

# Taxes & Spending

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# FACTS ABOUT TAXES & SPENDING IN TEXAS

## Restraining the Growth of Texas State Spending

- ★ In 1977, the Texas Legislature passed the **Texas Tax Relief Act**, a proposed Amendment to the Texas Constitution, Article VIII, Section 22, limiting growth of the state's spending from general revenues to the "estimated growth" of the state's economy. The voters gave overwhelming approval to its ratification.
- ★ Despite this Amendment, state spending has exceeded the growth of the state's economy from the 1978-1979 biennium through the 2002-2003 biennium.
- ★ The "Limitation of Spending Amendment," (Article VIII, Section 22) - as drafted and administered - applies only to spending from tax revenues not dedicated by the Constitution. It exempts over half of state government revenues.
- ★ The "Limitation of Appropriations to Anticipated Revenues Amendment" (Article III, Section 49-a) - the so-called "balanced budget" amendment - does not require appropriations for a biennium to be limited to revenue sources collected during the biennium.
- ★ On a per capita basis, the state of Texas only spends 75.4 percent of what U.S. states spend on average. As a percentage of personal income, Texas state and local governments spend 89.7 percent of what U.S. state and local governments spend on average.
- ★ Texas' gross state product (GSP) grew 423.4 percent from 1978-79 to 2000-01. Over the same period, personal income grew 498.7 percent, 75.3 percent more than GSP. Unfortunately for taxpayers, total spending by Texas state government grew far more than either: 42.2 percent more than personal income and 91 percent more than GSP.
- ★ Given the current budget outlook and how state government created these problems, stricter spending restraints would be desirable for a remedial period.
- ★ A spending freeze for the '04-'05 biennium would be justifiable to reduce excesses of government spending more rapidly.
- ★ During the 2002-03 biennium, excess spending will cost a family of four in Texas \$2,885. Since the 1978-79 biennium, total excess state spending has cost \$26,846 for a family of four.

### What is the Worst Tax for Texas?

- ★ The cost of government has exploded in states that instituted an income tax in the past 40 years.
- ★ The average overall tax burden (measured by taxes per \$1,000 of personal income) rose by an astonishing 37.2 percent in states that implemented an income tax after 1957, compared with a much more reasonable 10.5 percent in the no-income-tax states.
- ★ Income tax states tend to be big government states, whereas non-income tax states like Texas, New Hampshire, and Florida tend to have more moderate levels of government spending and taxation relative to income levels.
- ★ Income taxes harm income growth, discourage savings and investments, and fuel unproductive increases in the size of government.
- ★ On average, real income per person grows faster in low-tax states like Texas
- ★ Sales taxes are less harmful than income taxes because they tax *consumption* of output, not the *production* of it.
- ★ Texas' policy of having relatively low corporate taxes is a pro-development move, although not as obvious as having low or no income taxes.

- ★ States that rely relatively heavily on fees and user charges tend to have higher growth. Correctly levied, a fee or user charge is a price for a government service, which the beneficiary of the government service pays.
- ★ Being a "mature" oil and gas state with depleted resources and rising production costs, Texas is particularly vulnerable to adverse productive effects of severance taxation.
- ★ Keep the overall tax burden low, since higher taxes fuel government growth, which always results in less economic growth. This means keeping governmental expenditures modest.
- ★ Make relatively heavy use of sales and other forms of consumption taxation, and make little or no use of income taxation. States without an income tax should under no circumstances create one. Try to keep property tax burdens moderate as well.
- ★ De-emphasize securing federal grants-in-aid, and especially do not increase local spending to "match" federal funds.
- ★ Use the benefit principle of public finance where appropriate, employing user fees or charges aggressively.

### The Effect of Taxes on Economic Growth

- ★ More than 60 research studies show that, in most industrialized countries, government has grown to the point

where it has become a serious drag on economic growth.

- ★ Studies have shown that each one percent tax increase lowers output per worker by about two percent. That finding has been confirmed by state-by-state comparisons between high-tax and low-tax states.

### Population Growth & Taxation

- ★ During the 1990s, some 2,849,310 people moved *from states with income taxes into states without income taxes*. That means that, excepting Sundays, some 1,000 people moved into states without income taxes every day for nine years - more than the number of people who moved from East to West Germany during the Cold War.
- ★ The marginal costs of serving more people (reflected in government spending) does not exceed the marginal revenue associated with having those added residents add to the tax coffers by their labor and spending. In other words, population growth in low-tax states adds revenues that exceed the cost of serving more people.
- ★ Total personal income growth is dramatically higher in states receiving the least amount of federal aid. This implies population growth is greater in states with low federal subsidies of state and local government activity.
- ★ Businesses and people want low taxes more than big government, and

they vote with their feet by moving to low-tax havens like Texas.

### The Texas Tax Burden Compared to Other States

- ★ Texas has the fourth-lowest tax burden in the nation.
- ★ More than 21 cents of each dollar earned by Texans (or \$214.02 of each \$1,000) was taken by state and local governments in fiscal year 1998 - a figure that sounds high but is actually more than 13 percent below the U.S. average.
- ★ Estimated Texas state tax collections in fiscal year 2001 were more than 11 times as high as they were in fiscal year 1972. Tax revenues have grown at a compounded annual rate of 8.87 percent annually over the past 29 years.
- ★ One-fifth of the American population lives in states with a tax burden similar to or lower than that of Texas.
- ★ The state and local tax burden in Texas is slightly more than 10 percent lower than in the typical state.
- ★ Texas is not alone as a low-tax state. It is one of 10 states with a combined 60 million in population with a low or very low tax burden.
- ★ The property tax burden in Texas is somewhat above the national average.

- ★ The burden of property taxes in Texas exceeds the national median by about 15 percent. Nationwide, there are a dozen states with higher property tax burdens than Texas; some have property taxes that absorb 30 percent more income than the Lone Star State.

### **Texas Spending Compared to Other States**

- ★ At both the elementary and collegiate levels, Texas devotes a larger percent of its tax revenue to education than the national average – between 9 and 10 percent higher. More than 40 cents of each dollar of general government spending in Texas goes for education, while the comparable figure nationally is 34 cents.
- ★ Texas spends significantly less of its tax revenues on welfare – about 25 percent less – than other states.
- ★ While the average state derives 39 percent of its tax revenue from local governments, the proportion is nearly 47 percent in Texas.
- ★ Comparing Texas with the median of all 50 states, the sales, property and “other” tax burden in Texas is somewhat (10 - 20 percent) higher, reflecting the fact that Texas relies on these

tax sources because it doesn't have an income tax.

- ★ Nationwide, 15 states have general sales tax revenues that are a larger proportion of personal income than Texas.
- ★ Texas has been able to avoid income taxation without having unusually high taxation in other areas by moderating its overall tax burden and holding the line on more than the majority of states.

### **Low Taxes Help the Poor**

- ★ Research shows that higher tax burdens are associated with *greater* poverty.
- ★ The relationship between immigration and poverty is not even statistically significant, although it is positive.
- ★ Several decades of studies by economists confirm the proposition that *the higher the level of taxation, the lower the rate of economic growth*. A low rate of economic growth will always have a disproportionate impact on the poor who are at the margins of employment and job security.

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# RESTRAINING THE GROWTH OF TEXAS STATE GOVERNMENT SPENDING

## The Issue:

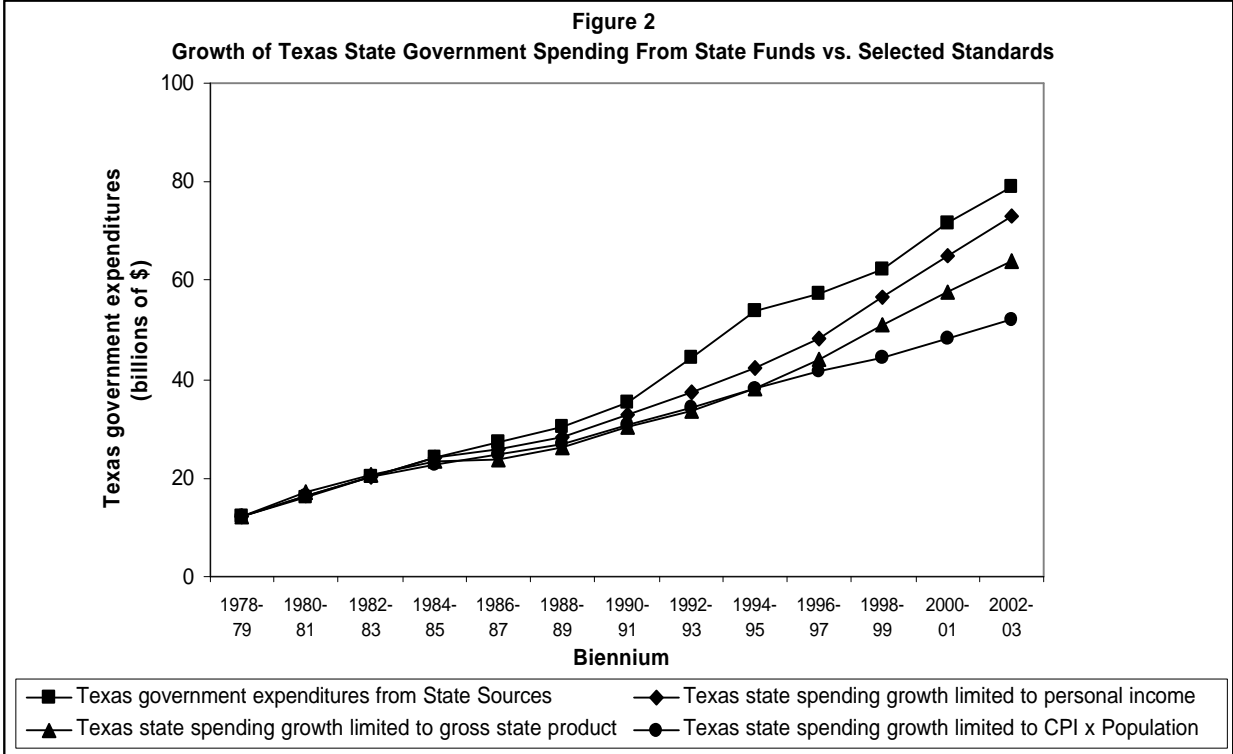
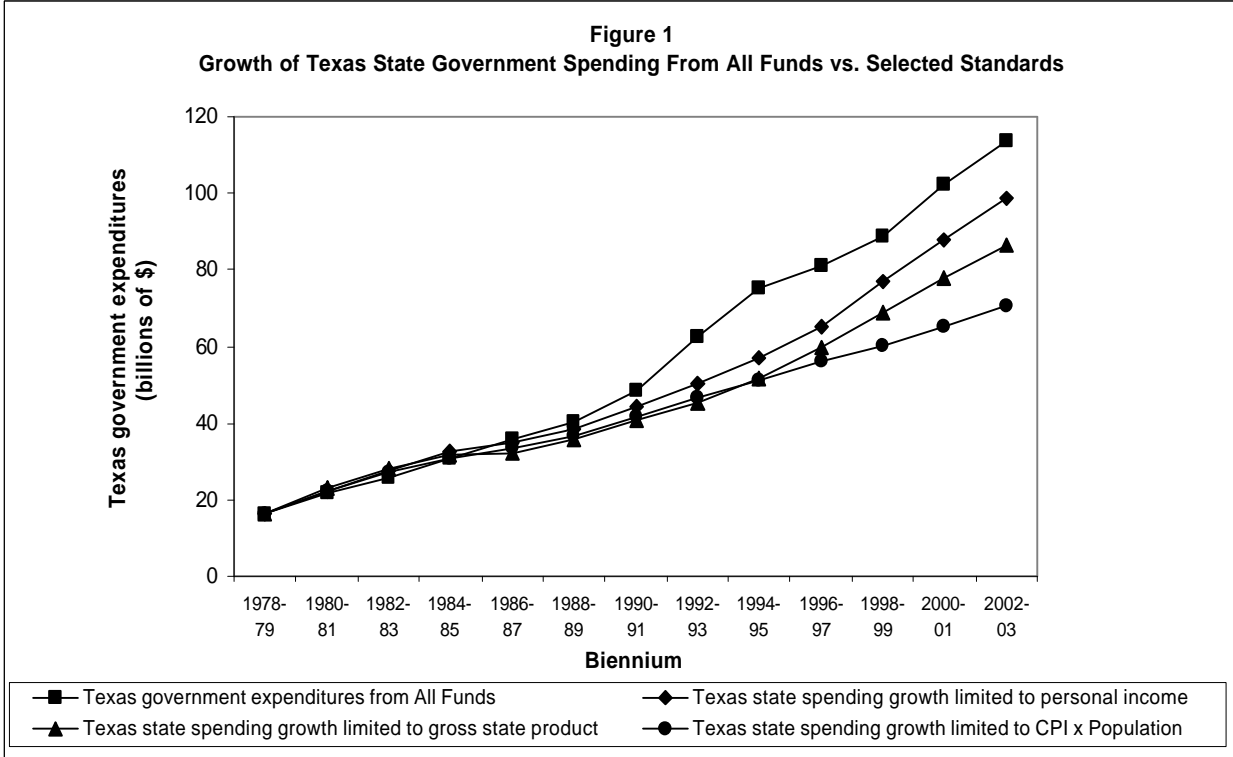
The state's budget is growing faster than the economy's ability to fund it because our state constitutional limitation on growth in state spending is not working.

### Overview

Government was the dominant growth industry of the 20<sup>th</sup> Century. Growth of all U.S. government over the course of that century took fully one-half of the entire growth of real personal incomes of Americans from productive sources. Although the highest income tax rates have receded from the confiscatory levels of the "New Deal," the total tax burden of productive Americans has grown relentlessly.

By 1977, it had become clear to Texans that runaway growth of state spending posed a clear and present danger to the health of the Texas economy. During Governor Briscoe's administration, the Texas Legislature passed the **Texas Tax Relief Act**, a proposed Amendment to the Texas Constitution, Article VIII, Section 22, limiting growth of the state's spending from general revenues to the "estimated growth" of the state's economy. The voters gave overwhelming approval to its ratification.

Despite this Amendment and its evident influence, state spending, whether tallied from all sources including federal funds, or from state sources alone, has exceeded the growth of the state's economy. Figure 1 shows that the growth of the Texas state budget (all funds) from the 1978-79 biennium through the 2002-2003 biennium has exceeded the growth of personal income, the official measure of growth as defined by the state Legislature. State budget growth has also exceeded the growth of gross state product, as well as that of population and inflation, by even greater margins. Figure 2 shows that growth of state spending just from state funding sources has exceeded all three measures as well. The data upon which Figures 1 and 2 are based is displayed in Table 1. Presuming total state spending during 2002-2003 will overrun the budget as it perennially does, it will exceed growth of state personal income and add to the excesses shown in Figures 1 and 2.



**Table 1**  
**Growth of State Government Spending vs. Selected Standards Data**

		Texas State Spending from All Funds, Bil\$	% Incr.	Revenue from federal sources Bil\$	% Incr.	Texas government expenditures from State sources Bil\$	% Incr.	Texas Personal Income, Bil\$	% Incr.	Texas Gross State Product Bil \$	% Incr.	CPI x population	% Incr.	Texas population	Consumer Price Index (1982-84=100)
1978-79	Governor	16.5		4.3		12.2		222.1		313.8		916.9		13.7	67.2
1980-81	Clements I	21.6	30.9%	5.5	27.9%	16.1	32.0%	299.4	34.8%	437.8	39.5%	1226.1	33.7%	14.5	84.4
1982-83	Clements I	25.7	19.0%	5.3	-3.6%	20.4	26.7%	371.1	23.9%	533.6	21.9%	1514.7	23.5%	15.6	97.1
1984-85	White	30.9	20.2%	6.6	24.5%	24.3	19.1%	436.8	17.7%	602.3	12.9%	1707.8	12.8%	16.3	104.8
1986-87	White	35.6	15.2%	8.2	24.2%	27.4	12.8%	472.4	8.1%	607.3	0.8%	1863.0	9.1%	16.8	110.9
1988-89	Clements II	40.1	12.6%	9.6	17.1%	30.5	11.3%	516.9	9.4%	678.2	11.7%	2036.1	9.3%	17.0	119.9
1990-91	Clements II	48.3	20.4%	12.9	34.4%	35.4	16.1%	596.5	15.4%	779.3	14.9%	2304.4	13.2%	17.5	132.0
1992-93	Richards	62.7	29.8%	18.3	41.9%	44.4	25.4%	678.5	13.7%	862.3	10.7%	2581.9	12.0%	18.1	141.5
1994-95	Richards	75.0	19.6%	21.2	15.8%	53.8	21.2%	768.3	13.2%	982.5	13.9%	2851.1	10.4%	18.9	149.4
1996-97	Bush I	81.1	8.1%	23.8	12.3%	57.3	6.5%	879.8	14.5%	1135.7	15.6%	3115.6	9.3%	19.6	157.8
1998-99	Bush I	88.9	9.6%	26.6	11.8%	62.3	8.7%	1033.5	17.5%	1313.2	15.6%	3349.0	7.5%	20.4	164.0
2000-01	Bush II	102.4	15.2%	30.8	15.8%	71.6	14.9%	1181.1	14.3%	1483.8	13.0%	3626.4	8.3%	21.1	173.6
2002-03	Perry	113.8	11.1%	34.8	13.0%	79.0	10.3%	1329.7	12.6%	1642.5	10.7%	3916.8	8.0%	21.8	182.8
78-79/02-03			589.7%		709.3%		547.5%		498.7%		423.4%		327.2%		

A common exaggeration is that Texans bear a far lower burden of state government than the citizens of most other states. However, the average state funds less at the local level and more at the state level than does Texas. Also, Texas personal income per capita is lower than the U.S. average. Table 2 shows that, on a per capita basis, the state of Texas only spends 75.4 percent of what U.S. states

spend on average. However, as a percentage of personal income, Texas state and local governments spend 89.7 percent of what U.S. state and local governments spend on average.

Correction of this misconception is important to the erroneous perception that Texans are being denied adequate spending on government.

**Table 2**  
**Comparison of Texas with U.S. State & Local Revenue & Spending, 1998**

	TEXAS	TOTAL U.S.	TEXAS % U.S.
<b>Total</b>			
State Revenue (\$Billions)	57.8	1,095.9	
State Expenditures (\$Billions)	51.1	930.0	
State & Local Revenue (\$Billions)	100.4	1,720.9	
State & Local Expenditures (\$Billions)	93.3	1,529.3	
Personal Income, (\$Billions)	500.1	7,351.5	
Population (millions)	19.7	270.2	
<b>Per Capita</b>			
State Revenue Per Capita (\$)	2,934.0	4,055.9	72.3%
<b>State Expenditures Per Capita (\$)</b>	<b>2,593.9</b>	<b>3,441.9</b>	<b>75.4%</b>
State & Local Revenue Per Capita (\$)	5,096.4	6,369.0	80.0%
State & Local Expenditures Per Capita (\$)	4,736.0	5,659.9	83.7%
Personal Income Per Capita (\$)	25,385.8	27,207.6	93.3%
<b>Percent of Personal Income</b>			
State Revenue (% Personal Income)	11.6%	14.9%	77.5%
State Expenditures (% Personal Income)	10.2%	12.7%	80.8%
State & Local Revenue (% Personal Income)	20.1%	23.4%	85.8%
<b>State &amp; Local Expenditures (% Personal Income)</b>	<b>18.7%</b>	<b>20.8%</b>	<b>89.7%</b>
<i>Data Source: U.S. Census Bureau</i>			

**Current State Budget & Spending Constraints**

The Texas Constitution provides three constraints upon state spending that, in

principle, should restrain state government spending to reasonable proportions. In practice, they exert some influence on spending but fail to achieve the restraint intended.

The "Limitation of Appropriations to Anticipated Revenues Amendment" (Article III, Section 49-a) - the so-called "balanced budget" amendment - does not require a balanced budget in the generally accepted sense of the term. That is, it does not require appropriations for a biennium to be limited to revenue sources collected during the biennium. It allows funds carried over from the prior biennium plus authorized new borrowing to be included in "anticipated revenues." This is the equivalent of a household calling a balanced budget that amount of spending equal to income plus bank accounts plus whatever the household can borrow.

The "Economic Stabilization Fund Amendment," (Article III, Section 49-g) - intended to impound half of general revenue fund balances carried over from the prior biennium - should substantially mitigate the problem of including fund balances in available revenue. But state officials have found artful ways to avoid making deposits to this "rainy day fund" intended to avoid financial crises in recessions. Thus we find that half of the surpluses of the past boom have not been retained for budgetary problems like Texas is facing in the 2003-2004 biennium.

Finally, the "Limitation of Spending Amendment," (Article VIII, Section 22) - as drafted and administered - has shortcomings as well. The limitation applies only to spending from tax revenues not dedicated by the Constitution. In effect, it exempts over half of state government revenues. Also, the use of personal income growth as the standard for limiting appropriations is flawed, as will be

shown in considering alternatives later in this section.

## State Government Spending Criteria

Government limited to functions which Abraham Lincoln defined as those which individual citizens cannot provide for themselves in their separate and individual capacities is an essential condition of a free society. But history has taught us that government must be restrained from invading the person, property and income. This was the fundamental founding principle of American government. Discerning when restraint is necessary requires clearly evident criteria, particularly in matters of spending and taxation by governments and an order of priority of these criteria.

The first priority is LEGALITY, as defined by the Texas Constitution and laws found constitutional, given that this is a nation ruled by law.

Next is SOLVENCY, the ability of the state to fund its appropriations and remain functionally capable, particularly during economic slowdowns.

Then NECESSITY, in order that the state provides for what citizens must seek from government to provide for their sustenance, health, and safety that they cannot provide themselves.

It is imperative that EFFICIENCY govern all of the state's legitimate functions to provide the desired result with the least expenditure of revenues and interference with citizens.

EQUITY of apportionment of both the burdens and benefits of government and equality of individual opportunity is essential, *not to be confused with equality of outcomes.*

The AVAILABILITY of the means from current taxation without undo burdens upon taxpayers should temper inclinations to arbitrarily enlarge the role of government and its burdens.

It should be observed that these criteria are first and foremost *limitations upon government*, not license to expand the province of government beyond the justifiable use of its irresistible power.

### **Improved Controls on the Growth of State Spending**

The following is a discussion of various measures that would enhance the control over state government spending.

#### 1. Limitation of Growth Standards

*After a century of outlandish growth of total government spending and taxation, it should be evident that taxpayers have all the government that they need or want. State spending routinely exceeds the state budget for mandated federal entitlements and also for oversights or un-budgeted "urgencies." The objective should be budgets that do not spend surpluses on current account, but instead provide ample reserve from prior surpluses for emergencies or tax relief, or state spending will inevitably outpace the growth of the state's economy.*

#### a. Growth of Personal Income

From a practical budgetary viewpoint, limitation of state government spending in total - not just spending from general revenues, or even from total state revenue sources - should be pegged to growth of the state's economy as a *maximum*, not as a minimum target.

It should be noted that personal income has not proven to be an appropriate measure of growth of the state's economy as defined by the enabling legislation of Article VIII, Section 22. As shown in Table I, the actual measure of the state's economy, gross state product, grew 423.4 percent over the 20-year period from 1978-79 to 2000-01. Over the same period, personal income grew 498.7 percent, 75.3 percent more than GSP. Unfortunately for taxpayers, total spending by Texas state government grew far more than either, 42.2 percent more than personal income and 91 percent more than GSP.

#### b. Growth of Gross State Product

Soaring health and welfare expenditures of the federal government were the principal reason that personal income grew faster than gross state product over the past 22 years, and growing social security distributions will cause this trend to continue. *Gross State Product measures the productive in-*

come from which most state taxes are paid, and as a result, would be a far better measure for limiting growth of state spending on government. Using GSP as the standard for growth of state government spending could be unduly restrictive during a recession, at which time curtailing government spending may be undesirable. However, the accumulation of a \$10 billion economic stabilization fund (about a tenth of biennium appropriations) would fill the breach for justifiable "emergency funding," as provided for by the enabling legislation of the current limitation of spending amendment.

c. Growth of Population and Inflation

Given the current budget outlook and how state government created these problems, an even more restrictive budget limitation restraint would be desirable for a remedial period. The estimated growth of population and inflation would be an appropriate measure. As shown in Table 1, the Clements-White-Clements administrations overshot this mark by only 10 percent between 1979 and 1989, which maintenance of expenditures during the economic slowdown of the 1980s could have justified. The first two budgets under Governor Bush came within one percent of restricting growth to this standard.

*What commends a standard of limitation to population and inflation is the*

*fact that government would not be curtailed, but limited to a decreasing share of the state's economy.*

This would require that new government programs be financed by more efficient operation of existing government. There would appear to be ample areas for efficiency improvement to meet this goal.

d. Freezing State Spending

*A spending freeze for the '04-'05 biennium would be justifiable to reduce excesses of government spending more rapidly.*

2. Balanced Budgets

The serious restraint of a balanced budget is not required, as assumed, by Article III, Section 49-a, in that general revenue fund balances from the prior biennium and new borrowings are included in "available revenues." This is a *solvency* restraint, not a *budgetary* restraint.

*The definition of a balanced budget requires current appropriations to be matched by current revenues. The re-drafting of this Amendment, with the inclusion of the requirement that a super-majority vote (two-thirds or 66.7 percent of the members of both houses) be required to exceed a truly balanced budget or to raise taxes or fees would be a far more resolute proposition to limit state spending.*

3. Funding Reserves

The economic stabilization fund, to be funded under Article III, Section 49-g, is an important reserve for maintaining state spending when justified by emergencies. As suggested above, 10 percent of a biennium's spending would provide an ample reserve. However, it must be faithfully funded to serve this purpose. *Any budgetary surplus of receipts over appropriations for a biennium should be either refunded to taxpayers, paid down on the debts of the state, or half deposited to the economic stabilization fund for this purpose without exception.*

### **The Impact of State Spending on Texas Families**

U. S. Senator Everitt Dirksen once wryly observed, "a billion here or a billion there and pretty soon it adds up to real money." It is astounding to determine the effect of state spending excesses upon the pocketbook of a family of four. Table 3 shows the burden of these excesses as measured by the three standards for efficient state spending discussed above.

The most consistent measure of reasonable growth of state government from state sources (GSP) shows how substantial a cost of excessive government spending burdens have been levied upon Texas families. During the 2002-03 biennium, spending in excess of the growth of GSP will cost a family of four in Texas \$2,885. Cumulative excess spending since 1978-79 biennium totals \$26,846 for a family of four. Other standards shown in Table 3 total greater or lesser excesses. Bear in mind that these excesses of spending con-

sider only those due to the cost of state government; consider the stress on the typical family when excess growth of federal income taxes and of local property taxes are added as well.

Three standards for comparison of growth of state spending are used for a reasonable determination of how much spending has cost. Of these, Personal Income, the official standard, shows the least excess, but is considered an overly generous standard. The measure of the growth of the state's economy, gross state product, which provides the most defensible standard, is the middle measure of spending growth. Growth of population and inflation, the most restrictive measure of growth, shows the largest excesses of spending. Measuring state spending from all funds (including federal) results in larger excesses, and would be most consistent for comparison with state personal income, which benefits from federal transfer funds. Spending from states sources, which would compare most consistently with gross state product, results in mid-range estimates of excesses.

This excess was reduced only under the Clements Administration and during the first term of the Bush Administration. However, *starting with Governor Bush's second term and including Governor Perry's first term, state spending has been pushing the growth limits, and the as yet unbudgeted '04-'05 biennium threatens to exceed any of the standards for an acceptable rate of growth of state government spending. Texans need new standards that provide tougher restraints for state spending, and resolve on the part of politicians to observe these restraints.*

<b>Table 3</b>			
<b>State Government Excess Spending Under Various Limitations</b>	<b>State Personal Income</b>	<b>Gross State Product</b>	<b>Population &amp; Inflation</b>
<b>Excess Spending From All Funds</b>			
Current 2002-03 Biennium (\$Billions)	+15.0	+27.4	+43.3
Cost Per Texas Family of 4, \$	+2,885	+5,269	+8,327
Cost 78-79 through 02-03, Present Value at 5 percent (\$Billions)	+126.4	+206.7	+256.4
Cost Per Texas Family of 4, \$	24,308	39,750	+49,308
<b>Excess Spending From State Sources</b>			
Current 2002-03 Biennium, (\$Billions)	+6.0	+15.1	+26.9
Cost Per Texas Family of 4, \$	+1,154	+2,904	+5,135
Cost 78-79 through 02-03, Present Value at 5 percent, (\$Billions)	+80.2	+139.6	+176.4
Cost Per Texas Family of 4, \$	+15,423	+26,846	+33,923

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# WHAT IS THE WORST TAX FOR TEXAS? *COMPARING INCOME, PROPERTY, SALES & CORPORATE TAXES*

## The Issue:

The Legislature should pursue tax policies that can provide for essential government services while limiting the growth of government and putting as much money as possible into the pockets of consumers.

Some taxation is necessary to pay for government services, including schools, roads, law enforcement, and social services. But providing those services must be balanced against the need to keep the rate of economic growth rising. It would be counterproductive to raise taxes to the point that the drop in personal income and the expansion of government costs lead to no or even negative economic growth.

Tax policy can affect growth; this has clearly been established by economists who have demonstrated that high taxation has had an adverse impact on states such as Illinois,<sup>1</sup> Puerto Rico,<sup>2</sup> and Massachusetts.<sup>3</sup>

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<sup>1</sup> James A. Heins, *Illinois Growth Study*, University of Illinois, Urbana, IL, July 1976.

<sup>2</sup> Victor A. Canto and Arthur B. Laffer, "Report to the Governor: Recommendations for Economic Reforms in Puerto Rico," H.C. Wainwright & Co., Boston, MA, 1979.

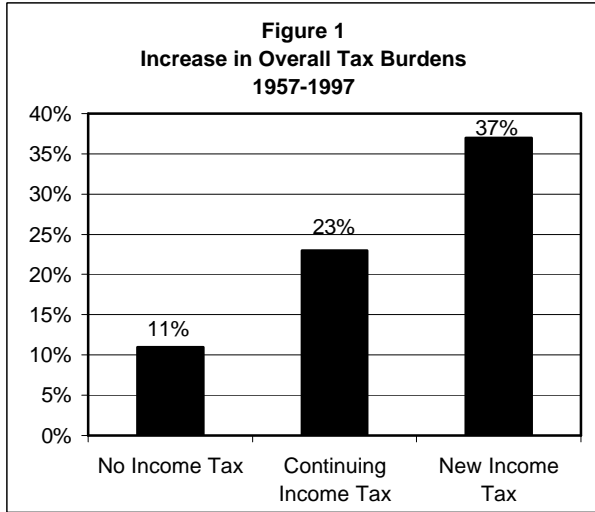
<sup>3</sup> Charles W. Kadlec and Arthur B. Laffer, *An Analysis of Fiscal Policy and Economic Growth in Massachusetts*, A.B. Laffer Associates, Rolling Hills Estates, CA, 1981.

## Expanding Government

Texas wouldn't be alone if it enacted an income tax. Forty states in the continental United States now have an income tax. Twelve have enacted one within the past 40 years.

What has the effect been in these jurisdictions? The cost of government has exploded in states that instituted an income tax in the past 40 years.

Figure 1 shows that the average overall tax burden (measured by taxes per \$1,000 of personal income) rose by an astonishing 37.2 percent in states that implemented an income tax after 1957, compared with a much more reasonable 10.5 percent in the no-income-tax states. In states that had an income tax in 1957 and have continuously maintained it, the tax burden rose 23.4 percent.



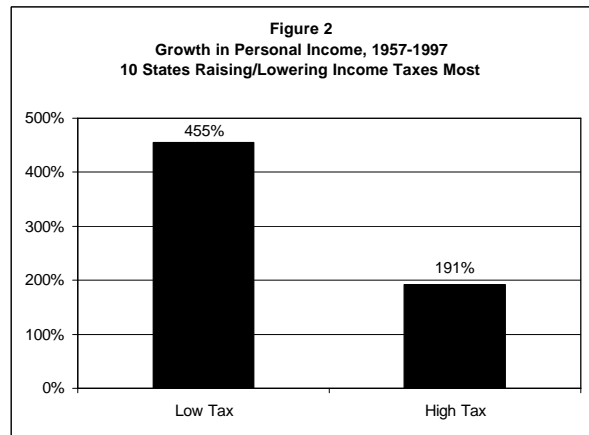
The conclusion is the same looking at absolute increases in the tax burden. Taxes per \$1,000 of personal income went up by an astonishing \$30.46 in the states instituting income taxes – more than three times the much more modest \$9.64 increase for those states that had no income taxes throughout the period.

Why did this happen? One part of the answer is that the income tax, because it is progressive and thus taxes high wage earners at higher levels, typically takes in more revenue than other types of taxes – and no government has ever shown itself unable to spend increasing tax revenues. Income tax states tend to be big government states, whereas non-income tax states like New Hampshire, Florida, and Texas tend to have more moderate levels of government spending and taxation relative to income levels. That gap tended to close very quickly once a state enacted an income tax: by 1997, states that enacted an income tax after 1957 had a tax burden that was very nearly as large as states that had had income taxes all along.

## Contracting Income

While income taxes fuel the explosive growth of government, they also act as a significant drag on personal income growth. Internationally-acclaimed economist Richard Vedder compared the 10 states with the greatest income tax burden from 1957 to 1997 to the 10 states with the smallest increase in burden (in several cases, zero, as they had no income tax throughout the period).

Figure 2 shows that real personal income growth was *more than twice as high* in the states raising their income taxes the least (or not at all), compared with states with the biggest increase in tax burden. Most of that reflected larger population growth in the low- or no-income-tax states. However, real income *per person* also grew faster on average in the low-tax states, a group that includes Texas.



Income taxes also have a clear effect on population growth, which fuels tax revenue. During the 1990s, some 2,849,310 people moved *from states with income taxes into states without income taxes*. That means that, excepting Sundays, some 1,000 people moved into states without

income taxes every day for nine years – more than the number of people who moved from East to West Germany during the Cold War.

Income taxes tip the balance between economic growth and government growth, a balance that should be the objective of every tax system; they hinder growth and are thus counterproductive.

### Taxing Consumption

Income taxes are the fastest-growing large tax revenue source of state and local governments. But general sales taxes still provide more revenue in many states. Of course, there are a wide variety of sales taxes among the 50 states, with several states having no general sales taxes at all (for example, Oregon, Delaware, and New Hampshire), while other states, including Texas, tax items up to or beyond eight percent. Also, the sales tax base varies dramatically; some states, for example, exclude food and drugs.

While there is a strong negative relationship between income taxes and economic growth, however measured, the relationship between the sales tax and growth is ambiguous. Looking at the 10 states with the highest average general sales tax burden from 1957 to 1997 and comparing them with the 10 states with the lowest such burden, Dr. Vedder found moderately higher rates of growth in per capita income in the low sales tax states, suggesting these taxes too are harmful at the margin.

*But with respect to total personal income growth, the reverse is true: the high sales tax*

*states actually had, on average, greater growth.* One reason is that no-income tax states often have relatively high sales taxes – Nevada, Tennessee, and Washington, and to some extent Texas, for example, are no-income tax states with relatively high sales taxes. It might be that people who move decide that sales taxes are the lesser of two evils and relocate to low- or no-income-tax states, even if it means paying a higher sales tax, since the benefits of having no income tax are clear.

Sales taxes are less harmful than income taxes because they tax *consumption* of output, not the *production* of it. Income taxes are levies on the fruits of labor and capital investments that lead to the production of goods. Sales taxes are levies on the benefits of production. Further, they can be avoided by saving, but income taxes actually hinder savings by taxing both capital and interest. Of course, savings and capital formation, along with technological progress, are the primary engines of economic growth.

There are some problems with sales taxes, especially when tax rates are high. In our mobile society, people will often cross state lines to escape the tax. But this competition can also be a good thing, as it constrains the rates government can charge.

Second, high sales tax rates are relatively more successful in states with large tourism and convention business, especially Louisiana, Florida, and Hawaii. These states in a sense export part of their tax burden to those living out of state by collecting revenues from those who only

draw on government services in a limited way. The economic damage of sales taxes is likely to be higher in states like Iowa or Alabama, with less tourism and convention business, than in states like Nevada and Louisiana, which export much of the burden to conventioners and tourists going to Las Vegas and New Orleans. The same principle applies to some extent with severance and production taxes on minerals: producers in Texas pay these taxes, some of which are passed along to out-of-state consumers in the form of higher product prices.

Although Dr. Vedder's analysis did not include an extensive examination of Texas' system of severance taxes, it did determine that any tax on production potentially has adverse impacts. By lowering the rate of return on productive activity, such taxes typically reduce investment and often lead to a distortion in the allocation of resources. Severance taxes on extremely low-cost producers (say those who have newly-discovered rich sources of oil) can have limited adverse effects on the local economy, since the reduction in the extremely high rate of return of producers is not sufficient to lead to reduced production. In situations like those, a state's severance taxes can largely be exported, particularly if the mineral resources are owned by out-of-state interests. As resources are depleted and production costs rise, however, the adverse marginal impact of a given severance tax increases substantially, and the taxes now can lead to otherwise profitable exploration becoming unprofitable. Being a "mature" oil and gas state with depleted resources and rising production costs, Texas is particularly vulnerable to

adverse productive effects of severance taxation.

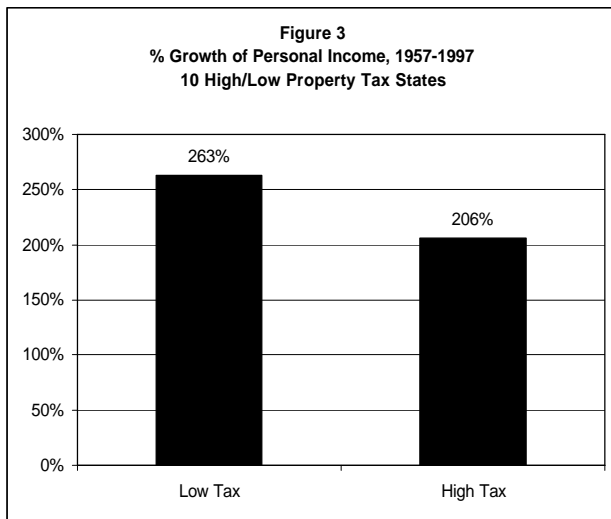
### Paying for Property

The most important source of revenue for local governments historically has been the property tax. Most jurisdictions finance a large part of their public school budget through property taxes, though recent attacks on the equity of property tax financing have led to the decline of the importance of the property tax in some states. Are property taxes more like the income tax or the sales tax in their effect on economic growth and personal income?

Again, Dr. Vedder took the 10 states with the highest average property tax burden as a percent of personal income in the period 1957 to 1997, and compared them with the 10 states with the lowest average burden. The 10 high property tax states (Maine, Massachusetts, Montana, Nebraska, New Hampshire, New Jersey, New York, South Dakota, Vermont, and Wyoming) had personal income growth of 206 percent, compared with 263 percent in the low property tax states (Alabama, Arkansas, Delaware, Kentucky, Louisiana, New Mexico, South Carolina, Oklahoma, Tennessee, and West Virginia) (Figure 3).

Dr. Vedder also determined that the income tax had the most severe adverse impact on personal income growth, followed by the property tax (whose adverse impact on income growth, dollar for dollar, was about three-quarters as large as the income tax), and lastly by the

sales tax, whose impact was negative, but not very large in magnitude.



### Other Tax Sources

There are other taxes and non-tax revenue sources that have economic effects. Again, Dr. Vedder looked at the 10 states with the highest and lowest average use of the revenue source, as measured by the average of the source's share of personal income as of three years: 1957, 1977, and 1997.

Dr. Vedder found that corporate income taxes have an adverse effect on the growth of total personal income over time, but not necessarily on per capita income growth. This implies that states with low corporate taxes have higher population growth. It is possible that low corporate taxes induce capital formation and investments, which in turn stimulates people to move into a state. On balance, Texas' policy of having relatively low corporate taxes is thus a pro-development move, although not so obvious as having low or no income taxes.

Second, the only instance where high taxes were associated with higher growth (measured either in terms of total or per capita income) was with respect to selective sales taxes, a relatively minor revenue source. This includes taxes on gasoline, cigarettes, alcoholic beverages, and other so-called "sin taxes." The states with higher tax burdens had higher growth. The most important of these taxes was motor fuel taxes, which in most states are in effect user charges that finance highway investments. Since these "sin" taxes are often used for investment instead of consumption, they generally have a pro-growth effect.

Third, large infusions of federal funds to state and local governments did not lead to higher growth. Actually, the opposite is closer to the truth. There was no meaningful difference in per capita income growth between the 10 states receiving the most federal aid as a percent of personal income and those receiving the least such aid. However, total personal income growth was dramatically higher in states receiving the least such aid. This implies population growth was greater in the states with low federal subsidies of state and local government activity. People actually moved away from states receiving large federal subsidies to those receiving relatively little aid - including rapidly growing states like Texas.

Fourth, states relying relatively heavily on fees and user charges tended to have higher growth. Correctly levied, a fee or user charge is a price for a government service, which the beneficiary of the government service pays. Good examples include university tuition fees or charges

for use of public parks. Fees and charges use a market solution to finance activity rather than general taxpayer subsidy, and as such tend to be more efficient than taxes. The cost makes fee payers more conscious of the costs of the service and provides an incentive to reduce waste.

### Principles to Live By

What can be concluded from this comparison between different tax systems? Four principles become clear:

- ★ Keep the overall tax burden low, since higher taxes fuel government growth, which always results in less economic growth. This means keeping governmental expenditures modest.
- ★ Make relatively heavy use of sales and other forms of consumption taxation, and make little or no use of income taxation. States without an income tax should under no circumstances create

one. Try to keep property tax burdens moderate as well.

- ★ De-emphasize securing federal grants-in-aid, and especially do not increase local spending to "match" federal funds.
- ★ Use the benefit principle of public finance where appropriate, employing user fees or charges aggressively.

After all the tests are run and the results analyzed, the conclusion is clear: income taxes are nowhere near as efficient and effective as other forms of taxation, especially sales taxes. They harm income growth, discourage savings and investments, and fuel unproductive increases in the size of government.

★★★

*Prepared by Richard Vedder, Ph.D., former economist with the Joint Economic Committee of Congress and author of "Taxing Texans," TPPF's six-part series examining taxes in the Lone Star State.*

# THE EFFECT OF TAXES ON ECONOMIC GROWTH

## The Issue:

Research clearly demonstrates that government has grown to the point where it has become a serious drag on economic growth.

In the arguments over flat taxes, regressive and progressive taxes, hidden taxes, loopholes, and all the other technical matters, it is easy to lose sight of the fundamental question: How does any particular tax or level of taxation improve the material welfare of the citizenry? Does taxation spur or impede economic growth for everyone?

No one denies that some government is essential for prosperity, since property rights have to be protected and the nation defended. But more than 60 research studies reviewed by economist Richard Vedder show that, in most industrialized countries, government has grown to the point where it has become a serious drag on economic growth.

For example, studies have shown that each one percent tax increase lowers output per worker by about two percent. That finding has been confirmed by state-by-state comparisons between high-tax and low-tax states.

The most recent studies by Martin Feldstein of Harvard concluded in 1997 that "the deadweight burden caused by in-

cremental taxation ... may exceed one dollar per dollar of revenue raised, making the cost of incremental government spending more than two dollars for each dollar of government spending."

In a study in the highly regarded *Journal of Monetary Economics*, economists from the Federal Reserve and the University of Florida examined changing marginal income tax rates in the U.S. over time, concluding that "lowering taxes significantly raises economic growth and that changing the tax rate schedule also has significant effects on economic growth." This conclusion not only reflects the view that high taxes lower income generation, but that the *type* of tax itself can make a difference as well.

Other studies have shown that high taxes discourage business entrepreneurs from locating in a given area; reduce the inflow of new residents into a region and increase the outflow of residents out of a region; and reduce job opportunities and sometimes lead to higher unemployment.

Numerous research studies make it clear. A growth-oriented fiscal policy should:

- ★ Stress general tax relief for the entire citizenry rather than targeted tax abatements or other subsidies for specific individual businesses.
- ★ Emphasize public investment in highways and parks rather than entitlement or income maintenance programs.

- ★ Minimize governmental regulation of business and keep a rein on unemployment and worker compensation costs.

★★★

*Prepared by Richard Vedder, Ph.D., former economist with the Joint Economic Committee of Congress and author of "Taxing Texans," TPPF's six-part series examining taxes in the Lone Star State.*

# POPULATION GROWTH & TAXATION

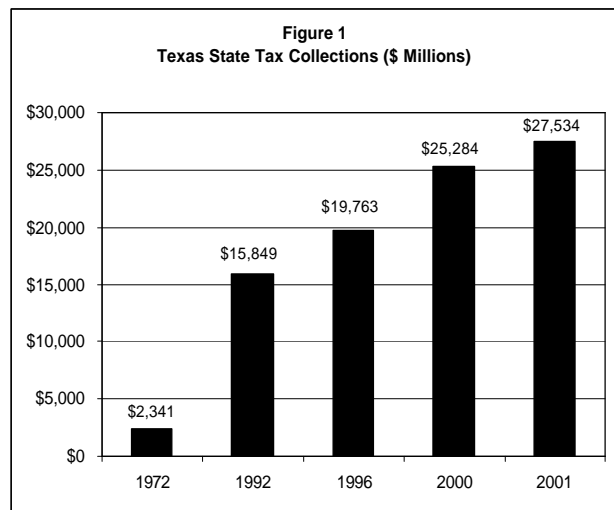
## The Issue:

Taxes need not increase due to rising population. Indeed, taxes should be allowed to fall, at least on a per capita basis.

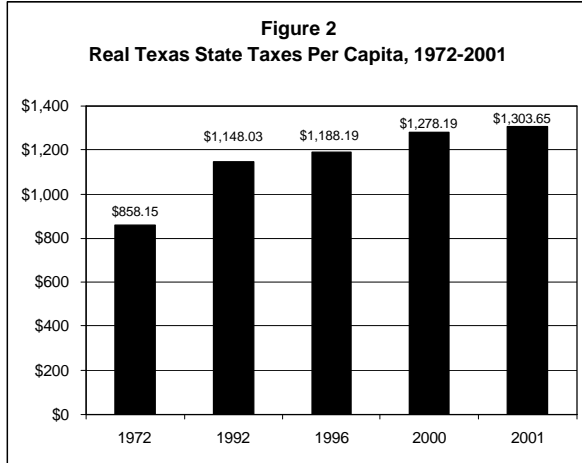
For most people, the following proposition makes sense: growth in population requires higher taxes, because the cost of providing essential government services increases with each new citizen. States with high population growth, like Texas, have greater needs for new school buildings, new highways, improved sewage systems, and hundreds of other infrastructure improvements. These capital outlays alone ought to require higher taxes.

At first glance, the experience of Texas seems to bear out that proposition. Government in Texas – and with it, the taxes that are levied to pay for public services – has grown dramatically over time.

Figure 1 shows that Texas state tax collections in fiscal year 2001 (partly estimated) were more than 11 times as large as they were in fiscal year 1972. Tax revenues grew at a compounded annual rate of 8.87 percent over the 29-year period.



It is true that inflation reduced the purchasing power of the dollar over time, and the Texas population nearly doubled. To deal with these problems, economist Richard Vedder calculated tax collections in per capita dollars, using the Consumer Price Index (CPI) and Bureau of Labor Statistics to “deflate” numbers to dollars of current (2001) purchasing power. The findings (Figure 2) show a steady per capita growth in tax collections.



Texas tax revenues have been rising faster than inflation plus population growth. Moreover, the 1.45 percent rate is almost certainly understated. There is virtual universal consensus in the economics profession that over time the CPI overstates the true amount of inflation. Correcting for that, the growth in per capita real taxes from 1972 to 2001 is likely to be in excess of 100 percent – more than doubling, implying an annual growth in real per capita tax revenues of at least 2.4 percent.

Tax collections have been growing *too* fast – faster than the rate of inflation plus population growth. The marginal costs of serving more people (reflected in government spending) does not exceed the marginal revenue associated with having those added residents add to the tax coffers by their labor and spending. In other words, population growth in low-tax states adds revenues that exceed the cost of serving more people.

Comparing the 1990 and 2000 Census, population growth varied from less than one percent (in North Dakota and West Virginia) to over 66 percent (in Nevada). Twelve states gained more than 20 per-

cent in population (Arizona, Colorado, Florida, Georgia, Idaho, Nevada, New Mexico, North Carolina, Oregon, Texas, Utah, and Washington), while seven gained less than five percent (Connecticut, Maine, North Dakota, Ohio, Pennsylvania, Rhode Island, and West Virginia).

If the notion that “population growth increases revenue needs” is correct, a positive relationship between population growth and tax burdens should be expected. But the data show that the exact opposite occurred: on average, states with high population growth have lower tax burdens than states with low population growth.

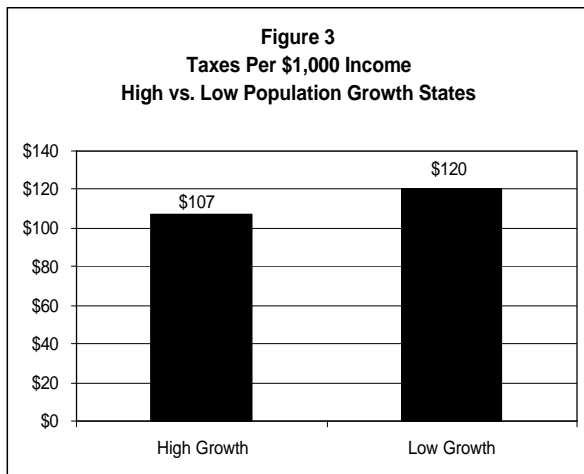
Dr. Vedder examined the relationship between decennial population growth from 1990 to 2000 and the tax burden in 1998, as measured as a percent of personal income. The observed relationship was negative and statistically significant at the five percent level. One interpretation of this finding is that new residents who participate in the labor force at high levels tend to raise more revenue at the margin for governments than they cost in incremental spending, allowing a somewhat lower tax burden.

One could calculate a population-adjusted ranking of the states in terms of tax burdens, taking into account the fact that lower taxation is expected, on average, in high-population-growth states. What would be Texas’ tax burden ranking if its population growth, and that of all other states, was at the national average growth rate of 13.1 percent during the 1990s? The state’s ranking would actually rise from 46th to 44th, passing Virginia and Missouri in terms of tax burden. This

further supports the view that Texas' tax burden, while generally relatively low, is actually roughly equal or above that of many rather populous states, including Florida, Virginia, and Tennessee.

A simple graphical presentation makes this point even stronger. Take the seven states that from 1990 to 2000 grew faster than Texas - Arizona, Colorado, Florida, Georgia, Idaho, Nevada, and Utah. All had population growth of at least 23 percent. Now, compare their tax burden (which is closely correlated with spending) to the seven states with the slowest population growth, in each case under five percent - Connecticut, Maine, North Dakota, Ohio, Pennsylvania, Rhode Island, and West Virginia.

The results (Figure 3) are startling. The tax burden in the low-population-growth states was actually \$13 higher for each \$1,000 in personal income - a tax burden approximately 12 percent larger than in high-growth states.



The causation between population growth and government size has actually been reversed. Rather than population growth dictating larger government (which has clearly been shown incorrect), or even that population growth allows smaller government, it seems clear that low taxes associated with modest-sized government induce greater population growth. Businesses and people want low taxes more than big government, and they vote with their feet by moving to low-tax havens like Texas.

Some 2,849,310 persons moved into the no-income-tax states from the states that levied taxes on the productive activity of their citizens over the past decade. Excepting Sundays, around 1,000 people moved to states without an income tax *every day for nine years*. That's more people than fled from East to West Germany during the Cold War. And all of those people added to the extraordinary economic growth of these low-tax states, growth that exceeded the increased costs of government.

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*Prepared by Richard Vedder, Ph.D., former economist with the Joint Economic Committee of Congress and author of "Taxing Texans," TPPF's six-part series examining taxes in the Lone Star State*

# GOVERNMENTAL FINANCES: TEXAS AND THE U.S.

## The Issue:

Texas has been able to avoid income taxation without having unusually high taxation in other areas by moderating its overall tax burden, and by restricting expenditures somewhat from what is the case in a majority of states.

Texans are paying more than ever in taxes. Estimated state tax collections in fiscal year 2001 were more than 11 times as high as they were in fiscal year 1972. Tax revenues have grown at a compounded annual rate of 8.87 percent annually over the past 29 years.

But where does Texas stand in relation to other states, both in levels of taxation and the services it provides taxpayers. Is the tax base growing or shrinking? Is the present system of taxation pro-growth or will it hinder economic expansion? Do Texans get more bang for their buck in terms of government services?

### **State and Local**

In answering these questions, it is critical to include local governments in the analysis, since local government makes up such a varied amount of the funding mix in different states. In Hawaii, for example, there is one school district for the entire state. From state to state, the role of state government in funding schools,

roads, and other improvements can vary significantly.

The most authoritative and comprehensive data on state and local finances is gathered by the U.S. Bureau of the Census in the Department of Commerce. Unfortunately, the numbers are published with a considerable time lag.

Texas is often considered a low-tax state. While there is some factual basis for that conclusion, the full picture is far more complex. Table 1 ranks the states on the basis of state and local tax burden per \$1,000 in personal income for fiscal year 1999. It is true that Texas is one of four states that taxed its citizenry less than \$100 for each \$1,000 earned – less than the Biblical tithe of one-tenth of one's income. Ranking 47th in terms of severity of tax burden, Texas can take pride in the fact that it offers state services at a more affordable price than most other states, including "peer" states with which Texas is often compared – all its neighbors and several other large Sun Belt and industrial states.

**Table 1**  
**State and Local Taxes Per \$1,000 Personal Income,**  
**50 U.S. States, Fiscal Year 1999**

Rank	State	Taxes	Rank	State	Taxes
1	Hawaii	\$151.03	26	Louisiana	\$108.01
2	New York	\$140.34	27	Iowa	\$107.95
3	Maine	\$139.07	28	Georgia	\$107.74
4	Wisconsin	\$127.08	29	Nebraska	\$107.64
5	Minnesota	\$126.26	30	Kansas	\$107.58
6	Vermont	\$121.70	31	Pennsylvania	\$107.17
7	New Mexico	\$121.73	32	South Dakota	\$106.55
8	Connecticut	\$121.47	33	North Carolina	\$105.51
9	Utah	\$116.76	34	Illinois	\$104.95
10	West Virginia	\$116.63	35	South Carolina	\$104.75
11	Rhode Island	\$115.55	36	Oklahoma	\$104.77
12	North Dakota	\$114.87	37	Indiana	\$104.69
13	New Jersey	\$113.68	38	Maryland	\$104.62
14	Michigan	\$113.59	39	Arkansas	\$104.56
15	California	\$113.58	40	Alaska	\$102.58
16	Wyoming	\$113.41	41	Colorado	\$102.23
17	Idaho	\$112.61	42	Nevada	\$101.77
18	Delaware	\$112.30	43	Virginia	\$101.63
19	Washington	\$111.13	44	Missouri	\$101.55
20	Kentucky	\$110.98	45	Florida	\$100.24
21	Mississippi	\$110.53	46	Oregon	\$100.19
22	Ohio	\$109.86	<b>47</b>	<b>TEXAS</b>	<b>\$99.79</b>
23	Montana	\$108.82	48	Alabama	\$91.11
24	Arizona	\$108.64	49	New Hampshire	\$88.37
25	Massachusetts	\$108.53	50	Tennessee	\$87.99
	<b>MEDIAN</b>	<b>\$108.27</b>			

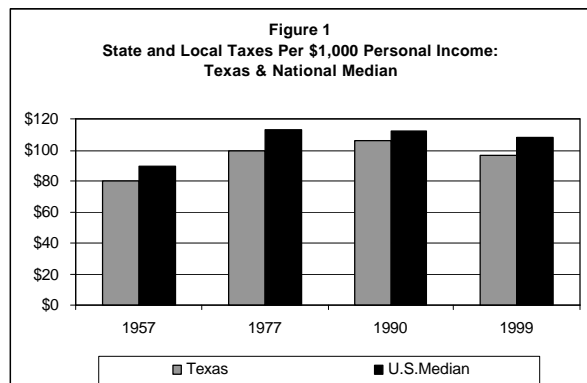
Source: U.S. Bureau of the Census, Bureau of Economic Analysis, Author's Calculations.

At the same time, Texas is certainly not unique in having a tax burden that is lower than found in most states. While its tax burden is markedly smaller than California or New York, it is not significantly lower than Florida, and it is actually above two Sun Belt states, Alabama and Tennessee. Four states - Florida, Missouri, Oregon and Virginia - have a tax burden within five percent of that of Texas. *One-fifth of the American population*

*lives in states with a tax burden similar to or lower than that of Texas.* The notion that Texas has unusually low taxes - significantly different from that in any other important state - simply is not true.

Figure 1 looks at how the aggregate tax burden has changed over time. In the 1960s and 1970s, taxes rose sharply in Texas and elsewhere. In Texas, that ris-

ing tax burden continued in the 1980s, even after the tax revolt nationally led to some moderation in other states. In the 1990s, however, the overall tax burden fell somewhat in Texas.



In fiscal year 1957, Texas ranked 36th in the proportion of income taxed away by state and local governments. Twenty years later (1977), Texas ranked 43rd; its tax burden having risen significantly, but less than most other states. From 1977 to 1990, the rise in tax burden in Texas led to its rank rising (to being tied for 39th). In the 1990s, the aggregate tax burden fell in most states, but somewhat more in Texas, so its rank fell to 47th.

Today, the typical Texan pays over \$11 less in state and local taxes for each \$1,000 earned than workers in other states.<sup>4</sup> That suggests a Texas family with an income of \$50,000 a year would have a tax bill that is about \$550 less than it would be in the median or typical state. Put differently, the state and local tax burden in Texas is slightly

<sup>4</sup> That is comparing Texas with the median state. State and local taxes per \$1000 personal income in the "middle" or median state were \$108.27 in 1999. Yet the average (arithmetic mean) tax burden was slightly higher (over \$110), as the average gives greater weight to extreme values and also is an unweighted average (big states count more than small states in the compilation).

more than 10 percent lower than in the typical state.

Yet these statistics on total tax burden disguise significant differences in the tax structure of the states. Texas, for example, is one of only nine states without a general individual income tax. As a consequence, it relies more on other taxes as Table 2 shows.

First, comparing Texas with the median of all 50 states, sales, property and the "other" tax burden in Texas is somewhat (10 - 20 percent) higher, reflecting the fact that Texas must rely on these tax sources because it doesn't have an income tax. "Other" taxes include selective (e.g., tobacco, alcohol, gasoline) sales taxes, public utility taxes, severance taxes, corporate income taxes, inheritance taxes, and some other minor levies. Note that the Texas tax burden in all of these areas is not out of line with national norms. Compare Texas with Florida and New York. The Texas figures are very similar to those prevailing in Florida - no income taxes in both states. Florida derives somewhat more sales tax revenue (probably reflecting its very large tourist business), and within 10 percent of the proportion of property and other taxes collected in Texas. New York derives an enormous amount of funds from income taxes, but its tax take on other levies closely approximates that of Texas, being somewhat lower in general sales taxes, but higher in property taxes. Compared with Texas, New York's income tax does not substitute for other taxes, but rather it is the source of the much higher overall tax burden in

the Empire State compared to the Lone Star State.

While Texas' general sales taxes absorb about a 20 percent larger proportion of the income of its citizens than is typical, the Texas figure is no great aberration from the norm. Note in Table 2 that the sales tax burden is higher in Florida, Tennessee, and Georgia, and the Texas proportion is not dramatically larger than in California. Nationwide, 15 states have general sales tax revenues that are a larger proportion of personal income than Texas.

The same can be said of property taxes. The burden in Texas exceeds the national median by about 15 percent. Yet it is lower in Texas than in New York or Illinois, and it is very similar to that in Massachusetts. Nationwide, there are a dozen states with higher property tax burdens than Texas; some have prop-

erty taxes that absorb 30 percent more income than the Lone Star State.

The same is true of the "other tax" category. Texas is about 12 percent above the national median in terms of burden, but is below such neighboring states as New Mexico and Oklahoma and major Sun Belt competitor Florida. Overall, Texas ranks 20th in "other taxes" as a percent of personal income.

In short, while Texas does have moderately high non-income taxes relative to the "typical" state, it does not stand out as being unusual, not ranked in the top quintile (fifth) of states in tax burden in any major category. Texas has been able to avoid income taxation without having unusually high taxation in other areas by moderating its overall tax burden, and by restricting expenditures somewhat from what is the case in a majority of states.

<b>Table 2</b>					
<b>Major Taxes Per \$1,000 Personal Income, Texas &amp; Peer States, Fiscal Year 1999</b>					
<b>State</b>	<b>Income Tax</b>	<b>General Sales Tax</b>	<b>Property Tax</b>	<b>Other Taxes</b>	
<b>TEXAS</b>	<b>\$0.00</b>	<b>\$31.44</b>	<b>\$36.73</b>	<b>\$28.62</b>	
California	\$32.99	\$29.77	\$27.29	\$23.52	
Colorado	\$28.33	\$28.55	\$28.83	\$16.52	
Florida	\$0.00	\$35.62	\$34.23	\$30.16	
Georgia	\$26.42	\$32.99	\$25.15	\$15.43	
Illinois	\$20.02	\$18.83	\$38.94	\$27.16	
Massachusetts	\$39.17	\$15.94	\$35.58	\$17.84	
Michigan	\$28.26	\$27.33	\$33.31	\$24.69	
New Mexico	\$21.98	\$49.16	\$15.95	\$34.64	
New York	\$44.11	\$25.84	\$41.94	\$28.45	
North Carolina	\$34.20	\$22.85	\$22.59	\$25.87	
Oklahoma	\$27.72	\$30.99	\$16.58	\$29.49	

**Table 2**  
**Major Taxes Per \$1,000 Personal Income,**  
**Texas & Peer States, Fiscal Year 1999**

Pennsylvania	\$26.75	\$20.60	\$29.20	\$30.63
Tennessee	\$1.19	\$41.29	\$19.99	\$25.51
Median: 50 States	\$26.70	\$25.89	\$31.79	\$25.43

*Source: U.S. Bureau of the Census, U.S. Bureau of Economic Statistics, Author's Calculations.*

Texas actually is very similar to other states without income taxes. There are a total of nine non-income tax states: Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. Together, their 2000 population exceeded 52.5 million, almost the size of such important European nations as Italy, France, or Great Britain. Some 19 of every 100 Americans live in a non-income tax state. Moreover, the population of these states is rising sharply faster than the income tax states, as resources move to avoid income taxation.<sup>5</sup>

Table 3 looks at the tax burden in Texas, the nine non-income tax states, and the 41 income-tax states. Note that the total tax burden is substantially lower in the non-income tax states, suggesting that income taxation is not merely a substitute for other taxes, but rather a means of paying for larger government. Note that Texas's sales, property, and "other" tax burdens

are within about five percent of the median of the nine non-income tax states.

The "other tax" category in Table 3 includes selective excise and corporate income taxes, as well as motor vehicle license taxes and inheritance taxes. Unfortunately, data limitations prevent a comprehensive comparative analysis in this category. One problem is that published data are not detailed enough; another problem is a definitional one. For example, the Census Bureau records no "corporate income tax" revenues for Texas, counting franchise tax receipts under the "other taxes" category. Yet in most states, most non-property or sales-based business taxes are recorded as "corporate income taxes" as opposed to other taxes, so making interstate comparisons of business taxation is difficult. Considering that severance taxes on mineral production produce significant revenues in Texas, but are not explicitly delineated as a separate category in the Census data, there is a tendency to understate business taxation in Texas.

With this caveat, the published data show that selective sales taxes are generally far more substantial than the national average. Taxes on motor fuel, alcoholic beverages, and tobacco products are all more substantial in Texas than the national av-

<sup>5</sup> The median percentage population increase of the nine non-income tax states between 1990 and 2000 was 16.7 percent, compared with 9.7 percent for the income tax states; using the arithmetic mean, the non-income tax state growth was 21.5 percent, compared with 12.2 percent in the 41 states with income taxes. The reason for this differential is not fertility variations, but rather human migration. About three million native-born Americans moved from the income to the non-income tax states in this period.

erage, while public utility taxes are about the same. For example, while motor fuel taxes nationally average \$4.08 for each \$1,000 in personal income, they average \$5.10 in Texas, or 25 percent higher. For liquor taxes, the differential was even greater – the Texas tax burden was two-thirds higher than the national average (\$0.95 vs. \$0.57). In part, however, this differential may well reflect higher gasoline and liquor consumption per capita in Texas as opposed to higher tax rates.

**Table 3**  
**Taxes Per \$1,000 Personal Income,**  
**1999: Texas, Non-Income Tax States and**  
**Income-Tax States**

Tax	TEXAS	Median, Non- Income Tax States	Median, Income- Tax States
All Taxes	\$96.79	\$100.99	\$112.42
Individual Income Taxes	\$0.00	\$0.00	\$28.23
General	\$31.44	\$30.23	\$25.77
Sales Taxes			
Property	\$36.73	\$35.31	\$30.15
Taxes			
Other Taxes	\$28.62	\$30.23	\$24.31

*Source: Author's calculations from Census Bureau of Bureau of Economic Analysis data.*

### Non-Tax Forms of Revenue

A majority of revenues of state and local governments in the United States come from *non-tax* sources. It is even truer in Texas. In the Lone Star State, 58 cents of each dollar collected by state and local governments in fiscal year 1999 came from non-tax sources (vs. 56 cents nationwide). There are three types of non-tax revenues: grants from the federal

government; income from fees, charges and some miscellaneous sources of revenues (e.g., lotteries, interest earned on investments); and income from government-run business operations, such as utilities, liquor stores (in some states) and insurance trust programs (e.g., unemployment insurance, public employee retirement systems, worker compensation). Table 4 compares Texas with the national average with respect to major forms of non-tax revenues. All told, total non-tax revenues per \$1,000 income (the sum of the last three rows in the table) are actually slightly higher in Texas than the national average. Texas taxes less than the average, but derives a larger proportion of its revenue from non-tax sources. Total revenues (tax and non-tax) are only slightly lower in Texas (less than five percent) than is the national norm.

By deriving a slightly larger proportion of its total revenues from non-tax sources, Texas is able to have a relatively lighter tax burden. While federal government assistance to state and local governments was slightly below the national norm, fees and charges approached the national average, and revenues for utilities and insurance trust funds significantly exceeded the average. Closer examination of the data reveals that Texans devoted an extraordinary 21.9 percent larger proportion of their income to financing state and local government employee retirement plans than the national average. This higher contribution may reflect: 1) higher employee benefit levels in Texas than the national average; 2) greater (sounder) funding of retirement liabilities in Texas, or 3) a combination of both.

An issue in public finance is whether to use the benefit principle or the ability-to-pay principle to pay for public services. According to the benefit principle, government services are paid by those who use them. Using this reasoning, fees and charges should be enacted where administratively feasible to do so (that is, for those goods not jointly consumed by the population as a whole). According to this principle, educational and recreational services would be financed by tuition fees or park admission charges, not by general taxation. The ability-to-pay principle argues that those who earn more should pay more – the rich should pay more, in proportion to income, than the poor.

From an efficiency perspective, a very strong case can be made for the benefit principle, as resources tend to be allocated more efficiently when users have to pay for their use. Governmental fees are analogous to prices for services in the private sector. To illustrate, dollars are

less likely to be wasted on schools if the users of the schools have to pay for them. Yet some would argue that this is inappropriate on fairness grounds. Texas relies a bit more than the national average on non-tax revenues including user charges, but not dramatically more so.

Texas has a relatively low, but not extraordinarily unusual, tax burden. Like the other eight non-income tax states, Texas relies somewhat more than the national average on sales, property and other non-income forms of taxation. Some would argue that this means that Texas is “starving” its public services. An alternative interpretation is that Texas is able to provide needed public services at a more affordable price than most competing states. The evidence on taxes and economic growth, discussed in other studies in this series, demonstrates that Texas has benefited from an environment of no income taxation and a relatively low overall state and local tax burden.

**Table 4**  
**Tax and Non-Tax Sources of**  
**State and Local Government Revenue, FY1999\***

Revenue Category	Texas	U.S.	Texas: % Compared to U.S.
Total Revenue	\$231.00	\$242.98	- 4.9%
General Revenue <sup>+</sup>	\$177.59	\$194.22	- 9.1%
Taxes	\$96.79	\$110.42	- 12.3%
Federal Aid	\$34.77	\$36.65	- 5.1%
Charges, Misc. General Revenue <sup>#</sup>	\$46.02	\$47.14	- 2.4%
Commercial Operations <sup>++</sup>	\$53.41	\$48.76	+ 9.5%

\*Per \$1,000 in personal income.

+ Excludes utilities, insurance trust revenues, liquor store receipts.

# Fees, charges, interest earnings, property sales, special assessments, etc.

++ Utilities, insurance trust funds (including employee retirement), liquor store revenues.

Source: U.S. Bureau of Census, author's calculations

**Where It Goes**

Texas spends less on government than the national average (Table 5). "General expenditure" excludes from total spending on such things utilities, state liquor stores, and insurance trust plans.

While overall spending is 8 to 10 percent below the national average when measured as a proportion of income, the deviation of spending from the national average varies substantially category to category.

**Table 5**  
**State and Local Expenditures Per \$1,000 Income**  
**FY 1998: Texas vs. U.S.**

Category	Texas	U.S.	% Difference Texas vs. U.S.
Direct General Expenditures	\$173.30	\$189.72	-8.7%
Capital Outlays	\$22.31	23.31	-4.3%
Operations	\$150.99	\$166.42	-9.3%
Education	\$70.02	\$65.00	+7.7%
Capital Outlays	\$9.49	\$7.12	+33.3%
Higher Education	\$17.79	\$16.29	+9.2%
Primary, Secondary Education	\$50.61	\$45.91	+10.3%
Public Welfare	\$22.06	\$29.53	-25.3%
Hospitals	\$11.87	\$10.05	+18.1%
Health	\$4.63	\$6.41	-7.5%
Highways	\$11.25	\$12.59	-10.06%
Capital Outlays	\$6.42	\$6.94	-7.5%
Public Safety	\$16.96	\$17.49	-3.0%
Police Protection	\$6.22	\$7.28	-14.6%
Fire Protection	\$2.42	\$2.93	-17.4%
Corrections	\$7.62	\$6.13	+24.3%
Other	\$0.70	\$1.15	-38.0%
Parks and Recreation	\$2.20	\$3.23	-31.9%
Housing and Community Devel-	\$2.58	\$3.56	-27.5%
Sewerage	\$3.18	\$3.70	-14.1%
Government Administration	\$7.81	\$10.21	-23.5%
Interest on General Debt	\$8.38	\$9.32	-10.1

Source: U.S. Census Bureau, Author's Calculations

**Education:** Critics have charged that the state of Texas has shortchanged education to pay for tax cuts that keep the state's tax burden one of the lowest in the country. But the data shows how nonsen-

sical that criticism is: At both the elementary and collegiate levels, Texas devotes a larger percent of its tax revenue to education than the national average - between 9 and 10 percent higher, in fact. True,

some of this spending is explained by the fact that Texas spends a good deal more than the typical state on capital outlays in education (especially school construction), which is no doubt a function of higher population growth. But the Lone Star State also spends more on current outlays as well. Indeed, more than 40 cents of each dollar of general government spending in Texas goes for education, while the comparable figure nationally is 34 cents.

***Welfare, Hospitals and Health:*** In contrast to education, Texas spends significantly less of its tax revenues on welfare – about 25 percent less. Adding health and hospitals into the category of medical-related expenses, spending in Texas is close to the national average, being higher in hospitals but lower in the general health category.

***Highways and Public Safety:*** Texas spends a modestly smaller proportion of its resources on highways and on public safety than the national average, with the deviation from the average most pronounced for police and fire protection (15 to 17 percent below the average) and in corrections (24 percent above the average).

Some would argue that high corrections expenditures may, in part, explain low police/fire expenditures, since Texas incarcerates a relatively larger proportion of its criminals – and for longer sentences – than other states.

***Other Forms of Spending:*** In other areas of spending – including parks and recreation, housing and community development, sewers, governmental administra-

tion, and interest on debt – Texas tends to spend less than the typical state. In some categories, the presence of a significant rural and small town Texas population may be partially responsible for the trend.

### **...And Who Gets it There?**

State governments aren't the whole picture when it comes to funding and providing government services. Instead, they share those responsibilities with a variety of county, municipal, educational, and other governmental units. In some states, more of the activity is centralized at the state level than in others. Table 6 shows the proportion of various revenue and expenditure categories carried out by local governments or any governmental unit other than the state government.

Texas is more dependent on revenues raised by local governments than most states. While the average state derives 39 percent of its tax revenue from local governments, in Texas the proportion is nearly 47 percent. In part this may reflect the composition of taxation – Texas does not have individual and corporate income taxes, which are typically administered largely if not entirely at the state level.

With regards to spending, the pattern is less clear. There are several categories where a larger proportion of the spending actually came from the state government, although on balance again there was a slightly higher proportion of total spending financed locally in Texas compared to the nation as a whole.

**Table 6**  
**The Proportion of Revenues or Spending Derived**  
**from Local Governments in 1998**

Category	Texas	U.S.
General Revenue from Own Sources (non-Fed.)	50.4%	43.9%
Taxes	46.8%	38.9%
Property	100.0%	95.4%
General Sales	19.9%	17.7%
Motor Vehicle License	22.5%	8.2%
Current Fees and Charges	65.4%	62.2%
Direct General Expenditures	60.2%	58.3%
Education	76.9%	73.7%
Higher	21.0%	14.7%
Primary and Secondary	99.0%	99.1%
Public Welfare	2.2%	15.9%
Highways and Roads	34.6%	40.4%
Public Safety and Corrections	60.6%	65.3%
Governmental Administration	66.0%	58.0%

Source: U.S. Bureau of the Census, Author's Calculations; data are for FY 1998.

### Grading the Texas System

How does the tax system in Texas rate in terms of encouraging economic growth? The Small Business Survival Committee (SBSC), the American Legislative Exchange Council (ALEC), *Bloomberg Personal Finance*, and economist Richard Vedder graded Texas, neighboring states and top Sun Belt competitors. In the end, the Lone Star State did very well in all four measures (Table 7), and the median of all studies is a very respectable B+. Moreover, Texas generally receives higher marks than all of its neighbors, dramatically so in the case of New Mexico. While the state is graded substantially higher than one of its important Sun Belt competitors (California), it ranks be-

low Florida, one of the best states in the Union on almost all fiscal evaluations.

What conclusions can be drawn from the Texas rankings? Take it easy and go slow – the Texas system is not in need of radical reform. Instead, moderate changes are needed to make the state even more attractive to individuals and businesses.

**Table 7**  
**Grading the States:**  
**Texas, Neighbors, Top Sun Belt Competitors**

	ALEC	<i>Bloomberg</i>	SBSC	BHI	Vedder	Median*
<b>TEXAS</b>	<b>B</b>	<b>B</b>	<b>B+</b>	<b>B-</b>	<b>A</b>	<b>B</b>
Arkansas	C	C	C+	C+	C	C
California	C-	C-	D-	C	C-	C-
Florida	A	A	A-	C	A-	A
Louisiana	C	A-	C+	D	B	B-
New Mexico	F	C+	D-	C	C	D+
Oklahoma	C-	C	C	C-	C+	C

\*Where median is between two grades, higher grade is given.

Source: Lathrop (2001), Saler (2001), Keating (2001), Beacon Hill Institute (2001), Vedder (2001).



*Prepared by Richard Vedder, Ph.D., former economist with the Joint Economic Committee of Congress and author of "Taxing Texans," TPPF's six-part series examining taxes in the Lone Star State.*

## LOW TAXES HELP THE POOR

### The Issue:

Research shows that high taxes are detrimental to the poor and an impediment to economic growth.

In the debate over whether to change Texas's current tax structure from a sales and property tax model to an income tax model, no charge packs more emotional punch than the notion that the poor suffer under the state's "inequitable" tax system.

Critics of Texas' current sales-and-property-tax system level two main charges. First, that the current tax structure is excessively regressive: the sales tax does not tax the rich, proportionally, as much as the poor. The addition of a progressive income tax would shift more of the tax burden onto those individuals who best can afford it. Second, critics say that the additional revenues raised by new taxes would allow Texas to expand programs to help the poor, such as more generous welfare payments.

But research shows that higher tax burdens are associated with *greater* poverty. Big government that is tax-financed is more likely to add, rather than subtract, from poverty rolls. Moreover, *there is no statistically significant relationship between a state's proportion of taxes derived from income taxation and their rate of poverty.* Moving away from existing tax sources to partial reliance on income taxes will not significantly reduce poverty, if the U.S. ex-

perience of the late 1990s is representative.

One might expect the results from Texas to be skewed because of the relatively high number of immigrants in the Lone Star State. Actually, the relationship between immigration and poverty is not even statistically significant, although it is positive.

Several decades of studies by economists confirm the proposition that *the higher the level of taxation, the lower the rate of economic growth.* A low rate of economic growth will always have a disproportionate impact on the poor who are at the margins of employment and job security.

More recently, Martin Feldstein of the National Bureau of Economic Research (NBER) - the most prominent economic research organization in the field - concluded in a 1997 report that "the deadweight burden caused by incremental taxation ... may exceed one dollar per dollar of revenue raised, making the cost of incremental government spending more than two dollars for each dollar of government spending." A recent NBER study concluded that Feldstein's finding "is consistent with the view that raising income tax rates discourages the growth of small businesses."

Finally, there is mounting evidence that high taxes reduce job opportunities and sometimes lead to higher unemployment. Economists have noted a negative correlation between taxes and metropolitan area employment growth. They also have observed that high taxes are often positively associated with unemployment, both in the U.S. and internationally. The

research points to one conclusion: high taxes hurt economic growth, and especially hurt the poor.

★ ★ ★

*Prepared by Richard Vedder, Ph.D., former economist with the Joint Economic Committee of Congress and author of "Taxing Texans," TPPF's six-part series examining taxes in the Lone Star State.*

# TAX & SPENDING PUBLICATIONS & EXPERTS

## Other TPPF Tax & Spending Publications:

The following publications can be downloaded from the Texas Public Policy Foundation's website at [www.tppf.org](http://www.tppf.org):

*State Tax Policy: The Why & What of Econometric Models*

by David G. Tuerck, Ph.D.

VERITAS, Spring 2002

*Taxing Texans: A Six Part Series Examining Taxes In The Lone Star State\**

By Richard Vedder, Ph.D.

- ★ *Part One: The Worst Tax For Texas? Comparing Income, Property, Sales & Corporate Taxes*  
February 28, 2002
- ★ *Part Two: The Effect of Taxes on Economic Growth: What Research Tells Us*  
March 29, 2002
- ★ *Part Three: A Growing Population Requires Less Taxation*  
April 12, 2002
- ★ *Parts Four - Six* to be published later in 2002.

*Dynamic Modeling: New Method of Tax Analysis Accounts for Taxpayer Behavior*

April 2001

*The Texas Tax Relief Act in Retrospect*

by David A. Hartman

VERITAS, Fall 2000

*A Taxing Challenge: Maintaining Your Privacy on the Internet*

by Bartlett D. Cleland

VERITAS, Summer 2000

*The Texas State Tax Analysis Modeling Program (Texas-STAMP)*

TPPF's own market-clearing, dynamic, econometric tax model simulates the effects of tax changes on the Texas state economy. Results are expressed in terms of jobs and capital created, payrolls, wage rates, effects on size of working age population, and effects on downstream tax revenues.

*The Texas Tax Relief Act After 12 Years: Adoption, Implementation & Enforcement*

by Michael D. Weiss, August 1991.

Details the adoption of Texas' spending limitation measure and its lack of enforcement.

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