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Eliminating the State Income Tax in Oklahoma: An Economic Assessment



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Arduin, Laffer & Moore
ECONOMETRICS

About the Oklahoma Council of Public Affairs

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About Arduin, Laffer and Moore Econometrics

Arduin, Laffer and Moore Econometrics is a research firm which advises governments and private entities on economic, fiscal, and state policies. The firm operates under the leadership of acclaimed economist Wayne Winegarden; former California, Florida, New York, and Michigan budget director Donna Arduin; and the visionary “Father of Supply-Side Economics,” Arthur Laffer.

Executive Summary

Oklahoma has the opportunity to establish itself as America's premier destination for economic freedom, through a complete phaseout of the state's personal income tax. This would create a long-lasting economic boom, benefiting generations to come. A phaseout of Oklahoma's personal income tax would result in Oklahoma having the lowest tax burden of any state except Alaska. Eliminating the personal income tax would provide Oklahomans with approximately the following savings (based on 2010 data) in state personal income taxes:

- Single Person, Gross Income \$30,000 – Savings: \$950
- Family of 4, Gross Income \$50,000 – Savings: \$1,373
- Family of 4, Gross Income \$60,000 – Savings: \$1,924
- Family of 4, Gross Income \$75,000 – Savings: \$2,748
- Family of 4, Gross Income \$100,000 – Savings: \$3,651

OCPA and Arduin, Laffer & Moore Econometrics (ALME) have evaluated the economic impacts of a complete phaseout of the personal income tax. The evidence illustrates that Oklahoma could expect a significant increase in state GDP growth, personal income growth, and employment growth if the proposal were implemented.

The reductions of waste and non-core government spending necessary to accomplish this proposal are not draconian by any measure—approximately \$300–\$400 million, or 6 percent of current appropriations. By gradually lowering personal income taxes, the proposal does slow the total growth in appropriations and in total tax collections. This is an outcome to be desired, especially considering how much the economy and state and local tax revenues would grow if the proposal were implemented.

Based on the analysis, Oklahoma could expect the following economic impacts with the proposed tax reform from 2013 through 2022 compared to a baseline scenario:

- Oklahoma's real annual personal income growth increasing to 3.27 percent in 2013 and accelerating to 5.65 percent by 2022—compared to real annual personal income growth of 2.39 percent in the

baseline scenario between 2013 and 2022.

- o By 2022, personal income in Oklahoma would be \$47.4 billion, or 20.6 percent, larger than it would be without the tax reform.
- The annual growth rate of real annual GDP increasing to 2.95 percent in 2013 and accelerating to 5.44 percent by 2022—compared to 2.03 percent in the baseline scenario.
 - o By 2022, state GDP would be \$53.4 billion, or 21.7 percent, larger than it would be without the tax reform.

By 2022, the proposed tax reform would create 312,000 more jobs in Oklahoma than the number of jobs that would be created in Oklahoma under the baseline scenario.

Additionally, while the individual income tax currently raises more than one-third of total tax revenues in Oklahoma, the dynamic revenue benefits created by the accelerated economic growth recaptures about one-half of the static revenue losses. Thus, while appropriated revenue growth would be slower under the proposed tax reform than it would be under the baseline scenario, total appropriated revenues for the state would grow over this time period.

From a theoretical perspective, the gradual elimination of the individual income tax would simultaneously improve two separate parts of Oklahoma's economic environment: (1) it would eliminate the tax on individual income, thereby increasing the incentive to work, produce, and save in Oklahoma; and (2) it would reduce the overall cost of government on the taxpayer, reinforcing the positive incentives to work, produce, and save.

The anecdotal evidence supports the statistical conclusions of our analysis. Those states that do not levy an individual income tax and/or levy a lower overall tax and expenditure burden consistently experience greater economic growth than the nation—and Oklahoma.

Based on both the statistical and anecdotal evidence, it is clear that Oklahoma's economy would soar if the

proposed economic plan were implemented.

It used to be the case that the sole purpose of the tax code was to raise the necessary funds to run government. But in today's world taxes play many other roles, including redistributing income, rewarding favored industries, and punishing unfavorable behavior.

Even with the greatly expanded tax mandate, finding an appropriate tax code would be relatively straightforward if only people would stop changing what they do when the tax code changes. The system is like dodgeball; if only the opponent would not duck when we threw the ball at him it would be easy to win. But the opponent *does* duck, and he almost always ducks just when we throw the ball at him.

Economics is all about incentives—ducking to avoid being hit by the dodgeball. When a state's economic policies establish pro-growth economic incentives, strong economic growth follows. The reverse is true as well. Overall, Oklahoma's economic policies

are good. According to the 2011 edition of *Rich States, Poor States: ALEC-Laffer State Economic Competitiveness Index*, Oklahoma ranked 14th—and that was before the personal income tax rate was cut to 5.25 percent (effective January 1, 2012).

Oklahoma's Achilles' heel remains the state's progressive personal income tax. Progressive income taxes filled with special interest loopholes and exemptions are especially bad. Progressive income taxes produce disproportionately large distortions and revenue volatility, and thereby seriously damage the economy. The damage they cause to the economy always reduces other tax revenues.

Oklahoma can significantly increase its economic competitiveness by phasing out its state personal income tax. Before reviewing the proposal in Section II, it is helpful to review the evidence that illustrates why phasing out Oklahoma's personal income tax will increase economic growth in the state so significantly.

I. The Evidence from States across the United States

The Overall Tax Burden Matters

States that have high and/or increasing taxes relative to the nation experience relative declines in income, housing values, and population as well as rising relative unemployment rates. Consistently, economic growth rates in the states that have the highest government tax and expenditure burdens lag the economic growth rates in the states with the lowest government tax and expenditure burdens.

Table 1 presents the relationship between the Tax

Foundation's estimated state and local tax burden for 2009 (latest year available) and a series of economic metrics of the state's health, including the 10-year growth rate in state GDP between 2001 and 2010. Table 1 compares the nine states with the highest tax burdens to the U.S. average of all states and the nine states with the lowest tax burdens. For comparison, Oklahoma's tax burden of 8.7 percent, which is below the national average, is displayed as well. Those states that imposed the smallest tax burdens in 2009

Table 1
The Nine States with the Highest and Lowest Tax Burdens
10-Year Economic Performance between 2001 and 2010

State	State & Local Government Tax Burden as a % of Personal Income*	Gross State Product Growth	Nonfarm Payroll Employment Growth	Population Growth	Net Domestic In-Migration as a % of Population	State & Local Tax Revenue Growth ***
Alaska	6.3%	77.0%	12.2%	12.1%	-2.0%	452.6%
Nevada	7.5%	58.9%	6.1%	28.9%	14.1%	100.1%
South Dakota	7.6%	58.5%	6.4%	7.3%	0.8%	51.2%
Tennessee	7.6%	38.6%	-2.8%	10.3%	4.2%	61.7%
Wyoming	7.8%	105.6%	15.2%	14.3%	4.3%	172.2%
Texas	7.9%	57.7%	8.7%	17.9%	3.4%	75.5%
New Hampshire	8.0%	35.2%	-0.7%	4.7%	2.5%	59.6%
South Carolina	8.1%	37.1%	-1.0%	13.8%	6.4%	45.2%
Louisiana	8.2%	58.7%	-1.6%	1.6%	-6.1%	70.4%
9 States with Lowest Tax Burden as a % of Personal Income**	7.67%	58.57%	4.72%	12.34%	3.05%	120.94%
<i>Oklahoma</i>	<i>8.70%</i>	<i>51.81%</i>	<i>2.14%</i>	<i>8.50%</i>	<i>1.05%</i>	<i>58.53%</i>
U.S. Average**	9.38%	46.61%	0.51%	8.63%	0.86%	70.23%
9 States with Highest Tax Burden as a % of Personal Income**	11.02%	38.24%	-2.89%	3.78%	-2.48%	57.46%
Maine	10.1%	35.4%	-2.5%	3.4%	2.3%	45.3%
Vermont	10.2%	36.1%	-1.6%	2.2%	-0.1%	64.5%
Minnesota	10.3%	39.5%	-1.9%	6.4%	-0.9%	43.8%
California	10.6%	42.1%	-4.8%	8.0%	-3.9%	77.2%
Rhode Island	10.7%	38.1%	-4.1%	-0.5%	-3.8%	52.4%
Wisconsin	11.0%	35.3%	-2.8%	5.1%	-0.1%	39.9%
Connecticut	12.0%	40.9%	-4.3%	4.2%	-2.6%	55.3%
New York	12.1%	43.1%	-0.4%	1.5%	-8.3%	68.3%
New Jersey	12.2%	33.7%	-3.6%	3.6%	-4.8%	70.4%

*State & Local Government Tax Burden as of 2008 according to Tax Foundation

**Equal-weighted averages.

***1999-2008

Sources: U.S. Census Bureau, Bureau of Economic Analysis, Tax Foundation, and ALME calculations

experienced higher rates of economic growth than both the average state and those states that imposed the largest tax burdens.

There are two notable generalizations in Table 1. The first is that, on average, low-tax states significantly outperform the highest-taxed states whether one focuses on Gross State Product growth, employment growth, population growth, in-migration, and, yes, even tax revenue growth. These types of differences are not achieved by chance. Taxes matter and they matter a lot.

The second noteworthy feature of Table 1 is how well Oklahoma has performed relative to the average

state due to its below-average—albeit not in the best group—tax burden. In this 10-year period, Oklahoma’s Gross State Product growth, employment growth, and net domestic in-migration (current U.S. residents choosing to live in Oklahoma on net) well outperformed the nation. However, population growth lagged the nation, and neighboring Texas has a lower overall tax burden and outperformed Oklahoma in every category. While Oklahoma’s overall tax environment is competitive, it can do better.

The Personal Income Tax

It is not just the size of the tax burden that matters—

Table 2
The Nine States with the Lowest and Highest Marginal Personal Earned Income Tax (PIT)
10-Year Economic Performance between 2001 and 2010

State	Top Personal Income Tax Rate*	Gross State Product Growth	Nonfarm Payroll Employment Growth	Population Growth	Net Domestic In-Migration as a % of Population	State & Local Tax Revenue Growth ***
Alaska	0.00%	77.0%	12.2%	12.1%	-2.0%	452.6%
Florida	0.00%	47.7%	0.2%	15.0%	6.5%	82.3%
Nevada	0.00%	58.9%	6.1%	28.9%	14.1%	100.1%
New Hampshire	0.00%	35.2%	-0.7%	4.7%	2.5%	59.6%
South Dakota	0.00%	58.5%	6.4%	7.3%	0.8%	51.2%
Tennessee	0.00%	38.6%	-2.8%	10.3%	4.2%	61.7%
Texas	0.00%	57.7%	8.7%	17.9%	3.4%	75.5%
Washington	0.00%	47.8%	3.0%	12.3%	3.4%	57.8%
Wyoming	0.00%	105.6%	15.2%	14.3%	4.3%	172.2%
9 States with no PIT**	0.00%	58.54%	5.36%	13.65%	4.12%	123.66%
Oklahoma	5.25%	51.81%	2.14%	8.50%	1.05%	58.53%
U.S. Average**	5.47%	46.61%	0.51%	8.63%	0.86%	70.23%
9 States with Highest PIT Rate**	9.92%	42.06%	-1.68%	5.49%	-1.91%	61.79%
Ohio	8.24%	24.8%	-9.3%	1.2%	-3.1%	44.5%
Maine	8.50%	35.4%	-2.5%	3.4%	2.3%	45.3%
Maryland	9.30%	50.9%	1.7%	7.4%	-1.5%	67.0%
Vermont	9.40%	36.1%	-1.6%	2.2%	-0.1%	64.5%
New York	10.50%	43.1%	-0.4%	1.5%	-8.3%	68.3%
California	10.55%	42.1%	-4.8%	8.0%	-3.9%	77.2%
New Jersey	10.75%	33.7%	-3.6%	3.6%	-4.8%	70.4%
Hawaii	11.00%	57.4%	5.7%	11.7%	-2.2%	72.1%
Oregon	11.00%	55.0%	-0.3%	10.4%	4.5%	46.8%

*Highest marginal state and local personal income tax rate imposed as of 1/1/2011 (except Oklahoma, whose 5.25% rate becomes effective 1/1/2012) using the tax rate of each state’s largest city as a proxy for the local tax. The deductibility of federal taxes from state tax liability is included where applicable. New Hampshire and Tennessee tax dividend interest income only.

**Equal-weighted averages

***1999-2008

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

although clearly size does matter. The manner in which the tax burden is levied also matters. Economic growth is stronger in states with no personal income tax and weaker in states with the highest marginal personal income tax rates—in good times and bad (see Table 2). States without an income tax also exhibit less economic volatility. States without a personal income tax exhibit *more tax revenue stability* during bad economic times and *stronger tax revenue growth* during good economic times.

An examination of the personal income tax rate alone reveals how much better the zero-tax states perform relative to the nation as a whole and especially relative to the highest-tax states. To single out just one metric over the past decade, employment growth in

the zero-tax states was 5.36 percent versus 0.51 percent for the nation and -1.68 percent for the highest-tax-rate states.

It is worth noting here that over the past 50 years 11 states have, at differing times, instituted a progressive state income tax: Connecticut (1991), New Jersey (1976), Ohio (1972), Rhode Island (1971), Pennsylvania (1971), Maine (1969), Illinois (1969), Nebraska (1968), Michigan (1967), Indiana (1963), and West Virginia (1961).

The results have not been pretty. Compared to the time just prior to the introduction of the progressive income tax, each state's share of the U.S. economy is now smaller. And some of the declines are quite large. In each case, not only has the state's economy become a smaller portion of the overall U.S. economy,

Table 3
Laffer State Competitive Environment Rank vs. 10-Year Economic Performance
2000–2009

State	Rank	Gross State Product Growth	Net Domestic In-Migration as a % of Population	Nonfarm Payroll Employment Growth
Utah	1	62.2%	2.0%	11.8%
South Dakota	2	61.5%	0.8%	7.3%
Virginia	3	55.1%	2.2%	4.4%
Wyoming	4	119.8%	4.1%	19.4%
Idaho	5	48.2%	7.4%	10.7%
Colorado	6	45.9%	4.1%	2.6%
North Dakota	7	73.3%	-2.9%	12.5%
Tennessee	8	36.2%	4.3%	-4.3%
Missouri	9	30.8%	0.7%	-2.9%
Florida	10	51.6%	6.9%	3.9%
10 Highest Ranked States*		58.5%	3.0%	6.5%
Oklahoma	14	56.0%	1.0%	4.4%
U.S. Average*		48.8%	0.9%	1.5%
10 Lowest Ranked States*		41.6%	-2.4%	-0.9%
Pennsylvania	41	38.4%	-0.4%	-1.0%
Rhode Island	42	42.0%	-4.3%	-3.8%
Oregon	43	46.2%	4.6%	-0.6%
Illinois	44	30.9%	-5.1%	-7.0%
New Jersey	45	36.9%	-5.3%	-1.8%
California	46	43.0%	-4.0%	-2.3%
Hawaii	47	58.8%	-2.2%	8.6%
Maine	48	39.2%	2.0%	-0.7%
Vermont	49	39.3%	-0.5%	0.2%
New York	50	40.8%	-8.6%	-0.5%

*Equal-weighted averages

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

but also the state's citizens have seen their prosperity dramatically reduced, and the population of each of these states has given their state government a big raspberry by voting with their feet and leaving. The introduction of a progressive personal income tax in each state that has implemented it over the past 50 years has been a total failure.

Oklahoma's 5.25 percent top marginal personal income tax rate is near the national average of 5.47 percent. And Oklahoma's performance, while better than average, is falling behind compared to the states with no personal income tax (including Texas).

ALEC-Laffer Competitive Environment Ranking

Of course, factors other than taxes matter as well. Table 3 accounts for those other factors that also impact growth. Table 3 presents the latest results from the ALEC-Laffer state competitive environment rankings. The following 15 policy factors are included in the *ALEC-Laffer State Economic Competitiveness Index*:

- Highest Marginal Personal Income Tax Rate
- Highest Marginal Corporate Income Tax Rate
- Personal Income Tax Progressivity

- Property Tax Burden
- Sales Tax Burden
- Tax Burden from All Remaining Taxes
- Estate Tax/Inheritance Tax (Yes or No)
- Recently Legislated Tax Policy Changes
- Debt Service as a Share of Tax Revenue
- Public Employees per 1,000 Residents
- Quality of State Legal System
- State Minimum Wage
- Workers' Compensation Costs
- Right-to-Work State (Yes or No)
- Tax or Expenditure Limits

The rank is based on the above 15 state-policy variables. States that spend less (especially on income-transfer programs), states that tax less (particularly on productive activities such as working or investing), and states that regulate less experience higher growth rates than states that tax and spend more.

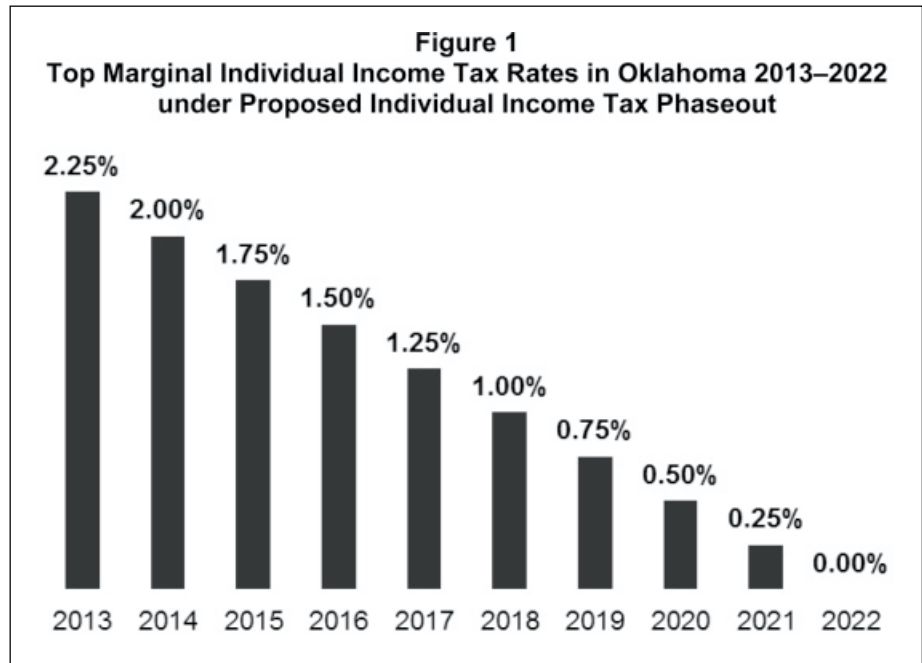
Based on this comprehensive measure of state economic policies, Oklahoma ranks well, but not within the top 10 states. And, as would be expected, Oklahoma's economic performance is strong, but not within the top economic performers in the country.

II. The Proposal

The results presented above indicate that while Oklahoma's economic performance is solid, the state is not a top economic performer. Becoming one of the elite economic growth states requires a policy reform that will increase Oklahoma's economic competitiveness vis-à-vis the other 49 states. Phasing out Oklahoma's personal income tax is such a proposal. Without a personal income tax, Oklahoma would join that elite group of economic performers that do not have a personal income tax—a group to which Texas currently belongs. Additionally, phasing out the personal income tax would lower Oklahoma's overall tax burden. Oklahoma would also join the lowest-taxed group of elite economic performers—a group that Texas belongs to as well. The result would be a significant acceleration in Oklahoma's economic growth, income growth, and job growth. As former U.S. President Ronald Reagan reminded us in his "Time to Recapture Our Destiny" address in Detroit on July 17, 1980, "When I talk of tax cuts, I am reminded that every major tax cut in this century has strengthened the economy, generated renewed productivity, and ended up yielding new revenues for the government by creating new investment, new jobs, and more commerce among our people."

Because Oklahoma's individual income tax is progressive and levies marginal tax rates that are higher than necessary, the proposal would achieve two separate goals: (1) minimize the negative economic consequences of Oklahoma's state income tax while it remains in effect by levying the lowest possible tax rate; and (2) phase out the income tax over 10 years. According to the Oklahoma Tax Commission, if all

individual-income-tax deductions, exemptions, credits, and loopholes were eliminated, a 3 percent income tax rate would raise approximately the same amount of revenue as the current state income tax system with a top income tax rate of 5.25 percent. The individual income tax raised \$2.2 billion during 2010.



The proposal would then reduce the state income tax rate by 0.75 percent to 2.25 percent in the year of initiation—assumed to be 2013—and then reduce it in 0.25 percent increments until the individual income tax is completely eliminated by 2022 (see Figure 1).

Oklahoma State Government Revenues

Table 4 lists the major tax revenue sources for Oklahoma from FY 2003 through FY 2010.¹

On average, Oklahoma's individual income tax represents about 37 percent of all tax revenues, or \$2.23 billion as of FY 2010. Total individual income tax revenues in FY 2012 were slightly less at an estimated \$2.1 billion.² Relying on the slightly higher FY 2010 estimate, each basis point (1/100th of a percentage point) of Oklahoma's individual income tax raises around \$7 million.

On a static basis, the reduction in Oklahoma's

Table 4
Major Tax Revenue Sources: Total Dollar Amounts and Percentages of Total Taxes
(in billions \$)
FY 2003–FY 2010

	2003	2004	2005	2006	2007	2008	2009	2010
Gross Production Tax—Oil and Gas	0.54	0.65	0.75	0.88	0.79	0.95	0.98	0.58
Income Tax (individual)	2.11	2.32	2.47	2.76	2.77	2.78	2.61	2.23
Income Tax (corporate)	0.10	0.13	0.17	0.30	0.55	0.36	0.38	0.21
Sales Tax	1.40	1.50	1.55	1.68	1.79	1.91	1.99	1.81
Total	5.73	6.38	6.65	7.01	7.39	7.57	7.54	6.32
Tax Revenues Share of Total Tax Revenues								
Gross Production Tax—Oil and Gas	9.4%	10.1%	11.3%	12.6%	10.7%	12.6%	13.0%	9.2%
Income Tax (individual)	36.9%	36.4%	37.1%	39.4%	37.5%	36.7%	34.6%	35.3%
Income Tax (corporate)	1.8%	2.1%	2.5%	4.3%	7.5%	4.8%	5.0%	3.4%
Sales Tax	24.5%	23.5%	23.3%	24.0%	24.2%	25.3%	26.4%	28.6%
Total	100%	100%	100%	100%	100%	100%	100%	100%

Source: Oklahoma 2010: Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2010
Columns are not intended to add as smaller revenue sources are excluded.

individual income tax marginal rate from a statically revenue-neutral rate of 3 percent with no deductions to 2.25 percent in 2013 would reduce state tax revenues by \$558 million. Total Oklahoma revenues, on a static basis, would then decline \$186 million per year from 2014 through 2022. The revenue declines estimated are actually higher than these amounts as the total expected individual income tax revenue in 2013—the assumed year of implementation—will be higher. And, of course, the world is not static.

The actual dollar loss to Oklahoma would be less than the static revenue estimates once the dynamic economic impacts are incorporated into the analysis. Several notable individuals have spoken to the realities of dynamic economic impacts. As former U.S. President John F. Kennedy observed on January 17, 1963, in his annual budget message to the Congress, “Lower rates of taxation will stimulate economic activity and so raise the levels of personal and corporate income as to yield within a few years an increased—not a reduced—flow of revenues to the federal government.”

None other than John Maynard Keynes commented

on the importance of including dynamic impacts into economic analyses:

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

Nor should the argument seem strange that taxation may be so high as to defeat its object, and that, given sufficient time to gather the fruits, a reduction of taxation will run a better chance than an increase of balancing the budget. For to take the opposite view today is to resemble a manufacturer who, running at a loss, decides to raise his price, and when his declining sales

increase the loss, wrapping himself in the rectitude of plain arithmetic, decides that prudence requires him to raise the price still more—and who, when at last his account is balanced with nought on both sides, is still found righteously declaring that it would have been the act of a gambler to reduce the price when you were already making a loss.³

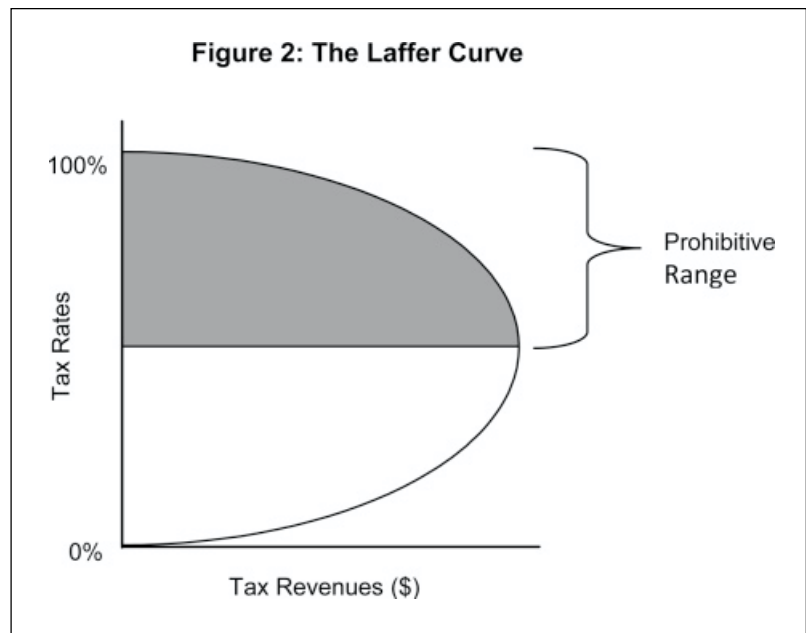
The basic idea behind the relationship between tax rates and tax revenues is that changes in tax rates have two effects on revenues: the arithmetic effect and the economic effect.

- **The arithmetic effect** simply states that if tax rates are lowered, tax revenues per dollar of tax base will be lowered by the amount of the decrease in the rate. And the reverse is true for an increase in tax rates.
- **The economic effect** recognizes the positive impact that lower tax rates have on work, output, and employment and thereby the tax base by providing incentives to increase these activities. Raising tax rates has the opposite economic effect by penalizing participation in the taxed activities.

The arithmetic effect always works in the opposite direction from the economic effect. Therefore, when the economic and the arithmetic effects of tax-rate changes are combined, the consequences of the change in tax rates on total tax revenues are no longer quite so obvious.

Figure 2 is a graphic illustration of this concept as illustrated by the Laffer Curve. At a tax rate of 0 percent, the government would collect no tax revenues, no matter how large the tax base. Likewise, at a tax rate of 100 percent, the government would also collect no tax revenues because no one would be willing to work for an after-tax wage of zero—there would be no tax base. Between these two extremes, there are two tax rates that will collect the same amount of revenue: a high tax rate on a small tax base and a low tax rate on a large tax base.

The Laffer Curve itself does not say whether a tax cut will raise or lower revenues. Revenue responses to a tax-rate change will depend upon the tax system in place, the time period being considered, the ease of moving into untaxed activities, the level of tax rates already in place, the prevalence of legal and accounting-driven tax loopholes, and the proclivities of the productive factors. If the existing tax rate is too high—in the “prohibitive range” shown below—then a tax-rate cut would result in increased tax revenues. The



economic effect of the tax cut would outweigh the arithmetic effect of the tax cut.

Oklahoma has demonstrated the dynamic effects of tax cuts. For example, prior to personal income tax cuts beginning in FY-2005, the annual state sales tax growth rate was 2.7 percent for the preceding four years. Once the personal income tax cuts began in FY-2005, annual sales tax growth for the following five years was 6.6 percent. It is important to note that, according to the 2005 Oklahoma Senate session summary, 2005 session tax cuts were estimated to have a static loss of \$150.8 million in FY-2007. Despite this estimate, individual income tax collections grew by more than \$305 million, and state sales tax collections grew by more than \$243 million.

In the case of the proposal in Oklahoma, the

economic effects would reduce the static revenue loss of the arithmetic effect, although not completely. Consequently, the proposed tax reform needs to be implemented with requisite spending restraint. By rightsizing Oklahoma’s government, however, the spending restraint would further enhance the growth benefits to Oklahoma’s economy. These benefits are examined in the next section.

Projected Economic Benefits

To empirically examine the potential economic benefit from the gradual phaseout of Oklahoma’s individual income tax, we employed a pooled regression analysis, detailed in the appendix to this paper.

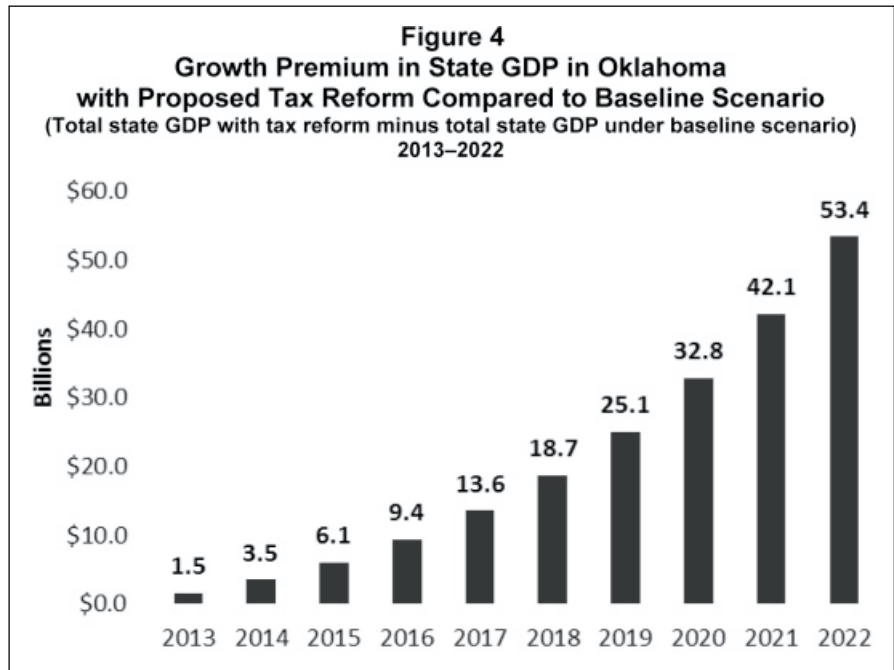
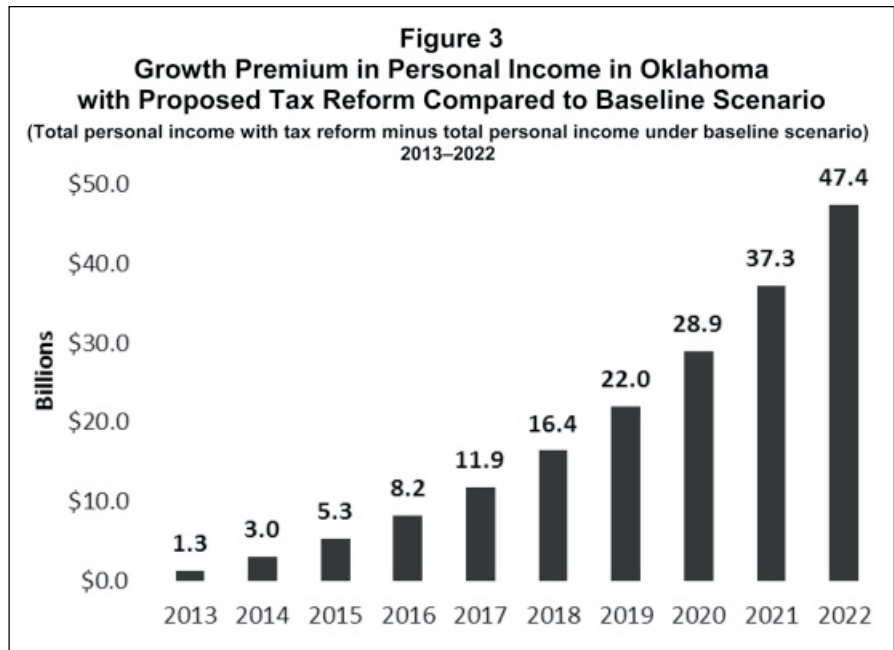
The purpose of the tax reform proposal is to accelerate economic activity in the state. Based on the anecdotal evidence presented in the previous section, Oklahoma should expect higher state GDP growth, higher income growth, and higher employment growth. The econometric estimates illustrated in the appendix provide further support. The coefficients (column 2, Table A1) for both the PIT and EXP variables are both negative and highly significant.

Consequently, accelerated personal income growth should result through both the lowering (and eventual elimination) of Oklahoma’s individual income tax rate and the reduction in the total government expenditure burden. Based on the close relationship between income growth and state GDP growth and employment growth, the impacts on state GDP and employment can also be estimated.

To get a sense of how much Oklahoma’s economy would benefit

from the proposal, we examined the impact from the proposed tax reform on total income, state GDP, and employment from 2013 through 2022 compared to a baseline economic projection over this same time period. The baseline economic projection is based on the following assumptions:

- Population growth remains at its 10-year average growth rate of 0.9 percent per year;
- The total top personal income tax rate in Oklahoma



(including all federal taxes and the deductibility of state taxes from federal taxes) is 41.3 percent;

- The total state and local expenditure burden in Oklahoma remains at its 2008 level of 19.8 percent; and
- Inflation is estimated to be 2.3 percent per year, or the average annual inflation between 2001 and 2010.

Based on these assumptions, and using the coefficients estimated in Table A1, Oklahoma’s real annual personal income growth in the baseline scenario is estimated to be 2.39 percent between 2013 and 2022. Based on the relationship between personal income growth and state GDP growth in Oklahoma between 1980 and 2010, real annual GDP growth is estimated

to be 2.03 percent between 2013 and 2022. Under the proposed tax reform, real annual personal income growth increases to 3.27 percent in 2013 and accelerates up to 5.65 percent by 2022. Real annual GDP growth is similarly stronger, jumping to 2.95 percent in 2013 and accelerating up to 5.44 percent by 2022. Figures 3 and 4 (see page 10) illustrate how much larger both income and state GDP could be in Oklahoma if the proposed tax reform were implemented. By 2022, personal income in Oklahoma would be \$47.4 billion, or 20.6 percent, larger than it would be without the tax reform, and state GDP would be \$53.4 billion, or 21.7 percent, larger than it would be without the tax reform.

The growth in income and state GDP would also benefit overall employment in Oklahoma. Output per worker in Oklahoma grew at an average rate of 2½ percent per year between 2001 and 2010. Projecting the growth rate in output per worker for the 2013 through 2022 period and applying the projected output per worker to the total output

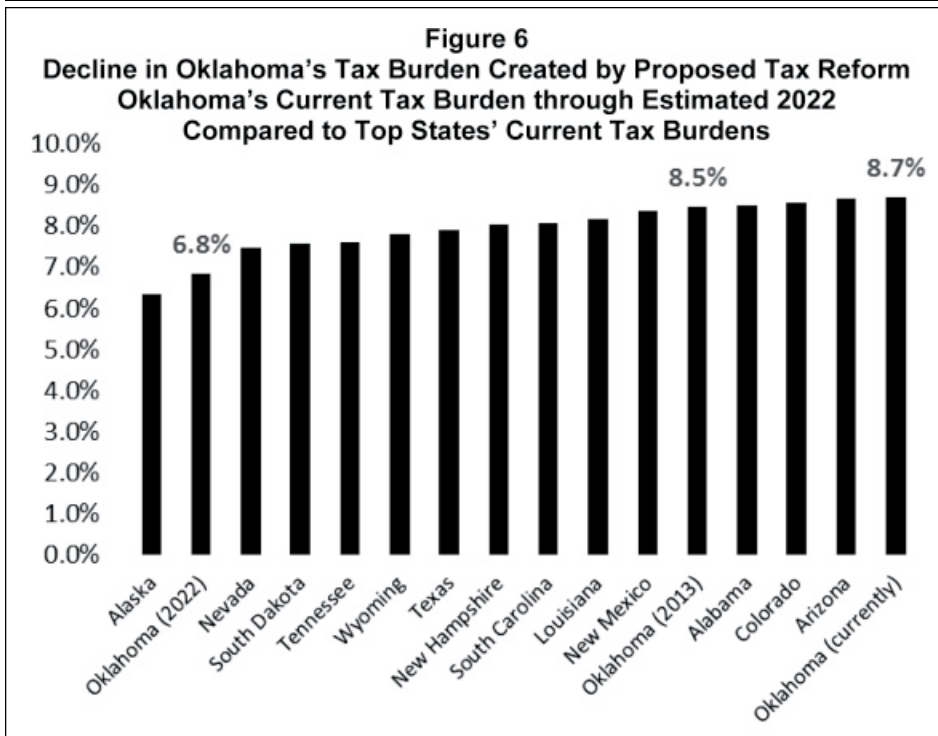
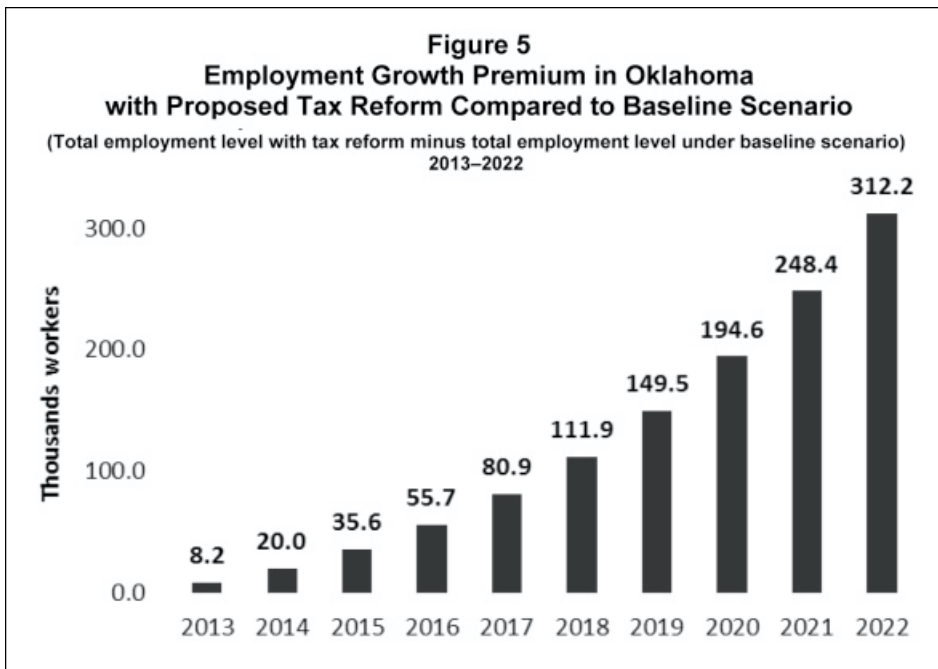


Table 5
Oklahoma Sales Tax Revenues, Estimated Sales Tax Base, and
Sales Tax Base as a Percentage of Personal Income (PI)
(in billions \$)
2003–2010

	2003	2004	2005	2006	2007	2008	2009	2010
Sales tax revenues	\$1.404	\$1.496	\$1.547	\$1.678	\$1.790	\$1.913	\$1.989	\$1.806
Sales tax rate	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%
<i>Sales tax base</i>	\$31.206	\$33.253	\$34.370	\$37.286	\$39.782	\$42.520	\$44.211	\$40.134
Sales tax base % PI	33.1%	32.9%	31.9%	31.4%	31.9%	30.7%	35.0%	30.1%
Average Sales tax base % PI	32.1%							

Source: *Oklahoma 2010: Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2010*

(state GDP) under the tax reform and baseline scenarios reveals that by 2022 the proposed tax reform would create 312,000 more jobs in Oklahoma than the number of jobs that would be created in Oklahoma under the baseline scenario (see Figure 5).

The proposed tax reform would also reduce Oklahoma’s overall tax burden from 8.7 percent of personal income currently (as estimated by the Tax Foundation) down to an estimated 6.8 percent by 2022 (see Figure 6). Compared to the current tax burdens across all 50 states, a tax burden of 6.8 percent would be the second smallest tax burden in the country, with only Alaska having a lower tax burden.

The proposed tax reform, consequently, would have a significant and positive impact on Oklahoma’s economy. The rate of income growth, state GDP growth, and employment growth would all accelerate each year. While the benefits quantified above end at 2022, the benefits to Oklahoma’s economy would continue as the accelerated rate of economic growth continued.

Projected Impacts on State Revenues

These accelerated economic benefits would also increase the tax revenues Oklahoma receives from the state sales tax, the state corporate income tax, the state excise taxes, and the other state tax revenue sources that grow naturally when Oklahoma’s economy grows. These dynamic state tax revenue benefits would offset about one-half of the static revenue losses created by the elimination of the state individual income tax. Importantly, due to these dynamic benefits, total tax revenues received by

Oklahoma would grow over the 2013 through 2022 period—they would just not grow as quickly as they would under the baseline scenario.

Take the state sales tax as an example. Based on the total sales tax revenues collected, and Oklahoma’s sales tax rate, the dollar value of Oklahoma’s effective sales tax base can be calculated. These calculations are illustrated in the first three rows of Table 5. Rows 4 and 5 illustrate the sales tax base as a percentage of personal income (PI). On average, Oklahoma’s sales tax base has been approximately 32 percent of personal income. Because the total sales tax base and sales tax revenues grow proportionately with personal income, the acceleration in personal income growth would accelerate sales tax revenue growth under the proposed tax reform compared to the baseline scenario.

This same connection between economic growth and state tax revenues exists for Oklahoma’s other tax bases (e.g., corporate income taxes and excise taxes). When economic growth accelerates, government revenues accelerate due to the now-higher tax base that offsets some of the static revenue losses from the phasing out of the individual income tax. These dynamic impacts are the “economic effects” discussed above when describing the theory behind the Laffer Curve. The economic effects always work in the opposite direction of the “arithmetic effects,” or the static revenue losses created by the phasing out of Oklahoma’s individual income tax. The economic effects from the phasing out of Oklahoma’s income tax are positive and significant as illustrated by the

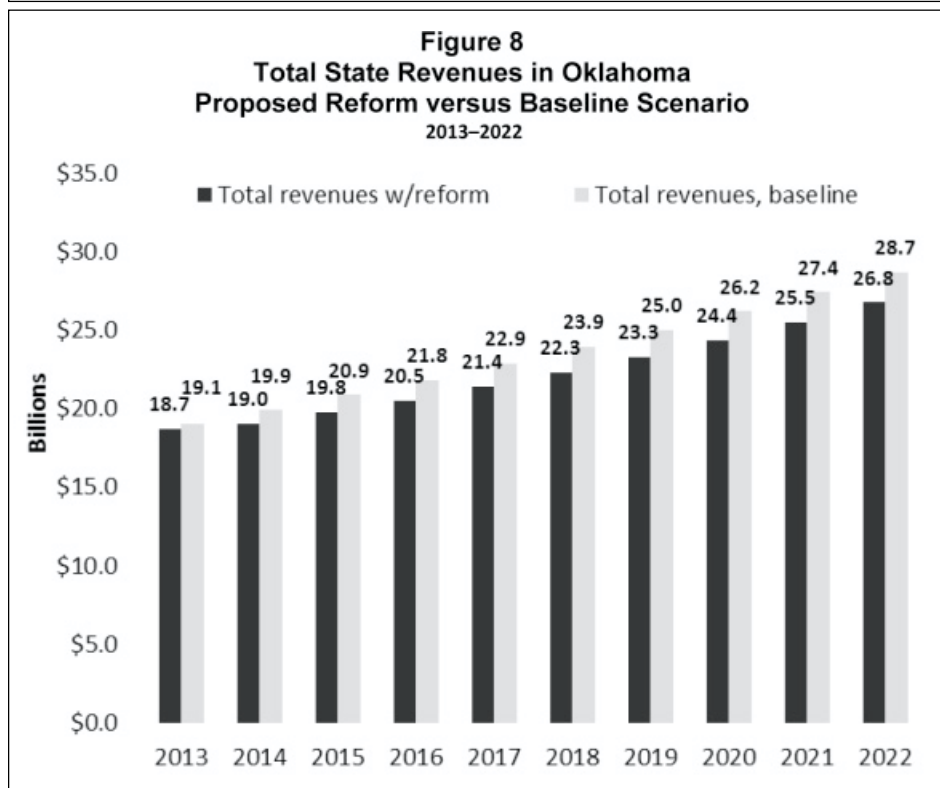
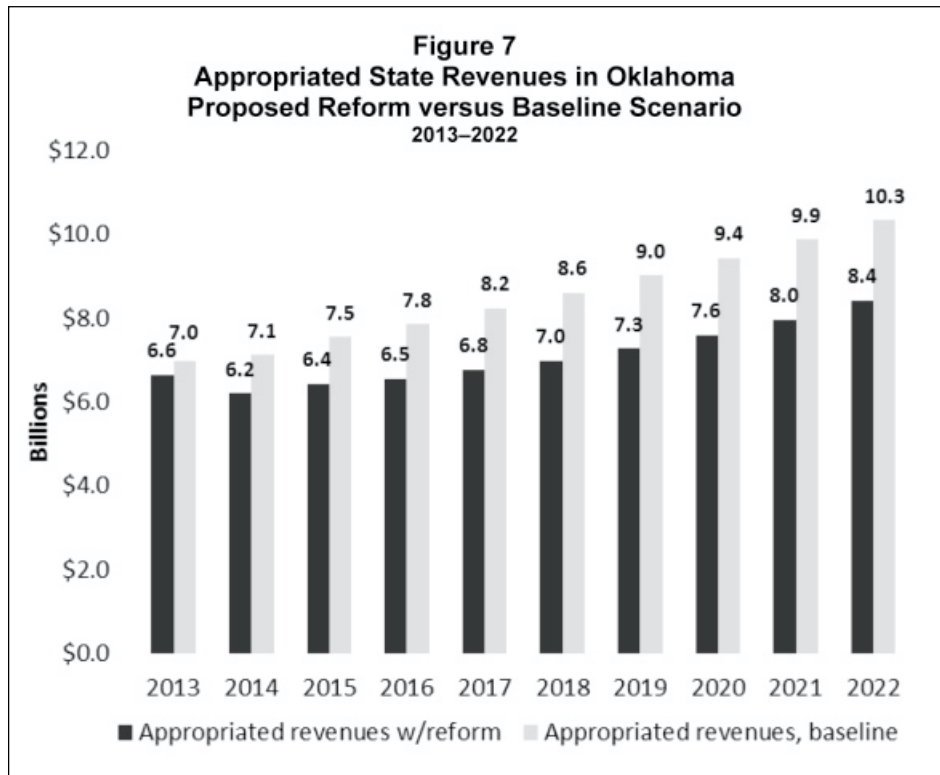
econometric results in the appendix. The Oklahoma state government's revenue losses would, consequently, be much smaller than the static revenue

losses would indicate.

Because the tax reform would not apply to all of FY 2013 (becoming effective in January 2013, or halfway

through the fiscal year), the static tax revenue losses would be lower in FY 2013. Applying the accelerated economic growth rates from the proposed tax reform to Oklahoma's non-individual income tax bases illustrates that the dynamic economic impacts would grow to be 23.8 percent higher than the estimated static revenue losses by 2022. In total dollar terms, and including the dynamic impacts, the proposed tax reform would lower revenues relative to the baseline by \$365 million in 2013 (effective for only one-half the fiscal year), rising to up to \$2.1 billion by 2022 (see Figure 7). It is important to note that actual total appropriated revenues under the proposed tax reform grow by \$1.8 billion between 2013 and 2022, but more slowly than the growth in revenues under the baseline scenario.

Looking at total tax revenues, a similar pattern holds (see Figure 8). Total revenues still grow—by \$8.1 billion over the 2013 through 2022 time period—just at a slower rate than the growth in total revenues of \$9.6 billion under the baseline scenario. The difference, of course, is that under the proposed tax reform scenario, total revenues would grow

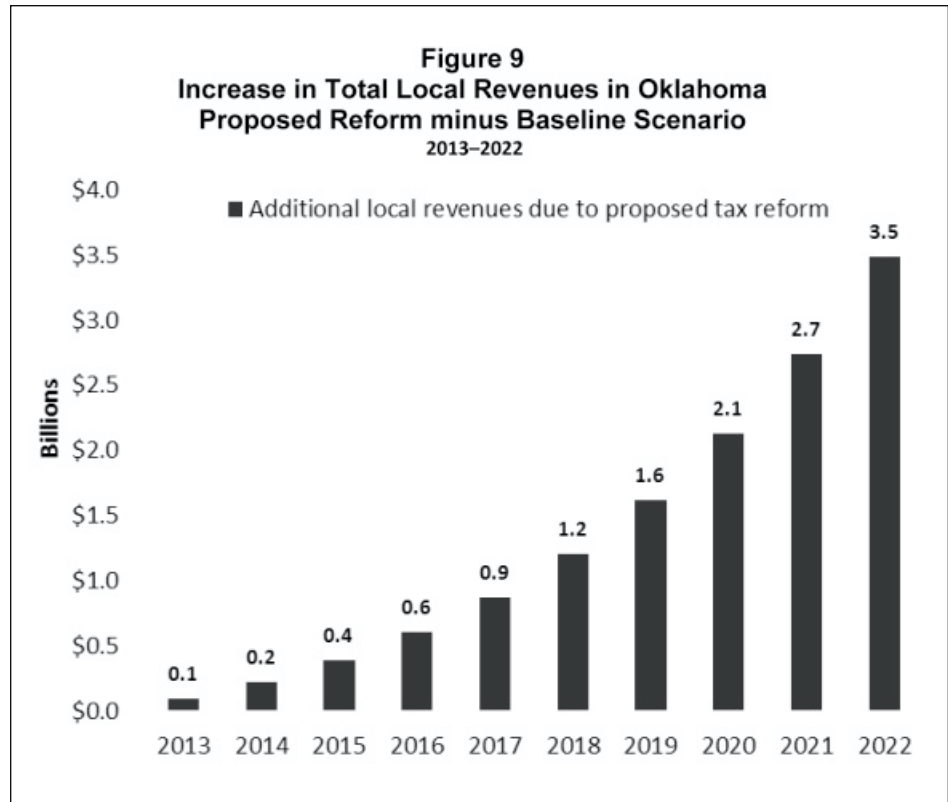


robustly because the economy would be growing more strongly, as opposed to the government appropriating a larger share of a smaller economy.

And the effects measured here still understate the total impact on Oklahoma’s budget because the accelerated economic growth would reduce the need for government expenditures on Medicaid and other income-support programs. Less government spending would be necessary if the proposed tax reform were implemented compared to the baseline scenario. (These impacts are not included in Figure 7 above.)

It is not just the state government that would benefit. Stronger economic growth would also increase revenues for local governments across Oklahoma. And, because there is no static tax reduction, every dollar of increased revenue created by Oklahoma’s stronger economy would increase the expenditure power of the local governments. Based on

the economic growth estimated above and assuming local government revenues’ share of personal income remains constant, in aggregate, revenues for local governments would increase by \$100 million in 2013, rising to an increase of \$3.5 billion by 2022 (see Figure 9).



Conclusion

Oklahoma's economic policies are quite good. There is room for improvement, however. Oklahoma can increase its rate of economic growth, income growth, and job growth by adopting reforms that transform Oklahoma's currently competitive economic policy environment into a top-tier economic policy environment. The proposal to phase out Oklahoma's current individual income tax would achieve this goal.

Under the proposal, the current tax system with a top individual income tax rate of 5.25 percent would be converted to a revenue-neutral 3.0 percent by eliminating all individual-income-tax exemptions, deductions, and credits. The tax rate would then be phased down to 0 percent by 2022.

The gradual elimination of the individual income tax would simultaneously improve two separate parts of Oklahoma's economic environment: (1) it would eliminate the tax on individual income, thereby increasing the incentive to work, produce, and save in Oklahoma; and (2) it would reduce the overall cost of government on the taxpayer, reinforcing the positive

incentives to work, produce, and save in the state. Due to the greater economic incentives directly attributable to the tax reform, the total revenue losses to the state would not be as large as static revenue estimates would indicate.

This study illustrates that, based on both anecdotal and statistical evidence, Oklahoma could expect a significant increase in economic activity following the proposed tax reform. Anecdotally, those states that do not levy an individual income tax and/or levy a lower overall tax and expenditure burden consistently experience greater economic growth than the nation—and Oklahoma. Our statistical analysis confirmed this result.

Based on this evidence, it is clear that Oklahoma's economy would soar if the proposed economic plan were implemented. Oklahoma has the opportunity to establish itself as the premier destination for economic freedom, through a complete phaseout of the state's personal income tax. This would be a historic choice for Oklahoma, one that would create an enduring economic boom benefiting generations to come.

Appendix

Pooled regression analyses are based on the use of panel data, a combination of time series and cross-sectional data. There are a couple of reasons why we chose to use pooled regression techniques. The first reason is that with the use of panel data, one can better get a feel for the effects that typically cannot be observed using time series or cross-sectional data alone. Additionally, pooled regressions using panel data allow us to understand complicated behavioral models, such as the behavior of an economy in response to both the size of the tax burden as well as the top marginal individual income tax rate.

The panel data set included a cross-section across all 50 states from the years 2001 to 2008. The endogenous variable under this framework was the year-

over-year percent change in real personal income (PI). The exogenous, or independent, variables in the model were the percent change in state population (POP), the combined top federal and state income tax rates (PIT), and the total state and local expenditure burden relative to personal income (EXP).

The basic structure of the model is:

$$PI = \beta_1 + \beta_2 POP + \beta_3 PIT + \beta_4 EXP$$

Where,

$$\beta_{1i} = \beta_1 + v_i \quad i = 1, 2, \dots, 50$$

Given that the unobserved heterogeneity seemed to be uncorrelated with the regressors in the model, we ran the model using estimated generalized least squares controlling for random effects.⁴ The results can be seen in Table A1.

Table A1
Pooled Regression Output

Dependent Variable: CHG_PI?				
Method: Pooled Least Squares				
Date: 11/02/11 Time: 14:54				
Sample (adjusted): 2001 2008				
Included observations: 8 after adjustments				
Cross-sections included: 50				
Total pool (balanced) observations: 400				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
β1	0.26810	0.03263	8.21713	-
POP	0.84789	0.18401	4.60795	-
PIT	(0.31871)	0.05329	(5.98034)	-
EXP	(0.51153)	0.08583	(5.95951)	-
Fixed Effects (Cross)				
OKLAHOMA—C0.003866				
	R-squared	0.405124	Mean dependent var	0.023855
	Adjusted R-squared	0.315979	S.D. dependent var	0.020207
	S.E. of regression	0.016712	Akaike info criterion	-5.2225
	Sum squared resid	0.096916	Schwarz criterion	-4.69363
	Log likelihood	1097.501	Hannan-Quinn criter.	-5.01306
	F-statistic	4.544522	Durbin-Watson stat	2.061236
	Prob(F-statistic)	0		

Endnotes

¹ Governor Brad Henry, *Oklahoma 2010: Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2010* (Office of State Finance, December 30); <http://www.ok.gov/OSF/documents/cafr10.pdf>.

² Shelly Paulk, "State Budget Outlook: Multi-Year Trend Analysis" (Office of State Finance, January 5, 2011); http://www.ok.gov/OSF/Budget/State_Budget_Outlook.html.

³ John Maynard Keynes, *The Collected Writings of John Maynard Keynes* (London: Macmillan, 1972).

⁴ A Hausman Test was conducted with a Chi-Square statistic being equal to zero. As such, there was a failure to reject the null hypothesis suggesting that a random effects model is appropriate.



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