’s sales tax revenue is also increased by the application of that state’s general sales tax to motor fuels.

The general sales tax share reported in Table 5 for Washington was 26.75 percent—significantly greater than for the other three comparison states. The Census Bureau source used for Table 3 uses this category for both general sales tax receipts and for gross receipts tax receipts. Washington calls its gross receipts tax a “business and occupation” tax.<sup>10</sup> This is a tax on gross income paid by virtually all corporations, partnerships, sole proprietors, and nonprofit organizations operating in the state. The tax rates vary with type of operation; most businesses appear to be paying 0.48 percent (manufacturing, wholesaling) or 0.47 percent (retailing), but service providers pay as much as 1.5 percent.

**The Property Tax: Oklahoma as an Outlier**—Nationwide, the property tax generated 16.97 percent of state/local general revenue in 1996-97. However, his tax accounted for only 8.53 percent of Oklahoma’s state/local general revenue—half the share for which the tax

accounted nationally. The property tax shares for Florida (19.34 percent), Texas (20.79 percent) and Washington (18.49 percent) suggest that these states may have made up for the absence of the personal income tax and the grocery sales tax in part by loading more burden on the property tax. Put differently, those states’ willingness to pay property taxes has helped permit them to avoid a state income tax and a grocery sales tax.

At 13.03 percent of general revenue, Nevada’s property tax is relatively less significant than for the other three comparison states or for the nation as a whole, but is still greater than in Oklahoma. It remains difficult to make comparisons with Nevada because it gets nearly 10 percent of its general revenue from an “other selective sales tax”—largely its casino entertainment tax.

Relative to the four comparison states and the U.S., Oklahoma places very low reliance on its property tax. This low reliance is illustrated by comparing its revenues with population and personal income. Here is property tax revenue per capita in 1996-97:

<i>Oklahoma</i>	\$330
<i>United States</i>	816
Washington	928
Texas	843
Florida	840
Nevada	594

And here is property tax revenue as a percent of total personal income:

<i>Oklahoma</i>	<i>1.65 percent</i>
<i>United States</i>	3.35
Washington	3.74
Texas	3.81
Florida	3.47
Nevada	2.30

As with the general sales tax, we need to examine both the rate and the base of the property tax as we search for explanations of Oklahoma’s comparative status. We will examine farmland and residential property.

The value of the property tax base for farmland is relatively low in Oklahoma. This is illustrated by data on the average value of farm land and buildings per acre in 1995.<sup>11</sup>

<i>Oklahoma</i>	\$ 547
Florida	2,219
Washington	1,065
Texas	550
Nevada	289

The property tax rate that Oklahoma applies to farm real estate is also relatively low. Here are the taxes per \$100 of full value per acre for farm real estate in 1995:

<i>Oklahoma</i>	<i>0.37 percent</i>
Florida	0.80
Washington	0.74
Texas	0.61
Nevada	0.36

Roughly the same story holds for residential real estate, though these tax rates tend to be substantially higher than farm tax rates in all five states. Here are median home prices for Oklahoma City and the largest city in the four comparison states in 1999:<sup>12</sup>

<i>Oklahoma City</i>	\$ 84,200
Seattle	183,700
Las Vegas	130,800
Houston	105,300
Jacksonville	95,200

And here are 1999 effective property tax rates per \$100 of housing value:<sup>13</sup>

<i>Oklahoma City</i>	<i>1.12 percent</i>
Houston	2.84
Jacksonville	2.13
Seattle	1.18
Las Vegas	1.09

The comparison states exhibit a relatively high tax base per unit of property and/or a relatively high rate—hence the relatively high property tax share of state/local government revenues. Oklahoma has relatively low values and low rates.

Throughout the nation, the property tax is primarily a local government tax. No state property taxes were collected in Texas and Oklahoma during 1996-97. In Florida, 6.4 percent of total property tax collections were at the state level, while Nevada's state share of the tax was 6.1 percent. In Washington, however, 37 percent of total property tax collections were by state government.

**Miscellaneous Revenue Source Comparisons**—Florida received nearly 3 percent of its state/local general revenue from a selective sales tax on utilities. That state levies a 2.5 percent gross receipts tax on utilities including electricity, gas, and telecommunications services.

In Texas and Oklahoma, a severance tax on mineral production is of greater importance than in the other comparison states. However, the 1996-97 shares of state and local government general revenue in that fiscal year were only 1.6 percent for Oklahoma and 0.9 percent for Texas. Those shares will be higher following 1999. Oklahoma recently adopted an innovative sliding scale of gross production tax rates for oil in which rates of 1, 4, and 7 percent are triggered by price ranges below \$14, \$14-17, and above \$17 per barrel.

Intergovernmental revenue from the federal government is a significant component of general revenue in Oklahoma and the comparison states. The relatively large shares in Texas (18.87 percent) and Oklahoma (17.62 percent) are partially a result of the already-mentioned high poverty rates in those states. Higher poverty rates mean more people eligible for such programs as Medicaid and compensatory education. Lower shares in Washington and Nevada are consistent with their generally higher income levels. With a poverty rate matching Oklahoma's and a large elderly population, it is surprising that Florida does not exhibit a larger flow of funds from the federal government.

Texas and Washington levy "health care providers" taxes. Texas levies a 1.25 percent tax on non-Medicaid receipts of hospitals doing a substantial amount of Medicaid business. Washington taxes hospital Medicaid receipts at a 20 percent rate.<sup>14</sup> The funds are then recycled as part of the state governments' required match to get federal Medicaid funds. Florida and Nevada are not reported as having such a tax, though they might have a similar program labeled as a fee or charge. Oklahoma voters rejected such a tax scheme in 1992 in State Question 647, but the Oklahoma Legislature adopted a nursing home fee for the same purpose in 2000.

State gasoline taxes per gallon in 1999 in Nevada (24.0 cents), Texas (20.0 cents), and Washington (23.0 cents) were greater than Oklahoma's 17.0 cents. Florida's state rate was only

15.5 cents. Most states, including Oklahoma, Texas, and Washington, do not have local gasoline taxes. However, Florida and Nevada do utilize a local tax. In 1999, the total state/local gasoline tax in Las Vegas was 33.0 cents, and the tax in Jacksonville was 26.6 cents.<sup>15</sup> None of the four comparison states applies a different rate to diesel fuel, while Oklahoma applies a rate of 14 cents.

So-called “sin taxes” on liquor and cigarettes are always of interest. Oklahoma’s 1999 cigarette tax of 23 cents per pack was below Florida (33.9 cents), Nevada (35 cents), Texas (41 cents) and Washington (82.5 cents). Oklahoma’s tax on distilled spirits of \$5.56 per gallon compared with Florida’s \$6.50 per gallon, Nevada’s \$2.05, and Texas’s \$2.40. Washington uses state operated liquor stores.<sup>16</sup>

Florida has a corporate income tax, while Nevada, Texas, and Washington have none. Florida’s basic rate of 5.5 percent is only slightly less than Oklahoma’s 6.0 percent.<sup>17</sup> In the case of Texas, however, the lack of a corporate income tax is clearly compensated by a significant corporate franchise tax of 4.5 percent of “earned surplus” based primarily on the taxable income reported by firms for their federal corporation income tax (making it, in effect, a corporate income tax in all but name). Franchise taxes in Florida, Nevada, and Washington are nominal.

Nevada’s 10 percent casino entertainment tax is a unique revenue source that clearly relieves the burden on other taxes. Nevada does not have a state operated lottery, while such lotteries operate in Florida, Texas, and Washington.<sup>18</sup>

All four comparison states received about the same share of their state/local general revenue from motor vehicle license taxes (1.22-1.32 percent). This source was much more important in Oklahoma—accounting for 4.27 percent of its general revenue. This large share reflects the fact that Oklahoma’s license tax system is applied partially in lieu of a property tax.

**Brief Comment on New Hampshire and Tennessee**—New Hampshire’s state/local finance picture is of interest because that state has *neither* a significant individual income tax nor any general sales tax at all. Its individual income tax applies only to interest and dividend income and was responsible for only 1.1 percent of state/local general revenue in 1996-97. As a result, New Hampshire relies very heavily on the property tax. The state received 37.4 percent of its 1996-97 state/local general revenue from the property tax. The dominance of the property tax also meant that twice as much tax revenue was raised at the local level than at the state level. New Hampshire’s farmers paid a property tax rate averaging 1.04 percent on farm real estate

with an average value of \$2,486 per acre. In 1999, residents of that state's largest city, Manchester, paid residential property tax rates of 3.12 percent. (Data on median housing value are not available.)

Tennessee presents a state/local finance picture that also holds some interest for Oklahoma. That state's individual income tax applies only to dividends and interest on certain bonds and generated only 0.6 percent of 1996-97 state/local general revenue. Tennessee apparently does not offset the absence of significant individual income tax revenue by emphasizing the property tax. That tax accounted for only 11.03 percent of the state's 1996-97 state/local general revenue. Tennessee does not exempt groceries from its general sales tax and applies that tax to 71 services—almost as many as Texas. Another key to Tennessee's ability to do without the personal income tax appears to be linked to an unusually large flow of intergovernmental revenue received from the federal government—accounting for 25.07 percent of state/local general revenue in 1996-97.

#### **LESSONS FROM STATE COMPARISONS**

The above analysis has been undertaken within the context of eliminating Oklahoma's individual income tax and exempting groceries from the general sales tax. Comparisons have largely applied to 1996-97 because that is the latest year for which comprehensive financial data are available for state and local governments combined.

Placed in contemporary terms of 2001-02 Oklahoma state/local finances, the challenge in implementing an initial revenue-neutral change is to offset the loss of about \$2.4 billion in individual income tax receipts, probably another \$300 million (\$200 million state, \$100 million local) in sales tax receipts from groceries, and \$47 million in estate tax revenues. We estimate that this is around 15-17 percent of combined state/local government general revenue.

The “big three” taxes used by state/local governments throughout the nation are the property tax, the general sales tax, and the individual income tax. In 1996-97, these three taxes accounted for three-quarters of all state/local tax revenues nationwide. Before summarizing lessons from other states, it is emphasized that, *in a comparative context*, Oklahoma's state/local revenue system appears as though the state has already eliminated one-half of the largest of the “big three” taxes, i.e. the property tax. Nationwide, the property tax was responsible for 16.97

percent of state/local general revenues in 1996-97; in Oklahoma the property tax share (8.53 percent) was almost exactly one-half the national share.

Having eliminated half of one of the big three tax sources, Oklahoma now contemplates totally eliminating a second source - i.e., the individual income tax. If it does, it will be giving up a revenue source that tends to grow faster than income grows. It is also slightly progressive, although the current tax kicks in at a relatively low level of income. Moreover, a large share of it (around \$400 million) is exportable via deductibility from the federal income tax. On the other hand, individual income tax collections are sensitive to the business cycle and it may provide an incentive for Oklahomans to move to Texas to escape it (or at least its high marginal rates) altogether.

This puts tremendous pressure on Oklahoma to eliminate or reduce the tax. Since the income tax distorts the relative price of labor versus leisure, it is expected that its removal would enhance work effort. Saving and investing would be stimulated by the absence of a tax on interest and dividends. Investment would be further stimulated by the fact that the abolition of the individual income tax also automatically involves an end to taxing individual capital gains.

In addition, Oklahoma contemplates eliminating perhaps \$300 million in grocery sales tax revenue. This change appears to involve lots of money, but it probably accounts for no more than about 2 percent of state/local general revenue—an amount that pales in comparison with the revenue from the individual income tax. Replacing the individual income tax, and to a much lesser extent, replacing the general sales tax on groceries, will necessarily require major adjustments in the roles of other sources of state/local revenue. Several important lessons can be gleaned from interstate comparisons.

#### **GENERAL SALES TAX GROCERY EXEMPTION**

Thirty of the 50 states exempt groceries from their general sales tax. By adopting such a policy, Oklahoma would bring its tax system into line with the majority of states. Moreover, such a change would certainly make the state's sales tax more progressive—a policy change that might be viewed as desirable in a state with a relatively high incidence of poverty and a relatively high degree of income inequality. However, economic efficiency would be reduced by such a narrowing of the general sales tax base, i.e. the price of groceries to the consumer would



be lower relative to their actual cost of production than would be the case for goods and services subject to the sales tax. Such a differential would tend to distort consumer choice. Removal of groceries from the sales tax base would also reduce the stability of sales tax collections because grocery purchases tend to be relatively insensitive to the business cycle. There are also administrative costs associated with determining precisely what groceries are exempt. For example, should packaged cupcakes be included? Such problems could be overcome, however, by simply applying the exemption to all items currently covered in the federal food stamp program.

Perhaps the biggest drawback to exempting groceries from the sales tax base, however, is that the presumed objective of providing tax relief for lower-income families can be achieved with a much smaller revenue loss with a tax credit available primarily to these families. In fact, Oklahoma currently has a sales tax credit that provides up to \$40 a year in income tax relief. At a state tax rate of 4.5 percent, this is equivalent to exempting \$878 in grocery purchases from the state sales tax. Although only part of the households who are eligible file for and receive this credit, the state gave up \$34.6 million in this way in fiscal year 2001. Even a doubling of this credit to cover sales taxes on food more thoroughly would result in lower revenue losses than those resulting from the exemption of food from the sales tax base.

## **GENERAL SALES TAX ON SERVICES**

Three of the four comparison states extend their general sales tax to a larger number of services than Oklahoma. As Oklahoma removes groceries from the general sales tax, an expansion of the sales tax to a greater range of services would be consistent with patterns in other states. Such a broadening of the sales tax base could have a positive effect on economic efficiency (just the opposite effect of exempting groceries from the sales tax base). This would also make sales tax revenues more responsive to economic growth than is currently the case. As societies become more and more affluent over time, there is a well-established trend for the ratio of services demanded to rise relative to the amount of goods demanded. This effect would be particularly marked if the sales tax were extended to health care services. The broader the sales tax base, the more stable sales tax revenues will tend to be. Finally, the burden of a sales tax base that includes services should be distributed more progressively than one that largely excludes

services. In fact, the only drawback appears to be the prospect of higher costs of tax administration, enforcement and compliance.

### **GROSS RECEIPTS TAX**

The state of Washington receives a significant share of its tax revenue from a gross receipts tax (its Business and Occupations Tax). This tax on all production satisfies several of the criteria of a good tax. Its very broad base and low rate have a favorable impact on economic efficiency. Horizontal equity is achieved through its near universal application. Since it is a tax on all production, the revenue from this tax should be very closely related with cyclical and trend economic conditions.

The large revenue potential of this base may even permit the state to eliminate the corporate income and franchise taxes as sources of revenue. The former is a particularly inviting target for elimination. It is a very unstable source of revenues, and its mere existence allows it to be used as a tool against Oklahoma in the competition for new enterprises. In fact, Washington justifies its use of the gross receipts tax, in part, as a superior alternative to the corporate income tax.

### **SALES TAX ON UTILITIES**

Oklahoma could take a lesson from Florida and apply its state sales tax to utility sales to residential customers (currently exempt). The impact of such a change on equity is unclear, but broadening the tax base should positively affect economic efficiency.

### **PROPERTY TAX**

The four states without a state personal income tax and grocery sales tax rely more heavily on the property tax than Oklahoma. It will be difficult for Oklahoma to adjust its state and local government revenue system to the absence of these two tax sources without greater reliance on the property tax. A shift from reliance on the individual income tax to the property tax will have an uncertain impact on equity—certainly the income tax is progressive, and there is evidence that the property tax, too, is progressive.<sup>19</sup> There are, however, serious problems of

comparison associated with the proposition that income tax liabilities are positively related to annual income, while, on a year-to-year basis, property tax liabilities are independent of current income. Even in the long run, property tax revenues are not as responsive to economic conditions as the sales and income taxes.

### **PROPERTY TAX: LOCAL AND STATE**

In Florida, Nevada, and Texas, heavier reliance on the property tax also means generating a greater share of state and local tax revenue at the local level by cities, school districts, and counties. Heavy local reliance on the property tax may mean that the tax performs well in terms of the benefits received criterion of a good tax. People vote locally to tax themselves to supply local services which they demand. State and local property taxes are also partly exportable via deductibility from the federal income tax. However, especially with respect to school finance, greater reliance on the local property tax means greater inequality of per capita local spending because of variations in assessed valuation per person among the various jurisdictions. The state of Washington collects a substantial share of its property tax revenues at the state government level. This Washington pattern could be applied to increases in the Oklahoma property tax, with proceeds from the statewide tax flowing into the state's general revenue fund.

### **CHARGES AND MISCELLANEOUS REVENUE**

Charges and miscellaneous general revenue account for about one-quarter of total revenue in the comparison states. Although Florida and Nevada may be more inclined toward this source, it does not appear that doing without the individual income tax or sales tax on groceries has led to substantially greater emphasis on user charges. There are always opportunities for substituting user charges for general revenue appropriations—again consistent with the concept that beneficiaries of government services should be responsible for paying for those services.

## **SEVERANCE (GROSS PRODUCTION) TAX**

Oklahoma's severance tax policy gains little insight from the states of Florida, Nevada, and Washington—states with little energy production. Texas taxes gas production at a higher rate than oil, but does not use a system of sliding oil tax rates triggered by the price of oil. Perhaps Oklahoma could learn from itself and add a series of rates even higher than 7 percent as the price of crude oil reaches a series of notches above \$17 per barrel. With substantial royalty ownership by out-of-state residents, such a tax change would have merit as an exportable measure. The chief drawback to this option is that this tax base is steadily disappearing along with declining oil reserves.

In a longer-run context, the revenue potential from an increase in the gross production tax on natural gas is much greater and the base is probably somewhat more stable. The gross production tax on gas is also partly exported to non-resident owners of gas-bearing property.

## **HEALTH CARE PROVIDERS TAX**

In addition to levying a “fee” of 6 percent on nursing home receipts rather than a “tax,” Oklahoma's 2000 measure could be expanded to include fees applied to hospital receipts and prescription drug sales. Such fees would further reduce the need for general fund commitments to match federal Medicaid dollars. These are high-powered dollars; in the current fiscal year, \$1.00 of state Medicaid matching funds in Oklahoma brings in \$2.48 in federal funds, greatly reducing the real cost of this tax to Oklahomans. This area of taxation/charges could prove extremely important as the number of elderly Oklahomans increases dramatically in the not-too-distant future. In the case of nursing homes, such a fee roughly fits the benefits received criterion because a very large share of nursing home residents are supported by Medicaid. However, the correlation between beneficiaries and fee payers is less clear with respect to hospital services and prescription drugs.

## **MOTOR FUEL TAXES**

Oklahoma's motor fuel taxes are less than those of the comparison states. As Oklahoma seeks small change under the sofa cushions, perhaps it might turn to motor fuel taxation, e.g., by

eliminating the lower rate for diesel fuel, increasing both the rate on diesel fuel and gasoline to match those charged by neighboring states (especially Texas), and allowing municipalities to levy the tax. With motor fuel taxes earmarked for highways, this is a tax that meets the criterion of benefits received. Oklahoma has found it necessary to use its general revenue fund to supplement motor fuel tax revenues; an increase in motor fuel taxes might remove that pressure on the general revenue fund. On the other hand, higher taxes on diesel fuel might impede the development of the state's trucking, warehousing, and distribution industries.

### **“SIN TAXES”**

Support can always be garnered for raising sin taxes—though the four comparison states offer little policy insight. More can be learned by looking at competitive excise taxes in bordering states. Taxes on tobacco products and liquor are probably regressive. As with any selective excise tax, increasing tax rates on these products would have a negative impact on economic efficiency. There is a good argument, however, that society does not want economic efficiency in this domain. Oklahoma probably faces limited options with respect to raising taxes on tobacco products because such products are also available at Native American tribal retail outlets charging lower tax rates.

### **CORPORATE INCOME TAX**

Only Florida among the comparison states has a state corporate income tax. Thus Nevada, Texas, and Washington have not used that source to offset the absence of an individual income tax and a grocery sales tax. Texas creates a special competitive problem for Oklahoma's use of the corporate income tax. Texas asserts that it has no corporate income tax—an assertion that is technically correct. However, its use of a substantial corporate franchise tax keyed to corporate income reported to the federal government makes up for the absence of a corporate income tax. Oklahoma could choose one of two competitive alternatives. First, it could completely abolish its corporate franchise tax as suggested by the 1998 report of Oklahoma's Citizens' Task Force on Taxation.<sup>20</sup> Or it could mimic Texas and abolish the corporate income tax while greatly expanding the corporate franchise tax. Or it could use the gross receipts tax

base to fund the elimination of the corporate income tax and simultaneously promote truth-in-tax advertising.

### **UNIQUE TAX/REVENUE SOURCES**

There is virtually no chance that Oklahoma would be either inclined or able to establish a significant casino gambling industry, so there is little to be learned from Nevada's casino entertainment tax.

Florida, Texas, and Washington all utilize state operated lotteries to supplement tax revenues. Any major restructuring of Oklahoma's tax system is likely to incite new pleas for a state lottery.

### **CONCLUSION**

As we conclude this discussion of comparative state/local revenue systems, we are reminded of the relative uniformity in the functional distribution of state/local expenditures. This reflects a degree of similarity in the services that citizens expect of their state and local governments throughout the nation.

The great variation in *how* these state and local government services are financed also reminds us that state/local revenue systems reflect the unique economic structures and value systems of states and localities as they have evolved over time. For example, the citizens of the states of Washington and Texas look at the property tax in a different light than Oklahomans. Nevada, with its substantial revenue from a casino entertainment tax has a different view of gambling than Oklahoma, which only in recent years approved pari-mutuel betting on horse races. New Hampshire, with awesome property taxes and neither individual income nor general sales taxes, views state/local finance from a perspective different from most other states. As pointed out above, Oklahoma's unique value system and historical precedents create constraints for changing the state's revenue system. These will be combined in section VI with the assessment just outlined to identify options for replacing the proposed revenue reductions.

## ENDNOTES

<sup>1</sup>Federation of Tax Administrators, 444 N. Capitol St. N.W., Washington, DC, [www.taxadmin.org](http://www.taxadmin.org).

<sup>2</sup>Research Institute of America, *All States Tax Handbook*, New York: 2001, pp. 99-107.

<sup>3</sup>M. David Gelfand and Peter W. Salsich, Jr., *State and Local Taxation and Finance*, St. Paul: West Publishing Co., 1985, p. 5.

<sup>4</sup>Throughout this section, and in Tables 1-4, the data used are from the U.S. Census Bureau's 1996-97 reports of financial statistics for state and local governments. See [www.census.gov/govs](http://www.census.gov/govs).

<sup>5</sup>U.S. Census Bureau, internet release, Dec. 28, 2000.

<sup>6</sup>U.S. Department of Commerce, Bureau of Economic Analysis, "State Personal Income & State Per Capita Personal Income: 2000," news release, April 24, 2001, [www.bea.doc.gov/bea/newsrel](http://www.bea.doc.gov/bea/newsrel).

<sup>7</sup>U.S. Census Bureau, "Poverty 1999," [www.census.gov/hhes/poverty](http://www.census.gov/hhes/poverty).

<sup>8</sup>Jared Bernstein, *et al.*, *Pulling Apart: A State-by-State Analysis of Income Trends*, Washington, DC: Center on Budget and Policy Priorities, 2000, p. 9.

<sup>9</sup>Federation of Tax Administrators, "FTA Survey of Taxation of Services," Dec. 1996.

<sup>10</sup>State of Washington, Department of Revenue, "Information on Washington's Tax Structure, Business and Occupation Tax," July 1999, <http://dor.wa.gov>.

<sup>11</sup>U.S. Department of Agriculture, *Agricultural Statistics 2000*, p. x-1, [www.usda.gov/nass/pubs/agroo](http://www.usda.gov/nass/pubs/agroo).

<sup>12</sup>Nancy V. Kniskern and Dawn Bokenkemp Toth, eds., *Moving & Relocation Sourcebook and Directory 2001*, Detroit, MI: Omnigraphics, 2000.

<sup>13</sup>Government of the District of Columbia, Chief Financial Officer, *Tax Rates and Tax Burdens In The District of Columbia—A Nationwide Comparison*, July 2000, <http://cfo.washingtondc.gov/services/studies>, p. 29.

<sup>14</sup>Commerce Clearing House, *State Tax Guide*, Chicago: CCH Incorporated, 2001.

<sup>15</sup>Government of the District of Columbia, p. 35.

<sup>16</sup>Research Institute of America, pp. 258-59, 274-75.

<sup>17</sup>Research Institute of America, pp. 57-58.

<sup>18</sup>For a discussion of a potential lottery in Oklahoma, see Kevin Washburn, *Fiscal and Economic Issues of a Lottery in Oklahoma*, Oklahoma Office of State Finance, Dec. 1989.

<sup>19</sup>Ronald C. Fisher, *State and Local Public Finance*, 2<sup>nd</sup>.ed., Chicago: Irwin, 1996, pp. 365-68.

<sup>20</sup>Howard Cotner, Chair, *Final Report, Citizens' Task Force on Taxation*, Oklahoma Legislature, 1998, p. 14.

## **VI. POTENTIAL REVENUES**

The preceding discussions provide a basis for identifying new sources of revenue to replace those that would be lost. In this section, we examine the revenue potential of several sources..

The prospective sources are:

- changes in the sales and use tax code
- an increase in the motor vehicle excise tax rate
- additional gross receipts taxes
- an increase in property tax rates
- an increase in motor fuels tax rates
- an increase in the gross production tax rate
- an increase in taxes on cigarettes, tobacco products, and alcohol

We will also discuss revenues that could be derived from a lottery and taxes on health care providers.

Table 7 provides a summary of the estimates of the tax receipts from the potential changes that will be discussed, along with the source of the estimates: OTC is the Oklahoma Tax Commission and OU/OSU refers to estimates made by this study team. All estimates are made on the basis of best available data. The OU/OSU estimates, in particular, would require additional research, including assistance from tax experts in state government, before they could be used as "certifiable" estimates.

### **CHANGES IN THE SALES AND USE TAX CODE**

We consider two types of changes in the sales and use tax code: (1) an increase in the rate levied on the existing tax base, and (2) the addition of various services to the existing tax base. We also include an increase in the motor vehicle excise tax rate in this section; it is simply a sales/use tax levied on a particular product.



**Table 7**

**Potential Tax Receipts from Selected Changes in the Tax Code**

Tax	Change	Receipts \$ Thousand	Year Code	Source
<b>Sales Tax</b>				
Current Base	1 Percentage Point Rate Increase	330,222	2	OTC
<b>Services Tax Base</b>				
Services Taxed by Texas	1 Percentage Point	17,262	2	OTC
Smallest Services Sector	1 Percentage Point	Unknown	4	OU/OSU
Largest Services Sector	1 Percentage Point	Unknown	4	OU/OSU
All Services Sectors	1 Percentage Point	632,541	4	OU/OSU
<b>Use Tax</b>				
Current Base	1 Percentage Point Rate Increase	23,395	2	OTC
<b>Motor Vehicle Tax</b>				
	1 Percentage Point Rate Increase	71,692	3	OTC
<b>Gross Receipts Tax</b>				
Smallest Sector	1 Percentage Point	1,392	4	OU/OSU
Largest Sector	1 Percentage Point	454,903	4	OU/OSU
All Sectors	1 Percentage Point	2,041,818	4	OU/OSU
<b>Property Tax</b>				
Centrally-Assessed	1 Mill Increase	2,132	1	OTC
Locally-Assessed	1 Mill Increase	11,821	1	OTC
<b>Motor Fuels Tax</b>				
Gasoline	1 Cent Per Gallon Increase	19,096	4	OTC
Diesel	1 Cent Per Gallon Increase	7,489	4	OTC
<b>Gross Production Tax</b>				
Crude Oil	1 Percentage Point Increase	17,168	4	OTC
Natural Gas	1 Percentage Point Increase	79,046	4	OTC
<b>Cigarette Excise Tax</b>				
State Sales	1 Cent Per Pack Increase	2,385	2	OTC
Tribal Sales	1 Cent Per Pack Increase	286	2	OTC
<b>Tobacco Products Excise Tax</b>				
<b>State Sales</b>				
Small Cigars	0.5 Cents Per Cigar	1	2	OTC
Large Cigars	0.25 Cents Per Cigar	2	2	OTC
Smoking Tobacco	5 Percent Increase	27	2	OTC
Chewing Tobacco	5 Percent Increase	517	2	OTC
<b>Tribal Sales</b>				
Small Cigars	5 Percent Increase	1	2	OTC
Large Cigars	5 Percent Increase	6	2	OTC
Smoking Tobacco	5 Percent Increase	3	2	OTC
Chewing Tobacco	5 Percent Increase	62	2	OTC

Year Code: 1=1999; 2=2000; 3=2001; 4=2002

The current sales tax base is relatively narrow, consisting mainly of sales of tangible property and excluding sales of most services. Application of a tax rate increase to the current base, however, is a significant potential source of new revenues. According to Table 7, a one percentage point increase in the state sales tax rate would produce over \$330 million in additional tax receipts. Given that Oklahoma already has a relatively high combined state and local sales tax rate (7.5 - 8.0 percent), the levy of such an increase may be questionable.

The sales tax on services is intended as a levy on purchasers of services, although it would, for practical reasons, be collected from vendors or sellers of services. How much could be collected depends on what constitutes a service, which purchasers should pay the tax, and the rate that should be charged.

One option is to tax the services that are currently taxed in Texas, but not in Oklahoma. Although some believe that this would be a source of significant new revenues, the tax base for services taxed in Texas, but not in Oklahoma, is really quite narrow. Accordingly, Oklahoma would raise only \$79 million by applying its 4.5 percent rate to this base (see Table 7).

The definition of potentially taxable services is a difficult matter. In the view of most tax experts, services include those that are produced in the so-called Services Sector, plus those produced in other sectors, as well; most notably, in Agriculture, Mining, Construction, Transportation, Communications, Utilities, Finance, Insurance, and Real Estate. As the data in Table 7 indicate, the potential revenue from taxing sales of services in all of these sectors is quite large – over \$603 million per percent. Table 7 also indicates that the range across sectors is quite large.

A relatively detailed sectoral breakdown is presented in Table 8. The data in this table are based on the 1997 Economic Census of the U.S. Census Bureau. The data are allocated according to the North American Classification System (NAICS) codes used for the first time in 1997. These data provide the most detailed breakdown possible of the sales tax base. Whether they could be used as estimates of impacts of specific legislation, however, would depend on the way in which the Oklahoma legislature defines "sales subject to taxation". We have anticipated that they would exclude sales to government and have deleted this element from the tax base. We have made no other adjustments for specific legislative priorities, however.

**Table 8**  
**Potential Sales Tax Receipts**

Sector	Estimated Net Taxes Per Percent \$2002 (000)
Forestry, Fishing and Hunting and Ag Support Services	965
Construction	94,043
Transportation, Communication, and Public Utilities	138,084
Finance, Insurance, and Real Estate	133,030
Services	266,418
Total	632,541

To project gross receipts beyond 1997, we make the assumption that gross receipts will grow at least as quickly as wages and salaries by industry. The 1997 figures are updated to 2000 by applying the actual rate of growth of wages and salaries by industry for Oklahoma from 1997 to 2000. Estimates for fiscal year 2002 are made by updating the 2000 figures using the average rate of growth of wages and salaries that prevailed in Oklahoma from 1992 to 1999 by major industry.

**GROSS RECEIPTS TAX**

The gross receipts tax is intended to be levied on and collected from producers. How much it could yield depends on which producers are taxed (the tax base) and the rate levied on these producers. Table 9 depicts our estimates of potential gross receipts taxes. The base is so huge that it can produce significant receipts at low tax rates - a little over \$2 billion with a rate of one percent, after excluding the items that are currently subject to a gross receipts tax.

**Table 9**

**Potential Receipts from Gross Receipts Tax**

Sector	Estimated Net Taxes Per Percent \$2002 (000)
Farming	38,876
Forestry, Fishing and Hunting and Ag Support Services	1,392
Mining - Non oil and gas	2,704
Construction	118,854
Manufacturing	454,903
Wholesale Trade	415,365
Retail Trade	378,893
Transportation, Communication, and Public Utilities	183,065
Finance, Insurance, and Real Estate Services	136,121
	311,644
Total	2,041,818

Note: excludes existing gross receipts taxes on oil and gas extraction and insurance premiums.

Similar to Washington, Oklahoma's gross receipts tax base consists of the value of goods and services produced in Oklahoma (not including government). To determine the gross receipts tax base, we start with 1997 Economic Census data and use the same procedures described above for the sales tax estimates to project the 1997 data to the year 2002<sup>1</sup>

Oklahoma's gross production tax on oil and gas is equivalent to a gross receipts tax on oil and gas produced at the wellhead, so this sector should probably be exempt from further gross receipts taxation. Oklahoma also has a tiny gross receipts tax (0.1 of 1%) on public lodging, on food, confections, and drinks sold by hotels, restaurants and bars, on private tourist attraction admissions, on motor vehicle rentals, and on tour bus and sight-seeing passenger tickets. An adjustment for this tax would not make a noticeable difference in total gross receipts, however.

The legislature may be tempted to exclude gross receipts from agriculture. A case can be made for levying a lower rate on Wholesale and Retail Trade on the grounds that these sectors have very low profit margins. A case can be made for including the services sector in the gross receipts tax base (or in the sales tax base) on the grounds that elimination of the individual

income tax would exempt a lot of service producers from income taxation. Many service producers are unincorporated businesses subject to provisions of the individual income tax code.

## **PROPERTY TAX**

As discussed extensively above, institutional constraints preclude the adoption of changes in the tax base of the property tax. In fact, the local property tax should simply be left alone and any new property taxes should be raised with a state property tax. Interstate comparisons noted already indicate that there may be room for an effective property tax rate increase. Table 7 shows that an additional mill (one-tenth of a cent per dollar) levied on the 1999 property tax base (appraised value) would have raised \$2.1 million if imposed on centrally-assessed property and \$11.8 million if levied on locally-assessed property. A state property tax may be able, however, to bear only a small share of the burden of supplying new taxes. Not only is the property tax quite unpopular, but it grows slowly relative to income and raises the specter of future increases in order to achieve long-run revenue neutrality.

## **MOTOR FUELS**

Interstate comparisons indicate that there is some room for equalizing the excise tax rate on diesel fuel and gasoline and for raising them both to a higher level. The 20 cent per gallon rate charged on both in Texas may be a reasonable target. According to data provided by the Oklahoma Tax Commission, and reported in Table 7, an additional levy of one cent per gallon would yield \$7.5 million from diesel fuel and \$19.1 million from gasoline.

## **GROSS PRODUCTION TAX**

If current rates were raised by one percentage point to 8% and applied to both crude oil and natural gas production, the gross production tax would produce an additional \$96 million in fiscal year 2002, according to estimates provided by the Oklahoma Tax Commission. The case for levying such an increase is not compelling, however, given the relative instability that marks this tax and the already high gross receipts tax levied on firms in this sector.

## LOTTERY

Thirty-seven states have lotteries. Among those bordering Oklahoma, only Arkansas does not operate a lottery. Oklahoma voters rejected a state lottery in 1994 (State Question 358) by a 60-40 margin. Nevertheless, the lottery's widespread usage among other states indicates that it remains a revenue raising measure that will be proposed from time to time.

It is difficult to predict how much revenue an Oklahoma lottery would raise. Lottery revenues for individual states wax and wane depending on the effectiveness of management, promotion, and the attractiveness of specific games. A rough idea of revenue potential can be gained by examining lotteries in surrounding states. Here are the annual lottery sales per capita for 1999-00 as reported by the North American Association of State and Provincial Lotteries ([www.naspl.org](http://www.naspl.org)).

Colorado	\$86.27
Kansas	71.58
Missouri	90.22
New Mexico	60.77
Texas	127.45

If Oklahoma did no better than New Mexico or Kansas, then a lottery in 1999-00 might have generated gross sales of between \$210 and \$247 million. "Profits" or state revenues from a lottery of 25-30 percent of sales appear reasonable for a state the size of Oklahoma. Hence an Oklahoma lottery might generate \$50-\$75 million per year.

We emphasized in Chapter IV that a state's system of generating state and local government revenues is the outcome of an evolutionary political process. This process reflects the collective values of the state's citizens. We do not recommend a lottery largely on grounds that its compatibility with Oklahoma's political culture was tested and rejected in a 1992 statewide vote. Several other factors also suggest not including a lottery in a package of measures to raise revenue. The lottery would not be a big generator of revenue. When viewed as a substitute for a tax, the lottery fails to measure up to the criteria of a good tax. Lottery revenues are unstable. Administrative costs are much higher than is the case with even a difficult-to-collect tax. A lottery is probably regressive.

As we reject a lottery, we do not deny its most attractive feature in comparison with taxes. Playing lotto or buying pull-tabs is always the result of a voluntary decision.

## ALCOHOLIC BEVERAGE TAXES

Taxes on beer (beverage tax) and liquor (alcoholic beverage excise tax) generated \$46 million in revenue for Oklahoma in 1999-00. A \$0.10 per gallon increase in the tax on beer would put Oklahoma's rate at \$0.50—only slightly greater than in comparison to Florida. An increase of \$1.00 per gallon on distilled spirits would bring Oklahoma's rate (\$6.56) slightly above Florida's \$6.50. Under most favorable assumptions of no negative impact on quantity purchased and the quantity sold forecasts implicit in the State Equalization Board's Feb. 20, 2001, itemized estimates of revenue, these rate increases would generate perhaps \$10.4 million in new tax revenues in 2001-02.

The important frame of comparison for a change in an excise tax is with neighboring states where there is likely to be substantial across-the-border trade. Here are the tax rates per gallon for Oklahoma and the four neighboring states with the greatest border interaction:

	<u>Oklahoma</u>	<u>Arkansas</u>	<u>Missouri</u>	<u>Kansas</u>	<u>Texas</u>
Beer	\$0.40	\$0.23	\$0.06	\$0.18	\$0.19
Liquor	5.56	2.50	2.00	2.50	2.40

Alcoholic beverage taxes are already about twice as high in Oklahoma as in neighboring states. Thus it is expected that further increases in Oklahoma rates would result in additional loss of sales in border areas. Because of this competitive border effect and because of the relatively small contribution to state/local general revenue that would be made by substantial rate increases, we do not recommend raising these rates.

## Cigarette and Tobacco Products Taxes

Cigarettes in Oklahoma are taxed by the state at a rate of \$0.23 per pack. A hypothetical increase of \$0.05 per pack suggests how this tax might operate to generate additional state revenue. This increase would leave Oklahoma well below Texas's rate of \$0.41, close to Arkansas (\$0.315) and Kansas (\$0.30), but well above Missouri's rate of \$0.17. Using Oklahoma Tax Commission estimates of \$2.7 million in increased revenue per penny increase in

the tax, this would have generated \$13.7 million in new revenue in 1999-00. Cigarette tax revenues have been trending downward, so it is likely that the 2001-02 receipts would be less—perhaps down 2 percent at \$13.4 million.

Cigarette tax revenue is affected by a significant trend decline in smoking. In Oklahoma, uncertainty about the effect of changing cigarette tax rates is enhanced by the availability of cigarettes at tribal outlets not subject to the state tax. Most tribes have compacted with the state to collect and remit a rate equal to one-quarter of the state rate. Thus an increase of \$0.05 by the state would trigger a \$0.0125 increase at tribal outlets. This means that the current state/tribe differential in the tax of \$0.1725 would grow to \$0.21, generating an additional stimulus for smokers to shift to tribal sources.

We do not recommend raising the cigarette tax (or the tax on tobacco products) for the following three reasons. First, the result would stimulate a further shift to tribal outlets and probably to communities in bordering states—shifts that are difficult to predict. Second, the trend decline in smoking means that this tax source is unlikely to keep pace with economic growth and will, in fact, continue to decline. Third, potential revenue from this source is relatively small.

#### **HEALTH CARE REVENUES FOR MEDICAID**

In Section V it was pointed out that comparison states Texas and Washington (which have no individual income tax and no grocery sales tax) use a “health care providers tax” to help fund the state match required to receive federal funds for the states’ Medicaid programs. A health care providers tax program was proposed for Oklahoma in 1992 that would have levied taxes on hospitals, nursing homes, and retail pharmacies for prescription drugs. In State Question 291, the voters rejected this proposal by 61-39 margin. In its 2000 session, the Oklahoma Legislature crafted a related program applying a 6 percent Nursing Facilities Quality of Care Fee to patient gross revenue of licensed nursing homes (House Bill 2109). This fee is expected to generate about \$40 million of state revenue per year that is used by the Oklahoma Health Care Authority to help achieve the state’s Medicaid match.

The attractiveness of further expansion of schemes to garner revenues from health care providers to finance Medicaid is illustrated by the fact that Oklahoma currently receives \$2.48 in



federal money for every dollar of state money put into the program. There is no doubt that an extension of some sort of percentage fee to revenues of hospitals and the sale of prescription drugs could generate significant flows to the state treasury. Health care is a very big sector in the state's economy and will continue to grow more rapidly than most other sectors.

If benefits are viewed in tandem with citizen costs, a fee on hospital services or prescription drugs is like a very progressive tax, with low-income Medicaid clients receiving substantial net benefits. Such a program also is similar in effect to a highly exportable tax, i.e. an entity outside the state, the federal government, bears 71 percent of the total burden of the program.

We do not recommend further provider taxes/fees at this time because of the recent implementation of the 6 percent nursing home fees. Moreover, specialized tax/fees with revenues earmarked should be avoided where consideration is given to expanding the domain of a broad-based tax such as the gross receipts or general sales taxes. As pointed out in Chapter IV, we generally take the position that funding priorities should not be driven by the structure of the tax system. A decision to extend the state's general sales tax to services and to adopt a gross receipts tax includes the possibility of applying these taxes to the health care industry. If this is done, then further extension of provider taxes/fees becomes a moot point.

#### **ENDNOTE**

<sup>1</sup> Gross receipts for FY-2002 for the oil and gas sector was provided by the Oklahoma Tax Commission.

## **VII. REPLACEMENT REVENUE SCENARIOS**

### **INTRODUCTION**

This section of the report provides summary results of simulations of alternative sources of replacement revenue for the three tax changes discussed in Section III.: (1) repeal of the individual income tax; (2) removal of the sales tax on groceries; and (3) modification of the estate tax. In Section III the estimate of the shortfall in revenue for FY-2002 was approximately \$2.65 billion, which enlarges to a \$4.16 billion shortfall by FY-2010. Because state and local governments in Oklahoma, in combination, have already given up one-half of the property tax in comparison with the average state, it is a daunting task to find additional revenue sources. Nevertheless, the simulation capabilities of the revenue projection model we have compiled in the conduct of this research makes it possible to analyze a large number and variety of alternative tax structures, in terms of both rates and bases.

### **THE SCENARIOS**

The possible number of simulations of alternative tax structures is, in fact, infinite. We concentrate in this section, however, on five replacement-revenue scenarios that we believe to be representative of the range and variety of potential scenarios. The scenarios and their key characteristics are presented in Table 10.

All of the scenarios incorporate the major tax adjustments we were asked to examine. The Property Tax Reliance scenario examines the implications of relying on a statewide property tax to replace revenues lost from these adjustments. As has been noted, the property tax, both in its locally- and centrally-assessed forms, has historically had a weak income elasticity (a value significantly less than 1). Property tax revenues, that is, grow less than proportionately to the growth in personal income. An increase in personal income of 10 percent results in only a 7.3 percent increase in taxes collected from locally-assessed property and in only a 4.7 percent increase in tax collections from centrally-assessed public utility property. The major implication of this weak elasticity is that property tax rates would have to rise each year to keep pace with personal income growth.

**Table 10**  
**Replacement Revenue Scenarios**

<b>Scenario</b>	<b>Principal Features</b>
Property Tax Reliance	Repeal of individual income tax Elimination of sales tax on groceries Modification of estate tax Sole reliance on property tax to produce initial revenue neutrality
Sales Tax Reliance	Repeal of individual income tax Elimination of sales tax on groceries Modification of estate tax Sole reliance on a broad-base for the sales tax and sales tax rate adjustments to produce initial revenue neutrality
Gross Receipts Tax Reliance	Repeal of individual income tax Elimination of sales tax on groceries Modification of estate tax Sole reliance on a broad-based gross receipts tax to produce initial revenue neutrality
Hybrid I.	Repeal of individual income tax Elimination of sales tax on groceries Modification of estate tax Increases in the property tax Increases in the sales tax base to include a tax on services, except sales of health care and government purchases of services Use of a gross receipts tax Increase in motor fuels taxes to 20 cents per gallon
Hybrid II.	Repeal of individual income tax Elimination of sales tax on groceries Modification of estate tax Increases in the property tax Use of a gross receipts tax Increase in motor fuels taxes to 20 cents per gallon

The second scenario, the Sales Tax Reliance scenario, examines the use of a very broad-based sales tax for revenue replacement. Several sectors of the Oklahoma economy would be subject to this sales tax, including construction, transportation, communications, utilities, finance, insurance, real estate, and services, including health services. As will be noted, even with an extremely broad base for this tax, rate increases are needed to make up for initial

shortfalls. The third scenario, Gross Receipts Tax Reliance, calls for use of a gross receipts tax broadly applied to all sectors of the Oklahoma economy, exclusive of government and oil and natural gas, the latter being a sector where a gross receipts tax is already applied. The tax base for such a revenue source is estimated to be \$204.2 billion. Consequently, it takes only a small tax rate to generate significant revenues. Firms would pay this flat rate on the value of their production or output.

The final two scenarios are hybrids that combine several tax sources to produce initial revenue neutrality. In Hybrid I., the sales tax base is extended to include a tax on the services sector only, exclusive of health services and government. It makes use of the gross receipts tax, at a rate less than one-half required under sole reliance, and increases fuel taxes to 20 cents per gallon. Increases in the property tax are then added to produce initial revenue neutrality. Just taxing the services sector, SIC codes 7000-8900, would yield an expansion of the sales tax revenue of \$1.2 billion, we estimate. Excluding health care reduces the tax yield by about 20 percent. Hybrid II. leaves sales tax bases and rates constant, except for elimination of the sales tax on groceries. It raises fuel taxes, but the principal issue addressed is how much gross receipts and property taxes have to rise to produce initial revenue neutrality.

These replacement revenue scenarios involve significant changes in disposable household income, changes in after-tax income for private-sector establishments, and changes in costs for private-sector establishments. In addition, the policy changes described in the scenarios may create shifts in the distribution of spending by households and businesses that could cause aggregate spending to increase, decrease, or not change at all. Given the limits of this study, we assume that the net effect of on aggregate spending in the Oklahoma economy is zero in each scenario. That is, we assume that the expansionary effects of tax cuts on aggregate employment, output, and income are offset by the contractionary effects of tax increases for each scenario.

### **PROPERTY TAX RELIANCE SCENARIO**

As noted, this scenario examines by just how much the locally- and centrally-assessed property tax would have to rise to replace revenues lost through the three proposed tax changes. A state-wide property tax would have to expand by 190 percent (that is, would almost have to be triple present levels) to produce equivalent revenue now being produced by the individual

income tax, the sales tax on groceries, and the estate tax. Moreover, the property tax rate would have to increase each year owing to the weak income elasticity of this form of taxation. By FY-2010, the tax would have to expand by 230 percent or by 3.3 times present levels. Table 11 below shows the projections, assuming that the revenue shortfall is initially made up by this dramatic 190 percent increase in property taxes with no future rate adjustments.

**Table 11**  
**Property Tax Reliance Scenario**  
**Baseline and Alternative Revenue Projections**  
**Repeal of Income Tax and Sales Tax on Groceries and Modification of Estate Tax**  
**Replacement Revenue Source: Locally- and Centrally-Assessed Property Tax Only**  
**(\$Millions)**

Fiscal Year	Baseline Projection	Alternative Projection	Shortfall	Tax-to-Income Ratio
FY-2000 (Actual)	6,832	6,832	-	8.65%
FY-2001	7,145	7,145	-	8.66%
FY-2002	7,475	7,507	(32)	8.71%
FY-2003	7,820	7,782	38	8.64%
FY-2004	8,183	8,069	114	8.57%
FY-2005	8,564	8,367	198	8.50%
FY-2006	8,965	8,677	288	8.44%
FY-2007	9,386	8,999	386	8.38%
FY-2008	9,828	9,335	492	8.31%
FY-2009	10,292	9,685	607	8.25%
FY-2010	10,780	10,048	732	8.19%

As seen in Table 11, the shortfall rises from -\$32 million to \$732 million. The ratio of the sum of all tax sources to total personal income falls from 8.65 percent to 8.2 percent with this increase in the shortfall. The resulting percentage shortfall rises to 6.8 percent in comparison to the baseline projection of the current tax system in FY-2010 (i.e., 732 is 6.8 percent of 10,780). It would seem apparent that the property tax is not an ideal replacement source.

**SALES TAX RELIANCE SCENARIO**

This scenario relies on a very broad base for generation of sales tax revenue along with some adjustment in the sales tax rate. Net of the sales tax on groceries, this broad base would generate slightly less than \$2.7 billion in revenue in FY-2002. The motor fuels increases are also

imposed. The “pick-up” state estate tax revenue impacts are also included. The state’s sales tax rate, however, would be able to fall to 4.3 percent from 4.5 percent to produce an essentially revenue neutral impact for FY-2002. The increase in the sales tax base is so substantial under this scenario that a decline in the sales tax rate is possible.

**Table 12**

**Sales Tax Reliance Scenario  
Baseline and Alternative Revenue Projections  
Repeal of Income Tax and Sales Tax on Groceries and Modification of Estate Tax  
Replacement Revenue Source: Broad Tax on Sales, Sales Tax Rate Decrease, and Motor  
Fuels Tax Increases  
(\$Millions)**

Fiscal Year	Baseline Projection	Alternative Projection	Shortfall	Tax-to Income Ratio
FY-2000 (Actual)	6,832	6,832	-	8.65%
FY-2001	7,145	7,145	-	8.66%
FY-2002	7,475	7,513	(38)	8.71%
FY-2003	7,820	7,833	(12)	8.69%
FY-2004	8,183	8,167	16	8.67%
FY-2005	8,564	8,517	48	8.66%
FY-2006	8,965	8,882	83	8.64%
FY-2007	9,386	9,264	121	8.62%
FY-2008	9,828	9,664	164	8.61%
FY-2009	10,292	10,082	210	8.59%
FY-2010	10,780	10,519	261	8.58%

As is apparent in this proposed scenario, the shortfall in FY-2002 is negative, indicating that projected revenues exceed baseline values. The additional projected revenue is only \$38 million, essentially a revenue neutral result. However, under this system, the shortfall expands to \$261 million in FY-2010, a 1.9 percent deficit. The combined ratio of all taxes in relation to personal income falls from 8.65 percent to 8.58 percent.

## GROSS RECEIPTS RELIANCE SCENARIO

This scenario contemplates use of a gross receipts tax at a rate capable of initially producing revenue neutrality. It incorporates repeal of the individual income tax, the sales tax on groceries, and the revenue impact of estate tax modifications. The gross receipts tax rate necessary to produce initial revenue neutrality is 1.25 percent.

**Table 13**

**Gross Receipts Tax Reliance Scenario  
Baseline and Alternative Revenue Projections  
Repeal of Income Tax and Sales Tax on Groceries and Modification of Estate Tax  
Replacement Revenue Source: Gross Receipts Tax  
(\$Millions)**

Fiscal Year	Baseline Projection	Alternative Projection	Shortfall	Tax-to-Income Ratio
FY-2000 (Actual)	6,832	6,832	-	8.65%
FY-2001	7,145	7,145	-	8.66%
FY-2002	7,475	7,514	(39)	8.71%
FY-2003	7,820	7,839	(19)	8.70%
FY-2004	8,183	8,179	5	8.69%
FY-2005	8,564	8,534	30	8.67%
FY-2006	8,965	8,906	59	8.66%
FY-2007	9,386	9,295	90	8.65%
FY-2008	9,828	9,703	125	8.64%
FY-2009	10,292	10,129	163	8.63%
FY-2010	10,780	10,575	205	8.62%

We believe, although we have little evidence at this time, that a gross receipts tax would carry an elasticity of about 1.1, slightly higher than the sales tax presently produces. The revenue surplus relative to the baseline is an initial \$39 million, growing to a shortfall of \$205 million, or 1.9 percent of the baseline in 2010. The combined tax-to-income ratio falls from 8.65 percent to only 8.62 percent. This is the lowest intermediate-term, FY-2010, shortfall we have seen in the scenarios thus far, a result consistent with the elasticity expectation. Obviously, there is considerable revenue generating power in a gross receipts tax.

**HYBRID I.**

Use of a combination of revenue sources reduces the potential for distortions on the economy. Hybrid I. expands the base of the sales tax to services exclusive of health care sales and government purchases, utilizes the gross receipts tax at a very low 0.5 percent (one-half of one percent) tax rate, and makes up for remaining differences by increasing the tax on property. Repeal of the individual income tax, the sales tax on groceries, and estate tax changes are included. Sales tax rates fall to 4.2 percent from 4.5 percent. The property tax is adjusted upward by 50 percent to produce initial revenue neutrality. Table 14 reports the results of this simulation.

**Table 14**

**Hybrid I.  
Baseline and Alternative Revenue Projections  
Repeal of Income Tax and Sales Tax on Groceries and Modification of Estate Tax  
Replacement Revenue Source: Expansion of Sales Tax Base to Services Sector Sales  
Exclusive of Health Care and Government Purchases, Use of the Gross Receipts Tax, and  
Increases in Property Taxes  
(\$Millions)**

Fiscal Year	Baseline Projection	Alternative Projection	Shortfall	Tax-to-Income Ratio
FY-2000 (Actual)	6,832	6,832	-	8.65%
FY-2001	7,145	7,145	-	8.66%
FY-2002	7,475	7,586	(111)	8.80%
FY-2003	7,820	7,898	(78)	8.77%
FY-2004	8,183	8,224	(41)	8.73%
FY-2005	8,564	8,565	(0)	8.70%
FY-2006	8,965	8,920	45	8.68%
FY-2007	9,386	9,292	94	8.65%
FY-2008	9,828	9,680	148	8.62%
FY-2009	10,292	10,085	207	8.59%
FY-2010	10,780	10,508	272	8.57%

As Table 14 suggests, this scenario initially yields somewhat higher revenue than the baseline projection at \$111 million. Yet, the shortfall rises to \$272 million in FY-2010, or 2.6 percent of the baseline value in that year. The combined tax-to-income ratio falls to 8.57 percent.



## HYBRID II.

This hybrid scenario leaves the present sales tax base and rates untouched, save for the exclusion of the sales tax on groceries. Property tax increases are the same as Hybrid I., a 50 percent increase. Thus, this scenario examines the rate necessary on the gross receipts tax to produce initial revenue neutrality. That rate is three-fourths of one percent (0.75 percent). Individual income tax repeal and modification of the estate tax are also included in this scenario.

**Table 15**

**Hybrid II.**  
**Baseline and Alternative Revenue Projections**  
**Repeal of Income Tax and Sales Tax on Groceries and Modification of Estate Tax**  
**Replacement Revenue Source: Use of the Gross Receipts Tax, and Increases in Property**  
**Taxes**  
**(\$Millions)**

Fiscal Year	Baseline Projection	Alternative Projection	Shortfall	Tax-to-Income Ratio
FY-2000(Actual)	6,832	6,832	-	8.65%
FY-2001	7,145	7,145	-	8.66%
FY-2002	7,475	7,469	5	8.66%
FY-2003	7,820	7,778	42	8.63%
FY-2004	8,183	8,101	82	8.60%
FY-2005	8,564	8,438	126	8.58%
FY-2006	8,965	8,790	174	8.55%
FY-2007	9,386	9,158	227	8.52%
FY-2008	9,828	9,543	284	8.50%
FY-2009	10,292	9,945	347	8.48%
FY-2010	10,780	10,365	415	8.45%

The shortfall rises under this scenario to \$415 million, or 3.8 percent. The combined tax-to-income ratio falls to 8.45 percent. The rather large shortfall generated by this scenario is primarily a consequence of the weak elasticity of the property tax.

## CONCLUSIONS

There are literally an infinite number of ways that the state's tax system could be restructured to achieve revenue neutrality (i.e., replication in the replacement scenario of the tax to income ratio in the baseline scenario) in the face of the proposed elimination of the individual income tax, exemption of groceries from the sales tax base, and modification of the estate tax. We have constructed five scenarios in this study that we believe are representative of the range of possibilities. The first three scenarios prescribe reliance on a single tax to take up the slack. Approaching the problem this way would require either a tripling of the property tax, a drastic expansion of the sales tax base to practically all sectors of the state's economy, or imposition of a broad-based gross receipts tax with a rate of 1.25 percent. The last two scenarios are hybrids, involving changes in more than one tax to achieve revenue neutrality. These scenarios illustrate how revenue neutrality can be achieved by combining several tax increases to offset the proposed tax reductions.

The obvious conclusion is that there is no easy way to make up for the loss of the most significant state and local revenue source in a state that has already taxing property, one of the big three revenue sources, at one-half the national average rate. While from a policy perspective it is true that any changes to Oklahoma's system should be as simple as possible, our simulations indicate that some mixture of rate and base increases, and interjection of a new tax, is probably the best strategy.

One of the most important features of the approach we have taken is that it offers a more complete understanding of how various options impact the state's revenue system. We know that our knowledge of operations of the state's system has been increased significantly as a result of application of the methodology we have developed in the conduct of this research. Additional scenarios could (and perhaps should) be constructed. We will undoubtedly do more of this as the debate on tax reform unfolds. We will make this methodology publicly available for others to apply their best judgments of policy alternatives. We are willing to assist others who may want to do it themselves by making our simulation methods and instructions in their use readily available.

## **VIII. LEGAL ASPECTS**

Changing the Oklahoma tax system in any of the ways proposed faces two significant constitutional barriers; Article X, section 9, which bars the imposition of a state-wide property tax and Article 5, section 33, which mandates a supermajority approval by the legislature of any tax increase. A further legal consideration is the method by which these tax system changes might be presented to the voters in the form of a referendum. Each of these issues is reviewed below.

### **IMPOSITION OF A STATEWIDE PROPERTY TAX**

Oklahoma is one of 11 states that do not have a statewide property tax. All states in the study group, with the exception of Texas, have a statewide property tax that allows them, in differing degrees, to finance their government services without the use of an individual income tax. Oklahoma imposed a statewide property tax until 1933 when, with the urging of Governor “Alfalfa” Bill Murray, it was abolished through a constitutional amendment. It is important to note that at the time of Oklahoma’s previous statewide property tax there was no sales tax and the income tax was an insignificant part of the tax base. Indeed, state government was funded almost exclusively with the property tax and the gross production tax, with some reliance on insurance premium taxes.

The structure of the statewide property tax envisioned here is also very different from that which Oklahoma used in the past and many institutional changes have occurred which bear mention. Oklahoma’s previous statewide property tax was used by the State Equalization Board to balance the state budget each year. The state legislature met only every other year at that time and it fell to the State Equalization Board to fund the budget in non-legislative years. The Board actually set the millage rate to determine the level of state spending. This was prior to the constitutional mandate for a balanced budget, which did not appear in the constitution until 1941. With the collapse of the U.S. economy in the 1930’s and the dramatic decline in oil prices, Oklahoma’s budget was increasingly funded by the statewide property tax as gross production tax revenues fell. The millage rate varied year to year to make up for the swings in the gross production tax. In the face of a general depression, an agrarian economy such as Oklahoma’s could not fund government services on the basis of ever-increasing property tax burdens. In some years

the change in the property tax burden was as much as 150% with no reduction in other tax burdens. It is little wonder that the previous statewide property tax was repealed and with it the extraordinary tax-setting power of the State Equalization Board.

A statewide property tax today would be imposed by legislatively determined millage rates, as with any other tax, and all current legal and institutional systems would remain in place. The legal and constitutional advantage of such a proposal over simply increasing the current millage caps on *local* property taxes is (1) it minimizes the number of constitutional changes required and (2) it allows the current state aid formula for school district operating budgets to remain intact. Raising millage caps on local property taxes would require as many as 10 constitutional amendments and perhaps running afoul of the single subject requirement of the State Supreme Court. Creating a statewide property tax would require only a single vote amending one section of one article of the constitution. Statutory language would also have to be crafted to impose the tax rate and apportion the revenue to the general revenue fund. If desired, this statutory language could be placed before the people in a referendum containing the other statutory changes proposed for changing Oklahoma's tax system. It is proposed here, however, that the tax rate on the statewide property tax would remain a statutory rate and not a constitutional rate.

#### **TAX LIMITATION AMENDMENT**

The second constitutional consideration deals with the tax limitation provision of the constitution, Article 5, Section 33. Because some taxes would be increased, either through increases in the rate or the expansion of the base, Article 5, section 33, requires a three-quarters affirmative vote in both houses of the legislature and the signature of the governor before becoming law. Further, any tax changes could not become law until 90 days after adjournment of the legislature. While such statutory change may find this level of approval, the intent of those requesting this study appears to be to seek approval from the people directly. This may be accomplished through the referendum process. All statutory changes required to effectuate any of the proposals made here can be combined into a legislatively initiated referendum and placed before the people.

In summary, the options presented here for changes in the Oklahoma tax system could be placed before the people in the form of two questions: a constitutional amendment allowing a statewide property tax and a referendum specifying all required statutory changes in other taxes. The questions could be linked so that if either one fails neither is activated. There is a precedent for such linking. Constitutional changes to the office of State Auditor and Inspector, membership on the State Equalization Board, and other changes to various elected offices in 1975, required contingent links more complicated than those required here. Of course, if no statewide property tax is proposed, this negates the need for that constitutional amendment and the people may simply choose the new tax system in one vote on a referendum.

The crafting of specific language of constitutional amendments, statutory changes, and legislative referenda is beyond the scope of this study and outside the area of expertise of the study team. It is reserved for those with bill drafting expertise and detailed understanding of the timing required to produce an orderly transition to a new tax system.

## **IX. CONCLUSIONS AND RECOMMENDATIONS**

The proposed tax changes that occasioned the need for this study would result in large revenue losses. They would be so large, in fact, that there are only three tax sources potentially capable of generating enough revenue to achieve revenue neutrality: the property tax, the sales tax on services, or a new broad-based tax, such as the gross receipts tax we examined. We examined how the revenues required to achieve revenue neutrality could be raised by relying on these taxes, both individually and in combination.

If property taxes were used exclusively, Oklahoma would have to institute a state property tax and levy rates essentially three times as large as the rates levied on property under the existing local property tax. This would have the effect of tripling the tax burden on property. There would be serious impacts on the real estate market and unknown effects on equity, both within and across generations. Moreover, the "fix" would be temporary; the low income elasticity of the property tax would require significant annual increases in tax rates to keep the ratio of taxes to income equal to that produced by the current tax system in order to maintain revenue neutrality.

If the sales tax were relied on exclusively, the tax base would have to be broadened to include services produced in many sectors of the economy outside the traditional services sector, including construction, finance, insurance, real estate, and transportation, communications, and utilities. In fact, the required increase is so large that the latter would have to ante up as much as the services sector. Unfortunately, even with all this, there would not be enough new revenue without a sales tax rate increase.

The required rate increase is problematic because Oklahoma's combined state and local sales tax rate is already high by national and regional standards. The cultural traditions and political history embodied in the current sales tax code indicate that it would also be extremely difficult to achieve the scope envisioned for the sales tax in this option.

If exclusive reliance on a single tax were required, it would probably be best to rely on a new tax with a broad base, such as the gross receipts tax used in the state of Washington. The broad base of this tax permits the levying of a low tax rate and promotes greater efficiency and horizontal equity relative to a narrower base coupled

with a higher rate. There will be some pyramiding of this tax, but it should not be significant if the rates are kept low. The tax will be difficult to pay for new and emerging firms and for firms in wholesale and retail trade where profit margins are low. These problems could be mitigated by establishing lower rates for such firms and industries. It would be difficult, however, to replicate the incentives now offered new and expanding enterprises through the income tax.

It is far better, in our judgment, to rely on a mix of new revenue sources. We examine two such mixes in response to the elimination of the individual income tax, exemption of groceries from the sales tax, and modification of the estate tax. A third scenario considers a modified individual income tax system. The first relies on an increase in the property tax burden, coupled with the imposition of the sales tax on services produced in the services sector and a low-rate gross receipts tax. The increase associated with each tax would be smaller, of course, than if each were relied upon exclusively. The second mixed, or hybrid, scenario relies on an increase in the property tax and the gross receipts tax, with no change in the sales tax. Some would advocate the first of these on the grounds that it is a more balanced approach and involves a smaller increase in the property tax. This second scenario levies a higher tax on property but taxes services at a lower rate.

We believe that there is a need to reform Oklahoma's tax system in the direction of greater dependence on taxation of services, regardless of whether the individual income tax is eliminated or modified. Failure to do so will make it necessary to repeat the search for new revenue more frequently. We do not believe, however, that the traditional approach to doing this - by applying the sales tax to additional services - is as promising a route as that of applying a gross receipts tax to the output of businesses that produce services.

Finally, assuming that the legislature/people make the modifications in the tax system that required this inquiry, it is clear that additional revenues will be required to achieve revenue neutrality. Far better, in our view, that alternative revenues come from a gross receipts tax than from an increase in the property tax.

