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SPECIAL POINTS  
OF INTEREST

- This year's appropriated budget is 6 percent less than two years ago. More than half of all state appropriated agencies have been cut by 15 percent or more.
- Deeper cuts may seriously harm the well-being of schoolchildren, seniors, persons with disabilities and mental illness, correctional and public safety officers, and other members of our communities.
- In order to protect core services, a number of revenue options should be examined by the legislature, including budgeting measures, income tax measures, and sales tax measures.

## Protecting Core Services: Revenue Options for a Balanced Budget

BY DAVID BLATT, DIRECTOR, & GENE PERRY, POLICY ANALYST

Funding for state services has undergone repeated rounds of cuts over the past two years, as Oklahoma has struggled with plunging tax revenue triggered by the worst recession in a generation. Overall, this year's appropriated budget is 6 percent less than two years ago, with more than half of all state appropriated agencies absorbing cuts of 15 percent or more.

No area of government has been immune from cutbacks. The impact is being felt by Oklahoma families, businesses and communities in far-ranging ways: increased class sizes; higher tuition rates; closure of facilities serving people with mental health problems; elimination of preventive health programs; cuts in payment rates to private community-based contractors; severely overcrowded correctional facilities; court delays, and oth-

ers. Deeper cuts will further impinge the ability of state agencies to fulfill their core missions and may seriously affect the well-being of schoolchildren, seniors, persons with disabilities and mental illness, correctional and public safety officers, and other members of our communities. Further cuts will also hurt the state's pri-



rate sector businesses that rely on government contracts for revenue and count public sector employees as customers, while shifting more of a burden onto private non-profits and faith groups.

Unfortunately, even as the economy recovers, revenue growth is not expected to return to pre-downturn levels or fully offset the loss of federal stimulus dollars and state Rainy Day Funds used to minimize budget shortfalls over the past two years. Next year's certified revenue of \$6.2 billion is over \$500 million less than current year appropriations and \$900 million, or 12.6 percent, less than FY '09. This comparison understates the magnitude of the shortfall, as various programs, such as Medicaid and corrections, re-

quire additional dollars simply to maintain current operations given rising caseloads and costs.

In her FY '12 Executive Budget, Governor Fallin proposed additional cuts of 3 to 5 percent for most

state agencies. If enacted at her levels, next year's state appropriations would be \$800 million, or 11.2 percent, less than the budget for FY '09 (Table 1).

Governor Fallin's funding levels were based on additional revenue generated by moving to two-year car registration, approving \$200 million in additional bonds, and adopting a variety of government reforms intended to produce savings and efficiencies. However, several of the Governor's proposals have thus far generated minimal support in the legislature, and legislative leaders are now warning of cuts from 3 to 7 percent for all agencies, with some agencies facing cuts as high as 10 percent.<sup>1</sup> Governor Fallin has emphasized the need to protect core state services in education, law enforcement, health, transportation and corrections and asked for suggestions, saying, "If they have a different way of being able to fund the budget and make up for the \$500 million budget shortfall, I invite them to bring those ideas forth. There's room for all kinds of ideas."<sup>2</sup>

Given the harm that would be inflicted on our families, communities and economy by another round of deep budget cuts, elected officials need to consider all options for bringing the state budget into balance. In this brief, we set out a series of ideas for generating additional revenue. We present our ideas in three areas, discussing the merits and possible drawbacks of each:

1) budgeting measures; 2) income tax measures; and 3) sales tax measures. We recognize that few, if any, of these ideas will be politically easy to adopt. However, compared to the alternatives, balancing modest cuts with revenue-generating proposals presents the best approach for preserving Oklahoma's prosperity, security and well-being.

### 1. Budgeting Measures

One approach to closing next year's budget shortfall would not generate new revenues but rather make additional existing revenues available for appropriation in next year's budget. The Governor's FY '12 Executive Budget already frees up \$200 mil-

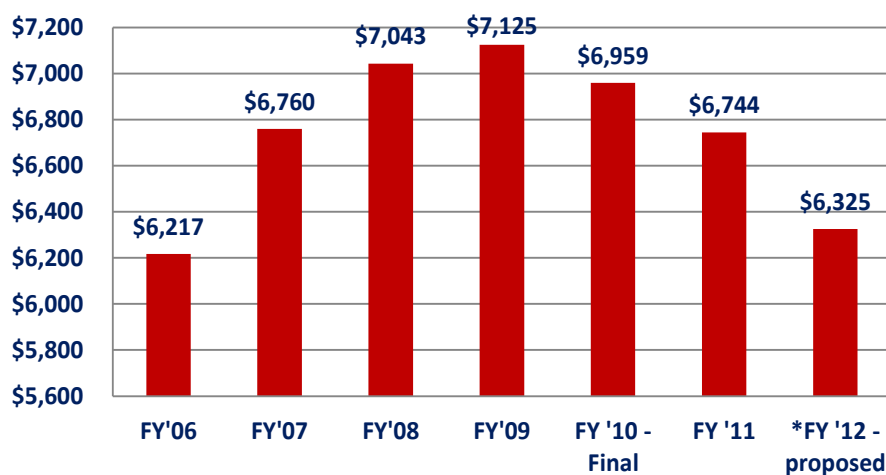
lion by issuing \$100 million in transportation bonds through the Oklahoma Capitol Investment Authority and \$100 million in bonds for information technology capital projects. Other possible budgeting measures include appropriating a portion of the 5 percent funds and transferring revolving fund balances.

### APPROPRIATING 5 PERCENT MONEY

Under the state Constitution, the Legislature may only appropriate up to 95 percent of estimated collections for the upcoming year for certified revenue funds. If actual collections to the General Revenue (GR) Fund come in above 95 percent by the end of the year, the "5 percent money" gets deposited to the GR Fund at the beginning of the next fiscal year and is then available for appropriation in the following year (General Revenue above 100 percent of the estimate goes to the Rainy Day Fund).

So far through the first nine months of FY '11, actual General Revenue collections are at 104.2 percent of the certified estimate. If revenues remain above 100 percent of the certified estimate through the remainder of FY '11, this would make \$244 million in 5 percent revenue available at the beginning of FY '12. Recently, Treasurer Ken Miller and House Appropriations and Budget Chair Earl Sears have echoed calls initially made by former Treasurer Scott Meacham that at least a portion of the FY '11 5 percent money be used to offset cuts in the FY '12 budget.<sup>3</sup> Critics of this approach will note that the state has never before budgeted current year 5 percent

**Table 1: State Appropriations, FY '06 - FY '12\***  
(in \$Millions; includes supplementals; \*FY '12: Executive Budget)



money for the upcoming budget year, and doing so is likely to require special statutory authority. There will certainly be concern from legislators about building 5 percent money into the base budget that would then have to be replaced in subsequent years, along with other non-recurring money in the FY '12 budget. This also creates a precedent that could get the state into trouble in years when revenues fall short of projections. However, compared to other solutions that could generate substantial additional revenue, using a portion of the 5 percent funds may face the least opposition.

#### TRANSFERRING REVOLVING FUND BALANCES

In late February, the Oklahoman ran a story by reporter Paul Monies that found that state agencies and public colleges and universities maintained over 500 revolving funds, most funded by fees or other dedicated revenue sources, with total balances as of December 2008 in excess of \$1.2 billion.<sup>4</sup> From a spreadsheet that Monies compiled and made available, it is clear that some fund balances have grown considerably over the past two years. Although it is very hard to know which funds may have been allowed to build up “too large” of a balance without careful research into each particular fund’s purpose and history, it seems more than likely that there is revenue sitting in various agency revolving funds that could properly be substituted for state

appropriated dollars in next year’s budget.

There are precedents for dipping into revolving funds to make up for budget shortfalls. The FY '11 budget includes \$7 million allocated from the Treasurer’s Unclaimed Property Fund, the Insurance Department Revolving Fund and the Underground Storage Fund. In FY '10, \$8 million was transferred from Insurance Depart-

“Where agency revolving funds have grown to unnecessarily large amounts, they could be used either to offset a decrease in an agency’s appropriations or transferred to General Revenue to help fund other areas of government.

ment Revolving Funds and the Secretary of State. More controversially, over \$120 million of tobacco tax revenues has been shifted from the Insure Oklahoma Fund in recent years to help cover general operating expenses of the Medicaid program. This year, the Legislature transferred \$5.25 million from the Department of Correction’s Industries Revolving Fund in lieu of a supplemental appropriation to avert additional furlough days.

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agency’s appropriations or transferred to General Revenue to help fund other areas of government. Both Senate President Brian Bingman and House Speaker Kris Steele have indicated recently that agency revolving funds are being examined as part of budget deliberations.<sup>5</sup>

## 2. Income Tax Measures

Last legislative session, in order to help address the looming budget shortfall for FY '11, the Legislature and Governor Henry agreed to suspend and defer payment for two years on a wide range of income tax credits that subsidize various forms of economic activity. Suspending and deferring income tax credits had a revenue impact of some \$60 million for FY '11 and FY '12. Rebate payments for gross production taxes on horizontal and deep well drilling were also deferred for two years.

Other income tax measures that could be considered this year to generate additional revenue on either a one-year or ongoing basis include: stopping further cuts to the top personal income tax rate; limiting itemized deductions; eliminating the state tax deduction for state income taxes; and suspending other state tax deductions.

#### MAINTAINING THE TOP INCOME TAX RATE

During the mid-2000’s, the Legislature phased down the state’s top individual income tax rate from 6.65 percent to 5.5 percent, with a further cut down to 5.25 percent to be triggered the first year General Revenue collections were pro-

jected to grow from one year to the next by 4 percent. Unless the Legislature acts to defer or repeal it, the tax cut will automatically take effect January 1, 2012, reducing revenue available for appropriation in FY '12 by \$38 million. When fully implemented, this tax cut will reduce revenue collections by an estimated \$120 million. The income tax cut was approved during a time of strong economic growth and robust economic collections, yet it is phasing in when revenues are only partially rebounding from the depths of the recession. Next year's GR collections are projected to remain \$744 million, or 12.5 percent, below their pre-downturn level of FY '08.

Of the total tax cut, households in the top fifth of income will receive 73 percent of the benefit, while the median income household will receive just \$24. Forty-three percent of Oklahomans will receive no tax cut at all.<sup>6</sup> Proceeding with the cut to the top income tax rate contributes to next year's budget shortfall and would force deeper sacrifices from those populations that depend on public services. If not repealed entirely, the tax cut could at least be deferred until revenues have fully recovered and funding for core services has been restored.

#### LIMITING ITEMIZED DEDUCTIONS

Oklahoma allows taxpayers who claim itemized deductions on their federal income tax return to claim the same deduction on their Oklahoma tax return. This is an espe-

cially costly and regressive feature of our state tax system: low-income families receive virtually no benefit from these deductions, and the greatest benefits are reserved for the upper-income families who need them the least. Almost three out of every four Oklahomans had household income under \$50,000 in 2007, yet only one in eight of these low- and moderate-income households claimed itemized deductions (the rest claim the standard deduction). By contrast, the 8 percent of Oklahoma households with income over \$100,000 accounted for a full 47 percent of total itemized deductions.<sup>7</sup> Even among itemizers, the same deduction – say \$15,000 in mortgage interest payments – is worth

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more to someone in the top income tax bracket than to someone in a lower tax bracket.

The Institute on Taxation and Economic Policy has analyzed various policy options that could minimize the cost and regressivity of the current system.<sup>8</sup> Oklahoma could:

- Repeal itemized deductions entirely while simultaneously increasing the standard deduction available to all families;

- Cap the total value of itemized deductions;
- Convert itemized deductions to credits;
- Phase out itemized deductions for the highest-income taxpayers.

Depending on the specific limits and amounts decided on under the various options, the revenue potential for the state would be considerable, ranging from \$100 million to \$115 million.<sup>9</sup> ITEP's analysis shows that most low- and moderate-income households would pay the same amount or less in taxes under these proposals.

#### ELIMINATING THE DEDUCTION OF STATE INCOME TAX

If legislators decide not to eliminate all itemized deductions, they can at least do away with the deduction created by how state and federal taxes interact. Federal law allows taxpayers to deduct state income taxes paid on their federal tax returns, and then Oklahoma allows taxpayers to carry over all federal deductions onto their state tax return. In effect, this means itemizing taxpayers can deduct state tax payments from their state taxable income. This deduction has no legitimate rationale and is allowed only in Oklahoma and five other states. New Mexico eliminated the deduction in 2010. According to estimates generated by the Institute on Taxation and Economic Policy (ITEP), the revenue impact of eliminating the deduction for state income taxes would be \$118 million.



## ELIMINATING OR SUSPENDING OTHER INCOME TAX DEDUCTIONS

Oklahoma tax law allows for various tax deductions that do not fulfill a vital economic or social purpose. For example, the state allows a deduction of \$100 per individual and \$200 per joint filer for interest and dividends paid on deposits in Oklahoma financial institutions. According to the 2010 Oklahoma Tax Expenditure report, this deduction has a \$2.2 million fiscal impact, yet it is unlikely to have much, if any, impact on where or how much Oklahomans choose to save and invest. Oklahoma also grants a \$100 per individual and \$200 per joint filer deduction for contributions to political candidates (\$188,000 revenue impact in FY '10), which is available to all contributors regardless of income. Finally, the state provides a deduction of up to \$20,000 per household for contributions to an Oklahoma College Savings (529) Plan. This deduction had a FY '10 price tag of \$2.8 million. Although the deduction may incentivize Oklahomans to invest in the state's plan rather than other state 529 Plans, the amount of the deduction seems unnecessarily generous and skewed towards the wealthiest households that are able to save substantial amounts for college.

## ADOPTING COMBINED CORPORATE REPORTING

One of the ways that some corporations seek to improperly avoid or minimize their state tax liability is by moving income around between parent and subsidiary companies. A large multi-state company can use separate accounting to shift taxable profits to low-tax jurisdictions. These tax avoidance strategies take various forms –

prominent examples include Wal-Mart's "captive REIT" tax shelter (featured in a front-page Wall Street Journal story in February 2007) and the "Delaware Trademark Holding Company" shelter adopted by Toys R Us and many other retailers.<sup>10</sup>

To put an end to these tax-avoiding strategies and ensure that multi-state corporations pay their fair share of taxes, just like local businesses, state can adopt a reform known as combined reporting. Under combined reporting, multi-state corporations must add

"While Oklahoma generally taxes the sale of all tangible personal property in the state, state statutes provide an extensive and ever-growing list of nearly 150 exemptions from the general sales tax.

together the profits of all their subsidiaries into one total. The state then taxes a share of that combined income based on a formula that takes into account the corporate group's level of activity in the state as compared to its activity in other states.

Combined reporting has now been adopted by more than half of all states that assess a corporate income tax, but not by Oklahoma. By adopting combined reporting, Oklahoma could shore up corporate income tax collections in a way that puts an end to abusive

tax-avoidance strategies and promotes fairness between different kinds of businesses.

## 3. Sales Tax Measures

The sales tax is the single largest revenue source for state and local government combined. However, the tax is increasingly falling short as a growing share of economic activity falls outside the sales tax base.<sup>11</sup> While some sales tax issues, including the taxation of currently untaxed services, must await more comprehensive tax reform, there are more modest steps that could be pursued to strengthen the sales tax and provide additional revenue for state and local governments, including suspending or eliminating sales tax exemptions and enhancing collection of online sales.

## ELIMINATING SALES TAX EXEMPTIONS

While Oklahoma generally taxes the sale of all tangible personal property in the state, state statutes provide an extensive and ever-growing list of nearly 150 exemptions from the general sales tax. Some of these exemptions, including sales to manufacturers, sales for resale, and sales to other state agencies or other levels of government, have a strong economic justification, while some, such as exemptions for disabled veterans and community mental health centers, have an identifiable social purpose. The overall composition of the list, however, gives the appearance of a hodge-podge of favors and privileges for various industries, sectors and populations

that lacks any clear or consistent rationale.

Among the industries and activities that currently benefit from sales tax exemptions are: agricultural sales (\$64.7 million fiscal impact in FY '10); advertising sales (\$41.6 million); newspaper and periodical sales (\$17 million); and sales of horses (\$1.2 million). The state also exempts sales to certain kinds of events, including National Basketball Association and National Hockey League games, (\$1.9 million), and museum admission tickets (\$290K).

Another area of sales tax exemptions that could be eliminated is electronic downloads. Oklahoma is one of only 12 states that does not tax downloaded computer programs and one of 21 states that does not collect tax on downloaded music, video games and books, when the same product would be taxed if purchased at a physical store. To avoid penalizing local retailers, Oklahoma could follow the lead of other states by changing its law to tax all online goods and services if the comparable "real world" purchase is taxed.

#### ENHANCING COLLECTION OF ONLINE SALES

When purchases are made of taxable goods from an out-of-state vendor – whether via the Internet, catalogs or other sellers – a companion to the sales tax called a "use tax" is still legally owed by the purchaser. However, as a result of US Supreme Court rulings, states are unable to require retailers who lack a physical presence in a state, or "nexus," to collect and remit use tax owed to the state. This puts "Main Street" Oklahoma retailers at a competitive disadvantage compared to online retail-

ers of the same goods. It also leads to substantial lost revenue for state and local governments – an estimated \$92.7 million for Oklahoma in 2009, rising to \$156.3 million in 2012.<sup>12</sup>

Last year, the Oklahoma Legislature adopted a few modest measures to encourage use tax collections, including requiring that remote sellers disclose to consumers that they may owe use tax on what they are buying and requiring paid tax preparers to remind clients of their use tax obligations. However, a growing number of states are going even further in pursuing use tax collections. Colorado, for example, now requires Internet retailers to send their customers an annual statement of purchases and to report the total annual purchases of their customers to the state Tax Commission annually. But the most aggressive state efforts have aimed at expanding the definition

" So-called "Amazon Laws" have been enacted in Arkansas, Illinois, New York, North Carolina, and Rhode Island, while at least nine other states, including Texas, are actively considering similar legislation.

of "nexus". This involves passing a law that asserts that relationships such as an affiliate program, in which a company like Amazon.com pays independent websites commission for providing links that result in sales, are sufficient to establish physical presence in the state. So-called "Amazon Laws" have been enacted in Arkansas, Illinois, New York, North Carolina, and Rhode Island, while at least nine other states, including Texas, are actively considering similar legislation.<sup>13</sup> Amazon and some other online retailers have fiercely re-

sisted these measures, but thus far the laws have been upheld by appeals courts. Large retailers such as Wal-Mart, Barnes and Noble, Target and Best Buy are becoming increasingly vocal in their support of efforts to level the playing field between them and their online competitors.

#### Conclusion

Some or all of these measures can be implemented this year to protect Oklahomans from losing the public infrastructure and support that we all depend on. As State Treasurer Ken Miller wrote in the Oklahoma Economic Report, "Some base level of spending on safety, infrastructure and education provides the very foundation for a functioning free market economy. Therefore, policymakers must consider both the positive and negative effects while seeking the government spending level that maximizes economic output."<sup>14</sup> With the significant budget cuts of previous years already disrupting many important public services, the evidence suggests that we have gone far beyond simply eliminating waste. In addition, several revenue measures discussed above can make Oklahoma more stable and secure over the long term, while ending arbitrary and inefficient subsidies to special interests. If the legislature and governor want to show responsible leadership, these options need to be on the table.

## ENDNOTES

<sup>1</sup> Michael McNutt, "Oklahoma agencies may face steeper budget cuts," Oklahoman, March 25, 2011.

<sup>2</sup> Michael McNutt, "Oklahoma governor opposes steeper state agency cuts," Oklahoman, March 26, 2011.

<sup>3</sup> Barbara Hoberock, "Leaders say budget cuts may reach 7 percent," Tulsa World, March 25, 2011; and Michael McNutt, "Oklahoma budget negotiations prepare to tap cash reserve fund to help balance budget," Oklahoman, April 10, 2011.

<sup>4</sup> Paul Monies, "Oklahoma agencies have \$1.2 billion stashed away in revolving funds," Oklahoman, February 27, 2010

<sup>5</sup> "Pro Tem Brian Bingman analyzes conservative progress in Senate, including Tea Party role," CapitolBeatOK, April 7, 2011; and "House Speaker Kris Steele says study of tax credits and exemptions is serious, ongoing," CapitolBeatOK, April 8, 2011.

<sup>6</sup> "Cutting Oklahoma's Top Income Tax Rate: Who Benefits?," Oklahoma Policy Institute, February 2010

<sup>7</sup> Oklahoma Policy institute, "Limiting Itemized Deductions Would Improve Fairness and Adequacy of the State Income Tax", <http://okpolicy.org/blog/taxes/limiting-itemized-deductions-would-improve-the-fairness-and-adequacy-of-the-state-income-tax/>

<sup>8</sup> "Writing Off" Tax Giveaways: How States Can Help Balance Their Budgets By Reforming (or Repealing) Itemized Deductions," Institute on Taxation and Economic Policy, August 2010.

<sup>9</sup> Oklahoma Policy Institute blog, "Bridging the Gap (2): Closing the circle on the state income tax deduction," March 2010; at: <http://okpolicy.org/blog/budget/bridging-the-gap-2-closing-the-circle-on-the-state-income-tax-deduction/>

<sup>10</sup> This issue is discussed in Michael Maze-rov, "A Majority of States Have Now Adopted a Key Corporate Tax Reform – "Combined Reporting"", Center on Budget

and Policy Priorities, revised April 2009; at: <http://www.cbpp.org/files/4-5-07sfp.pdf>

<sup>11</sup> For a full discussion of the issues discussed in this issue, see David Blatt, "Fixing the Sales Tax Base: Options for Reforms," Oklahoma Policy Institute, February 2011; at: <http://okpolicy.org/fixing-sales-tax>

<sup>12</sup> Donald Bruce, William E. Fox and LeAnn Luna, "State and Local Government Sales Tax Losses from Electronic Commerce," University of Tennessee April 2009; at: [http://www.streamlinedsalestax.org/uploads/downloads/EC%20Executive%20Committee%20Meeting%20Docs/SSTP%20e-commerce%202009%](http://www.streamlinedsalestax.org/uploads/downloads/EC%20Executive%20Committee%20Meeting%20Docs/SSTP%20e-commerce%202009%20)

<sup>13</sup> John Buhl, "Arkansas Legislators Approve 'Amazon' Law," State Tax Today, April 1, 2011.

<sup>14</sup> Ken Miller, "Rightsizing Government," Oklahoma Economic Report, March 16, 2011, [http://www.ok.gov/treasurer/documents/OER\\_3-16-11.pdf](http://www.ok.gov/treasurer/documents/OER_3-16-11.pdf)

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