

# Research Report

MARCH 2004

## The Business Activity Tax

*Is The BAT A Homerun Or A Strike-Out?*

By

**Richard Vedder, Ph.D.**

Ohio University

&

**Byron Schломach, Ph.D.**

Texas Public Policy Foundation



[www.TexasPolicy.com](http://www.TexasPolicy.com)

# TABLE OF CONTENTS

	<u>Page</u>
INTRODUCTION.....	3
WHAT IS THE BUSINESS ACTIVITY TAX?.....	4
What the Business Activity Tax is Supposed to Solve?.....	4
PROBLEMS WITH THE BUSINESS ACTIVITY TAX.....	6
Increased State Spending and Tax Burdens Over Time.....	6
Negative Effects on Economic Growth.....	7
The Case of Michigan.....	7
The Case of Europe.....	9
Onerous Costs on Business.....	10
Lack of Transparency.....	11
Risks to Future Tax Revenues.....	11
Impact on Student Learning from Moving to a Statewide Tax.....	12
ADVANTAGES OF THE BUSINESS ACTIVITY TAX.....	13
Replacement of Other Taxes.....	13
Universal Applicability – Tax Equity.....	13
Minimal Economic Distortions.....	14
Simplicity.....	15
Elimination of Robin Hood.....	15
POTENTIAL FOR IMPROVED REVENUE STABILITY.....	16
CONCLUSIONS.....	17

---

## ABOUT THE AUTHORS

### **Richard Vedder, Ph.D.**

Distinguished Professor of Economics, Ohio University

Richard Vedder is a distinguished professor of Economics at Ohio University in Athens, Ohio, and a Senior Fellow at the Texas Public Policy Foundation. Dr. Vedder has written several books, and authored more than 100 scholarly papers published in academic journals and books. His work has also appeared in newspapers and magazines such as the *Wall Street Journal*, *Washington Post*, *Investor's Business Daily*, *Christian Science Monitor*, and *USA Today*.

Dr. Vedder worked as an economist with the Joint Economic Committee of Congress, with which he maintains a consulting relationship. He has also served as the John M. Olin Visiting Professor of Labor Economics and Public Policy at the Center for the Study of American Business at Washington University in St. Louis. Dr. Vedder has taught or lectured at many other universities.

### **Byron Schломach, Ph.D.**

Chief Economist, Texas Public Policy Foundation

Byron Schломach came to the Foundation from the Texas Education Agency. He has also served as a staff member in the Texas Legislature, most recently as the chief of staff to State Rep. Kent Grusendorf, the chairman of the House Committee on Public Education.

Previously, Byron was a researcher in the Office of the Texas Comptroller. There he conducted research into education and transportation, and was the principle author of a study examining the public school start dates. Byron has served as an assistant lecturer in the Texas A&M Department of Economics, and has taught at Austin Community College.

## INTRODUCTION

Some in the Texas Legislature are presently considering several proposals to replace at least a portion of the school property tax with a business activity tax (better known as a value-added tax). It is believed this proposal would enable the state to eliminate “Robin Hood” and provide funds to alleviate educational disadvantages caused by existing property tax limitations.

Without taking a position on the business activity tax, the Texas Public Policy Foundation’s free market philosophy dictates that any tax policy alternative be fully considered in the marketplace of ideas. To this end, the strengths and weaknesses of any proposed policy must be considered and that is the purpose of this paper.

All too often, policy changes that have profound economic effects are made with little regard to the economics of the issue. For example, some years ago, popular sentiment in favor of “taxing the rich” encouraged the U.S. Congress to impose taxes on various “luxury” goods such as furs, small private aircraft, and yachts.

Tax revenues plummeted as the rich went elsewhere for their luxuries. At the same time, the middle class workers who made the luxury goods were rendered unemployed.

Policymakers ignore economic analysis at the peril of themselves and their constituents. The politics of making policy are not avoidable. The economic effects of politically determined policy are even less avoidable. Just as potential policy changes have their political positives and negatives, so too do they have their economic positives and negatives. The business activity tax is no different.

### **The Business Activity Tax**

#### **Cons**

- Potential for increased state spending
- Negative effect on economic growth
- Increased costs for business
- Lack of transparency for taxpayers
- Possibly unstable revenue
- Potential negative impact on student learning

#### **Pros**

- Potential replacement for:
  - Franchise tax
  - Property tax
  - Severance tax
- Fair due to universal applicability
- Minimal economic distortions
- Simple
- Potential elimination of “Robin Hood”

## **WHAT IS THE BUSINESS ACTIVITY TAX?**

A business activity tax (BAT) is a type of value added tax (VAT – the acronyms BAT and VAT will be used interchangeably in this paper). A value added tax is one that taxes each stage of the production process, taxing the net increase in value of the output as compared to the value of the inputs. Theoretically, such a tax does not add to itself and tends to be economically efficient. That is, it does not distort economic decisions since relative prices would be unaffected.

The most serious proposal in Texas would essentially tax payrolls (wages and salaries) and profits (where present) since these do reflect the value of production processes. Governments' and nonprofit enterprises' payrolls would be taxed under one proposal while other proposals would limit the tax to the private sector.

The BAT, under the most serious proposal and with no exemptions for businesses with low revenues, would generate an estimated \$4 billion per one-percent rate. With such a large amount of revenue resulting from such a low rate such a tax is understandably attractive to policymakers.

## **What the Business Activity Tax Is Supposed to Solve**

Since the regular session of the 78<sup>th</sup> Texas Legislature concluded, state representatives have gathered in Austin to examine alternatives to the current state system of school finance. The current system is broadly criticized across the political spectrum for several reasons.

Without commenting on their validity, these criticisms include:

- Heavy reliance on local property taxes to fund the “lion’s share” of public schools,
- Incentives for schools to raise property taxes,
- Slowed economic growth from high tax rates on business property,
- Use of local property taxes to achieve financial equity by redistributing funds from “rich” to “poor” school districts, and
- Insufficient funding for schools to prepare students to meet higher state standards established by new state assessments.

Many state leaders are presently calling for increased state funding for public schools. Property owners have been in a state of near-revolt for some years now. If the legislature is to increase state funding, there are two choices: reallocate current state revenues or reform the state tax system to generate new revenues.

There are, no doubt, significant problems with current property taxes. Property holders correctly perceive that property tax burdens have risen significantly over time. The reasons for this, however, are largely a consequence of the huge increase in spending per pupil in Texas schools over time and the associated fall in the productivity of resources

used to produce educated students. All of this in turn prompts calls for more money and raises property taxes yet higher.

In the absence of the spending problem, the property tax increases (which reflect sharp rises in assessed valuation more than rate increases) would have been far more moderate. The \$1.50 property tax cap and the growing revenue redistribution under Robin Hood have added to the discontent. This is not an indictment of the property tax *per se*, but rather of the legal restrictions and court interpretations relating to the uses of property tax revenues.

## **PROBLEMS WITH THE BUSINESS ACTIVITY TAX**

### **Increased State Spending and Tax Burdens Over Time**

Most proposed tax changes in the context of the current school finance debate are not revenue neutral in any meaningful sense. For revenue neutrality to occur in the short run, the net increases in state taxation would have to be offset, *dollar for dollar*, by reductions in local property taxation. It is not clear how revenue neutrality for every school district can be assured, particularly since local property taxation varies spatially. Even if this question were resolved, for example by having an absolute across-the-board reduction in statewide property tax rates by an amount exactly equal to the net revenue to be raised by the proposed new taxes, the longer term impact would likely not be revenue neutral.

It is unlikely that the long-run elasticity of the business value added tax and other new taxes with respect to personal income will be lower than that of the property taxes replaced. In plainer English, the new taxes will likely rise more over time than the property tax being replaced. During 1990-2000, for example, sales tax revenues rose faster than property tax receipts.

Growth in tax revenues due to economic growth is certainly acceptable. However, growth in a tax due to an increasing burden on taxpayers is not good in an economic sense. Property tax revenues have increased due to increased rates and increased property valuations. Valuations, to some degree, reflect economic growth, but combined with increases in rates, much of the property tax growth is due to increased burdens rather than to increased ability to pay brought about by economic growth.

There is abundant evidence that the BAT proposal will produce a net increase in tax burden, and a negative impact on economic growth for Texas. One of the most accepted and well-tested propositions in politics is that politicians spend all the money that is available to them. At the federal level, where the constitutional constraints of balanced budgets do not exist, the empirical evidence suggests that spending rises by well over one dollar for every one dollar of new taxes levied. Spending enhances the popularity of legislators, presidents and governors, other things equal.

This proposition has also proven true at the state level in Texas over the past decade. In the long economic boom of the 1990s, tax revenues in Texas rose significantly, and spending rose roughly in lockstep with it, to the point that there was relatively little financial cushion after the 2001 recession hit. For new revenues, state government exercised the “marginal propensity to spend” - for every new dollar of revenue generated, there was a dollar spent.

Increased government spending is bad for the economy. Each new dollar of government spending means one less dollar of private sector spending. By itself, this lowers the disposable (after-tax) income of taxpayers. Even worse, it almost certainly will work to lower economic growth of the state, as the private sector is relatively more productive in its use of resources than the public sector.

In the current debate, it is particularly true because the presumptive reason for the tax reform is to rationalize the financing of public education. If new tax monies are earmarked for education, it is clear money will be leaving the private sector with its rising productivity to go to public education, which by most measures has experienced a sharp *decline* in productivity over time.

## **Negative Effect on Economic Growth**

Why would not the BAT raise the rate of economic growth, since it is a broad based, low rate tax, replacing much of the property tax that handicaps economic growth when rates are high? *The answer is simple: BAT or VAT taxes always lead to a significant growth in the size of government, and the crowding out of private enterprise lowers the rate of economic growth.*

Indeed, the evidence is so striking that it explains another phenomenon not discussed by the proponents of the BAT. BAT taxes are extremely unpopular in the U.S. *Only one state actually has had a BAT for a sustained period - Michigan – and that state is phasing out the tax because of its deleterious effects.*

Why would Texans adopt a tax because of some theoretical appeal, when the evidence shows the tax has been a flop in the real world? The only place where this form of taxation continues to be universal and important is Europe – an area that has undergone continuous and growing economic stagnation.

The reason for the negative effect on economic growth is so simple that many forget this simple principle. Simply put, when an activity is taxed, people participate in the activity less than they would otherwise. The BAT, like an income tax, is a tax on productive activity. It is a tax on work. Accordingly, less work – less productive activity – occurs in the presence of a BAT.

### ***The Case of Michigan***

In 1975, Michigan became the first state in the Union to adopt what it calls the “single business tax,” a value-added tax on gross receipts minus business deductions (a tax similar to what is proposed for Texas). For many years, it was the only such tax in America. At the time of its adoption, it was hailed as an improvement over older forms of corporate income taxation. Allegedly, the tax would reduce problems of tax-caused distortions in the allocation of resources, would consequently help the economy relative to other forms of taxation, and would be easy to collect.

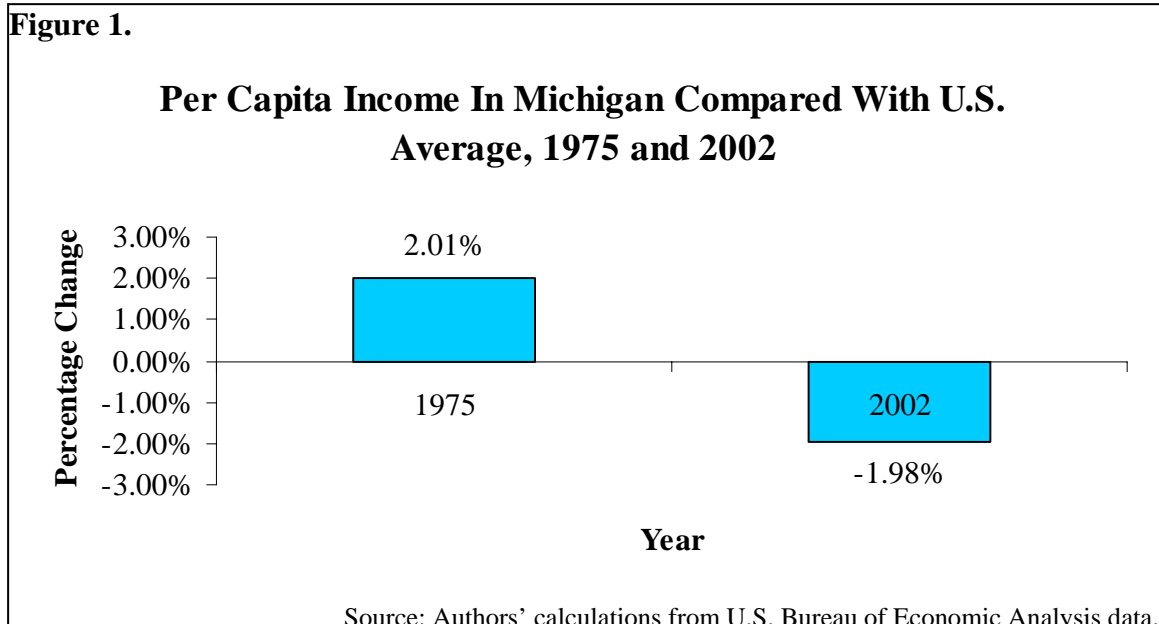
Today, Michigan political leaders in both political parties are singing an altogether different tune. In 1998, the legislature and governor approved a phased elimination of the tax, and the rate is being lowered by 0.1 percentage point per year until its elimination, probably around 2010.

Although the tax is scheduled to be eliminated around 2010, it may be eliminated far sooner. New Democrat Governor Jennifer Granholm has called on the state treasurer to propose alternatives to the single business tax, speeding up the end of the unpopular levy.

The Michigan Chamber of Commerce is pressing the Legislature for immediate relief from the value-added tax. Although the Michigan tax exempts all businesses with gross receipts of less than \$250,000, the Chamber argues the tax is an insupportable burden for small businesses. If small businesses in Michigan are burdened with a \$250,000 threshold, imagine the burden on small businesses in Texas facing a possible \$25,000 threshold (in one proposal) to qualify for taxation.

The single business tax has not improved the business climate in Michigan. The 2003 Business Climate Index, compiled by the nonpartisan Tax Foundation, gives Michigan an overall ranking of 18<sup>th</sup> (of 50 states), a ranking that is respectable but not particularly good, and below Texas (13<sup>th</sup>). On the sub-index relating to corporate income taxation (the category in which Michigan's tax is placed), however, the state ranks only a dismal 38<sup>th</sup>. It should be noted that Texas, in contrast, is currently ranked 26<sup>th</sup>, near the national average on corporate taxation. The single business tax, Michigan's counterpart to the BAT, is viewed as a negative for the state tax climate, a negative that far outweighs the negative impact of Texas' franchise tax.

The "bottom line" question that Texans should ask is this: are people better off or worse off economically with the BAT compared with alternatives? While there are many other (non-tax) determinants of economic growth, the evidence on BAT suggests it is very unlikely that the tax has had a positive impact, and very well may have had a negative one. Figure 1 offers a look at how personal income per capita in Michigan has fared since 1975, the year the Single Business Tax was enacted, through 2002, the last year for which data are available.





*Michigan has gone from above the national average in income per capita to below that average in the quarter of a century since enacting its version of a BAT.*

To be sure, Michigan is part of the industrial Midwest, a region that has lagged economically behind the nation somewhat in modern times, but Michigan's growth rate since 1975 has been below the average of the Great Lakes states. In any case, Michigan's lagging growth rate, poor business climate rankings, and the current phase-out of the BAT suggests that Michigan's experience with the tax has not been a happy one.

### ***The Case of Europe***

Europe moved towards the value-added form of taxation in the 1960s, with the nations in the European Economic Community (now the European Union) adopting a resolution requiring a community-wide tax in 1967.

The era of what is known as the universal value added tax (VAT) began very shortly before 1970. Being a relatively invisible tax that raised vast sums of revenue, the VAT was juxtaposed on top of relatively high income taxes. Economists generally concede that the VAT contributed significantly to the increase in the aggregate tax burden as a percent of GDP within Europe. Since the VAT was established as a major revenue source, the tax burden as a percent of gross domestic product (GDP) has risen over time in the four largest EU nations.

<b>Nation</b>	<b>1970</b>	<b>2001</b>
France	35.6%	49.3%
Germany	32.8%	42.8%
Italy	27.9%	46.0%
U.K. (Great Britain)	37.5%	40.9%

Source: Organization for Economic Cooperation and Development (OECD).

In every major country, the tax burden rose significantly, typically by 10 percentage points of GDP or more. By contrast, the United States, without a VAT, saw its tax burden rise relatively little – from 30.1 to 31.6 percent of GDP – less than one-half the growth even recorded in Great Britain.

Moreover, as Figure 2 shows, the advent of the universal VAT in Western Europe has been accompanied by a very sharp slowdown in the rate of economic growth. Growth in the post-VAT era has been sharply below what was recorded in the two decades prior to the VAT becoming widely adopted. The VAT, being relatively invisible to the typical taxpayer, was easy to levy and increase, with a minimum of pain to political leaders. This should be a lesson for Texas.

**Figure 2.**



Some might argue that the simple growth comparison in Figure 2 is inappropriate because the immediate postwar era was a period of reconstruction from World War II. While that argument may have some small validity, the fact is that European economic growth has slowed in every decade since the 1960s, and that it has declined relative to the U.S. – a nation without a VAT – fairly sharply. For example, in the 10 year period 1993-2002, the average annual growth rate in GDP in the U.S. was nearly 3.2 percent, compared with 1.9 percent in France and 1.3 percent in Germany.

### **Onerous Costs on Business**

The BAT would require an increase in tax administration costs for state government. Since the property tax would not be abandoned altogether, the infrastructure of tax appraisals, and billing that currently exists would remain in place. Since the BAT would likely be levied on all businesses beyond a certain size, it would impose new record-keeping and other tax-related requirements on many businesses, and require additional administrative enforcement personnel.

If small businesses are taxed by the BAT, they would be especially hard-hit by administrative costs. Take a very small beauty shop with annual receipts of \$50,000 and \$20,000 in deductible expenses. Such a business faces taxes on \$30,000, for a tax liability of \$900 with a three percent BAT. If forced to make monthly or quarterly reports, the business would face lots of paperwork over what is at best \$225 (quarterly) or \$75 (monthly) in periodic tax payments (at a three percent rate). That is, no doubt, precisely why Michigan exempts such businesses from taxation.

Large or small, the BAT represents a considerable risk for businesses. While BAT looks like it should be simple (since it is basically revenues minus costs except for labor), the likelihood is that some will find ways to legally avoid the tax. Others will try to avoid it

illegally. As with any tax, enforcement will have to be exercised. Rules and regulations will have to be made. As loopholes are discovered, they will have to be closed through legislation and rulemaking. The tax code will get more complex. Honest errors will be punished. And finally, some businesses will view Texas as a place with an unfriendly business climate regardless of the overall tax burden.

Right now, with the sales tax at least businesses subject to it are audited by the state mainly on the revenue side of their business. With the property tax, businesses see their inventories, personal, and real property values scrutinized. With a BAT, businesses will see their operations comprehensively under scrutiny for tax purposes. This is much more onerous in comparison to any tax currently existing in the state.

### **Lack of Transparency**

The BAT is directly paid only by businesses but since it is a tax on payrolls it has the effect of depressing after-tax wages even while increasing labor costs. Anyone who works and/or consumes helps to pay the tax.

As the description of Europe indicated, a VAT (or, the BAT in Texas), is not very transparent. The BAT is invisible to most of the citizenry even though all of the citizenry pays it. Invisibility is probably a major reason why areas with BAT-type taxes have historically seen an increase in tax burdens. If the legislature decides to increase the tax, voters are likely not to realize that their representatives in Austin, rather than their employers or other mysterious economic forces, are responsible for job losses. Whether in good times or bad, if the politics of the moment (i.e., for the next election cycle) warrant it, the tax will be raised without regard to the long term.

### **Risks to Future Tax Revenues**

Some BAT proposals include small business gross receipts exemptions. Then Governor Bush's 1997 business activity tax proposal included a \$500,000 gross receipts exemption. This is a giant loophole waiting to happen. Since businesses can deduct all costs except for payroll, it would behoove businesses to encourage many of their employees to become "independent contractors." As long as employees do not earn more than \$500,000 per year as contractors, they do not have to worry about paying the tax.

While it may take some years for a significant number of employees to be convinced to become contractors, it will happen to some extent. Revenues from the BAT will soften, possibly as badly as revenues from the franchise tax (another income tax) have softened. The result is an unstable tax system and the potential for future mischief on the part of lawmakers to correct a problem of their own making.

## **Impact on Student Learning from Moving to a Statewide Tax**

While weighing the positives and negatives of BAT, policymakers should also evaluate whether the negatives or cost of generating additional revenue for public schools may be justified by the results that additional funding can be expected to produce.

There are several studies that demonstrate that student academic performance varies directly with the proportion of school funding obtained at the local level through property taxes. The reasoning is when schools are highly dependent on their customers, who also are voters, to finance their activities through local taxes, they try harder to please those customers than when the money is coming a good deal of distance away (from Austin or Washington). To some extent, voters can hold school district officials' "feet to the fire," threatening to withhold funding if performance is not up to expectations.

Greater local funding translates into higher student performance. This finding holds true for Texas public schools and was demonstrated in a study conducted by the lead author for the Texas Public Policy Foundation (published February 2004).

Student performance on state assessments in 1,037 Texas public school districts showed learning increases with the proportion of a school district's revenue coming from local real and personal property taxes. That finding is statistically significant at the one percent level. Districts with a high proportion of local funding (say 100 percent), could be expected to have about three percent larger a proportion of its students pass all the TAKS tests than a district with low local funding (say 10 percent).

The proposal to generate revenues for public schools using BAT would lower the local component of school district funding materially, the exact amount of reduction could vary widely between school districts. At the very minimum, the local share of funding would likely fall by around 30 percentage points on average statewide.

The estimated aggregate impact of that is that about 1.2 percent of Texas students would not pass all their TAKS tests, holding other factors equal. Said in another way, *about 50,000 students would be predicted to fail one or more of TAKS when state funding lessens local financial accountability of the schools.*

If the goal of policymakers is to increase the state's share of education funding by the BAT or any other tax reform, change in state policy should result in academic gains for students.

## **ADVANTAGES OF THE BUSINESS ACTIVITY TAX**

### **Replacement of Other Taxes**

There are some taxes in Texas that are highly disliked. The property tax is one. Many feel like they never own their property, since it seems that property owners are permanently paying rent. Oil producers despise the severance tax as well as the property tax. Texas corporations especially dislike the franchise tax. The list of disliked taxes could go on.

The BAT, because it potentially could raise so much revenue (1 percent, recall, yields \$4 billion when applied to the private sector with no exemptions), is an attractive alternative to many who see its relatively low rate as a potential tax cut. No doubt, for some the BAT would represent a reduction of their tax burden.

The single tax most clearly targeted by tax reformers is the property tax. The property tax is particularly inefficient for the economy due to the fact that it taxes all kinds of investment. Texans enjoy less housing than they otherwise would because of the property tax. Texas businesses are penalized considerably for holding inventory and go to a great deal of expense to minimize inventories at the end of every calendar year.

Another targeted tax is the franchise tax. Called a voluntary tax by many because of the ease with which many are avoiding it, the franchise tax is widely considered unfair. In addition, though corporations have a choice of a capital tax or an earned surplus tax, it is a tax that doubles up only on Texas corporations. At least the BAT, if the franchise tax were repealed, would apply to everyone.

### **Universal Applicability – Tax Equity**

The BAT would universally apply to all forms of business and, therefore, all forms of income-producing activity. For many, this is an issue of fairness. Oil producers, for example, are especially hit hard when it comes to taxation of their income. The property tax taxes oil in the ground each and every year, repeatedly taxing the future income of owners of oil wells. Then, that income is taxed again with the severance tax.

Other professions, such as the legal profession, are veritable shelters in themselves under Texas' current tax system. Professionals such as lawyers and CPAs organize so as to avoid the franchise tax. There is no sales tax on their services. They do pay professional fees that are higher than necessary for state administrative purposes, but the state also protects those in these professions from competition through the licensing laws. Some argue that professional services are inputs and should not be taxed, but that begs the question of what real property is other than an input.

Manufacturing is particularly hard-hit by the property tax. In addition, the franchise tax impacts manufacturing. The franchise tax, it has been proven, is avoidable and is referred

to as a voluntary tax by many. Those who find it relatively easy to incorporate elsewhere can avoid it through the so-called Delaware-sub loophole.

Professional industries such as the legal and accounting professions are generally organized as limited liability partnerships which do not pay the franchise tax. So, while many (though certainly not all) manufacturers continue to pay the franchise tax and others go to extra expense to avoid it, other sectors of the economy – some of which are seeing a lot of growth – never have to give it a thought.

### **Minimal Economic Distortions**

The BAT would produce revenues from a broad base at a low rate that minimizes economic distortions caused by taxing some more than others. Economists generally agree that the economic distortions caused by a tax increases geometrically as the rate increases. This would certainly recommend the BAT in comparison to a tax like the sales tax as it exists in Texas today. A BAT with a rate of three percent is far preferable to a tax that stands at 8.25 percent in most cities.

No one is proposing the BAT as a sales tax replacement, though. Arguably, the property tax is more distortionary than the sales tax. Property tax rates can potentially vary across jurisdictions more than the sales tax. Property taxes take neither ability to pay nor benefits received from government into account. Property taxes are arbitrarily applied according to property appraisals and according to various shelters such as for agricultural land and for property owned by the elderly. The BAT, in this respect, is certainly a *potential* improvement.

If the BAT is more economically efficient than taxes it replaces (if it does so), it at least has the potential to increase economic growth. The analysis above brings this into doubt, but the main reason the BAT has resulted in economic stagnation elsewhere is because its hidden nature has allowed government to grow and government itself is not a productive part of the economy.

If the BAT is to replace other taxes it would certainly behoove the legislature to consider an amendment to the state constitution to cap its low rate and to somehow prevent the re-creation of taxes that it might replace. A change such as this would make the BAT much more attractive to many.

It is highly questionable, however, that the BAT will lead to more jobs and increased economic growth.

## **Simplicity**

The BAT would be simple, at least in principle. Its calculation would be easy. Basically, every business, whether it is a proprietorship, a general partnership, some other form of partnership, or a corporation, would do the same calculation. From revenues, all costs other than payrolls would be subtracted. To the remainder, a single flat rate would be applied and this would yield the tax an enterprise would pay.

Unlike the federal income tax, the BAT would not require any additional expensing calculations such as depreciation. There would be no personal deductions to deal with, either. Instead of a tax return from every individual in the state plus another from every corporation, there would only be tax submissions from businesses, which are far less numerous than the number of individual income earners.

The BAT would certainly be simpler than the franchise tax for corporations. There would be no need to compute the tax two different ways to determine the method that costs the least. It might be the case that many of the sheer quantity of rules governing the BAT would be considerably less than those governing the franchise tax.

Simplicity also recommends the BAT over the property tax. The system that is required to administer the property tax is costly. It requires that every example of real property in the state be appraised. This, in turn, requires the possibility that property owners can appeal appraisals. Inventories must be valued and reported. Businesses must value and report (render) the personal property they own. Various exemptions have to be computed and accounted for. The BAT, though, would not completely replace property taxes, even if school property taxes were completely replaced.

## **Elimination of Robin Hood**

The main reason for even discussing tax restructuring is the potential elimination of the so-called Robin Hood school finance system. Hated by many, the funding system as it exists today prevents constituencies that would like to from spending greater sums of money on their children's educations. By essentially forcing wealthy school districts to spend as if they were less wealthy, it is almost impossible for some constituencies who want more from their schools (in some form or fashion) from getting more.

There is at least the potential that if the state funds public education sufficiently from the state level, local jurisdictions can regain tax discretion. This would allow those who have the means and wish to do so to spend a good deal more than they are currently allowed.

To be sure, the end of the current Robin Hood system does not mean that redistribution will not occur. Many property poor school districts would continue to receive a good deal of funding from elsewhere. The money would simply come from state coffers instead of district coffers. The transfer from the rich to the poor would be hidden. The result is likely to be increased spending on public education, itself a positive for many.

## **POTENTIAL FOR IMPROVED REVENUE STABILITY**

Perhaps the holy grail of tax restructuring in Texas would be to find a source of government revenue that would make the painful cuts that are required during economic downturns unnecessary. Since the mid-1980s when Texas experienced a sharp economic downturn due to falling crude oil prices, much has been made of the need to find a stable source of revenue.

With respect to schools, the problem has been almost the direct opposite of the 1980s experience. During the last decade property values have increased precipitously as the Texas economy has expanded and as Texas has become a place to move to rather than a place to move from. The result has been a falling state share in public education finance.

The BAT, it has been suggested, would result in a more stable source of revenue than the property tax. No doubt, given that the BAT would be a state tax, it would certainly make it possible for the state to maintain a greater share of overall public education funding. However, the BAT is no more potentially stable during economic downturns than any other tax. In fact, it is probably less stable than the property tax.

Property values are actually relatively stable. The problem in the mid-1980s was that oil prices also determine the value of oil wells which is taxed as property. During the business cycle property values are much less volatile than incomes and profits. The boom-bust cycle of tax revenues therefore tends to be much greater for states dependent on income taxes than for states dependent on property taxes.

No tax's revenues will ever be insulated from general economic conditions. The BAT may be a little more stable than some taxes and it may be a little less stable than others. It will not, however, prevent a situation like that of 2003 when a state legislature used to spending every available dime and used to growing the government faster than the economy finally faced a day of reckoning.



## CONCLUSIONS

While economists can find all sorts of economic benefits from the proposed tax change, those findings should be carefully examined. The fact that reported econometric results vary widely show that these findings are volatile and subject to considerable error. Moreover, they fail to consider the dynamic effects arising from the impact that business activity taxes historically have had on the economies of the areas implementing them.

Why are business activity taxes rare in the United States, and why is the largest experiment in this form of taxation being ended after a generation of mediocre economic results? Probably, the answer lies more in the political economy of the impact that highly invisible taxes have on political behavior than on strict economic criteria.

The single biggest lesson from this and other analyses of potential tax changes is that the watchword for tax restructuring should be *caution*. Consideration should be given to making small changes with an eye to making larger changes later after the small ones have been tested. Also, changes should be made with an eye for creating a climate in Texas that is conducive to greater economic growth. With growth, the revenues for essential government services will result.

## **THE FOUNDATION'S PREVIOUSLY RELEASED PUBLICATIONS ON PUBLIC SCHOOL FINANCE**

### **Follow the Money**

*Published October 2003.*

#### ***A 50-State Survey of Public Education Dollars***

By Chris Patterson, with Chad Blevins and Andrew Brown

This study provides an unprecedented look at how public education dollars fit into the overall financial structure of each of the 50 states. For each state, the authors track the sources of public education dollars, determine the amount spent on public education, and identify the relationship between public education dollars and total state spending. The authors also examine the relationship between state spending, revenues and personal income as a measure of each state's ability to sustain public education funding.

### **Putting the Sides Together**

*Published December 2003.*

#### ***Twelve Perspectives on Texas Public School Finance***

Edited by Chris Patterson

A comprehensive collection of papers by the leading voices on school finance reform from across the ideological spectrum, **Putting the Sides Together** identifies the diversity of opinion voiced in Texas today and the areas of fundamental agreement. The importance of school finance reform – for public education, taxation, and the state economy – dictates that all Texans be fully engaged in a measured and thoughtful debate.

### **Splitting the Difference**

*Published January 2004.*

#### ***Residential and Business Property Taxes in Texas***

By Byron Schlomach

A report by the Foundation's Chief Economist examining the pros and cons surrounding the concept of taxing business and residential property at different rates.

### **Effective, Efficient, Fair**

*Published February 2004.*

#### ***Paying For Public Education In Texas***

By Richard Vedder and Joshua Hall

A comprehensive report by Richard Vedder and Joshua Hall exploring better ways to deliver education in Texas and the competing proposals to fund it. As Texans consider how best to reform public education and end "Robin Hood," this study offers insights into the importance of money, funding sources and resource allocation in improving student achievement.

### **Texas-STAMP**

*Published March 2004.*

#### ***A Sophisticated Tax Model for Texas***

By The Beacon Hill Institute at Suffolk University

The benefits and costs of changing the state tax code can now be estimated by a dynamic computer program, developed for the Foundation by the Beacon Hill Institute. Texas-STAMP provides highly detailed information about the effects of specific tax changes on various aspects of the state economy over a five year period. Accessed over the Internet, Texas-STAMP will be used in the halls of the Capitol as legislators debate tax proposals, such as increases in the sales tax, property tax reduction and the introduction of a business activity tax. Texas-STAMP is the centerpiece of the multi-faceted, comprehensive research initiative on school finance that the Foundation began in 2003.

These studies, and all of the Foundation's publications, are available online at [www.TexasPolicy.com](http://www.TexasPolicy.com), or by calling (512) 472-2700.



## **We need your help!**

The Texas Public Policy Foundation is a non-profit, non-partisan research institute guided by the principles of limited government, free enterprise, private property rights and individual responsibility. We seek to improve Texas government by producing academically sound research on important issues offered to policy makers, opinion leaders, the media and general public.

We do not take government funding or sell research outcomes, so we completely rely on the generous contributions of individuals, foundations and civic-minded corporations.

*If you believe studies like this are important for Texas, won't you consider a financial gift to support the Foundation and our mission?*

Give generously today by visiting us online at  
**[www.TexasPolicy.com](http://www.TexasPolicy.com)**,  
or calling toll-free, (800) 694-8773.

And after supporting the Foundation with your financial gift, please pass this publication on to a friend and introduce them to our work!

**Thank you for your generous support!**

### **ABOUT THE TEXAS PUBLIC POLICY FOUNDATION**

The Texas Public Policy Foundation is a 501(c)(3) non-profit, non-partisan research institute guided by the core principles of limited government, free enterprise, private property rights and individual responsibility.

The Foundation's mission is to improve Texas government by generating academically sound research and data on state issues, and by recommending the findings to opinion leaders, policy makers, the media and general public. The work of the Foundation is conducted by academics across Texas and the nation, and is funded by hundreds of individuals, foundations and corporations.



# Texas Public Policy

F O U N D A T I O N

15TH ANNIVERSARY

[www.TexasPolicy.com](http://www.TexasPolicy.com)