

Texas Tax Reform May Lighten Your Wallet

by

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Important people in Austin and elsewhere are suggesting that Texas needs to explore a reform of its state and local tax system. While “reform” can take many forms, Texas’ tax structure differs from that of most American states in one crucial aspect: the Lone Star State has no income tax. Thus, calls for “reform” are very likely to be an effort to get Texans to consider adopting an income tax, perhaps to partially replace other onerous levies, such as the property tax.

The Pros and Cons

Proponents of an income tax tend to stress two factors. First, the income levy is elastic with respect to revenues. In other words, tax receipts rise with the growth of the economy, and that allows government to maintain its activities and services as population increases and inflation occurs. It is argued that this avoids the constant fiscal crises that arise when less elastic revenue sources are used. Second, proponents contend that an income tax is an extremely fair tax that better fits the “ability to pay” principle of taxation. Advocates claim an income tax is more equitable than the less progressive property tax and the downright regressive sales tax, which takes a larger proportion of the income of the poor than the more affluent.

Opponents usually argue that the income tax reduces incentives to save, invest, and work, and thus lowers the rate of economic growth. Moreover, surveys show that Americans find the highly progressive income tax to be the least fair American tax. The public’s dislike for the property tax is relatively high as well; however, the sales tax is generally well tolerated.

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There is another issue that warrants closer examination: does the inauguration of an income tax lead to increases in overall taxation, or does the income tax tend to substitute for other taxes – merely changing the tax mix, but not the overall tax burden?

I am in the early stages of an investigation into America’s state and local tax system in general, and the Texas fiscal structure in particular. The Texas Public Policy Foundation (TPPF) will issue a major report containing my findings later this year.

The Historical Perspective

One thing is clear from the outset of my research: states that adopt an income tax have historically seen large growth in their overall tax burdens – far greater than the growth observed in non-income tax states. A vote for an income tax is a vote for bigger government, at least if the U.S. historical experience is any guide.

To get some historical perspective, I gathered key tax data for all states and the District of Columbia from the 1957 and the 1997 Census of Government.¹ This information gives a long-run perspective on how tax burdens have changed over time.

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In 1957, 28 of the then-48 states already had income taxes on individual income, although these taxes tended to have lower rates than prevail today. Of the 20 states that had no income tax in 1957, 12 subsequently adopted one, while eight, including Texas, have not.²

I then looked at what happened to the tax burden between 1957 and 1997 in three groups of states: those that had an income tax over the entire 40-year interval; those that had

¹ The Census of Government is published by the U.S. Bureau of the Census every five years, taken in years ending in 2 and 7. The 1997 Census has not been published in hard copy, but is available at <http://www.census.gov>.

² A few of the non-income tax states (e.g., New Hampshire, Tennessee) have a levy on dividends, interest and other forms of so-called “non-earned” income. I considered a state to have a meaningfully broad income tax if the tax raised an amount greater than \$3 for every \$1,000 in personal income in the state.

no income tax over that period; and those that instituted an income tax after 1957.³ I calculated the amount of income and other taxes collected for each \$1,000 in personal income in both 1957 and 1997 for each group of states.

The Results

The results, shown in Figure 1, are striking. While the overall tax burden rose for all three groups of states, it was most dramatic in the states that instituted a new income tax after 1957. The average increase in tax burden was more than three times greater in the states initiating income taxes than in the states that did not. While the 12 states initiating income taxes took an average of \$30.46 more out of the pockets of taxpayers for each \$1,000 earned in 1997 compared with 1957, the increase for the eight non-income tax states was a much more modest \$9.64. For the 28 states that had income taxes throughout the period, the growth in burden was \$21.19.

Figure 1
Increase in Taxes, 1957-1997, Per \$1,000 Personal Income

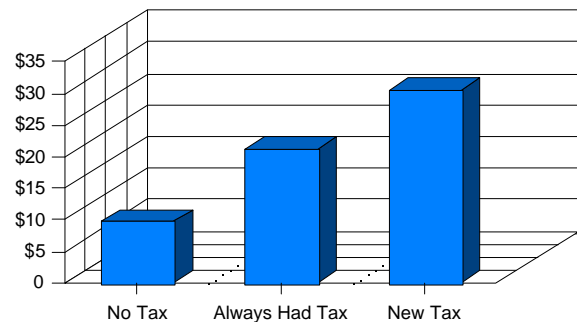
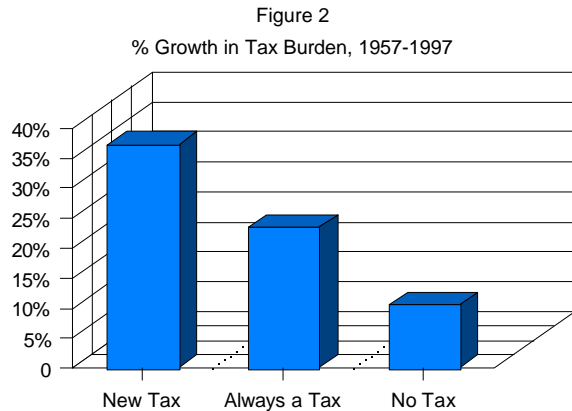


Figure 2 looks at fiscal changes by calculating the growth in the percent of income taken by all state and local taxes for 1957 and 1997. In the states instituting income taxes, the tax burden over the 40 years grew on average by an astonishing 37.2 percent! By contrast, in the states that held the line against income

³ In doing this analysis, I excluded Alaska and Hawaii, in large part because neither area was an American state in 1957. Alaska is an unusual state in any case, being the only state in the Union that abolished an income tax between 1957 and 1997.

taxes, the growth in the aggregate tax burden was a far more reasonable 10.5 percent (for the states with continuing income taxes, the growth was 23.4 percent).



Tax Savings or Spending Spree?

Was there at least some relief from other taxes as income taxes were instituted? In general, the answer from historical experience is a resounding “no.” In 1957, the 12 states that later instituted individual income taxes on average raised \$80.74 from levies other than the income tax for each \$1,000 in income in the state. By 1997, that number had actually risen, to \$87.04. The income tax was simply a new and very substantial burden on taxpayers.

Overall, the tax burden in the states with new or continuing income taxes in 1997 averaged \$112 per \$1,000 in personal income, compared with \$102 in states without income taxes. The income tax states claimed on average one percent more of the income of taxpayers – or about \$600 for a family with a \$60,000 income. Moreover, that understates the burden, as higher taxes mean lower economic growth and thus smaller incomes, a second and in the long run more severe burden.

This discussion raises two new questions. First, why do states that initiate income taxes have a much greater growth in tax burden than those with no such tax? Second, so what? If government is making good use of tax

resources, what difference does it make whether state and local governments take 11 percent or 10 percent of our income in taxes?

There are two reasons why the income tax states have bigger governments. First, as indicated above, income tax revenues are highly elastic to changes in economic conditions, or even inflation. If the incomes of taxpayers rise one percent in a typical income tax state, income tax revenues tend to rise more – maybe 1.3 or even 1.5 percent. Thus, over time, the income tax absorbs more and more income of taxpayers. This is great for politicians – they can increase the tax burden of citizens without voting to do so – a “stealth” or disguised tax increase.

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Additionally, the very real fact is that politicians tend to spend whatever money they have – and sometimes a little more. A 1998 study for the Joint Economic Committee of Congress that I conducted with Lowell Gallaway observed that the federal government operating with a budget surplus tends to dissipate an average of 60 cents of each surplus dollar within a year with new spending projects.⁴

Special interest groups have an appetite for new government spending that is never satiated. The recent spending surge in Washington suggests that history is repeating itself. The historical evidence would suggest that the same thing would happen in Austin if Texas adopted an income tax.

⁴ “Budget Deficits and Government Spending,” Study, Joint Economic Committee of Congress (Washington, D.C., 1998); available at <http://www.house.gov/jec>.

The ultimate question is: what is the impact of higher taxes and spending on economic growth and, more broadly, on the quality of life of the citizenry? In a 1995 study, I observed that the 25 states with the lowest tax burden had a one-third higher rate of growth in inflation-adjusted incomes from 1962 to 1994 than the 25 highest-taxed states (80 percent vs. 60 percent).⁵

There is broader evidence that several economists (including myself) successfully used last year to urge President Vladimir Putin of Russia to reduce his nation's tax burden: when government is extremely small, bigger government can actually be good economically, but when government gets bigger, further expansion tends to inhibit growth.⁶

The Great Tax Migration

Perhaps the ultimate expression of satisfaction or dissatisfaction with one's place of residency is migration. The Berlin Wall was built to keep persons migrating from undesirable, government-controlled East Germany to the market and capitalistic-oriented nation to the west. America has the opposite problem: millions of people have illegally migrated to the U.S. over the years to take advantage of superior economic opportunities. What is the

⁵ Joint Economic Committee Staff Report, "State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform," (Washington, D.C., December 1995).

⁶ Lowell Gallaway and I have observed that in a number of studies. See, for example, our "Government Size and Economic Growth," Study, Joint Economic Committee of Congress (Washington, D.C., 1998), available at <http://www.house.jec.gov>. Other papers making the same argument include "The Laffer Curve, Government and Economic Growth," *Journal of Private Enterprise*, January 1998, and "Constitutional Spending Limitations and the Optimal Size of Government," in Donald Raftery and Richard Wagner, eds., *Limiting Leviathan* (Aldershot, U.K.: Edward Elgar, 1999).

migration evidence with respect to income taxation?

I divided the nation into two groups of states: the 41 with comprehensive income taxes, and the nine (Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming) without. From 1990 to 1999, nearly 3 million native-born Americans migrated, net of out-migration, into the nine states that did not tax income individually – coming from the 41 income tax states. People voted with their feet in one of the great migrations in human history, moving more than 1,000 persons each workday for nine years to the states of economic opportunity – including Texas – that do not tax income.

All of this should be kept in mind as Texans hear the calls for tax reform. Perhaps some changes can be made in the Texas fiscal system to make the state a greater place for economic opportunity.

Certainly, the rise in state and local expenditures in modern times has been robust, and perhaps some mechanisms need to be in place to control tax and spending growth in the future. My forthcoming study for the Texas Public Policy Foundation will help address that and other issues. For now, however, I urge caution in heeding the calls for reform if "reform" is just a code word for instituting an income tax.

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