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### THE COST OF TAX CUTS IN OKLAHOMA

Income tax cuts since the mid-2000s have reduced state revenues by more than \$1 billion annually

by David Blatt, PhD, Executive Director

Repeated cuts to the state income tax made since the mid-2000s are one of the most significant reasons for an ongoing financial crisis that is eroding important public services and threatening Oklahoma's economic well-being.

Acute teacher shortages, college tuition and fee hikes, critically understaffed correctional facilities, longer waiting lists for services, and lower reimbursement rates for medical and social service providers are among the harmful consequences of chronic budget shortfalls.

Beginning with the Great Recession that reached Oklahoma in 2009, the state has experienced a continuing budget crisis. Even after the economy recovered from a severe national recession, Oklahoma's funding for core services remains well below pre-recession levels. Many state agencies still operate with one-quarter to one-third less state support compared to fiscal year 2009. Overall, this year's state appropriated budget is \$896 million, or 11.4 percent, below that of 2009 once adjusted for inflation.<sup>1</sup>

Numerous factors contribute to the growing gap between the cost of maintaining core services and the revenue Oklahoma collects to pay for them. These include erosion of the tax base through the growth of online commerce and the shift to a service-based economy, the ballooning number and cost of tax incentives, and an increasing share of tax dollars that are allocated off-the-top for specified purposes, leaving less revenue for general appropriations.<sup>2</sup> While these other factors contribute to budget shortfalls, the series of cuts to the state income tax that have reached an annual cost of more than \$1 billion in lost revenue cannot be overstated as a cause.

Due to these cuts, Oklahoma's top income tax rate has been slashed by almost a fourth, from 6.65 percent before 2004 to 5 percent beginning in 2016. The annual revenue loss from these cuts has now reached \$1.022 billion, according to an analysis prepared for OK Policy by the Institute on Taxation and Economic Policy. If a pre-approved tax cut that could take effect as soon as 2018 lowers the top rate again, to 4.85 percent, it will add another \$100 million to the annual cost of tax cuts.

These billion-dollar tax cuts have come at the direct expense of funding for core public services that are important for the prosperity and well-being of Oklahomans. As this paper will show, the tax cuts have not brought the boost to the state's economy that supporters predicted, and they have given the biggest cash benefits by far to the wealthiest Oklahomans while doing little to nothing for low- and middle-income families.



## A DECADE OF TAX CUTS

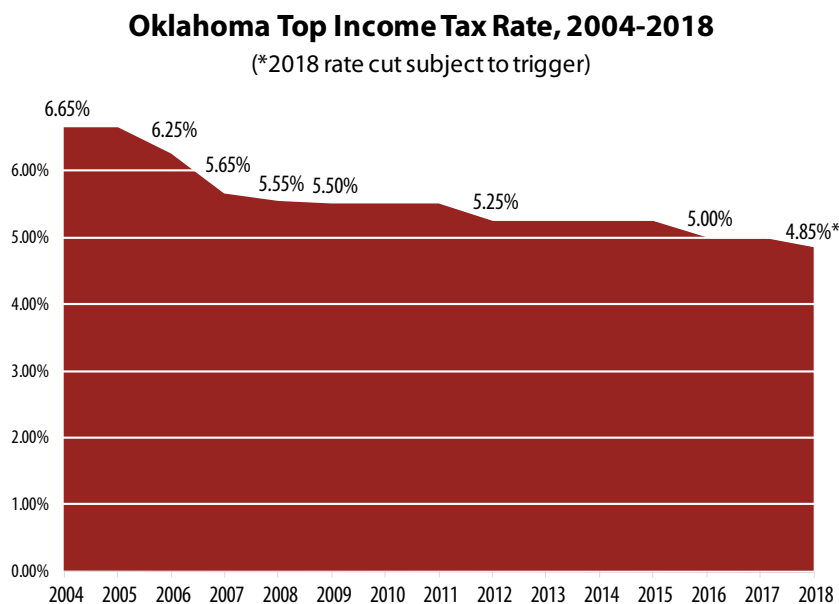
Following the passage of HB 1017 in 1990, Oklahoma's top income tax rate was 7 percent on taxable income above \$21,000 for married couples filing jointly and single parents and \$10,000 for singles and married couples filing separately. Shortly thereafter, Oklahoma voters approved State Question 640, which required that any future revenue increases needed approval by three-quarters of both legislative chambers or a majority vote of the people at the next general election. After these tight constraints were placed on the Legislature's ability to increase taxes to address budget shortfalls or meet pressing needs, elected officials initially were cautious about protecting the state's revenue base. Under the governorship of Frank Keating (1995-2003), the top rate was trimmed to 6.65 percent; however, until 2003, a trigger mechanism ensured that in years of revenue shortfalls, the top rate automatically reverted to 7 percent. That safeguard kicked in during the recession of 2002-03 but was then repealed.

The cautious approach to tax cuts was abandoned in the mid-2000s, once Democrat Brad Henry became Governor and Republicans gained control of the House of Representatives. Under a series of bills passed under bipartisan agreements between 2004 and 2007, the top rate was cut to 5.5 percent by 2009. These mid-2000s tax cuts also included a "trigger" that automatically reduced the top rate to 5.25 percent, just as Oklahoma was emerging from recession, in 2012.

Now under legislation passed in 2014 (SB 1246), the top rate has fallen again to 5.0 percent and could fall to 4.85 percent as early as 2018. The 2014 tax cut bill tied the rate cuts to a revenue growth trigger. However, because the trigger mechanism was based on early revenue estimates from before the oil and gas industry downturn, the rate cut took effect in January 2016 — even as state revenue collections plummet and Oklahoma faces massive budget shortfalls and mid-year budget cuts.<sup>3</sup>

The falling top rate has also flattened Oklahoma's tax brackets. The new top rate of 5 percent will apply to taxable income above \$7,200 for an individual or \$12,200 for a married couple or single parent. Many other states with income taxes have more graduated systems under which rates increase at higher income levels.

Besides slashing the top rate, the Legislature has enacted other personal income tax cuts since 2003. These include increasing the standard deduction and indexing it to the federal deduction level, increasing the deduction for seniors' retirement income, and fully exempting capital gains from the sale of Oklahoma-held property.



## THE EFFECT OF TAX CUTS ON THE STATE BUDGET

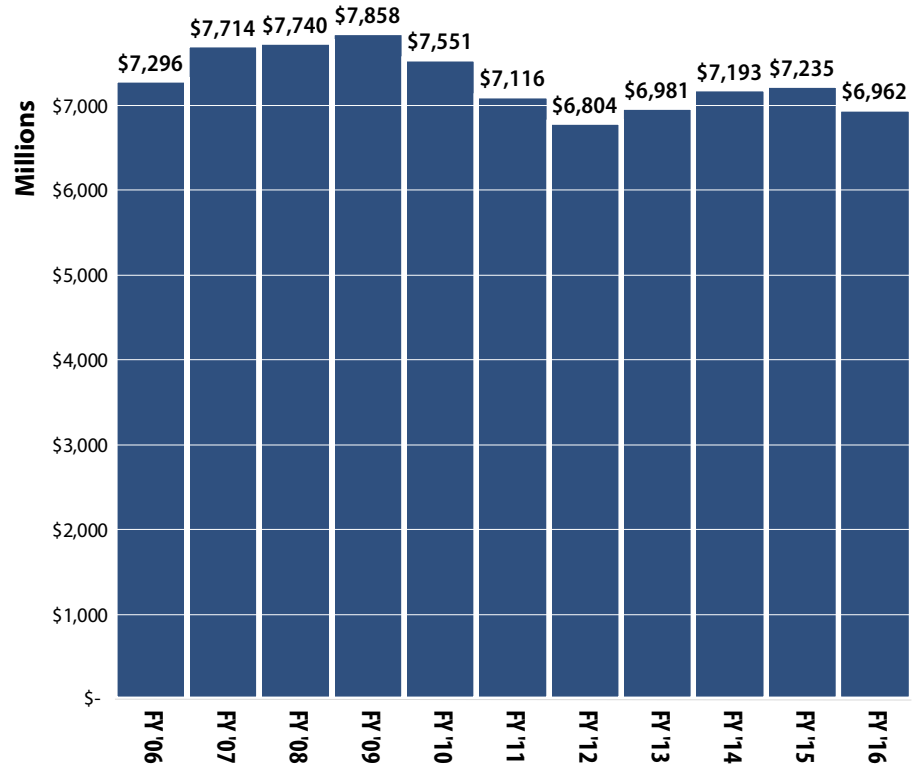
The annual cost of cuts to the top personal income tax rate enacted since 2005 is \$1.022 billion, according to an analysis conducted for Oklahoma Policy Institute by the Institute on Taxation and Economic Policy (ITEP), a non-partisan national research organization. This amount includes the reduction of the top income tax rate to 5.0 percent from 5.25 percent that took effect in January 2016.

When tax cuts were first approved in the mid-2000s, the economy enjoyed robust growth due to high energy prices, so state revenues continued to increase while tax cuts began to phase in. However, since 2009 state appropriations have seen seven straight years of cuts, flat funding, or only minor growth. The fiscal year 2016 state appropriated budget of \$6.962 billion (after mid-year cuts) is \$896 million, or 11.4 percent, less than in FY 2009 after adjusting for inflation.

Most state agencies are funded at levels 10 to 30 percent below 2009. For example, state funding for the Oklahoma Health Department has been reduced by 19 percent, the Department of Environmental Quality is down 30 percent, and the Arts Council has been slashed 32 percent.<sup>4</sup>

### Oklahoma State Appropriations, Inflation Adjusted

(in \$ millions; 2015 dollars adjusted for inflation using the Consumer Price Index)



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**Table 1: Share of Revenue Lost to Tax Cuts by Largest State Agencies Based on Current Budget Proportions**

Agency	Revenue Lost to Tax Cuts
Education	\$356 M
State Regents for Higher Education	\$138 M
Health Care Authority	\$139 M
Human Services	\$97.2 M
Corrections	\$69.4 M
Mental Health & Substance Abuse Services	\$48.4 M
<b>All Agencies</b>	<b>\$1.022 B</b>

No area of state government that is funded to a significant extent by state appropriations has been spared from cuts. Even core agencies that were shielded from the deepest appropriations cuts have not received funding adequate to keep pace with higher utility costs, rising caseloads and enrollment, declining federal contributions, and increased statutory responsibilities.

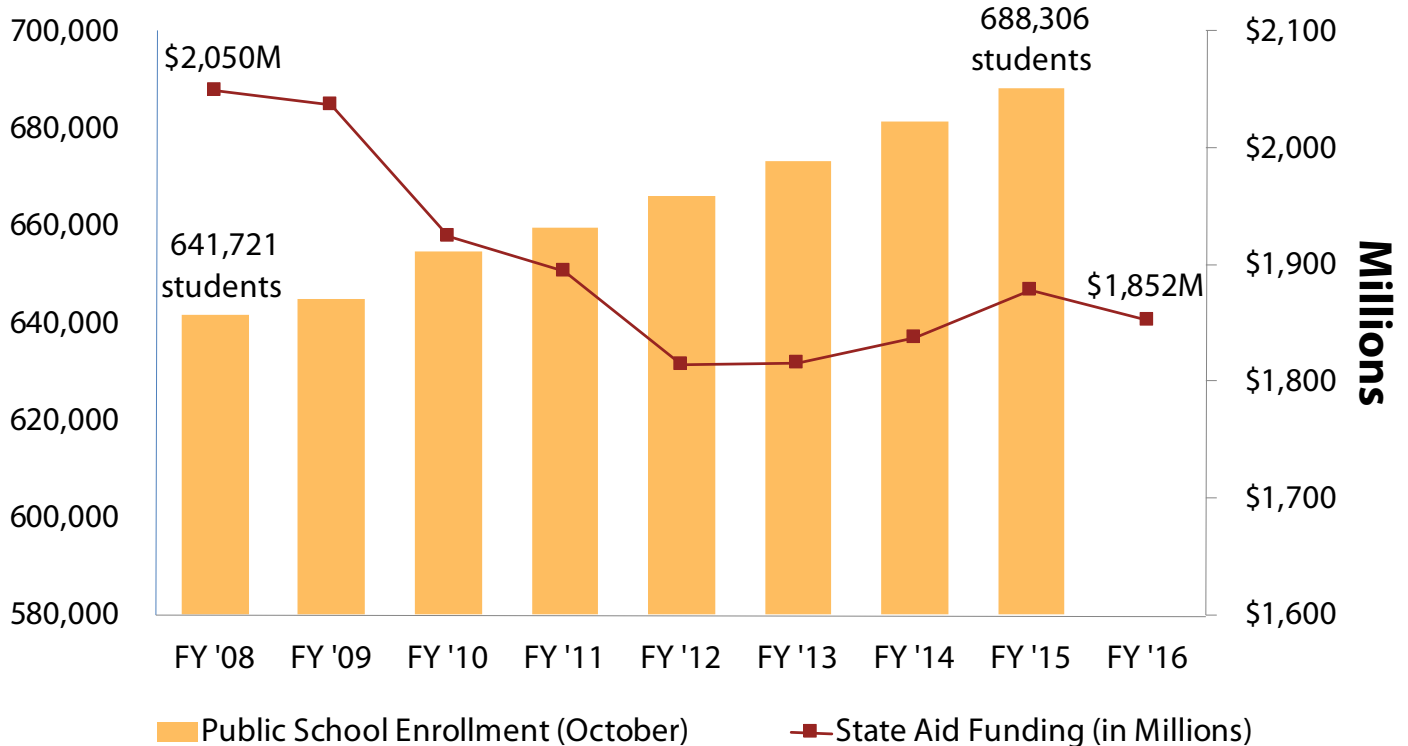
If personal income tax rates had remained at their 2005 levels, the Legislature would have had \$1.022 billion more revenue available for appropriation in the fiscal year that started July 1, 2015 (FY 2016). Table 1 shows how this enhanced amount would be allocated across the largest state agencies, assuming that this hypothetical budget were allocated in the same proportions as in the actual budget.

The additional funding could have provided:

- **More teachers and greater learning opportunities.** Since the 2009 fiscal year, state support for schools through the state aid formula has been cut by \$198 million while enrollment has grown by over 45,000 students.<sup>5</sup> Oklahoma has cut per capita state aid funding more than any state in the nation during this period.<sup>6</sup>

During this time, the number of teachers has decreased, average teacher experience has declined, class sizes have grown, and many class offerings and programs have been eliminated. Oklahoma now faces an acute teacher recruitment and retention crisis, with districts across the state forced to issue emergency certifications to under-qualified teachers and leave positions unfilled.<sup>7</sup>

### State Aid Funding for Schools Has Not Kept Up With Enrollment



Note: State Funding excludes money allocated for textbooks

Without the income tax cuts, \$356 million more would be available for K-12 education. According to the State Department of Education, it would cost \$59.2 million to provide a \$1,000 increase in teacher salaries along with associated employee benefit costs.<sup>8</sup> If the entire \$356 million in additional funding were allocated to teacher salaries, it would equate to a raise of about \$6,000 per teacher. Alternately, a portion of the additional funding could be used to provide additional days of instruction, hire more teachers, or expand priority programs such as early reading instruction, remediation services, or alternative education for at-risk students.

- **More affordable college costs.** State support for higher education has been cut by \$76 million since FY 2009. Colleges and universities have responded by hiking tuition and fees by an average of 4.5 percent annually over the past seven years to cover increased operating expenses.<sup>9</sup> For the current budget year, the Regents for Higher Education requested \$88.3 million to fund the Complete College America Oklahoma Plan initiative, which aims to increase the number of Oklahoma college graduates to meet the demands of the state's economy over the next decade.<sup>10</sup> Instead, state appropriations to higher education were cut by \$24.1 million. If the income tax had not been cut, \$138 million more would be available for higher education.

- **Better, more affordable health care.** The Oklahoma Health Care Authority (the state's Medicaid agency) was forced to implement cuts of over \$167 million in 2014 due to a shortfall of \$63 million in state appropriated dollars (the total cuts included the loss of federal matching dollars). The agency slashed reimbursements to almost all health care providers by 7.75 percent, increased co-payments for low-income Medicaid patients, and eliminated dental services for low-income adults.<sup>11</sup>

Additional cuts in services were enacted in 2015, and OHCA has implemented a preemptive 3 percent cut to provider rates effective January 1, 2016 in light of anticipated budget shortfalls in FY 2017.<sup>12</sup> OHCA would have \$139 million more had state income tax rates not been cut, easing the impact on health care for Oklahomans struggling to make ends meet.

- **Shorter waiting lists for seniors and people with disabilities.** This year, funding shortfalls forced the Department of Human Services to cut reimbursements to providers of care to seniors and Oklahomans with disabilities by 3.5 percent.<sup>13</sup> More than 7,300 families are on a waiting list for home and community-based services for those with developmental disabilities, and the wait has extended to 10 years; \$33 million in funding would allow all those on the waiting list to be served.<sup>14</sup> DHS would have an additional \$97.2 million had the income tax not been cut – enough to provide assistance to all those on the waiting list.

- **Safer correctional facilities.** Oklahoma's correctional facilities are operating at more than 10 percent above inmate capacity but with 30 percent less staffing, creating threats to the safety of correctional staff, prisoners, and the public.<sup>15</sup> Last year, the Department of Corrections requested \$84.5 million in additional funds, of which \$40 million was intended to provide pay raises for correctional officers and other staff, increase staffing to authorized levels, and manage the continued growth in inmate populations.<sup>16</sup> The agency did receive a \$14 million funding increase in this year's budget, but this was only a fraction of what is needed to bring staffing up to safe levels and not enough to bring funding back to pre-2010 levels. DOC would have an additional \$69.4 million if income tax rates had not been cut.



- **Better treatment of mental health and substance abuse problems.** Oklahoma has among the highest rates of mental illness in the nation, and 60 percent of Oklahoma adults with mental illness are not receiving treatment.<sup>17</sup> The result is that many people with treatable mental health conditions end up deteriorating further, resulting in suffering for them and their families and even higher costs to taxpayers when untreated people end up in the criminal justice system. Last year the Department of Mental Health and Substance Abuse Services (DMHSAS) requested \$96.6 million to provide adequate funding for its comprehensive Smart on Crime initiative that includes support for drug courts, mental health courts, screening and assessments, jail diversion, and re-entry programs.<sup>18</sup> Instead, the department received just \$2 million in additional funds for maintaining existing programs and nothing to address severe unmet needs. DMHSAS would have \$48.4 million more if the income tax had not been cut.

**“Oklahoma has among the highest rates of mental illness in the nation, and 60 percent of Oklahoma adults with mental illness are not receiving treatment.”**

These are just a few examples of how Oklahomans’ economic prospects, quality of life, education, and safety could have benefitted if the largest state agencies were funded more adequately. Many other agencies have absorbed large funding cuts in recent years, which has led them to reduce operations, eliminate services, and leave positions unfilled.

Another direct consequence of tax cuts is that Oklahoma is now more dependent on such non-tax revenue sources as fees, fines, and tuition to pay for government services. In the 2000 fiscal year, taxes accounted for 65.9 percent of total state and local revenues in Oklahoma, compared to 34.1 percent that came from non-tax sources. By FY 2012, taxes had declined to 64.0 percent of total revenues and non-tax revenues had increased to 36.0 percent.<sup>19</sup>

### **WHO BENEFITED FROM INCOME TAX CUTS?**

The changes in the personal income tax rates and brackets have disproportionately benefited those at the top of the income ladder. Of the total \$1.022 billion in income tax cuts from lowering the top rate, the wealthiest 20 percent of households — those making on average \$246,000 a year — have enjoyed 72 percent of the benefit. And the top 5 percent of households — those making on average \$568,000 a year — alone receive 43 percent of the benefit. Meanwhile, those with household income of \$62,200 and less — 60 percent of households — have received just 10 percent of the income tax reductions. Altogether, the wealthiest 1 percent of households in Oklahoma has received nearly the same share of the tax cuts as the bottom 80 percent.

The median Oklahoma household with annual income of \$49,800 has seen its taxes reduced by \$228, compared to a \$15,519 cut for the average household in the top 1 percent (income of \$476,600 and above). Households making less than \$21,700 – the bottom 20 percent of households - have received an average of just \$4 per year from cutting the top rate, since little or none of their income is taxed at the top tax brackets.

While some tax cut supporters and state officials have claimed that reducing the top rate helps almost all Oklahoma families because it kicks in at a relatively low amount of taxable income (\$7,200 for a single person or \$12,200 for a married couple), the reality is that after applying the standard deduction and personal exemptions, a large number of Oklahoma families do not reach this income level. For example, the tax cut set to take effect in 2016 will provide no money to more than 2 out of 5 Oklahoma households and very little to many others.<sup>20</sup>

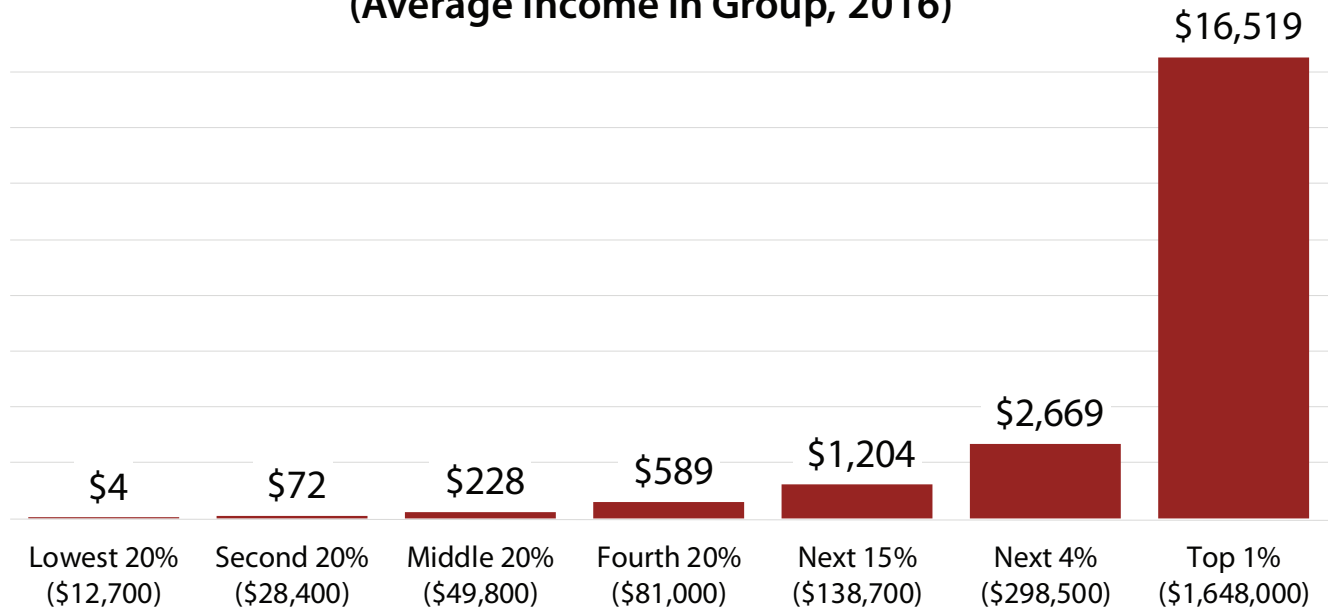
Top 1%	26%
Top 5%	43%
Top 20%	72%
Bottom 60%	10%
Bottom 80%	28%

The income tax cuts have made Oklahoma’s tax system more regressive, meaning that a higher share of total taxes is being paid by people of modest means. In 2015 the poorest 20 percent of Oklahoma households paid 10.5 percent of their income in state and local taxes compared to just 4.3 percent paid by the wealthiest 1 percent, a ratio of 2.4:1. The middle 60 percent pay, on average, 9.3 percent of their income in taxes, 2.2 times as much as the top 1 percent.<sup>21</sup> In only 15 other states is the overall state and local tax system less equitable Oklahoma, according to the Institute on Taxation and Economic Policy’s Tax Inequality Index.<sup>22</sup>

### Oklahoma Income Tax Rate Reductions Since Mid-2000s

#### Average Tax Cut for 2016

(Average Income in Group, 2016)



Data Source: Institute on Taxation and Economic Policy

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## HAVE TAX CUTS BOOSTED OKLAHOMA'S ECONOMY?

Tax cut proponents may counter that despite the substantial revenue losses, tax cuts were justified by the boost they provided to the state's economy. In reality, the impact has been negligible. Actual experience shows that state income tax cuts have not brought significant economic benefit to Oklahoma or other states.

According to a recent comprehensive review by the nonpartisan Center on Budget and Policy Priorities of research conducted over the past 40 years on state taxes and economic performance:

*The large majority of these studies find that interstate differences in tax levels, including differences in personal income taxes, have little if any effect on relative rates of state economic growth. Of the 15 major studies published in academic journals since 2000 that examined the broad economic effect of state personal income tax levels, 11 found no significant effects and one of the others produced internally inconsistent results.<sup>23</sup>*

This report found that four of the five states that have enacted the largest personal income tax cuts in the last five years – Maine, Kansas, Ohio and Wisconsin – have experienced total job growth and personal income growth *below* the national average since the tax cuts took effect. Among the most recent tax-cutting states, only North Carolina's economy has outperformed the national average, and only slightly.

The Center's report also examined states that cut taxes most aggressively in the years before the onset of the Great Recession. Of these six states, only Oklahoma saw large employment gains since taxes were cut. Conversely, four states - Ohio, Rhode Island, Louisiana and Arizona - saw a decline in their state's share of total non-farm employment; New Mexico's job growth was modest. This evidence led the Center's analysts to conclude that job growth in Oklahoma and New Mexico was attributable to high energy prices and the boom in hydraulic fracturing rather than to tax policy. They write:

*Indeed, these two states have seen their share of national employment drop in the last couple of years as oil prices stagnated and then declined sharply, reversing some — but not all — of the price growth from earlier years. More specifically, both New Mexico and Oklahoma have seen their share of national employment fall by 3 percent since October 2012.<sup>24</sup>*

A recent report for the Urban Institute and Brookings Institution further challenges the claim that state tax cuts lead to economic growth.<sup>25</sup> The research finds that “neither tax revenues nor top marginal income tax rates bear any stable relation to economic growth rates across states and over time.” While studies have found a negative relationship between taxes and economic growth in the 1980s and 1990s, the relationship seems to have reversed itself since then, showing a positive relationship between taxes and growth. The authors conclude:

*We find that states have no good reasons to believe that cuts in income tax rates will bring the desired benefits. Yet, states continue to erode their tax bases in the name of economic growth during*





*a time when few states can afford to cut services, such as education and infrastructure repair that are critical for both businesses and households.*

This trade-off between tax cuts and cuts in services that can follow in the wake of tax cuts is crucial. As economist Robert Lynch has argued, “there is little evidence that state and local tax cuts—when paid for by reducing public services—stimulate economic activity or create jobs... Any jobs that might be gained by cutting taxes can be more than offset by the jobs lost as a result of cuts in public services.”<sup>26</sup> This is especially true when dollars cut from the state budget come with the additional loss of one or more federal matching dollars, as is the case with cuts to the Medicaid program.

## CONCLUSION

Oklahoma has cut taxes by over a billion dollars since the mid-2000s and now faces a massive budget shortfall that could reach or exceed a billion dollars. With or without tax cuts, this immediate shortfall would loom. With a state tax system that remains heavily dependent on revenue from oil and gas production, current low energy prices would still have ensured difficult times. And other important factors – including the proliferation of tax breaks and off-the-top budget allocations –are contributing to Oklahoma’s chronic inability, in good years as well as bad, to bring our budget into balance and fund services at the level it takes to meet growing needs.

The key point, though, is that without the tax cuts of the past dozen years, we would be approaching this latest economic downturn from a far stronger starting point. Additional revenues over the past decade would have allowed greater public investment in the building blocks of a prosperous economy – a stronger education system, more widely available health care, and well-maintained roads and other infrastructure. It would have enabled us to pay our teachers more competitive salaries, ensure that prisons are properly staffed, limit college tuition increases, and provide critically-needed services for those with mental illness and developmental disabilities. In all likelihood, we would not already have cut per-pupil state aid to schools more than any other state in the nation. We would not be approaching this new round of tight budgets having already slashed funding to many agencies by 20 to 30 percent and threatened their ability to perform their core responsibilities. With larger budget surpluses during years of economic growth, we might also have saved more money in reserves to help us through our current economic challenges.

“Common sense dictates that until the state proves it can live within its means, it really should stop reducing them.”

If Oklahoma is ever to emerge from our perpetual budget crisis, we must reexamine the priority being given to cutting taxes without responsibly assessing the impact on the state economy and what it will take to preserve vital public services. The problem has been years in the making and will take years to fix. A sensible place to start is to repeal the most recent tax cut and to cancel the next tax cut already scheduled for as early as 2018. As Oklahoma State Treasurer Ken Miller recently said, “common sense dictates that until the state proves it can live within its means, it really should stop reducing them.”<sup>27</sup>

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