

Texas State Tax Reform Via the Flat Bat

David A. Hartman is chairman of the Lone Star Foundation, which publishes the Lone Star Report and conducts public policy studies. Mr. Hartman has published federal fiscal and taxation papers through Cato Institute, Institute for Policy Innovation, Howard Institute, Rockford Institute, and the Family Research Council. He has served as chairman of Texans for Responsible Government and was a candidate for State Treasurer.

EXECUTIVE SUMMARY

The compelling reasons for Texas state tax reform are twofold: First, to provide an equitable basis for an adequate Foundation School Program fully funded by the state. Second, to more equitably distribute the business tax burden in order to provide a more attractive climate for Texas' economic growth.

The proposed basis for achieving this reform is the adoption of a business activity tax (the "Flat BAT"), a single rate subtraction method value added tax levied upon all employers and recipients of commercial revenues, including corporations, partnerships, proprietorships, and governments. The tax base would be all revenues received less all purchases of goods and services, including plant and equipment investment. By directly expensing fixed investment, the Flat BAT is the equivalent of a consumption tax or a consumed income tax – the tax base considered most equitable and efficient by tax reformers.

The proposed Flat BAT would be levied at an estimated maximum 3.0 percent rate, subject to adjustment for revisions in determination of adequate Foundation School funding for each level of education, including capital improvements. At that rate the Flat BAT would replace the following state and local taxes:

Local school ad valorem tax: The portion of school ad valorem tax used for Foundation School funding would be replaced by the Flat BAT; a local option tax capped at \$0.30/100 would allow non-shared enrichment funding.

State business taxes: The Flat BAT would replace inequitable state business taxes, including the franchise tax levied only on corporations; industry specific taxes on oil and gas, insurance and utilities; and property taxes on commercial equipment and inventories.

The adoption of the Flat BAT would be "tax neutral" for state and local taxation in total. That is to say, the amount of local school ad valorem taxes, franchise tax, and other business taxes eliminated would equal the additional revenues provided by the Flat BAT.

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The result would be taxes levied equitably on all businesses at the lowest possible rate due to the broadest possible base. The burden of local taxation on real property local school ad valorem tax would be eliminated, other than a non-equalized local option of \$0.30 per \$100 maximum. At the same time excessive taxation of corporations and manufacturers is relieved, the Flat BAT will “knock out Robin Hood.”

Alternatively, the Flat BAT could be paired with the proposed broadening and increase of the state sales tax to complete removal of the local school ad valorem tax. A 2.0 percent Flat BAT could replace the remaining \$0.75 per hundred ad valorem tax while replacing all principal state business taxes, including the franchise tax.

THE PURPOSE: The compelling purposes for reform of Texas state taxation are twofold. First, to provide an equitable basis for an adequate Foundation School Program fully funded by the state. Second, to more equitably distribute the business tax burden in order to provide a more attractive climate for Texas’ economic growth.

THE PROBLEMS: Texas has encountered periodic revenue “crises” resulting from school funding lawsuits, rising welfare entitlements, and demands for roads and criminal confinement – along with laxity of spending restraint in between these “crises.” The consequences have been recurrent increases in taxes and fees and new taxes where obtainable, rather than an optimal distribution of the tax burden, resulting in the following problems:

1. Funding of the Foundation School Program growth has been shifted to local school ad valorem taxes to the extent that most districts are at or near statutory limits.
2. “Robin Hood” transfers of “enrichment” from higher property value districts to those of lesser property values come from a rapidly increasing proportion of school districts.
3. Excessive taxation of business property, equipment, and inventories – together with the franchise tax and industry specific taxes – threaten Texas’ business climate and economic prospects.
4. The burden of business taxation is particularly inequitable for corporations and manufacturing enterprises, which is exacerbated by comparable inequitable incidence of federal taxation.
5. The current tax code in composite tends to produce surplus yields in boom years (encouraging excessive spending) and lean yields in hard times (“justifying” tax increases).
6. Spending on public education is not “efficient,” in part from failure to adequately define the necessary funding to provide a quality education at each *level* of schooling, but particularly due to ineffective technology, incentives, organization,

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and management by modern business standards, resulting in relentless demands for increased funding not necessary by efficient standards.

ALTERNATIVES FOR STATE TAX REFORM

The recurring problems of the state tax code as enumerated above particularly result in excessive property taxation, and excessive burden on corporations and manufacturing.

The claim is often made that state taxation in total is “regressive” – that is, disproportionately shared by lower incomes relative to income. This allegation is very questionable. The relevant taxes to examine are the state sales tax, business taxes, and local school ad valorem taxes which make up the bulk of state taxation. State sales tax exemptions far exceed necessities, while business taxes are (at least in theory) paid by capital, but are really principally paid by consumers proportionate to consumption expenditures. Local school ad valorem taxes are roughly 50 percent on individuals and subject to both homestead and aged exemptions. The balance is commercial and industrial, also paid from business income, but with principal incidence proportionate to personal consumption expenditures. This leaves little more than taxes on motor vehicles (effectively use taxes) and non-tax revenues – principally fees, the lottery, and government miscellaneous revenue. In sum total, state taxation does not appear to be regressive; the real complaint of populists would appear to be that it is not highly *progressive*.

The most compelling argument for tax reform is the substantial evidence that *progressive* taxation of incomes appears to have *regressive* consequences. Tax reformers emphasize that the lower the marginal rates, the more conducive to saving for investment and economic growth. Increases in output over the long term are shared 60 percent by labor, 30 percent by government, and only 10 percent by capital. Everyone gains, but labor gains most. In summary, they argue that taxes proportionate to *consumption* are preferable to progressive multiple layers of taxation on capital income as being more equitable (based on taxing proportionate to what one consumes, rather than one produces) and more conducive to capital formation, incentives and growth that benefits everyone.

Bearing these criteria in mind, consider the alternatives being offered for a state tax reform.

1. *Increase the base or the rate of the state sales tax.* A sales tax is a “good” tax, because it is levied proportionate to consumption. There certainly is room to include more consumer purchases in the sales tax base, but the barriers are formidable. Every candidate for inclusion from hair care to residential real estate has its organized resistance. The rate could be increased, but this would incentivize tax evasion across state borders, via the Internet, by barter, or the underground economy.
2. *Increase the base of the business franchise tax.* The franchise tax more honestly should be called the corporate income tax (except for a minimum tax on capital if

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you do not make enough income). In order to expand the base, partnerships and proprietorships would need to be included. But to do so requires removal of the constitutional prohibition of the state income tax. Guess what would follow....

3. *Shift the school ad valorem tax to commercial and industrial property.* As we noted, the multiple burdens of tax on corporate and manufacturing capital and corporate income (franchise tax) already is a competitive burden on Texas' business climate. Shifting the tax burden even more heavily upon commerce will result in lower job growth – which will hurt, not help, tax collection efforts.
4. *Adopt a personal state income tax.* Income taxes attack the incentives to invest and produce, rather than taxing those who consume the fruits of labor and capital. The highest growth businesses being located in Texas are in high-tech industries, which depend upon high salaried workers' intellectual capital. Texas is preferred as a business location because it does not have a personal income tax. Economist Richard Vedder has repeatedly shown in studies for the Texas Public Policy Foundation that states without the personal income tax have higher growth rates than those which have a personal income tax. Politicians rarely resist the opportunity provided by an income tax to adopt a progressive rate schedule to soak the few and redistribute to the many at the expense of jobs and growth. Again, why shoot ourselves in the foot?
5. *Reform the state code by adopting a value added tax.* A subtraction method value added tax is a comprehensive consumed income tax levied on all enterprises, preferably including government. Its base is easily determined as the difference between revenues and all purchases of goods and services, including expensing of investment in fixed assets and inventories. It is levied as a flat rate, and as such is a tax proportionate to consumption by end users – precisely the type of tax considered both the most economically efficient and most equitable by tax reforming economists. Compared to the franchise tax on corporations, and selected taxes on industries, a value added tax should be proportionately levied upon *all* commerce – including governments. Also a value added tax is deductible from federal income taxes.

STANDARDS FOR AN IMPROVED TAX STRUCTURE

The objectives for changing the structure of state taxation should be sufficiency of tax yield subject to transparency, neutrality, and efficiency. Specifically, this means:

1. The state should ensure adequate – but not excessive – funding of each level of the public school system.
2. This will require that the state increase its funding to fully provide an adequate Foundation School Program for all Texas school children, and include:
 - a. Relief from school ad valorem tax ceilings.
 - b. An end to “Robin Hood” equalized funding of “enrichment.”

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- c. Appropriate funding for each *level* of education, including capital expenditures.
 - d. Simplification of funding on the assumption that equalization of efficient funding best serves both equity and efficiency.
3. The burden of taxation should be more equitably distributed from corporations and manufacturers across *all* business enterprises.
 4. The structure of the state tax code in composite should assure a stable growth of revenue relative to population and inflation.
 5. The tax code should importantly promote a business climate that enables a growing Texas economy, and as such should avoid discriminatory taxation of any business sector and, most particularly, avoid a state personal income tax.
 6. Any change in the tax code should be “tax neutral”; that is, the total of tax yield from state tax and non-tax revenues, and local school ad valorem taxes under normal conditions should total no more after tax reform than before changes.
 7. In seeking “tax equity” in the taxation of individuals the standard should be taxation *proportionate to consumption* as the measure of what one *takes and benefits from*, rather than taxation levied upon income and capital, which measure what one *produces and invests in production, thereby increasing jobs, wages and economic growth*.
 8. Any new tax to be considered should be visible, in order to make taxpayers conscious of cost-benefit valuation of government.

PROPOSAL FOR ADOPTING A STATE “FLAT BAT”

The proposed reform of the state tax to resolve state tax code deficiencies is the adoption of a “subtraction method value added tax,” which should be termed the “flat business activity tax” or “Flat BAT.”

The Flat BAT would be levied upon all commerce, whether corporate, partnership, proprietorship, or government – in effect, upon any employer generating income or any recipient of commercial revenues, including rents, leases, or interest. The tax base to which the Flat BAT would be applied is revenues less purchases of goods and services, including expensing of fixed investment at time of purchase and installation. Intracorporate purchases will be deductible and intracorporate sales taxable on reasonable accounting of transfer prices based upon cost. Financial institutions would show *net* interest and other revenues, principally fees, as revenue, less purchases of goods and services but would not be allowed to expense capital expenditures other than buildings and equipment to the extent employed in providing financial services.

A Flat BAT tax return would be simple, employing the following general format:

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Total Revenues (excluding borrowing)
 less: Purchases for Inventory
 Purchased Services
 Plant and Equipment Expenditures
 = Taxable Value Added
 x Flat BAT Rate
 = Flat BAT Tax Due

The only grounds for dispute would arise on costing of intracompany purchases and sales. However, comparison of local to total corporate accounts could be audited to prevent “slight of hand” accounting.

In order to prevent the Flat BAT from being an invisible addition to the tax burden, the Flat BAT rate and value should be printed upon all invoices.

DETERMINATION OF THE FLAT BAT

The proposed Flat BAT would be the replacement for most of state business taxes, and most of the local school ad valorem taxation, other than local option “enrichment.”

The determination of the Flat BAT revenues and proposed rate is shown in the appendix attached. The evaluation was based upon data from the State Comptroller and the Texas Education Agency for the 2000-2001 biennium. This biennium was used to represent more normal business conditions and tax yields than expected for the current recessionary biennium.

The tax revenues to be replaced by the Flat BAT are shown in Table 1.

Table 1	
Flat BAT Revenues (Basis: = 2000 – 2001 Biennium)	
<i>Current Tax Source</i>	<i>Taxes to Transfer</i>
School Ad Valorem Taxes	\$22,268 mil
State Business Taxes	
Franchise Tax	4,026
Natural Gas Tax	2,295
Insurance Taxes	1,617
Oil Prod. & Reg.	859
Utility Taxes	<u>604</u>
Total Flat BAT Revenues	<u>9,401</u> <u>\$32,308 mil</u>

In order to determine the required Flat BAT Rate to provide \$32,308 million, the Flat BAT base was determined. This required some assumptions owing to lack of public data on State of Texas total fixed investment for the biennium. Using comparative data for the U.S. economy as a whole, Gross State Product was reduced 21.08 percent for fixed investment and other related adjustments. The result was a \$1,188.1 billion Flat BAT Base for 2000 – 2001 Biennium. This yields an unadjusted Flat BAT rate of 2.72 percent.

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In order to provide for estimation and evasion error the Flat BAT required could more realistically require at most a 10 percent higher, three percent Flat BAT rate.

This in effect proposes a consumed income tax not to exceed three percent levied upon all commercial enterprises' value added. It replaces the corporate franchise tax and all industry specific levies, plus all local school ad valorem taxes except for a local option "enrichment" ad valorem tax which is not state equalized and limited to \$0.30 per \$100 valuation. It is proposed that even for the local option ad valorem school tax, commercial personal property and inventories be excluded from the property tax base. It is inequitable to tax business, but not individual, personal property, while Texas is one of the few states where inventories are subject to ad valorem tax.

The adoption of the Flat BAT would be "tax neutral" for state and local taxation in total. That is to say, the amount of local school ad valorem taxes, franchise tax, and other business taxes eliminated would equal the additional revenues provided by the Flat BAT.

RECONCILIATION OF ESTIMATES OF VAT YIELD

The Revenue Estimating Division of the Comptroller of Public Accounts has provided the Select Committee on Public School Finance with a preliminary estimate of the expected yield of a VAT amounting to \$3.2 billion per year per one percent of tax rate. This is considerably below the \$5.385 billion per year per one percent estimated for the Flat BAT.

Upon request of the Committee, the Revenue Estimating Division has provided a reconciliation of the differences as shown in the following table:

<u>Source of Revenue</u>	<u>Revenue per 1% per year</u>
Comptroller's Revenue Base	\$3.200 bil
Add: \$500,000 per Taxpayer Exempted	.700
Exempted Entities, Private	1.000
Exempted Governments	<u>.600</u>
Comptroller Estimate Adjusted Lone Star Base:	\$5.500 bil
vs. Lone Star Estimate, Annualized:	\$5.385 bil

It will be noted the difference in estimates is primarily the differences in assumptions as to what entities will be subject to the VAT.

The principles employed in determining the tax base for the Flat BAT were twofold. First, all the citizens of Texas will benefit both directly and indirectly from the elimination of the school ad valorem tax and therefore all should be included in the levy of its replacement. Also, it is intended to initiate an end to the inefficient and inequitable practices of selective taxation which allows the politically powerful to shed their share of taxation at the expense of both higher tax burdens for the remaining taxpayers, and of adequacy of tax revenues.

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PHASING IN THE FLAT BAT

Whereas the Flat BAT will be assessed upon and remitted by commercial enterprises, it is not intended that the incidence will be principally borne by these entities. Rather, the incidence should be upon the incomes of the workers and investors in these enterprises, who will be the ultimate beneficiaries of the property and business tax relief.

It is suggested that commencing the year that the school ad valorem taxes are abated, that same year all employers should expect three percent lesser increases in wages and salaries. The result will generally result in equitable allocation of the VAT burden. Rental properties would be required to pass through the initial benefit of ad valorem tax relief, which the market would discipline thereafter.

FLAT BAT ALTERNATIVES

The Flat BAT could be adopted in varying forms or combinations with modifications to other taxes.

An immediate question has been raised concerning levying the Flat BAT on government. In principle, since all government employees will benefit directly and indirectly from reduction of ad valorem taxes, then levying the Flat BAT on their employers in such a manner as to cause them to assume the incidence like all other Texans would be equitable. However, in the absence of including governments in the tax base the alternative Flat BAT rate of 3.33 percent would be necessary.

A proposal broadening the base and increasing the rate of the state sales tax has been proposed, for partial elimination of public school ad valorem taxes, leaving a \$0.75 maximum rate for school ad valorem tax to fund the local share. A Flat BAT of approximately two percent could replace the franchise and industry specific taxes, and completely eliminate the balance of the local school ad valorem tax. In so doing it would have eliminated entirely two principal state taxes, the franchise tax and the local school ad valorem tax, while more equitably broadening the sales tax base. If government is not included in the Flat BAT base, then a 2.33 percent rate would be required.

Given the same objective of *completely* eliminating the school ad valorem tax via the Flat BAT alone (in order to prevent a creeping redundant reincarnation) a 3.33 percent Flat BAT would be required. Without inclusion of government in the base, the Flat BAT required would be 3.66 percent.

EQUITY OF THE FLAT BAT BURDEN

The adoption of the Flat BAT will be principally borne by all incomes. How this will affect tax burdens by income level is shown in Appendix C. Wage and salary workers are shown assuming the burden of a three percent Flat BAT, and being relieved of 1.25 percent local school ad valorem tax, 0.264 below the average for the 00-01 biennium. The result is slightly lesser taxation at levels \$15,000 to \$150,000 per year.

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Also shown is the tax burden change for a professional office, such as for a doctor or lawyer with \$250,000 taxable income (\$150,000 for the professional, and \$100,000 for assistants) housed in 2,000 feet of office. The result is an equal reduction in ad valorem tax burden to the increase added by the Flat BAT.

THE CONCLUSIONS:

Adoption of a Flat BAT, a subtraction method value added tax, is an efficient and equitable basis for reforming the tax code of the State of Texas. A three percent Flat BAT would replace the school ad valorem tax for foundation school funding, and provide a more equitable basis for business taxation. The franchise tax (the income tax levied solely upon corporations) and industry specific taxes (oil, gas, utilities, and insurance), and ad valorem tax upon commercial equipment and inventories would be eliminated by the Flat BAT even in the event of retention of a limited ad valorem tax for enrichment.

The results of adopting the Flat BAT would be a more equitable and reliable basis for school funding. At the same time, there would be a significant improvement in how business is taxed, particularly corporations and manufacturers, and consequent improvement of attractiveness of Texas as a location for economic growth.

A two percent Flat BAT paired with proposed expansion of the state sales tax base and moderate rate increase of its rate could completely remove the local school ad valorem rate, while reforming business taxation and the franchise tax.

In the event government is not included in the Flat BAT base, a 1/3 percent higher rate would be required.

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APPENDIX A

DETERMINATION OF THE "FLAT BAT"

(Basis: Data from 2000-2001 Biennium)

A. State & Local Taxes to be Replaced

1. *School Ad Valorem Taxes**

Assume: Foundation Programs@ 90% State & Local Funding	
State & Local Revenues 99/00 yrs	\$25,423 mil
State & Local Revenues 00/01 yrs	<u>28,305</u>
Total Biennium School Revenues, S & L	53,728
Continuing Local Funding @ 10% =	5,373 mil
Local Revenue Fiscal 2000 =	13,220
Local Revenue Fiscal 2001 =	<u>15,060</u>
Total Biennium Local Revenues	28,280
less: Continuing Local Revenue	<u>(5,373)</u>
School Ad Valorem Tax to Replace	22,907 mil

2. *Standardize Homestead Deductions @ \$20,000*

Assume: SF \$120,000/unit	
MF \$ 40,000/unit	
SF: \$496,893 mil/\$120,000 =	4.14 mil
MF: \$50,893 mil/\$40,000 =	<u>1.27 mil</u>
Total Dwellings	5.41 mil
x \$20,000 deduction/unit =	108 mil
less: Current Homestead Deduct =	<u>61 mil</u>
Addition Homestead Deduct =	<u>47 mil</u>

3. *Business Taxation to Replace*

Franchise Tax	\$4,026 mil
Natural Gas Tax	2,295
Insurance Taxes	1,617
Oil Prod. & Reg.	859
Utility Taxes	<u>604</u>
Total Business Taxes to Relieve	9,401 mil

4. *Total Tax to the "FLAT BAT"*

\$32,308 mil

B. FLAT BAT Base

1. *Gross State Product***

Fiscal 2000	\$728.2 bil
Fiscal 2001	<u>777.2 bil</u>
Biennium 2000/2001	\$1505.4 bil

* Data from TEA Snapshots

** Data from Comptrollers Forecasts

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2. <i>Adjustments</i> ^{***}		
less: Gross Private Investment =		(17.33%)
plus: Residential Real Estate =		3.29%
less: Imputed Rents =		<u>(7.04%)</u>
less: Net Adjustments		x(21.08%)
Adjustments =		(\$317.3 bil)

3. *FLAT BAT Base* \$1188.1 bil

C. FLAT BAT Rates

1. <i>State FLAT BAT Rate</i>		
FLAT BAT Tax Revenue =		\$32,308 mil
÷ FLAT BAT Base =		<u>÷ \$1188.1 bil</u>
FLAT BAT Rate		<u>2.72%</u>
Adjusted Flat BAT (w/10% for Estimating/Evasion)		<u>3.0%</u>

2. <i>Local School Ad Valorem Rate</i>		
Ad Valorem Revenue		
Local Revenue Required for Optional Tax		
Revenue Replaced		\$5,373 mil
Homestead Exemption		<u>47 mil</u>
		\$5,420 mil

less: Non-Ad Valorem Revenue ^{****}		
Fiscal 2000 =		\$1,890 mil
Fiscal 2001 =		<u>\$1,370 mil</u>
		(\$3,260 mil)

Ad Valorem Revenue \$2160 mil

Ad Valorem Property Values		
Fiscal 2000 =		\$784.5 bil
Fiscal 2001 =		<u>864.3 bil</u>
		\$ <u>1648.6</u> bil

Local School Avg. Ad Valorem Rate = \$0.13/100

*** Estimated as U.S. % GDP per NIPA accounts, 2000

**** Primarily school bond issues

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APPENDIX B



COMPTROLLER OF PUBLIC ACCOUNTS

P.O. BOX 13528
AUSTIN, TX 78711-3528

August 4, 2003

The Honorable Kent Grusendorf
State Representative
Texas House of Representatives
Capitol Building, Room 1W.05
Austin, Texas 78701

Dear Chairman Grusendorf:

Thank you for your question regarding a reconciliation between the value-added tax (VAT) revenue estimate presented by this office to your Select Committee on Public School Finance on July 16 and a "Flat BAT" (a VAT) estimate presented that same day by Mr. David Hartman of the Lone Star Foundation.

A Preliminary Reconciliation of the Estimates:

	\$3.200 bil.	Comptroller revenue estimate for a hypothetical VAT at a rate of 1% and expressed as an annual figure.
+	\$0.700	Add back for assumed \$500,000 per taxpayer exemption included in the Comptroller estimate.
+	\$1.000	Add back for VAT tax revenue from exempt entities excluded from the Comptroller estimate.
+	\$0.600	Add back for VAT tax revenue from governmental entities excluded from the Comptroller estimate.
=	\$5.500 bil.	Adjusting Comptroller estimate to Lone Star tax base.
	\$5.385 bil.	Lone Star estimate, on an annual basis. ¹

¹The Lone Star annual estimate, for the purposes of this reconciliation, is calculated using a biennial VAT revenue estimate of \$32.308 billion at a 3% tax rate (page 7 of July 16th Lone Star handout), adjusting to a 1% rate, and further adjusting to reflect only one year of estimated revenue. The resulting figure reflects business activity in 2000/2001; the Comptroller estimate is for state fiscal 2003.

This is a preliminary analysis and work continues in this office on the Select Committee's questions regarding a VAT. In addition, we are working to complete responses to the questions to our staff by the committee during the July 16th meeting. They will be forwarded to you as soon as possible.

If you have any questions or comments, please do not hesitate to call James LeBas at 936-6269 or myself at 475-0042.

Sincerely,

A handwritten signature in black ink that reads "John Heleman".

John Heleman
Assistant Manager, Revenue Estimating Division

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APPENDIX C

CHANGES IN TEXAS STATE TAX BURDEN: REPLACING SCHOOL AD VALOREM WITH FLAT BAT

		<u>POVERTY LEVEL</u>	<u>MEDIAN FAMILY</u>	<u>CORPORATE EXECUTIVE</u>	<u>PROFESSIONAL OFFICE</u>
(1)	Taxable Income	\$ 15,000	\$ 55,000	\$ 150,000	\$ 250,000
	Flat BAT @ 3%	\$ 450	\$ 1,650	\$ 4,500	\$ 7,500
(2)	Residence Value	\$ 40,000 *	\$ 135,000	\$ 400,000	\$ 400,000
	Ad Valorem @ 1.25% **	\$ 500	\$ 1,688	\$ 5,000	\$ 5,000
(3)	Office Value	—	—	—	\$ 200,000 ***
	Ad Valorem @ 1.25%				\$ 2,500
(4)	Change in Tax Burden (1) – (2) – (3)	\$ (50)	\$ (38)	\$ (500)	\$ (0)

*Rental Unit @ \$500 per month

**After allowance of \$10,000 homestead value

***Office 2,000 square feet valued @ \$100./sq. ft.

APPENDIX D

Memorandum

DATE: September 2, 2003
TO: Kent Grusendorf, House Select Committee on Public School Finance
FROM: David A. Hartman
SUBJECT: CORRECTING MISCONCEPTIONS REGARDING THE “FLAT BAT” FOR STATE TAX REFORM

The Flat Business Activity Tax, “(Flat BAT),” a single rate tax on the “value added” by all Texas commercial enterprises and employers, has been proposed to the House Select Committee on Public School Finance as the appropriate alternative to both school ad valorem taxes and inefficient and inequitable business taxation.

A 3% “Flat BAT” would provide sufficient reserves to replace the local portion of Foundation School funding. In addition, it would replace the corporate franchise tax (alias for the corporate income tax), and industry specific taxes, including the oil, gas, insurance and utility taxes.

Consideration of the “Flat BAT” has encountered the following concerns and misconceptions which are easily dispelled by the following factual rebuttals:

1. **The Flat BAT levies the same burden on goods as levied upon services.** Representatives of such services as law, medicine or advertising have protested that value added taxation will be disproportionately levied upon services revenues that are primarily based on wage and salary expense, but this is not true. Manufacturers who buy components that are deductible appear to pay a lesser proportion of value added tax. However, their component manufacturers pay value added tax, as do the raw material suppliers to the component manufacturers. When all steps are consolidated the composite value added tax burdens levied upon the manufacturing goods sector is the same as that levied upon the services sector.
2. **The tax revenue yield of the Flat BAT has been seriously underestimated by the State Comptroller as provided to the Select Committee.** The Flat BAT as proposed anticipates \$5.4 billion per 1 percent of rate per annum; the Revenue Estimation Division of the State Comptroller predicted \$3.2 billion for a value added type business activity tax. However, reconciliation with the Estimation Division showed \$0.7 billion for \$500,000 exclusion, \$1.0 billion for exemptions,

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- and \$0.6 from excluding governments, explaining all the disparity on the basis of reconciliation of assumptions.
3. **Value added taxation overseas has been a booming success for U.S. trading competitors.** It is an article of faith among conservative and libertarian economists that value added taxation caused the runaway growth of government in Europe. The truth is that value added taxation provided broad based and highly remunerative taxation of consumed income *in addition to* rather than replacement of progressive personal and corporate income. What is proposed here in Texas is *replacement* of present school ad valorem and business taxation with more equitable and efficient value added taxation on a tax neutral (dollar for dollar) basis, with no hidden net tax increase.
 4. **The Flat BAT is neither regressive nor progressive.** The taxation of value added at one rate subjects all income to proportionate taxation, whether paid to labor or capital, with no exceptions or exclusions. *Should* state taxation be progressive? The fact that federal exemptions, deductions, and credits in the 2000 tax year were *double* income taxes imputed on necessities suggests that federal income redistribution is more than sufficient for all taxation, even without consideration of federal progressive taxation of incomes.
 5. **All commercial enterprises and employers should be included in the Flat BAT base.** The proposed Flat BAT would be levied all enterprises and employers, including governments. The question has been raised as to whether taxing governments would not require commensurate increase in tax revenues. However, introduction of the Flat BAT is proposed to be with the understanding that statewide pay increases would be 3% of payroll lower in the year of introduction. No additional government funding would be required at equilibrium, and a “tax neutral” exchange of personal ad valorem tax deductions and commercial prices benefits would be received for wage increases and capital income foregone. By including *all* incomes the lowest tax rates and most equitable distribution will be achieved. (It should be noted that it would likely not be possible to tax federal employment in Texas).
 6. **The tax proceeds from the Flat BAT would grow in proportion to the state’s economy over the long term.** The Flat BAT can be conceptually considered a constant percentage of the Texas Gross State Product less fixed investment. Over the long haul fixed investment should be more volatile but on average a relative constant percent of GSP. Therefore the Flat BAT should grow at the same rate on average over the long term but with less volatility over the short term.
 7. **The Flat BAT would neither be difficult nor costly to report or collect for Texas businesses.** The Flat BAT is levied on the difference between the revenues of commercial enterprises and the goods and services it purchases. The value added in effect is measured as the total of incomes to labor and capital after exclusion of fixed investment, what economists would term “consumed income.”

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The determination is as simple in concept for independent businesses as reporting sales tax.

8. **It would not be difficult to collect the Flat BAT from interstate corporations operating in Texas.** If corporations transfer internal sales and purchases at market prices, then Flat BAT tax returns would be as simple as for Texas businesses. If they account transfers at cost, then adding their pretax cash flow, margin would result in acceptable approximate to value added.
9. **The Flat BAT can be made just as visible as the retail sales tax.** All retail sales will include the Flat BAT as if it were a standard mark-on. Retail cash registers could calculate and show both the rate and amount of Flat BAT in each sale.