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## Oklahoma Policy Institute

### SPECIAL POINTS OF INTEREST

- Oklahoma's revenue has fallen dramatically in the last half of FY '09 and official estimates are that the decline will continue for FY '10.
- Most indications are that the recovery will come soon enough that state revenues will start climbing again for FY '11. The recovery, however, will be slow and the state budget may not recover to pre-recession levels until FY '13.
- The federal stimulus will reduce a projected \$1.45 billion shortfall over the next three years to approximately \$500 million.
- If revenues do start to recover in FY '11, the rules governing the Rainy Day Fund will preclude using most of it to make up for budget shortfalls.
- Part of the Rainy Day Fund should be used in FY '10. Failing to do so results in unnecessarily deep budget cuts in FY '10 and makes it likely that most or all of the Rainy Day Fund will be left intact when the recession ends.

## Now's THE TIME: Using Stimulus and Rainy Day Funds Can Reduce the Impact of State Budget Cuts

### 1. INTRODUCTION

The national economic downturn has been felt in every state and every county. Credit has disappeared, housing prices have fallen, and millions have lost their jobs. The recession has taken its toll on every sector of the economy. Few, though, have been hit as hard as state governments, which have seen tax revenue fall while demands for many of the services they provide have increased. States have been squeezed in a fiscal vice; just when we depend on them to provide an economic and social safety net, their resources are choked off. The resulting budget gaps are staggering. The Rockefeller Institute of Government projects that states will face total gaps—differences between actual revenue and the cost of maintaining existing services—of \$370 billion over the next two and one-half years.<sup>1</sup>

Oklahoma initially was better off economically than most other states, but recently has seen a steep economic downturn and substantial budget gaps. Entering the present legislative session, the state faced nearly a ten percent loss in revenue. The budget cuts that will result from this

shortfall can have significant consequences for Oklahoma. Citizens and communities lose access to key public services, the state economy recovers more slowly due to the decline in spending, and the economic and social benefits of investing in public structures—education, health, infrastructure, and public safety—are delayed by years, or lost altogether.

Clearly, Oklahoma needs to take action as soon as possible to minimize these costs to the state's future. Before we determine what actions to take, however, we need to understand what we are facing.

This issue brief evaluates the recent and future challenges facing Oklahoma's economy and their impact on state revenue. It estimates budget shortfalls through the economic downturn and projects the impact of the federal stimulus package. It also evaluates the potential for using the Rainy Day Fund to minimize reductions in state services as the economy recovers.

The key findings of this issue brief are:

- Oklahoma state revenue has fallen in fiscal year

2009 and will continue to do so in FY '10. While revenue is likely to grow starting in FY '11, the recovery will be slow.

- The state's revenue shortfalls have been, and will continue to be, hampered by the growing fiscal impact of tax cuts and diverting revenue to favored programs.
- We project that over the course of the recession, the state will face a cumulative budget shortfall of \$1.45 billion from recurring resources. It will be FY '13 before the state budget recovers to the FY '08 level.
- The federal stimulus package should provide approximately \$900 million, mostly in FY '10 and FY '11, to reduce the overall budget shortfall.
- The rules governing the Rainy Day Fund (RDF) preclude using most of it once revenues begin to recover. As a result, not using the RDF in FY

'10 may leave most of the Rainy Day Fund balance untouched at the end of the worst recession in decades.

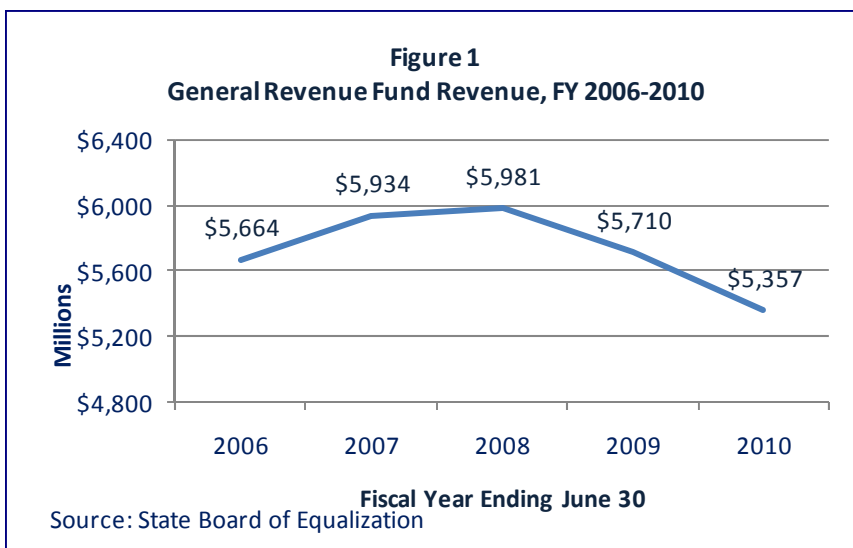
In order to preserve state services through the recovery, Oklahoma Policy Institute recommends a strategy of gradually spending the Rainy Day Fund in FY '10, '11, and '12. We further recommend delaying scheduled cuts in income and estate taxes until the economy has fully recovered. To improve the budget outlook for future downturns, we recommend restructuring the rules for the Rainy Day Fund and improving our long-range forecasting efforts.

## 2. THE REVENUE OUTLOOK

In order to project the revenue and budget shortfalls we will face—and to offer solutions—it is necessary to understand the first part of the recession and what is likely to happen next—both nationally and in Oklahoma. This section describes the recession to date and projects the economic recovery. It then shows how the recession has affected state revenues in the first two years of the downturn. Finally, it projects state revenues for the next four years based on economic models described below. It shows that Oklahoma can expect to face total budget shortfalls of \$1.45 billion before using any of the federal stimulus or the Rainy Day Fund. Just as important, it shows that the state's budget is not likely to return to pre-recession levels until FY '13 at the earliest.

The national economy entered a recession in December of 2007 (FY '08). While Oklahoma's economy performed reasonably well for the first year of the recession, the state's recent performance has been weaker and Oklahoma's economy now is tracking closely with the national economy. The question we must address is, how far may the economy fall and for how long?

Most evidence suggests the economy is reaching its lowest point and soon will begin to recover. Nationally, the Federal Re-



serve Systems' Federal Open Market Committee expects that the economy will flatten out and start growing again late in 2009 thanks to federal monetary and fiscal policies and recovery in the housing and financial markets.<sup>2</sup> Although Oklahoma entered the recession late, as is historically often the case, the experience over the course of post-war recessions is that we typically recover at the same time as the nation as a whole.<sup>3</sup>

Turning to the state's revenue picture, the impact of the economic downturn is shown clearly in the history of Oklahoma's General Revenue Fund (GRF) revenues in Figure 1. Revenues peaked in FY '08. FY '09 revenues are forecast to be \$271 million below that peak. The annual figures hide the speed and magnitude of the revenue drop during FY '09. For the first five months of FY '09, the state's General Revenue collections were 7.9 percent higher than the previous year; for the next three months, revenue was 15 percent below last year's levels. The official estimate forecasts an additional drop of \$353 million for FY '10. Over the two years, the GRF is projected to decline by \$624 million.<sup>4</sup>

What has happened so far is important, but it is not all we need to know in order

to understand the recession's impact on Oklahoma's budget and public services. The remainder of this paper looks into the future, projecting the revenue and budget shortfalls and the options available to address them.

The Rockefeller Institute of Government recently released an analysis of the last three recessions, which began in 1981, 1990, and 2001.<sup>5</sup> In all three cases, the economy recovered sufficiently that state revenues, adjusted for inflation, began growing the third year of the recession. In the current downturn, FY '11 will be the third year. Recoveries take time, though; in previous recessions it has taken three to five years for state revenues to reach their pre-recession peak, when adjusted for inflation. Rockefeller projects that full recovery will take five to six years.

The Rockefeller Institute study provides a basis for forecasting how state revenues will behave after FY '10. Rockefeller used the history of state revenues in previous recessions to project state

revenues for the current one. Figure 2 shows Rockefeller's projection of how the current recession has and could translate into state revenues under two scenarios: a "low-gap" or moderate case and a "high-gap" or more severe (but not the worst) case. We have overlaid Oklahoma's estimated performance for the first two years (through FY '10) and our projections for the next three (through FY '13).<sup>6</sup>

Each line of Figure 2 measures GRF revenues as a percentage of the actual revenue collected in the peak year, FY '08. For the first two years of the recession (FY '09 and FY '10), Oklahoma's performance has closely tracked the Rockefeller high-gap scenario. Had Oklahoma not cut income and estate taxes and diverted GRF funds to the ROADS highway program and the OHLAP scholarship program, Oklahoma's revenue would much more closely resemble the Rockefeller low-gap scenario. As compared to FY '08, these law changes cost the GRF \$173 million in FY '09 and will cost \$341 million in FY '10.

Projections and previous experience indicate that *Oklahoma's revenue will*

*start to increase in FY '11 by an estimated 1 percent.* Oklahoma Policy Institute projections call for a smaller increase than either Rockefeller scenario because conservative assumptions are appropriate in assessing long-term shortfalls and because Oklahoma entered the recession so late that a late recovery also is plausible. Tax cuts also have an impact on our projections. As compared to FY '10 revenues, tax cuts and revenue diversions will cost at least \$47 million in FY '11, \$92 million in FY '12, and \$122 million in FY '13—a total of \$261 million lost during the recovery.

As the recovery strengthens, OK Policy's projected revenue growth is approximately five percent for FY '12 and six percent for FY '13. While this would represent a slower recovery than Oklahoma has experienced in the past, the national recession is deeper and different in character than previous downturns.

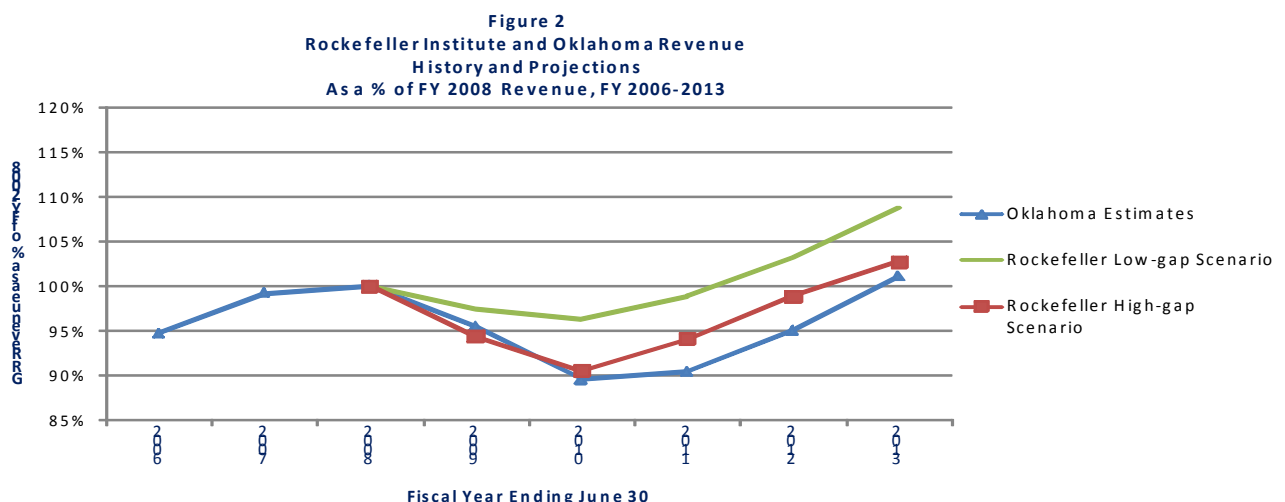
This analysis arrives at two important conclusions that should be considered in projecting the state's budget outlook and determining the most effective course of action for recovery. First,

revenues are likely to begin growing again in FY '11. Second, it will be FY '13 or later before revenues recover to FY '08 levels.

### 3.THE OKLAHOMA BUDGET OUTLOOK

While it is natural to focus on the immediate problem—developing a workable budget for FY '10—it is important to make decisions in light of the long-term outlook. All indicators point to a long, slow recovery. The OK Policy projections suggest it will be FY '13 or later before revenues recover back to their levels of FY '08. The key questions thus become, how long will the downturn last, and how large will the budget shortfall be, by year and in total? This section applies the Rockefeller and Oklahoma Policy Institute projections to estimate the state's overall budget—or appropriations—for the next four years.

Figure 3 shows historical, estimated, and projected appropriations. Total appropriations is a broader measure than the GRF revenue discussed above, as it includes funds restricted for education, transportation, and other uses. While there is some risk of



Source: Rockefeller Institute adapted from Donald J. Boyd, *What Will Happen to State Budgets When the Money Runs Out?* Oklahoma estimates from Oklahoma Policy Institute.

error in applying projections based on the GRF alone to the state's entire budget, the risk is mitigated by the fact that GRF comprises 83 percent of the total budget for FY-10 and that the funds other than GRF share many of the same revenue sources as GRF.

Figure 3 shows that the total budget peaked in FY '09 at \$7.089 billion.<sup>7</sup> The official estimate for FY '10—set at 95 percent of forecast revenue for most funds—will limit the budget to \$6.456 billion, a \$633 million decline from the previous year.

Oklahoma Policy Institute projects appropriations for FY '11 and beyond. To do so, we apply the same growth rates that we projected earlier in Figure 2. These projections are based on expectations that the national economy is nearing its low point and on the Rockefeller projections that state revenues will slowly turn back up starting in FY '11. These resulted in annual GRF revenue growth of approximately one percent in FY '11 and approximately five and six percent respectively in FY '12 and FY '13. In Figure 3, the same growth percentages are

applied to the official estimate of total appropriations in FY '10.

While monies available for appropriation are projected to turn back up in FY '11, it will be until FY '13 before they return to the pre-recession level. In FY '10 the Board of Equalization already has estimated a budget shortfall of \$633 million from the FY '09 level. OK Policy projects that the shortfall will be only slightly smaller in FY '11—\$571 million—and the FY '12 budget will still be \$241 million less than the FY '09 budget. For the three years together, then, total budget shortfalls of \$1.45 billion are projected.

While these budget shortfalls are dramatic, they actually *understate* the financial impact on the state's budget and services. They assume that the FY '09 budget would buy the same state services in FY '10-FY '13, which is not the case. Each year it is more costly for the state to provide the same level of services. Health insurance costs for state employees, teachers, and Medicaid recipients rise well beyond the level of inflation. Retirement contributions increase as well. Some supply

and service costs are outside the state's control and will rise regardless of the money available. State employees and teachers cannot be expected to go years without salary increases, either. State agency budgets also have been stretched by having to absorb inflation out of essentially flat budgets in recent years. Even a very modest three percent growth rate would suggest that the cost of maintaining services at the FY '09 level would be \$7.7 billion by FY '12.

Fortunately, Oklahoma has two tools available to reduce the damage to our economy and our social structures. How well we maintain services and our economy depends on how wisely we use these two tools: federal stimulus funds and the Constitutional Reserve Fund (better known as the Rainy Day Fund, or RDF).

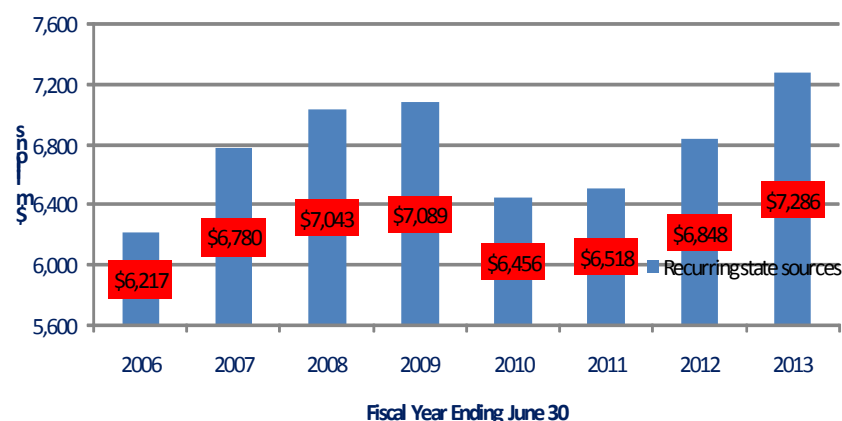
#### 4. USE OF FEDERAL STIMULUS

The federal stimulus (American Recovery and Reinvestment Act of 2009, or ARRA) will help Oklahoma fill its budget gaps. This section describes the elements of ARRA that affect the state's overall budget picture and projects their impacts on the budget through the economic recovery. It concludes that ARRA will reduce, but not eliminate, the budget gap. Even with all available stimulus funding, Oklahoma faces a cumulative budget gap of \$525 million over the next three fiscal years.

ARRA will bring \$2.6 billion to Oklahoma state and local governments between now and mid-2011. Of this amount, between \$600 million and \$1.4 million will be available to help the state balance its budget, depending on growth in Medicaid costs.

The most flexible money from the ARRA is the State Fiscal Stabilization

Figure 3  
Totals Available for Appropriation



Source: Oklahoma Board of Equalization for 2006-9, Oklahoma Policy Institute projections for 2011-13

Fund (SFSF), which totals \$578 million. Of this total, \$105 million is available for any purpose and can be used to supplement the state's budget. The remaining \$473 million is for states to maintain education funding at FY '08-'09 levels. The entire State Fiscal Stabilization Fund of \$578 million will be available to commit to the state budget between now and September 30, 2011 (early in state FY '12).

OK Policy assumes that 50 percent of the SFSF (\$289 million) will be spent in FY '10, because the budget shortfall is large and immediate and there will be pressure to use stimulus money quickly. OK Policy assumes that 40 percent of the SFSF (\$231 million) will be spent in FY '11. This could help maintain overall spending levels and allow the state to keep education spending at FY '08-'09 levels. Finally, we assume that ten percent of the SFSF (\$58 million) will be spent in FY '12. This can help ease the transition from reliance on the stimulus to growing state revenues.

The state also will receive \$950 million or more in federal stimulus money

for the Medicaid health insurance program due to an increase in the federal share of costs, also known as FMAP.<sup>8</sup> This is particularly important to Oklahoma because our FMAP has been dropping and we expected that trend to continue. The ARRA Medicaid funding reverses that drop. This money must be used first to fund additional Medicaid costs resulting from increasing health costs and higher enrollment during the recession. If Medicaid cost growth is less than the additional federal money, the state will be able to reduce state funding for Medicaid and shift some of the money to plug the budget holes for other state services.

Based on Medicaid cost growth in the last recession and the years preceding this downturn, OK Policy projects that Medicaid costs will increase a total of \$617 million over three fiscal years. This leaves \$342 million of the ARRA Medicaid money to be spent for other uses in the state budget.<sup>9</sup>

As shown in Figure 4, the stimulus can reduce budget shortfalls as state revenues reach their trough and begin rebounding. Substantial shortfalls re-

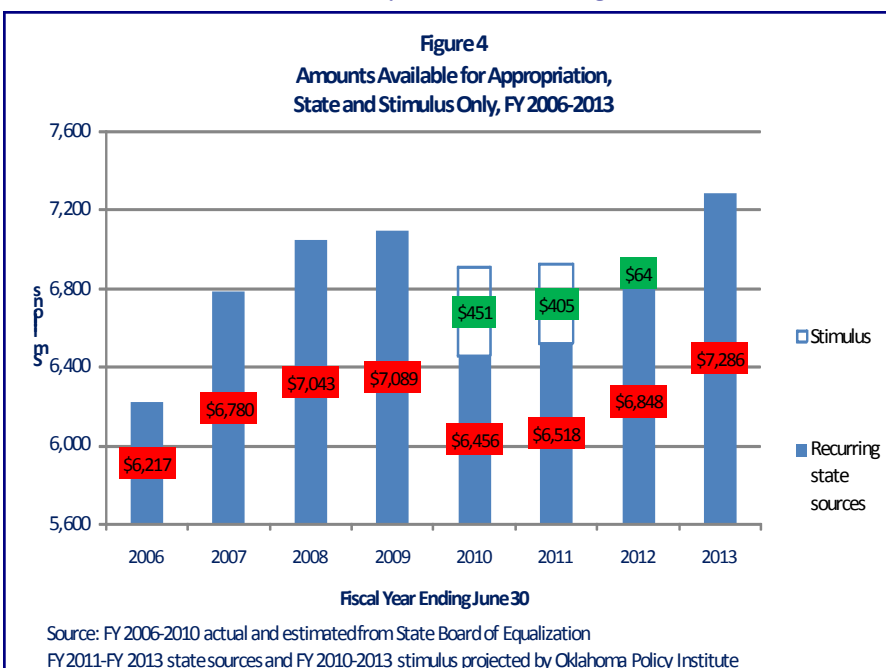
main, however. The FY '10 budget would be \$182 million below the FY '09 budgets. The shortfalls in FY '11 and FY '12 would be similar—\$166 and \$177 million, respectively. The cumulative shortfall of \$525 million is an improvement over the \$1.45 million shortfall without the stimulus, but it still requires significant budget cuts. Again, these shortfalls ignore the effects of inflation and built-in cost increases, so they understate the impact on state services.

## 5. USE OF RAINY DAY FUND

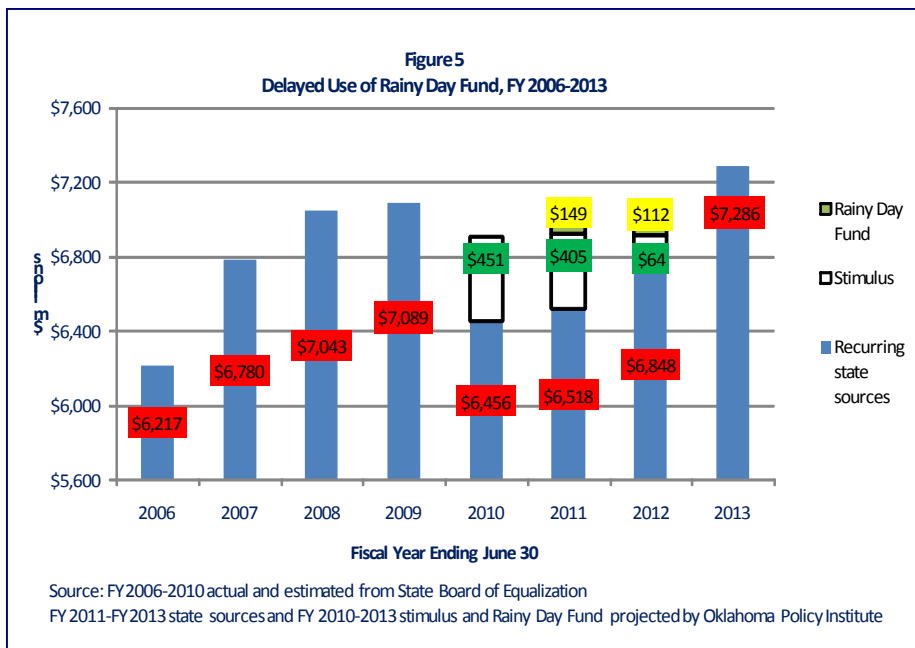
In the 1980s, Oklahomans created the Constitutional Reserve Fund (better known as the Rainy Day Fund or RDF), expressly as a way to minimize the extent of budget cuts or need for tax increases during economic downturns. Thanks to strong revenue performance since the 2001 recession, the fund balance is \$596.6 million, the maximum amount allowed by law. The fund has been built up to help smooth out funding in economic downturns, which certainly face us now. This section summarizes the rules governing the Rainy Day Fund and explores two alternative ways to use the RDF in the current recession.

The Rainy Day Fund fills up when revenues exceed the official estimates of the Board of Equalization. GRF revenue that exceeds 100 percent of the certified amount flows into the Constitutional Reserve Fund until it reaches ten percent current year GRF revenue. The Constitution allows the fund to be spent in these instances:

- Up to 3/8 of the amount in the Fund can be used to make up for a shortfall in the current year's collections compared to appropriations.







- Up to 3/8 of the amount in the Fund can be used in the budget for the next year *if* next year's General Revenue collections are forecast to be less than the current year's collections, but only up to the amount of the difference between the collections.
- Up to 1/4 of the amount in the Fund can be spent through the appropriations process for an emergency. Emergency standards are strict; either the governor must declare an emergency and both houses of the legislature approve spending the RDF by a 2/3 majority or both houses must approve spending by a 3/4 majority if the governor does not act.<sup>10</sup>

Governor Henry and legislative leadership have advocated not using the RDF in FY '10, holding it in reserve in case the recession gets worse. While that is possible, it is not likely. *It is more likely revenue will start growing in FY '11.* If revenue begins to grow in FY '11, we will be limited to using no more than 1/4 of the RDF each in FY '11 and FY '12, and then only if the constitutional standard for an emergency is met. While waiting could

help stabilize the budget in later years, it creates two problems needlessly:

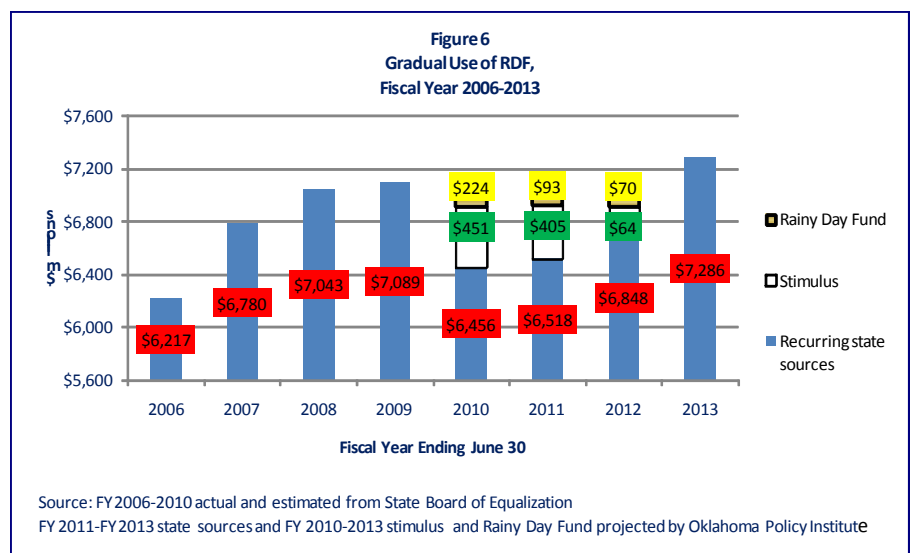
- It makes for a dramatic one-time budget shortfall in FY '10.
- It risks leaving over one-half the Rainy Day Fund untouched at the close of one of the worst recessions Oklahoma has ever faced.

Figure 5 shows the budgets and shortfalls that would result from delaying use of the Rainy Day Fund until FY '11 and then only using the amount allowed for emergencies

for two fiscal years. This alternative leaves the FY '10 shortfall at \$182 million, the same as after the stimulus. It can nearly eliminate shortfalls in FY '11 and FY '12, when they would be \$17 million and \$65 million, respectively. Total shortfalls, however, would still be \$264 million, while \$336 million would be left in the Rainy Day Fund after a full economic recovery. While the remainder of the RDF could be held in reserve against the possibility of a mid-year shortfall in collections, a shortfall of such magnitude is unlikely.

Figure 6 shows a better alternative—gradual use of the Rainy Day Fund to stabilize budgets as close as possible to current levels. This can be accomplished by using 1/4 of the balance of the RDF in FY '10 (less than the 3/8ths allowed by the Constitution) and then using 1/4 of the remaining balance in each of the following two years.<sup>11</sup>

Figure 6 shows that this alternative smoothes out the state's annual budget and results in the smallest budget shortfalls—\$33 million in FY '10, \$54 million in FY '11, and \$93 million in FY '12 for a total shortfall of



\$180 million. This alternative would leave \$250 million of the Rainy Day Fund available in the event of a mid-year shortfall in revenue collections.

## 6. RECOMMENDATIONS

In order to maintain a stable state budget through the recession and recovery and to minimize the loss of state services, Oklahoma Policy Institute recommends that the state:

- Appropriate 1/4 of the balance of the Rainy Day Fund for use in the FY '10 budget and appropriate 1/4 of the remaining balance each in FY '11 and FY '12. This leaves sufficient balances in the RDF for mid-year shortfalls in collections and other unforeseen events.
- Delay scheduled tax cuts—standard deduction increases and top rate decreases in the income tax and elimination of the estate tax—until the budget has recovered to pre-downturn levels.

For the long run, Oklahoma's goal should be to establish a stable and sustainable level of public services. Oklahoma Policy Institute recommends the following steps toward that goal:

- *Restructure the Rainy Day Fund.* As a constitutional amendment, this would require voter approval in 2010, still in time to make a difference in our economic recovery. Current rules do not lend themselves to a gradual use of the RDF through multiple years of budget shortfalls. We know that recessions create budget shortfalls for more than one year and we should retool to use the RDF in a more realistic manner by changing the trigger that allows Rainy Day Funds to be applied. We should replace the current provision that allows 3/8ths of the fund to be

committed to the coming year's budget only when revenues are forecast to fall to a provision that allows RDF money to be used any time revenues are below the peak of the current economic cycle. This allows the RDF to be used judiciously to smooth out recessions, while the current rules encourage using the RDF just once and possibly at the wrong time.

- *Consider changing the way the RDF is funded and how large it can grow.* We could explore dedicating specific revenues to the RDF—possibly erratic revenues such as gross production taxes on oil and gas. We also could study increasing the maximum amount that can be in the fund. The current recession has demonstrated how inadequate a \$600 million Rainy Day Fund is to address a \$1.45 billion problem.
- *Require meaningful multi-year forecasting* in the revenue certification, executive budget, and appropriation phases of developing the state budget. The FY '10 budget deliberations are based on a vague assumption that “things could get worse,” but there is no official forecast of revenues and expenditures beyond the end of FY '10. It is thus impossible for policy makers and the public to evaluate the assumptions—stated and unstated—that underlay budget proposals and to study and debate proposals that make the most sense over the long run rather than in one year.

## 7. CONCLUSION

The national recession has created revenue declines and budget shortfalls for state governments across the nation and will continue to do so for several more years. While Oklahoma's revenue downturn was delayed, it has proven to be severe. While revenues are projected to hit bottom next year and begin to recover in FY '11, it will be years before they return to pre-

recession levels. The official estimate of a \$633 million shortfall for FY '10 is just the beginning; Oklahoma Policy Institute projects that, for the duration of the recession, state revenues will fall \$1.45 million short of FY '09 levels. Budget shortfalls of this magnitude and length damage the state's economy and its public services. Oklahoma will benefit by using all available tools to minimize this damage.

The federal stimulus package is projected to inject approximately \$900 million into the budget picture, reducing the shortfall to \$525 million over the next three fiscal years. Fortunately, the Rainy Day Fund, created just for this purpose, has a balance of nearly \$600 million. Some have suggested the RDF should be kept in the bank in case the recession worsens. Oklahoma Policy Institute's analysis, however, shows that projected revenue growth in FY-11 would limit our ability to use the RDF and would leave most or all of it unused at the end of the recession. An alternative approach, which gradually applies the Rainy Day Fund over three fiscal years results in a more even spending pattern and in smaller budget shortfalls—\$180 million over three years. This shortfall could be reduced further by delaying scheduled tax cuts until the recovery is complete.

Oklahoma also should take steps to improve our ability to cope with future downturns. Options that should be explored include restructuring the Rainy Day Fund to allow more to be used throughout a recession rather than only in years when revenue falls, changing the funding mechanism of the RDF and allowing

it to reach a higher maximum amount, and requiring multi-year forecasting mechanisms to better understand the economic and revenue outlooks and craft strategies to address them.

Oklahoma's budget shortfalls are serious and damaging. We have tools to help reduce the damage, however, and should use them wisely and aggressively. As the economy recovers, we should turn our at-

tention to sharpening and adding to the tools we will have available for the—inevitable—next time

## END NOTES

<sup>1</sup>Donald J. Boyd, *What Will Happen to State Budgets When the Money Runs Out?* February, 2009, p. 1, 4; at [http://www.rockinst.org/pdf/government\\_finance/2009-02-19-What\\_Will\\_Happen\\_to.pdf](http://www.rockinst.org/pdf/government_finance/2009-02-19-What_Will_Happen_to.pdf).

<sup>2</sup>Board of Governors of the Federal Reserve System, *Press Release*, April 29, 2009; at <http://www.federalreserve.gov/newsevents/press/monetary/20090429a.htm>.

<sup>3</sup>Chad Wilkerson, "U.S. and Oklahoma Economic Outlook," presented to *Economic Security for Oklahomans, A Conference of the Oklahoma Asset Building Coalition*, Oklahoma City, Oklahoma, April 22, 2009.

<sup>4</sup>State Board of Equalization, *Proposed FY-2010 Revenue Certification*, February 2009, p. 6; at <http://www.ok.gov/OSF/Budget/index.html>.

<sup>5</sup>Boyd, *What Will Happen*.

<sup>6</sup>The Rockefeller projections and methodology are from Boyd, *What Will Happen*, p. 2-3. Those projections remove effects of population growth, inflation, and law changes so that they portray past revenues and forecast future ones in constant dollars, populations, and tax laws. Oklahoma Policy Institute has re-estimated these projections to include historical and projected inflation and growth in the Oklahoma population to maintain consistency between Oklahoma's history and OK Policy's projections.

<sup>7</sup>Note that actual revenues from all funds available for appropriations for FY '09 are now estimated to be \$243 million below the original estimate. Because the Constitution limits spending to 95 percent of revenue estimates for most funds and current estimates are above the figure, the state still will be able to spend at its original budget level.

<sup>8</sup>Federal Funds Information for the States, *Updated Estimates of ARRA Bonus FMAPs*, Issue Brief 09-14, April 8, 2009; available by subscription. The actual amount received depends on unemployment levels.

<sup>9</sup>Oklahoma Policy Institute's projections are as follows:

Fiscal year	Increased Medicaid Cost	ARRA Medicaid Increase	Net Gain to State
2009	\$121 million	\$283 million	\$162 million
2010	\$212 million	\$385 million	\$173 million
2011	\$284 million	\$291 million	\$ 7 million
Total	\$617 million	\$958 million	\$342 million

The projections apply the "Net Gain to State" from FY '09 to the FY '10 budget and the "Net Gain to State" from later years to the following year's budget. Note that while this is projected as additional revenue, the actual mechanism is that the additional federal Medicaid payments reduce the state's budget for Medicaid. This "freed up" money can then be used for other budget needs. Projections show it as revenue for the purposes of simplicity and to more clearly portray its impact on the budget shortfall.

<sup>10</sup>The RDF also may be used for Up to \$10 million of the RDF also may be spent on tax incentives for at-risk manufacturers.

<sup>11</sup>In FY-11 and FY-12, an emergency declaration would be required if revenues rise as projected.

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