Ways and Means explores fiscal note process

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by William Lutz

You could almost hear the axes being sharpened.

On Sept. 21 the House Ways and Means committee, responsive to an interim charge, held a hearing to “Evaluate the process used by the Office of the Comptroller and the Legislative Budget Board to evaluate and provide information on the impact of tax legislation.”

Old Capitol hands wondered whether the hearing would rehash the disagreements between the House leadership and Comptroller-gubernatorial candidate **Carole Keeton Strayhorn** over the revenue estimate for HB 3, the House’s school finance proposal.

In a word: no. The topic never arose.

Center stage belonged instead to the tax equity notes, produced by the Legislative Budget Board, supposedly showing tax changes enacted during the school finance debate as hurtful to poor people.

During the legislative session, supporters of the swap between a business and property tax strongly challenged that conclusion. Despite past disagreements, the hearing was cordial and friendly.

Representatives of the Legislative Budget Board and the Comptroller’s Office detailed how they prepare fiscal and tax equity notes on bills. It was all a bit technical, but some policy differences showed through the cracks.

Such as how much value to place on tax equity notes, which, pursuant to legislative mandate, analyze the incidence of tax bills. “Incidence” is a term used by economists to describe who actually pays the tax. Initial or statutory “incidence” pertains to whom the law requires to write the check. Economic or final “incidence” pertains to whom the tax leaves with less money to spend.

For example, the initial incidence of a sales tax is on the consumer, because the tax gets added to the consumer’s bill. Statutory incidence falls on the retailer, who has to forward the money to the Comptroller. Economic or final incidence depends on the industry. Some industries might have to cut prices in response to a sales tax increase to avoid losing a large amount of sales. In this case, the incidence is on the businesses whose prices were cut. In other industries, the increase could be passed fully though to the customers — on whom, in this case, the economic incidence falls.

Income incidence describes how a tax change would affect different income groups. In other words, who would pay more, the rich or the poor?

It’s not as easy a question as it might sound, according to **Byron Schlomach**, chief economist with the Texas Public Policy Foundation. Schlomach questioned the value of tax equity notes as currently calculated. He discussed as an example the federal luxury tax, passed in the early 1990s and sold to Congress as a tax on the “rich” because it affected purchases of yachts, diamonds, expensive cars, and the like.

Nevertheless, Schlomach explained, the tax (since repealed) ended up pinching middle class workers for companies that made those products. Buyers switched to products made in countries that taxed them less. The result: layoffs by American competitors.

“I’m not sure that decision-makers, from these pure incidence analyses, when you’re looking at this chart with income levels and trying to guess how they might change, I’m not sure policy makers get that much from that,” Scholmach said. “I think you need to pay attention more, when you are making your decision, to how the economy as a whole is going to be affected.”

Schlomach encouraged the committee to look at other states and countries to see how their tax systems affect their economies. “A lot of the tax regimes that we consider progressive don’t do very well when it comes to economics. The fact is, the way the economy goes is the way your poor go. If you do something that hurts the economy, you’re going to hurt the poor, and you’re probably going to hurt them disproportionately to everyone else. And if you do something that helps the economy, you’re going to help the poor disproportionately.” Schlomach noted that some of the “poor” are elderly people who do not have high income but own property.

Dick Lavine, senior fiscal analyst with the Center for Public Policy Priorities, defended the use of tax equity notes. Lavine

brought the committee copies of similar studies done at the federal level and in other states. "This is an indication that large numbers of jurisdictions feel that this is useful information … [T]he question is, even though it's based on assumptions, do other people feel that this is information worth having and making decisions based on [it]? And the answer very clearly seems to be yes," he said.

Wayne Pulver, of the Legislative Budget Board, explained to the committee how tax equity notes are produced. Pulver told the committee that the state purchased an economic model from what was then-KPMG .

The model describes the economy and includes 27 taxes. The model analyzes the impact of tax changes on the economy and on specific income groups. The LBB looks both at the initial incidence of the tax and the final incidence or who finally pays the tax.

One critical question is how sensitive conclusions in tax equity notes are to the assumptions in the state economic model. All economic models make assumptions about the economy. Economists often examine what happens when one changes the assumptions in an economic model.

"What is driving our results," asked **Dale Craymer**, chief economist with the Texas Taxpayers and Research Association. "Is it data that we have a good, concrete handle on or is it more the assumptions we use to massage that data to produce the answer to a question we've asked."

In particular, Craymer questioned how accurately an incidence study can predict how businesses would react to imposition of a tax.

He also reminded the committee about the importance of manufacturing to the economy, the extra jobs a manufacturing plant generates, and the tax revenue paid by manufacturing.

Craymer recommended discontinuing analysis of final incidence in tax equity notes "because the results are driven by the assumptions made rather than any empirical evidence."

Lavine, however, told the committee members that Minnesota did a study on the assumptions made in their equity studies, finding that the conclusions were not sensitive to the assumptions made.

In addition to the tax equity note issue, the committee discussed how the state produces fiscal notes on tax bills. The state's revenue estimator **John Heleman** described the process to lawmakers. The state produces two types of revenue estimates: static and dynamic.

A static analysis looks only at the effect of a tax change on state revenue, without making assumptions about changes in business behavior prompted by the tax. If a tax is cut by one-third on baseballs, the Comptroller would likely assume a revenue loss of one-third on sales tax proceeds from baseballs.

Dynamic analysis assumes businesses and consumers change their behavior in response to taxes. Cutting taxes increases economic growth, and raising taxes can stunt it. Hence, if the state lowers taxes on baseballs, the state would get less revenue from each baseball purchased, but that revenue loss would be partially offset by the fact that more baseballs were sold.

The state purchased a model from the REMI firm that analyses the state economy. Most of the data on individual products that the state uses is collected by the federal government nationally.

Several who testified suggested more transparency in the assumptions used to produce revenue or tax equity estimates.

It was also suggested that these estimates be reported in ranges, because many of these economic models have a margin of error.

The committee will consider the testimony and produce a report prior to next year's regular legislative session.