



Oklahoma Economic Report™

News and analysis of Oklahoma's economy

A publication of the Office of the State Treasurer • Treasurer Ken Miller, Ph.D.

Shifty business

States have less than six months to prepare for the first set of consequences of Washington's inability to reach agreement on reducing the national debt. The last battle over raising the federal government's debt limit resulted in the Budget Control Act of 2011 that mandates \$1.2 trillion in spending cuts over 10 years, beginning January 2013.

One likely place federal spending will be reduced is in payments to state governments for operation of mandated programs.

Some on the receiving end view the trend as unfunded mandates and

unwanted competition for already strained resources. Others see the shift as federalism in action; reevaluation of the roles of national and sub-national governments and an opportunity for more local control.

In 1995, this philosophy helped drive reform of several aid programs into the Temporary Assistance to Needy Families (TANF) Act. TANF replaced several long-standing federal programs with block grants to states, giving them more flexibility in designing their own limits and requirements within general guidelines.

The House Budget Committee's budget resolution for Fiscal Year 2013, perhaps the most aggressive budget plan offered in Congress and the only one to pass a chamber, calls for similar changes to Medicaid. The proposal, authored by committee chairman Congressman Paul Ryan, would convert the joint federal-state program into block grants to the states.

Projected to save \$810 billion in federal spending over 10 years, the block granting of Medicaid would constrain the program's ballooning costs.

SEE SHIFTY PAGE 3

Inside

- Treasurer's commentary: Budget briefing
- 529 Plans: One of the best ways to save for college
- Total collections grow in May as gross production slides
- State employment reaches record levels
- Economic indicators

Contributors

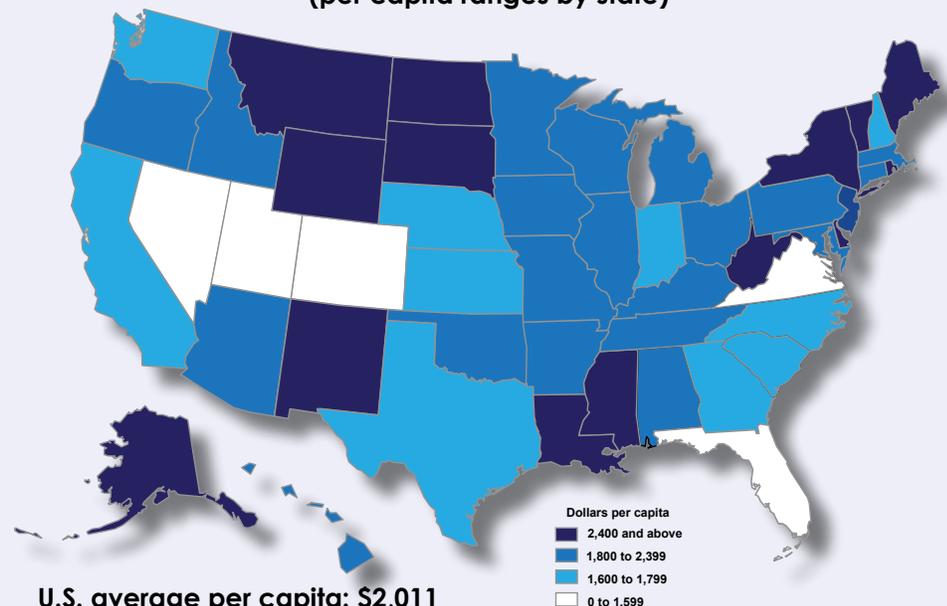
Regina Birchum, Deputy Treasurer for Policy

Paul Ackerman, CPA

Editor

Tim Allen, Deputy Treasurer for Communications

Federal Aid to State and Local Governments (per capita ranges by state)



Source: US Census Bureau, Federal Aid to States for Fiscal Year 2010



Treasurer's Commentary By Ken Miller, Ph.D.



Budget briefing

With the primary elections passed, most state lawmakers can now take a deep breath and plan for the next legislative session. Though adjourned only four weeks ago, the last legislative session seems a distant memory. Most pundits have long since weighed in and it seems what didn't happen will likely overshadow what did.

Regardless of one's opinion of the many unsuccessful tax cut proposals, most would agree that each was sufficiently bold. Less aggressive were this session's spending reforms. A thorough review of the FY 2013 budget reveals both good and bad.

Positives include holding the line on spending for most agencies while providing targeted increases into the core areas of education, transportation, public safety and health and human services. This year's General Appropriations bill increased by 4.9 percent compared to last. Adding FY 2012 supplemental funding to the mix,

the 3.2 percent increase is lower than population growth plus inflation.

Negatives include the perpetual problem with prioritization and continued dependence on non-recurring revenue sources. Unnecessary programs continue to siphon taxpayer resources from core areas critical to our state's success. Simply limiting spending growth is not enough. Non-core functions must be eliminated so funding can be redirected into areas of highest return and responsibility. Perhaps then, budget writers will not need to supplement certified revenues with well over \$100 million in one-time funds while working to eliminate recurring funds.

That being said, those who paint current officeholders as the biggest spenders in state history are being disingenuous.

A recent Tax Foundation study cited by critics lists states according to their spending increases, with Alaska and Oklahoma on opposite ends.

The report claims Alaska has the nation's lowest spending increase. The state leaves little else to emulate. It has the largest government in the country

“Simply limiting spending growth is not enough.”

at over 28 percent of its Gross State Product (GSP), a 48 percent tax on energy extraction and a \$57 billion reserve, the result of over-taxation more than five times its annual budget.

Thanks to the inclusion of federal dollars, the study shows Oklahoma with the highest spending increase over the last decade. Federal spending is the responsibility of Congress and the President, not state lawmakers; even though many Oklahomans might appreciate more of their tax dollars returning to support transportation and troops. Nonetheless, such spending increases will subside if Washington finally gets serious about taming its deficits.

The total increase in Oklahoma state appropriations since FY 2006 – the first budget written under new party leadership – is, as with this year's budget, lower than population growth plus inflation. Even so, government size in Oklahoma has

SEE COMMENTARY PAGE 3



Commentary

FROM PAGE 2

crept from 18 percent of GSP in 2005 to the national average of 21 percent. This negative trend will likely worsen

with certain federal cost-shifting ahead. Unless serious reexamination of state responsibilities occurs, needed tax reform will prove most difficult.

Each approaching session brings

opportunity to tackle problems and build on successes. Oklahoma is already doing a lot of things right, but has room for improvement. Let's plan to make next session's spending reforms as bold as the tax cut proposals are sure to be.

Shifty

FROM PAGE 1

However, states would have increased responsibilities and the burden of either spending more or making significant cuts.

Ryan says Medicaid's current structure gives states a "perverse incentive to grow the program and little incentive to save," as states pay less than half the costs of the program.

States historically adverse to program cuts are now being proactive in anticipation of reduced federal support

of Medicaid, which is expected with or without the Ryan plan. The Congressional Budget Office estimates that, without changes, federal spending on Medicaid alone will grow nearly \$350 billion over the next 10 years.

Medicaid costs will increase even more if the Affordable Care Act is implemented as planned. Every state has citizens who are eligible for the program but are not enrolled. According to the Oklahoma Health Care Authority, there are at least 44,000 Medicaid-eligible children who are currently not enrolled that would be added. The number of Oklahoma residents that are eligible

but not participating is surely greater, but the authority notes it is difficult to estimate. For comparison, the number of Medicaid-eligible new entrants for Texas is expected to be around one million.

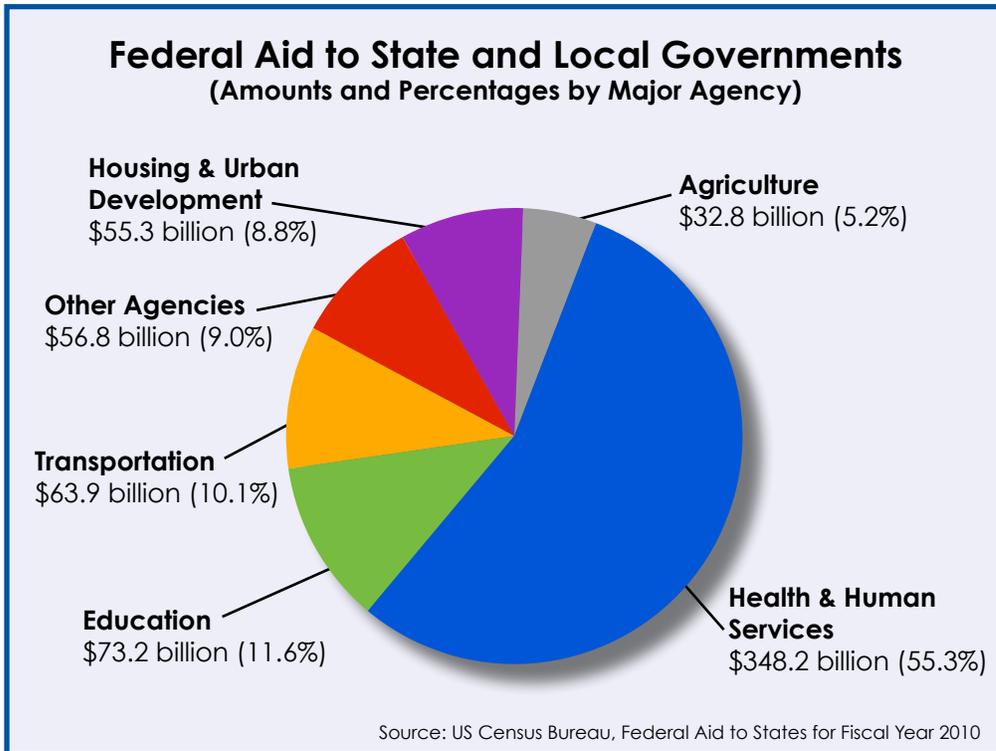
The Chairman of the Senate Budget Committee, Sen. Kent Conrad, agrees with Ryan that the nation's debt level is unsustainable, but contends that cuts and dramatic changes in Medicaid and other programs can be avoided by increasing revenue through tax policy.

The Ryan budget passed the House but it, along with four other budget plans, was rejected by the Senate. Aside from the forced cuts required by the Budget Control Act, the states have no indication of what a long-term budget plan from Congress might look like.

States are being put on notice by bond rating agencies, which have said the level of a state's dependency on federal funding could negatively impact ratings if the state does not demonstrate an ability to address a reduction in aid. Total federal spending in Oklahoma was estimated at \$37.5 billion in 2010, while total state and local spending was approximately \$31 billion.

Earlier this month, the governor of Illinois signed into law a plan that includes \$1.6 billion in Medicaid cuts. Florida recently changed the way counties are billed for Medicaid costs

SEE SHIFTY PAGE 4





Shifty

FROM PAGE 3

and authorized the state to withhold sales tax revenue from counties to cover past and future Medicaid costs.

As the feds evaluate national vs. local responsibilities, states are also looking for ways to shift responsibility of services

onto federal support. Several states are looking to mimic a program first implemented in Washington that moved thousands of veterans off the state's Medicaid rolls and onto benefits provided by the U.S. Department of Veterans Affairs.

The federal fiscal reckoning has states reconsidering benefit programs. Maryland, one of the few states that bear the entire employer cost of teacher pensions, is considering making local

governments pick up half the cost. Illinois is considering shifting some state-funded pension benefits onto employers. The governor-led effort focuses on employees who are not directly employed by the state, such as those working for universities or schools.

“The federal fiscal reckoning has states reconsidering benefit programs.”

Amid the attempts to push burdens off the states, some are seeking to move select responsibilities to the states, provided the money comes too. Representatives from

New Jersey and Utah support a plan to shift most of the responsibility for transportation to the states, along with the bulk of gas tax revenue.

The Surface Transportation and Taxation Equity (STATE) Act would reduce the federal tax on fuels to as little as two cents if states choose to make up the difference through state gas taxes. Other proposals to phase out federal transit programs or allow states to manage

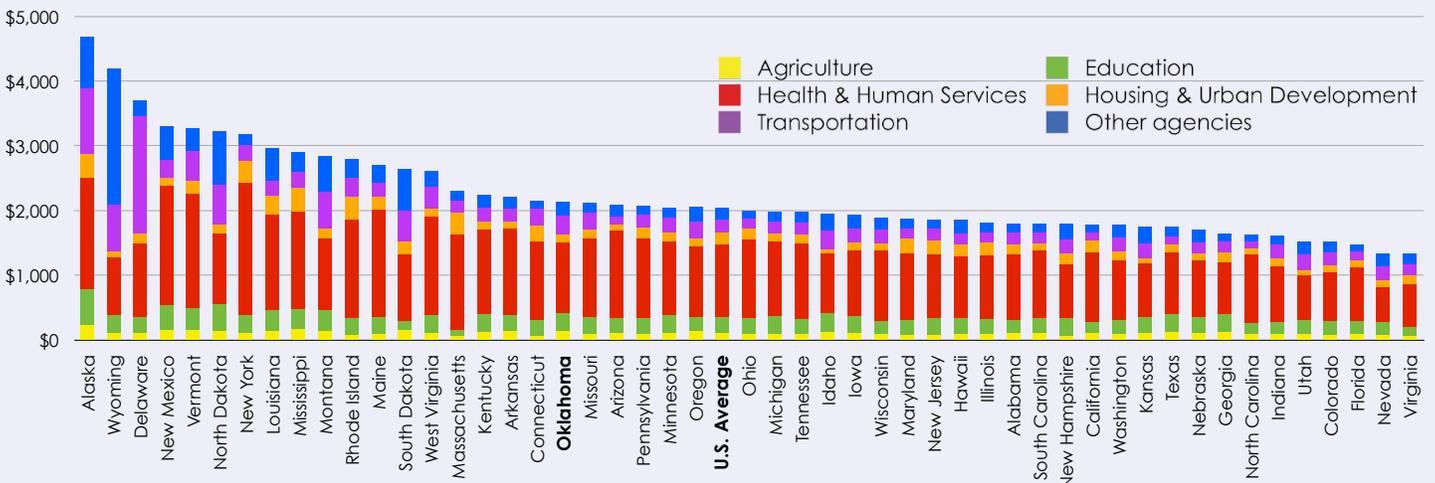
their own excise and gasoline taxes have been introduced by congressmen from Oklahoma and Georgia.

The cost-shifting debate among the states is driven by federal fiscal problems, which become worse with each passing day. Currently, the federal government is spending approximately 25 percent of Gross Domestic Product, but collecting only about 15 percent adding to a national debt that already exceeds 100 percent of GDP.

Eventually, Congress will have to fund only the amount of government the citizens are willing to pay for.

Perhaps shifting costs and responsibilities to the states will alleviate some of the federal symptoms as citizens wait for national leaders to craft solutions. But the problem will be passed to the states, which must be prepared to accept more responsibilities. Some are better prepared than others. Looking forward, states will have to plan their tax and spend policies based not on what is happening today, but on what is certainly coming.

Federal Aid to State and Local Governments (per capita amounts by state, by agency)



Source: US Census Bureau, Federal Aid to States for Fiscal Year 2010



529 plans: One of the best ways to save for college

It's no surprise that another consequence of the difficult economy is that parents continue to struggle to pay for their children's college costs. According to the most recent study by Sallie Mae, "How America Pays for College 2011," the amount parents paid towards college costs from savings and income has fallen from 36% to 30% over the past two years.

So what can you do about this? For starters, financial planning studies estimate that parents saving for college should save about 6% of their income annually to have sufficient assets accumulated by the time their child goes to college.

Folks who are saving for their child's future college costs say they feel more confident in the fact that they have a plan to save.

Some also report using supplemental funding sources and rewards programs (such as UPromise) to increase college savings. Clearly saving for college is a more viable strategy for parents with younger children who are years away from college than for those whose children are in their last few years of high school.

If you decide to do this, then strongly consider using a 529 education savings plan. These plans are state-sponsored savings and investment programs.

The state sets up the plan with an asset management company of its choice, and you open a 529 plan account with that asset management company. Typically the parent is the owner of the account, and the child is the beneficiary.

The benefits of 529 plans

- The account owner does not pay current income taxes on the unrealized gains in the account.
- The owner/parent, not the child/beneficiary, always has control of the account.
- If the beneficiary/child doesn't go to college, the account can be used for another family member or other individual.
- Anyone can contribute to the account. There are no income limitations.
- Most states have no age limit for when the money has to be used.

The big advantages of 529 plans are the tax benefits.

First, while invested, the growth and investment gain on money in a 529 plan account is tax-deferred.

Second, withdrawals are tax free as long as they are used for qualified higher education expenses of eligible education institutions.

Generally this includes expenses for any accredited degree-granting educational institution, whether it is public, private, two-year, or four-year. Even some international schools qualify. In most states, qualified education costs include tuition, fees, books, supplies, room, board, transportation, and even

computers when one is required by the school.

Lastly, about 35 states offer tax benefits such as an above-the-line deduction from income or a tax credit for all or a portion of the contributions of their residents who contribute to their own state sponsored 529 saving plan.

Folks concerned that these benefits are too good to last should take comfort in the fact that in 2006 Congress approved a 529 tax permanency provision, removing the uncertainty surrounding the tax treatment of 529 plans and provides college savers using 529 plans with unique tax benefits going forward.

If the money in the account is no longer needed for college (because the child gets a scholarship, doesn't go to college, etc) then the account owner can withdraw the unused money.

When withdrawals are taken for non-qualified distributions, the earnings are taxed at ordinary income tax rates and there

is also a 10% penalty on the investment earnings. The taxes and penalty are not assessed on principal.

Distributions are allocated between principal and earnings on a pro-rata basis. An exception to the penalty can be claimed if you terminate the account because the beneficiary has died or is disabled, or if you withdraw funds not needed for college because the beneficiary has received a scholarship.

“The big advantages of 529 plans are the tax benefits.”



May numbers: Gross receipts vs. General Revenue Fund

A comparison of the Treasurer's June 5 Gross Revenue Report and State Finance's June 12 General Revenue Fund (GRF) report illustrates fundamental differences.

May gross receipts totaled \$858.9 million, while the GRF received \$430.3 million or 50.1% of the total. Last month, the GRF received 52.8% of the gross.

The GRF received between 35% and 58% of monthly gross receipts during the past 12 months, highlighting the value of using total collections rather than the GRF subset to gauge state economic performance.

From gross receipts in May, the GRF received:

- Personal income tax: 65.5%
- Corporate income tax: 42.1%
- Sales tax: 45.7%
- Gross production-Gas: 16.5%
- Gross production-Oil: 20.2%
- Motor vehicle tax: 32.5%
- Other sources: 55.2%

GRF collections for the month were below the official estimate by \$6.9 million or 1.6 percent.

Insurance premium taxes totaled \$3.7 million in May.

Tribal gaming fees generated \$10.1 million during the month.

Total collections grow in May as gross production continues slide

Even though natural gas and crude oil prices are lower than expected, Oklahoma's total revenue collections continue to rise, driven primarily by income and sales, State Treasurer Ken Miller said as he released the monthly gross receipts report for May.

"With incomes climbing and sales tax collections on the rise, Oklahomans continue to show confidence in the economy in spite of renewed global uncertainty and a pullback in U.S. job growth," Miller said.

May collections are up by 5.8 percent from May of last year, Miller said. That

compares to average growth over the past 12 months of 9.2 percent.

Watching natural gas and oil prices

In May, collections from gross production taxes on oil and natural gas were less than the same month of the prior year for a sixth consecutive month, and for the seventh time in eight months. Reflecting

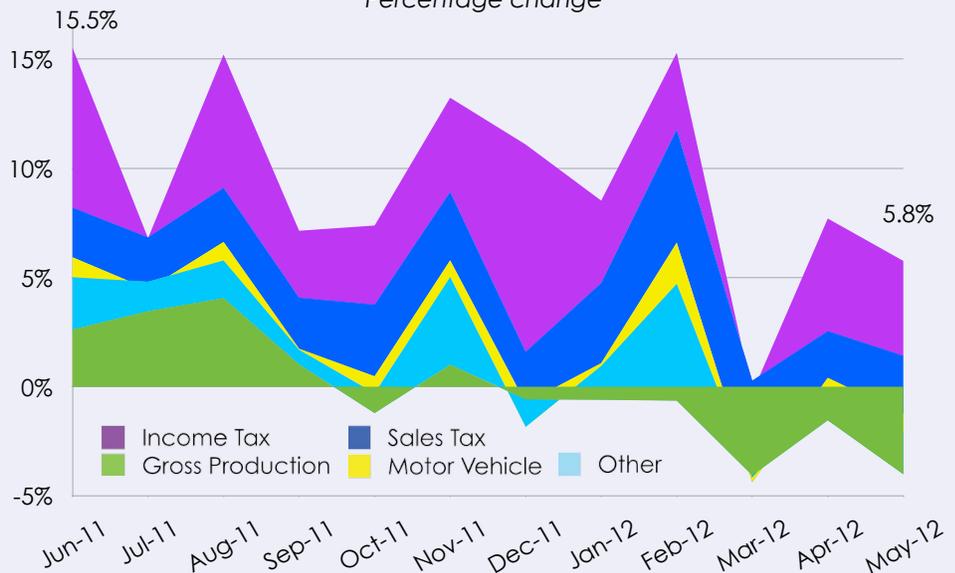
the continued downward slide in gross production collections, the 12-month running total for that revenue source turned negative this month.

SEE REVENUE PAGE 7

“... Oklahomans continue to show confidence in the economy ...”

Monthly Gross Receipts vs. Prior Year

June 2011 - May 2012
Percentage change



Source: Office of the State Treasurer



State employment hits record

The number of Oklahomans holding jobs hit a record high, according to the Oklahoma Employment Security Commission. OESC figures set the number of working Oklahomans at more than 1.7 million and the number of unemployed at 85,120.

During the past year, the number of working Oklahomans has increased by 47,410. The number of those unemployed has dropped by 19,720.

The May employment report, issued June 15, provides a stark contrast to national labor figures with U.S. unemployment listed at 8.2 percent, an increase of 0.1 percentage points from April's rate, but 0.8 percentage points lower than May 2011. Among the states, unemployment in North Dakota is 3.0 percent, the Texas rate is 6.9 percent and Nevada's unemployment rate is reported as 11.6 percent.

Revenue

FROM PAGE 6

The percentage of total gross production taxes generated by natural gas production has steadily fallen since last year.

In October, 51 percent of gross production collections came from gas extraction. By April, the amount had dropped to 32 percent. The proportion of the tax produced by natural gas for May was 30.5 percent.

Gross production collections in May reflect prices and production from March, when the spot price for natural gas at the Henry Hub in Louisiana, considered a benchmark for gas prices, averaged \$2.06 per thousand cubic feet. April prices dropped to an average of \$2.01, but May prices rose to an average of \$2.51.

In the past month, the price of crude oil has also trended downward. From late February until the end of April, the spot price of West Texas Intermediate Crude Oil at Cushing stayed above \$100 per barrel.

In May, crude prices dropped throughout the month, closing May 31 at \$86.53/bbl, levels not seen since last October.

Rig counts in late May were set at 192 total, 22 higher than at the same time last year. However, active natural gas rigs have dropped from 122 last year to 53 this year. Active oil rigs have climbed from 48 last year to 139 this year.

"In the coming months, we will be keeping a close watch on natural gas and crude oil prices and any potential spillover effect on the Oklahoma economy," Miller said.

Overall growth seen

Income tax collections have risen by double-digits from the same month of the previous year in nine of the past 12 months, while sale tax collections have averaged eight percent growth during the same time.

Since hitting the trough on revenue collections from the recession in February 2010, 12-month collections have increased by \$1.63 billion and are now only \$289 million below the peak in December 2008.

National economic news briefs

Twist and compromise

The decision to extend operation twist through year-end might have been a compromise between one faction of the FOMC that wanted more quantitative easing and another that wanted no additional stimulus.

Operation twist does not expand the Fed's balance sheet, so it is not an exercise in quantitative easing. It is an attempt to keep downward pressure on bond yields and mortgage rates which, thus far, has had relatively little impact on the housing sector and on the economy.

Now that inflation has slowed, thanks to the drop in energy prices, Chairman Bernanke probably decided that the Fed could continue to appear to be very accommodative without upsetting too many of the Committee hawks. This was the least costly way of appearing to respond to the recent softening in the economic indicators.

Recession watch

The Blue Chip Economic Indicators' survey of 50 forecasters finds 25% odds of a recession this year. Last year at this time, those odds were one in three and there was no recession.

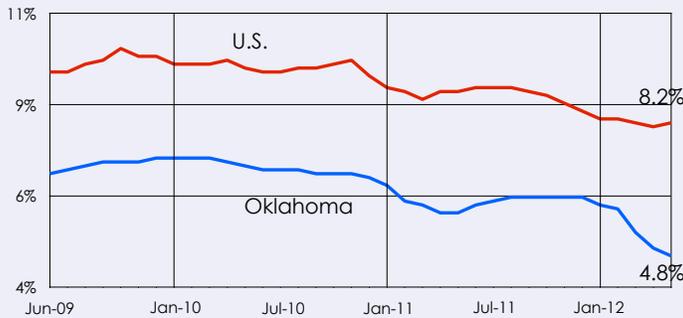
Reprinted from Baird Fixed Income Commentary, June 25, 2012



Economic Indicators

Unemployment Rate

June 2009 – May 2012



Source: Bureau of Labor Statistics

Oklahoma 12-Month Gross Receipts

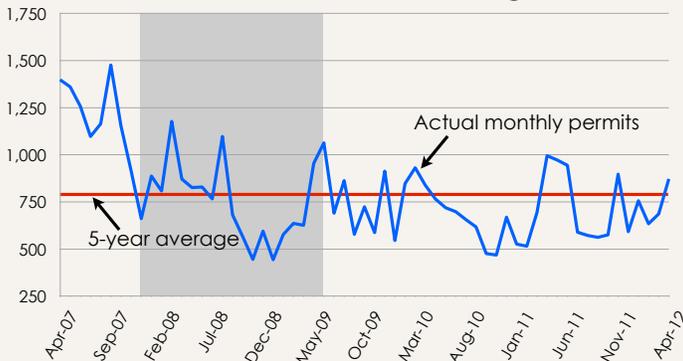
June 2008 - May 2012
(in millions)



Shaded area denotes U.S. recession

Source: Office of the State Treasurer

Oklahoma Residential Building Permits

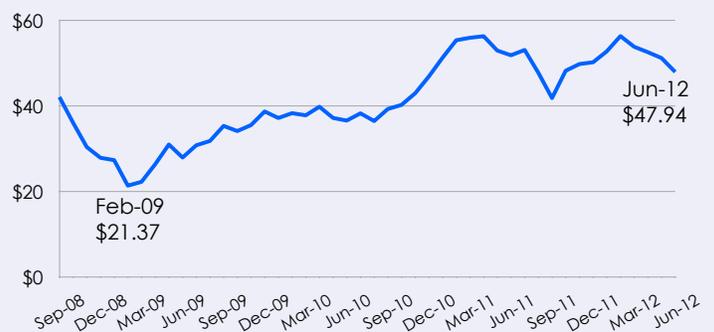


Shaded area denotes U.S. recession

Source: U.S. Census Bureau

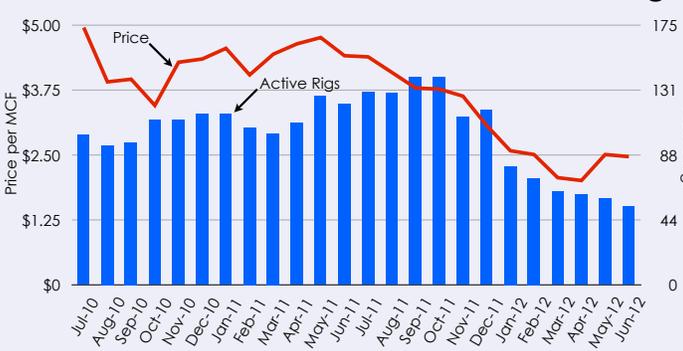
Oklahoma Stock Index

(Top 25 capitalized companies)



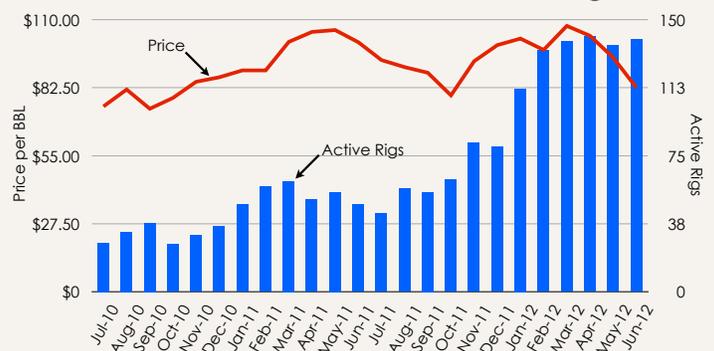
Source: Office of the State Treasurer

Oklahoma Natural Gas Prices & Active Rigs



Source: Baker Hughes & Bloomberg

Oklahoma Oil Prices & Active Rigs



Source: Baker Hughes & Bloomberg