Legislators' Guide to the Issues

INCOME TAX 8

STRENGTHS OF THE SALES TAX 10

BUSINESS TAX BURDEN IN TEXAS 12

BUYING DOWN THE PROPERTY TAX 14

TAX INCIDENCE 16

The Issue

Some policymakers have proposed establishing an income tax to provide increased revenue for expanding government services. Advocates of the personal income tax claim that a tax system is a "three-legged stool," but the third leg—an income tax—is missing in Texas. They claim the absence of an income tax prevents Texas from raising sufficient revenue and that current revenue sources are insufficient as spending needs grow. While such claims are unfounded, demands for increased state funding for health care and education stimulate periodic discussions about the efficacy of the income tax.

While an income tax could provide more revenue for the state, an increase in any other tax could accomplish the same. However, because the income tax relies on such a volatile base, it is a more unstable source of revenue than many other taxes. In addition, an income tax would bring with it adverse impacts on the Texas economy.

In fact, the absence of an income tax has been the primary reason for Texas' prosperity in recent decades. The experience of states with income taxes demonstrates they are particularly pernicious in their adverse economic impact. This experience is mirrored internationally; analysis of 23 other nations indicates the increase in revenue raised by taxing income has a negative correlation with economic growth.

In other words, the income tax damages an economy. The overall tax burden increases more rapidly in states with taxes on income, and state spending in income tax states exceeds that of states without an income tax.

The Facts

- ★ Income taxes have the most adverse economic impact of all tax systems—depressing capital investment, production, business expansion, job creation, wages, and living standards.
- ★ Texas is one of seven states without a personal income tax.
- ★ Twelve states that implemented income taxes during 1957-1999 experienced an average 37.2 percent overall increase in taxes compared to 10.5 percent in states without income taxes.
- ★ States with an income tax spend more than states without an income tax.
- ★ Income taxes lead to high levels of taxation that "crowd out" more productive economic activity in the private sector.
- ★ All taxes ALWAYS more negatively affect those with low incomes.

Recommendations

- ★ Do not create a personal income tax in Texas.
- ★ Do not expand the revised franchise tax by broadening it or increasing the rates.

Resources

- *Taxing Texans Part 1: The Worst Tax for Texans?* by Richard Vedder, Texas Public Policy Foundation (Feb. 2002) http://www.texaspolicy.com/pdf/2002-02-28-tax-taxingtexans1.pdf.
- *Taxing Texans Part 2: The Effect of Taxes on Economic Growth* by Richard Vedder, Texas Public Policy Foundation (Mar. 2002) http://www.texaspolicy.com/pdf/2002-03-29-tax-taxingtexans2.pdf.
- *Taxing Texans Part 6: Does Bigger Government Help the Poor?* by Richard Vedder, Texas Public Policy Foundation (Oct. 2002) http://www.texaspolicy.com/pdf/2002-10-29-tax-taxingtexans6.pdf.
- *The Economic Impact of Eliminating the Income Tax in Arizona* by Debra Roubik, Goldwater Institute (Sep. 2000) http://www.goldwaterinstitute.org/pdf/materials/96.pdf.

The Issue

One of Texas' biggest economic strengths is the state's reliance on the sales tax to fund state and local government. The greatest virtue of a sales tax is that it does not directly impede investment, work effort, or job creation. Compared to the alternatives, the sales tax is more visible to taxpayers, simpler, less intrusive, and less subject to manipulation. The sales tax has proven to be a stable and robust source of revenue for the state, growing faster than the sum of the population growth rate and inflation.

The sales tax, however, gets a major black eye from those who claim to advocate for low-income individuals. They claim the sales tax is regressive, and that it does not and cannot meet the needs of the state.

Measured in terms of economic progress, the sales tax is a relatively desirable tax. States that depend on it instead of the income tax, which is considered progressive, have seen healthier economies and stronger fiscal situations when faced with the inevitable downturns. Truly progressive policy is that which creates the greatest possible economic opportunities for individuals at all income levels. Compared to other tax systems, the sales tax is part of just such progressive policy. Sales tax transparency helps to keep the tax and government burden low, promoting economic opportunity.

Sales tax revenues have consistently grown, even when the sales tax rate and base have remained constant. Nevertheless, it is true that the sales tax has not kept up with state-financed expenditures. What this points to, however, is a spending problem rather than a revenue problem. State expenditures, net of federal revenues, have consistently grown 2 percentage points faster than population growth plus inflation. (See Spending Priorities and Expenditure Limits, pages 20-23.)

The current sales tax is also criticized as being outdated. Many services that constitute an increasing share of the state's economy are not taxed by the sales tax. This criticism is not justified where services are provided by one business for another business. However, the economy is distorted to the extent that some final consumer goods and services are exempted or otherwise not taxed under the sales tax. Many goods and services, such as car washes, newspapers, and interior decorating services, could be included in the sales tax.

Any broadening of the sales tax—or any other change that would result in greater revenues—should be offset by reductions in other taxes. While it is possible the sales tax could be broadened and the rate reduced to offset the increased revenues, it might be more prudent to reduce other taxes, such as the property tax or the revised franchise tax.

The Facts

★ The sales tax is simple, easy to understand, relatively easy to administer, and has low taxpayer compliance costs.

- ★ The sales tax does not directly tax work, job creation, or investment.
- ★ The sales tax is transparent—i.e., it is not hidden from those who pay it.
- ★ The sales tax can be easily applied regardless of the types of industries that prevail in the state.
- ★ Fifteen states tax the sale of food; 13 states tax the sale of non-prescription drugs.
- ★ Only five states have no sales tax at all.
- ★ Texas is tied with California with the seventh highest weighted average state and local sales tax rate—7.95 percent. Tennessee has the highest weighted average state and local sales tax rate at 9.4 percent.
- ★ Texas has the sixth highest state sales tax rate, at 6.25 percent; the highest in the nation is 7 percent.

Recommendations

- ★ Should the legislature determine that more state revenue is needed in order to offset cuts in other types of taxes, it should broaden the sales tax.
- ★ The sales tax could be broadened to final goods and services which are currently exempted or excluded, allowing a decrease in the sales tax rate as well as decreases in other taxes.
- ★ Some controversial final goods and services could be taxed at a lower rate in order to reduce concerns about regressivity.
- ★ Any broadening of the sales tax that produces more revenue for local entities should be offset with property tax reductions.
- ★ Increases in the sales tax rate should be offset with reductions in other taxes and should be very modest.

Resources

- *Virtues of a Consumption Tax* by Byron Schlomach, Texas Public Policy Foundation (Mar. 2006) http://www.texaspolicy.com/pdf/2006-03-testimony-bs.pdf.
- *All Taxes Are Not Created Equal* by Byron Schlomach, Texas Public Policy Foundation (Feb. 2006) http://www.texaspolicy.com/pdf/2006-02-PP-consumptiontax-BS.pdf.
- *The Best Tax Plan For Texas*, Texas Public Policy Foundation (May 2005) http://www.texaspolicy.com/pdf/2005-05-taxplan.pdf.
- *An Economic Analysis Of Property Tax Relief Funded By A Sales Tax Increase* by Milton L. Holloway, Texas Public Policy Foundation (Apr. 2004) http://www.texaspolicy.com/pdf/2004-04-sales-property-tax.pdf.

The Issue

Businesses do not pay taxes. Only people do—in lost jobs, lost wages, lost profits, and higher prices.

Nevertheless, it does make a difference how and what types of taxes are levied in an economy. Human beings do react to incentives, and taxes are negative incentives. Business taxes directly penalize certain productive activity including hard work, capital investment, job creation, and thrift. Property taxes penalize capital investment and property development. Anything that is taxed—i.e., penalized—will be reduced; that is, compared to what they would do otherwise, people will avoid taxed activities.

A society and its members are made prosperous through productive activity. Therefore, the last thing government should do is tax it. When productive activity shrinks, so do job opportunities, and when job opportunities shrink those who are least skilled are the first to feel the effects. Business taxes hurt low-income individuals more than anyone else through lost employment opportunities.

Unfortunately, Texas has one of the highest state and local business tax burdens in the nation, when direct business taxes are measured as a percentage of gross state product. According to the Council on State Taxation, Texas currently has the 11th highest business tax burden. That ranking will likely rise with the implementation of the revised franchise tax in 2008, even though the reduction in the property tax will significantly accrue to the benefit of business.

The Facts

- ★ Of the 60 taxes, fees, and assessments in the Comptroller's Sources of Revenue Growth report, at least 39 are derived in whole or in part directly from Texas businesses; this includes a substantial portion of the sales tax.
- ★ According to the Council on State Taxation, state and local taxes directly on business constitute 5.6 percent of Texas' gross state product.
- ★ Texas' business tax burden is greater than that of California, Massachusetts, Michigan, and Florida.
- ★ Only three states see a higher proportion of their revenues come from state and local business taxes than Texas.
- ★ Sixty-one percent of state and local tax proceeds in Texas come directly from business.
- ★ More than half of the revenue raised by the six major state and local taxes analyzed by the Texas Comptroller in the Tax Exemptions and Tax Incidence report comes from business.

Recommendations

- ★ Further increases in direct business taxes should be avoided.
- ★ State-level business taxes should be gradually repealed with lost revenues financed either from future surpluses or changes to the sales tax rate or application.
- ★ Reductions in business taxes should NOT be accomplished through targeted tax credits but through general decreases and repeals.
- ★ If the revised franchise tax collects more than was anticipated, the tax rate should be reduced.

Resources

- *All Taxes Are Not Created Equal* by Byron Schlomach, Texas Public Policy Foundation (Feb. 2006) http://www.texaspolicy.com/pdf/2006-02-PP-consumptiontax-BS.pdf.
- *The Business of Taxing Business* by Byron Schlomach, Texas Public Policy Foundation (Nov. 2005) http://www.texaspolicy.com/pdf/PP14-2005-taxingbusiness.pdf.
- *An Examination of Texas' Economic State* by Stephen Moore, Donna Arduin, and Arthur B. Laffer, Texas Public Policy Foundation (Sep. 2005) http://www.texaspolicy.com/pdf/2005-09-texaseconomy.pdf.
- *The Best Tax Plan For Texas* by Texas Public Policy Foundation (May 2005) http://www.texaspolicy.com/pdf/2005-05-taxplan.pdf.
- *Total State and Local Business Taxes* by Robert Cline, Tom Neubig, and Andrew Phillips, Ernst & Young LLP, Council on State Taxation (Mar. 2006) http://www.statetax.org/Content/ContentGroups/Home_Page_Content/COST_Studies,_Articles_and_Testimony/50StateTaxStudyMarch2006.pdf.
- *Tax Exemptions & Tax Incidence* by Texas Comptroller of Public Accounts (Jan. 2005) http://www.window.state.tx.us/taxinfo/incidence05/.

The Issue

School taxes represent the bulk of property tax bills, while county and city taxes make up much of the rest. The school portion, however, has increased most rapidly, creating a double squeeze on taxpayers as property values and tax rates have risen simultaneously.

Property taxes at the city and county levels, and for many special districts, have a rational basis in that property ownership is somewhat correlated with demand for services from these entities. Property taxes for education have less of a rational basis, since the value of real property owned bears little relationship to demand for education services.

The school tax issue is further complicated by the complex nature of the school funding system and repeated lawsuits against the state over issues surrounding the school property tax. Large differences in property values across school districts and the Edgewood court decisions have necessitated the creation of the so-called "Robin Hood" school funding system. This system almost inevitably leads to a de facto statewide property tax, which the Texas Supreme Court has also ruled unconstitutional.

For these reasons—the rising school property tax burden, the lack of a rational link between school property taxes and educational services, and the constitutional complexities surrounding the school property tax—many believe it is necessary to substantially reduce, if not eliminate, school property taxes.

During the Third Called Session of the 79th Legislature, substantial reductions in the school property tax were enacted. Using a large portion of the state's regularly-occurring surplus, a mandated reduction of seventeen cents in property tax rates was offset with state funds.

Even before the special session, it was calculated that if the growth in state-funded expenditures were limited to the sum of population growth and inflation, and if school expenditures were similarly limited, the school M&O property tax could be reduced to zero within two decades. This could be accomplished just by slowing the growth of state expenditures. With the school property tax reduced substantially by 2008, this could be accomplished even more quickly, and using future surplus windfalls for property tax reduction would even more swiftly accomplish this task.

The Facts

- ★ In fiscal year 2004, Texas ranked 13th in per capita local property tax collections at $1,254.
- ★ In 2004, property taxes comprised 43.5 percent of all state and local taxes in Texas; only New Jersey and New Hampshire depended more heavily on property taxes.

- ★ The property tax is strictly a locally-determined tax in Texas; this is true of only 12 other states.
- ★ Of all state and local in-state revenues, state revenues in Texas comprise only 47.7 percent of the total, the third lowest percentage among the states.
- ★ Property taxes raise more money in Texas than any other tax, including the sales tax.
- ★ There is substantial evidence that some local funding for education is associated with better school performance than if there is no local funding source.

Recommendations

- ★ Use future state surpluses to fund reductions in school M&O property tax rates.
- ★ Maintain a local share of school funding.
- ★ Make property tax reductions more substantial by implementing stricter expenditure limits at the state and local levels.
- ★ If any tax is increased in order to reduce property taxes, it should be the sales tax; no other tax should be created or increased for the sake of property tax relief.

Resources

- *Putting The Sides Together: Twelve Perspectives On Texas Public School Finance* edited by Chris Patterson, Texas Public Policy Foundation (Dec. 2003) http://www.texaspolicy.com/pdf/2003-12-sf2.pdf.
- *Splitting The Difference: Residential And Business Property Taxes In Texas* by Byron Schlomach, Texas Public Policy Foundation (Jan. 2004) http://www.texaspolicy.com/pdf/2004-01-26-sf-splitroll.pdf.
- *Effective, Efficient, Fair: Paying For Public Education In Texas* by Richard Vedder and Joshua Hall, Texas Public Policy Foundation (Feb. 2004) http://www.texaspolicy.com/pdf/2004-02-25-vedderhall-all.pdf.
- *Follow The Money: A 50-State Survey Of Public Education Dollars* by Chris Patterson, Texas Public Policy Foundation (Oct. 2003) http://www.texaspolicy.com/pdf/2003-10-22-sf-followmoney.pdf.

The Issue

Any time a change in the state's tax structure is contemplated, the first issue brought to the attention of decision makers is how it will affect Texans at various income levels. Texas' current tax structure is often derided as "regressive." That is, lower-income households allegedly pay a greater share of their income in state and local taxes than do higher-income households. So-called "progressive" tax policies would have higher-income households paying a higher percentage of their incomes in taxes than would lower-income households.

Any tax based on purchases of goods and services, such as the sales tax, is likely to be regressive as measured by prevailing methods. At best, those who measure tax incidence—a measure of who truly bears the burden of a tax—can observe who directly pays a tax to government, surmise some share borne by consumers, producers, and employees, and attempt to build into the analysis some dynamic economic effects. Long-term effects such as growth rates, investment, and population migration are virtually impossible to quantitatively forecast and measure accurately even though such qualitative effects are easily predictable.

The best example of the law of unintended effects, with respect to tax incidence, is the short-lived federal luxury tax. Intended as a tax on the rich, the burden was actually borne by low and middle-income Americans who worked in targeted luxury industries. Though it could be predicted that high-income Americans would reduce purchases of luxury items, the exact degree of reaction could not be predicted. In the end, while the exact cost of this failed tax policy cannot be calculated, it was much higher than the amount of tax collected and the rich bore little of it.

The only tax that is generally considered "progressive" is the progressive income tax. This tax is invariably associated with relatively stagnant economic growth, out-migration of individuals who would otherwise invest in an economy, and disincentives to work, invest, and create jobs. The more steeply progressive this tax is, the worse its effects.

Every type of tax is a drag on an economy. Those most negatively affected by factors negatively impacting an economy are those with low incomes. Therefore, since government—and thus taxes—are necessary, the most truly progressive tax policy is that which does the least harm to the economy as a whole. But popular notions of what constitutes a "regressive" or "progressive" tax ignore this and prove harmful when allowed to permeate policy discussions about taxation.

More care must be taken in analyzing tax recommendations to ensure their long-term effects and their unintended consequences are carefully considered and fully understood.

The Facts

- ★ The franchise tax, on average, is measured as more regressive than the sales tax by the Comptroller's Office.
- ★ The federal luxury tax, intended as a tax on the rich, was actually a tax on low and middle income jobs in luxury industries.
- ★ Attempts to achieve "fairness" by taxing high incomes and businesses backfire by reducing investment and job availability.
- ★ Due to the complexity of our economy and human behavior, measures of regressivity and progressivity of taxes cannot take long-term dynamic effects into account and provide no meaningful input into policy debates on taxation.
- ★ ALL taxes ALWAYS more negatively affect those with low incomes.

Recommendations

- ★ Legislative committees should stop requesting so-called "Tax Equity Notes" from the Legislative Budget Board.
- ★ Tax policy should largely be based on its overall economic effects, recognizing that the goal is to minimize economic harm.
- ★ Institute strict tax-limiting measures to minimize harm to the economy—i.e., reduce the size of state and local government.

Resources

- *Progressive or Regressive, Is That Really The Question?* by Byron Schlomach, Texas Public Policy Foundation (Mar. 2006) http://www.texaspolicy.com/pdf/2006-02-PP-taxincidence-bs.pdf.
- *A Tax On One Is A Tax On All* by Byron Schlomach, Texas Public Policy Foundation (Jan. 2005) http://www.texaspolicy.com/pdf/2005-01-taxes.pdf.
- *Taxing Texans Part 2: The Effect of Taxes on Economic Growth* by Richard Vedder, Texas Public Policy Foundation (Mar. 2002) http://www.texaspolicy.com/pdf/2002-03-29-tax-taxingtexans2.pdf.
- *Taxing Texans Part 6: Does Bigger Government Help the Poor?* by Richard Vedder, Texas Public Policy Foundation (Oct. 2002) http://www.texaspolicy.com/pdf/2002-10-29-tax-taxingtexans6.pdf.
- *Tax Exemptions & Tax Incidence: A Report to the Governor and the 79th Texas Legislature* by the Texas Comptroller (Jan. 2005) http://www.texaspolicy.com/pdf/2002-10-29-tax-taxingtexans6.pdf.