The Beacon Hill Institute

Repealing Oklahoma Franchise Tax: Lowering Businesses Costs, Boosting the Economy

Executive Summary

The Beacon Hill Institute at Suffolk University (BHI) applied its STAMP® (State Tax Analysis Modeling Program) to estimate the effects of permanently repealing the Oklahoma franchise tax. We simulated the effect of similar tax changes in other states to ascertain the effects of repealing the franchise tax in Oklahoma.

BHI found that repealing the Oklahoma Franchise Tax would:

- increase private employment by 500 jobs;
- boost investment by over $135 million; and
- increase real disposable income by $85 million.

The state would forgo approximately $47.6 million franchise revenues, based on the latest data from Fiscal Year (FY) 2009-2010. However, the revenue lose would be mitigated by increases in income, sales and severance tax revenues due to the economic effects of the tax repeal.

Tax policy has real implications for the health of state economies, a fact frequently neglected in discussions of most tax changes. Our results show that permanently repealing the Oklahoma franchise tax would increase the return to capital investment, which, in turn boosts investment, employment and incomes of Oklahoma families. The governor and new legislature should take tax reform seriously in the upcoming term to further promote the competitiveness of the Oklahoma economy.

Introduction

The Oklahoma system of taxation relies on sales and income taxes for the bulk of state revenues, in addition to severance taxes on oil and gas. Up until July 1, 2010, the state also collected a state franchise tax, accounting for $47.6 million in revenue in FY 2009 - 2010. On that date, the state suspended the collection of the tax, and in doing so, reduced the economic distortions of the franchise tax.

The franchise tax punishes those companies with a nexus in the state, which tends to hinder economic growth and, at the state-level, discourage labor and capital formation. However, the moratorium adds uncertainty in businesses planning, insofar as the state government could decide to begin collecting the tax again. A permanent repeal of the franchise tax would remove this uncertainty.

The Oklahoma franchise tax was levied directly on the state's business sector. Each business located, or doing business, in the state was required to calculate and pay the franchises tax based on the amount of dollars invested or employed in the state. The franchise tax is imposed on firms' profits, which, in turn, reduces the after tax return to capital and, any tax on the earnings of capital discriminates against saving and risk taking.

Tax Results

The Beacon Hill Institute at Suffolk University (BHI) used its State Tax Analysis Modeling Program (STAMP®) to estimate the effects of permanently repealing the Oklahoma franchise tax on the state economy.[1] STAMP is a five-year dynamic Computable General Equilibrium model that simulates the economic effects of changes in taxes, costs (general and sector specific) and other "exogenous" variable changes. As such, it provides a mathematical description of the economic relationships among producers, households, governments and the rest of the world.

STAMP is general in the sense that it takes all the important markets, such as the capital and labor markets as well as flows into account. It is an equilibrium model because it assumes that demand equals supply in every market (goods and services, labor and

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[1] For a description about the STAMP model see
http://www.beaconhill.org/STAMP_Web_Brochure/STAMP_HowSTAMPworks.html.

capital). This equilibrium is achieved by allowing prices to adjust within the model. And it is computable because it can be used to generate numeric solutions to policy and tax changes.

We analyzed the effects of a reduction in a state franchise tax in three other state STAMP models to estimate the effect in Oklahoma. To make the size of the tax reduction similar across different states, we used the ratio of franchise tax revenues relative to Gross Domestic Product (GDP) by state.[2] In fiscal year 2010, the franchise tax represented 0.034 percent of Oklahoma's GDP. We calculated the amount of tax revenue in Texas, Pennsylvania and North Carolina that would also represent 0.034 percent of each state's GDP and modeled a tax cut in the respective STAMP models.

We then averaged percent changes to relevant economic variables due to the tax change across the three STAMP models. We applied average percent change to projected economic indicators for Oklahoma in 2013 to obtain our estimate of the effect of permanently repealing the franchise tax.

We assumed the franchise tax will be permanently repealed in 2013 and report the results for that year and 2017.   STAMP allows us to calculate the dynamic revenue effects, as opposed to static effects, under the tax change.

Static estimates assume that there is no change in underlying economic activity in response to a change in tax law. For example, a static estimate of a cut in the franchise tax, say from 1% to 0.5%, would cause revenues to fall by 50% (=1 – 0.5)/1). A dynamic estimate would show a smaller drop in revenue because it would capture the positive effect on the tax base of the cut in the property tax. The complete elimination of the franchise tax would not enable any dynamic revenue effects for the tax itself, since the rate would be zero. However, businesses would have more money to make profitable investments in Oklahoma, thus increasing investment and employment, incomes and retail sales which, in turn, boosts sales and property tax collections. One of the principal purposes of STAMP is to capture such dynamic effects.

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[2] U.S. Department of Commerce, Bureau of Economic Analysis, GDP & Personal Income Tables, http://www.bea.gov/iTable/iTable.cfm?reqid=70&step=1&isuri=1&acrdn=1#reqid=70&step=1&isuri=1.

Table 1 displays the results of permanently repealing the franchise tax against a baseline of no tax policy change; that is allowing the franchise tax to be assessed again.

Table 1: Economic Effects of Repealing the Oklahoma Franchise Tax (2013)

Private Employment (jobs)	500
Gross Wage Rate ($ per worker)	9
Investment ($ millions)	135
Real Disposable Income ($ millions)	85
Change in State Tax Revenues ($ millions)	-39

The absence of the franchise tax leads to a reduction in the after-tax burden on income derived from capital investments. This provides an incentive for business owners inside Oklahoma to continue investing in their businesses. Investment in the state will be $135 million higher, compared to a baseline of allowing the moratorium to end. This higher level of investment will be coupled with 500 more jobs in the state, as workers will be need to operate the new investments. Higher demand for labor will push up average annual wage rates by $9 per worker.

Investment projects that may not have been profitable enough to justify the investment when taking into account the franchise tax, now become more profitable on an after tax basis. Moreover, firms looking to locate new facilities in the United States would find Oklahoma even more attractive location in the absence of the franchise tax. As a result, real disposable income will be $85 million higher than a baseline of the franchise taxes reinstatement.

The economic boost produced reduces the loss of tax revenue due to the franchise tax repeal. In FY 2010 the franchise tax collected $47.6 million, according to the Oklahoma tax Commission.[3] We estimate that under the franchise tax repeal, the state would lose $47.6 million in revenue from that tax. However, the boost to the economy would increase income, sales, severance tax and other tax revenues. Thus, the state would only lose $39 million in tax revenues under permanent repeal of the franchise tax.

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[3] Oklahoma Tax Commission Annual Report 2012, Oklahoma Tax Commission, http://www.tax.ok.gov/annrpts.html,

Conclusion

When elected officials discuss tax changes, they tend to highlight the benefits of higher government spending or investment. However, any discussion must include an estimate of how the state's economy will respond to tax changes. Tax cuts do not exist in a vacuum; consumers, investors and taxpayers often change their behavior in response to lower taxes. This can lead to more demand for labor and capital, strengthening a state's economy.

Like all governments, Oklahoma state government relies on a healthy underlying economy for tax revenue. As we show with STAMP, lower businesses taxes attract and retain productive companies, while fostering entrepreneurs and start-ups. Permanently repealing the state franchise tax will produce a strong state economy for its residents.

Methodology

To identify the economic effects of the tax discounts and understand how they operate through a state's economy, BHI utilized its STAMP (State Tax Analysis Modeling Program) model. STAMP is a five-year dynamic CGE (computable general equilibrium) model that has been programmed to simulate changes in taxes, costs (general and sector specific) and other economic inputs. As such, it provides a mathematical description of the economic relationships among producers, households, governments and the rest of the world.[4]

A CGE tax model is a computerized method of accounting for the economic effects of tax policy changes. A CGE model is specified in terms of supply and demand for each economic variable included in the model, where the quantity supplied or demanded of each variable depends on the price of each variable. Tax policy changes are shown to affect economic activity through their effects on the prices of outputs and of the factors of production (principally, labor and capital) that enter into those outputs.

A CGE model is in "equilibrium," in the sense that supply is assumed to equal demand for the individual markets in the model. For this to be true, prices are allowed to adjust within the model (i.e., they are "endogenous"). For instance, if the demand for labor rises, while the supply remains unchanged, then the wage rate must rise to bring the labor market into equilibrium. A CGE model quantifies this effect.

Finally, a CGE model is numerically specified ("computable"), which is to say it incorporates parameters that are believed to be descriptive of the actual relationships between quantities and prices. It produces estimates of changes in quantities (such as employment, the capital stock, gross state product and personal consumption expenditures) that result from changes in prices (such as the price of labor or the cost of capital) that result from changes in tax policy (such as the substitution of an income tax for a sales tax).

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[4] For a clear introduction to CGE tax models, see John B. Shoven and John Whalley, "Applied General-Equilibrium Models of Taxation and International Trade: An Introduction and Survey," *Journal of Economic Literature* 22 (September, 1984): 1008. Shoven and Whalley have also written a useful book on the practice of CGE modeling entitled *Applying General Equilibrium* (Cambridge: Cambridge University Press, 1992). See also Roberta Piermartini and Robert Teh *Demystifying Modelling Methods for Trade Policy* (Geneva, Switzerland: World Trade Organization, 2005) http://www.wto.org/english/res_e/booksp_e/discussion_papers10_e.pdf (February 7, 2013).

The Beacon Hill Institute at Suffolk University in Boston focuses on federal, state and local economic policies as they affect citizens and businesses. The Institute conducts research and educational programs to provide timely, concise and readable analyses that help voters, policymakers and opinion leaders understand today's leading public policy issues.