

# Research Report

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## Changing Texas' Tax Structure: A Fair Tax for Texas?

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## 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, corporations and charitable institutions.

By refusing government funding, the Foundation maintains its independent voice on the issues important to Texas' future.

In 1989, a small group of civic-minded Texans created the Texas Public Policy Foundation to bring independent, market-based thinking to tackle problems facing state government. Through the years, the Foundation has championed solutions to the day's pressing issues, and won support for market-based policies that have made Texas a better place to live and work.

## **EXECUTIVE SUMMARY**

Texans are displeased with the state's current tax system, especially when it comes to property taxes. Though property taxes are levied at the local level, school property taxes are widely considered a state issue, and Texans are demanding change. While the real issue might be the way schools are funded, it is also of great interest to all Texans as to what an optimal tax system for Texas would look like.

Many alternatives to the current property tax have been considered. One alternative is to broaden the applicability and increase the rate of the state's existing sales tax. Is it possible to discover a single system that would be the most effective at maximizing revenues collected as well as compliance, fairness, efficiency, transparency and economic growth, all while minimizing collection costs, compliance and enforcement costs, economic distortions and unintended consequences?

An even broader and bolder concept is to transform the Texas tax system into something more akin to the "Fair Tax" proposed at the national level. This proposal would replace all federal taxes with a single, nationwide sales tax levied on all final consumer purchases of goods and services. By eliminating or substantially reducing other hidden taxes, the costs of doing business and the cost of making many purchases in Texas could actually decline.

A Texas Fair Tax could take many forms. The national Fair Tax proposal has as its major end the elimination of the national income tax. A Texas Fair Tax would at least replace a major portion, if not all, of the school property tax that funds daily operations (leaving other local taxes intact), as well as virtually all of the state's other taxes, including the corporate franchise tax.

All in all, it is difficult to make the case that Texas' tax structure is wholly inadequate. It has kept up admirably despite marked increases in expenditures. It is demonstrable, however, that the property tax burden has increased considerably, and this, of course, is where taxpayer displeasure is most discernible and where change is most desired.

Various possibilities considered for the Texas Fair Tax are that it could replace all or only half of the maintenance and operations (M&O) school property tax. Also, in order to reduce or eliminate regressivity, there could either be a per capita tax refund or exemptions for goods and services associated with health care, food, and education.

It is estimated that the statewide sales tax rate under a Fair Tax (not including local rates) would range from 7.9 percent to 10.9 percent, depending on whether all or only half of the M&O school property tax was replaced and whether or not a per capita refund or exemptions was employed.

The most modest econometric modeling results show that investment in the state would increase over current projections by one-fifth in five years. Employment would not grow as quickly as currently projected, but employment growth would be put on a path likely

to surpass what would otherwise occur in 10 years. Real disposable income would exceed current projections by 2 percent to 3 percent.

The econometric modeling assumes that a state sales tax, like a Texas Fair Tax, is not federal income tax deductible. However, with the passage of the American Jobs Creation Act of 2004, the sales tax becomes deductible again. This makes moving from the already deductible property tax to a sales tax all the more attractive.

The idea of a Texas Fair Tax is worth additional consideration. The property tax issue is not going away. The current system depresses investment and ultimately employment in Texas. No change in the tax system, however, is likely to be effective without greater spending discipline.

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### ABOUT THE AUTHORS

**Richard Vedder, Ph.D.**, is a Distinguished Professor of Economics at Ohio University in Athens, Ohio, and a senior fellow with the Texas Public Policy Foundation. He has written extensively on labor issues, authoring such books as *The American Economy in Historical Perspective* and, with Lowell Gallaway, *Out of Work: Unemployment and Government in Twentieth-Century America*.

Dr. Vedder has published over 100 scholarly papers. His work has also appeared in newspapers such as the *Wall Street Journal*, the *Washington Post*, *Investor's Business Daily*, the *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.

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

### Instituting a Texas Fair Tax

#### *Advantages*

- Less distortion of relative prices than with other taxes
- Can be used to reduce the property tax burden
- Increases capital investment in Texas
- Increases real, per capita income
- Taxes consumption instead of productive activity

#### *Disadvantages*

- Short-term drop in employment growth
- Potential to drive Texans to buy from other states
- Mitigating regressivity is difficult
- Increased reliance on a statewide tax by local schools
- Federal income tax deductibility currently limited to two years

## DISSATISFACTION WITH THE TEXAS TAX SYSTEM

There has been a chorus of complaints about the Texas public finance system, particularly about the property tax, which provides a majority of the funding for public schools as well as some funding of other local governments. The Texas Legislature has wrestled in a special session with the issue, and the state's political leaders have publicly noted their interest in changing the system. How can Texas reduce reliance on the property tax without threatening the generally favorable tax environment that has contributed to the prosperity of the Lone Star State? This paper explores one option to the current system, an option that might be relatively growth friendly, fair, and administratively workable. It could also help make possible a revision of Texas' method of funding public schools. Specifically analyzed is the possibility of replacing Texas school property taxes and several other taxes on businesses with a new comprehensive consumption tax, termed here the Texas Fair Tax, based on the name given to a proposed federal counterpart.

## THE TEXAS FAIR TAX CONCEPT

Even economists of a decidedly free-market bent recognize the necessity of government's existence. Even if government were significantly smaller than it is today, it would still have to be financed. From an economic perspective, an effort should be made to create a tax system that does the least harm to the economy, regardless of government's size and scope. In a market economy, that especially means creating a tax system that has the least possible effects on relative price levels of goods and services. That way, markets, rather than the tax system, determine the movement and distribution of resources, thereby ensuring that the greatest possible benefit accrues from market activity according to what Adam Smith called "The Invisible Hand," the magic that markets perform in converting self-interested behavior to that which benefits society as a whole.

From a purely theoretical perspective, consumption taxes do the least to distort relative prices. Many economists agree that a sales tax applied only to goods and services

purchased by the final consumer would minimize distortions. Given this highly desirable property of a sales tax, it is certainly worthwhile to fully consider the possibility of more broadly depending on a sales tax for government revenue. This is currently being discussed at the national level.

### *The National Fair Tax Proposal*

Among many tax reform proposals put forward at the federal level in recent years is that of a national sales tax. None other than the Speaker of the U.S. House, Dennis Hastert, has suggested such a tax as a possible alternative to the current federal income tax. A bill has been introduced in Congress, HR 25 (Fair Tax Act of 2003), authored by Representative John Linder of Georgia. Fifty-four members of the U.S. House have signed on as cosponsors of the bill. Of these, eleven are from Texas.

The proposal is to replace all income and payroll taxes, including social security payroll taxes, with a single nationwide sales tax on all final goods and services. For example, new construction would be sales taxed, but real estate transactions involving already-existing structures would not be. Services would be taxed, even those not commonly taxed by state sales tax systems, such as legal services. The principle is to tax broadly, taxing everything only once — at the point of sale for final consumption. This proposal is called the “Fair Tax” by its proponents.<sup>1</sup> For instance, under such a system, business legal services would not be taxed but personal legal services would be. All groceries and health services as well as prescriptions would be taxed, in addition to traditionally sales taxed items such as furniture and other personal items.

A common concern about such a proposal is that it would cause prices to rise by the amount of the tax. However, this is not true. It is easy to forget that a significant part of the burden of the national income tax is somewhat hidden. Because of withholding, except for those who are self-employed, most individuals never have to actually write a check for their income tax bill. This is especially true for payroll taxes. Income and payroll taxes are just another part of the cost of doing business and are, therefore, automatically built into the cost of goods and services. If the income and payroll taxes were replaced with a sales tax, the before-tax price of goods and services would fall with uncertain net (after-tax) effects for any given good or service.

A national sales tax, it is asserted, would be fairer than the current income tax. Proponents claim it would take fewer resources to enforce. There would be less complexity. It would be more difficult to avoid. It would be more difficult to pass special-privilege tax treatments with a sales tax than it is with an income tax. Instead of having to audit firms and individuals comprehensively, only revenues would have to be audited, and then only businesses would be audited because they would serve as the collection point. And since 45 states already collect a sales tax, the collection mechanism is largely in place. For this reason, the national Fair Tax proposal is often touted as a way to rid the nation of the Internal Revenue Service.

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As with any sales tax, a primary criticism is that a Fair Tax would be regressive. That is, the tax would disproportionately draw from the incomes of lower-income families and individuals. Fair Tax proponents have considered this issue and propose that a check be cut to every man, woman, and child in the nation once each year, refunding the amount of taxes paid on final goods and services that are necessary to maintain a standard of living consistent with some level of well-being, such as the nation's poverty level.

### *The Texas Fair Tax Proposal*

Because Texas has only a limited income tax in the form of the corporate franchise tax and already depends heavily on a sales tax, it could almost be argued that Texas already has its own state-level "Fair Tax" — a Texas Fair Tax. However, this is not true. The state depends heavily on the property tax to fund its schools. There are also a plethora of other state taxes in addition to the franchise tax such as the oil severance tax, occupancy taxes, insurance taxes, and fuel taxes, just to name a few. It is easy to conceive of consolidating all or most of these taxes into a single tax on final goods and services.

Implementing a Texas Fair Tax system, though, is not as simple as increasing the current sales tax rate to make up for current revenues from other taxes that would be abolished for the simple reason that the current sales tax in Texas does not qualify as a Fair Tax under the standards set by Fair Tax proponents. The current sales tax in Texas is riddled with exemptions and exclusions.<sup>†</sup> In a January 2003 publication, the Texas Comptroller estimated that if sales tax were collected on goods and services specifically exempted from the tax, an additional \$19 billion would be collected in fiscal 2004. The same number for exclusions amounts to \$4.3 billion, for a total of over \$23 billion in tax revenues that the state could have collected on sales transactions for goods and services.<sup>2</sup>

The huge numbers just mentioned contemplate taxing *all* transactions. The Fair Tax concept would *not* do this. It would only tax *final* transactions — transactions that transfer goods and services to the final consumer, not transactions between businesses since these are input transactions. The current sales tax, in fact, does tax a number of inputs. For example, most of what is categorized as personal property, when purchased by a business, is sales taxed just as it would be if purchased by an individual. Office furniture, office equipment, and office supplies are all sales taxed even though they are inputs and truly are not goods being purchased by final consumers in most instances.

On the other hand, the current Texas sales tax does not tax a number of goods and services that would be taxed under a Texas Fair Tax. For example, food is not currently sales taxed. It would be under an ideal or pure Texas Fair Tax. Legal services for individuals are not sales taxed. They would be under a pure Texas Fair Tax. There would also not likely be a tax holiday under a Texas Fair Tax. Any exemptions and/or holidays would push up the tax rate and this would be avoided.

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<sup>†</sup> Under the terminology employed by the Texas comptroller, an exemption occurs when law specifically excludes a good or service from taxation that would otherwise be taxed under general law. An exclusion is a transaction for a good or service not mentioned for taxation under the law.

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The numbers above also contemplate taxing sales of used goods, such as used cars, used furniture, and other items often sold used. A Texas Fair Tax would not tax used goods. New goods, however, would be fully taxed. For example, a new house would be fully sales taxed although the value of the land on which it was built would not be sales taxed. New houses today have some level of sales tax built into their price. All the materials that go into building a new house are taxed. However, the labor is not. Under a Texas Fair Tax, the labor and materials in a new house would not be taxed but the value of the house would be, and clearly that value will generally exceed the value of labor and materials.

The current Texas sales tax does not conform to the Fair Tax concept except that it is a sales tax. The Texas sales tax is applied to a lot of business to business (input) transactions that a Fair Tax ideally would avoid. In fact, currently 47 percent of revenues from the Texas sales tax are collected from business purchases, some \$6.9 billion in fiscal 2004.<sup>3</sup> A true Fair Tax would collect the tax only from final consumers. More will be said about the Texas Fair Tax proposal below. While the theoretical desirability of such a tax is plain to see, there are practical considerations as well. One thing to consider is what tax (or taxes) the Texas Fair Tax would replace. Although there is a good deal of dissatisfaction with the current tax system in Texas, an alternative might just be worse. This is impossible to know without first gaining some familiarity with the facts about the state's current tax system.

### GROWTH AND CHANGE IN TEXAS' TAX STRUCTURE

By any means of measurement, Texas' state and local governments have grown enormously in scale over the past generation. As Table 1 shows, "general revenue" of state and local governments grew over five-fold from 1980 to 2002. The share of those revenues arising from taxes, charges, miscellaneous sources (e.g., interest income, asset sales), or federal aid remained relatively constant (Table 2), with a slight decline in the reliance on taxes, and a modest increase in the relative importance of user fees and federal grants. Throughout the period, however, a majority of revenues came from taxes.

**Table 1**  
**State and Local Government Revenues in Texas, 1980-2002\***

Revenue Source	1980	1990	1997	2002
All General Revenue	\$ 20,276	\$ 48,763	\$ 78,655	\$ 109,128
Taxes	11,466	28,243	43,562	58,981
Charges, Fees	2,619	6,931	11,540	16,160
Miscellaneous	2,418	6,251	8,713	11,073
Federal Aid	3,763	7,357	14,841	22,915

\*In millions of dollars. Source: U.S. Bureau of the Census.

**Table 2**  
**Percent of State and Local Revenues from Major Revenue Sources, 1980-2002**

Revenue Source	1980	1990	1997	2002
<b>Taxes</b>	56.55%	57.90%	55.38%	54.05%
<b>Charges, fees</b>	12.92	14.21	14.67	14.81
<b>Miscellaneous</b>	11.91	12.81	11.08	10.15
<b>Federal Aid</b>	18.56	15.07	18.87	21.00

Source: U.S. Bureau of the Census.

Table 3 looks at revenues from major taxes, as classified by the U.S. Bureau of the Census. It should be noted that the Texas corporate franchise tax, which many regard as a type of income tax, is classified in the category "other," along with such significant revenue sources as mineral production levies and excise taxes. Note that the property tax is consistently the most important revenue source, increasing rather dramatically some six-fold from 1980 to 2002, although a similar growth also occurs in general sales taxes. Growth of motor fuel and motor license taxes and "other taxes" was markedly smaller. Given that prices roughly doubled in that time period, inflation-adjusted property and sales tax revenues nearly tripled.

**Table 3**  
**Revenue from Major Taxes, Texas, 1980-2002\***

Type of Tax	1980	1990	1997	2002
<b>All Taxes</b>	\$ 11,466	\$ 28,243	\$ 43,562	\$ 58,981
<b>Property</b>	3,980	11,058	16,349	24,521
<b>General Sales</b>	3,016	9,249	13,891	18,322
<b>Motor Fuel</b>	481	1,515	2,383	2,835
<b>Motor Vehicle Licensing</b>	302	864	1,031	1,292
<b>Other</b>	3,681	5,557	9,907	11,701

\*In millions of dollars. Source: U.S. Bureau of the Census.

**Table 4**  
**Percent of Tax Revenues Coming From Major Taxes, 1980-2002**

Type of Tax	1980	1990	1997	2002
<b>Property</b>	34.71%	39.15%	37.53%	41.57%
<b>General Sales</b>	26.30	32.75	31.89	31.06
<b>Motor Fuel</b>	4.20	5.36	5.47	4.81
<b>Motor Vehicle Licensing</b>	2.59	3.06	2.37	2.19
<b>Other</b>	32.16	19.68	22.74	19.84

Source: U.S. Bureau of the Census, authors' calculations.

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The state's reliance on the property tax, always substantial, has risen significantly over time, with big jumps in the proportion of tax revenues coming from property taxes in the 1980s, and again in the late 1990s and the beginning of this decade (Table 4). While the property tax has historically been Texas' leading tax source, its dominance has increased markedly, more than for its closest rival, the general sales tax.

While tax revenues have risen substantially, even after allowing for inflation, perhaps the best measure of the burden that taxes place on the citizenry is the proportion of its income that taxes absorb. Since incomes in an inflation-adjusted sense rise over time, an increase in real per capita taxes does not necessarily mean an increase in the *proportion* of one's material resources confiscated by taxation. Table 5 looks at taxes for each \$1,000 in personal income earned. Comparing 2002 with 1980, note that both general revenues (including non-tax sources) and taxes have increased — the burden has grown, albeit only modestly in the case of taxes. Note the tax burden rose considerably in the 1980s, but fell after 1990, although not quite enough to restore it to 1980 levels.

**Table 5**  
**Taxes, General Revenue Per \$1,000 in Personal Income, 1980-2002**

Revenue Source	1980	1990	1997	2002
<b>General Revenues</b>	\$165.15	\$177.95	\$183.85	\$176.88
<b>All State Taxes</b>	93.39	103.02	101.83	95.49
<b>Property Tax</b>	32.42	40.34	38.22	39.70
<b>General Sales Tax</b>	24.57	33.74	32.47	29.66
<b>Other Taxes</b>	36.40	28.94	31.14	26.13

Source: Bureau of the Census, Bureau of Economic Analysis, authors' calculations.

**Table 6**  
**Overall Tax Burden Per \$1,000 in Personal Income, Texas vs. the Nation, 1980-2002**

Year	Texas	United States	TX % More U.S.
<b>1980</b>	\$93.89	\$108.80	- 13.70%
<b>1990</b>	103.20	109.74	- 5.96
<b>1997</b>	101.83	111.88	- 8.98
<b>2002</b>	95.49	101.68	- 6.09

Source: Bureau of the Census, Bureau of Economic Analysis, authors' calculations.

Note that the tax burden rose sharply (by roughly one-fourth) for the property tax over time, not exhibiting the same decline after 1990 observed for "other taxes" and the general sales tax. The "other tax" decline reflected in part the major decline in the relative importance of mineral production taxes as Texas' economy has increasingly shifted from oil and gas.

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Table 6 shows that Texas' state tax burden has grown significantly relative to the national average of state taxes over time. For the nation as a whole, total state and local taxes fell from 1980 to 2002 by \$7.12 for every \$1,000 in personal income. In Texas, by contrast, the aggregate tax burden *rose* by \$2.10 for each \$1,000 earned. In 1980, the tax burden in Texas was almost 14 percent below the national average; by 2002, it was only 6 percent below the average. In other words, a majority of the low price advantage with respect to government services in Texas, as measured by the overall tax burden, was wiped out. It should be pointed out that this phenomenon occurred in the 1980s; in the years after 1990, the tax burden fell in Texas, although it did also in the nation, so Texas' relative tax advantage remained roughly constant.

Given the high interest in the property tax, the Texas tax burden with respect to that levy is compared to the nation's in Table 7. In 1980, the property tax burden in Texas was close to the national average — actually slightly below. Over time, the U.S. property tax burden remained relatively constant, actually declining a bit in the years around 2000 (probably as a consequence of some move away from the property tax as a school financing device in several states). But in Texas, the burden rose considerably, so that by 2002, property tax burdens were well over 26 percent higher in Texas than the average in the Union as a whole.

**Table 7**  
**Property Tax Burden Per \$1,000 Personal Income, Texas and the U.S.**

Year	Texas	U.S.	TX % > U.S.
1980	\$32.42	\$33.35	- 2.8%
1990	40.34	34.04	+ 18.5
1997	38.22	33.60	+ 13.8
2002	39.70	31.36	+ 26.6

Source: U.S. Bureau of the Census, Authors' calculations.

This abbreviated review of modern tax history points out several things. It is simply not factually correct to assert that Texas is “hamstrung” by a tax system that is “inflexible” in terms of producing revenues. Revenues have increased more in Texas than has been typical nationally, and faster than incomes have gone up. While in part this is a consequence of discretionary legislative actions, for the most part it reflects the fact that tax revenues in Texas are actually rather sensitive to changes in income. It is far less true than it once was that “Texas is a low-tax state” in any meaningful sense.

It is also true that in Texas property taxes are far more important than is typical nationally (providing well over 40 percent of tax revenues, compared to about 30 percent in the average state), in large part reflecting the absence of personal income taxation. Rising property tax revenues reflect three phenomena operating simultaneously: rising assessed values of existing properties, new construction, and increases in property tax rates. Of the four forms of local government that depend on property taxes, schools appear to be the most insatiable, unsatisfied with the revenue growth these three effects have produced.<sup>4</sup>

## CHANGING THE TAX SYSTEM

There are two primary types of motivations for those wishing to change the tax system. First, there are those who equate “tax reform” with “revenue enhancement.” Some argue that the state does not extract enough revenues from the people, and more tax revenues are needed to fund expanded state services. Second, there are those who are interested in a revenue-neutral (or even revenue-reducing) change in the system, but one that reduces problems associated with it. This report concentrates on the second form of change — substituting a new type of tax for several existing taxes in an attempt to have a better tax system.

There is an enormous literature that suggests that raising the tax burden is likely to have adverse economic effects, such as lower growth in incomes, jobs, and business formations.<sup>5</sup> Therefore, Texas has benefited from having a relatively low tax burden overall, although that low tax advantage has eroded somewhat over time. Further erosion should be avoided to prevent a slowdown in Texas' economic growth.<sup>†</sup> In short, “tax reform” should not be a disguised (or not-so-disguised) tax increase. Any change that increases the overall tax burden should not be considered reform at all.

In deciding whether to impose a new tax, several questions need to be asked:

- Can the tax be collected cheaply, with minimal cost to the government and to those paying the tax?
- Will the tax distort the allocation of resources, leading to inefficiencies and lower rates of growth in economic activity?
- Will the proposed tax be fair — treating people equally, or in an equitable manner?
- Is the proposed tax transparent, with the burden apparent to those paying it?

If the cost of tax collection are, say, 30 percent to 40 percent of the revenue a tax raises, then that is far less desirable than if administrative costs are only 1 percent to 2 percent. Moreover, in considering tax collection costs, the time and effort it takes taxpayers to calculate and pay the levy must be taken into account (known as “compliance costs”), not merely costs to the government. If a tax can be evaded fairly easily, enforcement costs increase sharply and collected revenues fall, another dimension that must be considered in evaluating any tax.

Taxes all tend to distort the use of resources compared to what would happen in the absence of the tax, but the goal is to minimize these distortions per dollar of tax revenue raised. For example, taxes on, say, perfume, are fairly easy to collect and are transparent, but their imposition distorts the use of resources, leading people who like perfume to forego it for reasons unrelated to their tastes and preferences. More important, taxes on

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<sup>†</sup> From 1990 to 2003, personal income grew 55.3 percent in real terms in Texas, vs. 34.4 percent across the United States. See [www.bea.doc.gov](http://www.bea.doc.gov) for details on personal income growth. Price adjustments were measured by the Consumer Price Index for all urban consumers; see [www.bls.gov](http://www.bls.gov) for details.

inputs used in the production process tend to discourage the use of those inputs (e.g., labor, capital), leading to less output. High income taxes in particular discourage work and capital formation, thereby reducing output.

People have to perceive that a tax is reasonably “fair” in order for it to be widely accepted. In 1990, Prime Minister Margaret Thatcher of Great Britain proposed a “community charge,” which essentially was a head tax — so many pounds sterling per person. The tax was extremely low cost from an administrative perspective, had less distortive impact on economic activity than any alternative tax, and was quite transparent. Yet the tax was perceived as being extremely unfair, to the point that it contributed importantly to the end of the Thatcher government. Fairness, however, is impossible to evaluate objectively, as attitudes vary dramatically between people. Many think it is fine to tax everyone the same percentage of their income (a proportional tax), while others argue the rich should pay a larger portion of their income than the less affluent (a progressive tax). Some think of fairness largely in terms of horizontal equity — treating people of similar economic circumstance in a similar fashion.

Transparency arises as an issue only because in a democracy it is generally felt that as a rule the elected representatives of the people should be guided by what a majority of the citizenry want. If the citizens are unaware of the burden that a tax imposes, the public is being deceived regarding its tax burden, and that tax serves the democratic ideal less well than otherwise. More practically, it may lead to a higher burden of taxation than the public would prefer, given the evidence that high taxation tends to lower economic growth. This could also have negative “spillover” effects that lower the material welfare of the citizenry.

### *The Property Tax*

Since Texas' leading tax is the property tax, and since its role in Texas public finance is significantly greater than is typical in the United States, any revision of the Texas tax code has to center on reducing the state's reliance on the local property tax. How does the Texas property tax measure up on the usual criteria used to evaluate taxation?

There are major administrative problems with the property tax. It is based on property valuations, which require fairly frequent, labor-intensive assessments of values. If assessments are done annually, they are quite costly, but if they are done infrequently, property values are often grossly misstated, property tax revenues lag behind changes in the economy and inequities arise, assets are not likely to move as readily where they are most highly valued, and tax burdens become unpredictable. Placing market valuations on unique pieces of property is as much an art as a science, and significant errors are common, leading to considerable taxpayer bitterness over allegedly unjust treatment from the assessing authorities, resources being devoted to appealing assessments, and tax revenues being uncertain.

Moreover, the property tax does not get particularly high marks on efficiency/resource allocation grounds, either. There is generally a more negative correlation between

property tax revenues and economic growth than there is between consumption tax revenues and growth. Property taxes are taxes on wealth, but not on all forms of wealth, so some forms of wealth (e.g., financial assets) are generally given favorable tax treatment relative to real estate assets, leading to a distortion in resource allocation that can lead to a number of additional effects, such as higher housing rental prices than otherwise would exist. Property taxes are effectively levies on capital — on investment goods, and as such they can discourage investment and capital formation. Attempts to relieve this problem through property tax abatement of new investment solve one problem but create others, such as inequitable treatment of taxpayers and distortion in resource usage.

While the administrative cost/efficiency issues with property taxes are substantial, they are small in comparison to issues of equity and fairness. Some of the concerns are actually not about the property tax per se, but rather about the uses of tax revenues raised. In particular, it is argued that schools financed by property taxes have excessive variations in educational offerings as manifested in big differences in per pupil spending. Educational equity, it is argued, requires reduced reliance on property taxation, which is levied locally, and greater reliance on levies administered at the state level.

Beyond that, however, there are other equity concerns. Property taxes tend to be most heavily felt by relatively young and particularly relatively old people with low to moderate incomes, and less so by middle-aged individuals with relatively high incomes. The reason is that people buy homes when they are young and live in them until they are old. The taxes might remain relatively constant, but incomes vary across the life cycle, being relatively low early in one's working career and in retirement, but higher during the prime working years. Some consider this a form of intergenerational inequity and discrimination. Attempts to relieve this problem (e.g., special property tax breaks for senior citizens) lead to a smaller tax base and higher rates, and sometimes exempt wealthy seniors from paying taxes that most individuals think they can and should pay. Moreover, individual property holders often see inequities in their taxes relative to neighbors, owing to perceived inaccuracies in the assessment process.

While property taxes get high marks on the transparency criterion (people who own real property are quite aware of the size of their property tax burden, though renters are much less aware), their relatively low marks on the other criteria suggest that it may be possible to improve the tax structure by reducing reliance on property taxes. Income taxes are prohibited constitutionally and have truly devastating negative economic effects, and Texas' lack of an income tax has always worked to its advantage. The other major form of taxation is some type of consumption tax.

### *Other Taxes*

Texas does rely on a number of lesser taxes that collectively are relatively important. Generally, they have significant problems associated with them. The corporate franchise tax is subject to major administrative problems with respect to interstate firms, where the production and sale of goods and services involves activities in several states.

Corporations seek to shift activities, at least on paper, in such a way as to minimize tax liability. Beyond that, corporate income taxes are widely condemned by economists on other grounds as well. On neutrality and resource allocation grounds, taxing capital (the resources corporations own) but not labor (there is no Texas income tax) creates biases toward labor-intensive production processes that might otherwise be inefficient. Some economists debate the issue of who bears the burden of corporate income taxes. "Corporations" are ultimately made up of people, rich and poor, Texan and non-Texan. If the burden of the corporate income tax falls on consumers, then it is a somewhat capricious and non-transparent consumption tax of unknown progressivity. If the burden of the tax falls on stockholders, then the tax hurts widows and orphans who own stock the same as wealthy people, a scenario some find objectionable on equity grounds. Clearly the tax is bad from a transparency perspective.

Similarly, mineral production taxes are highly questionable. They tax one form of production (e.g., oil and gas production) more than others (e.g., the production of washing machines), leading to distortions in resource usage. The maturing of the oil and gas industry suggests that these taxes are marginalizing some forms of production that are already becoming less competitive as reserves are increasingly depleted. Similarly, excise taxes in general are subject to criticism on the grounds that they violate principles of tax neutrality, and by altering prices, lead the market system to work less well, as price signals no longer reflect demand and supply conditions alone.

### **IMPLEMENTATION OF A TEXAS FAIR TAX**

Texas currently relies on two major forms of consumption taxation, the general sales tax and a variety of selective excise taxes, such as levies on cigarettes, alcoholic beverages, and motor fuels. Consumption taxes have several major advantages over income and wealth taxes. These taxes are directed to the end result of economic activity, consumption, not toward the production of that activity. They are taxes on ultimate outputs, not inputs. From an equity perspective, they tax what people take away from the economy (consumer goods) rather than what they put into it (their productive inputs). Some polling evidence suggests that people find sales (consumption) taxes fairer than other forms of taxation.<sup>6</sup>

Moreover, empirical evidence generally suggests that consumption taxes have far fewer adverse economic effects than income and property levies. The reason for this is simple. Income taxes and property taxes penalize productive activity. They tax enterprise and creativity (unless you are a tax lawyer) and in so doing, they discourage such activity. Consumption taxes, on the other hand, while they do discourage some consumption, through the absence of production taxes may encourage individuals to just work harder to overcome the consumption tax burden.

There is one major problem with existing consumption taxation in Texas (and, for that matter, in all other states). It is limited to a small base since it excludes most services. This causes three problems. First, because a large part of consumption is excluded from the tax base, tax rates need to be relatively high. High tax rates invite evasion and

avoidance (e.g., buying goods tax free on the Internet). Second, by taxing goods but not services, the tax distorts the allocation of resources, leading people to reduce their consumption of taxable goods and increase consumption of non-taxable services. People are being thwarted from exercising their welfare-maximizing consumption patterns by artificial, government-imposed changes in relative prices imposed by an uneven tax policy. Third, the narrow tax base imposes some inequities. Expanding the tax base might well reduce the regressivity of the tax system, since many of the non-taxable items are consumed by relatively high-income groups. Moreover, the exclusion of some items from the base leads to what economists call horizontal inequities — people of similar economic circumstance paying widely differing amounts of tax (some consume lots of taxable goods, while others consume more non-taxable services). A broader-based consumption tax would solve these problems.

At the national level, there has been widespread disenchantment with our highly dysfunctional federal income tax system, and one major proposal for reform is the “Fair Tax,” a national sales tax that would replace the federal income tax and potentially lead to the abolition of the Internal Revenue Service in its present form. A Texas Fair Tax would be conceptually similar. In its purest form, *all* “final” goods and services would be taxed at a uniform rate. A “final” good or service is a good or service ready for its ultimate use. Final goods are distinct from “intermediate goods” — goods produced that then are further refined before ultimately being consumed. Steel is an intermediate good used in making, for example, automobiles. Automobiles are the final good — steel is an intermediate good.

A Texas Fair Tax would extend the current sales tax base over some currently exempt goods, and all services designed to meet the needs of the ultimate or final customer. Thus, a Texas Fair Tax would tax auto repairs, beauty salon and barber shop services, tax preparation services, medical and educational services, travel and entertainment services (e.g., concerts and plays) — virtually everything people spend money on. The only part of income that would not be taxed is that income which is saved (not consumed), and that income consumed out of state (some attempt might be made to tax some of the latter income, but generally it is very difficult to do so at any reasonable cost).

Because the base of the tax would be huge, the rate applied to achieve revenue neutrality should not be any higher than the existing retail sales tax, and perhaps a bit lower. Moreover, that assumes the replacement not only of the school property tax, but a variety of other taxes, including corporate franchise, mineral production, and some excise taxes. A low rate reduces the potential problems for Texans attempting to engage in strategies of tax evasion or avoidance — in most cases the tax savings from avoiding tax on a purchase is so small that there is little incentive to engage in avoidance exercises.

### *Collecting the Texas Fair Tax*

One of the four basic criteria mentioned above for evaluating a tax system is that it be easy to enforce. There are some significant potential administrative problems with the tax. With some purchases, it is difficult to differentiate final and intermediate good use. A

person in the construction business buys a pick-up truck for work use, but also uses it a good deal for personal consumption. Is it taxable or not? A truck used to help build something is an intermediate good, but one used to go to the grocery store or to go boating is a final good. An airline ticket used for business purposes also could be used for personal consumer travel.

The Texas Fair Tax would be collected in the same way that the current sales tax is collected. The tax would be assessed at the time of purchase. The retailer would collect the tax from a consumer and retain the proceeds to be remitted to the state government at specified intervals. The vast majority of retailers in Texas are already used to this well-established system. Service industries, however, would have to get used to recordkeeping that has not been necessary in the past. For example, legal work for private individuals would necessitate that attorneys account separately for proceeds from business-related work and work related to private individuals.

Legal services provide one example of the kind of potential problems that can arise from any tax. One of the most effective enforcement weapons a tax authority has at its disposal is the ability to audit the books of taxpayers. Although the final consumer is ostensibly the taxpayer in a consumption tax regime, businesses that initially collect the tax clearly are responsible for its collection and, to some degree, its enforcement. Attorneys would have to make a judgment as to whether or not a specific service was a “final” service to an individual or an “intermediate” service to a business. Often, the same type of work can apply to either case. The enforcement authority would have to have the ability to delve into the work of an attorney being audited and determine, in some cases, that a tax not paid is nevertheless a tax owed. Questions could arise as to attorney/client privilege were the enforcement authority to delve too deeply.

To be sure, there are ways to deal with the attorney/client privilege. Laws related to the national and various state income taxes allow for attorneys to be audited. However, there would doubtlessly be a learning curve with the initial administration of a Texas Fair Tax, with some businesses being inexperienced in collecting a sales tax and being required to determine the buyer's position in the stage of production.

The easiest, and probably administratively most effective, way to deal with whether or not a particular buyer is subject to a fair tax is to issue certificates to businesses that register with the taxing authority. Business customers would present these certificates when they make purchases and present them when they make purchases from other businesses as proof of their exemption from the tax. This sort of administrative solution is already in use in Texas with non-profit organizations that are exempt from the sales tax. Doubtlessly, though, there will be problems differentiating final use purchases from intermediate use purchases of goods and services.

### *The Fair Tax and Economic Activity*

For economists, a big issue for any tax is whether or not it will create incentives for individuals and businesses to behave significantly differently from how they would absent the tax. For example, the main reason health insurance exists as a benefit from employers is that benefits are not subject to the federal income tax. The federal income tax only targets wages. Because it is (or was) a convenient way to avoid various payroll taxes and the income tax, it behooves employers and employees alike to agree to compensation in the form of benefits instead of in pure monetary terms. This, in turn, has helped lead to various problems with health care costs since it has become increasingly rare for health service consumers to bear the costs of their consumption. In short, the federal income tax system has distorted not only the labor market but has also mightily distorted the health care market.

One positive effect of a Fair Tax could be on the overall economic activity of producers and employers in Texas. The magnitude of the effects is somewhat uncertain. However, with the elimination of a significant portion of the property tax and the corporate income tax (franchise tax), a good deal of economic activity previously discouraged would take place. Manufacturing involving heavy capital investment would expand. Employment in such sectors would expand accordingly.

Texas-made goods might even gain some advantage with Texas consumers. Wal-Mart imports into the state nearly everything it sells. The Fair Tax would fall on every one of the items it sells. Even though Wal-Mart property taxes would fall, the comparative rise in taxes on its sales would offset the fall in property taxes. In addition, companies like Wal-Mart that have enjoyed a good deal of comparative tax relief from property tax abatements would see the abatements become nearly meaningless.

The down side of a Fair Tax would be that many employees of already-existing enterprises in the state would see some of their living costs increase. For example, little of what Wal-Mart sells in Texas is manufactured in Texas. The Texas property tax represents a low percentage of any item's price, given Wal-Mart's sales volume. Therefore, many of the products Texans buy will not fall in price and, in fact, might rise in price after the tax.

This would, of course, result in demands for higher wages in order to compensate for the higher cost of living. Some more service-oriented businesses without a large capital investment in the state, such as call centers, would find it easy to migrate elsewhere. However, the overall effect on service industries is quite uncertain. Many services are geographic-specific and the expansion of capital-intensive industries would tend to increase demand for many services. Remember, too, that out-of-state consumers of Texas-made goods would not pay the Fair Tax, and that even though some Texas wage rates might have to rise, increasing production costs, other taxes would fall, simultaneously decreasing production costs.

Another related problem — one of the biggest with regard to sales taxes — relates to issues of tax jurisdiction. It is easy to buy airline tickets, for example, over the Internet. How does Texas enforce the Fair Tax? It would certainly be inequitable and violate concepts of neutrality to tax travel agents but not internet providers. The fact that no other state has a comprehensive consumption tax aggravates the problem. If, for example, the M.D. Anderson Cancer Center in Houston has to tax all surgical procedures, might some customers go to other states? Might the cancer center open branch operations in, say, Oklahoma or Louisiana to avoid the \$1,000 to \$10,000 tax that would be associated with each major operation? Or would the \$1,500 to \$2,000 tax that would be associated with annual tuition charges at major private universities lead students to look for colleges out of state? On the latter issue, does the student paying \$30,000 in tuition but getting a \$10,000 scholarship have to pay the tax on the gross tuition of \$30,000, or the discounted tuition (after scholarship) of \$20,000?

The worst distortion that might occur with a sales tax that has no real comparable counterpart in other states is that businesses might locate to a different state altogether, or Texas consumers might make purchases from companies outside the state. How likely this is depends on the business involved. Out-of-state purchases usually involve shipping charges, often making it more economical to purchase within the state even with a sales tax assessed. The biggest difference will be made in the purchase of services such as the airline example above. Even with the imposition of a use tax like that instituted in Texas whereby Texans are supposed to declare out-of-state purchases and pay the applicable sales tax rate, the tax is routinely ignored and essentially unenforceable.

### *Texas Fair Tax Fairness*

Another issue raised is that a Fair Tax might burden lower income persons more than wealthy ones — that it is regressive. The evidence on regressivity is pretty sparse, although it is true that the propensity to consume out of income is higher for lower income persons than more affluent ones. One way of dealing with this is to have rebates for lower income persons. That, however, not only erodes the revenue base but imposes significant new administrative costs, for example, in ascertaining who is eligible for the rebates and in what amounts. The exclusion of some products used heavily by low income individuals, such as food and medical care, would materially reduce and perhaps end the potential regressivity “problem” if one even exists.<sup>†</sup>

Another way to mitigate the regressivity issue and keep the cost of that mitigation low might be to piggyback on the state's Lonestar Card program. Those who meet certain income criteria could apply for and receive either the Lonestar Card or a similar device. Then, when they make purchases, they could be exempted from paying the sales tax. In order to prevent fraud whereby recipients of the exemption might make purchases for others who do not qualify, recipients could be restricted to making exempted purchases that total only the amount of a certain cutoff at or near their declared income.

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<sup>†</sup> It is not clear that the American people view tax progressivity as a virtue and tax regressivity as a vice. One survey of Americans explicitly on this point in the 1980s showed that fewer than half of Americans considered the principle of tax progressivity to be fair and equitable.

Whether or not regressivity is a problem is a debatable issue. The fact is that higher-income individuals buy more, and they buy relatively expensive items compared to lower-income individuals. That means high-income families will pay a greater proportion of the Texas Fair Tax than low-income families. This can be seen with the current sales tax, for which it is estimated that the top 20 percent of income earners pay 35.7 percent of the sales tax paid by Texans.<sup>7</sup> On the other hand, it is true that low-income individuals pay a higher percentage of their total incomes to a sales tax. Fairness is therefore in the eye of the beholder. Virtually any tax imaginable, except for the income tax, tends to be regressive. Perhaps the best test of a tax system's regressivity, though, is the degree to which it keeps low-income individuals from progressing to higher incomes. There is no evidence that the sales tax or a Fair Tax would negatively affect income progression.

### *Transparency of a Texas Fair Tax*

The federal Fair Tax proposal would require that every item be posted with a before- and after-tax price. In addition, the amount of tax would appear on the sales receipt. The current Texas sales tax already essentially achieves this level of transparency in that it is added on at the time of sale and appears on sales receipts. Occasional complaints are that prices posted do not accurately reflect the true cost because posted prices do not include the sales tax in most instances. However, by requiring the posting of before- and after-tax prices, even this transparency issue can be solved with a Fair Tax.

The only other transparency issue with a Fair Tax that cannot really be solved is that the tax would accrue in small increments over time. In all likelihood, few would save receipts and total the taxes paid. The extent to which this occurs now with the sales tax mostly concerns taxed business purchases. Therefore, it is likely that few Texans would have any idea how much of a Fair Tax they would have paid over time. Even so, it would be relatively easy for them to keep up with the amount of tax paid if they so wished.

Ultimately, a Fair Tax must be judged on the transparency issue as it compares to various alternatives. A sales tax is probably less or no more transparent than an income tax. Income taxes, when withheld from wages, are fairly transparent given that check stubs generally state current withholding as well as withholding on a year-to-date basis. The settle-up process of filing income tax returns yields a bottom line as well.

Payroll taxes are not nearly as transparent as even the income tax. In most cases, as with the Social Security tax and unemployment insurance, there is a so-called employer share that never appears on a check stub. Few people are aware that their take-home pay is negatively affected by the supposed employer share. In fact, few people have any idea that there is an employer share at all.

Property taxes, franchise taxes, and other business taxes especially lack transparency. For those who actually write the checks to government entities, these taxes are not at all hidden. However, renters pay property taxes through their rent. Corporate customers pay the franchise tax and the property tax through the prices they pay. All businesses that pay

the property tax must incorporate their costs in pricing determinations. Transparency in the case of most taxes is all but nonexistent.

### **ECONOMETRIC SIMULATIONS**

The Texas Public Policy Foundation commissioned the Beacon Hill Institute (BHI) at Suffolk University to use its well-developed and frequently used econometric tax model to simulate the economic impact of moving to a state Fair Tax. The model is a multiple equation model of the computable general equilibrium (CGE) variety and has been helpful in analyzing tax policy in a large number of states, including Texas.<sup>8</sup> To be sure, all econometric models have their limitations, and this model is no exception. The task of identifying complex human behavioral relationships is tricky, and reliable data are not always available. Moreover, econometric models implicitly assume future behavior will in some fashion mirror past behavior. While that is generally a reasonable assumption, the Texas Fair Tax is a somewhat unique form of taxation at the state level, so there is little or no historical experience on which to fully model behavior.

Four possible configurations of a Texas Fair Tax are considered. In all four scenarios, all state taxes are reduced to zero, except for fuel taxes and the Fair Tax itself. Local sales taxes and city, county, and special district property taxes are left intact. In Scenario 2, the closest scenario to the Fair Tax proposed at the national level, the local school property tax is completely eliminated, and a per capita refund is provided to all individuals in the state equal to an amount of the sales tax that would be paid on purchases totaling to the per capita poverty level. All final purchases are taxed under this purest form of the Texas Fair Tax.

In fact, under all four of the possibilities considered, all final purchases are taxed. The tax rate changes mainly depending on the amount of the school property tax that is to be eliminated. The Texas Fair Tax ends up with a larger base than is the case with the current sales tax. Some of the current base is eliminated as business purchases currently taxed are eliminated from the base but final purchases of goods and especially services that currently escape taxation are included under the Texas Fair Tax. Because the overall base ends up being enlarged, local governments, whose rates are assumed to stay as they currently are, enjoy a windfall.

In Table 8, the four scenarios are modeled and some broad results shown. Two possibilities are considered with respect to how much of the local school property tax is eliminated, both intended to be revenue neutral when comparing the amount of property tax given up and the additional state revenue. One possibility considered is the elimination of 50 percent of the local school property tax. The other is the elimination of 100 percent of the local school property tax. In addition, two methods for reducing the regressivity of a sales tax are modeled. One is to refund some of the proceeds on a per capita basis as described above. The other is to exempt food, medical goods and services, and education services from the tax. Of these two methods to limit the effects of regressivity, the latter (tax exemptions) is the more realistic logistically.

**Table 8**  
**Modeled Texas Fair Tax Scenarios and Prognosticated Economic Results**

PARAMETERS	Scenario 1	Scenario 2	Scenario 3	Scenario 4
<b>% of School Property Tax Eliminated</b>	50%	100%	50%	100%
<b>Per Capita Refund</b>	No	No	Yes	Yes
<b>Exempt Food, Medical, Education</b>	Yes	Yes	No	No
<b>ECONOMIC RESULTS</b>				
<b>State Fair Tax Rate Required</b>	7.86%	9.86%	8.7%	10.91%
<b>Real Disposable Income Per Capita in 5 Years*</b>	Increases 2.6%	Increases 3.5%	Increases 1.9%	Increases 2.8%
<b>Investment in 5 Years*</b>	Increases 21%	Increases 38.5%	Increases 20.6%	Increases 38%
<b>Private Employment in 5 Years*</b>	Decreases 0.6%	Decreases 1.5%	Decreases 1.2%	Decreases 2.3%

\* Percentage changes represent deviations from projected growth.

Care must be taken in interpreting these results. First, the percentage changes are deviations from a baseline forecast that assumes a long-run economic growth rate. *Even where employment is predicted to decrease, it is a decrease compared to growing employment. The actual number of jobs is still likely to increase — just not as much.* Second, it must be recognized that the tax rates estimated are only for the state's rate. Local sales tax rates would have to be added to the rates listed to determine the total sales tax rate for a given locality. Third, it is assumed in the model that current local rates continue as they are. The model predicts that there will be a significant windfall for local governments as a result. The state could require local sales tax rate reductions (often called compression) in order to force revenue neutrality on local governments. Fourth, local governments will also receive a further tax windfall from growth in the capital sector. Local city, county, and special district property taxes are assumed to continue. Fifth, school interest and sinking property taxes are also assumed to continue.

The employment numbers illustrate how cautious the economist must be in interpreting econometric modeling results. The model implies that capital investment might cause a drop in employment due to the falling cost of capital. Short-term effects can be very different from long-term effects, however. In fact, capital in the United States is much less costly than it once was. The capital wealth of the United States is immense — greater on a per capita basis than for any nation on earth. If the short-term results in the model were an accurate indicator of capital's effect on employment, it should not be the case that the highest proportion of the United States' population in its history is working and is enjoying the highest standard of living in the nation's history.

To summarize the body of evidence succinctly, the BHI econometric model results suggest that a move, in a revenue-neutral fashion, from the existing tax system to a Fair Tax system that eliminates a large proportion of school property taxes and most other state-level levies would increase the rate of economic growth. Incomes of Texans five years from now would be materially higher (the precise amounts depending on the tax change modeled). The new form of taxation would lead to more efficient uses of the means of production, reduced tax-induced distortions, and markedly increased capital formation. The productivity of labor is unambiguously positively impacted, with output rising relative to labor inputs. In short, the BHI results confirm suspicions based on economic theory that the Fair Tax approach would have several overall, long-term positive economic effects.

At the same time, any proposal for significant change in the tax system has some negative dimensions. There are winners and losers. The BHI model predicts some loss in jobs with a probable short-term adverse impact in terms of employment. The reason for this is that under the Fair Tax there is some reduction in distortive taxation of capital, making capital relatively less expensive, and leading to some substitution of capital for labor. In the long run, positive economic growth effects will lead to expansion in labor usage, offsetting short and intermediate term negative employment effects. In fact, over the five-year period that the model prognosticates, this is indeed the case. Even in the worst case employment scenario (Scenario 4) employment might well exceed what it would otherwise have been in ten years, judging by the five-year trend.

No economic model can possibly fully take into account all potential human behavior. There is no way to fully model the degree to which Texas consumers might pursue out-of-state purchases. It could very well turn out that the model grossly underestimates this effect for some reason. On the other hand, the model could just as well overestimate it. No comprehensive tax change should be made on the basis of a single economic model. However, the BHI model predicts a more vibrant, faster-growing economy with investment essentially sky-rocketing. And why shouldn't it? The elimination or near elimination of the school property tax would lift a considerable and growing burden from the capital sector of the state's economy.

### **FEDERAL INCOME TAX DEDUCTIBILITY**

Since the 1986 reform of the federal income tax, state sales taxes have not been deductible. Many have resisted increasing Texas' reliance on a sales tax for this reason. If the state shifted from the property tax, which is currently deductible, to the sales tax, which is not deductible, the result would be a net loss to the state's economy since more money would flow from the state into federal coffers.

The situation has now changed. With the passage of the American Jobs Creation Act of 2004, the sales tax has once again become deductible from federal income taxes. A Texas Fair Tax, while not called a sales tax, is in fact a sales tax. In many respects it would tax different transactions, and it would tax at a different rate depending on how much of the

school property tax was replaced, but it would certainly qualify or could be made to qualify for deduction under the federal law.

The econometric analysis above assumes that sales taxes are not federally income tax deductible. This means with federal deductibility of sales taxes, the positive economic impacts of substituting a Fair Tax for school property taxes would be *more* positive than indicated above. The negative impact (i.e., on jobs) would be *less* negative than indicated above. The differences would not be huge, but they would be significant. Especially in the case of Scenario 1 in Table 8, the negative job effects would likely disappear entirely or nearly so.

The small percentage of private employment loss in Scenario 1 associated with Texas Fair Tax implementation represents about 53,000 jobs. However, with federal income tax deductibility of the *current* sales tax, the Texas Comptroller estimates that more than 21,000 jobs will be created.<sup>9</sup> Given that the Texas Fair Tax is more comprehensive than the current sales tax, the comptroller's job impact estimate bodes very well for Texas Fair Tax implementation. Under Scenario 1, the likely result would be no job loss at all, and considerably smaller job loss under the other scenarios.

### OTHER ISSUES

The impetus for tax reform is primarily an issue of funding Texas public schools. Any move to a Fair Tax would shift part of the burden of taxation from the local to the state level. That leaves some potentially thorny issues surrounding the allocation of funds from state governments to local school districts. Any such move like the one discussed and modeled here is likely to lead to winners and losers, which always ignites controversy. The "winner and loser" comment also applies to taxpayers: Some businesses would feel benefited by a Fair Tax, while others, such as untaxed services industries, would feel hurt. The tax burden would also shift among individuals and households. Aside from the issue of vertical equity (the progressivity or regressivity of the tax system), there are issues of horizontal and even intergenerational equity. The precise dimensions of concerns would depend on whether and how extensive exemptions are under the Texas Fair Tax. Also, because of its unique nature (no other state has a truly comprehensive consumption tax), there are significant issues of tax avoidance whose magnitude is hard to predict, but which are likely to be material.

One other issue relates to educational outcomes. There is a body of literature that calls into question educational finance reform done in the name of equity.<sup>10</sup> Some studies show that student academic performance is greatest, other things being equal, when local funding is a relatively large proportion of the total.<sup>11</sup> Thus in fixing a tax problem, there is the possibility of worsening an educational concern. There is pretty strong evidence that schools function best when local educational leaders are empowered to make decisions, and accountability is enhanced by having to face voters for approval for some funding. Moving the locus of financial power to Austin is inconsistent with moving toward more local entrepreneurship in education. That concern, however, could be relieved by offering other competition-inducing reforms, such as increasing scholarship

aid to students (as opposed to greater state aid to school districts), expanding charter school options, subsidizing parental costs under homeschooling, and giving tax credits against private school tuition fees, among other options.

One issue that is hard to assess with precision but is worth considering is the impact that such a radical change would have on the long-run taxpayer burden. While a fair tax might be neutral in its short run revenue effect, its long-run impact is likely non-neutral. If, as BHI predicts, such a tax increases incomes for Texans, even if total tax revenues were to rise relative to the status quo, it does not necessarily mean that the tax burden (taxes as a percent of income) would rise. Still, for those concerned about tax reform being “a disguised tax increase,” the solution may be to move forward simultaneously with a proposal to constitutionally limit taxation and/or spending.

### CONCLUSION

The purpose of investigating the possibility of a Texas Fair Tax is to demonstrate that there are viable alternatives to the existing structure of state and local taxation in Texas that would relieve most of the problems with the current property tax system, ease dramatically the problem of dealing with school finance issues, be constitutionally far less suspect compared to other alternatives, promote economic growth, and at the same time continue the tradition of Texas being a low-tax state. The Texas Fair Tax, as analyzed here, would seem to present opportunities to Texas lawmakers to configure a tax system that is fairer, that encourages economic growth, and that ultimately leads to more employment opportunities for Texans.

From a theoretical perspective, the Fair Tax idea appears to hold a great deal of economic promise. There are some potential practical problems with enforcement of the tax and properly determining when it is to be applied, but with today's technology, it may be that these problems are relatively easy to overcome. The real issues are political. Though the positive economic effects of the Fair Tax would be large and immediate, the negative effects, relatively small, would be immediate as well. In the end, Fair Tax implementation, if successful, would likely result in economic benefit for the state, but the short-term negative effects would have to be weathered.

In short, policymakers should fully explore the options of the Texas Fair Tax idea. Texas already has a pretty good tax system relative to other states. It is far from perfect, but more conducive to expanding economic welfare than most. While caution therefore must be exercised in changing the system significantly, opportunities should be taken to improve when improvement is possible. The Texas Fair Tax may be an option that would improve Texas' economy yet allow the state to meet constitutional and political imperatives. The Texas Fair Tax idea should be given a fair chance.

## ENDNOTES

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<sup>1</sup> For more information on the Fair Tax proposal at the federal level, see [www.fairtax.org](http://www.fairtax.org).

<sup>2</sup> Office of the Texas Comptroller, *Tax Exemptions & Tax Incidence: A Report to the Governor and the 78<sup>th</sup> Texas Legislature*, January 2003, p. 3.

<sup>3</sup> *Ibid.*, p. 49.

<sup>4</sup> Byron Schlomach, *Tax And Expenditure Limitation Reform: Is It Needed In Texas?* (Texas Public Policy Foundation: August 2004), [www.texaspolicy.com/pdf/2004-08-TEL.pdf](http://www.texaspolicy.com/pdf/2004-08-TEL.pdf).

<sup>5</sup> Representative studies include:

L. Jay Helms, "The Effect of State and Local Taxes on Economic Growth: A Time Series-Cross Section Approach," *Review of Economics and Statistics*, November 1985; Aladdin Mofidi and Joe A. Stone, "Do State and Local Taxes Affect Economic Growth?" *Review of Economics and Statistics*, November 1990; James R. Hines, Jr., "Altered States: Taxes and the Location of Foreign Direct Investment in America," *American Economic Review*, December 1996; and Robert Carroll et al., "Personal Income Taxes and the Growth of Small Firms." NBER Working Paper W7980 (Cambridge, MA: National Bureau of Economic Research, October 2000).

<sup>6</sup> The Advisory Commission on Intergovernmental Relations in the 1970s and 1980s regularly polled individuals on tax fairness, finding the income tax the most unfair tax, with property taxes a close second. See Richard K. Vedder, "Tithing for Leviathan: The Case for a True Flat-Rate Tax," in Dwight R. Lee, ed., *Taxation and the Deficit Economy* (San Francisco: Pacific Research Institute, 1986), chapter 5 for some discussion of this evidence.

<sup>7</sup> Office of the Texas Comptroller, *Tax Exemptions & Tax Incidence: A Report to the Governor and the 78<sup>th</sup> Texas Legislature*, January 2003, p. 49, authors' calculation.

<sup>8</sup> David G. Tuerck et al., *Texas-STAMP: A Sophisticated Tax Model for Texas* (Texas Public Policy Foundation: March 2004), [www.texaspolicy.com/pdf/2004-03-10-stamp.pdf](http://www.texaspolicy.com/pdf/2004-03-10-stamp.pdf).

<sup>9</sup> Office of the Texas Comptroller, *American Jobs Creation Act of 2004 Adds Federal Tax Deduction for Texas State and Local Sales Taxes*, [www.window.state.tx.us/comptrol/ajca2004/](http://www.window.state.tx.us/comptrol/ajca2004/).

<sup>10</sup> Caroline M. Hoxby and Ilyana Kuziemko, "Robin Hood and His Not-So-Merry Plan: Capitalization and the Self-Destruction of Texas' School Finance Equalization Plan," July 2004, <http://post.economics.harvard.edu/faculty/hoxby/papers/txpaperaug2004.pdf>.

<sup>11</sup> Richard Vedder and Joshua Hall, *Effective, Efficient, Fair: Paying for Public Education in Texas* (Texas Public Policy Foundation: February 2004), <http://www.texaspolicy.com/pdf/2004-02-25-vedderhall-all.pdf>; and Caroline M. Hoxby, "Local property Tax-Based Funding of Public Schools," *Heartland Institute Studies* #82 (May 1997).



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