Pro-Growth Tax Reform for OKLAHOMA

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EXECUTIVE SUMMARY

Overview

Oklahoma policymakers have been focused on tax reform for many years, always keeping an eye on the state's neighbor to the south. Legislators succeeded in reducing rates for both individual and corporate income taxes, but Oklahoma is far from alone in this pursuit. In an increasingly mobile economy, states are rightly becoming more concerned about their tax competitiveness, and many have similarly moved to reduce rates—and to make structural reforms, besides.

Although the recent rate reductions are an important step forward, many elements of Oklahoma's tax code remain an impediment to its competitive standing. Fortunately, Oklahoma finds itself in a good position: the state is in need of pro-growth tax reform at the very same time that it has a revenue buffer to help absorb transition costs from tax policy changes.

In the following pages, we identify a number of deficiencies in Oklahoma's tax code and outline possible solutions for reform. Several of the proposals could be adopted on their own because they have minimal revenue impacts, but others are possible through revenue triggers or tax swaps that shift reliance onto less distortive taxes, or by forgoing a certain amount of revenue growth. Overall, our recommendations would create a more neutral tax code that would encourage long-term growth in the state.

A Menu of Tax Reform Solutions

Corporate Income Tax Reforms

Oklahoma's corporate income tax currently features a flat, 6 percent rate that is set to drop to 4 percent in tax year 2022. While this is a competitive rate, several structural elements work against it, penalizing businesses that sell both into and out of the state. The following recommendations would create a more competitive corporate tax environment that would encourage long-term investment in Oklahoma.

Repeal the throwback rule. Oklahoma's throwback rule punishes businesses that sell out of state, encouraging them to relocate to—or at least locate distribution facilities in—other states. With studies suggesting that, over time, tax avoidance strategies eliminate most or all revenue gains from throwback rules, repealing the throwback rule would be a sound investment in Oklahoma's economy.

Shift to single sales factor apportionment. Many states have shifted from traditional three-factor apportionment. As long as Oklahoma retains its current apportionment formula, it will tax in-state investment more heavily than other states. In order to compete in the changing tax landscape, the state should consider following suit and adopting single sales factor apportionment.

Lock in full expensing of capital investment. Commendably, Oklahoma conforms to the recent federal policy of allowing corporations to fully deduct the cost of their machinery and equipment purchases in the first year. But with the current federal treatment scheduled to expire, Oklahoma would be well-advised to lock in the current system, decoupling from future changes to federal law and instead providing permanent full expensing.

Individual Income Tax Reforms

Oklahoma currently has a six-bracket individual income tax with a top rate of 5 percent, which is set to decline to 4.75 percent in 2022. This rate is competitive, although the state sees stiff competition from neighboring Texas, with its lack of an income tax. While full income tax repeal would be difficult, the state has a number of responsible options for income tax rate reform short of complete elimination.

Consider options for rate reductions that build on previous reforms. Oklahoma lawmakers could select from a menu of options for prioritizing continued income tax relief. In this publication, we explore the implications of several options, including:

- Creating a single-rate income tax with a $10,350 standard deduction, simultaneously eliminating the state's marriage penalty.
- Phasing in income tax rate reductions using revenue triggers.
- Adopting a 3 percent top marginal income tax rate, in an across-the-board cut, paid for with moderate sales tax base broadening.
- Moving to a 2 percent or lower top marginal income tax rate paid for by sales tax base broadening and higher sales tax rates.
- Shifting to a consumed income tax, which would eliminate the tax's current penalty on saving and investment.

Sales Tax Reforms

Oklahoma's state-level sales tax rate of 4.5 percent is relatively modest on its own, but local option sales taxes ramp up the average combined sales tax to 8.95 percent, the sixth highest rate in the country. As the state's reliance on sales taxes is higher than average among states, it is especially important that the sales tax is as stable and neutral as possible. The following recommendations would move the state in this direction and provide revenue that could pay for additional tax reform in other areas.

Moderately broaden the sales tax base. An ideal sales tax is levied on all final consumption, but Oklahoma currently exempts most consumer services from taxation. While expanding the sales tax base to capture all goods and services is not politically feasible, moving toward a broader base would modernize and stabilize the sales tax base while facilitating income tax rate relief. Meaningful but responsible base expansion could provide an estimated $732 million of revenue at current rates to pay down income tax rate reductions or other reforms.

Maintain local revenue neutrality under base broadening. Any sales tax base expansion the state uses to pay down reforms will yield sizable increases in tax collections on the local level. To avoid an extra tax burden for residents, the state should limit local sales tax collections in some way if the base is expanded, whether that takes the form of a levy limit, a rate cap, or a change in local aid formulas.

Change to market-based sourcing of services. Oklahoma currently imposes sales tax on tangible goods in the place they are purchased. It should extend this same treatment to services instead of adding complexity by taxing them where the income-producing activity occurs, an approach which puts in-state producers at a competitive disadvantage.

Property Tax Reforms

While Oklahoma's effective property taxes are comparatively low, the burden falls most heavily on commercial entities, which, in addition to general *ad valorem* taxes, are also subject to franchise taxes and compliance-heavy tangible personal property taxes. Reforming the *ad valorem* tax in several key areas would help Oklahoma become a more competitive business destination.

Adopt a *de minimis* exemption for taxes on tangible personal property. Many small businesses face negligible tax liabilities but are still forced to go through a costly filing and compliance process. Exempting a certain amount of business machinery and equipment from taxation and making this exemption a filing threshold would take these small businesses off the tax rolls with minimal revenue loss.

Repeal the inventory tax. Oklahoma has already agreed to exempt short-term inventory for businesses in the state. It should build on this effort and consider a full repeal of its inventory tax, either with a local phaseout or state revenue transfers. This would make the state more attractive to retailers, distribution centers, and any other inventory-heavy businesses.

Eliminate the franchise tax. Franchise taxes are levied on a business's net worth instead of its ability to pay. As such, franchise taxes cause economic distortion and hit businesses especially hard in times of economic downturn. Oklahoma limits this damage by imposing a low rate and capping payments at $20,000, but the franchise tax still functions as a nuisance tax: businesses must track asset values and remit these taxes at the cost of considerable time and effort. Many states have shifted away from such taxes, and Oklahoma should follow their lead, removing a tax that burdens businesses without providing much revenue for the state.

INTRODUCTION

Oklahoma policymakers have been grappling with tax reform for decades, spurred by a desire to enhance the state's competitiveness, and particularly by the success of the state's neighbor to the south, which has harnessed a competitive tax system and other pro-growth policies to attract people, jobs, and businesses. These reforms have yielded reductions in both individual and corporate income tax rates, which is desirable especially given the trajectory of tax rates in peer states, but there remains important work to do in addressing the structural inefficiencies that keep Oklahoma from realizing the full potential of its low-rate tax environment.

This publication is designed to provide policymakers with a menu of options: some of them bold, comprehensive approaches and others small standalone policy tweaks, but all designed to make Oklahoma a more attractive place to live and work. Each major tax category—individual income taxes, corporate income taxes, sales taxes, and *ad valorem* and other property taxes—is considered in turn, with discrete reform options within each tax category. Additional options, however, cross categories, identifying ways to reform two taxes in tandem to maintain revenue neutrality while shifting toward more economically efficient forms of taxation.

Post-Pandemic Finances

In the 2021 legislative session, Oklahoma lawmakers signaled their desire to make Oklahoma's tax code more friendly to residents and businesses. Through a package of three bills,[1] the state will implement reduced rates on both corporate and individual income taxes.

Beginning in 2022, the corporate income tax rate will stand at 4 percent, down from 6 percent. Among states with a traditional corporate income tax, this ties Oklahoma with Missouri for the second lowest rate in the nation, surpassed only by North Carolina's 2.5 percent. At the same time, the individual income tax comes in for a trim, with rates reduced by 0.25 percentage points across the board. Accordingly, the top rate—previously 5 percent—declines to 4.75 percent, the sixth lowest of states that levy an income tax.

These rate cuts reduce state revenue, but Oklahoma policymakers identified an opportunity to pay for them out of growth. Oklahoma, like many other states, saw revenues increase during the pandemic. Although most of the revenue growth consisted of one-time funds, the state still experienced an increase of $552 million in recurring revenue,[2] with tax revenue growth of 5 percent in the general fund between fiscal years 2019 and 2021, sufficient to pay down permanent rate reductions.[3]

Oklahoma was not the only state with an eye on tax competitiveness in the 2021 legislative session. With burgeoning revenues in the wake of the coronavirus crisis and the prospect of workplace flexibility greatly enhancing the salience of tax competition, 11 states cut individual or corporate income tax—or

1 Oklahoma House Bills 2960, 2962, and 2963 (2021).

2 Oklahoma State Board of Equalization, "Proposed FY 2022 Revenue Certification," Feb. 16, 2021, https://oklahoma.gov/content/dam/ok/en/omes/documents/boe02162021.pdf.

3 Katherine Loughead and Jared Walczak, "States Respond to Strong Fiscal Health with Income Tax Reforms," Tax Foundation, July 15, 2021, https://www.taxfoundation.org/2021-state-income-tax-cuts/.

both—in the 2021 legislative session. There is every reason to believe that more states will follow suit in the coming year.

States concluded FY 2021 with substantially more revenue than most thought possible in the early days of the COVID-19 pandemic. This is true even when looking exclusively at tax or other own-source revenue, and excluding all federal transfers under the CARES Act, the American Rescue Plan Act, or other federal legislation enacted in response to the pandemic. Taxable income grew over the past year, partly due to those time-limited federal infusions, but largely because longer-term economic trends continued almost unabated. States emerging from the public health crisis not only with adequate revenue, but in many cases robust growth, recognized an opportunity for tax relief. Many policymakers across the country saw it not just as an opportunity but as a necessity, a way of demonstrating their state's commitment to tax and overall economic competitiveness in an increasingly mobile world.

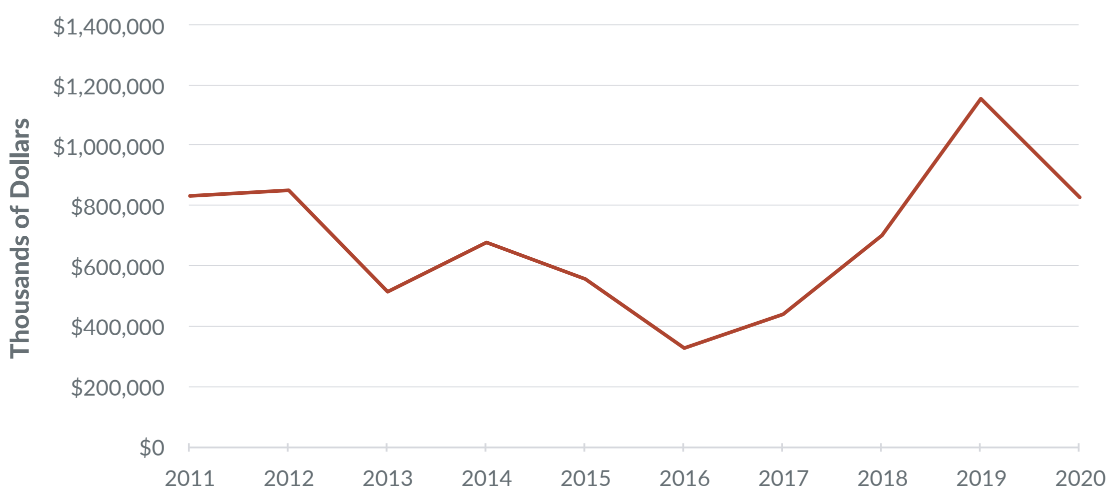
Reliance on Severance Taxes

Oklahoma's reliance on the severance tax, which is imposed on the extraction of oil and other minerals, should provide additional motivation for tax reform. Severance taxes comprised just under 11 percent of state tax collections in fiscal year 2019, and a little over 8 percent in fiscal year 2020.[4] This is well above national averages, but consistent with Oklahoma's standing as the fourth-largest energy producer in the United States in calendar year 2019, accounting for 5.2 percent of all U.S.-produced energy.[5] While this is far from the state's main source of revenue, fluctuations in the oil and gas industry can affect the state's financial footing.

FIGURE 1.

Severance Tax Revenues are Highly Volatile

Oklahoma Severance Tax Collections, 2011-2020



Source: US Census Bureau, Annual Survey of State Tax Collections.

4 United States Census Bureau, "Annual Survey of State Government Tax Collections," 2020, https://www.census.gov/programs-surveys/stc.html.

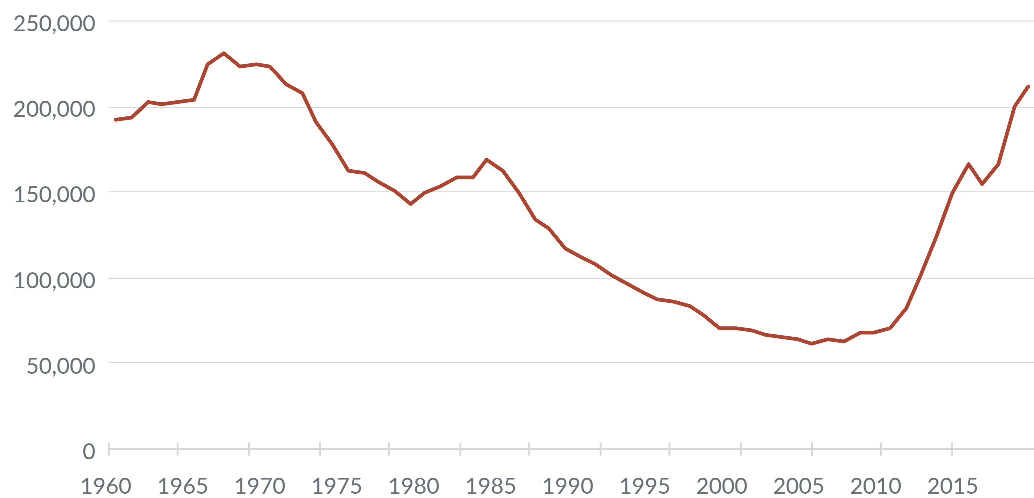
5 U.S. Energy Information Administration, "State Total Energy Rankings, 2019," https://www.eia.gov/state/.

As helpful as this revenue can be, severance tax collections are extremely volatile, and a significant reliance on them as a funding source can create difficulties for revenue estimation and budgeting. From 2011 to 2020, the state saw severance revenues range from $331 million to $1.2 billion (in nominal dollars).

FIGURE 2.

Oklahoma's Oil Production Dropped Steeply for Decades

Oklahoma Historical Crude Oil Production, 1960-2019



Note: Units in thousands of barrels
Source: U.S. Energy Information Administration.

Since the 1960s, crude oil production in the state has also seen large fluctuations. Production reached a high in 1966 but dropped steeply in the 1990s and early 2000s. Since 2010, production has once again picked up, but Oklahoma cannot count on this trend to continue forever, especially with the rise of alternative energy sources. Oil, gas, and other natural resources will continue to play an important role in Oklahoma for the foreseeable future, but policymakers need to focus on diversification to prepare for a decline in the resource sector's fortunes.

Oklahoma is seeking to gain ground in new energy sectors, or in new industries entirely. However, the state tax code includes many elements that may hold back the state in this endeavor. The state's throwback rule disadvantages businesses that sell out of state, and the tax on inventory disadvantages businesses that sell within the state. The anticipated elimination of full expensing will target manufacturers and other capital-intensive industries—precisely the businesses that Oklahoma will be looking to attract. And many individuals and businesses will continue to look to neighboring Texas, which forgoes an individual income tax, as an attractive alternative.

Consequently, lawmakers still have an opportunity to make significant improvements to Oklahoma's tax code. They should seize the opportunity to implement tax reforms that improve the state's competitiveness and enhance its appeals to employers and employees alike. Oklahoma needs a growth agenda, and it cannot come too soon.

CORPORATE INCOME TAXES

Beginning in 2022, Oklahoma's corporate income tax will be levied at a rate of 4 percent, the result of rate reductions adopted during the last legislative session. A 4 percent rate ties Oklahoma with Missouri for the second-lowest rate in the nation, surpassed only by North Carolina's 2.5 percent among states with a corporate income tax. The ideal rate of taxation on capital is zero, and corporate income taxes are a form of double taxation since income is taxed again when distributed or taken in salary. Nevertheless, all but two states have either a corporate income tax, a gross receipts tax, or both. Corporate income taxes are preferable to gross receipts taxes, and Oklahoma's rate is highly competitive.

Despite a low rate, however, Oklahoma's corporate income tax advantage is hindered by several structural impediments. A throwback rule dramatically increases corporate income tax costs for some in-state businesses, and the state's three-factor apportionment formula is increasingly out of line with a national trend toward single sales factor apportionment, which eliminates the tax's bias against in-state investment. Meanwhile, the imminent expiration of the federal policy of full expensing of capital investment, to which Oklahoma conforms, presents Oklahoma with a choice of whether to retain this highly pro-growth policy even if the federal government does not. Addressing these issues within the corporate tax code would enhance the state's attractiveness for C corporations at a time when mobility is at record highs.

The Throwback Rule

Ask most people what a throwback rule is, and they may explain the local requirement to throw back a visiting team's home run from the hometown bleachers. Ask a member of the business community and she is likely to tell you about how the tax has affected her business. While opaque to the average citizen, the business community clearly understands the impact of the throwback rule due to its dramatic effect on a firm's taxable income. It has also been shown to affect business location decision-making. Not unlike other complex tax policies, throwback rules are often enacted with one intent but end up causing unintended consequences.

However, before we can address the uncompetitive nature of throwback rules, it is first necessary to explain why they exist, how they work, and where they fit into a corporate income tax.[6]

Apportionment In Oklahoma

When C corporations conduct business in multiple states, it is necessary for states to apportion that income for tax purposes. That means they must determine what share of their income is taxable in each involved state.[7] Currently, states can use three factors in their apportionment formulas: the share of total property, payroll, and sales that a firm has located in each state. Historically, most states weighted

6 This section adapted from Jared Walczak, "Throwback and Throwout Rules: A Primer," Tax Foundation, July 2, 2019, https://www.taxfoundation.org/throwback-rules-throwout-rules-2019/.

7 Only business income is apportioned. Nonbusiness income, e.g., income arising from investments or property ownership, is typically allocated in its entirety to a specific state where the company is domiciled or the property is located. See Charles McLure Jr., "Understanding Uniformity and Diversity in State Corporate Income Taxes," *National Tax Journal* 61:1 (March 2008), 147.

these factors evenly. However, there is a pronounced trend toward giving greater—or even exclusive—weight to the sales factor. Doing so generally benefits in-state companies while exporting some of the tax burden to companies with sales, but less of a physical presence, in that state.[8]

The apportionment technique can make a huge difference in businesses' tax burdens. Iowa, for example, has a high corporate income tax top rate of 9.8 percent, but manufacturers often face light corporate income tax burdens due to the state's single sales factor apportionment.[9] On the other hand, Montana has a lower top rate of 6.75 percent, but it employs an evenly weighted three-factor apportionment formula. This creates an above-average corporate income tax burden on many manufacturers.[10]

Oklahoma has opted for the more traditional choice of evenly weighted three-factor apportionment. Notably, it also allows firms with capital investment of more than $200 million the choice of using double-weighted sales factor apportionment.

Courts have granted states substantial leeway in adopting competing approaches to apportionment, provided that the chosen approach meets two main criteria. First, the apportionment decision must have some rational relationship to the company's activity in the state—a very permissive standard. Second, the apportionment must be internally consistent. In other words, if every state chose the same given apportionment formula, no more than 100 percent of a corporation's income would be taxed. This criterion stands even if in practice the interaction of competing standards yields double taxation.[11]

The problem of taxing more than 100 percent of income has vexed taxpayers and practitioners, but states have often perceived a different problem: the possibility of taxing less than 100 percent of a corporation's business income.

For states to levy taxes on a company, there must be a sufficient connection—termed "nexus"—between the state and the company's economic activities. The chief limitation on state nexus is Public Law 86-272. This federal law prohibits states from taxing income arising from the sale of tangible property into the state by a company whose only activity in that state is the (remote) solicitation of sales. In other words, if a company maintains a warehouse in the state or even just a kiosk; if it has a sales office, or even just a traveling salesman; if it so much as delivers one of its products into the state with its own employees or in its own vehicle— if any of these factors are present, the company has nexus with the state and is taxable according to the state's apportionment formula. If, however, any marketing is produced in another state, the sales office records the transactions in another state, and products are shipped to customers via a common carrier, it does not matter whether the sales into that state are 1 percent or 100 percent of the company's revenues. By law, that sales income is not taxable in the destination state, because the contacts with the state are insufficient under federal law to establish nexus.[12]

8 For a brief synopsis of developments in formulary apportionment, see generally, Joann M. Weiner, "Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level," U.S. Department of the Treasury, OTA Paper 83, April 1999, https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-83.pdf.

9 Jared Walczak, Katherine Loughead, Ulrik Boesen, and Janelle Cammenga, *Location Matters 2021: The State Tax Costs of Doing Business*, May 5, 2021, 43, https://www.taxfoundation.org/publications/location-matters/.

10 Id., 52.

11 This summation omits significant nuance and is intended as an abbreviated summary to facilitate the understanding of throwback rules. For a more comprehensive overview of apportionment, see Charles McLure Jr., "Understanding Uniformity and Diversity in State Corporate Income Taxes," and Bradley W. Joondeph, "The Meaning of Fair Apportionment and the Prohibition on Extraterritorial State Taxation," *Fordham Law Review* 71:1 (2002).

12 15 U.S. Code § 381-383.

Companies stand to benefit if they can avoid any economic activity other than the remote solicitation of sales into a state. This decision is made at the margin as many other factors influence the decision of where to locate facilities and employees. In fact, many larger businesses are resigned to the fact that they will have nexus almost everywhere. Indeed, many business models are structurally unsuited to avoiding the establishment of nexus in states where they have sales. Still, some companies have flexibility in where they produce and where they sell. These can benefit from locating their production in a single sales factor or low corporate income tax state all the while selling into states which lack the jurisdiction to tax them. This is where throwback rules come into play.

What Is a Throwback Rule?

The average citizen's intuition in defining a throwback rule was not far off. In states where firms have no nexus for taxation, either because of apportionment rules or lack of jurisdiction, a firm's sales to that state result in "nowhere income." Throwback rules are designed to reclaim "nowhere income," from a state that has no legal authority to tax it and give that income back to a state with jurisdiction over the taxpayer. Under a throwback rule, sales of tangible personal property are figuratively "thrown back" across state lines and incorporated into the numerator of the origin state's sales factor—even though the state would not otherwise be able to claim that income.

How Throwback Rules Work

Although some states have adopted their own language, the standard throwback rule establishes uniform language promulgated as part of the Multistate Tax Compact,[13] which imposes two requirements. First, the taxing state must be the location from which the tangible property was shipped. Second, the income cannot be taxable in the state of the purchaser, either because the purchaser was the federal government or because the destination state lacks jurisdiction to levy a tax.

Importantly, throwback rules do not apply in cases where a state voluntarily chose not to tax corporate income. Throwback rules ask whether the corporation *is* taxable in the destination state, not whether it *was* taxed. (Sometimes, policymakers in states without a corporate income tax, or which provide incentives which zero out some corporations' tax liability, express concern that the revenue they forgo is being swept up by another state's throwback rules. They need not worry.)

A company's income from one state cannot be thrown back to another if the firm can demonstrate that the good was subject to a net income, franchise, or capital stock tax in the destination state, or if that state possessed jurisdiction to levy a tax on the company but opted not to impose corporate taxes.

The list of applicable taxes in destination states is not exhaustive, and that is by design. A company immunized against destination state taxation under P.L. 86-272 cannot avoid throwback by exposing itself to some minimal business fee or tax in the destination state or making a voluntary payment; the tax must be a corporate income tax or a state's alternative to one.[14]

13 Uniform Division of Income for Tax Purposes Act (UDITPA).

14 Bruce Fort, "Report on Application of the 'Taxable in Another State' Provisions in Multistate Tax Compact Article IV.3 and Model Allocation and Apportionment Regulations IV.3.(a), (b) and (c). 3," Multistate Tax Commission, July 14, 2011.

TABLE 1.

States with Throwback and Throwout Rules for Sales of Tangible Personal Property

As of July 1, 2021

State	Throwback	Throwout
Alaska	✓	
Arkansas	✓	
California	✓	
Colorado	✓	
Hawaii	✓	
Idaho	✓	
Illinois	✓	
Kansas	✓	
Kentucky	(a)	
Louisiana		✓
Maine (b)		✓
Massachusetts	✓	
Mississippi	✓	
Montana	✓	
New Hampshire	✓	
New Mexico	✓ (c)	
North Dakota	✓	
Oklahoma	✓	
Oregon	✓	
Rhode Island	✓	
Utah	✓	
Vermont	✓	
West Virginia		✓
Wisconsin	✓	
District of Columbia	✓	
Totals	21	3

(a) Kentucky has a throwback rules that only applies to sales to the federal government and is not typically counted as a throwback state.
(b) Maine replaced its throwback rule with a throwout rule in 2010 but continues to use throwback for sales to the federal government.
(c) New Mexico's throwback rule only applies to businesses opting to be taxed under single sales factor apportionment.
Source: State statutes and administrative codes.

Competitive and Economic Effects of Throwback Rules

While throwback rules were created to avoid the perceived under-taxation of corporate income, they can lead to double taxation and frequently impose tax burdens high enough to make the state unattractive for businesses.

In terms of attracting corporations to the Sooner State, Oklahoma is at a slight comparative disadvantage in that it does not rely on sales alone for its apportionment formula. Single sales factor apportionment has the effect of exporting part of the corporate income tax burden to out-of-state firms. The introduction of a throwback rule further erodes the competitive advantage otherwise held by in-state firms.

Whatever revenue Oklahoma generates from the throwback rule will most likely be offset by lost revenue as a result of firms' relocations—the natural response to uncompetitive tax rates and apportionment rules. The throwback rule increases a firm's in-state income by the sum of the firm's "nowhere income." Therefore, the sales factor ratio necessarily increases. Paradoxically, the more a throwback rule increases a firm's sales factor, the larger a company's effective tax rate, and the less relevant the state's corporate income tax rate becomes.[15] Effective rates on the income actually generated in-state can become so high as to make certain types of business activity unviable in states with such rules, and over time, businesses have adjusted to this reality. The economic literature suggests that this self-sorting is so prevalent that, even though the throwback rule raises revenue from businesses which have not acted to avoid it, the rule may lose revenue in the long run due to activity driven out of state which would otherwise be subject to the full range of state taxes.

In terms of simplicity, Oklahoma's corporate tax code does offer a silver lining. Unlike many states, Oklahoma requires separate reporting for unitary groups. This means that each company in a related group of corporations (parent companies, subsidiaries, and affiliates) files a separate tax return. Alternatively, many states opt for combined reporting where all related corporations file as a unitary group. Thanks to the separate reporting policy, Oklahoma avoids the added complexity that occurs when the challenges of throwback rules are exacerbated by combined reporting.

The Inequity of Throwback Rules

Four arguments speak to the inequity of throwback rules. First, the logic of the throwback rule suggests that an origination state has the right to tax income properly associated with another state simply because the other state is unable to tax the income itself. Proponents hold up throwback rules as a means of righting the perceived wrong of anything less than 100 percent taxability of business income. Opponents, for their part, tend to see the rule as "levying the wrong tax at the wrong rate in the wrong state."[16] That a business has untaxed activity in one state is not, of itself, a clear reason why an outside jurisdiction should tax that activity.[17]

Second, the degree to which many businesses can avoid the consequences of throwback rules undermines the equity argument. The rules ultimately become a tax on a relatively small number of businesses that lack avoidance opportunities. Moreover, states' equity concerns tend to be one-sided and preoccupied only with under-collection, not over-collection. For instance, there has been notably less handwringing from states since the courts have permitted a pastiche of mismatched apportionment formulas and rules which can lead to double taxation. In the words of one scholar, "Why should 'nowhere income' be any more unpalatable than the over-taxation or 'imaginary income' that results for some taxpayers?"[18]

15 For a detailed example of this phenomenon, see Jared Walczak, "Throwback and Throwout Rules: A Primer."

16 David Sawyer, "Re: COST's Opposition to House Bill 1051, 'Throwback' of Sales for Corporate Income Tax," Council on State Taxation Testimony to the Maryland House Ways and Means Committee, Feb. 28, 2018.

17 Brian Strahle, "The Bridge to 'Nowhere Income,'" *State Tax Notes*, Feb. 17, 2014.

18 Margaret C. Wilson, "Apportionment Apoplexy: Throwback, Throwout, or Just Throw Up Your Hands," *Tax Executive* 57:4 (July 1, 2005), 364.

Third, the result of throwback rules is not neutral taxation, since any income “thrown back” is taxed at the origination state’s rate, not the rate of the destination state which is unable to tax it. Companies with little ability or inclination to design their corporate structure around the tax code will face uncommonly high tax burdens, while other businesses may locate their sales activities in non-throwback states.[19]

Finally, throwback rules undermine the theoretical justification for making sales a factor in formulary apportionment in the first place. State authority to tax is premised on some connection between the activities of the taxpayer and either the costs they impose on the state or the benefits they receive from the state (though this requirement is construed broadly). There can be little doubt that companies benefit from the governance of states in which they have payroll or property. The justification for apportioning partly or entirely based on sales, however, has historically been that companies benefit from access to a marketplace for which the state is in some ways responsible. For a throwback state to tax income from outbound sales is in some respects a repudiation of that theory. It operates as if the other state conferred no benefits whatsoever and thereby left the tax revenue for the originating state to claim.[20]

Repealing the Throwback Rule

As a rule, tax cuts do not pay for themselves. Throwback rules, however, may very well be the exception. Since Oklahoma is on solid financial footing following the coronavirus pandemic, the state is well-positioned to cover any short-term transition costs associated with the repeal of its throwback rule. In the longer term, repeal will increase Oklahoma’s ability to attract and retain businesses, thereby expanding, stabilizing, and promoting greater equity within its corporate tax base.

Formulary Apportionment

As noted, Oklahoma is one of a dwindling number of states to use evenly weighted three-factor apportionment for most companies, with some permitted to elect double-weighted sales factor apportionment, where sales account for 50 percent of apportionment and payroll and property are responsible for 25 percent apiece. There are good historical reasons for including payroll and property in the apportionment formula, or even making them the only factors, to the exclusion of sales. These arguments work best, however, if such a formula is adopted uniformly across the states. At a time when many other states have shifted to single sales factor apportionment, Oklahoma’s choice undermines its competitiveness with its peers. Only seven states still use evenly weighted three factor apportionment as its primary apportionment factor.

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19 William F. Fox, Matthew N. Murray, and LeAnn Luna, “How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?” *National Tax Journal* 58:1 (March 2005), 150-151.

20 Walter Hellerstein, “Construing the Uniform Division of Income for Tax Purposes Act: Reflections on the Illinois Supreme Court’s Reading of the ‘Throwback’ Rule,” *U. Chi. L. Rev.* 45:4 (Summer 1978), 779.

TABLE 2.

State Apportionment Formulas

State	Single Sales	Sales-Weighted	Three Factor
Alabama		✓	
Alaska			✓
Arizona*	✓		
Arkansas	✓		
California	✓		
Colorado	✓		
Connecticut	✓		
Florida		✓	
Georgia	✓		
Hawaii			✓
Idaho		✓	
Illinois	✓		
Indiana	✓		
Iowa	✓		
Kansas			✓
Kentucky	✓		
Louisiana	✓		
Maine	✓		
Maryland	✓		
Massachusetts*	✓		
Michigan	✓		
Minnesota	✓		
Mississippi*	✓		
Missouri	✓		
Montana			✓
Nebraska	✓		
New Hampshire		✓	
New Jersey	✓		
New Mexico*			✓
New York	✓		
North Carolina	✓		
North Dakota*			✓
Oklahoma			✓
Oregon	✓		
Pennsylvania	✓		
Rhode Island	✓		
South Carolina	✓		
Tennessee		✓	
Texas	✓		
Utah	✓		
Vermont		✓	
Virginia*		✓	
West Virginia		✓	
Wisconsin	✓		
District of Columbia	✓		
Totals	30	8	7

*State has a choice of apportionment formula or different formulae for different industries. Primary apportionment formula shown.
Source: Federation of Tax Administrators.

The best argument for including payroll and property in the apportionment formula is that these factors capture the actual business activities which impose costs on government and are a proxy for the services those businesses receive. While the sales factor is justified on the grounds that companies exploit a state's market and rely on government to ensure conditions conducive to commerce, this connection is much more nebulous than the idea that companies derive benefit from government services where, say, their offices and factories are located.

By taxing based on these factors, however, Oklahoma bases corporate income tax liability, in substantial degree, on a company's footprint in the state. Single sales factor apportionment, by contrast, is based exclusively on sales activity into the state, without regard to the location of the company's productive activity. This succeeds in exporting a significant portion of the tax burden to out-of-state companies, which many state policymakers like, but it also avoids "punishing" businesses for choosing to locate their facilities in-state.

One complicating factor for Oklahoma is its extractive industries. Oklahoma raises considerably less than it could from out-of-state businesses, but more than it would otherwise from its in-state businesses—including oil, gas, and mining operations which cannot easily leave the state. Policymakers would have to evaluate the trade-offs associated with shifting to single sales factor apportionment, but if it could be done without sacrificing revenue (as has been the case in many states), it would help reduce the corporate income tax's discouraging effect on in-state operations.

Full Expensing

Full expensing, or the immediate write-off of all business investment, is a key driver of future economic growth, and can have a larger pro-growth effect per dollar of revenue forgone than cutting tax rates.[21] The Tax Cuts and Jobs Act (TCJA) made significant progress in improving the cost recovery treatment of business investment by enacting 100 percent bonus depreciation.

Oklahoma and many other states currently conform to full expensing, but when the current federal treatment begins phasing out in 2023, Oklahoma's expensing policies will be curtailed and ultimately sunset as well. Whereas businesses were permitted 50 percent initial cost recovery prior to enactment of the TCJA, the expiration of the current tax provision will ultimately bring "bonus depreciation" to zero, creating a bias against investment in both federal and state tax codes. Oklahoma cannot reverse the federal policy, but it can act to maintain its current favorable treatment even if the federal provision is allowed to expire.

Generally, when businesses calculate their income for tax purposes, they subtract business costs from business revenues. This makes intuitive sense, because the corporate income tax is a tax on business profits. In many cases, however, businesses are not allowed to deduct their full expenses. This occurs, for instance, when firms make new capital investments (e.g., equipment, machinery, buildings). Typically, businesses are required to deduct capital expenses in accordance with preset depreciation schedules. As a result of these mandated accounting rules, businesses end up paying taxes on profits that, in

21 Erica York, "Permanence for 100 Percent Bonus Depreciation Provides More Cost-Effective Growth than Permanence for Individual Provisions," Tax Foundation, Sept. 5, 2018, https://www.taxfoundation.org/100-percent-bonus-depreciation-permanence-offers-more-bang-for-the-buck/.

reality, do not exist. Instead of immediately deducting capital expenses in the year the investment occurred, it could take 20 years before the government acknowledges the full cost of an investment to a firm.

This creates a problem. Due to inflation and the time value of money, a dollar in the future is always worth less than a dollar today. Delaying deductions for the cost of business investments means that the real value of the deductions will always be less than the original cost. Ultimately, this treatment means that the corporate income tax is biased against investment in capital assets.

TABLE 3.

The Present Value of Delayed Deductions Is Smaller Than the Original Cost

	5-year asset	15-year asset	20-year asset
Expensing	$100.00	$100.00	$100.00
MACRS at 0% inflation	$92.97	$78.64	$75.50
MACRS at 2% inflation	$88.75	$69.32	$63.87
MACRS at 3% inflation	$86.77	$66.69	$59.07

Sources: Author's calculations. Assumes half-year convention, 3 percent real discount rate, plus inflation.

States that subject capital to long-term expensing rules legislate a bias in favor of other business expenses (e.g., labor, advertising, and supplies) that can be written off in the first year. Moreover, legislators have imposed a tax disadvantage on new in-state capital investment. This is especially harmful to businesses in equipment-intensive, manufacturing industries. All else being equal, states with stingy expensing provisions are less attractive for in-state investment than those offering full expensing.

It is not fair to the investor that he or she must wait years or decades to claim the cost of machines, equipment, or factories on their tax returns,[22] but it is also not fair to the worker who uses the capital. Less capital formation results in lower productivity, and lower productivity results in lower wages.[23] Full expensing boosts long-run productivity, economic output, and incomes, because investments that were not profitable under long-term depreciation rules become profitable under full expensing. Put differently, workers are impeded from reaching their full earning potential when capital formation is hindered. However, greater capital investment means greater productivity per worker, and the more productive a worker, the higher his or her wage will be.

Long-term conformity to full expensing is a pro-growth tax change that would eliminate Oklahoma's unintended bias against capital investment and establish Oklahoma as a state leader.

While many states have chosen to conform to full expensing, none has made these changes permanent. As the federal provision begins to phase out in 2023, every state that currently conforms to them will automatically follow suit. By conforming to the immediate expensing of short-lived assets over the last several years, Oklahoma has already shown that it understands the benefits of this treatment of capital

22 Scott Greenberg, "What is Depreciation, and Why Was it Mentioned in Sunday Night's Debate?" Tax Foundation, Oct. 10, 2016, https://www.taxfoundation.org/what-depreciation-and-why-was-it-mentioned-sunday-night-s-debate/.

23 Erica York, "Cost Recovery Treatment Short of Full Expensing Creates A Drag on Economic Growth," Sept. 17, 2018, https://www.taxfoundation.org/cost-recovery-treatment-short-full-expensing-creates-drag-economic-growth/.

investment. To provide an even more attractive and stable environment for in-state investors and would-be investors, Oklahoma should take the initiative to make full expensing permanent rather than waiting for Congress to act, and thus avoid an unlegislated tax increase that would undercut business investment in the state.

If Oklahoma made full expensing permanent, it would become a leader for all states in creating a stable business tax environment. Ensuring that full expensing remains in effect even after the federal phaseout is one of the most valuable changes Oklahoma could make to improve its tax competitiveness and establish itself as a destination for new business investment. Importantly, moreover, it represents a continuation of the status quo—avoiding an economically harmful tax increase, not adopting a new tax cut.

INDIVIDUAL INCOME TAX

Oklahoma's individual income tax is a six-bracket graduated-rate tax which will feature a top rate of 4.75 percent beginning in 2022, the result of rate reductions adopted in the last legislative session. This is a competitive rate, though Oklahoma faces stiff competition from neighboring Texas, which does not levy an individual income tax. The current system also imposes a marriage penalty, where married couples filing jointly face a modestly higher tax burden than if each filed separately. Cognizant of the competitive edge associated with lower—or no—individual income taxes, reforming or even eliminating the income tax has been a significant theme in Oklahoma public policy circles.

The Economic Implications of Income Taxes

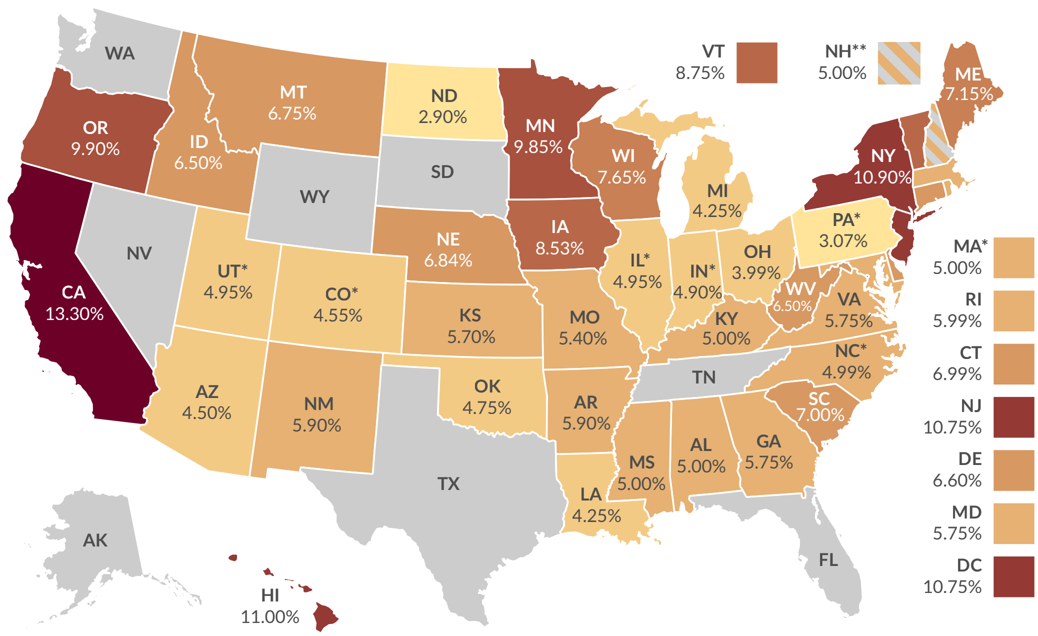
Migration and National Trends

Nine states forgo broad-based individual income taxes, including neighboring Texas, which has seen its economy grow 75 percent faster than Oklahoma's over the past two decades. In real (inflation-adjusted) terms, Texas's gross state product soared almost 56 percent between 2001 and 2020, while Oklahoma's economy increased a much more modest 32 percent, slightly below the national average of 35 percent growth for the period. Gross state product is 28 percent higher per capita in Texas than in Oklahoma, and personal incomes are 11 percent higher.

Texas is not an outlier in this regard. Over the past decade, states which forgo income taxes have seen their populations grow at twice the national rate, and gross state product grew 56 percent faster in states without an income tax than it did in those with one over that period. In 2018 (the most recent year for which data are available), the 41 income tax states lost a net of 285,000 residents to the nine states without an income tax. Oklahoma's population has grown a modest 5.1 percent over the past two decades, less than one-third the national growth rate of 16.3 percent, while Texas's population has burgeoned by 37.7 percent, well over twice the national rate. While income tax policy is hardly the only driver of economic activity in these states, it is little wonder that the Texas model—and that of other no- or low-income tax states—is highly attractive.

FIGURE 3.

Top Marginal State Individual Income Tax Rates (as of January 1, 2022)



Note: Map shows top marginal rates: the maximum statutory rate in each state. This map does not show effective marginal tax rates, which would include the effects of phase-outs of various tax preferences. Local income taxes are not included. Missouri's top marginal rate will be reduced to 5.3% if certain revenue triggers are met.
(*) State has a flat income tax.
(**) State only taxes interest and dividends income.
Sources: Tax Foundation; state tax statutes, forms, and instructions; Bloomberg Tax.

Top State Marginal Individual Income Tax Rates
Lower Higher

Moreover, the ongoing migration from high- to low-tax states, and particularly states with low income taxes, is likely to accelerate with the growing viability of telework post-pandemic. Increasingly, many people will be able to live wherever they wish. Those who are highly sensitive to taxes will find it easier than ever to relocate to jurisdictions with lower tax burdens, regardless of where their employer may be located. Those who want to remain close to family will increasingly be able to do so with less sacrifice to job prospects. And employers themselves will have more location flexibility as geography becomes less of a constraint on their workforces.

Ten states cut individual income tax rates in 2021, the most in two decades. In the early days of the coronavirus pandemic, the notion that 2021 would be a year of long-term tax relief would have been almost unthinkable, but states closed out FY 2021 with substantially more revenue than they anticipated and recognized an opportunity for tax relief. Many policymakers, moreover, saw it not just as an opportunity but as a necessity, a way of demonstrating their state's commitment to tax and overall economic competitiveness in an increasingly mobile world.

Oklahoma was among the states cutting individual income tax rates, but also the state which did so on the smallest margins. Idaho's tax revenue exploded between FY 2019 and 2021, shooting up 35 percent, but most states that cut individual income taxes in 2021 did so from a position of robust growth, with seven of the 10 experiencing a double-digit biennial growth rate. Louisiana, which saw only modest revenue growth, is cutting rates, but with offsetting base provisions that make the plan almost revenue neutral. Oklahoma's income tax cut was modest, shaving a quarter of a percentage point off the state's individual income tax rates starting in 2022, but it was also adopted amid economic growth that was slower than that experienced in many peer states.

TABLE 4.

States Cut Individual Income Taxes from Revenue Growth

General Fund Tax Revenue Growth Between FY 2019 and FY 2021

State	Growth
Idaho	35%
Arizona	21%
Montana	19%
Missouri	17%
Iowa	13%
Ohio	13%
New Hampshire	11%
Wisconsin	9%
Louisiana	6%
Oklahoma	5%

Sources: state revenue agencies; Tax Foundation research.

Taxes are far from the only factor that influences location decision-making, but with job availability likely to become less salient as remote work arrangements increase in popularity, they are an important factor, and just as importantly, they are a factor that policymakers can control.

Comparison with Consumption Taxes

All taxes are not created equal. Any tax creates a certain amount of economic drag; this is unavoidable. There is truth to the adage that "whatever you tax, you get less of"—so it makes sense for policymakers to think carefully about what they choose to tax, and how. Individual income taxes fall on labor; on the margin, they lower the payoff to work, decreasing the supply of labor while increasing its cost.

An income tax can be conceptualized as a tax on consumption plus the change in savings, while a well-structured sales tax is a tax on income less the change in savings (that is, on both the income spent now and on income saved to be spent in the future). An income tax reduces capacity for future consumption; economically, it acts like a sales tax that increases the cost of future consumption, with each additional hour of labor producing fewer goods in the future. Functionally, what this means is that income taxes penalize savings, while consumption taxes do not. Consumption taxes are much more economically neutral by comparison, and the economic literature consistently finds that sales taxes are less of an impediment to economic growth or location decisions than are income taxes.[24]

24 See Joseph Bankman and David A. Weisbach, "The Superiority of an Ideal Consumption Tax over an Ideal Income Tax," *Stanford Law Review* 58:5 (April 2010); and Jens Matthias Arnold et al., "Tax Policy for Economic Recovery and Growth," *The Economic Journal* 121:550 (February 2011).

Consumption taxes do fall on suppliers of labor and capital, like income taxes, but they do so neutrally and—at least when well-designed—avoid double-taxing these factors. (Oklahoma, like all states, taxes some intermediate transactions in its sales tax, creating tax pyramiding and diverging from the model of a pure consumption tax.) Oklahoma's sales tax is, appropriately, destination-sourced, meaning that the tax is imposed where a good or service is consumed, not where it is produced. Thus, unlike income taxes, the sales tax does not discourage investment or job creation.[25] This is, however, only true insofar as the tax falls on final consumption; when the tax falls on business inputs, it increases the cost of investing in-state.

Evidence of the adverse impact of individual income taxes has been documented at the local, state, federal, and even international level. In a series of Organisation for Economic Co-operation and Development (OECD) working papers, OECD-affiliated economists concluded that corporate income taxes are the most harmful to growth, followed by individual income taxes, while consumption and property taxes are less economically damaging. They found that a 1 percent shift of tax revenues from income taxes to consumption and property taxes would increase gross domestic product per capita by as much as 1 percent in the long run, and that income taxes were more strongly associated with lower incomes than were sales or consumption taxes.[26] A Canadian study, meanwhile, found that increases in sales taxes are generally associated with increases in economic growth, because they often replace income taxes and other taxes on investment.[27]

One interesting local tax study concluded that a 1 percentage point increase in a state individual income tax rate reduces annual population growth rates by 0.81 percentage points, while a similar 1 percentage point increase in local sales tax rates actually increases the annual growth rate by 0.83 percent,[28] evidently because residents favor the services provided by sales taxes more than they dislike the tax, whereas the opposite is true for local income taxes. The study's authors also speculated that residents considered the sales tax to be more exportable, though the degree to which this is true may be greater for a locality than it is for a state.

Because a well-structured sales tax is more economically efficient than income taxes, using revenue from sales tax rate increases to pay down income tax rate reductions is economically competitive, as is generating revenue for the same purpose from sales tax base broadening, provided that the base is broadened to previously untaxed final consumption and not to intermediate transactions.

Sales taxes also offer greater stability than income taxes, as can be seen in aggregate state tax collections during and immediately after the Great Recession. By 2010, general sales taxes were down 8 percent from their 2008 peak, while individual income taxes fell 16 percent and corporate income tax

25 Douglas L. Lindholm and Karl A. Frieden, "After Wayfair: Modernizing State Sales Tax Systems," *State Tax Notes*, May 14, 2018, 667, https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/after-wayfair-modernizing-state-sales-tax-systems.pdf.

26 Åsa Johansson, Christopher Heady, Jens Arnold, Bert Brys, and Laura Vartia, "Tax and Economic Growth," OECD Economics Department Working Papers No. 620, 2008; and Jens Arnold, "Do Tax Structures Affect Aggregate Economic Growth? Empirical Evidence from a Panel of OECD Countries," OECD Economics Department Working Papers No. 643, 2008.

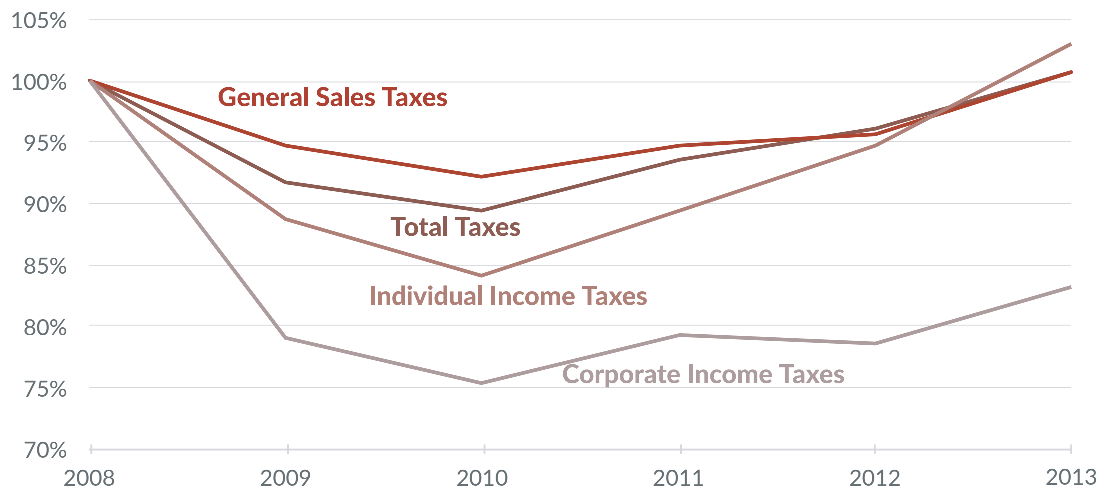
27 Ergete Ferede and Bev Dahlby, "The Impact of Tax Cuts on Economic Growth: Evidence from the Canadian Provinces," *National Tax Journal* 65:3 (September 2012).

28 Stephen T. Mark, Therese J. McGuire, and Leslie E. Papke, "The Influence of Taxes on Employment and Population Growth: Evidence from the Washington, D.C. Metropolitan Area," *National Tax Journal* 53:1 (March 2000), 114-116, https://www.ntanet.org/NTJ/53/1/ntj-v53n01p105-24-influence-taxes-employment-population.pdf.

collections plummeted a full 25 percent.[29] In Oklahoma, the phenomenon was even more pronounced. In 2010, Oklahoma's individual income tax individual income tax collections were down 20 percent and corporate income tax receipts slipped 40 percent, while sales tax collections only declined 6 percent.[30]

FIGURE 4.

Volatility of State Tax Collections During the Great Recession



Sources: U.S. Census Bureau; Tax Foundation calculations.

The relative stability of sales taxes compared to income taxes was not unique to the Great Recession, and indeed, it makes logical sense. While most of us curtail some expenditures during an economic downturn, there is only so much we can—or are willing to—cut. Even those with no wage income continue to consume, supported by savings and governmental assistance, while those whose incomes decline are likely to reduce savings rates more drastically than consumption. Corporate income tax collections are the most volatile because, even in a deep recession, most individuals earn taxable income, whereas corporations may post actual losses and thus have no net income to tax.

Both income and consumption fall when the economy contracts, but not in tandem, with personal expenditures representing a greater share of income during a downturn. The coronavirus pandemic was the exception that proved the rule, however: sales tax collections were indeed stable, with revenues growing at a steady pace after an initial dip during stay-at-home orders. Rather than declining, however, income tax collections actually rose as fast or even faster than sales tax collections in many states, thanks to generous income infusions from the federal government which drove personal income to all-time highs. In the absence of such extraordinary intervention, consumption taxes provide a better buffer against the vicissitudes of the business cycle.

29 Jared Walczak, "Income Taxes Are More Volatile Than Sales Taxes During an Economic Contraction," Tax Foundation, Mar. 17, 2020, https://www.taxfoundation.org/income-taxes-are-more-volatile-than-sales-taxes-during-recession/.

30 U.S. Census Bureau, "Annual Survey of State and Local Government Finances," https://www.census.gov/programs-surveys/gov-finances.html.

Impact on Pass-Through Businesses

Over 96 percent of all Oklahoma businesses are what is known as pass-through businesses, meaning that business income is taxed on ("passes through to") the individual income tax returns of the owner or owners, rather than being taxed at the entity level like a traditional C corporation.[31] Pass-through businesses are often thought of as small businesses, but this is not entirely true. Most pass-through businesses are small businesses, but for that matter, most C corporations are as well. Over 99 percent of Oklahoma businesses meet the U.S. Small Business Administration's definition of a small business, and small businesses—the vast majority of which pay through the individual income tax—employ 52 percent of the state's workforce.[32]

The individual income tax is therefore extremely important to businesses, because it is the tax that most businesses pay. And while the roughly 15,000 C corporations subject to the state's corporate income tax[33] are also exceedingly important to the state's economy, and punch substantially above their weight in share of the workforce, many of their suppliers and clients are subject to the individual income tax, so they too have a stake in lower individual income taxes.

Impact on Migration and Remote Work

Tulsa made waves as one of the first cities to offer a generous "move-in package" to attract newly mobile workers, extending $10,000 in cash and free access to coworking facilities to entice employees of out-of-state businesses who now have remote work flexibility. The Tulsa Remote program began before the pandemic, but its salience dramatically increased as remote work became increasingly possible because of—and extending beyond—the pandemic.[34] Such programs are not particularly scalable on a state level, and they are better thought of as a local marketing and development effort than a long-term, statewide economic development strategy. The more wide-ranging benefits of such a program likely have more to do with growing a city's brand and name recognition than with the direct economic impacts generated by residents attracted through the incentive. However, local officials in Tulsa have identified a very real phenomenon: a growing share of the workforce can now live anywhere with a high-speed internet connection, regardless of their employer's location.

Traditionally, employees have been tied to specific geographies. When almost all work is performed in physical offices, an employer engaged in locational decision-making must find an equilibrium representing the optimal balance of a variety of often competing factors. They must balance costs of doing business (tax burdens, operating costs, regulatory costs, and labor costs) with access to a qualified workforce and quality of life considerations (schools, research universities, transportation systems, housing markets, cultural amenities) that are important to both executives and the workforce they want to attract. Depending on their business model, they may also need to be located close to clients, suppliers, or their customer base.

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31 Internal Revenue Service, "Statistics of Income," Historical Table 2 and State Tax Data FY 2018, https://www.irs.gov/statistics/soi-tax-stats-irs-data-book.

32 U.S. Small Business Administration Office of Advocacy, "Oklahoma," 2020 Small Business Profile, https://cdn.advocacy.sba.gov/wp-content/uploads/2020/06/04144146/2020-Small-Business-Economic-Profile-OK.pdf.

33 Internal Revenue Service, "SOI Tax Stats – State Data FY 2018," https://www.irs.gov/statistics/soi-tax-stats-state-data-fy-2018.

34 Sarah Holder, "The Great Tulsa Remote Worker Experiment," Bloomberg CityLab, Feb. 28, 2020, https://www.bloomberg.com/news/features/2020-02-28/the-great-tulsa-remote-worker-experiment.

Simplify the decision, for a moment, to a question of attracting a qualified workforce. Certainly there are plenty of companies that could locate in Tulsa or Oklahoma City, and which the state of Oklahoma would love to attract to those locations. Tax policy is one way to bring in these employers. But for every business that is located elsewhere, there may still be some employees who would prefer to live in Oklahoma. Previously, that option was not available to them. The workforce balance that is optimal overall is never optimal for each individual. Some employees will gladly pay a premium for what more expensive cities have to offer, while others take little or no advantage of their amenities—even though they are paying for them through taxes and a high cost of living—and would far prefer a different arrangement. Traditionally, however, individual preferences are in tension with each other: a person may not appreciate any of the amenities they are paying for but appreciate working in a field which recruits heavily from people who do.

The rise of remote work changes the equation. To the extent that teams can operate virtually, employees can decide for themselves which bundle of amenities—priced in both cost of living and tax burdens—contribute to their quality of life and which do not, and choose where to live accordingly, knowing that their job will follow them there. Not everyone who takes advantage of this flexibility will do so in pursuit of financial savings. A highly compensated employee might abandon one high-cost, high-tax jurisdiction for another similarly costly locale because she prefers living in a resort destination to a major metropolitan area. Others, however, will move for lower taxes, a lower cost of living, or a higher (to them) quality of life—things that will often go together.

Oklahoma's great challenge, of course, is its border with Texas, which forgoes an individual income tax. But Oklahoma does not need to go to zero to enhance its competitive standing. High property taxes are one of the trade-offs in Texas, where the effective tax rate on owner-occupied housing is almost twice Oklahoma's rates (1.6 percent compared to 0.83 percent of market value).[35] With sufficiently low-rate income taxes, Oklahoma could be a highly attractive location for remote workers who care about low tax costs and a modest cost of living.

Reform Options

With a new top rate of 4.75 percent beginning in 2022, Oklahoma will have the seventh-lowest rate among those states levying an individual income tax, and the 16th-lowest overall (counting states with no income tax). This change, along with the restoration of a refundable Earned Income Tax Credit, is expected to reduce income tax collections by $237 million in FY 2023.[36]

This represents a continuation of efforts, dating to the late 1990s, to make the income tax more competitive, with many leading lawmakers—including multiple governors—articulating a vision of eventually eliminating it entirely. When the rate cut is implemented in 2022, it will be the culmination of a series of reductions bringing the top rate from 7.0 to 4.75 percent over two and a half decades.

35 Janelle Cammenga, "How High Are Property Taxes in Your State?" Tax Foundation, July 7, 2021, https://www.taxfoundation.org/high-state-property-taxes-2021/.

36 Emily McPherson, "Bill Summary: HB 2962," Oklahoma House of Representatives, May 17, 2021, http://webserver1.lsb.state.ok.us/cf_pdf/2021-22%20SUPPORT%20DOCUMENTS/BILLSUM/House/HB2962%20FULLPCS1%20BILLSUM.PDF.

Many policymakers want to build on these efforts. Lawmakers have a number of options in achieving this goal, including: (1) implementing a single-rate income tax, (2) enacting revenue triggers to phase in future rate reductions subject to revenue availability, (3) using sales tax base broadening to pay down income tax rate reductions, or even (4) converting the current income tax into a consumed income tax.

Implementing a Flat Tax

Oklahoma currently imposes a six-bracket graduated-rate income tax, but the top rate (4.75 percent as of 2022) kicks in at $7,200 for single filers and $12,200 for joint filers. This means that the overwhelming share of all taxable income is exposed to the top marginal rate. The system is graduated, but the effect is relatively flat, with the standard deduction of $6,350 and a $1,000 personal exemption providing more of a tax benefit to low-income households than the lower marginal rates. If all income were taxed at the top marginal rate, a single taxpayer would face up to $189 in additional tax liability. If, however, there was no standard deduction or personal exemption, that taxpayer's liability would increase by $345.

The first five bracket widths are doubled for married couples filing jointly, but the last bracket kicks in at $12,200 for joint filers—$2,000 short of doubling the bracket width for single filers. This creates what is known as a marriage penalty, where joint filers have more income exposed to higher marginal rates than if the two were filing separately. That additional taxable income costs up to $95 in additional tax liability per household, not an enormous amount, but still an inequity, particularly for lower-income households.

Eliminating the marriage penalty should be a goal of policymakers, but it comes at a cost: if the final bracket width were doubled, income tax revenues would decline by about $55 million. It is, however, possible that the state may eventually wish to absorb this loss to create fairer treatment of married couples, or to incorporate it into broader reforms, including the transition to a flat-rate income tax.

The economic literature on graduated-rate income taxes is unfavorable, since economic decision-making takes place on the margin—in this case, with regard to the top marginal rate, which is the relevant rate for most Oklahoma taxpayers, and for nearly all pass-through business activity. Furthermore, while recent rounds of rate reductions have yielded moderate rates, graduated-rate income taxes tend to be far easier to raise. When most or all taxpayers share in a tax increase, there is substantial political pressure to balance revenue needs with tax competitiveness. The ability to single out select taxpayers for higher rates—which will also fall on many small businesses—would make future tax increases easier. There are practical and political limits on how high a rate can go when it is applied uniformly, and these do not exist in the absence of a flat rate.

Nine states have a flat rate income tax; of these, the highest rate is 5.25 percent in North Carolina. States like Illinois (4.95 percent), Massachusetts (5.0 percent), and Pennsylvania (3.07 percent), not known for a commitment to low taxes, have maintained low rates largely because of their flat-rate structure. Indeed, when Illinois lawmakers have sought to amend the state constitution to allow a graduated-rate tax, they have paired it with proposals that would, in some cases, yield double-digit top marginal rates. And whereas only North Carolina has a flat tax with a rate higher than 5 percent, states with graduated-rate income taxes have top rates as high as 13.3 percent in California, 10.9 percent in

New York, 10.75 percent in New Jersey and the District of Columbia, 9.9 percent in Oregon, and 9.85 percent in Minnesota.[37] While Oklahoma would never adopt California-style rates, a flat-rate system would be an investment in keeping rates competitive for the long term.

Oklahoma could, for instance, adopt a higher standard deduction in exchange for a single-rate income tax. Increasing the standard deduction by $4,000, to $10,350 would not only bring the Oklahoma standard deduction closer to the federal one ($12,550 in 2021) but would pull off a hat trick: providing tax relief for the lowest-income Oklahomans, ensuring that no one experiences a tax increase, and holding the revenue loss to what is effectively a rounding error.

This change provides savings for the lowest-income taxpayers because more of their income is exempted from taxation entirely, rather than simply being taxed at low rates. A single filer earning $11,350 or less would have no income tax liability, for instance, whereas they currently owe $77. Above about $18,550, tax liability would be unchanged.

This approach, moving to a flat-rate income tax with a 4.75 percent rate and a higher standard deduction, would not yield any significant immediate changes in tax liability, but it would help secure competitive rates going forward, providing a defense against high top marginal rates in the future. This competitive advantage could be locked in even more effectively if safeguarded by a constitutional amendment, as other states have. This reform could, of course, be adopted as a standalone policy or combined with revenue offsets or net tax cuts to reduce rates overall, which could make the plan even more attractive.

Reducing the Rate with Revenue Triggers

Oklahoma's experience with revenue triggers was at most a qualified success. The state's efforts to dedicate a share of future revenue growth to tax relief was complicated by a curious design which did a poor job of capturing actual revenue conditions. Properly designed triggers, however, would be a responsible way of returning a portion of future tax revenue growth with taxpayers in the form of lower income rates. This could stand alone or could complement other reforms.

Across the country, revenue triggers have emerged as an effective way to implement or phase in tax rate reductions or other tax reform measures as revenues permit. Tax triggers are a newer take on an old concept: contingent enactment of a legislative provision. States have long relied upon bills with contingent enactment clauses, providing that certain features of new legislation shall only be operative if certain conditions are met. Tax triggers build on this model, making tax reform measures contingent on state revenues meeting or exceeding established targets.[38]

37 Katherine Loughead, "State Individual Income Tax Rates and Brackets for 2021," Tax Foundation, Feb. 17, 2021, https://www.taxfoundation.org/publications/state-individual-income-tax-rates-and-brackets/.

38 Jared Walczak, "Designing Tax Triggers: Lessons from the States," Tax Foundation, Sept. 7, 2016, https://www.taxfoundation.org/designing-tax-triggers-lessons-states/.

Tax triggers can help ensure revenue stability and limit the uncertainty associated with changes to the tax code while providing an efficient way for states to dedicate some portion of revenue growth to tax relief. Their ability to do so, however, depends on their design. Poorly designed triggers can implement cuts when economic conditions do not warrant it or postpone reductions even when revenue growth would permit it. By contrast, properly constructed tax triggers are a valuable mechanism for providing meaningful rate relief.

Well-designed triggers require selecting a baseline revenue figure—either a given year's revenue or a statutorily-established amount—and then establishing benchmarks that reflect meaningful revenue growth. While this may sound simple, Oklahoma and other states have learned that it is possible to get the benchmarks wrong.

Oklahoma's previous triggers were designed to reduce the top marginal income tax rate from 5.25 percent to 4.85 percent in two stages. Ultimately, the second reduction was not implemented, and officials later lowered rates independently of the trigger. Notably, these triggers were based on year-over-year general fund balance projections, with each of the two stages of planned rate reductions implemented if thresholds were met. This approach had at least three shortcomings.

First, by focusing on single year revenue changes, Oklahoma opened itself up to the possibility of a downward ratchet effect, where recovery from a year of revenue decline could trigger a tax cut even if revenue levels are stagnant or even down over a longer time frame. For a variety of reasons, the COVID-19 pandemic did not yield the revenue losses many anticipated. Imagine, however, if revenues had slipped 5 percent rather than rising by a similar amount. If, the following year, revenues merely recovered to pre-pandemic levels, this would appear to be meaningful growth on a year-over-year basis, when it actually represents a revenue decline in real (inflation-adjusted) terms from a pre-pandemic baseline.

Second, it relies on projections rather than actual revenues. This was intended to make the triggers more forward-looking and aligned with the budget process, but the result was to divorce the process from real-world collections, merely looking at the change from one year's projection to the next. Use the pandemic as an example once again. In the spring of 2020, state forecasts for the coming fiscal year were extremely pessimistic. In the spring of 2021, by contrast, most forecasts for FY 2022 were decidedly rosier. While revenues in FY 2022 are likely to be higher than FY 2021, comparing the two forecasts would yield a much sharper growth trajectory than would looking back at actual collections for each fiscal year.

And third, it was potentially subject to gamesmanship because it incorporated a fund balance component under which lawmakers could pre-authorize expenditures or divert funds to postpone otherwise scheduled tax cuts even in good years.[39]

39 Jared Walczak, "Oklahoma Failed to Trigger a Tax Cut. That's a Success for Tax Triggers," Tax Foundation, Dec. 21, 2016, https://www.taxfoundation.org/oklahoma-failed-trigger-tax-cut-thats-success-tax-triggers/.

Oklahoma can and should look at revenue triggers again, but with an emphasis on best practices. Instead of using year-over-year revenue changes, policymakers should establish a specific revenue baseline and employ benchmarks that measure real revenue growth, adjusted for inflation, over that base year amount. Ideally, reductions should not be tied to specific years, but instead triggered whenever real revenue growth is adequate to reduce rates by at least a given increment—say 10 or 25 basis points—with the actual size of the reduction based on a statutorily-established proportion of inflation-adjusted revenue growth.

There may, of course, also come a time when lawmakers determine that they have adequate revenues to implement an immediate tax rate reduction. Under a flat-rate tax with a $10,350 standard deduction, each percentage point of rate reductions would cost an estimated $875 million in current dollars, meaning that, for instance, adopting a flat 4 percent rate would forgo just under $660 million in lost revenue. Under the current graduated rate system with a lower standard deduction, an across-the-board rate reduction of one percentage point would cost just over $830 million.

Paying Down Rate Reductions with Sales Tax Modernization

With each passing year, Oklahoma's sales tax becomes less representative of the state's economy. Sales tax bases across the country are eroding as consumer spending patterns shift, so modernizing the sales tax base can generate revenue for income tax rate relief. Done properly, this is a win for taxpayers, as it reduces reliance on an uncompetitive tax by raising more money from a less damaging one, while creating a more neutral—and thus less inefficient—tax base for the sales tax by eliminating economically unsound carveouts and exclusions. Policymakers should, however, avoid the temptation to chase a rate—or the elimination of the individual income tax—if it means making unsound choices about base broadening. Highly significant reforms are possible even on an incremental basis.

A responsible expansion of the sales tax base, as enumerated elsewhere in this publication, could yield a 3 percent top marginal income tax rate without adjusting current sales tax rates. Further cuts could be achieved using a combination of base broadening and rate increases.

However, while reducing income tax burdens by shifting further toward consumption taxes is not only viable but desirable, full repeal of the individual income tax through a broader sales tax base, higher rates, or both would yield potentially unpalatable sales tax rates. Expanding to a broad, but still attainable, range of currently untaxed goods and services—outlined in the discussion of sales tax reform options—would generate about $732 million, enough to pay for an across-the-board rate reduction yielding a new top rate of about 3.87 percent.

If, moreover, local sales tax rates could be adjusted to make local collections revenue neutral on the new base, base broadening could pay for a 3 percent top marginal income tax rate while aggregate sales tax rates remain identical—a higher state rate, but lower local rates, commensurate with the broader base on which revenue can be raised.

This is highly competitive, since the only states with income tax rates below 4 percent are Ohio (3.99 percent), Indiana (3.23 percent), Pennsylvania (3.07 percent), and North Dakota (2.9 percent), among the 41 states that impose wage income taxes.

But to zero out the income tax using this broader base, the state sales tax rate would have to nearly double, from 4.5 percent now to just shy of 9 percent. While a 9 percent state sales tax rate is high, it can be competitive in the proper environment—but less so in Oklahoma, where it would be combined with local option sales taxes which are quite high in their own right. Even with a broader base, Oklahomans would be looking at a combined average state and local sales tax rate of 12.3 percent to fully offset the elimination of the individual income tax if local sales tax rates were adjusted to reflect the expanded base, and 13.1 percent if they were not. These rates are likely to be considered prohibitively high. They would likely induce additional crossborder sales, and businesses which face sales taxes on their business-to-business transactions would be at a competitive disadvantage compared to their out-of-state peers.

If, instead, the sales tax base was broadened to include nearly all final consumer transactions—including things like health care and education, to the extent that they are legally taxable under federal law and regulations—the new combined sales tax rate would be about 10.1 percent (or 11.6 percent without a local adjustment), above the current high of 9.55 percent in Louisiana and Tennessee and on a much broader base. And replacing the income tax with higher sales tax rates alone, in the absence of any base broadening, would require an entirely unrealistic all-in rate of 15.3 percent.

A prior effort to broaden the sales tax base to pay down reforms elsewhere gained little traction, with former Gov. Mary Fallin (R) proposing expansions that relied heavily on the taxation of intermediate transactions,[40] leading to tax pyramiding that would undercut the competitiveness of in-state businesses and lead to Oklahomans—particularly lower- and middle-income Oklahomans—paying the same tax several times over in some of their purchases.

It is crucial that policymakers avoid this mistake in considering sales tax base broadening as a way to pay down income tax rate reductions. There are responsible ways to broaden the base—but lawmakers should avoid the temptation of seeing every sales tax exemption as a potential revenue-raiser. Some exemptions are structurally necessary to avoid tax pyramiding. The ideal base is final consumption, so the exclusion of business inputs should not be deemed a carveout; it is, rather, consistent with the definition of consumption taxation.

Instead of the distraction of trying to identify sales tax base-broadening options to eliminate the income tax, policymakers could prioritize a more incremental—but still highly significant—reform, using sales tax base broadening to facilitate an across-the-board income tax cut, building on reforms adopted in 2021 to make Oklahoma's income tax rates among the lowest in the country. The sales tax base-broadening options to pay for these reductions are delineated in our discussion of sales tax reforms.

40 Trevor Brown, "Fallin's Plan to Tax Services Appears to be on the Ropes," Oklahoma Watch, Feb. 15, 2017, https://oklahomawatch.org/2017/02/15/fallins-tax-package-faces-legislative-challenges/.

The following table assumes that the full set of reasonable expansions to the sales tax base laid out in our discussion of the sales tax are adopted and looks at the revenue-neutral sales tax rate necessary to implement across-the-board rate reductions bringing the top income tax rate to 4 percent, 3 percent, and 2 percent, or to repeal it entirely. The sales tax rates necessary to achieve these targets using the current base are also included, starting from the current average combined state and local sales tax rate of 8.95 percent. Finally, this analysis assumes that local option sales tax rates are proportionally reduced to make base broadening revenue neutral at the local level (options for doing so are discussed elsewhere), but a separate line is provided using the assumption that local sales tax rates remain the same, yielding increased revenue for localities.

TABLE 5.

Sales Tax Rates to Achieve Income Tax Reduction Targets

	Income Tax Top Marginal Rate Target				
Assumption	**Current**	**4%**	**3%**	**2%**	**0%**
Current Sales Tax Base	8.95%	9.90%	11.17%	12.44%	15.28%
Modernized Sales Tax Base					
without local adjustment	8.06%	8.82%	9.84%	10.86%	13.13%
with local adjustment	7.18%	7.94%	8.96%	9.98%	12.25%

Sources: U.S. Bureau of Economic Analysis; Tax Foundation calculations.

Notably, Oklahoma could achieve a top individual income tax rate of 3 percent without any change in sales tax rates if it right-sized its sales tax base as recommended elsewhere in our analysis.

Creating a Consumed Income Tax

Many economists have championed the idea of a consumed income tax as a replacement for the individual income tax. Such a tax would only apply to income used for consumption, excluding savings and thus eliminating the economic disadvantages inherent in traditional income taxation. An ideal consumed income tax would exclude all saved and invested income from the base until it is withdrawn from savings and used for consumption. This addresses the current income tax's bias against investment and reduces its adverse effect on labor.

An ordinary income tax reduces the return on invested income twice, while reducing the returns to consumption only once, creating a bias against investment and, at the margin, reducing the incentive for work generating income above consumption levels. This issue is compounded by the effects of inflation, since the taxpayer will be taxed on nominal investment returns even if they reflect losses or low returns in real terms. A consumed income tax, by contrast, would not tax income while it is being invested, only when it is spent.

In practice, a state-level consumed income tax would likely require the creation of a state-recognized universal savings account through which taxpayers could save and invest, and where income would be exempt until withdrawn. In this way, it would be much like other tax-advantaged investment vehicles well-known to taxpayers, like IRAs and 401(k)s, except that there would be no contributions limit and no penalty for withdrawals—other than the imposition of tax when income is withdrawn to be spent.

To raise the same amount of revenue as the current income tax, a consumed income tax rate would have to be higher, since it operates on a narrower base. Oklahomans saved roughly $12.6 billion in 2018,[41] suggesting that the revenue neutral rate for a consumed income tax would be about 5.4 percent, compared to the 4.75 percent rate of the current income tax as of 2022. While this rate is higher, the tax base is much more economically efficient, as it does not discriminate against savings and investment the way the current income tax does.

SALES TAXES

Oklahoma's reliance on the sales tax is slightly higher than average: the state brings in just under a third of its state and local tax collections from the sales tax, while most states rely on sales taxes for just under a quarter of collections. At issue is not the state sales tax, with its modest 4.5 percent rate on a fairly ordinary base, but rather local sales taxes, with rates that often rival the state rate. Sales taxes accounted for only 12.8 percent of local tax collections nationwide in 2019 but made up 39.8 percent of local collections in Oklahoma that same year.[42]

As addressed elsewhere, this heavy reliance on the sales tax can be partially explained by the limited number of local government entities given authority to levy property taxes (called the *ad valorem* tax in Oklahoma). Additionally, sales tax is an attractive way for localities to raise revenue, because it creates a possibility for some of the tax burden to be outsourced to those who shop across district lines.

This higher reliance is reflected in higher rates. The state-level rate is below average at 4.5 percent, but when combined with local rates, the average Oklahoman faces rates of 8.95 percent, the sixth-highest combined rate in the country. Oklahoma has remained in an unenviable position for many years, only moving from fifth to sixth due to other states increasing their rates, rather than any effort on Oklahoma's part to lower the sales tax burden.

TABLE 6.

Sales Tax Rates, Oklahoma and Bordering States

State	State Rate	Average Local Rate	Combined Rate
Oklahoma	4.50%	4.45%	8.95%
Arkansas	6.50%	2.98%	8.40%
Colorado	2.90%	4.82%	7.72%
Kansas	6.50%	2.20%	8.70%
Missouri	4.225%	4.03%	8.25%
New Mexico	5.13%	2.71%	7.84%
Texas	6.25%	1.94%	8.19%

Note: City, county, and municipal rates vary. These rates are weighted by population to compute an average local rate. The sales tax in New Mexico has a very broad base that includes many business-to-business transactions.
Sources: Sales Tax Clearinghouse; Tax Foundation calculations; state revenue department websites.

41 Author's calculations based on personal savings rate and disposable income data.

42 U.S. Census Bureau, "State & Local Government Finance," 2019, https://www.census.gov/data/datasets/2019/econ/local/public-use-datasets.html.

Neighboring Arkansas does experience a far higher average rate of 9.48 percent, but Oklahoma still surpasses most of its neighbors and compares unfavorably with rates throughout the rest of the country. The limited reach of the property tax plays a major role in these rates, but a modest sales tax base, combined with below-average per capita personal consumption, is at play as well. Modernizing the sales tax base, and using revenue from base broadening to pay down income tax rate reductions at the state level and local option sales tax rate reductions at the municipal level, is a compelling way to address this issue.

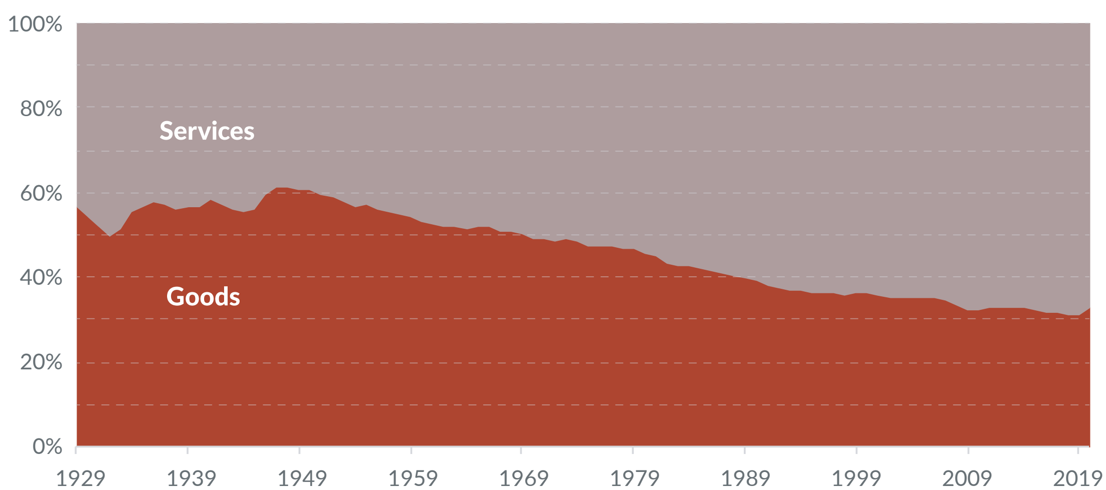
Oklahoma's Sales Tax Base Is Narrow and in Need of Modernization

Like most states, Oklahoma imposes its sales tax on a base that consists of most goods and relatively few services. With limited exceptions, the state's sales tax is imposed on transactions involving tangible property—appliances but not apps, light fixtures but not landscaping. As is often the case, this was less of a conscious choice than an accident of history, a relic of the fact that Oklahoma's sales tax was first imposed in 1933, at the height of the Great Depression. Services comprised a far smaller share of the economy, and it was administratively simpler in that earlier era to focus almost exclusively on retail sales of goods.

Today's economy has little in common with that of 1933 or even 1993. Higher incomes and changing consumer tastes have shifted a greater share of consumption to services, while a digital economy is upending traditional categories. Not only does more disposable income go to the consumption of services, but some traditional consumption of goods has been displaced by services and subscriptions.

Percentage of Total Personal Consumption Expenditrues

Goods vs. Services, U.S., 1929-2020



Source: Bureau of Economic Analysis, National Income and Product Accounts.

FIGURE 5.

Oklahoma's sales tax base is not as narrow as some of its peer states' bases, but it remains narrow—and erodes further each year. Apples-to-apples comparisons of state sales tax bases are difficult, but one method is to calculate the value of taxed transactions as a percentage of personal income. Hawaii, for instance, has a sales tax breadth of 107 percent of state income.[43] The state exempts some transactions which arguably should be taxed, but double-taxes others. Oklahoma also exposes some transactions to multiple levels of taxation but omits far more transactions altogether. The state's sales tax breadth, as a percentage of state income, is 36 percent.

TABLE 7.

Sales Tax Breadth as a Percentage of Personal Income (FY 2020)

State	Breadth
Oklahoma	36%
Arkansas	41%
Colorado	34%
Kansas	34%
Missouri	30%
New Mexico	70%
Texas	42%

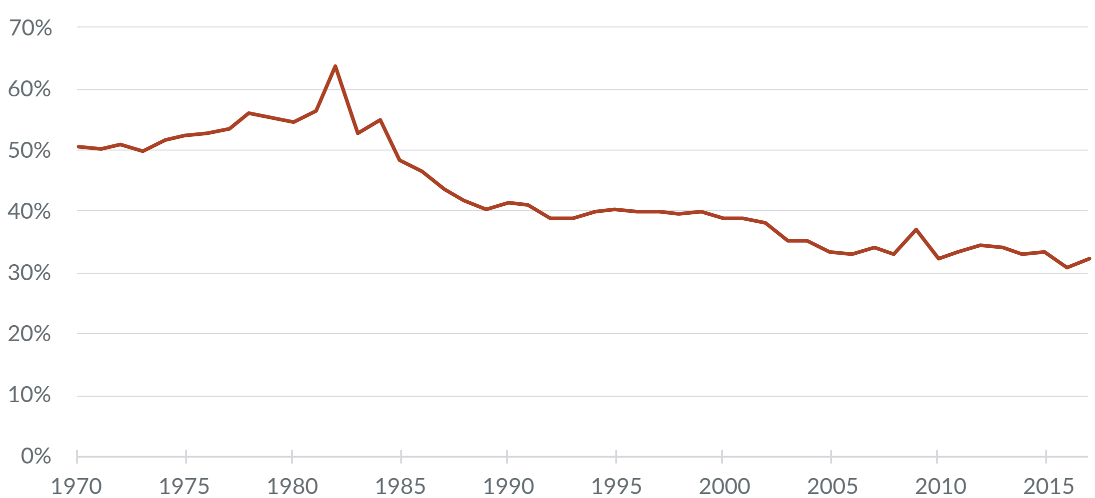
Source: Tax Foundation research.

A robust sales tax base would not reach 100 percent, as not all income is consumed in any given year, but, per personal consumption data, should be about 73 percent of state income in Oklahoma, suggesting that the state is only reaching half of its sales tax base potential.

FIGURE 6.

Oklahoma's Sales Tax Base as a Percentage of Personal Income

1970-2017



Source: Prof. John Mikesell (Indiana University).

43 Jared Walczak, "State Sales Tax Breadth and Reliance, Fiscal Year 2020," Tax Foundation, Feb. 9, 2021, https://www.taxfoundation.org/sales-tax-base-reliance-2020/.

The state's sales tax breadth has seen a substantial decline over time. It saw an especially steep drop in the 1980s, reflecting rising incomes, growth of interstate sales, and an accelerating shift toward the consumption of services. Oklahoma has taken action to collect more taxes on online sales, but there is an opportunity to build on that change with broader efforts to stabilize the tax base.

Another way of approaching the question of just how much Oklahoma carves out its sales tax base is to multiply all personal consumption in the state ($40.9 billion in 2019) by the state sales tax rate (4.5 percent in 2019), which yields $6.3 billion in state sales tax collections, more than twice what the state actually collects, even though the base includes several transactions which do not represent personal consumption at all.

Even if the sales tax base included all final consumer transactions, collections on those transactions would fall short of this figure since the state does not achieve 100 percent tax compliance; at the same time, the state's current collections also include revenue from business-to-business transactions which do not form a part of personal consumption. Whatever measure is used, however, the conclusion is inescapable: Oklahoma's sales tax fails to reflect modern consumption.

Oklahoma Should Right-Size its Sales Tax Base

As Oklahoma's sales tax base continues to shrink as a share of total personal consumption, the state has three choices: accept reduced revenue, raise sales tax rates, or shift collections to other taxes. Instead of increasing rates on a narrow base, lawmakers should consider broadening the base itself. Right-sizing the sales tax base would make the tax more neutral in its application, while generating additional state and local revenue that could be used to reduce reliance on more unstable or economically harmful taxes.

In this search for a more modern sales tax base, policymakers should keep in mind several main principles and features of sales taxation that are broadly accepted by public finance scholars and tax policy researchers across the board, namely:

1. An ideal sales tax is imposed on all final consumption, both goods and services;
2. An ideal sales tax exempts all intermediate transactions (business inputs) to avoid tax pyramiding;
3. Sales taxes should be destination-based, meaning that tax is owed in the state and jurisdiction where the good or service is consumed;
4. The sales tax is more economically efficient than many competing forms of taxation, including the income tax, because it only falls on present consumption, not saving or investment;
5. Because lower-income individuals have lower savings rates and consume a greater share of their income, the sales tax can be regressive, though broadening the base to include additional consumer services (much more heavily consumed by higher-income individuals) represents a progressive change;

6. The sales tax scales well with ability to pay, because it grows with consumption and is therefore more discretionary than many other forms of taxation; and

7. Consumption is a more stable tax base than income, though the failure to tax most consumer services is leading to a gradual erosion of sales tax revenues as services become an ever-larger share of consumption.

In practice, policymakers are unlikely to opt for the inclusion of all personal consumption in the sales tax base, since this would include education and health services.[44] Failing to make any realignment at all, though, risks a sales tax that no longer reflects sales and consumption in Oklahoma.

The Importance of Excluding Business Inputs

The goal of base broadening is not—or at least should not be—higher revenue, but rather, greater stability. Lawmakers should take care to avoid newly applying the sales tax to goods or services that are primarily purchased as business inputs. By definition, retail sales taxes should apply to final consumer transactions, not intermediate transactions. When intermediate goods and services are exposed to the sales tax, this increases the costs of production. As a result, many of those taxes get passed along to consumers in the form of higher prices, but this disguises the true costs of government, as consumers have no way of knowing how much of the cost of the final good or service is attributable to tax pyramiding.

Whether businesses can pass on these costs depends on the nature of the market in which they operate. Businesses that are regional in their nature will largely pass these costs onto purchasers since the cost is shared by most if not all of their competitors. Those operating within larger markets, however, may absorb the costs themselves if their out-of-state peers are not exposed to similar levels of taxation on their inputs, as they cannot raise prices without putting themselves at a competitive disadvantage. In this way, sales taxes on business inputs also operate as a punitive tax on in-state businesses compared to competitors with production out-of-state.

When a sales tax exposes many business inputs to taxation, the sales tax ends up functioning more like a gross receipts tax, which is among the most economically harmful taxes states levy. The taxation of business inputs inevitably impacts some businesses and industries more heavily than others depending on how heavily a business consumes taxable products and services. The threat of tax pyramiding can distort business decision-making and inefficiently favor some business models—or sizes of operations—over others. For instance, vertically integrated firms—those which keep more operations in-house—have fewer outside transactions, and thus less exposure to a sales tax that inappropriately taxes a broad range of business inputs. This favors businesses able to keep everything from packaging, warehousing, and distribution to legal, accounting, and marketing in-house, and particularly favors larger firms over smaller businesses which might contract out for certain services.

44 For documentation of the taxability of services in Oklahoma and other states, see Federation of Tax Administrators, "FTA 2017 Services Taxation Survey," https://taxadmin.memberclicks.net/sales-taxation-of-services.

Imagine, for sake of argument, a manufacturer in Oklahoma City with $5 million retail sales and $4.5 million in expenses, earning a healthy profit of $500,000. Assume that they do their actual manufacturing in-house, but as a relatively small company, they contract out for a range of services, from accounting and legal services to packaging, distribution, and marketing, such that $580,000 of their $4.5 million in expenses are business services procured from other firms. We will assume that none of their non-service inputs are subject to the sales tax, though in practice, some may be.

Under a properly structured sales tax, the goods are taxed when sold at retail. At a combined rate of 8.625 percent in Oklahoma City, that would yield $431,250 on $5 million in sales. Under a European-style value-added tax, nearly every cost of production (in our example, everything except labor costs) would be taxed, including the final retail sale, but with credits against any previously taxed amount, meaning that only the incremental increase in value is subject to tax. At the same rate, this would also yield $431,250 in total taxation. If, however, a sales tax which falls on service inputs is applied, then the total tax is $485,156, an effective sales tax rate of 9.703 percent, compared to the statutory tax rate of 8.625 percent.

TABLE 8.

How Tax Pyramiding Works with the Taxation of Business Inputs

Component	Amount	Sales Tax	VAT	Sales Tax with Inputs
Labor	$2,000,000	$0	$172,500	$0
Property	$275,000	$0	$23,719	$0
Machinery	$600,000	$0	$51,750	$0
Energy	$350,000	$0	$30,188	$0
Raw Materials	$650,000	$0	$56,063	$0
Packaging	$60,000	$0	$5,175	$5,175
Distribution	$100,000	$0	$8,625	$8,625
Legal Services	$40,000	$0	$3,450	$3,450
Accounting/Auditing/HR	$75,000	$0	$6,469	$6,469
Marketing	$300,000	$0	$25,875	$25,875
Consulting	$50,000	$0	$4,313	$4,313
Retail Sales Revenue ($500,000 in profit)	$5,000,000	$431,250	$43,125	$431,250
Total Sales Tax		$431,250	$431,250	$485,156
Effective Sales Tax Rate		8.625%	8.625%	9.703%

Source: Tax Foundation calculations.

No state hews perfectly to the ideal of avoiding the taxation of business inputs altogether, Oklahoma certainly included. Nevertheless, Oklahoma should take care not to lean on these intermediate transactions as a source of revenue in any sales tax base-broadening efforts.

Some of the services that are currently excluded from the base could constitute either a final consumer transaction or a business input, depending on the identity of the purchaser. In such instances, the state should either define the categories in a way that excludes business inputs, or, preferably, provide a mechanism by which business purchases of such services are exempted. This could be done through sales tax exemption certificates for businesses or in a manner that is similar to how purchases of nonprofit organizations are exempted in many states.

Base-Broadening Options and Potential Revenue Impact

Modernizing Oklahoma's sales tax base to include services will go a long way to ensure stability and keep sales tax revenues from eroding. Base broadening should also be considered as a way to help pay for rate reductions in either the state sales tax rate or individual income tax rates, but the state should have reasonable expectations for how much revenue such a change can produce.

If we imagine a highly implausible scenario in which Oklahoma suddenly broadened its base to the point at which it taxed all personal consumption that involves a financial transaction and is legal to tax, the state would generate an additional $1.5 billion a year in sales tax revenue, adjusting for likely compliance.[45] It is worth noting that this extremely broad base includes things like health care, insurance, and private education, the inclusion of which is unlikely to be politically viable. Crucially, even this extremely aggressive scenario does not generate nearly enough revenue for repeal of the individual income tax.

Conversely, a responsible base-broadening plan would be able to raise over $700 million a year in additional revenue. Some items may be relatively uncontroversial, like car repairs and movie theater admission. Others, like household utilities and dental care, make good policy sense but require more political will. Because sales tax base expansion does not have to be an all-or-nothing endeavor, the following table estimates how much annual revenue each item would provide if added to the base. If every item on the list were taxed, the resulting revenue of $732 million would represent an increase of approximately 24 percent in annual state sales tax collections. This revenue could be used to pay down individual income tax rate reductions, as discussed previously.

45 Revenue officials can and do work to increase compliance, and the compliance gap is closing with the rise of marketplace facilitator laws and better means of capturing remote sales, but at present, it is common to assume that tax collections will reflect 85 percent of the potential taxable base.

TABLE 9.

Base-Broadening Options with Revenue Estimates

Revenues in Millions of Dollars

	Revenue Generation	
Base Broadener	**Cumulative**	**Component**
Motor vehicle maintenance and repair	$43.5	$43.5
Motor vehicle leasing	$58.3	$14.8
Campgrounds and related recreational services	$76.2	$17.9
Movie theater admission	$81.5	$5.3
Live entertainment, excluding sports	$96.4	$14.9
Veterinary and other pet services	$115.3	$18.9
Package tours	$121.8	$6.5
Recreational vehicle and sports equipment maintenance and repair	$124.2	$2.4
Professional and other services (personal consumption)	$175.8	$51.6
Personal care and clothing services	$227.4	$51.6
Gambling	$282.3	$54.9
Audio-video and similar services	$339.6	$57.3
Postal and delivery services (non-USPS)	$341.8	$2.2
Household maintenance services	$369.3	$27.6
Parking fees and tolls	$375.2	$5.9
Club memberships and participant sports centers	$398.1	$22.8
Museums and libraries	$401.9	$3.8
Financial service charges, fees, and commissions	$555.1	$153.2
Dental services	$612.1	$57.0
Household utilities	$732.0	$119.9

Sources: U.S. Bureau of Economic Analysis; Oklahoma statutes; Tax Foundation calculations.

Income and Sales Tax Rate Reduction Choices

A well-structured sales tax is more economically efficient than income taxes (as discussed elsewhere), so using revenue from sales tax base broadening to pay down income tax rather than sales tax rate reductions enhances the state's tax competitiveness.[46]

In using base broadening to pay down income or other tax rates, policymakers should avoid the temptation to chase a specific rate and find base broadeners sufficient to pay down such a rate reduction even if that expanded base undermines the state's tax competitiveness. This is an inversion of the process, and while lawmakers should ask the hard questions and balance difficult base-broadening choices against the promise of significant rate reductions, they should not feel under pressure to tax transactions they know should not be in the sales tax base, simply because it is necessary to achieve a

46 Income tax reduction options are discussed in more depth in the income tax section of this publication.

preset rate target. Taxes on income, for all their shortcomings, are less economically harmful than taxes that fall directly on capital investment, which is what happens when sales taxes are imposed on business inputs.

Sourcing Rules for Services

Under most circumstances, state sales taxes are destination-sourced, meaning that the relevant taxing authority is the one with jurisdiction over the location at which a customer receives a product. For these purposes, receipt is typically synonymous with taking possession, so a consumer who purchases an item in a Tulsa store pays Tulsa sales tax (collected by the seller at the point of sale) even if she then takes her purchase home to Stillwater. If, however, she bought the product online and it was shipped to her Stillwater address, it is the Stillwater sales tax that applies.

For tangible property, sourcing is relatively easy. There tends to be a clearly defined physical location where a good is received. The same goes for some services, particularly those involving on-site labor. In many cases, however, services are performed in a different location than the one in which they are received. Hiring a home cleaning service poses few challenges—but how about a cloud computing service?

Sometimes the determination is complex. If a customer who lives in Edmond pays for a digital service offered by a company headquartered in San Francisco but served out a of a data center in Austin, and that customer uses the service while on vacation in Honolulu, to which jurisdiction is the service sourced? Or if, for sake of argument, business-to-business services are taxed (even though they should not be), if a company based in New York City pays for a customer relations database that is used by salespeople across the country, including sales teams based in Norman and Lawton, is any portion of that transaction taxable in Oklahoma?

Within corporate taxation, some states have adopted a "look-through" approach for corporate apportionment, based on the location of the customer's own customers. Under this approach, if a service contracted in Oklahoma was ultimately consumed (either by the company or its customer) in another state, Oklahoma would not tax it, but if the customer's customer was in Oklahoma, that transaction would be sourced—or partly sourced—to the state. This approach has relatively little appeal in sales taxation, because it is complex and requires an assessment of a service's use over time, information that may not be available when the sale is transacted.

Therefore, Oklahoma would do well to avoid look-through and source services consistent with its current sales tax code, with receipt of a service sourced to wherever first use is made of the service, or for digitally transferred services, taking possession or making first use.[47] This approach cuts down substantially on complexity for taxpayers and tax collectors alike, and requires no change to the state's existing sourcing rules.

47 U.C.A. 1953 § 59-12-211.

Sourcing, moreover, is chiefly relevant for business and professional services, and is most complex for those purchased by businesses. Exempting business inputs, consistent with good tax policy, clears most of the complexity of sourcing. While it would remain a relevant issue for professional services consumed by individuals, the determination is rarely complex. An Oklahoma resident individual using a service would pay the sales tax on their fees; an Oklahoma company providing a service to an Arkansas customer would not collect sales tax on Oklahoma's behalf.

Adjusting Local Option Sales Taxes

Oklahoma's high-rate local option sales taxes pose a challenge for reformers, both because they limit the capacity for state sales tax rate increases and because broadening the sales tax base would increase local tax collections in the absence of commensurate rate reductions, yielding a sizable tax increase. The high rates are largely a consequence of Oklahoma's low property (*ad valorem*) taxes, which reflects policy choices at both the local and state levels. In particular, Oklahoma restricts city governments from imposing property taxes, pushing them toward heavier reliance on sales taxes.

Reducing local sales tax reliance would require tackling *ad valorem* taxation, discussed elsewhere. Even if sales taxes continue to raise the same amount of revenue for local governments, however, the rates themselves can and should come down if the sales tax base is meaningfully broadened. At the state level, this additional revenue could be used to pay down income tax rate reductions, making taxpayers whole. At the local level, however, base broadening could be a net positive to localities—and an extra tax burden for residents—unless adjustments are made.

Conceptually, the ideal policy would be rate reductions commensurate with base broadening. If, for instance, the base was broadened by 20 percent, the rate should be reduced by 17 percent, yielding the same amount of revenue. Because local governments possess rate-setting authority, however, pushing a uniform rate-trimming across all jurisdictions is likely to be prohibitively difficult. An aggressive solution would be to impose a levy limit on local sales taxes, requiring rates to be rolled back to keep collections constant (plus inflation and any allowable growth factor). Alternatively, the state could cap local sales taxes at a rate calculated to limit local jurisdictions' ability to increase revenue under a sales tax base-broadening plan.

Failing that, policymakers could consider another approach, leaving local sales tax rates alone, but reducing state aid to localities by formula to account for additional local sales tax revenue. If desired, the state could even give local governments a choice by tying the state aid formula to the growth in local sales tax collections. Localities could maintain current state funding levels by lowering their sales taxes to offset the broader sales tax base or could accept reduced funding while keeping rates higher. Either way, the goal would be to avoid an overall tax increase due to sales tax modernization.

Sales Tax Reform in Other States

Several states, including Hawaii, New Mexico, North Dakota, and South Dakota, already have fairly broad sales tax bases, though often with an overreliance on business inputs. Recent efforts to adopt significant base broadening have fallen short in several states, including in Illinois, Maine, South

Carolina, and Utah, where proposed by Republican governors, and Connecticut and Pennsylvania under proposals by Democratic governors. In at least some of these states, however, reform remains on the table.

Other parts of the country, moreover, have succeeded in adopting base broadening on a moderate scale in recent years. Examples include Iowa, Kentucky, North Carolina, and the District of Columbia.

In Kentucky, as part of a broader tax reform package, lawmakers expanded the sales tax base to include many (primarily) personal services, including:

- landscaping;
- janitorial services;
- pet care and grooming;
- small animal veterinary services;
- fitness and recreational sports;
- laundry, dry cleaning, and linen supply;
- nonmedical diet and weight loss centers;
- limousine services;
- bowling;
- overnight trailer campgrounds;
- extended warranties; and
- select other personal services.[48]

In North Carolina, an emphasis was placed on taxing services delivered by providers with an existing sales tax collections obligation. Beginning in 2017, a range of installation, repair, maintenance, and service charges were added to the sales tax base. The rationale for inclusion of these services, in particular, was that the service providers were already sales tax collectors in some aspects of their business, charging tax, for instance, on the tangible property being installed, or on parts used for maintenance and repair. Accordingly, broadening the sales tax base to cover other transactions in their purview did not require new sellers to register and begin collections for the first time. It should be noted, though, that within the existing base—whether in North Carolina, Oklahoma, or anywhere else—many very small sellers succeed in complying with the sales tax, and there is little reason to believe that new services providers could not as well.

Iowa is typical of the states that have broadened their sales tax bases specifically to digital goods, like e-books, movie and music downloads, file storage, and software as a service (cloud-based software). Ride-sharing services are also included in the base broadening.[49] Criterion cited by a tax commission in the District of Columbia in advance of the adoption of its tax reform package included (1) purchase by final consumers and (2) services linked to tangible goods or real property situated in the District, making them difficult to purchase online or in another state.[50]

48 Morgan Scarboro, "Kentucky Legislature Overrides Governor's Veto to Pass Tax Reform Package," Tax Foundation, Apr. 16, 2018, https://www.taxfoundation.org/kentucky-tax-reform-package/.

49 North Carolina Department of Revenue, "Repair, Maintenance, and Installation Service," SD-16-4, Nov. 15, 2016, https://files.nc.gov/ncdor/documents/directives/SD-16-4.pdf.

50 D.C. Tax Revision Commission, "Recommendations: Final Report," May 2014, 22, http://docs.wixstatic.com/ugd/ddda66_b54af5563fa54a17af9b41fc06aa672f.pdf.

Newfound authority to tax remote sales,[51] along with Oklahoma's size and geography compared to the District of Columbia, may suggest greater possibilities in the Sooner State. Moreover, one might expect that, while Washington, D.C. hosts the offices of many professional service providers, the personal consumption of those services is more likely to take place in neighboring jurisdictions, limiting the appeal of such base broadening in a way that is less relevant to Oklahoma.

Ideally, Oklahoma would exceed the base broadening implemented by Kentucky, North Carolina, Iowa, and the District of Columbia, among others, though successes here provide encouragement as to the possibilities. Base broadening worked for these places. Oklahoma has the opportunity to go bolder—and to use the revenue to make its income tax more competitive.

PROPERTY TAXES

The *ad valorem* tax, Oklahoma's unusual nomenclature for its property tax, takes a backseat in local government finance compared to the role that property taxes play in other states. Property taxes are often thought of as a tax on land and structures (what is termed "real property"), which is true, but they are also imposed on tangible personal property, which is property that can be touched or moved. Despite the "personal" part of the name, almost all such property subject to taxation in Oklahoma is business property: machinery, equipment, and inventory.

In fact, 49 percent of all *ad valorem* taxes in Oklahoma are paid by commercial entities, almost evenly split between taxes on their real and personal property. Businesses pay property taxes on everything from their land and buildings (as one would expect) to their machinery and equipment, their furnishings and fixtures, and even the inventory they hold to sell to customers. When imposed on land and structures, the property tax can be quite economically efficient, but when it falls on capital investment, or on products being held for sale, it can distort decision-making and undermine the state's tax competitiveness. Oklahoma generally has low property taxes on homeowners, but treats commercial enterprises unfavorably compared to many of its peers.

The state also imposes a franchise tax, a tax on the capital stock of businesses. Because this is imposed on the value of the business or its assets, it too is best understood as a property tax, though unlike the *ad valorem* tax, it is collected at the state level.

Oklahoma's Limited Reliance on Property Taxes

Oklahoma relies on property taxes less than many other states. As a result, Oklahoma residents experience property tax burdens well below the national average. These effective rates are especially competitive compared to neighboring Texas and Kansas. Oklahoma homeowners face effective property taxes of 0.83 percent of the fair market value of owner-occupied housing.[52] Residents of Texas and Kansas, on the other hand, face effective rates of 1.6 percent (sixth highest) and 1.28 percent (15th highest) respectively.

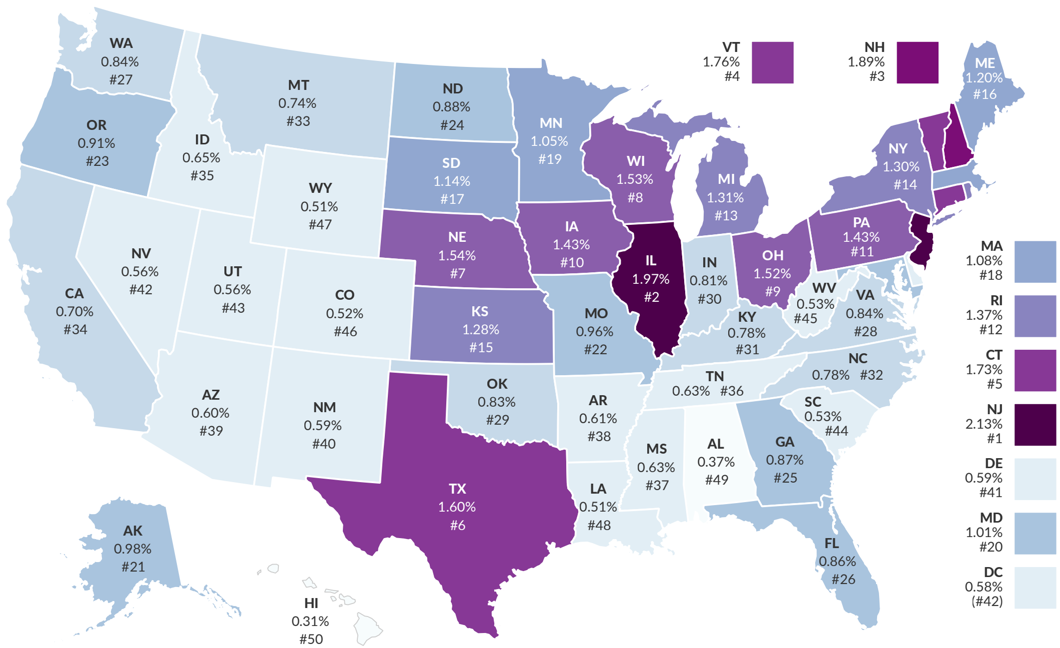
51 *South Dakota v. Wayfair, Inc.*, 585 U.S. ___ (2018); Joseph Bishop-Henchman, Hannah Walker, and Denise Garbe, "Post-Wayfair Options for States," Tax Foundation, Aug. 29, 2018, https://www.taxfoundation.org/post-wayfair-options-for-states/.

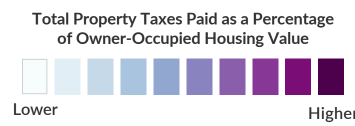
52 Janelle Cammenga, "How High Are Property Taxes in Your State?"

FIGURE 7.

Property Tax Effective Rates on Owner-Occupied Housing

Property Taxes Paid as a Percentage of Owner-Occupied Housing Value, 2019





Note: The figures in this table are mean effective property tax rates on owner-occupied housing (total real taxes paid/total home value). As a result, the data exclude property taxes paid by businesses, renters, and others. D.C.'s rank does not affect states' ranks, but the figure in parentheses indicates where it would rank if included.

Sources: U.S. Census Bureau, "2019 American Community Survey"; Tax Foundation

The state's low *ad valorem* taxes are largely explained by the fact that not all localities have the authority to levy these taxes, and that they are primarily used for school finance, whereas in much of the country, property taxes fund schools as well as local government operations. Counties, school districts, and assorted local health or emergency services may levy *ad valorem* taxes in Oklahoma, but cities may not, and local government operations are largely funded from local option sales taxes.[53]

This is atypical among states. Ordinarily, the property tax is the main source of local revenue, accounting for 71 percent of local tax collections nationwide in Fiscal Year 2018.[54] In Oklahoma, on the other hand, property taxes only provided 54.2 percent of local tax collections the same year. Most of the remaining revenue came from sales taxes, which accounted for 39.9 percent of local collections.

There are good reasons that property taxes are typically an important local funding source. Property taxes are more transparent than most other tax types: people often have a greater sense of what they pay in property taxes each year than they do for income taxes (much of which are typically withheld), let alone for sales taxes, which are paid in bits and pieces over the year. This transparency is good, but also makes the burden compare unfavorably to the burdens of other, less transparent, taxes in the minds of many taxpayers.

53 Tulsa County Assessor's Office, "Property Taxation 101," July 20, 2021, https://www.assessor.tulsacounty.org/PDFs/Property-Taxation-101.pdf.

54 Janelle Cammenga, "To What Extent Does Your State Rely on Property Taxes?" Tax Foundation, Jan. 19, 2021, https://www.taxfoundation.org/state-property-taxes-reliance-2021/.

Property taxes are also imposed on the value of owned property, which strikes some as unfair (paying taxes on something they already own), but which helps taxes on real property accord reasonably well with what is known as the benefit principle, where taxes are imposed in proportion to the benefit the taxpayer receives. The value of one's property corresponds, if imperfectly, with the market value of the benefits governments provide, like roads, police and fire protection, and schools. In fact, some of these expenditures are self-reinforcing: a better school district can improve the value of a property.

Local *Ad Valorem* Tax Authority

While it should not be considered a tax reform goal in and of itself, a gradual shifting of local reliance away from sales taxes and onto the property tax would allow the state more freedom in raising sales taxes to pay for other tax reform options in the future. Modestly higher rates on the sort of property that is appropriate to tax could also help reduce or eliminate reliance on classes of property that are rightly exempted in many states. As with any tax policy change, however, this shift would not be without trade-offs or difficulties.

Counties and school districts already have property tax authority, whereas *ad valorem* authority in cities is quite limited, consistent with its primary role of funding education to the exclusion of other local government services. Consequently, Oklahoma also relies more on state transfers to fund local government than many of its peers do. Ultimately, while it is a difficult undertaking, policymakers may wish to consider expanding property tax authority for both cities and counties to allow the tax to be used to fund more general government operations.

The issue of local property tax reliance is not one that can or should be solved overnight. However, it is necessary to be aware of the structuring of Oklahoma's property tax authority in order to understand how the state's local funding reliance can act as a restraint on state-level policy changes.

Tangible Personal Property Taxes

Oklahoma's property tax rates may be low, but there is more to a tax burden than rates alone. Tax structure can make a large difference in who bears the brunt of taxes and what their burdens look like. In Oklahoma's case, overall low rates help mitigate the damage from several uncompetitive structural elements.

As discussed earlier, taxes levied on real property generally align with the "benefit principle" of taxation: the beneficiaries of services are the ones funding those same services. The taxes are ideally levied on real property, and the property owners that pay taxes benefit from local services like schools and fire departments. Additionally, landowners cannot move their land in order to avoid tax liability—it is an immobile asset.

However, property taxes start to diverge from the benefit principle and cause economic distortion when they are levied on more than just real property. This is the case in Oklahoma and many other states which include tangible personal property (TPP) in their tax bases. The Sooner State relied on TPP for 22.74 percent of its property tax revenue in 2017, which is anomalously high.[55] In fact, while other states are showing a decreasing reliance on TPP, Oklahoma's reliance on TPP has increased in recent years.[56]

In contrast to real estate, TPP includes anything that can be touched or moved. Taxes targeted at TPP often fall on business inputs, as property such as machinery, equipment, and fixtures are part of a firm's production process, and their inventory—either of their own manufactured goods or those obtained at wholesale for sale to consumers—is part of their core business activity. Firms may pass along the tax in the form of higher prices when goods or services are sold in the production process, to the extent that their competitors are similarly disadvantaged. This may conceal the impact of the tax on consumers, as consumers may pay higher prices as a result of a tax on TPP. Companies competing in a multistate market against competitors not subject to such taxes are placed at a competitive disadvantage, as their peers elsewhere face lower tax costs on production.

As with a typical property tax, TPP liability is calculated by first determining the assessed value of the property and multiplying it by the assessment ratio for that class of property and finally by the millage (rate). However, determining the assessed value of TPP is much more involved than assessments on housing or real estate. These taxes are "taxpayer active"—the person paying the tax is responsible for keeping careful records of their possessions and how much they owe to the state. They must know the initial acquisition price of an asset and when it was placed into service, and they must depreciate it according to published schedules for each asset type. This creates significant compliance burdens for taxpayers in addition to the actual cost of the tax.

Assessment ratios may also be higher for TPP than for real residential property. Oklahoma is one of 15 states that allows localities to apply different assessment ratios for TPP than for other classes of property. Many localities take advantage of this freedom. In Oklahoma City, for example, real property sees an assessment ratio of 11 percent, while tangible personal property has a ratio of 13.75 percent.[57] According to statute, all types of TPP—whether inventory, machinery and equipment, or business furniture—are included under the classification of personal property.[58]

Taxes on TPP are a source of tax complexity and non-neutrality, incentivizing firms to change their investment decisions or relocate to avoid the tax. Because they are levied on the value of a business's tangible assets, TPP taxes reduce the return that can be generated by those assets. This can dissuade firms from making marginal investments in their enterprises.

Imagine, for example, a manufacturing firm considering a new investment in machinery that faces a 1.2 percent effective TPP tax rate annually (the average effective rate on inventory in Oklahoma). If the machinery can be fully expensed and depreciates at 5 percent per year, the effective tax rate on the marginal investment in machinery is 15 percent due to the TPP tax.[59] This means that at the break-

55 Lincoln Institute of Land Policy, "Significant Features of the Property Tax," 2021, https://www.lincolninst.edu/research-data/data-toolkits/significant-features-property-tax.

56 Garrett Watson, "States Should Continue to Reform Taxes on Tangible Personal Property," Tax Foundation, Aug. 6, 2019, https://www.taxfoundation.org/tangible-personal-property-tax/.

57 Oklahoma County Assessor's Office, "Figuring Taxes," https://assessor.oklahomacounty.org/215/Figuring-Taxes.

58 68 Okl.St.Ann. § 2807.

59 Calculations using a 7 percent rate of return.

even point, where an investment just covers costs in present value, marginal investment faces a 15 percent tax rate. This means that an investment that breaks even—earning a zero percent net return and covering costs in present value—faces a 15 percent tax rate. In other words, 15 percent of the gross return from the marginal investment covers the TPP tax. A TPP tax dissuades firms from making new investments.[60]

Seven states (Delaware, Hawaii, Illinois, Iowa, New York, Ohio, and Pennsylvania) exempt all tangible personal property from taxation, while another five states (Minnesota, New Hampshire, New Jersey, North Dakota, and South Dakota) exempt most such property from taxation except for select industries that are centrally assessed.

The Inventory Tax

While most states tax tangible personal property in some way, Oklahoma is one of 12 states—along with Alaska, Arkansas, Georgia, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Mississippi, Texas, and Vermont—that tax some or all inventory. Taxes on inventory are non-neutral, as businesses with larger quantities of inventory, like manufacturers and retailers, are disproportionately burdened by such taxes. Businesses with little to no inventory escape this form of property taxation, despite using local and state government services like firms with larger amounts of inventory.

Because it is levied on the value of a company's inventory, this base decision is especially harmful to large retail stores and other businesses that store large amounts of merchandise. Inventory taxes are highly distortionary, because they force companies to make decisions about production or stocking that are not entirely based on economic principles but rather on how to pay the least amount of tax on goods produced or held for sale. Inventory taxes also create strong incentives for companies to locate inventory in states where they can avoid these harmful taxes. Oklahoma's freeport exemption provides for inventory held temporarily in state for sale elsewhere,[61] but taxes inventory held in-state for ultimate in-state sale, creating an incentive to hold such inventory out-of-state where possible.

Economic Implications of TPP Taxation

The Tax Foundation's *Location Matters* study helps illustrate the extent to which tax structure can interact with tax rates to drive corporations' overall state and local tax burdens.[62] In this study, we design eight model firms and place them in each state (as both a new and a mature firm, since new firms are eligible for many incentives denied to long-established firms), calculating their tax liability.

The model distribution center illustrates the benefit of the freeport exemption. In its absence, one would expect a particularly high tax on this type of business in a state with inventory taxation, but in fact, their tax burdens on such firms are 14th and ninth best nationwide. The benefit this model firm receives, however, is not available to companies selling to Oklahomans. Companies which sell to

60 See generally, Huaqun Li, "Measuring Marginal Tax Rate on Capital Assets," Tax Foundation, Dec. 12, 2017, https://www.taxfoundation.org/measuring-marginal-tax-rate-capital-assets/.

61 Okla. Admin. Code 710:10-15-1

62 Jared Walczak, Katherine Loughead, and Janelle Cammenga, *Location Matters 2021: The State Tax Costs of Doing Business*.

Oklahomans must pay taxes on their inventory regardless of how long they hold onto it.[63] The model distribution center in *Location Matters* is able to take advantage of the freeport exemption because it makes only out-of-state sales, while many actual distribution centers in Oklahoma may not be as fortunate.

Even for companies that mainly sell out-of-state, a nine-month limit built into the freeport exemption penalizes businesses that sell products with longer shelf lives. Additionally, businesses must apply for this exemption every year and be approved in order to avoid the tax.

Oklahoma also provides an *ad valorem* exemption for new and expanded manufacturers, data centers, and research and development companies.[64] While presumably intended to shield manufacturers from the tax on machinery and equipment, this exemption favors new businesses and includes a number of employment, wage, and construction requirements that further limit which companies can benefit. The inventory tax is also an impediment to businesses due to the high compliance costs associated with it.

Reform Options

Oklahoma has already agreed to exempt short-term inventory and machinery for new manufacturers to encourage investment in the state. This concern for economic consequences is warranted, and the state should build on this strategy by working to reform its treatment of TPP (and particularly inventory) more broadly, rather than for targeted businesses.

Oklahoma's heavy reliance on tangible personal property may rule out a full repeal of TPP taxes, but there are several steps the state could take to make incremental improvements in its system.

First, the state should consider a full repeal of its inventory tax. This would undo some non-neutral tax treatment and make the state more attractive to retailers, distribution centers, and any other inventory-heavy businesses. This change would require a constitutional amendment, as the authority to tax personal property is given in the state constitution[65] and inventory is mentioned as a subset of personal property,[66] even if eligible personal property is defined more fully in statute.[67]

Because of the nature of property taxes, a state-level exclusion of inventory would have ramifications for local government revenue. Adjusting for the freeport exemption, the inventory tax brought in approximately $148 million for Oklahoma localities in 2020. If localities were authorized or required to exclude inventory from taxation, a 3 percent increase in collections on other property would offset the lost revenue. Particularly with property tax revenues rising in Oklahoma and across the country, it may be possible for local governments to absorb this transition if phased in over a number of years, even in the absence of millage increases.

63 OK Const. Art. 10, § 6A.
64 68 Okl.St.Ann. § 2902; 68 Okl.St.Ann. § 2887.
65 OK Const. Art. 10, § 6.
66 OK Const. Art. 10, § 6A.
67 68 Okl.St.Ann. § 2807.

The state currently places a rate limit on school districts.[68] A constitutional amendment eliminating the inventory tax might also adjust this limit to ensure school districts can retain their current funding levels. Oklahoma allows localities to set their own assessment rates for different classes of property, as long as they remain between 10 and 15 percent for personal property and between 11 and 13.5 percent for real property.[69] As such, different localities would likely rely on different combinations of millage increases and assessment rate increases in order to keep revenue stable.

Alternatively, the state could provide aid intended to offset the elimination of the inventory tax. Some states have experimented with tax credits to businesses to defray their liability, but this approach should be avoided, as it has several shortcomings. It continues to require businesses to comply with the tax, avoiding full savings on compliance costs. It has timing effects where businesses pay the tax before being made whole with the credit. And for many businesses, the credit may be unavailable, since they may not earn a profit in a given year and have no tax liability to offset.

If the state wishes to cover the $148 million necessary to repeal local inventory taxes, it would be far better to do so by formula-driven aid to localities. Inventory accounts for about 16.7 percent of tangible personal property tax collections, so states could make localities whole in a largely representative manner by modifying existing local aid formulas to augment each local government's remaining tangible personal property tax collections by about 20 percent. As the state's economy grows, the state may be able to absorb this cost out of growth and could even build a phasedown into a broader set of tax triggers.

Oklahoma lawmakers should also consider setting a *de minimis* threshold for tangible personal property taxes more broadly. This exempts a certain amount of TPP from taxation, giving relief to businesses which would not have provided much revenue for the state—and, in some cases, may have seen compliance costs higher than their tax payments. This will take many small businesses off the rolls at minimum revenue loss. Many small businesses face negligible liability but are still forced to go through a tedious compliance process.

Any exemption threshold should also be a filing threshold. This reduces compliance costs for firms, as firms under the threshold may have to file in many localities if filing requirements remain in place even when companies' taxable property is under the *de minimis* threshold. Indiana, for example, previously required taxpayers to file a TPP tax return and pay filing fees even if they qualified for exemption. In April 2019, the state prohibited counties from collecting TPP tax filing fees but kept the filing requirement for exempt taxpayers.[70]

68 OK Const. Art. 10, § 9.

69 OK Const. Art. 10, § 8.

70 Katherine Loughead, "Indiana Chips Away at Tangible Personal Property Taxes," Tax Foundation, Apr. 5, 2019, https://www.taxfoundation.org/indiana-tangible-personal-property-tax/.

Revenue impacts from a *de minimis* threshold would likely be minimal. A 2015 study on the state of Connecticut examined the possible effects of various personal property tax thresholds. The study estimated that a $5,000 *de minimis* would decrease revenues by 0.006 percent; a $7,500 threshold by 0.010 percent; and a $10,000 threshold by 0.014 percent.[71] Assuming these same percentages of impact on business TPP collections in Oklahoma, potential revenue changes would be as follows—statewide:

TABLE 10.

Potential Revenue Impacts of *De Minimis* Thresholds

Threshold Amount	Revenue Decrease
$5,000	$55,805
$7,500	$93,008
$10,000	$130,212

Sources: Lawrence C. Walters; Tax Foundation calculations.

The state has many examples to follow if it pursues this route. Indiana recently raised its *de minimis* exemption from $20,000 to $40,000 in business personal property per county and prohibited counties from collecting TPP tax filing fees from businesses that file but do not have a tax liability.[72] Indiana originally implemented its $20,000 *de minimis* exemption in 2015, and 89,749 taxpayers took advantage of the exemption.[73] An additional 28,300 exemptions were projected by the Indiana Legislative Services Agency as a result of the increase in the exemption threshold.

Utah, Colorado, Idaho, and Indiana have also enacted or expanded *de minimis* exemptions. Utah exempts individual items of TPP with an acquisition cost of $1,000 or less in addition to exempting TPP with a fair market value under $10,800.[74] In Colorado, the legislature added a state income tax credit to reimburse taxpayers' TPP tax between $7,001 and $15,000, effectively raising the state's $7,700 TPP exemption.[75]

If Oklahoma decides to implement a *de minimis* exemption, it should index this exemption for inflation. Otherwise, while the nominal value of the exemption will stay the same, the real value will decrease, exposing progressively smaller companies to tangible personal property taxes.

Making changes to the property tax base may be more complex than making tax changes on the state level. However, removing inventory from the tax base and creating an exemption for businesses under a certain level of personal property would go a long way to simplify the state's property tax system. A property tax that does not unfairly penalize certain businesses over others will create an environment that is more welcoming to businesses both new and old.

71 Lawrence C. Walters, "The Business Personal Property Tax in Connecticut," Romney Institute of Public Management, Brigham Young University, Nov. 17, 2015, https://www.cga.ct.gov/fin/tfs/20140929_State%20Tax%20Panel/20151117/Business%20Tangible%20Property%20Tax%20Walters.pdf.

72 Katherine Loughead, "Indiana Chips Away at Tangible Personal Property Taxes."

73 Id.; and Indiana Legislative Services Agency, "SB 233 Fiscal Impact Statement," Apr. 2, 2019, http://iga.in.gov/legislative/2019/bills/senate/233#document-0225b146.

74 Utah Code Ann. § 59-2-1115; see also Utah Tax Commission, "Business Personal Property Taxes," January 2019, https://tax.utah.gov/forms/pubs/pub-20.pdf.

75 Colo. Rev. Stat. § 39-22-537.

The Franchise Tax

Unlike corporate income taxes, which are levied on a business's net income (or profit), franchise taxes (also called capital stock taxes) are levied on a business's net worth. As a form of corporate wealth taxation, the franchise tax bears many of the same inefficient hallmarks of an individual wealth tax but with additional implications for the economy. As a result, only 16 states still levy capital stock taxes. Over the last 10 years, four states have repealed their franchise taxes and two more are in the process of phasing them out. The Sooner State has exempted limited liability corporations (LLCs) from the tax, but requires C and S corporations to pay.[76]

The term "capital stock" is easily conflated with the unrelated concept of "capital gains." However, capital stock taxes apply to the total accumulated wealth of a business, not its investment returns. Capital stock includes the value of all the physical components a firm uses to generate its goods or services, minus the firm's debt. Moreover, the requirement to remit the capital stock tax is absolute and does not depend on market appreciation. In fact, this invariability is a major aspect of what makes the tax so damaging. Franchise taxes are levied regardless of whether a business makes a profit. Thus, franchise taxes are especially onerous for businesses during periods of economic downturn and are a burden to new businesses that have yet to turn a profit.

Taxing a company based on its net worth essentially penalizes the firm for making additional capital investments. This disincentive results in firms that underproduce and operate below their full potentials. Purchasing additional equipment, or replacing old equipment, becomes more costly—both in terms of tax liability and tax compliance costs. Without additional capital investment, fewer workers are hired, and those that are employed are less productive. Since productivity directly influences wages, underproducing workers are also unable to realize their full earning potential. In short, the unintended consequences of capital stock taxation can have a limiting effect on the state's economy.

Oklahoma's franchise tax is imposed at a low rate and is capped at $20,000, which means that for many businesses, it operates chiefly as a nuisance tax. Businesses must track asset values and remit these taxes at a considerable cost of time and effort.

Capital stock taxes used to be much more common, but over time, lawmakers began to realize their negative economic impact. Accordingly, many states reduced such taxes or repealed them altogether. Kansas phased out its capital stock tax prior to tax year 2011. It was followed by Virginia and Rhode Island in 2015 and Pennsylvania in 2016. Mississippi is in the process of phasing out its capital stock tax, which should be eliminated by 2028.[77] Likewise, Connecticut is also phasing out the tax and is expected to complete the process by 2024.

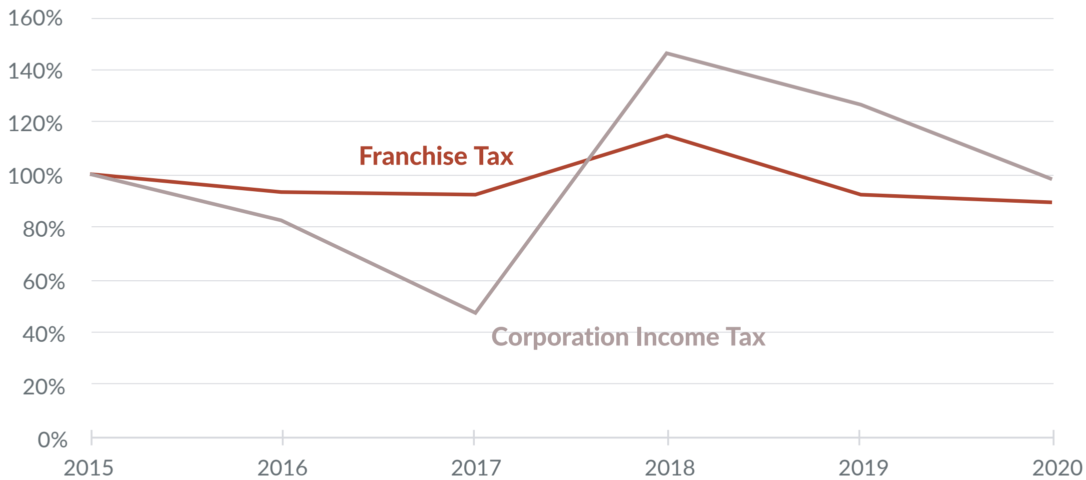
76 Oklahoma Tax Commission, "2020 Oklahoma Small Business Corporation Income and Franchise Tax Forms and Instructions," https://oklahoma.gov/content/dam/ok/en/tax/documents/forms/businesses/corporate-income-tax/current/512-S-Pkt.pdf.

77 Joseph Bishop-Henchman, "Mississippi Approves Franchise Tax Phasedown, Income Tax Cut," May 16, 2016, https://www.taxfoundation.org/mississippi-approves-franchise-tax-phasedown-income-tax-cut/.

FIGURE 8.

Franchise Taxes Do Not Adjust to Changes in Profitability

Annual Percent Change in Revenue, Corporation Income and Franchise Taxes, 2015-2020



Sources: Oklahoma Tax Commission; Tax Foundation calculations.

TABLE 11.

State Capital Stock (Franchise) Tax Rates

As of July 1, 2021

State	Tax Rate	Max Payment
Alabama	0.175%	$15,000
Arkansas	0.3%	Unlimited
Connecticut (a, b)	0.26%	$1,000,000
Delaware	0.035%	$200,000
Georgia	(c)	$5,000
Illinois	0.1%	$2,000,000
Louisiana (d)	0.3%	Unlimited
Massachusetts (a)	0.26%	Unlimited
Mississippi (e)	0.175%	Unlimited
Nebraska	(c)	(f)
North Carolina	0.15%	Unlimited
New York	0.1875%	$5,000,000
Oklahoma	0.125%	$20,000
South Carolina	0.1%	Unlimited
Tennessee	0.25%	Unlimited
Wyoming	0.02%	Unlimited

(a) Taxpayer pays the greater of corporate income tax or capital stock tax liability.
(b) Tax will be fully phased out by January 1, 2024.
(c) Based on a fixed dollar payment schedule. Effective tax rates decrease as taxable capital increases.
(d) The rate is 0.15% for the first $300,000 of taxable capital.
(e) Tax will be fully phased out by Jan. 1, 2028.
(f) Nebraska's Corporation Occupation Tax is due every other year. The maximum tax is $23,990 for domestic (Nebraska) corporations and $30,000 for foreign (out-of-state) corporations.

Note: Capital stock taxes are levied on net assets of a company or its market capitalization.
Sources: State statutes; state revenue departments; Bloomberg Tax.

Only two states have retraced their steps. New York finished a phaseout of the state's capital stock tax as of January 1, 2021, but the legislature decided to temporarily reinstate the tax due to coronavirus-related budget concerns. Similarly, Illinois had plans to exempt all capital stock from taxation by January 1, 2024.[78] However, after two years Illinois reneged on its phaseout plan and opted instead to freeze the franchise tax exemption at $1,000.[79]

Reform Options

To modernize Oklahoma's tax code, reduce the burden on businesses, and improve earning opportunities for workers, Oklahoma should work to repeal its franchise tax.

The state's franchise tax currently has a flat rate of 0.125 percent, with a cap of $20,000 on payments. The low rate and inclusion of a payment cap imply that Oklahoma lawmakers already understand the damaging nature of the capital stock tax. However, even this careful treatment has turned the franchise tax into something of a nuisance tax. Most payments are relatively low, but all businesses must still file and absorb the accompanying compliance costs.

Oklahoma has many examples to follow if it wants to eliminate this tax. States have commonly eliminated their capital stock taxes through scheduled rate reductions. Oklahoma could do the same to ensure gradual revenue losses that could be absorbed into a combination of natural growth and specified revenue offsets.

In fiscal year 2020, the state's franchise tax brought in $55 million, a relatively modest sum compared to the $511 million raised by the corporate income tax, and less than 0.5 percent of state tax collections.[80] Oklahoma could afford to begin phasing out the tax over time, as many of its peers have done, or even eliminate it in one fell swoop subject to revenue availability.

With revenues better than expected coming out of the pandemic, Oklahoma is in a good position to begin reducing reliance on taxes which discourage investment, impose high compliance and administrative costs, and are imposed without regard to ability to pay. Elimination of this antiquated tax would put Oklahoma in good company with other states which deemed the forgone revenue sufficiently modest to permit the gradual elimination of franchise taxation.

78 Mary Kay McCalla Martire and Lauren A. Ferrante, "Illinois Fiscal Year 2020 Income and Franchsie Tax Changes," *The National Law Review*, June 13, 2019, https://www.natlawreview.com/article/illinois-fiscal-year-2020-income-and-franchise-tax-changes.

79 Illinois Public Act 102-0016 (2021).

80 Oklahoma Tax Commission, "FY 2020 Revenue & Apportionment Report," https://oklahoma.gov/content/dam/ok/en/tax/documents/resources/reports/annual-reports/otc/AR-2020.pdf.

CONCLUSION

Oklahoma policymakers have a range of options to make their tax code more attractive to individuals and businesses alike. Some are big actions, like dramatically reducing reliance on, or even eliminating, the individual income tax, which will require thoughtful consideration and long-term fiscal planning. Others may be much less well-known, like repealing the throwback rule or phasing out the taxation of inventory, but could still have a profound impact on Oklahoma's competitive standing.

Several of the proposals in this publication could be adopted on a standalone basis, because they would have a negligible revenue impact or because they could be reasonably paid for out of anticipated revenue growth. Others are best accomplished with tax swaps, pairing additional revenues generated from more economically efficient taxes with reduced reliance on more distortive modes of taxation. Revenue triggers, better designed than the ones Oklahoma tried previously, can also help ensure that a portion of future revenue growth is dedicated to enhancing Oklahoma's tax climate.

The state's options include:

Individual Income Tax Reforms

- 3 percent top marginal income tax rate, in an across-the-board cut, paid for with moderate sales tax base broadening
- 2 percent or lower top marginal income tax rate due to sales tax base broadening and higher sales tax rates
- Single-rate income tax with a $10,350 standard deduction
- Consumed income tax with a higher rate but the elimination of the tax's current penalty on saving and investment
- Income tax rate reductions phased in over time using revenue triggers

Corporate Income Tax Reforms

- Repeal of the throwback rule to eliminate the corporate tax's penalty on in-state sellers
- Single sales factor apportionment to eliminate the current heavier taxation of in-state investment
- Permanent full expensing to lock in the benefits of immediate cost recovery

Sales Tax Reforms

- Moderate base broadening (about $732 million at current rates) to modernize and stabilize the tax base while facilitating income tax rate relief
- Sourcing of the sale of services to the market, and not where the service is performed
- Adjusting local option sales taxes to maintain revenue neutrality at the local level if sales tax bases are broadened

Property Tax Reforms

- Adopting a *di minimis* exemption for tangible personal property to take the smallest businesses entirely off the tax rolls
- Repeal of the inventory tax, either with a local phaseout or state transfers
- Elimination of the franchise tax

The Tax Foundation's *State Business Tax Climate Index*, which measures tax structure, can help illustrate how some of these reforms would enhance Oklahoma's competitive standing. The *Index* scores states across five broad tax categories (corporate, individual, sales and excise, property and wealth, and unemployment insurance taxes), with rankings within each category and overall. While not every reform proposed in this publication would affect Oklahoma's performance on the *Index*, many of the major reforms would yield significant improvements from the state's current 30th place ranking.

Several possible reforms are ranked separately here, then scored again as comprehensive reform packages. Within the comprehensive reform package, converting the individual income tax to a single-rate tax is also contemplated. Of course, many variations of these plans are possible, and several additional valuable reforms would not be reflected on the *Index*.

TABLE 12.

Sample Tax Reform Options with Projected *Index* Rankings

	Overall	Corporate	Individual	Sales	UIT	Property
Current Ranking	30	11	33	39	1	29
3% Top PIT with Sales Tax Broadening	25	11	27	38	1	29
Inventory or Franchise Tax Repeal	27	11	33	39	1	14
Inventory and Franchise Tax Repeal	25	11	33	39	1	8
Throwback Rule Elimination	29	8	33	39	1	29
All Reforms Listed Above	18	8	27	38	1	8
All Reforms with 3% Flat Tax	11	8	17	38	1	8

Sources: State Business Tax Climate Index; Tax Foundation calculations.

There is clear appetite for tax reform in Oklahoma—serious, meaningful reform that not only reduces rates but positions the state for long-term success. Oklahoma's competitors are not resting on their laurels, and Oklahoma faces an urgent need to further diversify its economy and compete with regional and national rivals. Tax reform is not the only thing that matters in attracting people and jobs to the Sooner State, but it is a valuable tool in the legislature's toolkit. Lawmakers should finish the work they have begun over the past few decades, tackling tax rates *and* structures to give the state a leg up in an era of enhanced competition.

ABOUT THE TAX FOUNDATION

The Tax Foundation is the nation's leading independent tax policy research organization. Since 1937, our research, analysis, and experts have informed smarter tax policy at the federal, state, and global levels. Our Center for State Tax Policy uses research to foster competition among the states and advises policymakers on how to improve their tax systems.

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Oklahoma policymakers have been grappling with tax reform for decades, spurred by a desire to enhance the state's competitiveness, and particularly to better compete with regional peers. While reforms have yielded meaningful reductions in both individual and corporate income tax rates, many elements of Oklahoma's tax code remain an impediment to its competitive standing.

Fortunately, Oklahoma finds itself in a good position: the state is in need of pro-growth tax reform at the very same time that it has a revenue buffer to help absorb transition costs from tax policy changes.

This publication is designed to provide policymakers with a menu of options: some of them bold, comprehensive approaches and others small stand-alone policy tweaks, but all designed to make Oklahoma a more attractive place to live and work. The state needs a growth agenda, and it cannot come too soon.

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