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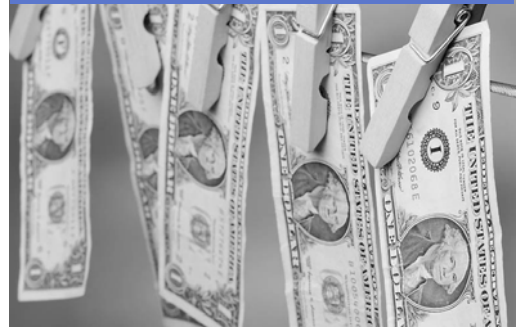
An Examination Of Texas' Economic State

By Stephen Moore,
Donna Arduin &
Arthur B. Laffer

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Texas Public Policy Foundation

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An Examination Of Texas' Economic State

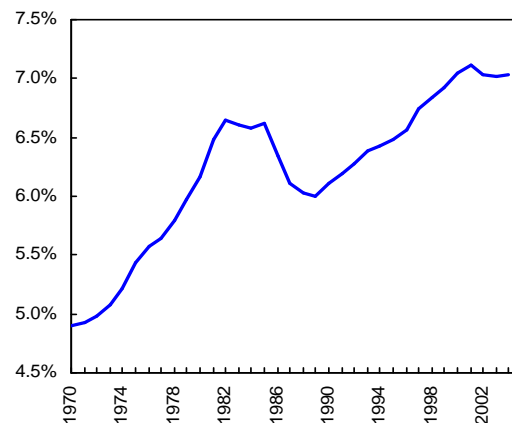by Stephen Moore, Donna Arduin
& Arthur B. Laffer

Executive Summary

If one looks at a map of the United States with a bit of imagination, one can almost see the mighty State of Texas muscling its overmatched neighbors toward the left and right coasts. Texas' economic engine will produce a whopping $925 billion of output this year alone, and nearly 23 million people, including tens of thousands of migrants each year, choose to make the Lone Star State their home. And it has reached these heights without—*gasp*—a personal income tax. Texas is an economic shining star, a fiscally sound, pro-growth state far removed from the high levels of anti-growth taxation and excessive spending of peer states such as California and New York.

Today, Texas Governor Rick Perry and the state legislature face a critical decision. The September 2004 ruling of the Texas state district court

**Figure 1
Texas Personal Income as a
Percent of U.S. Personal Income**

Source: Bureau of Economic Analysis

regarding public school finance made certain what we knew to be inevitable. The court has mandated a shift of a portion of the tax burden from local government property taxes to the state government. As predictable as the rising sun, there are calls for dramatic fiscal reform from those who seek a bigger share of the government pie and from those who seek to make the pie bigger—calls for the first personal income tax in Texas history; calls for a new payroll tax on businesses; and calls for higher taxes in virtually every category imaginable.

The shift in tax burden from local government to state government must be accomplished in a manner that will not hurt the Texas economy. With the path of reform yet to be decided, in this report we demonstrate through the lens of the State Competitive Environment model that moving in the direction of higher taxes and larger government would be a serious misstep that would harm the Texas economy for years to come.

Since Gov. Perry was sworn into office in December 2000, he and the state legislature have provided solid fiscal leadership for Texas through pro-growth policies and spending restraint. And this wasn't an easy task to accomplish. You may remember that the U.S. stock market started its long slide downward in March of 2000. Then, only nine months after Gov. Perry took office, the 9/11 attacks on America threw the whole country into a tailspin—including Texas. And if that weren't enough, oil prices dipped below $20 per barrel in late 2001. All of these events were beyond Texas' control and wreaked havoc on the Texas economy. Yet Gov. Perry and the legislature refused to take the easy road out of their fiscal troubles—tax increases—unlike many other state leaders. Instead, they cut spending and held firm against tax increases in their FY2004-05 biennial budget in the midst of the most difficult state fiscal period in U.S. history.

Texas now has a unique opportunity to not only resolve its local property tax crisis but to improve its competitiveness at the same time. Texas is in no need of a major overhaul—its economic outlook is already quite favorable—yet some improvements should be made. **Our recommendation for Texas is a permanent moderate reduction in local property tax rates, a slightly lower sales tax rate applied to a much broader base, an abolishment of the inane corporate franchise tax, a few other minor tax actions, and—critically—continued fiscal restraint**. We believe Texas' economy will benefit for years and years thanks to a more efficient tax structure and the dynamic effects resulting from these significant tax cuts.

Texas Today

Over the past 25 years there have been six major lawsuits filed over the structure of school finance in Texas.[1] In its recent decision of September 2004, the court declared that state government is failing to meet the Texas constitution's definition of "adequacy" and must bear a larger portion of the burden of funding the public school system. The court ruled that Texas' heavy and growing reliance on local property taxes to fund its public schools has created a *de facto* statewide property tax, a violation of the state's constitution. With the property tax rates of nearly 80 percent of school districts already straining against the legal maximum tax rate of $1.50 per $100 of valuation allowed for school maintenance and operations in 2003—the average maintenance and operations rate was $1.447—local governments have lost "meaningful discretion" in setting tax rates.[2]

With Texas' property taxes—which help fund not only school districts but cities, counties and special districts—and property tax burden growing year after year without reprieve, and far outpacing growth in personal incomes, it was only a matter of time before we saw a full-scale taxpayer revolt in Texas along the lines of California's 1978 Proposition 13 movement. Proposition 13 included constitutional amendments limiting property tax rates and was followed by limits on government spending growth included in Proposition 4. Yet the upheaval in Texas today is unique compared with that of California in 1978, or Massachusetts in 1980, or Missouri in 1980, or Colorado in 1992. In Texas today, runaway government spending is not the problem. The problem has specifically to do with Texas' high local property taxes. And, Texas' taxes are not as efficient as they could be. This unique situation in Texas today has tremendous implications for what should—and as importantly, what should not—be done by the governor and the legislature.

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[1] "A Primer on Texas School Finance," Education Reporter, Texas Association of School Boards, February 2004.

[2] 79 percent of school districts imposed a maintenance and operations rate between $1.40 and $1.50 per $100 of assessed value in 2003. Source: Carole Keeton Strayhorn, "Annual Property Tax Report," November 2004.

Our Approach To State Analysis

The fiscal policy of the U.S. government often draws the attention of academics, pundits, and policymakers alike, while at the same time the individual and aggregate impact of the fiscal policies of the states is discounted or ignored. This is unfortunate because the impact is substantial. We begin our analysis with a thorough review of the economic theory behind our State Competitive Environment model, which is the tool we use to evaluate the relative economic prospects of the states. This model has been refined over the years and reflects decades of state economic analysis and in-the-trenches experience.

Three ideas provide the framework for our analysis. The first is that individuals respond to economic incentives; in particular, to changes in expected after-tax income or returns. Therefore, the levels of taxation in a state and in the U.S. economy as a whole directly affect a state's economic growth. The second idea is that in an integrated economy with a high degree of factor mobility, changes in relative state tax burdens (i.e., relative prices) are critical. Finally, the third concept is that individual states are competitors in terms of their economic policies—competitors with their neighbors and/or peer states.

Following our review of the State Competitive Environment theory, we'll take a close look how the theory translates into the real world, both overall and for Texas. Moving on, we'll examine where Texas stands today in terms of revenue, spending, income, output, employment and the links between these measures and population metrics and asset values. Then we'll let the model take over, reviewing its analysis of Texas' economic prospects and highlighting areas of strength and weakness.

Finally, we'll recommend a path for the state of Texas to follow in order to improve its competitiveness. Suffice it to say, our recommendations do not include raising net taxes and bigger government.

In several areas of this report, we'll refer to the California experience of the past 30 years to see the costly results of large tax increases to fund ever-growing government. We present a fiscal policy checklist of sorts with rule-of-thumb concepts based on decades of state study. Texas' leaders need to remain familiar with the facts in order to make well-reasoned decisions.

Unless critical mistakes are made today, our analysis points to a future for Texas that is very bright.

Influences On Economic Growth

In the coming decade, every state in the U.S. will strive to attain economic growth—some with enviable success; others with disappointing results. What are the factors that will determine these successes and disappointments? What approach can a state government take to boost its employment, output, and income, and how much of an impact will those actions make?

Just how much of a state's economic performance is attributable to the state's pro-growth or anti-growth fiscal policies is open for debate. Monetary policy and federal fiscal policy are basically the same for all states. But it is clear that a lot of factors come into play when it comes down to a state's economy—many outside the state government's purview. In determining a state's competitiveness, a great number of local factors come into play—such as weather, proximity to major markets, geography, infrastructure, regulatory requirements, and so on. In addition, there are

other factors in play that are simply beyond the direct control of the state, such as national and global economic trends. So just how much influence can a state exert through its own fiscal policies?

As depicted in Figure 2, our research has estimated the average importance of the following four areas of influence on state economic growth:

♦ **44 Percent National and World Economic Trends:** On average, approximately 44 percent of the variation in a state's economic performance is associated with changes in the U.S. economy and is therefore outside the purview of state economic policies. The 2001 recession, for example, lowered growth in all states, whereas the recovery has buoyed output and employment across the nation. National and global policies and events can have a disproportionate effect on a particular state's growth rate. For example, employment, production and incomes related to the domestic oil industry have varied tremendously over the decades depending on global market conditions, adding to or subtracting from the fortunes of those states, such as Texas, with heavy concentrations in oil.

♦ **25 Percent State and Local Fiscal Policy:** Approximately 25 percent of a state's overall economic performance is associated with changes in a state's fiscal policy at the state and local government levels. As we will explore in detail later, changes in a state's tax rates and tax burden relative to the rest of the U.S. are major determinants of a state's relative and absolute performance. The tax burden, generally measured throughout this report as total state and local tax revenue divided by total state personal income, is widely accepted to compare tax policies across states. As such, the tax burden indicates the effective average tax rate of a particular state.

Figure 2
Four Areas of Influence on a State's Economic Growth
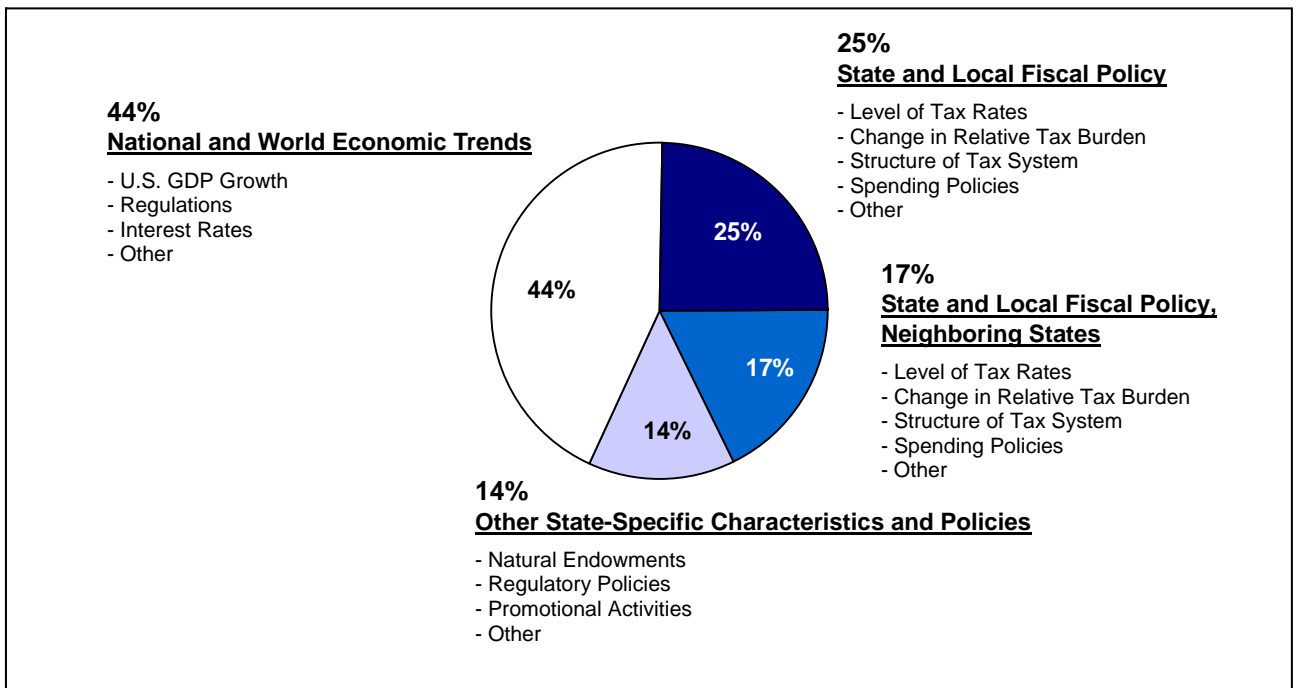
Source: Author calculations.

A state's economic policies, particularly tax policies, influence the level of economic activity in the state by altering the incentives to produce and invest. For instance, changes in tax rates alter the relative prices of labor and leisure and influence the labor force participation decision. This, in turn, will influence the relative amounts of market and (presumably less efficient) household production. Further, state economic policies may also affect the level, timing, and composition of investment spending. Generally speaking, the lower a state's tax burden relative to other states, the greater the incentive to invest in that state.

In addition, the *expected* path of policies can be as important as existing policies in determining a state's competitiveness. It is unlikely that a company will choose to build a manufacturing plant with a 30-year life in a state if the business climate in that state is expected to become less friendly. It follows, then, that concern over rising taxes, unpredictable regulatory requirements, or other governmentally imposed strictures will affect a state's competitiveness.

Our econometric analysis of the relationship between relative state growth rates to changes in state tax burden and changes in state expenditures has yielded two interesting results. The impact on state growth of a change in a state's tax burden relative to the U.S. average is negative and significant. On average, for every 1 percent rise in a state's relative tax burden, its rate of growth declines by approximately 0.5 percent in the year of the relative tax increase. Second, we have compared real per capita government purchases relative to the U.S. average with growth. These results indicate that state and local government expenditures on goods and services have only a minor impact on a state's economic performance.

♦ **17 Percent State and Local Fiscal Policy, Neighboring States:** For every action there is a reaction, and for every state foolish enough to tax itself into oblivion there are neighboring states that benefit tremendously. For example, in the early 1990s when California put through the largest tax increase in U.S. state history, Oregon, Nevada, and particularly Arizona (which was in the process of implementing tax cuts at the time) literally soaked up thousands upon thousands of residents and businesses leaving the tarnished Golden State. Their economies were boosted tremendously by California's actions.

Of course, this is an extreme example, given that California would be the world's sixth largest economy if it were a nation unto itself. The influence weights discussed here are estimates of the representative weights for the U.S. as whole. Clearly, fiscal policy decisions of California have a much larger effect on Arizona than vice versa, and the same could be said for Texas, Massachusetts, New York, etc., relative to their neighbors. But as a rule-of-thumb, this overview of the influences on state economic growth is right on target.

♦ **14 Percent Other State-Specific Characteristics and Policies:** Finally, the remaining 14 percent of a state's competitiveness and relative economic performance can be attributed to other factors that generally remain fairly constant over time, such as changes in natural endowments, weather, location, regulatory policies, etc.

State Competitive Environment Theory

We will now develop more fully the framework of the Laffer State Competitive Environment model. Each state within the U.S. is analogous to a country with open borders. Just as the U.S. competes with other countries for the location of economic activity, states compete with each other for the location of factories, offices, and jobs within the U.S. Competition of this type can

be seen directly through many overt state actions, such as tax-cutting battles with neighboring states and targeted tax incentives to encourage corporate relocation.

As states seek to hold companies and workers within their borders and attract new ones, the winners and the losers of the state economic race will be separated by their ability to "read" the state competitive environment and then, to the extent that they are able, influence events in such a way as to enhance their own state's relative appeal.

Our research suggests that state tax policies play a major role in a state's competitiveness and directly affect the returns to state-specific factors of production. Due to the connection between state and local tax policy and economic performance, the values of assets located in states that alter their tax policies will fluctuate in predictable directions. States lowering their relative tax burdens can be expected to experience accelerated economic growth and increased asset values, whereas those increasing their relative tax burdens on balance exhibit a slower pace of economic expansion and declining relative asset values.

Overtaxed states restrain growth. States that raise taxes—even if they currently aren't overtaxed—inhibit growth. The level of taxation, as well as changes in taxation, are both critical and are incorporated into the State Competitive Environment model's results.

Every state that raises its relative tax burden will find it difficult to retain existing facilities and to attract new businesses and workers. In tax-raising states, new business starts will decline and business failures will increase. With lost business, there soon will be lower wages, lower profits, and higher unemployment. The incentives for people and capital to migrate into the state will be diminished. Mobile capital and labor will emigrate to seek higher after-tax returns in other states, and immobile factors of production will be left behind to bear the burden of the state's taxes. Asset values will be depressed and the tax base will decline. The increased unemployment and business failures will result in higher overall government expenditures and contribute to a worsening of the state's financial position.

Symmetrically, a reduction in tax rates reduces the cost of doing business in a state. This increases demand for the now less-expensive goods and services produced within the state. The higher demand for the state's goods and services will result in an increased profitability for businesses located within the state. Business failures will decrease in states with declining relative tax burdens and business starts will rise. If all else remains the same, a reduction in tax rates increases the return to capital and work effort, leading to increases in the supplies of capital and labor within the state. Higher returns to labor and capital will also encourage the immigration of mobile factors from other states. Asset values will increase and the tax base will expand. The state's coffers will fill and revenues will exceed expectations, thanks to increased taxable economic activity and lessened need for government expenditures on social welfare programs.

Factor Mobility: "Voting With Their Feet"

These dynamic effects of fiscal policy actions result, in large part, from the ability of mobile factors of production to "vote with their feet" and relocate to political jurisdictions pursuing more favorable economic policies. Changes in tax rates have the greatest impact on the supplies of factors of production that are highly mobile. For example, a worker who is prepared to relocate to achieve a higher standard of living will be extremely sensitive to a change in his state's tax rates. By contrast, the supplies of immobile factors of production and/or real estate will be

affected only slightly by tax rate changes. For example, capital in the form of a new manufacturing plant is highly immobile. Its operating level initially will be relatively unaffected by an increase in a state's tax rates. The major impact of state tax rate changes will be on the plant's after-tax profits and, ultimately, whether to close down or to remain open. The implication of this analysis is that taxes levied on mobile factors will be passed on to the immobile factors located within the state. Thus, the burden of state and local taxes may very well be different from its initial incidence.

Consider two hypothetical manufacturing companies with production plants located close to each other. One company's plant is located north of the Dallas area, and the other company's plant, virtually identical to the first, is located just up I-35 across the border in Oklahoma. Each company's plant is separated by just a thin and invisible state line. Since we assume both companies sell virtually identical products in the U.S. market, competition will force them to sell their products at approximately the same price. Both will have to pay the same interest cost on borrowings, the same after-tax wages to their employees, and the same prices to their suppliers.

Now, consider what would happen if Texas were to put through a large increase in their corporate franchise tax rate, while Oklahoma held constant or lowered its corporate income tax rate. Because the market for the product produced is highly competitive, the Texas company would not be able to pass the tax hike forward to its customers in the form of higher prices. Likewise, the Texas company would not be able to pass the tax hike backward onto its suppliers or employees. The Texas firm would have to absorb the tax increase through lower after-tax profits. This drop in profits would be reflected by a fall in the Texas company's stock price. Clearly, the identical competitor in Oklahoma would benefit.

Whether the price of a commodity or factor of production is equilibrated across states on a pre-tax or after-tax basis depends on each item's mobility. This means that changes in tax rates will have two general effects: They will change the quantity and pretax price of mobile factors within the state and leave their after-tax rates of return unchanged; and they will change the rate of return of factors of production that cannot leave the state and leave the quantity within the state unchanged.

As time horizons lengthen following tax increases or tax cuts, the process of adjustment will incorporate the movement of capital and labor into or out of the state. This migration of factors of production will continue until after-tax returns for mobile factors within the state are equalized with after-tax returns for their counterparts elsewhere in the economy. The returns of state-specific immobile factors will reap the benefit or bear the burden of the tax change.

Migration And Population Change

The population of a state changes due to births, deaths, and net migration (between both domestic and international locations). Given that birth and death rates tend to be relatively constant over time, migration to and from other states (domestic migration) and from other nations (international migration) accounts for the majority of state population swings, especially in states such as Texas and California. As we have covered, there is considerable evidence that state economic policy can influence economic growth rates among states and, in turn, labor migration decisions. Therefore, if people tend to move to where they can improve their standard of living, as a result, other things being equal, states with rapidly growing economies are most likely those with rapidly growing populations.

State economic policy has a twofold impact on factor migration. First, the more (less) favorable the economic environment (or alternatively stated, the incentives to produce) relative to other states, the less (more) likely workers are to leave the state to relocate elsewhere. Second, the more (less) favorable a given state's incentives to produce relative to other states, the more (less) likely it will attract workers from states with less favorable economic environments to relocate there. Simply put, mobile factors will move into states that are lowering tax rates and emigrate from states that are raising tax rates.

Our research has tested the hypothesis that state economic policies influence state relative population growth by examining the relationship between changes in the relative tax burden of a state and factor immigration or emigration. A negative relationship between changes in state relative tax burdens and net immigration was regarded as a success, whereas the opposite would have been regarded as a failure. The tax burden of an individual state was assumed to simply equal the ratio of total tax revenues (from all sources) to state personal income for a given year.

It should also be obvious that other factors may affect the factor migration decision besides changes in state relative tax rates. This is one reason why our alternative hypothesis concerned only the direction and not the magnitude of the relationship.

This empirical analysis assumed that moving costs are zero. Of course, factor migration is influenced not only by the reward for moving but by the cost of moving as well. Differences in tax burdens may generate after-tax income differences that will, over time, cover the cost of moving from one locality to another. Other things being equal, the more costly a potential move is, the less likely a factor will make it. Further, if migration costs are nontrivial there will be a gradual—rather than immediate—adjustment of the population across states, as individuals arbitrage the difference in after-tax income across localities. Although trade in goods and factor migration will mitigate regional differences in income, differences in income and factor returns will remain for long periods of time owing to market imperfections. The gradual response to the changing economic conditions will generate lagged relationships between population growth and changes in relative tax burdens.

Empirically, we chose changes in state relative tax burden at a particular point in time as well as (decennial) lagged changes in state relative tax burden and state population growth as our characterization of the tax structure that may induce migrations across states. The variables as well as lagged values of population growth characterized adjustment costs.

Our results suggest that decennial changes in state relative tax burden, contemporaneous plus lagged, do have a significant and negative impact on state population growth. The results are consistent with the hypothesis that increases in tax rates will elicit a migration out of the new relatively higher tax areas. In addition, in all cases, the previous decade's state population growth is useful in forecasting state population growth. The result is consistent with the partial adjustment hypothesis. If there were prior migration into a particular region, under a partial adjustment the process is expected to continue; hence, a lagged response is to be expected. Our analysis indicates that the probability that the apparent negative relationship between changes in a state's relative tax burden and net migration occurred by chance was 7.4 percent during the period examined.

Housing Values

Traditionally, real estate is considered the quintessential fixed factor. It follows that the value of real estate should fluctuate in a predictable direction with changes in state and local policies. This is an empirically testable implication that is supported by the data. Fluctuations in the housing market are logical consequences of a series of events, starting with government policies such as taxes, and continuing on through a number of stages concluding with real estate values.

In the grand scheme of things, housing in the near and intermediate term is a relatively fixed factor. Only at great expense can houses or other forms of real estate be transported. In the long-run, however, new construction combined with depreciation can relocate enormous quantities of real estate at a relatively low cost. This long-run mobility of factors all but vanishes in the near term.

In the case of the real estate market, the importance of long-run forces is altogether too easy to overlook. While during any day, week, month, or year, long-run forces appear to be irrelevant, they do ultimately prevail over all else. Betting against these long run forces is literally "betting against the house." You do win from time to time, but the odds are not in your favor.

Whether in the long or short run, adjustments to market shocks occur through changes in price and/or changes in quantity. Increases in demand result in higher price and greater quantity. If the supply curve is elastic, then the increase in price will be small and quantity great.

In the near term, changes in housing demand invariably come up against relatively inelastic supplies. Therefore, real estate prices provide a great deal of the buffer for near-term adjustments to changes in market conditions, whereas the quantity of homes accounts for less.

The long-run tendency, however, is still worth keeping in mind. Over long periods of time, housing prices should gravitate toward equilibrating across different locations, although differences will remain due to varying local factors such as taxes and building codes, transportation costs, etc. Long-run changes in locational demand should be accommodated in large part by changes in supply—not relative prices.

We now have almost everything in place. Fiscal policy and other factors affect economic conditions; economic conditions affect production, output, employment and eventually migration patterns; and finally, economic conditions and migration together cause changes in asset values such as housing prices (Figure 3). The beauty of the economic theory behind these relationships is that it holds true across states and across time, although, of course, each state has unique factors that weigh heavily.

Figure 3
Linkage Between Fiscal Policies, Economic Conditions,
Population Growth and Home Prices and Affordability

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          ┌─────────────────────────────────────────┐
          │ The Overall Business Climate:  Tax Rates,│
          │    Changes in Tax Burden, Other Factors   │
          └─────────────────────────────────────────┘
                  ↙                        ↘
   ┌──────────────────────────┐   ┌──────────────────────────┐
   │  Relative Output, Employment │   │   Excess Unemployment Rate │
   │   and Personal Income     │   │                          │
   └──────────────────────────┘   └──────────────────────────┘
                  ↘                        ↙
          ┌─────────────────────────────────────────┐
          │          Excess Population Growth          │
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   │ Relative Asset/Housing Values │◄─►│ Relative Real Estate Affordability │
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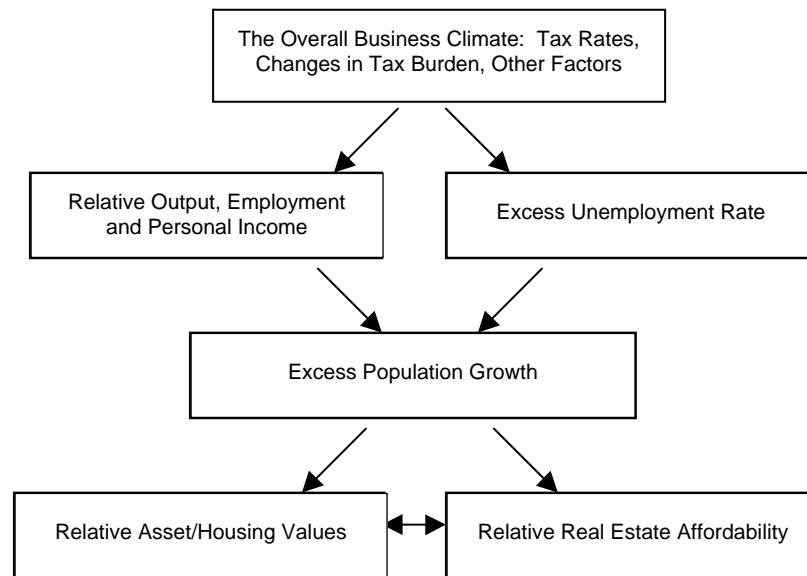
From Theory To Real World Evidence

Before we dive into our analysis of Texas, at this point it would be useful to take a step back from our discussion of the State Competitive Environment theory and see some real world illustrations of these concepts. As we would expect, the theory plays out in the real world beautifully.

The past 10 years have been a roller coaster ride for the states, ranging from the highs of the technology boom to the lows of the technology bubble and the post 9/11 economic slowdown. To say the least, it has been a challenging period for state leaders, especially handling the revenue collapse most states experienced between 2000 and 2003. This period afforded us a rare opportunity to observe the responses of each state's government to both good times and bad. Never before in the history of state and local governments has there been such a clear-cut demarcation of policies—policies that directly affect relative competitiveness and economic health.

In recent years, some states have chosen to spend, spend, spend and/or dramatically increase the tax rates and tax burdens on their citizens—New Jersey, New York and Ohio all come to mind. At the same time, other states—such as Florida, Iowa and South Dakota—have taken the opposite approach and restrained spending and lowered taxes. Given the outcry by some for Texas to "resolve" its current situation by implementing a state personal income tax and other taxes, what better way to show the detrimental effect of taxes on production, employment, incomes and relocation decisions than to compare and contrast the 10-year economic performance of high-tax states with low-tax states. The results are impressive—it quickly becomes apparent on which "team" Texas should choose to play.

In Table 1 on page 15 we examine the economic performance between 1994 and 2004 of the nine states that currently do not impose a personal income tax on their residents versus the nine states that impose the highest state and local marginal personal income tax rates.[3]

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[3] We use the personal income tax, if any, imposed in each state's largest city as a proxy for local personal income taxes in the state.

Table 1
Lower Taxes, Higher Growth:
Personal Income Tax (PIT) Rates vs. 10-Year Economic Performance
(current rate vs. performance between 1994 and 2004, unless otherwise noted)

	Top PIT Rate*	Gross State Product Growth	Personal Income Growth	Personal Income Per Capita Growth	Population Growth	Net Domestic In-Migration as a % of Population	Non-Farm Payroll Employment Growth	Unemployment Rate, 2004
Alaska	0.00%	57.5%	49.4%	37.5%	8.6%	-4.9%	17.0%	7.5%
Florida	0.00%	81.1%	77.4%	45.2%	22.2%	8.2%	29.3%	4.8%
Nevada	0.00%	118.0%	118.8%	40.5%	55.7%	21.1%	56.2%	4.3%
New Hampshire	0.00%	79.6%	78.5%	56.9%	13.7%	6.2%	19.9%	3.8%
South Dakota	0.00%	70.2%	67.8%	59.1%	5.5%	-1.7%	15.4%	3.5%
Tennessee	0.00%	65.7%	67.3%	48.3%	12.8%	4.6%	11.5%	5.4%
Texas	**0.00%**	**86.0%**	**81.4%**	**49.7%**	**21.1%**	**2.3%**	**22.3%**	**6.1%**
Washington	0.00%	73.1%	77.6%	53.9%	15.4%	3.4%	17.1%	6.2%
Wyoming	0.00%	85.7%	76.5%	67.4%	5.5%	-2.0%	17.7%	3.9%
9 States With No PIT**	**0.00%**	**79.7%**	**77.2%**	**50.9%**	**17.8%**	**4.1%**	**22.9%**	**5.1%**
9 States With Highest Marginal PIT Rate**	**9.67%**	**62.5%**	**60.2%**	**48.7%**	**7.8%**	**-2.2%**	**12.8%**	**5.2%**
Hawaii	8.25%	39.7%	38.0%	29.8%	6.3%	-7.4%	8.7%	3.3%
Maine	8.50%	60.2%	67.1%	57.7%	6.0%	3.2%	15.4%	4.6%
New Jersey	8.97%	60.8%	62.8%	50.0%	8.5%	-4.0%	12.7%	4.8%
Ohio	9.19%	47.1%	48.2%	44.3%	2.7%	-2.5%	6.6%	6.1%
Vermont	9.50%	64.3%	72.4%	62.0%	6.4%	1.3%	14.9%	3.7%
Rhode Island	9.90%	74.7%	62.4%	52.7%	6.4%	-1.8%	12.5%	5.1%
Oregon	10.25%	73.7%	63.9%	42.3%	15.2%	5.0%	17.0%	7.4%
California	10.30%	80.7%	72.1%	50.9%	14.0%	-4.0%	19.6%	6.2%
New York	12.15%	61.2%	54.4%	48.3%	4.2%	-10.0%	7.9%	5.8%
The Others								
Illinois	3.00%	52.9%	53.0%	43.3%	6.7%	-5.3%	6.3%	6.1%
Louisiana	3.90%	60.3%	55.6%	49.8%	3.9%	-3.8%	11.4%	5.8%
Indiana	4.10%	57.3%	56.1%	45.0%	7.7%	0.1%	8.0%	5.2%
Alabama	4.25%	56.5%	58.9%	49.4%	6.3%	0.8%	8.1%	5.4%
Colorado	4.63%	91.7%	93.7%	56.8%	23.6%	6.0%	24.1%	5.4%
Connecticut	5.00%	68.0%	61.5%	52.9%	5.7%	-3.5%	7.0%	4.6%
Mississippi	5.00%	51.3%	63.4%	51.3%	8.0%	0.5%	6.5%	6.8%
Arizona	5.04%	102.2%	100.3%	48.0%	35.3%	12.0%	40.3%	4.6%
Massachusetts	5.30%	72.3%	67.3%	58.9%	5.3%	-3.8%	9.5%	4.8%
North Dakota	5.54%	65.4%	62.5%	65.2%	-1.6%	-7.0%	14.4%	3.5%
Virginia	5.75%	81.6%	72.2%	52.2%	13.1%	1.9%	19.4%	3.6%
Utah	5.78%	88.2%	84.6%	51.5%	21.9%	-1.4%	28.3%	5.1%
Iowa	5.84%	65.2%	56.0%	50.5%	3.6%	-2.0%	10.3%	5.0%
Georgia	6.00%	79.4%	79.0%	45.1%	23.4%	6.9%	19.1%	4.8%
New Mexico	6.00%	48.5%	68.1%	48.6%	13.1%	-0.7%	20.3%	5.6%
Michigan	6.25%	41.3%	48.4%	40.8%	5.4%	-2.1%	6.0%	7.4%
Kansas	6.45%	61.3%	55.6%	46.8%	6.0%	-2.4%	13.5%	5.3%
West Virginia	6.50%	41.8%	50.0%	50.5%	-0.3%	-0.7%	9.3%	5.0%
Oklahoma	6.65%	62.7%	64.2%	52.9%	7.4%	0.1%	14.9%	4.6%
Wisconsin	6.75%	61.9%	61.2%	50.2%	7.3%	0.8%	12.6%	4.7%
Nebraska	6.84%	56.2%	61.0%	51.0%	6.6%	-1.8%	15.9%	3.8%
Arkansas	7.00%	58.4%	63.6%	48.3%	10.4%	2.6%	12.0%	5.6%
Missouri	7.00%	54.4%	58.7%	46.8%	8.1%	1.5%	9.0%	5.8%
South Carolina	7.00%	62.6%	67.6%	48.0%	13.3%	4.6%	13.4%	6.9%
Montana	7.15%	60.1%	61.8%	50.4%	7.6%	2.6%	21.0%	4.4%
Delaware	7.20%	91.1%	76.4%	52.4%	15.7%	5.1%	19.2%	4.1%
Pennsylvania	7.40%	56.5%	51.7%	48.8%	2.0%	-2.0%	8.6%	5.6%
Idaho	7.80%	80.1%	76.2%	44.9%	21.7%	7.2%	27.3%	4.5%
Maryland	7.80%	69.4%	69.7%	53.4%	10.7%	-0.4%	17.2%	4.2%
Minnesota	7.85%	76.6%	72.6%	56.0%	10.6%	0.9%	15.6%	4.5%
Kentucky	8.20%	51.2%	63.8%	52.0%	7.7%	1.7%	12.4%	4.7%
North Carolina	8.25%	78.2%	70.4%	43.4%	18.8%	6.4%	14.0%	5.3%

*Highest marginal state and local personal income tax rate imposed as of 1/1/05 using the tax rate of each state's largest city as a proxy for the local tax. The effect of the deductibility of federal taxes from state tax liability is included where applicable. New Hampshire and Tennessee tax dividend and interest income only. While Hawaii and North Carolina both impose the same top rate, Hawaii is included in the "nine highest" category due to a much lower top bracket.
**Equal-weighted averages.

Source: Author calculations based on data from: National Conference of State Legislatures, Bureau of Economic Analysis, Bureau of Labor Statistics, and U.S. Census Bureau.

These numbers are taken directly from the appropriate U.S. government sources and are not adjusted in any way. Relative to the average of the nine states with the highest marginal taxes on personal income, over the course of a decade the average of the nine states without a personal income tax demonstrated:

♦ Faster growth in gross state output (79.7% vs. 62.5%);
♦ Greater personal income growth (77.2% vs. 60.2%);
♦ A much greater increase in total population (17.8% vs. 7.8%), including a net *inflow* of residents into the nine no-tax states from other states (4.1% of total population) vs. a net *outflow* of residents from the nine high-tax states to other states (2.2% of total population);
♦ Much more rapid job creation (22.9% vs. 12.8%);
♦ Only slightly higher personal income per capita growth (50.9% vs. 48.7%); and
♦ Only a very slightly lower unemployment rate (5.1% vs. 5.2%).

These results bring a smile to our faces. It is not often in economics that the truth shines through so clearly. Texas, given its tax structure sans personal income tax, is included in our list of the top nine no-tax states. Impressively, over the 10-year period 1994 to 2004, Texas outperformed each and every one of the nine states with the highest marginal personal income tax rates in growth of gross state product, personal income growth, population growth and non-farm payroll employment growth. Not too shabby!

States with no or low-rate personal income taxes also tend to have more stable budgets and fewer revenue shortages, a seeming paradox which is simply the natural result of the combination of tax progressivity (or lack thereof), politics and human nature. This is a topic we will return to when we discuss why tax systems based on progressive personal income taxes fare relatively poorly in serving the revenue needs of a state—and California serves as a fine example.

To demonstrate this variability in budget stability, we've taken state government budget survey data published annually by the National Association of State Budget Officers (NASBO) and compiled the data into categories one could call budget "trouble signals" (Table 2). These trouble signals, all of which are often the result of revenue streams that are volatile and difficult to forecast, consist of: i.) mid-year budget cuts to an already-passed budget, ii.) legislated increases in taxes and/or fees, and iii.) year-end "rainy day" balances as a percentage of expenditures below the U.S. average. We've examined a four-year period from the time state budgets really hit their nadir in 2002 up to the present. In each and every case, for all four years examined, the nine states with the highest personal income tax rates experienced many more budget difficulties than did the nine states without personal income taxes.

Table 2
No-Tax and High-Tax States: Frequency of Budget "Trouble Signals"

	2002		2003		2004		2005	
	No Tax	High Tax	No Tax	High Tax	No Tax	High Tax	No Tax	High Tax
Budget Cuts Made After Budget Passage	3	9	3	7	1	5	0	3
Increase in Taxes and/or Fees	2	7	3	6	3	6	2	5
Year-End Balance as a % of Expenditures Below U.S. Average	5	6	2	4	2	8	2	7

Source: "The Fiscal Survey of States," NASBO, May 2002, June 2003, April 2004 and June 2005 editions.

Given these results demonstrating the harmful effect of high state personal income taxes on state economic performance, and the fact that states without personal income taxes benefit from more stable budgets than do high-tax states, why in the world would Texas impose a personal income tax? They shouldn't.

Keeping with this theme, let's go a step beyond personal income taxes. Perhaps the best measure of "big government" versus "small government" is the total state and local tax burden. Here we combine all tax revenues, from the biggest state taxes all the way down to the tiniest of taxes at the local level. (Thankfully, data from the U.S. Census Bureau's Government Finances division make this a manageable task). Then we express these tax revenues per $1,000 of personal income. The range in tax burden from the lowest taxed state (New Hampshire) to the highest taxed state (New York) is remarkable. For example, Alabama, New Hampshire and Tennessee all take less than $90 in state and local taxes for every $1,000 of personal income, while New York extracts $133 per $1,000 of personal income!

Examining economic performance for the same key variables between 1994 and 2004, Table 3 on page 18 reflects the results of comparing the 10 lowest-tax states with the 10 highest-tax states. A clearer picture couldn't be painted: Once again, those states which choose to impose a low level of taxation on their residents and businesses outperform those that do not in virtually every category. Relative to the average of the 10 states with the highest total state and local tax burden, the average of the 10 lowest taxed states showed:

♦ Faster growth of gross state output (71.7% vs. 62.4%);
♦ Greater personal income growth (70.2% vs. 60.4%);
♦ A much greater increase in total population (12.8% vs. 6.4%), including a net *inflow* of residents into the 10 low-tax states from other states (3.3% of total population) vs. a net *outflow* of residents from the 10 high-tax states to other states (2.5% of total population);
♦ Much more rapid job creation (16.9% vs. 12.6%);
♦ Only a slightly higher personal income per capita growth (51.0% vs. 50.7%); and
♦ A slightly higher unemployment rate (5.0% vs. 4.7%).

Another home run for the low-tax team!

With a state and local tax burden of $97.89 per $1,000 of personal income, Texas barely misses the 10 lowest-taxed states, coming in at 12th. In fact, Texas' tax burden was only 65¢ out of $1,000 higher than that of the 10th best state, Oregon. Once again, Texas fares well in comparison to the 10 states with the highest tax burden, outperforming each of those states in gross state product growth, personal income growth, population growth and non-farm payroll employment growth. Of the 10 highest-taxed states, only Maine had a greater net domestic in-migration as a percent of total population than did Texas. Wow!

This real world evidence backs up the notion that pro-growth policies result in higher after-tax returns, increased economic activity and an eventual improvement in overall state fiscal health; anti-growth policies result in the opposite effects. With an understanding of the economic theory behind the State Competitive Environment model, these are exactly the results one would expect to see out of states making pro-growth, incentive-based policy decisions. Texas is among the best states in these measures and it would make no sense for it to abandon its long-standing policy of low taxes and fiscal restraint.

Table 3
Lower Taxes, Higher Growth:
State and Local Tax Burden vs. 10-Year Economic Performance
(current tax burden vs. performance between 1994 and 2004, unless otherwise noted)

	S&L Tax Burden*	Gross State Product Growth	Personal Income Growth	Personal Income Per Capita Growth	Population Growth	Net Domestic In-Migration as a % of Population	Non-Farm Payroll Employment Growth	Unemployment Rate, 2004
New Hampshire	$85.20	79.6%	78.5%	56.9%	13.7%	6.2%	19.9%	3.8%
Alabama	$85.46	56.5%	58.9%	49.4%	6.3%	0.8%	8.1%	5.4%
Tennessee	$89.02	65.7%	67.3%	48.3%	12.8%	4.6%	11.5%	5.4%
Colorado	$90.90	91.7%	93.7%	56.8%	23.6%	6.0%	24.1%	5.4%
South Dakota	$94.23	70.2%	67.8%	59.1%	5.5%	-1.7%	15.4%	3.5%
Missouri	$94.24	54.4%	58.7%	46.8%	8.1%	1.5%	9.0%	5.8%
Virginia	$95.22	81.6%	72.2%	52.2%	13.1%	1.9%	19.4%	3.6%
Florida	$96.47	81.1%	77.4%	45.2%	22.2%	8.2%	29.3%	4.8%
Oklahoma	$97.02	62.7%	64.2%	52.9%	7.4%	0.1%	14.9%	4.6%
Oregon	$97.24	73.7%	63.9%	42.3%	15.2%	5.0%	17.0%	7.4%
10 States With Lowest Tax Burden**	**$92.50**	**71.7%**	**70.2%**	**51.0%**	**12.8%**	**3.3%**	**16.9%**	**5.0%**
10 States With Highest Tax Burden**	**$120.31**	**62.4%**	**60.4%**	**50.7%**	**6.4%**	**-2.5%**	**12.6%**	**4.7%**
New Jersey	$111.05	60.8%	62.8%	50.0%	8.5%	-4.0%	12.7%	4.8%
Ohio	$112.63	47.1%	48.2%	44.3%	2.7%	-2.5%	6.6%	6.1%
Rhode Island	$115.52	74.7%	62.4%	52.7%	6.4%	-1.8%	12.5%	5.1%
Minnesota	$116.96	76.6%	72.6%	56.0%	10.6%	0.9%	15.6%	4.5%
Nebraska	$117.15	56.2%	61.0%	51.0%	6.6%	-1.8%	15.9%	3.8%
Wisconsin	$118.24	61.9%	61.2%	50.2%	7.3%	0.8%	12.6%	4.7%
Hawaii	$121.53	39.7%	38.0%	29.8%	6.3%	-7.4%	8.7%	3.3%
Wyoming	$127.50	85.7%	76.5%	67.4%	5.5%	-2.0%	17.7%	3.9%
Maine	$128.98	60.2%	67.1%	57.7%	6.0%	3.2%	15.4%	4.6%
New York	$133.56	61.2%	54.4%	48.3%	4.2%	-10.0%	7.9%	5.8%
The Others								
South Carolina	$97.65	62.6%	67.6%	48.0%	13.3%	4.6%	13.4%	6.9%
Texas	**$97.89**	**86.0%**	**81.4%**	**49.7%**	**21.1%**	**2.3%**	**22.3%**	**6.1%**
Georgia	$99.03	79.4%	79.0%	45.1%	23.4%	6.9%	19.1%	4.8%
Montana	$99.15	60.1%	61.8%	50.4%	7.6%	2.6%	21.0%	4.4%
Idaho	$99.48	80.1%	76.2%	44.9%	21.7%	7.2%	27.3%	4.5%
Delaware	$99.67	91.1%	76.4%	52.4%	15.7%	5.1%	19.2%	4.1%
Massachusetts	$100.74	72.3%	67.3%	58.9%	5.3%	-3.8%	9.5%	4.8%
Nevada	$100.93	118.0%	118.8%	40.5%	55.7%	21.1%	56.2%	4.3%
North Carolina	$101.30	78.2%	70.4%	43.4%	18.8%	6.4%	14.0%	5.3%
Arkansas	$101.47	58.4%	63.6%	48.3%	10.4%	2.6%	12.0%	5.6%
Washington	$101.94	73.1%	77.6%	53.9%	15.4%	3.4%	17.1%	6.2%
Arizona	$103.09	102.2%	100.3%	48.0%	35.3%	12.0%	40.3%	4.6%
Iowa	$103.11	65.2%	56.0%	50.5%	3.6%	-2.0%	10.3%	5.0%
Alaska	$103.17	57.5%	49.4%	37.5%	8.6%	-4.9%	17.0%	7.5%
Maryland	$103.20	69.4%	69.7%	53.4%	10.7%	-0.4%	17.2%	4.2%
Pennsylvania	$103.31	56.5%	51.7%	48.8%	2.0%	-2.0%	8.6%	5.6%
Illinois	$103.52	52.9%	53.0%	43.3%	6.7%	-5.3%	6.3%	6.1%
Michigan	$106.08	41.3%	48.4%	40.8%	5.4%	-2.1%	6.0%	7.4%
Utah	$106.23	88.2%	84.6%	51.5%	21.9%	-1.4%	28.3%	5.1%
Kansas	$106.67	61.3%	55.6%	46.8%	6.0%	-2.4%	13.5%	5.3%
Indiana	$106.71	57.3%	56.1%	45.0%	7.7%	0.1%	8.0%	5.2%
Mississippi	$106.77	51.3%	63.4%	51.3%	8.0%	0.5%	6.5%	6.8%
Kentucky	$106.98	51.2%	63.8%	52.0%	7.7%	1.7%	12.4%	4.7%
North Dakota	$107.54	65.4%	62.5%	65.2%	-1.6%	-7.0%	14.4%	3.5%
California	$108.08	80.7%	72.1%	50.9%	14.0%	-4.0%	19.6%	6.2%
Connecticut	$108.34	68.0%	61.5%	52.9%	5.7%	-3.5%	7.0%	4.6%
Louisiana	$109.55	60.3%	55.6%	49.8%	3.9%	-3.8%	11.4%	5.8%
New Mexico	$109.58	48.5%	68.1%	48.6%	13.1%	-0.7%	20.3%	5.6%
West Virginia	$110.21	41.8%	50.0%	50.5%	-0.3%	-0.7%	9.3%	5.0%
Vermont	$110.28	64.3%	72.4%	62.0%	6.4%	1.3%	14.9%	3.7%

*FY2003 state and local tax revenue per $1,000 of personal income. FY2003 local data are an estimate.
**Equal-weighted averages.

Source: Author calculations based on data from: National Conference of State Legislatures,
Bureau of Economic Analysis, Bureau of Labor Statistics, and U.S. Census Bureau.

Texas Spending

> "Texas should follow the example of millions of Texas families. When times are tight, Texas families do not spend more. So why should government?"
>
> ~ Texas Governor Rick Perry[4]

The exhibits on the following three pages clearly reflect the fiscal discipline that Texas has demonstrated with each and every budget. Texas is a small government state and has been that way for a long time. Table 4 contains the elements of the new budget passed for 2006-07, including the effects of the two major appropriation bills passed since January. In nominal terms, total state spending is budgeted to grow 8.4 percent from 2004-05 to 2006-07, from $128.6 billion to $139.4 billion. Unbelievably, while most interest groups have criticized Gov. Perry for not spending enough—as one would expect—some have even criticized him for allowing spending to grow too fast in the new budget!

To be viewed properly, these expenditure figures need to be adjusted for inflation and population growth. When they are properly adjusted, one can seen that over a 10-year period from 1996-97 through 2006-07, total state spending in Texas grew just 12.8 percent above inflation and population growth, or 1.2 percent per year. This slow growth in adjusted spending was also seen in every major expenditure category of the budget.

Figures 4 and 5 show government spending and national rank for each level of government relative to personal income and on an inflation-adjusted per capita basis. In addition, Texas' peers and the U.S. average are shown. Also shown in the middle graph of each display is the effect of the new budget on spending (as indicated by the dotted line). Whether relative to personal income or on a per capita basis, the new budget maintains Texas spending at almost exactly the same adjusted level. The level of spending in the new budget was entirely appropriate.

Of course, each state provides services at different levels—some provide more at the state level, others more at the local level. Therefore, to view spending properly we look at state and local spending combined. As shown in Figure 4, Texas ranks 38th highest in total state and local spending per $1,000 of personal income, trailing New York and California by a large margin, the U.S. average by a modest margin, but slightly ahead of Florida. Figure 5 shows almost identical results on an inflation-adjusted per capita basis.

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[4] Quoted in Bill Kidd, "Governor Repeats Campaign Promise to Avoid New Taxes," State Tax Notes, Tax Analysts, 1/27/03.

Table 4
Texas State Spending and 10-Year Spending Trends (1996-97 through 2006-07)*
**(in $millions)**

Total (All Funds)

		Total	Agencies of Education	Health and Human Services	Business and Economic Development	Public Safety and Criminal Justice	General Government	Natural Resources	Other**
	1990-91	$50,600	$23,590	$13,935	$6,714	$3,397	$1,433	$820	$711
	1992-93	62,923	28,235	18,719	7,671	4,497	1,830	1,190	780
	1994-95	72,769	30,691	22,983	8,591	6,263	1,860	1,539	842
	1996-97	80,109	34,724	25,104	9,626	6,301	1,916	1,550	888
	1998-99	88,293	38,745	26,869	10,745	7,206	2,071	1,662	995
	2000-01	101,893	45,173	29,962	12,731	8,009	2,454	1,908	1,194
	2002-03	115,679	48,751	38,494	13,916	8,318	2,632	2,136	1,433
	2004-05(e)	128,624	52,073	45,294	15,805	8,205	3,481	2,342	1,423
	2006-07(r)	139,411	54,847	49,977	18,644	8,525	3,122	2,249	1,314
10-Year Growth	Total	74.0%	58.0%	99.1%	93.7%	35.3%	62.9%	45.1%	48.0%
	Annual	5.7%	4.7%	7.1%	6.8%	3.1%	5.0%	3.8%	4.0%
10-Year Adjusted Growth	Total	35.6%	23.1%	55.1%	50.9%	5.4%	27.0%	13.0%	15.3%
(Inflation)	Annual	3.1%	2.1%	4.5%	4.2%	0.5%	2.4%	1.2%	1.4%
10-Year Adjusted Growth	Total	12.8%	2.4%	29.0%	25.5%	-12.3%	5.6%	-6.0%	-4.1%
(Inflation and Population)	Annual	1.2%	0.2%	2.6%	2.3%	-1.3%	0.5%	-0.6%	-0.4%

General Revenue Fund

		Total	Agencies of Education	Health and Human Services	Business and Economic Development	Public Safety and Criminal Justice	General Government	Natural Resources	Other**
	1990-91	$29,318	$19,141	$6,159	$178	$2,304	$732	$353	$452
	1992-93	35,013	22,343	7,761	169	3,071	831	321	517
	1994-95	39,959	24,008	9,413	201	4,351	1,051	325	609
	1996-97	44,686	26,874	10,008	320	5,256	1,183	347	698
	1998-99	48,890	29,876	10,430	332	5,809	1,237	416	790
	2000-01	56,325	34,684	11,454	367	6,605	1,408	530	952
	2002-03	60,662	35,684	14,649	382	6,862	1,484	591	1,009
	2004-05(e)	60,308	34,487	15,838	378	6,603	1,481	504	1,016
	2006-07(r)	65,576	36,859	17,862	253	6,999	1,674	437	1,053
10-Year Growth	Total	46.7%	37.2%	78.5%	-21.0%	33.1%	41.6%	26.1%	50.9%
	Annual	3.9%	3.2%	6.0%	-2.3%	2.9%	3.5%	2.3%	4.2%
10-Year Adjusted Growth	Total	14.4%	6.9%	39.1%	-38.5%	3.8%	10.3%	-1.7%	17.6%
(Inflation)	Annual	1.4%	0.7%	3.4%	-4.7%	0.4%	1.0%	-0.2%	1.6%
10-Year Adjusted Growth	Total	-4.9%	-11.1%	15.7%	-48.8%	-13.7%	-8.3%	-18.3%	-2.2%
(Inflation and Population)	Annual	-0.5%	-1.2%	1.5%	-6.5%	-1.5%	-0.9%	-2.0%	-0.2%

*Data from the Legislated Budget Board, with data for 2004-2007 adjusted to include the LBB's estimates of the effects of SB1 and authors' estimates of the effects of HB10. Inflation and population data for 2005-2007 are authors' estimates.
**Judiciary + Regulatory + The Legislature.
(e) estimated, (r) recommended.

Source: Data from the Legislative Budget Board (LBB), with data for 2004-2007 adjusted to include the LBB's estimates of the effects of SB1 and author's estimates of the effects of HB10. Inflation and population data for 2005-2007 are authors' estimates.

Figure 4
Total State Spending Per $1,000 of Personal Income (and Rank)
(total direct expenditures, rank 1=highest, 50=lowest)
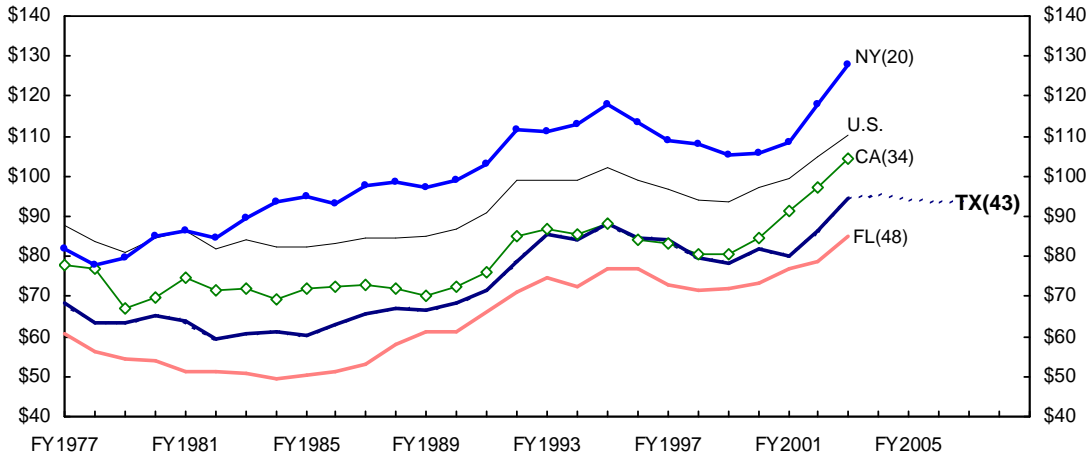
Total Local Spending Per $1,000 of Personal Income (and Rank)
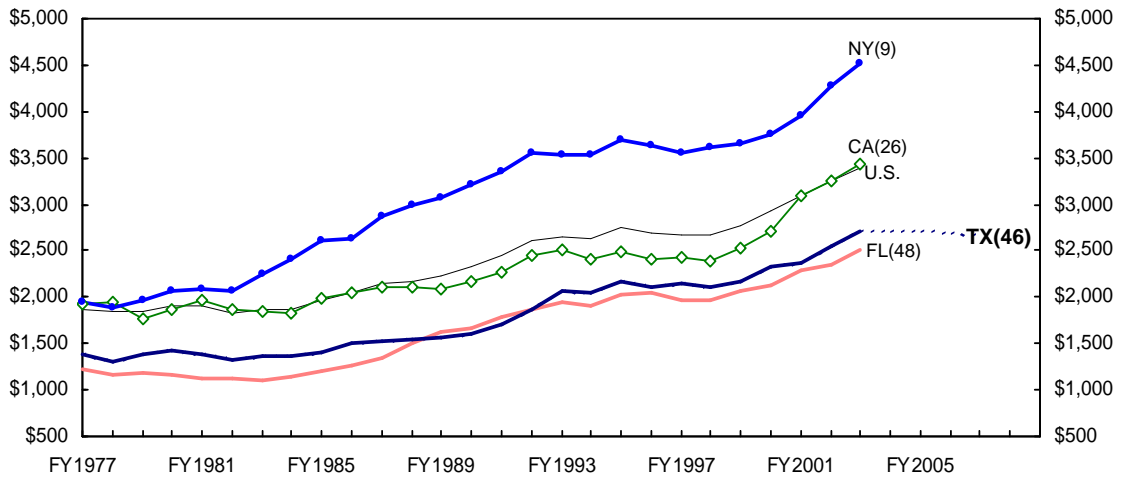**(total direct expenditures, rank 1=highest, 50=lowest)**
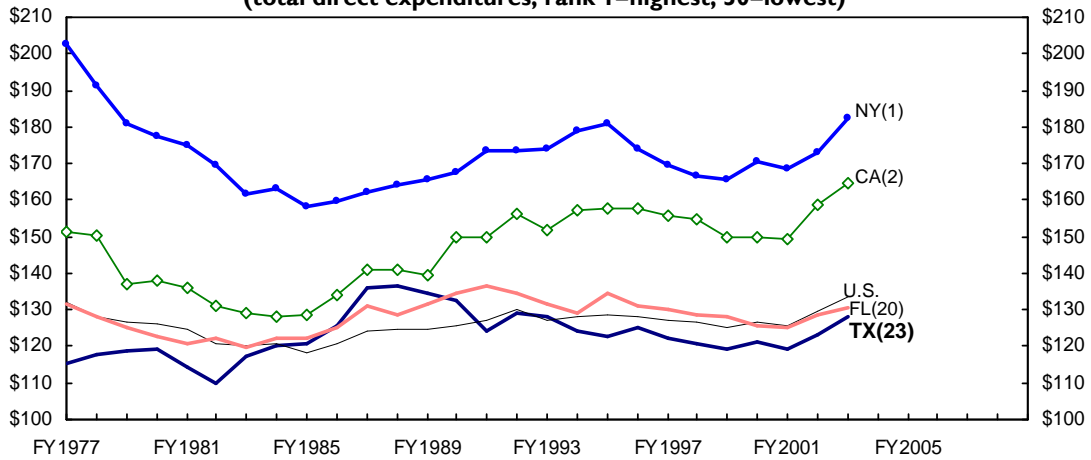
Total State and Local Spending Per $1,000 of Personal Income (and Rank)
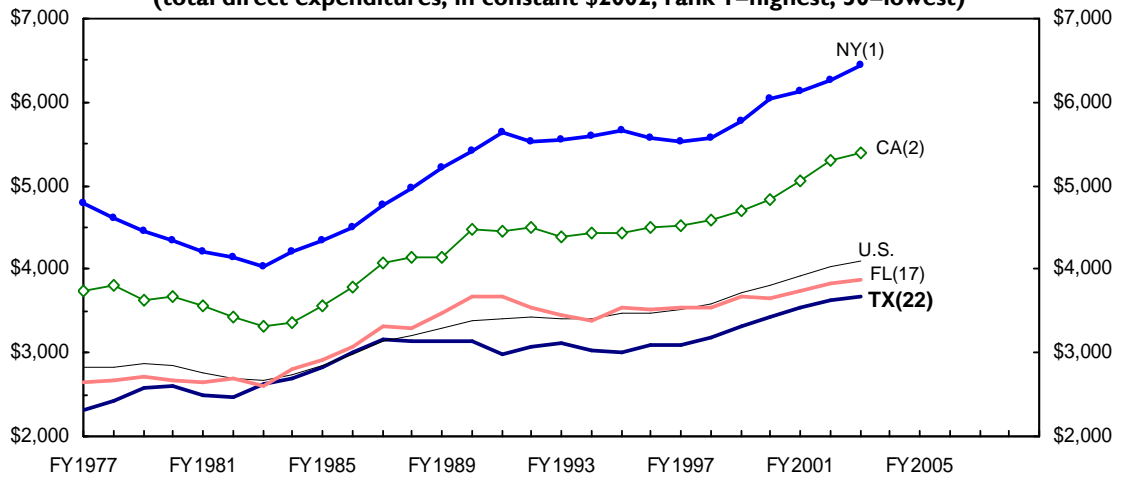**(total direct expenditures, rank 1=highest, 50=lowest)**
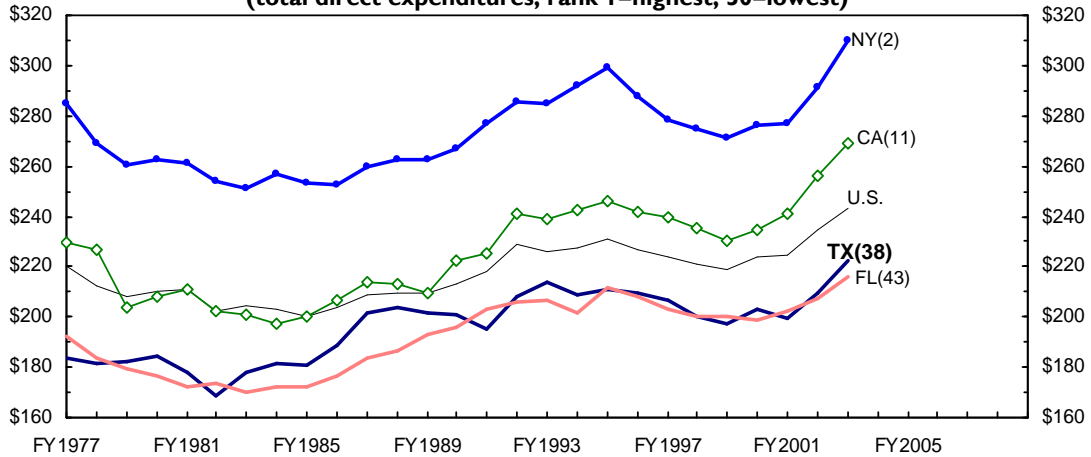
Source: U.S. Census Bureau; 2003 local component is an authors' estimate, as is personal income and population through 2007. Bureau of Economic Analysis.

Figure 5
Real Total State Spending Per Capita (and Rank)
(total direct expenditures, in constant $2002, rank 1=highest, 50=lowest)

Real Total Local Spending Per Capita (and Rank)
(total direct expenditures, in constant $2002, rank 1=highest, 50=lowest)

Real Total State and Local Spending Per Capita (and Rank)
(total direct expenditures, in constant $2002, rank 1=highest, 50=lowest)

Source: U.S. Census Bureau; 2003 local component is an authors' estimate, as is personal income and population through 2007. Bureau of Economic Analysis.
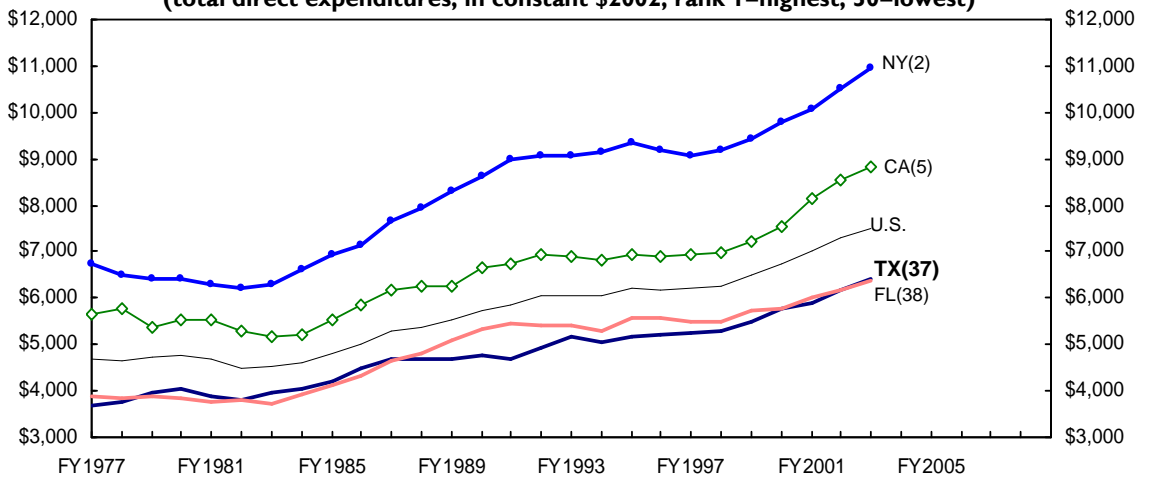
Texas Taxation And Revenues

> "When the economy is uncertain, it is precisely the wrong time to raise taxes…Economic slowdowns are usually temporary. Tax hikes are usually not."
>
> ~ Texas Governor Rick Perry[5]

While most state and local governments rely on four primary taxes—property, sales, and personal and corporate income— Texas relies on only three of those taxes. Thanks to its low levels of spending, Texas can afford to impose a very low state and local tax burden on its citizens (Figure 6). Texas' state and local tax burden, at $97.89 in taxes per $1,000 of personal income, ranks just 39th highest in the nation, and is significantly below the U.S. average of $105.86 and the burdens of California and New York. Texas' tax burden has remained constant over time: Going all the way back to 1977, Texas' tax burden has never been higher than 31st in the nation nor lower than 46th.

With annual collections estimated for 2005 at $32.3 billion, the property tax is by far the most important source of revenue for Texas state and local governments (Table 5). The property tax is followed in importance by the sales tax ($16.0 billion) and motor fuel taxes ($3.0 billion). Texas revenues are most notable for their lack of a personal income tax and the relative lack of importance of the corporate franchise tax (just $1.8 billion).

Figure 6
Tax Burden: State and Local Tax Burden Per $1,000 of Personal Income (and Rank)
(through FY2003, Rank: 1=highest, 50=lowest)
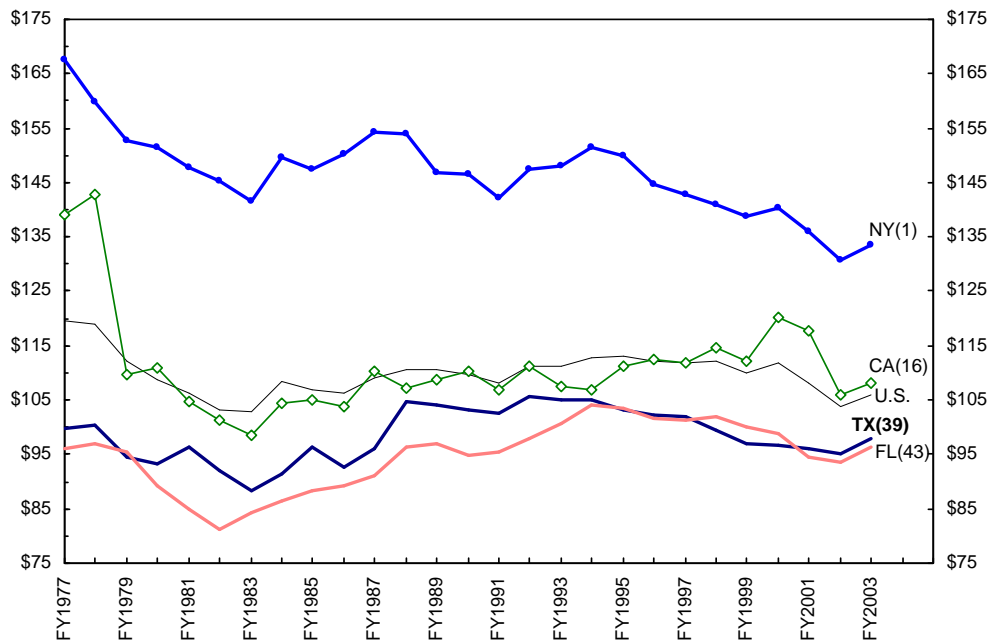
Source: U.S. Census Bureau and Bureau of Economic Analysis.

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[5] Quoted in Bill Kidd, "Governor: Businesses Should Be Taxed Fairly and Consistently," State Tax Notes, Tax Analysts, February 10, 2003.

Table 5
Texas State Tax Collections, By Major Source, Plus Local Property Taxes
(local taxes excluded except for property tax)

	Revenue (in $millions)				
	2001	2002	2003	2004	2005(e)
Property Tax	$25,310.4	$27,319.8	$28,893.4	$30,557.6	$32,317.7
Sales Tax	14,663.1	14,516.3	14,277.3	15,417.2	16,049.3
Motor Fuel Taxes	2,765.5	2,833.6	2,838.8	2,917.7	2,990.9
Motor Vehicle Sales and Rental Taxes	2,905.5	2,949.5	2,693.4	2,740.3	2,709.0
Oil and Natural Gas Production Taxes	2,039.5	967.2	1,493.5	1,888.5	2,127.2
Corporation Franchise Tax	1,960.4	1,935.7	1,716.6	1,835.0	1,809.7
Insurance Occupation Taxes	820.0	1,045.8	1,169.1	1,184.9	1,163.3
Alcoholic Beverage Tax	541.3	560.2	567.8	601.8	612.3
Cigarette, Tobacco Tax	584.6	540.0	582.7	534.6	558.8
Total State Taxes	$27,230.3	$26,279.1	$26,126.7	$27,913.0	$28,768.7
Total State + Property Taxes	52,540.7	53,598.9	55,020.1	58,470.6	61,086.4

	Revenue Per $1,000 of Personal Income				
	2001	2002	2003	2004	2005
Property Tax	$40.85	$43.79	$44.96	$44.96	$45.56
Sales Tax	23.66	23.27	22.22	22.68	22.62
Motor Fuel Taxes	4.46	4.54	4.42	4.29	4.22
Motor Vehicle Sales and Rental Taxes	4.69	4.73	4.19	4.03	3.82
Oil and Natural Gas Production Taxes	3.29	1.55	2.32	2.78	3.00
Corporation Franchise Tax	3.16	3.10	2.67	2.70	2.55
Insurance Occupation Taxes	1.32	1.68	1.82	1.74	1.64
Alcoholic Beverage Tax	0.87	0.90	0.88	0.89	0.86
Cigarette, Tobacco Tax	0.94	0.87	0.91	0.79	0.79
Total State Taxes	$43.95	$42.12	$40.66	$41.07	$40.55
Total State + Property Taxes	84.79	85.91	85.62	86.03	86.11

	Revenue Collections Per Capita				
	2001	2002	2003	2004	2005
Property Tax	$1,186.34	$1,257.63	$1,307.19	$1,358.72	$1,412.27
Sales Tax	687.28	668.24	645.93	685.51	701.35
Motor Fuel Taxes	129.62	130.44	128.43	129.73	130.70
Motor Vehicle Sales and Rental Taxes	136.19	135.78	121.85	121.85	118.38
Oil and Natural Gas Production Taxes	95.59	44.52	67.57	83.97	92.96
Corporation Franchise Tax	91.89	89.11	77.66	81.59	79.08
Insurance Occupation Taxes	38.43	48.14	52.89	52.69	50.84
Alcoholic Beverage Tax	25.37	25.79	25.69	26.76	26.76
Cigarette, Tobacco Tax	27.40	24.86	26.36	23.77	24.42
Total State Taxes	$1,276.33	$1,209.72	$1,182.02	$1,241.13	$1,257.18
Total State + Property Taxes	2,462.67	2,467.36	2,489.22	2,599.85	2,669.45

For years we have tracked legislated state tax actions in state legislatures across the nation as a primary input into the State Competitive Environment model. Texas' fiscal track record since the early 1990s is remarkable (Table 6). With the exception of a fairly large tax increase for 1991 and a large tax reduction for 1993, Texas has implemented few significant tax changes over a 15-year period.

As discussed, by going without a personal income tax and relying heavily on property taxes and sales taxes, Texas relies on two of the more stable revenue sources available. By avoiding imposing a progressive personal income tax, Texas manages to avoid much of the instability inherent in the tax systems of many other states. This effect, in combination with fiscal restraint of the legislature, means that Texas, more than most states, is influenced by national economic trends. Texas has in effect given up a larger portion of the cyclical control of its fiscal affairs in order to secure long-term economic prosperity. Texas has not been subject to the peaks and troughs brought on by good and poor economic times nearly as much as other states in large part because it does not have a progressive personal income tax. And, as we will explore later in our "fiscal checklist," the instability of other state's revenue streams naturally tends to drive up tax burdens over time.

Over the five-year period 2000-2004, Texas has cut taxes a net $0.26 per $1,000 of personal income in absolute terms, and cut taxes a net $1.52 per $1,000 of personal income relative to the U.S. as a whole. When compared to its neighbors and peers, Texas has cut taxes to a greater degree than all others except for Florida—very good company indeed. This has had the cumulative effect of increasing Texas' competitive environment dramatically relative to its competition. Table 7 demonstrates the consistency of the state's major tax rates over the years.

Table 6
Legislated Tax Changes per $1,000 of Personal Income: In Absolute and Relative Terms
(+ indicates tax increase, - indicates tax cut)

Change in Legislated Absolute Burden (Legislated tax change / 2 years ago personal income)

Legislative Session	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	5-Year Sum
Texas	2.87	0.00	-1.81	0.00	0.02	0.00	0.08	0.00	-0.24	-0.32	0.04	0.00	0.02	0.00	-0.26
New Mexico	1.19	-0.09	3.97	-1.80	-0.85	0.29	0.48	-0.59	-0.06	-0.22	-0.04	-0.13	1.01	0.12	0.73
Oklahoma	0.00	0.00	0.38	0.31	0.00	-0.01	0.00	-0.23	-0.38	0.36	0.12	1.12	0.75	-0.15	2.21
Arkansas	7.77	0.00	1.95	0.00	-0.58	0.00	0.65	0.00	0.20	0.00	3.46	0.00	1.90	5.51	10.87
Louisiana	4.92	6.88	0.97	0.24	0.00	-0.07	-1.36	-0.09	-0.10	1.99	-0.04	-0.03	0.00	1.28	3.20
California	9.86	0.00	1.23	0.00	-0.35	0.56	-0.21	-1.31	-0.32	-1.38	-0.05	1.26	0.09	0.43	0.35
Florida	0.20	1.53	0.04	0.00	0.01	-0.10	-0.14	-0.36	-0.85	-0.96	-0.05	0.30	-0.10	-0.43	-1.25
New York	2.83	3.29	3.29	-0.95	-1.98	-3.93	-1.52	-0.18	-1.85	-1.65	-0.47	0.41	4.40	0.73	3.42
U.S. Absolute	3.37	0.78	0.76	-0.34	-0.56	-0.57	-0.28	-0.80	-0.99	-1.11	-0.05	0.98	0.99	0.45	1.26

Change in Legislated Relative Burden (Legislated tax change / 2 years ago personal income)

Legislative Session	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	5-Year Sum
Texas	-0.50	-0.78	-2.57	0.34	0.58	0.57	0.36	0.80	0.75	0.79	0.09	-0.98	-0.96	-0.45	-1.52
New Mexico	-2.17	-0.87	3.21	-1.46	-0.29	0.86	0.76	0.21	0.93	0.89	0.01	-1.11	0.02	-0.33	-0.53
Oklahoma	-3.37	-0.78	-0.37	0.65	0.56	0.56	0.28	0.57	0.61	1.47	0.18	0.14	-0.24	-0.60	0.95
Arkansas	4.40	-0.78	1.19	0.34	-0.02	0.57	0.92	0.80	1.19	1.11	3.51	-0.98	0.91	5.06	9.61
Louisiana	1.55	6.10	0.21	0.58	0.56	0.50	-1.08	0.70	0.89	3.09	0.01	-1.01	-0.99	0.83	1.95
California	6.49	-0.78	0.47	0.34	0.21	1.13	0.07	-0.51	0.67	-0.28	0.01	0.28	-0.90	-0.02	-0.90
Florida	-3.17	0.75	-0.72	0.33	0.57	0.47	0.14	0.44	0.14	0.15	0.00	-0.68	-1.09	-0.88	-2.50
New York	-0.54	2.51	2.53	-0.62	-1.42	-3.36	-1.24	0.62	-0.86	-0.55	-0.42	-0.57	3.42	0.28	2.16
U.S. Relative	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00

Source: Author calculations based on data from: National Conference of State Legislators, National Association of State Budget Officers, and Individual State Finance Departments.

Table 7
Texas' Historical State and Local Tax Rates, Selected Major Taxes*
(tax rates in effect at end of year)

| | Sales and Use | Motor Vehicle Sales and Use | Motor Fuel | | Franchise | | Severance (On Production) | | Cigarette | Alcohol | |
			Gasoline	Diesel	On Earned Surplus**	On Taxable Capital**	Oil	Natural Gas		Beer	Liquor
1970	4.25%	3.00%	$0.050	$0.065	n/a	0.325%	4.6%	7.5%	$0.155	$0.139	$1.68
1971	5.00%	4.00%	$0.050	$0.065	n/a	0.450%	4.6%	7.5%	$0.185	$0.161	$2.00
1972	5.00%	4.00%	$0.050	$0.065	n/a	0.425%	4.6%	7.5%	$0.185	$0.161	$2.00
1973	5.00%	4.00%	$0.050	$0.065	n/a	0.425%	4.6%	7.5%	$0.185	$0.161	$2.00
1974	5.00%	4.00%	$0.050	$0.065	n/a	0.425%	4.6%	7.5%	$0.185	$0.161	$2.00
1975	5.00%	4.00%	$0.050	$0.065	n/a	0.425%	4.6%	7.5%	$0.185	$0.161	$2.00
1976	5.00%	4.00%	$0.050	$0.065	n/a	0.425%	4.6%	7.5%	$0.185	$0.161	$2.00
1977	5.00%	4.00%	$0.050	$0.065	n/a	0.425%	4.6%	7.5%	$0.185	$0.161	$2.00
1978	6.00%	4.00%	$0.050	$0.065	n/a	0.425%	4.6%	7.5%	$0.185	$0.161	$2.00
1979	6.00%	4.00%	$0.050	$0.065	n/a	0.425%	4.6%	7.5%	$0.185	$0.161	$2.00
1980	6.00%	4.00%	$0.050	$0.065	n/a	0.425%	4.6%	7.5%	$0.185	$0.161	$2.00
1981	6.00%	4.00%	$0.050	$0.065	n/a	0.425%	4.6%	7.5%	$0.185	$0.161	$2.00
1982	6.00%	4.00%	$0.050	$0.065	n/a	0.425%	4.6%	7.5%	$0.185	$0.161	$2.00
1983	6.00%	4.00%	$0.050	$0.065	n/a	0.425%	4.6%	7.5%	$0.185	$0.161	$2.00
1984	6.13%	5.00%	$0.100	$0.100	n/a	0.525%	4.6%	7.5%	$0.195	$0.194	$2.40
1985	6.13%	5.00%	$0.100	$0.100	n/a	0.525%	4.6%	7.5%	$0.205	$0.194	$2.40
1986	6.13%	5.00%	$0.150	$0.150	n/a	0.525%	4.6%	7.5%	$0.205	$0.194	$2.40
1987	8.00%	6.00%	$0.150	$0.150	n/a	0.525%	4.6%	7.5%	$0.260	$0.194	$2.40
1988	8.00%	6.00%	$0.150	$0.150	n/a	0.670%	4.6%	7.5%	$0.260	$0.194	$2.40
1989	8.00%	6.00%	$0.150	$0.150	n/a	0.670%	4.6%	7.5%	$0.260	$0.194	$2.40
1990	8.25%	6.00%	$0.150	$0.150	n/a	0.525%	4.6%	7.5%	$0.410	$0.194	$2.40
1991	8.25%	6.25%	$0.200	$0.200	n/a	0.525%	4.6%	7.5%	$0.410	$0.194	$2.40
1992	8.25%	6.25%	$0.200	$0.200	4.50%	0.250%	4.6%	7.5%	$0.410	$0.194	$2.40
1993	8.25%	6.25%	$0.200	$0.200	4.50%	0.250%	4.6%	7.5%	$0.410	$0.194	$2.40
1994	8.25%	6.25%	$0.200	$0.200	4.50%	0.250%	4.6%	7.5%	$0.410	$0.194	$2.40
1995	8.25%	6.25%	$0.200	$0.200	4.50%	0.250%	4.6%	7.5%	$0.410	$0.194	$2.40
1996	8.25%	6.25%	$0.200	$0.200	4.50%	0.250%	4.6%	7.5%	$0.410	$0.194	$2.40
1997	8.25%	6.25%	$0.200	$0.200	4.50%	0.250%	4.6%	7.5%	$0.410	$0.194	$2.40
1998	8.25%	6.25%	$0.200	$0.200	4.50%	0.250%	4.6%	7.5%	$0.410	$0.194	$2.40
1999	8.25%	6.25%	$0.200	$0.200	4.50%	0.250%	4.6%	7.5%	$0.410	$0.194	$2.40
2000	8.25%	6.25%	$0.200	$0.200	4.50%	0.250%	4.6%	7.5%	$0.410	$0.194	$2.40
2001	8.25%	6.25%	$0.200	$0.200	4.50%	0.250%	4.6%	7.5%	$0.410	$0.194	$2.40
2002	8.25%	6.25%	$0.200	$0.200	4.50%	0.250%	4.6%	7.5%	$0.410	$0.194	$2.40
2003	8.25%	6.25%	$0.200	$0.200	4.50%	0.250%	4.6%	7.5%	$0.410	$0.194	$2.40
2004	8.25%	6.25%	$0.200	$0.200	4.50%	0.250%	4.6%	7.5%	$0.410	$0.194	$2.40
2005	8.25%	6.25%	$0.200	$0.200	4.50%	0.250%	4.6%	7.5%	$0.410	$0.194	$2.40

*Tax rates imposed in Houston are included as a proxy for local taxes.
**Beginning in 1992, franchise tax liability equals the greater of tax liability on earned surplus or taxable capital.

Source: Texas Legislative Budget Board (LBB).

Finally, on the following page, Table 8 provides a comparison of the tax rates Texas imposes in major tax categories with its neighbors and peers. With the exception of property taxes and sales taxes, Texas is below most or all of its neighbors and peers and the U.S. average for all major taxes. Solid grades across the board!

Table 8
Texas vs. Neighbors and Peers: State and Local Tax Rate Comparison*
(Selected major taxes, Rank: 1=lowest/best, 50=highest/worst)

	Property Tax**	Rank		Property Tax Burden***	Rank		Sales and Use Tax	Rank		Personal Income Tax	Rank
Texas	$2.62	46	Texas	$41.34	40	Texas	8.25%	43	Texas	0.00%	1
Arkansas	$1.38	21	Arkansas	$15.74	3	Arkansas	7.50%	37	Arkansas	7.00%	32
Louisiana	$1.75	31	Louisiana	$17.81	7	Louisiana	9.00%	47	Louisiana	3.90%	11
New Mexico	$1.27	16	New Mexico	$17.35	5	New Mexico	6.75%	28	New Mexico	6.00%	23
Oklahoma	$1.16	12	Oklahoma	$17.19	4	Oklahoma	8.38%	44	Oklahoma	6.65%	28
California	$1.08	7	California	$27.53	16	California	8.25%	42	California	10.30%	49
Florida	$1.94	38	Florida	$33.23	28	Florida	7.00%	29	Florida	0.00%	1
New York	$1.12	10	New York	$41.87	43	New York	8.38%	44	New York	12.15%	50
Region Average	$1.64		Region Average	$21.89		Region Average	7.98%		Region Average	4.71%	
U.S. Average	$1.66		U.S. Average	$32.03		U.S. Average	6.13%		U.S. Average	5.68%	

	Corporate Income Tax	Rank		Gasoline Tax	Rank		Cigarette Tax	Rank		Beer Tax	Rank
Texas****	4.50%	6	Texas	$0.20	13	Texas	$0.41	11	Texas	$0.19	24
Arkansas	6.50%	18	Arkansas	$0.22	22	Arkansas	$0.62	21	Arkansas	$0.23	29
Louisiana	5.20%	11	Louisiana	$0.20	13	Louisiana	$0.36	8	Louisiana	$0.37	37
New Mexico	7.60%	29	New Mexico	$0.19	10	New Mexico	$0.91	31	New Mexico	$0.41	40
Oklahoma	6.00%	14	Oklahoma	$0.18	7	Oklahoma	$1.03	34	Oklahoma	$0.40	38
California	8.84%	35	California	$0.18	7	California	$0.87	30	California	$0.20	26
Florida	5.50%	12	Florida	$0.33	48	Florida	$0.34	7	Florida	$0.48	43
New York	16.35%	50	New York	$0.38	50	New York	$3.00	50	New York	$0.23	28
Region Average	5.96%		Region Average	$0.20		Region Average	$0.67		Region Average	$0.32	
U.S. Average	7.17%		U.S. Average	$0.23		U.S. Average	$0.96		U.S. Average	$0.32	

*The tax rates in each state's largest city are used as a proxy for local taxes. Highest marginal rates shown where appropriate. Tax rates have been adjusted for the deductibility of federal income tax liability where appropriate. All averages are equal weighted.

**The nominal residential property tax rate adjusted by the assesment level, per $100 of valuation, 2003. Any exemptions, deductions or credits are not included. Source: "Tax Rates and Tax Burdens…A Nationwide Comparison, 2003," August 2004, Government of the District of Columbia.

***State and local property taxes per $1,000 of personal income, FY2003. All local revenues included, not just largest city. Source: U.S. Census Bureau.

****Texas's corporate franchise tax liability equals the greater of tax liability on net taxable earned surplus or net taxable capital (at a 0.25% rate).

Source: "Tax Rates and Tax Burdens...A Nationwide Comparison, 2003," August 2004, Government of the Dist. of Columbia. Author calculations based on data from: Tax Foundation, tax analysts, and individual state finance departments.

Texas' Recent Economic Experience

Despite Texas' unique characteristics, including a heavy but declining reliance on severance taxes from oil and natural gas, the following exhibits demonstrate that Texas' economy is subject to the exact same linkages between fiscal policy and economic conditions; economic conditions and production, output, employment and eventually migration patterns; and finally, economic conditions and migration together and asset values.

No one need ever deny that non-economic factors also play a role in determining Texas' population growth—they do. The drop in the price of oil in the mid-1980s played havoc on Texas' economy. But fiscal policy plays an important role as well.

We love the charts on the following four pages, for they almost need no explanation. These pictures are truly worth a thousand words.

Texas currently is the sixth fastest growing state and the eighth fastest growing state in the U.S. over the past 10 years. On top of that, the U.S. Census Bureau recently announced that thanks primarily to the large number of Hispanics moving to the state, Texas is now one of four states to have what it calls a "non-white majority population."[6] It's a land of great opportunity.

Texas has maintained a remarkably strong population growth rate: Since 1950, in 45 out of 55 years Texas' total population has grown faster than the rate of U.S. population growth (Figure 7). Over this period, the U.S. total population has increased 93 percent versus 189 percent for Texas. Clearly the warm weather, the beautiful varied terrain and other natural endowments have played the part of the consistent siren's lure to Texas over the past 50 years. However, at the same time, there has been a great deal of variation in the willingness of the mobile to move to the Lone Star State, as measured by its excess (Texas-U.S.) population growth rate.[7] Quite simply, fiscal policies and other events have been the drivers of these changes.

Figure 7
Total Population Growth
(yr/yr)
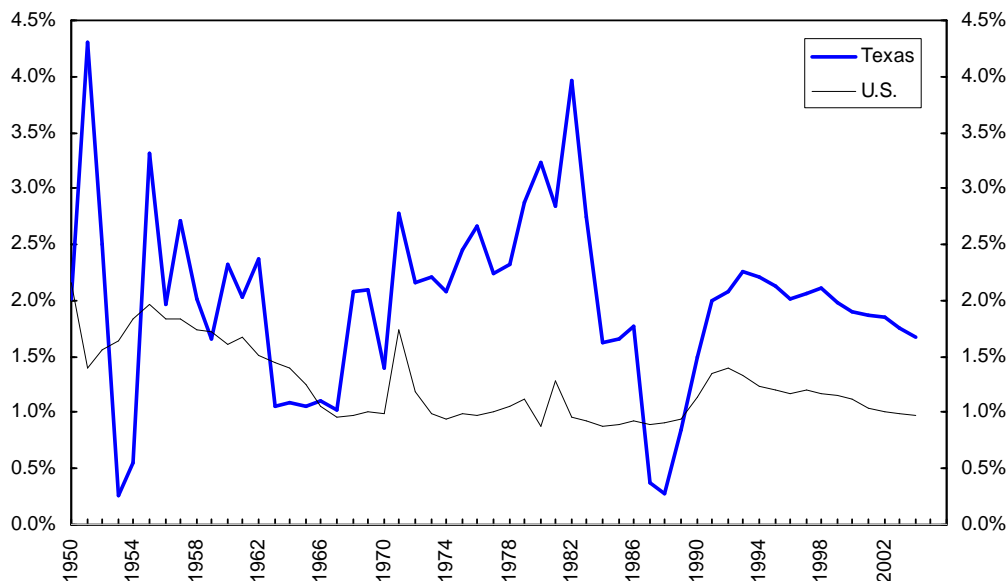
Source: U.S. Census Bureau.

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[6] The other three states are California, Hawaii and New Mexico. Source: "Minority Population Surging in Texas," MSNBC.com, 8/11//05.

[7] A note about comparing relative population growth rates over time: Back in the 1950s and 1960s, Texas' population growth significantly exceeded that of the nation in most years. While the average growth differential in the 1950s and 1960s was fairly high, the volatility was also very high. But some of that high volatility can be rationalized by the fact that the overall population of Texas was small by today's standards. Texas was relatively empty, and yet the rest of the country was relatively full. Perhaps back then the operational constraints were different than they are now.

Back in 1950, if a million people had moved to Texas, there was plenty of room, and that million people would have resulted in a 12.9 percent increase in Texas' population and 0.7 percent decline in the rest of the nation's population. In 2005, Texas is a different world altogether. While Texas may not be full, it surely is not as empty as it was in 1950. With a population today of just under 23 million people, to increase that population now by 12.9 percent would mean an influx of 2.9 million people or a reduction in the population of the rest of the nation by 1.1 percent. Whichever way you look at it, either from the supply side of the rest of the nation or the capacity of Texas to absorb, percentage population growth was a lot easier in 1950 than it was in 2005. Therefore, while long-term population comparisons are instructive, the different time periods are not strictly comparable. The basic conclusion must be that it will be harder and harder for Texas to maintain its relative population growth advantage over the rest of the nation. Texas is fuller, and the rest of the nation is relatively smaller.

It should come as no surprise that a high and/or rising state and local tax burden in Texas would be associated with unemployment rates in Texas greater than the U.S. average and per capita personal incomes declining relative to those of the U.S. (Figures 8 and 9).

Figure 8
State and Local Tax Burden vs. Excess Unemployment (Texas – U.S.)
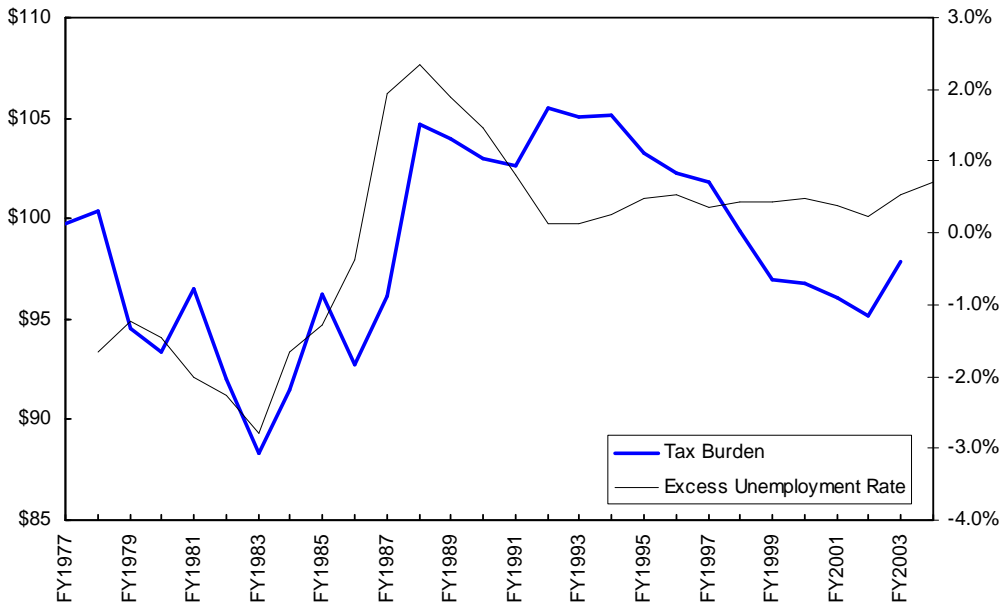
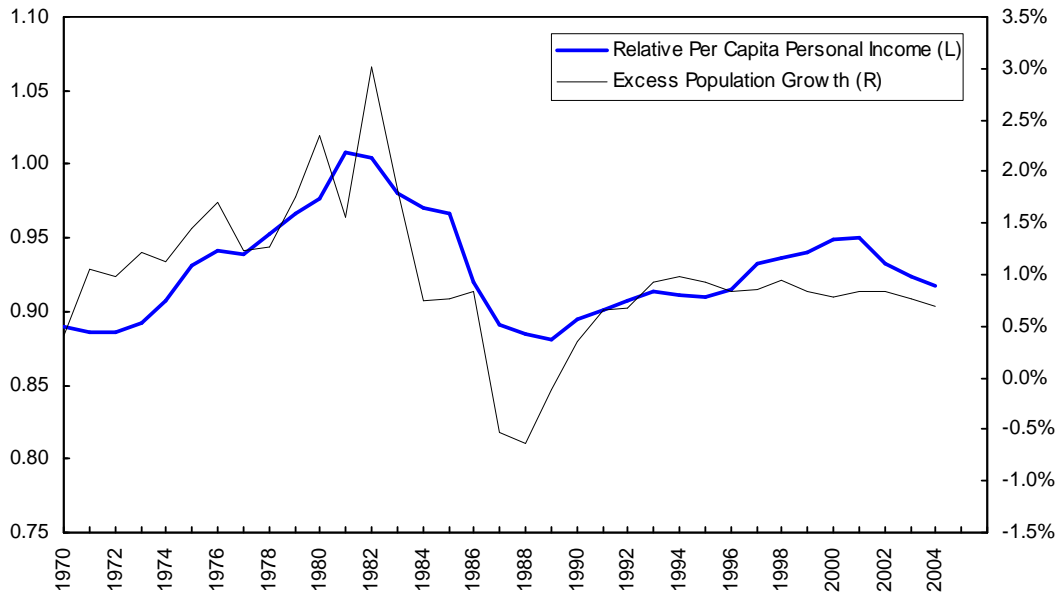*Source: U.S. Census Bureau and Bureau of Labor Statistics.*

Figure 9
State and Local Tax Burden vs. Relative Per Capita Personal Income (Texas/U.S.)

Source: U.S. Census Bureau and Bureau of Economic Analysis.

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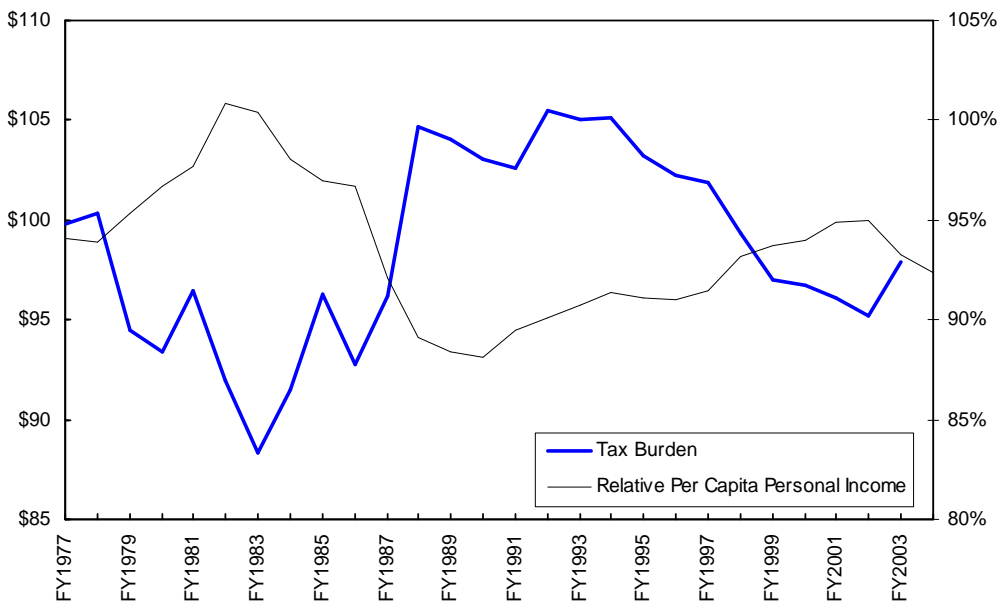
As we've tried to make clear, there is no lemma in supply-side economics more powerful than the lemma that economic incentives motivate people to relocate. In Figure 10, Texas' relative per capita income and Texas' excess population growth are plotted for the years 1970 to the present. This graph does show a strong corroboration of this. The lemma simply makes—and it's always nice when the data confirm—common sense. Higher per capita incomes in Texas relative to the U.S. are closely associated with more rapid population growth in Texas.

Figure 10
Relative Per Capita Personal Income (Texas/U.S.) vs. Excess Population Growth (Texas – U.S.)

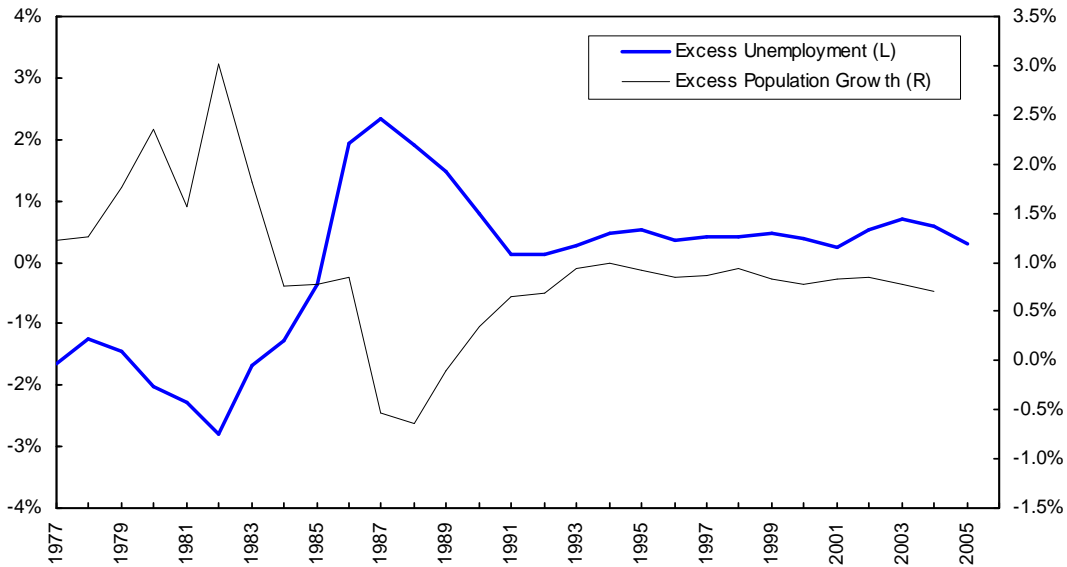*Source: U.S. Census Bureau and Bureau of Economic Analysis.*

Figure 12 displays yet another version of the basic supply-side lemma that people tend to move for economic advantage. The main difference is that the economic advantage variable is Texas' relative per capita income in Figure 9 and Texas' excess unemployment rate in Figure 12. Unemployment being a disadvantage, there should be an inverse relationship between Texas' excess population growth and Texas' excess unemployment. The numbers once again confirm supply-side economic logic. Simple common sense, once again, vanquishes complex error.

Figure 11
Unemployment Rate: Texas vs. the U.S. and the Excess (Texas – U.S.)
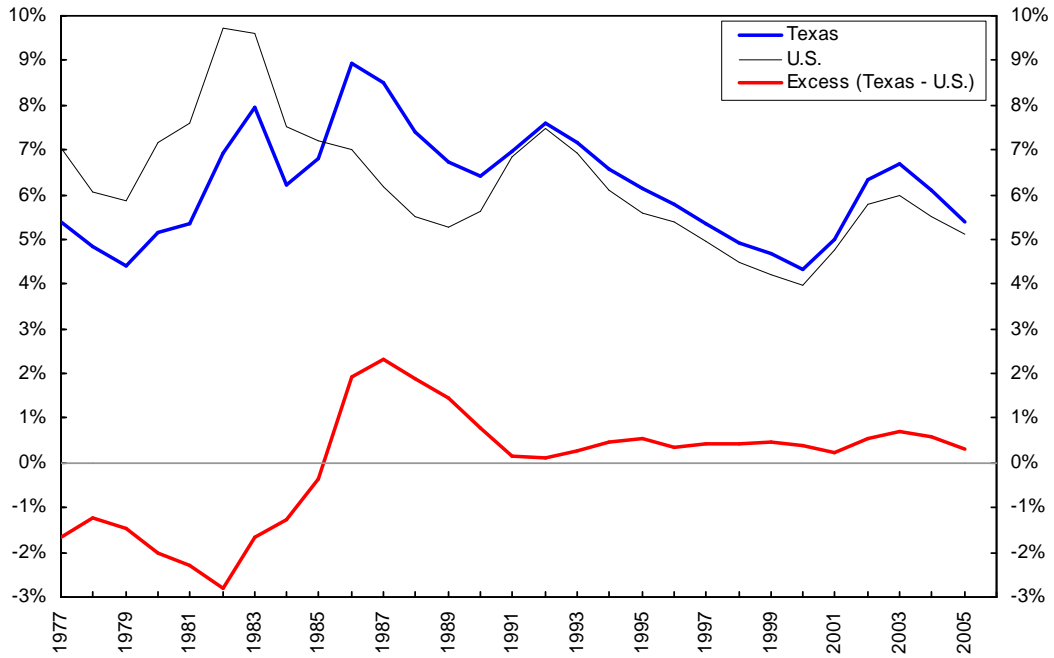

Source: Bureau of Labor Statistics.

Figure 12
Excess Unemployment Rate (Texas – U.S.) vs. Excess Population Growth (Texas – U.S.)

Source: U.S. Census Bureau and Bureau of Labor Statistics.

There are other implications of these results as well. Our research has demonstrated that because Congressional seats are allocated to states according to population as measured by decadal census data, it therefore follows that state economic policies, in due course, help to determine political power. Because the number of voting U.S. representatives is fixed at 435, any increase in political representation in the House for states with relatively fast growing populations must come at the expense of states with slower growing populations. When taxes combine with democracy, Adam Smith merges with Charles Darwin. Not only do the anachronistic high-tax states wither away in political influence, but progressive low-tax states flourish! It boils down to only a matter of time.

Figure 13
Texas Congressional Apportionment, Percent of Total Seats, 1845-Present
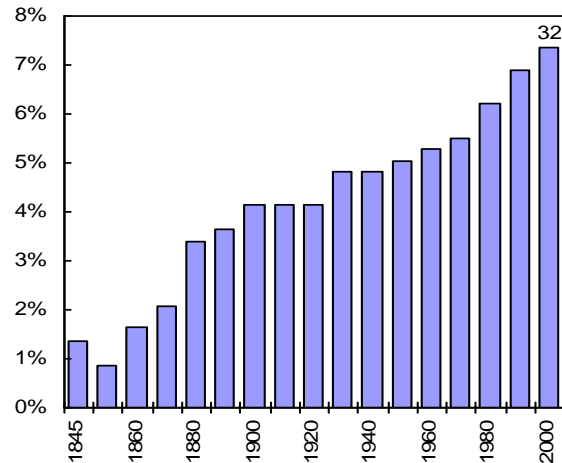
Source: U.S. House of Representatives

State Competitive Environment Model: Assessing The States

♦   How frequently does the state legislature turn to higher taxes, or do they resist the spend-and-tax cycle?

♦   What after-tax incentive is there to earn or invest that next dollar?

♦   Is income taxed in a relatively efficient manner?

♦   How does the state tax burden compare to that of other states?

♦   And what about workers' compensation costs and other indirect taxes?

These questions are just a few of those we ask when evaluating and ranking each state through the lens of our State Competitive Environment model. And recent times have provided interesting insights.

After years of remarkable prosperity, state and local government budgets were thrown into a tailspin during the 2000-03 period. This inordinate collective financial collapse—unprecedented in recent history—occurred primarily due to a downturn in stock prices, but falling output, employment, and production also weighed heavily. While fiscal conditions have improved over the past 24 months or so, this arduous period afforded us a rare opportunity to observe the response of each state's government to a period of extended crisis.

Going forward, how each state handles its budgetary affairs and chooses to address its budget will play a critical role in that state's competitiveness relative to other states. With people, products and capital free to move from state to state, state governments are ultimately competitors. Pro-growth and anti-growth state economic policies influence decisions on whether, where and how much to work, save, and invest. These policies influence the ability of a state to retain and attract residents and businesses. The evidence suggests that pro-growth policies result in higher after-tax returns, increased economic activity, and an eventual improvement in overall state fiscal health; anti-growth policies result in the opposite effects.

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For investors and corporate planners, knowledge of a company's exposure to a particular state and that state's economic outlook should be important inputs in investment and location decisions due to the relationship between economic policy and asset values.

For more than two decades, we have specialized in the analysis of state and local economic policies. In fact, over the years our State Competitive Environment model has repeatedly demonstrated its ability to forecast changes in state competitiveness and thereby economic health and asset values. Our current rankings, building upon the traditional State Competitive Environment model with additional analysis, represents the culmination of this knowledge and experience and represents the most comprehensive ranking of the states we've undertaken. The result is a supply-side ranking of the states' economic outlooks from best to worst.

Any ranking of the states can take on a multitude of forms and compare a wide spectrum of variables: measures of economic health such as production, employment and income; housing prices; education; even the quality of the weather. Of course, all of these variables influence the desirability of living and doing business in a particular city and state. And while most of these variables are examined in this study, they are not given any direct weight in the overall rankings. The focus of the State Competitive Environment, and therefore the basis of our rankings, is taxation (in its many forms) and changes in taxation—the true drivers of the other measures.

State Competitive Environment Rankings

The rankings are obtained through a blend of seven economic factors which quantify the following key aspects of a state's economic environment: i.) recent legislated tax changes affecting the state's relative tax burden; ii.) the after-tax incentive rate for various types and levels of income; iii.) the progressivity of the state's personal income tax; iv.) the property tax burden; v.) the general sales tax burden; vi.) the combined burden from other state and local taxes; and finally vii.) other important variables such as the state and local debt burden, workers' compensation costs, the number of state and local government employees, and the quality of the state's tort system.

Each factor assesses one component of the economic policy stance of each state and that state's chosen "focus city"—generally the largest city in each state. Using weights that reflect our determination of the importance of each factor to state and local governments, the seven factors are combined to reach a composite overall rank.
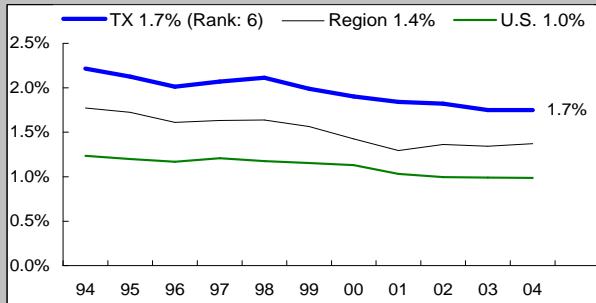
Overall Rank

Our model's economic snapshot of Texas can be found on the following two pages.[8] The overall rank can be viewed as a snapshot of the health of a state's competitive environment and our forecast of the state's relative outlook. The top ranked state receives a rank of 1, while the state with the poorest outlook receives a 50. In our rankings, Texas currently has the 19th best economic outlook.
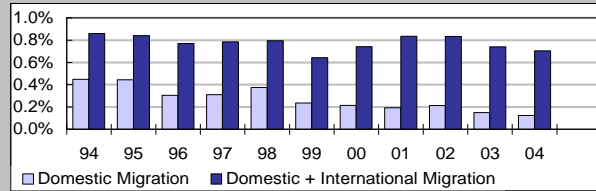
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[8] Due to differences in definitions, categorization, timing of measurement, etc., there may be minor discrepancies between data obtained from the U.S. Census Bureau and data obtained from Texas state budget sources.

Texas	19th
Focus City: Houston	Overall Rank

A state's overall rank is based on its performance in the seven economic factors shown below. Local taxes imposed in the focus city are included. (Rank: 1=best, 50=worst).

1) Tax Change (Two-Year Sum): -$0.66 12th
relative cut(-) or hike(+) per $1,000 of personal income Lowest

Major Legislated Tax Actions in 2005(p)
No major actions.

Legislated Changes in Relative Tax Burden, Recent History

Year	Change	Rank
2001	$0.09	37th
2002	-$0.98	9th
2003	-$0.96	13th
2004	-$0.47	13th
2005(p)	-$0.19	10th

State Political Office Control

		Started / End of Term
R	Gov. Rick Perry	12-00 / 1-07

		Rep	Dem	Other	Total
R	State Senate	19	12	0	31
R	State "House"	88	62	0	150
R	U.S. Senate	2	0	0	2
R	U.S. House	21	11	0	32

2) Income Incentive Rate: $1.048 1st
adjusted after-tax value of $1.00 of income Highest

		Income: $50,000 (Adjusted: $48,515)		Income: $150,000 (Adjusted: $145,546)		Income: $500,000 (Adjusted: $485,154)	
$1.00 Wage Income (66% weight)	Equivalent Job Wage-Adjusted $1.00	$0.970	27th	$0.970	27th	$0.970	27th
	Marginal Personal Income Tax Rate Faced	0.00%	1st	0.00%	1st	0.00%	1st
	Cost of Living Adjustment (Avg.=100)	88.7	2nd	88.7	2nd	88.7	2nd
	Wage Incentive Rate	**$1.094**	1st	**$1.094**	1st	**$1.094**	1st
$1.00 Dividend Income (17% weight)	Top Marginal Corporate Income Tax Rate	4.50%	6th	4.50%	6th	4.50%	6th
	Marginal Dividend Tax Rate Faced	0.00%	1st	0.00%	1st	0.00%	1st
	Dividend Incentive Rate	**$0.955**	5th	**$0.955**	5th	**$0.955**	5th
$1.00 Cap Gains Income (17% weight)	Top Marginal Corporate Income Tax Rate	4.50%	6th	4.50%	6th	4.50%	6th
	Marginal Capital Gains Tax Rate Faced	0.00%	1st	0.00%	1st	0.00%	1st
	Cap Gains Incentive Rate	**$0.955**	5th	**$0.955**	5th	**$0.955**	5th
Income Incentive Rates, Various Income Levels		**$1.048**	1st	**$1.048**	1st	**$1.048**	1st
Income Incentive Rate, Overall				**$1.048**	1st		

3) Tax Progressivity: $0.00 2nd
of the personal income tax Least Progressive

Measured as the difference between the average tax liability per $1,000 at incomes of $150,000 and $50,000.

At a Gross Income of $50,000
Estimated Total Tax Liability	$0	
Average Effective Rate	0.0%	1st
Average Tax Liability per $1,000	$0.00	

At a Gross Income of $150,000
Estimated Total Tax Liability	$0	
Average Effective Rate	0.0%	1st
Average Tax Liability per $1,000	$0.00	

Effective Average Personal Income Tax Rate (Tax Liability/Gross Income)

Legend: TX; U.S. Average (Income Weighted)

4) Property Tax Burden: $41.34 40th
per $1,000 of personal income Lowest

5) General Sales Tax Burden: $28.92 34th
per $1,000 of personal income Lowest

Are Groceries Taxable?	Total Sales Tax Rate:	8.25%	43rd
No	State Sales Tax Rate:	6.25%	43rd
	Local Sales Tax Rates:	2.00%	36th

6) Remaining Tax Burden: $20.91 32nd
per $1,000 of personal income Lowest

Includes remaining taxes (other than income, property and general sales taxes; severance taxes are also excluded).

Motor Fuel Taxes, Gasoline (per gallon):	$0.20	13th
Cigarette Excise Tax (per pack):	$0.41	11th
Beer Excise Tax (per gallon):	$0.19	24th
Wine Excise Tax (per gallon):	$0.20	4th
Distilled Spirits Excise Tax (per gallon):	$2.40	5th

7) Other Important Variables: 41st
Best

Based on an equal weighting of the five variables at right.

State and Local Gov't Debt Interest as a % of Tax Revenue:	10.3%	35th
Public Employees (Full Time Equiv.) per 10,000 Residents:	565.2	32nd
State Liability System Perceived Quality (1=worst, 100=best):	49.2	44th
State Minimum Wage "Business Tax" (federal "floor" is $5.15):	$5.15	1st
Workers' Compensation Costs (avg. per $100 payroll, 2004):	$3.08	38th

State Population Growth (yr/yr)*

TX 1.7% (Rank: 6) — Region 1.4% — U.S. 1.0%

1.7%

State Population Growth Due to Migration (yr/yr)*

□ Domestic Migration ■ Domestic + International Migration

State Personal Income Per Capita Growth (yr/yr)
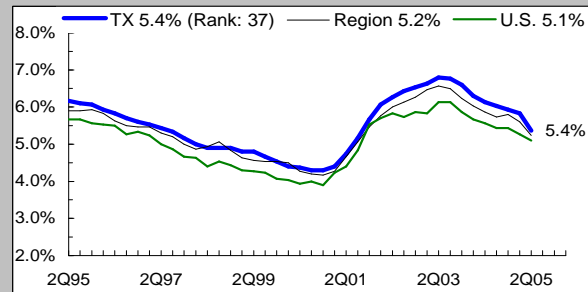
TX 5.1% (Rank: 40) — Region 5.4% — U.S. 5.6%

5.1%
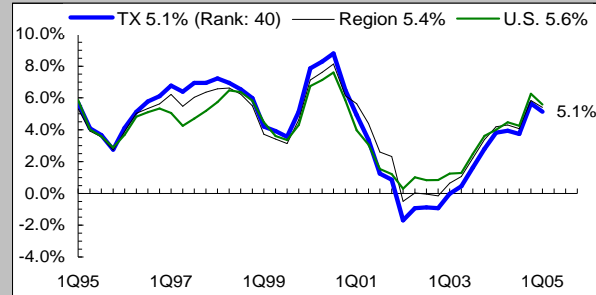
Texas Economic Performance Overview
(not factored into state's overall rank)   Focus City: Houston
Region: West South Central (AR, LA, OK, TX)

State Employment Growth (yr/yr, non-farm payrolls)

TX 1.2% (Rank: 33) — Region 1.2% — U.S. 1.6%

1.2%

State Unemployment Rate

TX 5.4% (Rank: 37) — Region 5.2% — U.S. 5.1%

5.4%
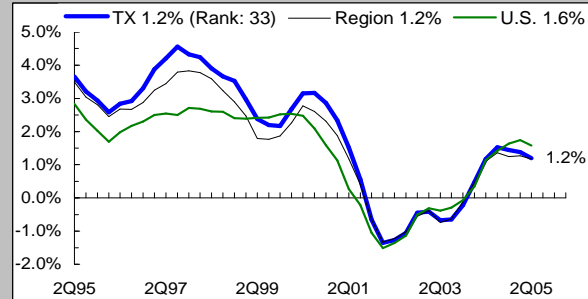
Focus City Cost of Living: 11.3% Below the National Average**

	Total	Housing	Grocery	Trans.	Utilities	Health	Misc.
	100%	30%	13%	9%	9%	4%	35%
	88.7	74.4	84.2	97.5	102.6	98.9	94.7

*Population growth = births - deaths + domestic migration + international migration.
**Values relative to a national average of 100. Taxes excluded. Source: ACCRA.

Laffer Cost of Housing Index (U.S.=1.000 in 1Q1994, higher index level indicates higher cost/lower affordability)

The index measures relative home ownership cost adjusted for mortgage rates, incomes, applicable taxes, ability to refinance, supply, etc.
- Texas housing is currently 20.3% more affordable than average U.S. housing (index value of 0.756 vs. 0.948).
- Texas housing has become 6.3% more affordable over the past year (index value change from 0.806 to 0.756).

	Current	Rank	1-Yr Ago	3-Yrs Ago	5-Yrs Ago	10-Yrs Ago
Texas Index	**0.756**	**16th**	**0.806**	**0.821**	**0.761**	**0.840**
Average U.S. Index	0.948		0.980	1.002	0.934	1.000
Selected Components of Index			1-Yr Chg	3-Yr Chg	5-Yr Chg	10-Yr Chg
Texas Housing Prices			3.8%	10.7%	24.5%	47.6%
Texas After-Tax 4-Person Median Household Income			5.2%	6.9%	14.8%	42.0%
U.S. Housing Prices			11.1%	25.5%	38.5%	68.6%

State and Local Tax Revenue by Type of Tax (FY2003)

	TX	U.S.
Individual Income Taxes	0.0%	21.2%
Corporate Income / Corporate License Taxes	3.5%	4.0%
Property Taxes	42.6%	31.6%
General Sales Taxes	29.8%	24.4%
Selective Sales Taxes		
Motor Fuel Taxes	4.6%	3.6%
Alcoholic Beverage Taxes	0.9%	0.5%
Tobacco Taxes	1.0%	1.3%
Public Utility Taxes	2.8%	2.2%
Other Selective Sales Taxes	7.7%	4.0%
Motor Vehicle License Taxes	2.2%	1.9%
Other Taxes	4.8%	5.3%
	100.0%	100.0%

State Credit Rating, G.O. Debt (S&P, end of period)

Credit Rating											
	NR	NR	NR	NR	NR	NR	NR	NR	NR	NR	NR
	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+
	AA	**AA**	**AA**	**AA**	**AA**	**AA**	**AA**	**AA**	**AA**	**AA**	**AA**
	AA-	AA-	AA-	AA-	AA-	AA-	AA-	AA-	AA-	AA-	AA-
	A+	A+	A+	A+	A+	A+	A+	A+	A+	A+	A+
	A	A	A	A	A	A	A	A	A	A	A
	A-	A-	A-	A-	A-	A-	A-	A-	A-	A-	A-
	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+
	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB
	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-
Rank	24th	25th	26th	28th	28th	29th	27th	25th	23rd	24th	23rd
Year	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Now

Factor #1: Tax Change (25 percent weight)

Changes in tax rates and tax burdens unleash dynamic effects affecting after-tax returns, factor relocation, incentives and economic growth (more on these effects in the next section of this report). For more than two decades, the State Competitive Environment model has ranked the states from the biggest tax cutters to the biggest tax raisers based upon close inspection of legislated state tax actions. This thorough and time-tested approach uses static revenue estimates of tax changes to calculate changes in the tax burden in each state (measured as tax revenues per $1,000 of state personal income). We do, however, remove from our calculations any "tax cuts" that have no effect on future incentives to work, produce and invest, such as those in the form of taxpayer rebates.

Following this same process, the tax change factor calculates each state's relative change in tax burden over the current and previous year combined. This time frame ensures that tax changes will impact a state's ranking long enough to overcome any lags in the tax revenue data. This factor is assigned a relatively large 25 percent weight due to its importance and is updated continuously as we monitor activity in the state legislatures.

From the beginning of its 2004 legislative sessions up to the present, the Texas legislature has implemented tax changes resulting in a net tax cut, relative to other states' combined tax changes, of $0.66 per $1,000 of personal income, resulting in a ranking of 12th. Thus, to date over this period 11 states have reduced their tax burdens to a greater degree than Texas has, while the other 38 states have become less competitive through their own tax actions.

Factor #2: Income Incentive Rate (25 percent weight)

While changes in taxation are critical to economic performance, absolute levels of taxation are important as well—just ask those New York City residents who pay a top personal income tax rate of 12.15 percent on every marginal dollar they earn. At the same time, the residents of Texas face a vastly different tax reality. People don't work and invest to pay taxes, they work and invest for the after-tax return. Here we measure the income incentive rate—the amount of a marginal $1.00 of income that actually makes it into one's pocket after state and local governments have taken their share. We calculate the after-tax value of $1.00 for three types of income—wage income, dividend income and capital gains income. Due to the progressive nature of many income tax codes, we pass this $1.00 through the tax rates applicable at gross incomes of $50,000, $150,000 and $500,000. This factor contributes a 25 percent weighting toward the overall rank due to the great importance of incentive rates on output, production, and investment.

Wage Income

We examine the incentive rate on wage income by calculating the value of a marginal $1.00 of wages after state personal income taxes (including local personal income taxes where applicable). As shown in Table 2, given that Texas and our focus city of Houston impose no state or local personal income taxes, the state fares as well as possible in this measure. Each and every dollar of wage income remains untaxed, no matter the level of income ($50,000, $150,000 and $500,000 are examined here). If we made no further adjustments, Texas' lack of a personal income tax would result in an incentive rate of $1.00.

However, we make two other adjustments to the data. Same-job wage differentials and cost-of-living differentials play an important part when it comes to the true cost of living in a particular area. For example, a secretary in New York City is paid significantly more than a secretary in Houston, Texas for performing the exact same function. However, that same

New York City secretary faces a dramatically higher cost of living that reduces the purchasing power of every dollar earned. In general, higher cost-of-living areas go hand-in-hand with higher same-job wages, although a premium is paid to live and work in certain areas while a premium is received to live and work in others. Using employment data from the Bureau of Labor Statistics, we have developed an "equivalent job wage index" which measures differences in the wages paid for the same jobs—from blue collar to white collar— across states. For example, relative to a national average of $1.00, New York City's equivalent-job wage adjusted $1.00 is $1.217 while the same measure for Houston is $0.970. This implies a New York City worker receives 25 percent more than a Houston worker for performing the same job. To reach our final wage income incentive rate, it is this equivalent-job wage adjusted $0.970 that is passed through the applicable personal income tax rates for each income level.

Important Considerations

Comparing taxes and tax burdens across states and cities isn't easy; critical elements are often overlooked, ignored or misinterpreted. Therefore, careful consideration has gone into the selection and development of each of our seven economic factors (which we will describe momentarily) to obtain the most rigorous results possible. For example:

◆ Local taxes, which on average generate 42 percent of total state and local tax revenues, have a large effect on incentives and should not be ignored. The Laffer State Competitive Environment model analyzes the taxes imposed in a selected focus city in each state as a proxy for local taxes.

◆ Each state's tax code is unique. While the top marginal tax rate is a key measure, ignoring other features of the tax code can leave hidden critical information that lies just below the surface. For example, the deductibility of federal income taxes from personal and corporate income is an allowance often overlooked when tax rates are compared. Using Montana as an example, when the 100 percent deductibility of federal taxes is factored in, Montana's top marginal personal income tax rate isn't *really* 11 percent, it's 7.15 percent—not an insignificant point. Where appropriate, we also factor in the standard deduction, personal exemptions and/or tax credits into our calculations.

◆ When comparing tax burdens, one of the more commonplace and revealing measures is state and local tax revenue per $1,000 of personal income. However, it is important to understand that this measure of tax burden has lots of limitations—especially when examining the progressivity of taxes and Laffer Curve effects. For example, a significant increase in marginal income tax rates, like those recently enacted in New Jersey, would at first glance be expected to raise revenues by the amount of the tax rate increase multiplied by the tax base. However, tax increases can have an enormously harmful effect on output, employment and productivity. The result is a reduced tax base and lower tax revenues than the static revenue tax change would have otherwise suggested. The change in the tax burden that would have occurred from the tax rate increase *per se* is reduced by the induced effect on revenues due to fewer people working, earning less income per person and thereby paying less in taxes. And, of course, revenues from all taxes are affected, not just those from the specific tax that was increased. In theory, tax revenues per $1,000 of personal income could actually *fall* despite higher tax rates.

To complete our calculation, the after-tax value of the $1.00 is subject to our adjustment for the area's cost-of-living. Keeping with the same example, New York City's cost of living adjustment is 173.4 (their cost of living is 73.4 percent higher than the national average of 100.0), dramatically reducing the purchasing power of each after-tax dollar. However, in Houston the same cost-of-living adjustment figure is 88.7 (the cost of living is 11.3 percent lower than the national average), indicating a higher purchasing power of each after-tax dollar. In fact, Houston enjoys the second lowest cost of living of any focus city in our analysis, trailing only Jackson, Mississippi.

Texas' combination of no personal income taxes, middle-of-the-road relative wages and remarkably low cost of living results in a wage income incentive rate actually greater than $1.00. For the three income levels of $50,000, $150,000 and $500,000, Texas' wage adjustment, personal income tax rates and cost-of-living adjustment result in a wage income incentive rates of $1.094. This is the best wage income incentive rate in the nation by a significant margin.

Dividend Income

$1.00 of income paid out as a dividend to investors is first taxed as income to the corporation at the applicable corporate income tax rate (state and/or local), and then at the applicable tax rate on dividends. In our calculations here we assume a corporation in Texas faces a corporate tax rate on net income of 4.50 percent. At the same time, once paid out to the shareholder, dividends are free from any further taxation due to the lack of a personal income tax in the state. Therefore, the dividend income incentive rates at gross incomes of $50,000, $150,000 and $500,000 are an identical $0.955, fifth best in the nation.

Capital Gains Income

$1.00 of income realized through capital gains is taxed as income to the corporation at the applicable corporate income tax rate (state and/or local), and then at the personal level at any applicable tax rate on capital gains. Similarly to the treatment of dividend income, capital gains income is taxed at Texas' corporate income tax rate of 4.50 percent yet faces no further taxation. Therefore, we calculate the after-tax value of $1.00 of capital gains paid to taxpayers with gross incomes of $50,000, $150,000 and $500,000 to be $0.955.

We combine the incentive rates for wage income, dividend income and capital gains income using weights of 66 percent, 17 percent, and 17 percent, respectively, to yield an incentive rate for all types of income combined at each of the three levels of gross income. In Texas, taxpayers face an identical income incentive rate for all types of income independent of their level of income. In other words, at an income level of $50,000, $150,000, or $500,000, the incentive to earn an additional $1.00 through wages, dividends, or capital gains is a return of $1.048. These three incentive rates are then averaged to yield an overall income incentive rate for the state, which in Texas' case is also $1.048. This overall income incentive rate is the best in the nation.

It is important to note that this measure is intended as a proxy for a state's after-tax incentive rate for all types of income. Of course, a taxpayer with no wage income but lots of income from dividends and capital gains would likely face a different after-tax incentive rate than what we've calculated here, and the same holds true for a wage earner with no investment income at all.

Factor #3: Tax Progressivity (10 percent weight)

Personal income tax codes often fall far short of the economic ideal of taxing the largest possible base at the lowest possible tax rates. Despite the fact that both might generate a similar revenue stream, the tax structure of a state which imposes a low flat-rate tax on a broad range of personal income has remarkably different implications for economic efficiency and performance than the tax structure of a state with a narrow, highly progressive personal income tax. We define and measure tax progressivity here as the difference in the average tax liability per $1,000 of income for gross incomes of $50,000 and $150,000. Included in our calculation of tax liability are all appropriate adjustments for the standard deduction, personal exemptions and/or credits, deductibility of federal income taxes, local personal income taxes, etc.

Very simply, a Texas resident with a gross income of $150,000 pays an effective average rate of $0 of tax liability per $1,000 of income, as does a resident with a gross income of $50,000. In regards to this measure of tax progressivity, the lack of a personal income tax in Texas is equivalent to a flat rate tax, due to the fact that higher income taxpayers do not face a higher effective tax rate than do lower income taxpayers. Naturally, Texas fares well in charging a broad, low flat-rate tax on personal income that does not distort economic decisions—it charges no tax at all! Texas ranks second best in the nation in the measure, trailing only Alabama, which, due to unique characteristics of its tax code, actually imposes a slightly regressive personal income tax between the income levels examined here.

Factors #4-6: Burden of the Property Tax, the General Sales Tax, and Remaining Taxes (25 percent weight combined)

This factor captures the burden of the property tax, the general sales tax, and, in the "remaining taxes" category, all other taxes not yet considered. Because these taxes are for the most part imposed at a flat rate, instead of examining tax rates, the burden measure we use is the total combined state and local tax revenues from these taxes per $1,000 of personal income. The "Remaining Taxes" category is comprised of the hundreds and hundreds of taxes that state and local governments impose. (Here in California those taxes range from A to Z, from the Admissions tax to the Zoning tax and all those in between). Fortunately, we don't have to track all of these taxes—state and local finance departments aggregate the tax revenues for us. Due to its unique nature and incidence, the severance tax is excluded.

Texas residents face an above average property tax burden (ranked 40th, or 11th highest), an above average general sales tax burden (ranked 34th, or 17th highest), and a tax burden for remaining taxes that is also above average (32nd, or 19th highest).

Factor #7: Other Important Variables (15 percent weight)

This final factor acts as a catch-all for five important variables that affect, directly or indirectly, the ability of people to live and do business in a state: state and local debt service as a share of revenues, the size of the public sector, the perceived quality of the state's liability system, state minimum wage law, and workers' compensation costs. When the equal-weighted average of Texas' ranking for each of these five variables (discussed below) is calculated, Texas does not fare very well; in fact, it ranks 41st in the nation. The importance of these measures should not be understated, and they represent areas in which Texas should strive to improve.

State and Local Government Debt Interest as a Percentage of Tax Revenue

While there are a number of ways to range the true magnitude of a state's debt, the interest paid on state and local government debt as a percentage of tax revenue is one of the best. This measure reveals just how much of every budget goes toward debt service and therefore is not available to fund current operations. In this category, Texas ranks 35th nationally; in other words, Texas faces the 16th highest debt service costs relative to its ability to raise revenue. How much of a problem is this?

General obligation (GO) bond debt is used to spread out the cost of a major capital outlay project over an extended period of time, say 20 to 30 years. As opposed to other types of debt utilized by states, such as traditional revenue bonds and lease revenue bonds (which are contingent upon and paid off through their own dedicated source of revenue), GO debt is backed by the full faith and credit of the state and is paid off through the taxing power of the state's general fund. In Texas, new state GO debt requires a two-thirds approval of the legislature and majority voter approval.

While a state's cost of borrowing varies depending upon variables such as the prevailing interest rate, the type of bond, and the length of repayment, given today's market conditions a general rule of thumb is that for every $1 borrowed, it eventually costs the state approximately $2 to pay back the principal with interest costs. After factoring in the effects of inflation, the true cost of the borrowed funds falls to $1.25 for every $1 borrowed. Of course, each state faces somewhat different borrowing costs based on perceived risk, which is reflected in the state's GO debt credit rating. Texas' current Standard and Poor's credit rating is a solid AA, which is two steps below the best rating Standard & Poor's offers and good for a rank of 23rd among the states. The Texas Bond Review Board had this to say:

> "Credit rating agencies consider four primary factors when rating a state's debt: economy, finances, debt and management…Texas' general obligation debt is split-rated Aa1/AA/AA+ by the three credit rating agencies…Texas' AAA rating was downgraded in 1987 due to the state's economic recession during the 1980s. Since that time, however, the state's economic base has shown considerable improvement. A steady transition from an oil and gas economy to one increasingly based on services, manufacturing and technology has broadened the state's sources of revenue.[9]"

Texas' credit rating has remained rock-steady at AA for many years, even during the past few turbulent years when many more credit rating downgrades than upgrades have occurred.

Texas state government had $19.9 billion in total debt outstanding as of FY2004, with $5.8 billion of that being of the general obligation variety. Moody's Investors Service examined net tax-supported state debt per capita and net tax-supported state debt as a percent of personal income in FY2004 in order to ascertain Texas' relative position among the states. For these two measures Moody's arrived at national rankings for Texas of fifth and fourth best (i.e., lowest debt loads), respectively. The 2004 Annual Report of the Texas Bond Review Board also clearly shows annual state debt service as a percentage of unrestricted general revenue to be low and even declining (1.17 percent in FY2004 versus 1.44 percent in FY2003). And Texas debt service payments are far below Texas' constitutional limit of 5

[9] "2004 Annual Report," Texas Bond Review Board, 2004.

percent of General Revenue Fund revenues. At the state level, Texas is light years from having a debt problem. However, to ignore local government debt in this analysis—a sector which makes up approximately 80 percent of Texas' total debt—would be a grievous error.

Perhaps the most thorough measure of total state and local government debt comes from the government finance reports from the U.S. Census Bureau. The Census Bureau publishes debt statistics for state and local governments for each state going all the way back to 1977, all on a consistent basis, and in nearly every form imaginable. However, there is an approximate two-year lag in the data.

Using this Census Bureau data, in Figure 14 we've plotted our favorite measure of debt: state and local total net long-term debt outstanding, backed by the full faith and credit of the state, per capita.[10] We've also included the U.S. and four of Texas' peers. This chart provides a solid long-term perspective. Texas state and local debt has risen in recent years, but this rise hasn't occurred in a vacuum and shouldn't be analyzed as if it occurred in a vacuum. State and local debt for the U.S. as a whole has risen just as sharply, as did federal government debt over this period as well. Similar data from the Texas Bond Review Board reveal that Texas local government tax-supported debt has increased 52.5 percent over five years through FY2003.

Continuing fiscal duress, low interest rates, and the need to continue to fund capital projects have contributed to these trends. In Texas, local government debt proceeds are used most by cities, towns and villages (39.2%), school districts (30.4%), water districts and authorities (17.5%), and counties (7.1%). Given Texas' rapid growth, these needs are certainly not going to abate. While no one knows for sure just how much debt is too much debt, and it certainly bears watching closely, Texas just isn't all that far out of line. And, debt of a fiscally rational state such as Texas is inherently more stable and secure than other scenarios.

Figure 14
Texas and Its Peers: State and Local Total Net Long-Term Debt Outstanding,
Full Faith and Credit, Per Capita
(2003 local component is an author estimate)
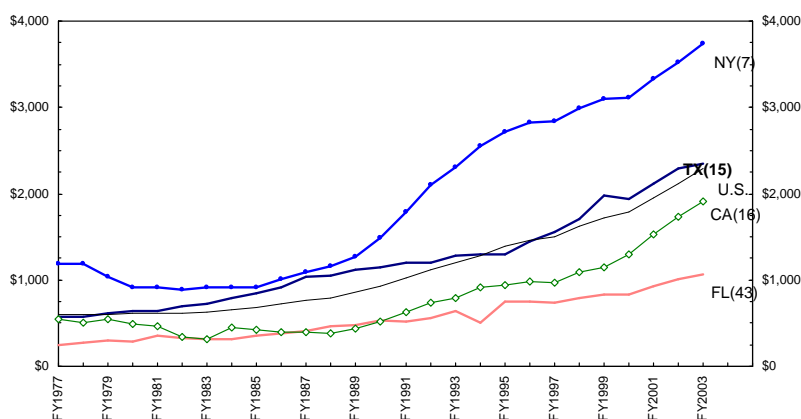
Source: U.S. Census Bureau.

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[10] As defined by the U.S. Census Bureau: Net Long-Term Debt Outstanding, Full Faith and Credit is the amount of total full-faith and credit long-term debt held by a government for which no funds have been set aside for its repayment. It consists of total full-faith and credit long-term debt outstanding less total offsets to full-faith and credit long-term debt (i.e., cash and security holdings in debt service, or sinking, fund).

Public Employees per 10,000 Residents

We also examine the number of state and local government employees per 10,000 residents as an indication of the relative size and potential inefficiency presented by government. Texas ranks 32nd in the nation with 565.2 public employees per 10,000 residents.

State Liability System Perceived Quality

The perceived quality and fairness of state liability systems is the first of three variables examined here that play a crucial role in creating an environment conducive or detrimental to business. Texas received a rather poor rating of 49.2 in the most recent survey, placing it 44th best in the U.S.

State Minimum Wage

Here we look for the existence of a "business tax" in the form of a state mandated minimum wage in excess of the federal minimum wage floor $5.15. Texas does not add on to the federal minimum wage floor, and it therefore receives a top score.

Average Workers' Compensation Costs per $100 of Payroll

High workers' compensation costs represent a tremendous tax on a business. Average costs for Texas in 2004 were $3.08, placing it 38th lowest in the nation (or 13th highest).

Potential Real-World Applications Of The Model's Results

Note that the State Competitive Environment model selects states, not stocks. Therefore, the model has many potential investment applications and can be used in conjunction with any number of disciplines. There are many applications in which the fundamental economic principles upon which this strategy is based will hold true, as has been documented over the years in our research.

Small Cap Investment Strategy

For investors and corporate planners, knowledge of a company's exposure to each state and that state's economic outlook going forward should be an important input in investment and location decisions. Companies with production facilities concentrated in a state where relative tax rates are declining, for example, can, in general, expect to reap higher after-tax rates of return than those companies in states with rising tax burdens. As we have discussed, the extent of the duration and magnitude of such gains and losses is tied inextricably to the mobility of each company's competitors, workers, and the sensitivity of its customers to the price of its goods.

We have developed a portfolio strategy that uses company location and the State Competitive Environment rankings to project stock performance. The key element to this strategy is investing in companies located in states ranked highly by the State Competitive Environment model—in other words, states that are cutting tax rates or taking other actions to create a more competitive environment for residents and businesses. Past data indicate a strong relationship between a state's tax rate changes relative to tax rate changes in other states and deviations between the average stock returns of companies located in that state *vis-à-vis* returns across all other states.

The universe of stocks considered in this paper to demonstrate the state portfolio effect is all U.S.-based companies in the lowest market capitalization decile of the New York, American and NASDAQ stock exchanges. Because most major corporations operate in many states and, likely, in many different countries, the lowest market cap decile is examined because we are most interested in small cap stocks which accurately reflect the economy of the state in which they are headquartered to the greatest extent possible.

For practical purposes, any stock priced for less than $1 per share at the beginning of the year—identical to the minimum price requirement the NASDAQ stock exchange uses—is removed from the stock universe. In addition, stocks without a closing price at both the beginning and end of the year were dropped from the universe. This definitely adds a survivor bias to the performance results. However, because the strategy predicts that more companies will go bankrupt in states with rising tax burdens than with falling tax burdens, this survivor bias would be expected to hurt, not help, the strategy performance.

For each of these micro-cap companies, the state in which the company is located is identified, or, if located in more than one state, the state which possesses the greatest percentage of the company's production facilities, employees, etc. Small-cap companies located in the states designated as "buys" by the State Competitive Environment model are assigned to the "buy" portfolio, and companies designated as "sells" are assigned to the "sell" portfolio.

For the purposes of our results, each stock in the portfolio carries the same weight, irrespective of its state location. An implicit assumption in our strategy is that we would expect that a state twice as large as another state would have twice as many stocks. In effect we have implicitly assumed that the selection process would yield a weighting scheme directly related to state importance (i.e., share of total U.S. personal income). By weighting the stocks equally we assume that the states will be represented in direct proportion to their size.

Over a period of some 20-plus years, the results of a state portfolio strategy have been very encouraging. In this case we've applied the strategy to the smallest U.S.-based stocks to illustrate its value added. As expected with such small stocks, the returns are quite volatile and not directly comparable to any existing small cap stock index; however, the performance differential between the highly ranked states and the low ranked states is significant and the strategy has produced superior results over many scenarios tested.

Banks and Financial Institutions

An alternate proxy to small-cap companies are state-specific banks and other financial institutions. The rationale is as follows: most state-specific financial institutions' deposits and loans originate in the local and state community. A decline in the state competitive environment will be reflected in the amount of business (i.e. profits) done by the bank as well as the value of the underlying assets backing the banks' loans. Therefore, the impact of the states' economic policies directly affects the financial institutions' prices.

Municipal Bonds

Municipal bonds are completely state-specific and are thus well suited to our investment strategy. Municipal bonds issued by state and local governments are in many cases rated by one or more of the investment service companies. These ratings represent a basic assessment of the relative credit quality of the issue. While a multitude of considerations go into the assignment of

a rating, ratings of general obligation (GO) municipal bonds are an indicator of the issuer's relative economic standing. Changes in state GO bond ratings occur infrequently and thus are likely to represent significant changes in perceived economic and financial conditions. Analysis of the timing and direction of past rating changes suggests they are directly related to state competitiveness. Because the State Competitive Environment rankings forecast changes in relative state competitiveness, the rankings can be used to anticipate changes in municipal bond ratings and thereby capitalize on changes in these bonds' prices.

Real Estate

While the residential real estate market is a nationally integrated market, largely influenced by changes in national macroeconomic variables, our research indicates that approximately 50 percent of the change in the value of residential real estate is explained through state and local regulatory and tax policy. As we've discussed, real estate is considered the quintessential immobile fixed factor, and immobile factors of production are unable to escape state and local taxation. It follows that the burden of taxation will fall on real estate no matter where the tax is placed. Through their effects on both supply and demand, taxes will be reflected through residential real estate prices.

From Theory To Real World Evidence, Part II

Once again we return to our basic real-world examination of top 10 and bottom 10 states and economic performance, this time comparing the 10 highest ranked states in the State Competitive Environment model with the 10 lowest ranked states (Table 9). Relative to the average of the 10 lowest-ranked states, the average of the 10 highest-ranked states showed:

♦ Faster growth of gross state output (72.2% vs. 61.5%);
♦ Greater personal income growth (72.6% vs. 60.0%);
♦ Higher personal income per capita growth (50.1% vs. 49.5%);
♦ A much greater increase in total population (15.1% versus 7.0%), including a net *inflow* of residents into the 10 top-ranked states from other states (3.1% of total population) vs. a net *outflow* of residents from the 10 low-ranked states to other states (2.9% of total population);
♦ Much more rapid job creation (17.6% vs. 13.0%); and
♦ A slightly lower unemployment rate (4.9% vs. 5.0%).

By this point, these positive results should come as no surprise!

Table 9
State Competitive Environment Rank vs. 10-Year Economic Performance
(current tax burden vs. performance between 1994 and 2004, unless otherwise noted)

	Rank*	Gross State Product Growth	Personal Income Growth	Personal Income Per Capita Growth	Population Growth	Net Domestic In-Migration as a % of Population	Non-Farm Payroll Employment Growth	Unemployment Rate, 2004
Tennessee	1	65.7%	67.3%	48.3%	12.8%	4.6%	11.5%	5.3%
Georgia	2	79.4%	79.0%	45.1%	23.4%	6.9%	19.1%	4.6%
Colorado	3	91.7%	93.7%	56.8%	23.6%	6.0%	24.1%	5.4%
Idaho	4	80.1%	76.2%	44.9%	21.7%	7.2%	27.3%	4.5%
South Dakota	5	70.2%	67.8%	59.1%	5.5%	-1.7%	15.4%	3.5%
Oklahoma	6	62.7%	64.2%	52.9%	7.4%	0.1%	14.9%	4.6%
Missouri	7	54.4%	58.7%	46.8%	8.1%	1.5%	9.0%	5.7%
Kentucky	8	51.2%	63.8%	52.0%	7.7%	1.7%	12.4%	4.7%
North Carolina	9	78.2%	70.4%	43.4%	18.8%	6.4%	14.0%	5.3%
Utah	10	88.2%	84.6%	51.5%	21.9%	-1.4%	28.3%	5.1%
10 Highest Ranked States**		**72.2%**	**72.6%**	**50.1%**	**15.1%**	**3.1%**	**17.6%**	**4.9%**
10 Lowest Ranked States**		**61.5%**	**60.0%**	**49.5%**	**7.0%**	**-2.9%**	**13.0%**	**5.0%**
Illinois	41	52.9%	53.0%	43.3%	6.7%	-5.3%	6.3%	6.1%
Montana	42	60.1%	61.8%	50.4%	7.6%	2.6%	21.0%	4.4%
California	43	80.7%	72.1%	50.9%	14.0%	-4.0%	19.6%	6.2%
Louisiana	44	60.3%	55.6%	49.8%	3.9%	-3.8%	11.4%	5.8%
New Jersey	45	60.8%	62.8%	50.0%	8.5%	-4.0%	12.7%	4.8%
Vermont	46	64.3%	72.4%	62.0%	6.4%	1.3%	14.9%	3.7%
Hawaii	47	39.7%	38.0%	29.8%	6.3%	-7.4%	8.7%	3.3%
Rhode Island	48	74.7%	62.4%	52.7%	6.4%	-1.8%	12.5%	5.1%
Maine	49	60.2%	67.1%	57.7%	6.0%	3.2%	15.4%	4.6%
New York	50	61.2%	54.4%	48.3%	4.2%	-10.0%	7.9%	5.8%
The Others								
Alaska	11	57.5%	49.4%	37.5%	8.6%	-4.9%	17.0%	7.6%
Delaware	12	91.1%	76.4%	52.4%	15.7%	5.1%	19.2%	4.1%
Oregon	13	73.7%	63.9%	42.3%	15.2%	5.0%	17.0%	7.2%
Michigan	14	41.3%	48.4%	40.8%	5.4%	-2.1%	6.0%	7.1%
Florida	15	81.1%	77.4%	45.2%	22.2%	8.2%	29.3%	4.7%
Indiana	16	57.3%	56.1%	45.0%	7.7%	0.1%	8.0%	5.2%
Massachusetts	17	72.3%	67.3%	58.9%	5.3%	-3.8%	9.5%	4.8%
South Carolina	18	62.6%	67.6%	48.0%	13.3%	4.6%	13.4%	6.9%
Minnesota	19	76.6%	72.6%	56.0%	10.6%	0.9%	15.6%	4.7%
Texas	**19**	**86.0%**	**81.4%**	**49.7%**	**21.1%**	**2.3%**	**22.3%**	**5.9%**
Wisconsin	21	61.9%	61.2%	50.2%	7.3%	0.8%	12.6%	4.7%
Maryland	22	69.4%	69.7%	53.4%	10.7%	-0.4%	17.2%	4.2%
Alabama	23	56.5%	58.9%	49.4%	6.3%	0.8%	8.1%	5.4%
Virginia	24	81.6%	72.2%	52.2%	13.1%	1.9%	19.4%	3.7%
Nevada	25	118.0%	118.8%	40.5%	55.7%	21.1%	56.2%	4.0%
Arizona	26	102.2%	100.3%	48.0%	35.3%	12.0%	40.3%	4.6%
New Mexico	27	48.5%	68.1%	48.6%	13.1%	-0.7%	20.3%	5.6%
Iowa	28	65.2%	56.0%	50.5%	3.6%	-2.0%	10.3%	5.0%
North Dakota	29	65.4%	62.5%	65.2%	-1.6%	-7.0%	14.4%	3.4%
Kansas	30	61.3%	55.6%	46.8%	6.0%	-2.4%	13.5%	5.3%
Nebraska	31	56.2%	61.0%	51.0%	6.6%	-1.8%	15.9%	3.8%
New Hampshire	32	79.6%	78.5%	56.9%	13.7%	6.2%	19.9%	3.4%
Pennsylvania	33	56.5%	51.7%	48.8%	2.0%	-2.0%	8.6%	5.5%
Washington	34	73.1%	77.6%	53.9%	15.4%	3.4%	17.1%	6.2%
Wyoming	35	85.7%	76.5%	67.4%	5.5%	-2.0%	17.7%	3.9%
Mississippi	36	51.3%	63.4%	51.3%	8.0%	0.5%	6.5%	6.8%
Ohio	37	47.1%	48.2%	44.3%	2.7%	-2.5%	6.6%	6.1%
Connecticut	38	68.0%	61.5%	52.9%	5.7%	-3.5%	7.0%	4.6%
Arkansas	39	58.4%	63.6%	48.3%	10.4%	2.6%	12.0%	5.6%
West Virginia	40	41.8%	50.0%	50.5%	-0.3%	-0.7%	9.3%	5.0%

*Current rank in the State Competitive Environment model.
**Equal-weighted averages.

Source: Author calculations based on data from: National Conference of State Legislatures,
Bureau of Economic Analysis, Bureau of Labor Statistics, and U.S. Census Bureau.

A Note On Texas Budget And Performance Assessments

Today, Texas budget methodology uses a promising premise: to break down government functions into activities and sort spending by policy goals instead of by government agency. Governor Bush in Florida has used this same premise to overhaul the budgeting process in Florida with his outcome-based interactive e-budget, created by Donna Arduin (http://www.ebudget.state.fl.us/).

To be useful, this approach must include first a business process analysis of every state government service and activity. Budgeted programs and line items are not business processes. Services include long-term care and adult supervision in prisons, for example. Every service should be divided into all of the activities performed, including eligibility determination, provision of services, and oversight functions, for example.

Second, outcomes and activity costs must be properly assigned to services and activities. Policy goals should be directly tied to dollars and outcomes. The legislature and citizens should be able to clearly see, for example, the cost per participant in each drug rehabilitation program and the recidivism (long-term success) rate for each program. This gives the legislature and taxpayers a true accounting of not only how tax dollars are being spent, but what they are getting for those dollars.

Once armed with this information, policy makers can diagnose all expenditures in the budget for performance, compare them with prior years, the overall growth of the budget, private sector alternatives, and other states' programs, and make rational decisions about state policies.

A program or line item may be, on its face, administered to implement one of the governor's priority goals, but if its performance does not contribute to, or as efficiently as other programs, contribute to furthering that goal, it should not be prioritized for limited tax dollars. If increased support for adoption programs, for example, yields no improvement in moving children from foster care to permanent homes, perhaps it is the program design that is in need of improvement.

More dollars are rarely the answer, but usually the response, to non-producing policies. Performance-based budgeting allows Texas to measure the effectiveness of tax dollars being spent.

Fiscal Policy Checklist: Dos And Don'ts

We now begin to turn our attention back to recommendations for improving Texas' already rock-solid economic outlook. While Texas' situation is certainly unique among the states, there are general truths to be found in economic theory and through our decades of state fiscal policy observation that should be noted before any decisions on tax action are made. Texas' legislature and voters would be wise to heed the following points:

♦ During prosperous times, life is relatively easy in state legislatures, as high levels of economic activity result in abundant tax revenues and spending that grows unrestrained with few immediate consequences; it is during the bad times that flaws are exposed. Bad times expose fiscal flaws, spending flaws, pension flaws, and yes, flaws in the tax codes.

♦ There is truly never a good time to raise taxes, but raising taxes during difficult times is especially bad. Tax increases only serve to worsen economic downturns. By raising taxes during depressed economic conditions, employers and employees face additional impediments

just to keep from moving backwards. It makes no sense to raise taxes on the last three people working. People don't work to pay taxes, nor do businesses locate their plant facilities as a matter of social conscience. People work to earn what they can after tax—after all taxes. During tough times after-tax earnings are depressed naturally, which is why unemployment rates are so high. Piling on more taxes only exacerbates the problem. Businesses locate their plant facilities to make after-tax returns for their owners. During depressed times, businesses often are desperate to reduce costs because of a shortfall in revenues. Increased taxes in one location can be the final straw leading to businesses relocating to more tax-friendly locations or to make the ultimate decision to close down operations.

♦ Raising tax revenues is far from cost free. Obviously, when tax rates on an activity are raised, the volume of that activity shrinks, leading to a revenue offset. There are also substantial collection costs to both the government and the taxpayer from raising taxes which result in less money being collected than is paid. To the extent taxpayers seek to avoid, evade or otherwise shelter and hide their taxable income, the amount of additional revenues is also greatly reduced and can, in fact, end up costing the government money directly as a consequence of raising taxes. In California in the early 1990s, Governor Pete Wilson and the legislature passed tax increases which in static terms would have raised total tax receipts by $7.4 billion. What resulted, however, was very different. Revenues actually fell. Capital flight and labor flight, along with companies going out of business, are classic responses to increased taxation at the state and local level. In many of these cases the state and local governments actually lose revenues when they raise taxes.

♦ If raising taxes actually were to improve a state's fiscal circumstances, it would do so by worsening the fiscal circumstances of those it governs. No phrase is more important for government to adhere to than *primum non nocere* (first of all do no harm). Balancing the government's budget by unbalancing its citizens' budgets is contrary to every moral justification of government I've ever heard.

♦ Raising tax rates, especially during difficult times when tax increases are most frequently considered, virtually always deludes politicians into believing that more revenues will materialize than actually do. Cutting tax rates does the opposite. Static revenue estimates always assume that no one's behavior will change, and therefore a 10 percent tax increase will increase tax revenues 10 percent. In fact, this is never true. The dynamic effects of slower growth, reduced profitability, higher unemployment (and its associated costs), and tax evasion and avoidance, just to name a few, combine to ensure that actual revenues fall short of forecasted revenues.

♦ Almost without exception, states underestimate revenues during good times and overestimate revenues during bad times. As a result of overestimating revenues during bad times, politicians believe their fiscal circumstances are less severe than they actually are, leading to spending above and beyond revenues or delays in implementing spending cuts when they are desperately needed. Then, when deficits later appear, state legislators often turn to higher taxes, which in turn result in deeper declines in the economy, revenues again falling short of expectations, and a continuation of the spend-and-tax cycle.

♦ A budget system—such as an efficient spending limit or a flat single rate tax system without deductions—that avoids excessive revenues and spending during good times will not tempt politicians to build up an excessive government sector that in turn will be unaffordable during tough times. It is the volatility of spending, whereby spending actually is cut during bad

times, that causes so much hardship among those most vulnerable. Spending limits and/or a flat tax with modest rainy day provisions may well be the most moral spending structure as well as the most productive tax structure.

What Not To Do: A Personal Income Tax (The California Experience)

If any state government has violated the rules of the fiscal checklist listed above more than California has, it would be news to us. The volatile yo-yoing of California's revenues and expenditures makes for a budgeting hell in the Golden State, not to mention the burden on the state's citizens and businesses of California's sky-high tax rates. When considering how to reform Texas' tax system, some in the state have pondered imposing a personal income tax. While we have already done our best to demonstrate that this anti-growth step would be an awful idea, perhaps an account of California's recent fiscal history would bolster our argument. But even before we get to the case of California, it should be self-evident that if government taxes work, output and employment, and rewards non-work, leisure and unemployment, that that state will have little work, output and employment and a lot of non-work, leisure and unemployment. This is basic economics.

California has found itself in dire fiscal circumstances time and time again over the years—back in the early 1970s when Ronald Reagan was governor, in the late 1970s under Jerry Brown, under Pete Wilson in the early 1990s, and again under Gray Davis in the early 2000s. When faced with his own deficit difficulty, the governor who truly set the example *not* to follow was Gov. Wilson. Facing a $14 billion deficit in 1991 (which represented approximately 35 percent of general fund spending), Wilson pushed through a $6.4 billion static revenue tax increase that year which, when combined with his $1 billion tax increase the previous year, gave California the dubious honor of having imposed the biggest state tax increase in U.S. history. It took years for California's economy to find its way again. Gray Davis tried a similar tax-hiking approach just two years ago, but the voters of California apparently had learned their lesson.

In January 2003, Texas' budget shortfall was estimated to be in the $9.9 billion range by Comptroller Carole Keeton Strayhorn. This budget gap—representing approximately 17 percent of Texas' general fund spending—was far short of the magnitude of California's 1991 problem, but it was daunting nonetheless. Gov. Perry wisely held the line against tax increases and stated:

> "In tough economic times the focus must be on government spending less, not on taxpayers paying more. While some will interpret the comptroller's revenue estimate as a very challenging scenario, I believe the financial outlook presents us with the opportunity to reexamine the core responsibilities of government and how every tax dollar is spent…While every state is facing tough economic decisions this year, we must also keep in mind that Texas remains in better fiscal shape than most states.[11]"

Instead of raising taxes, Gov. Perry cut spending sharply, eliminated more than 10,000 state jobs, consolidated a number of state agencies and imposed higher fees—not the perfect solution, but a good one.

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[11]Quoted in Bill Kidd, "Comptroller: Budget Writers Have $7.4 Billion Less to Work With," State Tax Notes, Tax Analysts, January 20, 2003.

California government—the polar opposite to Texas government in terms of stability—frequently reaches the fiscal crisis point due to: i.) excessively high tax rates combined with ii.) an inefficient and highly progressive tax code. California's politicians have never cottoned on to the idea that tax revenue should come from assessing the lowest possible tax rates on the largest possible tax base. Instead, they gouge their constituents with some of the highest tax rates in the nation. California's tax rates are remarkably high across-the-board with the single exception of property taxes, thanks to the limits imposed by Prop. 13.

The personal income tax is California's primary tax revenue generator, providing approximately 47 percent of general fund revenues in recent years. It is the most progressive personal income tax in the nation, and this progressivity has some nasty consequences:

i)   **Tremendous Volatility of Revenue.** California's tax revenues make up the vast majority of total revenue available to the state—84 percent in the current fiscal year. Forecasting these revenues is critical for the state's budget—yet depending on the state of California's economy and its fiscal policy, these revenues bounce around like a pogo stick. This is a state where income tax revenues solely from realized capital gains and exercised stock options swung from $5.5 billion in FY1997-98 to a peak of $17.6 billion in FY2000-01 and then back down to $5.2 billion in FY2002-03. That's a drop of $12.4 billion in just two years! Amazingly, at their peak in FY2000-01, these revenues accounted for almost 25 percent of total general fund revenue. The full taxation of capital gains and stock options, combined with extremely progressive rates, brings tremendous volatility to state tax collections and a dependence on the performance of the stock market. Texas could do without this revenue uncertainty, we can assure you.

Combining economic slowdowns with highly progressive personal income taxes is a sure-fire formula for disaster. Of course, Sacramento is aware of this—at least since Gov. Schwarzenegger and Finance Director Donna Arduin came to town—and mentioned it in the *FY2004-05 Governor's Budget Summary*:

"One dollar of income on a high-income tax return can generate nine times the revenue from a dollar on a low-income return. In addition, very high-income taxpayers usually have considerable discretion over the timing of income and deductions. Thus, substantial changes in the portfolios or tax planning of relatively few high-income taxpayers can have a dramatic effect on state revenues."

These remarkable swings in tax revenue have cried out for tax reform for literally decades. Our prescription is a low flat-rate tax for California's state and local governments. A flat tax would replace the myriad of state and local taxes and fees currently imposed. Under the flat tax, those governing the state could rely on a stable and predictable source of revenue which would grow along with state personal income.

Unfortunately, under the current system in California huge revenue swings are the reality, and they naturally lead to:

ii.) **A Buildup of Government Spending.** If the money's there, the politicians will spend it. Every time the state's coffers fill to the brim during good times, the spending bar is raised. The governor and Arduin hit the nail on the head in the *FY2004-05 Governor's Budget Summary*:

"While revenues have increased 25 percent over the past five years, state expenditures have risen by 43 percent. If government had simply spent at the same rate that California's economy has grown, the state's budget would be balanced…If state government had not spent the extraordinary tax revenues from the one-time surge in capital gains and stock options on ongoing programs, the state budget would not be in the crisis it is today."

Of course, when poor economic times arrive, the spending bar isn't lowered to where it once was. Politicians tend not to make painful spending cuts—can you blame them? Tax increases, especially on those most profitable (and most productive), are much more palatable than real spending cuts. Without an effective constitutional spending limit—which California briefly enjoyed under the Gann Spending Limit but discarded in the early 1990s with the passage of Prop. 111— this buildup of spending is a natural result of the political process. The resulting high taxes, fees and regulations naturally lead to:

iii.) **Great Inefficiency and Unfairness.** High tax rates and a tax code filled with credits, exemptions and deductions wither the tax base—not a model of economic efficiency. In addition, the people and businesses in the state—those who chose to remain in the state—are left to face a hostile environment in which to live and work.

During good times, revenue surges above forecasts. The dynamic effects on the economy of any tax cuts put into place— effects not accounted for in the budget process—lead to revenues far surpassing straight-line revenue projections. In total, the state's coffers overflow. Unfortunately, this unexpected bounty invites politicians to spend, spend, spend.

Then, when the bad times hit, high levels of spending lead to financial obligations the legislature can't honor as the state's revenues come in far below forecasts. Tax increases during bad times further stifle the economy, and cause tax revenues to fall far short of estimates. The illusory balances upon which budgets are based evaporate. True to form, the state again looks to taxes to make ends meet. The unrealistic revenue projections further delay spending cuts. It's a vicious cycle, one that Texas has done well to avoid.

Assisting The Poor: Supply-Side Version Of Robin Hood

And don't for a moment think that imposing a highly progressive tax structure helps the poor, the minorities, or the disenfranchised—it doesn't. Just on an intuitive level, it should be self-evident that if a government taxes people who work and pays people who don't work, there will be more people who don't work and fewer people who do work. The more workers are taxed and the more non-workers are paid, the more people there will be who don't work. It's as straightforward as 1-2-3.

The important question to address is, What is truly the best way to help the poor? All of us understand the importance of helping those who really do have difficulty helping themselves. The question is not whether you want to help the poor. The question is: How can you literally make the poor better off?

If the rich are taxed and the money is given to the poor, do not be surprised if there are a lot of poor people and very few rich people. People respond to incentives. Whether it fits with your view of what the world should be or not, it is the way the world works. If you make an activity less attractive, people will do less of it. If you make an activity more attractive, people will do more of it. Taxes make an activity less attractive and subsidies make an activity more attractive.

I'd like to retell the story of Robin Hood, only here the supply-side version of the story of Robin Hood. If you'll remember the story, it begins with Robin and his band of merry men in the English town on Nottingham. They would wake up in the morning and don their light green leisure suits and go zipping off into the Sherwood Forest, where they would wait for hapless travelers by the trans-forest throughway hiding amongst the trees.

If a rich merchant came by—and by rich I mean a *super* rich merchant (this guy didn't have a silver spoon in his mouth, he had a golden goblet down his throat)—Robin would stop him, chat with him for a few minutes and then take everything the guy had. He'd make the guy run naked back into the forest. But before you feel sorry for the guy, remember he is so rich that by the time he gets back to his castle there will be lots of other golden goblets, lots of other jewels and wealth. He'll be just fine, none the worse for the wear.

If a prosperous merchant came through the forest, one who was just rich but not super rich, Robin would take almost everything the guy had, but not quite everything. If a normal, everyday average businessman came through the forest, Robin would take just a moderate chunk of what the man had. And if a poor merchant came through the forest, one who could barely make it, Robin would just take a little token from that guy.

In the vernacular of our modern day society, Robin had a progressive stealing structure from the merchants who came through the forest. You recognize the model, don't you? Doesn't it sound like the model used by California government?

At the end of the day, Robin and his men would take their contraband and go back into Nottingham where they'd wander the streets. If they found someone who was down-and-out and had absolutely nothing, Robin would stop him and say, "Hi, my name's Robin Hood. I'm your local redistributionist agent around here and I'd just like to tell you how much I love you." And then Robin would give the destitute man a whole pile of goodies.

When Robin and his men found another person whom we'd call "working poor," with an income around $10,000 a year at about minimum wage, they would give him a smaller bundle of goodies than they gave to the guy who had nothing. And if Robin Hood found some normal, everyday average citizen walking around the streets of Nottingham, Robin would give the man a small token equivalent to our modern day tax rebate. Robin would add, "You and your wife go out to dinner and the wine's on me." If Robin happened to bump into a rich person, he might just rip him off.

Once again using today's words, the more a person makes the less Robin gives him, and the less a person makes the more he gives him. You follow the model: he stole from the rich and gave to the poor. The richer you were the more he'd steal from you, the poorer you were the more he'd give you. This is the story of Robin Hood.

Now, put on your supply-side economics hat and imagine for a moment that you are a merchant back in the ancient days of Nottingham: HOW LONG WOULD IT TAKE YOU TO LEARN NOT TO GO THROUGH THE FOREST? Those merchants who couldn't afford armed guards would have to go around the forest in order to trade with the neighboring villages. The route around the forest is a lot longer and full of rocks, bumps, logs, holes, etc.—it was far more costly doing commerce when you're traveling around the forest rather than going through the forest.

Those merchants who could afford armed guards (and by the way, today we call these armed guards lawyers, accountants and lobbyists) would go through the forest and Robin couldn't rip them off. And believe me when I tell you that those armed guards were as expensive then as they are today. So at the end of the second day, Robin Hood had no contraband whatsoever to give to the poor. All he had succeeded in doing was driving up the cost of doing business, which meant the poor had to pay higher prices and were literally worse off. By stealing from the rich and by giving to the poor, Robin Hood made the poor worse off.

A highly progressive tax structure is of no benefit to the truly needy. Let me put the theorem to you precisely (and I could prove it to you mathematically if need be): By trying to redistribute income, government never, ever succeeds in redistributing income. But what government does accomplish when it tries to redistribute income is the destruction of the volume of income. Government cannot change the distribution of income with taxes but it always lowers the volume of income with taxes.

To me the best form of welfare is still a good, high paying job. There is no alternative to economic growth.

Theory Of Efficient Taxation

> "The mode of taxation is, in fact, quite as important as the amount. As a small burden badly placed may distress a horse that could carry with ease a much larger one properly adjusted, so a people may be impoverished and their power of producing wealth destroyed by taxation, which, if levied in any other way, could be borne with ease."
>
> ~Henry George[12]

The important feature of a tax system is the conceptual framework upon which it is based. The tenets of economically sound and efficient taxation are generally acknowledged and accepted, with the true debate revolving around the issue of fairness—just how large of a role, if any, government should play in the redistribution of income. We have found no better summary of the tenets of economically efficient taxation than that provided by Henry George. George, in his chapter entitled "The Proposition Tried by the Canons of Taxation," enumerated as well as anyone the criteria by which tax policy may be analyzed:

> The best tax by which public revenues can be raised is evidently that which will closest conform to the following conditions:

1. That it bear as lightly as possible upon production—so as least to check the increase of the general fund from which taxes must be paid and the community maintained.

2. That it be easily and cheaply collected, and fall as directly as may be upon the ultimate payers—so as to take from the people as little as possible in addition to what it yields the government.

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[12] Henry George, "Progress and Poverty," (New York: Robert Schalkenbach Foundation, 1960).

3. That it be certain—so as to give the least opportunity for tyranny or corruption on the part of officials, and the least temptation to lawbreaking and evasion on the part of the taxpayers.

4. That it bear equally—so as to give no citizen an advantage or put any at a disadvantage, as compared with others.[13]

A recountal of efficient taxation theory is far beyond the scope of this project; others have done a very good job in this regard.[14] But it is this theory and our experience that guide our fiscal policy recommendations. We have been involved in evaluating and prescribing remedies for fiscally ill states and nations on many occasions, a process during which we often recommend an overhaul of the existing tax system and the imposition of our flat tax in place of all state and local taxes. The theory of incentives provides the basis for the concept of a flat rate tax, which is so-called because a single tax rate applies equally to all sources of income and does not change as a result of the taxpayer's volume of income. Any exemptions, deductions, differential rates, or progressivity would, as a matter of linguistics, preclude the name *flat rate*. They also represent a deviation from the principles of efficient taxation. Such exceptions to the even application of a single tax narrow the tax base, lead to a higher tax rate, make for greater complexity, and increase tax avoidance. The efficiency gains resulting from flat tax adoption would increase a state's competitiveness and result in a surge in growth and a more competitive economy.

Thankfully, as we have emphasized up to this point, Texas is in no way a fiscally ill state. It has a tax structure based upon solid principles and theory. And its tax structure has withstood the test of time.

Our Fiscal Policy Change Recommendations

Texas' tax system is certainly not perfect. During the debate of the past two-plus years Gov. Perry has been correct in not supporting tax reform plans—from a millionaire's tax to a payroll tax to an expanded corporate franchise tax—that would harm the state's job creation and economic growth. And Perry himself proposed a number of decent plans. Yet politicians in large numbers often can't see the forest through the trees. Building upon elements of Gov. Perry's recent proposals, we recommend the following changes to Texas' tax structure:

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[13] Ibid.

[14] One such study immediately comes to mind: George Zodrow, "Revenue Options for the State of Texas," 2004.

Table 10
Fiscal Policy Recommendations and Static Revenue Effects

Our Recommendation (Moderate)	Static Revenue Effect Estimate	Our Recommendation (Aggressive)	Static Revenue Effect Estimate
Reduce school district m&o propert tax rate ceiling from $1.50 to $1.25. Freeze future tax rate increases for all local taxing units.	-$3.0 billion	Reduce school district m&o propert tax rate ceiling from $1.50 to $1.25. Freeze future tax rate increases for all local taxing units.	-$3.0 billion
Abolish the corporate franchise tax.	-$1.9 billion	Abolish the corporate franchise tax.	-$1.9 billion
Reduce state general sales tax and motor vehicle sales tax rates from 6.25% to 6.00%.	-$0.6 billion	Reduce state general sales tax and motor vehicle sales tax rates from 6.25% to 5.75%.	-$1.2 billion
Broaden sales tax base to include almost all consumer and business services **(6.00%)**	+$4.2 billion	Broaden sales tax base to include almost all consumer and business services **(5.75%)**	+$4.0 billion
Raise cigarette excise tax from $0.41 per pack to $1.41 per pack.	+$0.8 billion	Raise cigarette excise tax from $0.41 per pack to $1.41 per pack.	+$0.8 billion
Net Static Revenue Effect	-$0.5 billion	Net Static Revenue Effect	-$1.3 billion

Sources: Static revenue estimates shown above are published figures taken primarily from either the state comptroller's office or state legislature sources. We have decreased the original estimated revenue gain of $4.3 billion from expanding the sales tax base due to our recommendation of cutting the rate.

Cut the Property Tax

First off, property taxes must be cut—that's our read on the court order. Total property tax revenues, as levied by school districts, counties, cities, and special districts, are increasing at a much faster rate than personal income, and there is virtually no means to limit growth other than the ineffective rollback process. Property tax liability owed to the nearly 4,000 local taxing units throughout Texas has been climbing due to the combined effect of three factors: the number of tax-paying units is growing (i.e., the number of homes and buildings is growing and therefore those homes and buildings make up a growing number of local tax-paying units), tax rates have been increasing, and the value of each unit being taxed has been increasing. We propose reducing and freezing the ceiling on the school district property tax for maintenance and operations from $1.50 per $100 of assessed value to $1.25 per $100. This reduction would cost an estimated $3.0 billion per year and would represent a decline in the property tax burden as a percentage of personal income from 4.6 percent to 4.1 percent, or 11 percent. A property tax cut has tremendous dynamic effects on a state's economy. As we will explain in the next section on the dynamic effect of tax changes, our research suggests that a cut of this magnitude would result in increased economic activity and an expansion of the overall tax base that would in due course increase personal income by some $57 billion (out of a current $709.4 billion) and total tax revenues some $5.6 billion.

It is critical, however, that once the property tax rate is cut, there must be limits on the future growth of local property taxes. Otherwise in time the property tax rate will slowly creep back up, year after year. The ideal way to accomplish this is not to cap annual growth of appraisals—as we have seen in California, this results in owners of properties with identical market values facing significantly different property tax burdens depending on the year of purchase. The solution is to freeze the property tax rate and never allow it to increase, just like what was done under Prop 13 in California.

In the long run, we would expect to see property tax revenues grow sufficiently fast for the revenue needs of cities, counties and special districts. In fact, given low property values and rapid immigration, property tax revenues should grow far faster than personal income.

Abolish the Corporate Franchise Tax

This albatross, the focus of so much of the attention of state legislatures, public policy experts and corporate tax accountants, is so chocked full of exemptions, deductions, credits and loopholes that it is projected to raise only $1.8 billion for the state in 2005. Many of Texas' largest companies completely avoid the tax simply by changing their corporate structure. Its revenue performance is volatile and its growth at best could be described as sluggish. On top of that, it is projected by the comptroller that more and more businesses will seek to avoid the tax and future revenues are projected to suffer for up to 20 years due to the accumulation of franchise tax credits since 1999.[15] The energy Texas companies must use up to either obey, evade or avoid this tax is terribly wasteful. We recommend simply abolishing the corporate franchise tax. We recommend this with the added benefit of knowing that once the tax is abolished it will be much more difficult to bring back, as opposed to the prospects of the tax rate rising again in the future if the tax rate were simply lowered today. Abolition of the corporate franchise tax would allow Texas to join the ranks of Nevada, South Dakota, Washington and Wyoming as states with neither a personal income tax nor a corporate income tax. The dynamic effects on the Texas business environment would be tremendous.

Cut the Sales Tax Rate by One-Quarter to One-Half Percentage Point

We advocate under our "moderate" proposal cutting the state sales and use tax rate and the motor vehicle sales and use tax rate from 6.25 percent to 6 percent; under our "aggressive" proposal we would cut the rate to 5.75 percent. When combined with local add-ons, this would reduce the rate in Houston from 8.25 percent to either 8 percent or 7.75 percent and improve Texas' national rank from 8th highest in the nation to 11th highest or 12th highest, respectively.

It's difficult to be at the top of all the state tax rankings, especially when you don't have a personal or corporate income tax! There's no shame in being 11th or 12th highest. For comparison purposes, Nevada, South Dakota, Washington and Wyoming, the four states currently without a personal or corporate income tax, impose state and local sales tax rates of 7.50 percent, 5.92 percent, 8.80 percent and 6 percent, respectively.

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[15] "Study: Unused Corporate Credits Will Reduce Future Revenue," by the Center for Public Policy Priorities and found in State Tax Notes, Tax Analysts, March 7, 2005.

A Revenue Option: Tax Amnesties

A beneficial tax increase? This is exactly what a tax amnesty is. The beauty of these programs is that they raise revenue not by burdening existing hard workers, but by giving those that have strayed off the straight and narrow a chance to get back on track. When they are coupled with tax cuts or tax simplification, tax amnesties are great.

Tax amnesties are a win-win for everybody. The tax burden on existing taxpayers is reduced, and those people caught in a web of deceit can voluntarily come back to the mainstream of law-abiding taxpayers. Critical programs can continue to be funded, fiscal solvency is restored, and with fewer scofflaws after the amnesty program, tax enforcement can be directed toward the hardcore tax evaders.

In the past two years, Texas has hosted two successful tax amnesty programs. SB340 imposed a 10 percent penalty for late filing and a 50 percent penalty for fraudulent filings of corporate property tax where previously there was no penalty for failure to report all property, plant, and equipment in tax filings. The bill allowed for an amnesty period that ran from the time Gov. Perry signed on June 20, 2003 until December 1, 2003, allowing business owners to come clean and file unreported property. The Texas Association of appraisal districts reported $2.11 billion of taxable property being added, resulting in an increase of over $58 million in additional tax revenue, an increase of 0.22 percent of the tax base. And this is not a one-time addition to revenue. This newly reported property will bring in additional revenue for years to come.

The second tax amnesty program was Project Pay-Up, which ran from March 11 through March 31, 2004. The amnesty applied to all state and local taxes administered through the state comptroller (essentially all taxes except property taxes and Public Utility Commission gross receipt assessments). The amnesty allowed tax evaders to pay up on late taxes without having to pay penalty fees or interest charges. The amnesty was also a huge success, bringing in a total of $438 million dollars (about 0.82 percent of the relevant tax base) versus a forecast of only $59 million by the state comptroller.

Texas' experience is not unique. We have studied some 75 state tax amnesties and have seen that these programs almost without exception bring in revenue far beyond expectations. We have calculated that the average tax-base weighted revenue increase of these programs is about 0.64 percent of the state's relevant tax base. True success stories include New Jersey, where in 1996 an amnesty program for all state taxes brought in the equivalent of 1.31 percent of their tax base. In 2003, a similar program in Illinois brought in $532 million, or 1.33 percent of their tax base. California had a successful amnesty program for tax shelter abuse in 2004, bringing in an amazing $1.34 billion.

The tax amnesty following the passage of SB 340 is an outstanding example of tax reform coupled with an amnesty program. Since there was previously no incentive to file property taxes under state law (other than integrity), honest businesses were paying more than their fair share. Now that the bill has created an incentive to file, an expanded tax base will provide long lasting revenues from all businesses, and the tax burden is evenly shared across all business, not just the honest ones.

Looking at the big picture, in high-tax states tax amnesty programs are only a short term palliative. Without tax reform, scofflaws, delinquents, and other non-compliers will soon be back to their old tricks. Faced with high and unfair taxes, sooner or later those being taxed feel ripped off and cheated. And, unfortunately, some of those disgruntled taxpayers may move to the dark side and become delinquents. Fortunately, Texas already imposes relatively low tax rates. However, if the state does go ahead with significant tax reform, it should consider whether another tax amnesty program would be appropriate.

Broaden the Scope of the Sales Tax

The second half of our effort to lower the sales tax rate and broaden its tax base consists of expanding the number of consumer and business goods and services subject to the tax.[16] In doing so we bring into the fold services, one of the fastest growing segments of the economy. While the taxation of business inputs has negative consequences, we feel the positive aspects of our proposal far outweigh the consequences. It's always better to have a broad tax base and a low rate than a small base and a high rate. A broad tax base with a low rate leads to less attempted evasion, avoidance and non-compliance. Such a broad based tax would have relatively little incentive effect and thereby revenue reduction.

Increase the Cigarette Excise Tax

Finally, we recommend increasing the cigarette excise tax per pack of cigarettes from $0.41 to $1.41. This would raise an estimated $800 million and move Texas' from having the 11th lowest cigarette taxes in the nation to having the 41st lowest (or 11th highest).

There is no better time than the present to make these changes. Nationwide, state tax revenue growth in the first quarter of 2005 increased at the fastest rate in more than 14 years.[17] The revenue situation in Texas looks just as promising, if not more so, fueling a $1.2 billion surplus ending the 2004-05 biennium driven by increasing sales and high oil and gas prices.[18]

Dynamic Effects Of Tax Changes

While our two proposals would result in static revenue shortfalls of $500 million to $1.3 billion, depending on the approach taken, there is no doubt that the dynamic effects of these changes would propel Texas' economy to a higher level, wiping out these projected shortfalls and leading to far greater solvency as time passes.

It is always difficult and often unbearably uncomfortable to project the dynamic effects of supply-side policy changes. Estimating what will happen as a consequence of a tax increase or tax cut is precarious to say the least. An accountant can always find comfort in his precision. But failing to estimate the dynamic consequences of a supply-side tax change will always be wrong. For my part, I'd rather be approximately correct than precisely wrong.

An understanding of incredible clarity was described by none other than John Maynard Keynes:

> "When, on the contrary, I show, a little elaborately, as in the ensuing chapter, that to create wealth will increase the national income and that a large proportion of any increase in the national income will accrue to an Exchequer, amongst whose largest outgoings is the payment of incomes to those who are unemployed and whose receipts are a proportion of the incomes of those who are occupied, I hope the reader will feel, whether or not he thinks himself competent to criticize the argument in detail, that the answer is just what he would expect—that it agrees with the instinctive promptings of his common sense.

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[16] For further discussion of which goods and services would be included, please refer to the comptroller's report referenced in: George Zodrow, "Revenue Options for the State of Texas," 2004.

[17] Nicholas W. Jenny, "2005 Opens with Strong State Tax Revenue Growth," *State Revenue Report*, The Nelson A. Rockefeller Institute of Government, June 2005.

[18] "Comptroller Strayhorn Reports $1.2 Billion Surplus…" Press Release, September 1, 2005.

Nor should the argument seem strange that taxation may be so high as to defeat its object, and that, given sufficient time to gather the fruits, a reduction of taxation will run a better chance than an increase of balancing the budget. For to take the opposite view today is to resemble a manufacturer who, running at a loss, decides to raise his price, and when his declining sales increase the loss, wrapping himself in the rectitude of plain arithmetic, decides that prudence requires him to raise the price still more—and who, when at last his account is balanced with nought on both sides, is still found righteously declaring that it would have been the act of a gambler to reduce the price when you were already making a loss."[19]

Below we have reproduced Table 10, this time including our estimates of the dynamic effects of our recommendations.

Table 10b
Fiscal Policy Recommendations and Static and Dynamic Revenue Effects

Our Recommendation (Moderate)	Static Revenue Effect Estimate	Our Recommendation (Aggressive)	Static Revenue Effect Estimate
Reduce school district m&o propert tax rate ceiling from $1.50 to $1.25. Freeze future tax rate increases for all local taxing units.	-$3.0 billion	Reduce school district m&o propert tax rate ceiling from $1.50 to $1.25. Freeze future tax rate increases for all local taxing units.	-$3.0 billion
Abolish the corporate franchise tax.	-$1.9 billion	Abolish the corporate franchise tax.	-$1.9 billion
Reduce state general sales tax and motor vehicle sales tax rates from 6.25% to 6.00%.	-$0.6 billion	Reduce state general sales tax and motor vehicle sales tax rates from 6.25% to 5.75%.	-$1.2 billion
Broaden sales tax base to include almost all consumer and business services (6.00%).	+$4.2 billion	Broaden sales tax base to include almost all consumer and business services (5.75%).	+$4.0 billion
Raise cigarette excise tax from $0.41 per pack to $1.41 per pack.	+$0.8 billion	Raise cigarette excise tax from $0.41 per pack to $1.41 per pack.	+$0.8 billion
Net Static Revenue Effect	-$0.5 billion	Net Static Revenue Effect	-$1.3 billion
Net Dynamic Revenue Effect within Two Years	+$4.5 billion	Net Dynamic Revenue Effect within Two Years	+$5.5 billion
Net Overall Effect	+$4.0 billion	Net Overall Effect	+$4.2 billion

Sources: Static revenue estimates shown above are published figures taken primarily from either the state comptroller's office or state legislature sources. We have decreased the original estimated revenue gain of $4.3 billion from expanding the sales tax base due to our recommendation of cutting the rate.

Case Study: Dynamic Effects Of A Property Tax Cut

Texas can learn a lot from the grass roots property tax revolt that swept California in the late 1970s, the results of which did propel California's economy to lower unemployment rates, greater housing values, and most of all, huge budget surpluses. This section, we hope, demonstrates just how powerful the dynamic effects of a significant tax reduction can be.

Residential and business property tax owners are taxed at levels previously unimagined, higher and higher levels each year…Property values are depressed…A cry for sanity rings out. No, this is not Texas in 2005, it was California in the late 1970s.

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[19] John Maynard Keynes, "The Collected Writings of John Maynard Keynes," (London: Macmillan Cambridge University Press, 1972).

In 1978, a force that had been building strength for several years finally brought a huge and dramatic change to the California economy. The public's frustration with high and rising state and local (particularly property) taxes found expression in the passage of Proposition 13—an initiative to limit state and local spending and taxation. In June 1978, Proposition 13 rolled the entrenched political establishment. Proposition 13 was a constitutional amendment that (1) set property taxes not to exceed 1 percent of a property's value (down from the 3.5 percent rate that existed at the time), (2) rolled assessed property tax values back to their 1976 levels, (3) allowed the base value to grow no more than 2 percent per year unless the property changed hands, and (4) required that all new or increased taxes be voted in by a supermajority of the electorate. Proposition 13 won in a landslide.

Following on Proposition 13's heels was an elimination of the state's inheritance tax, an indexing of the state's income tax, and an elimination of the state's business inventory tax. In 1979, Proposition 4 passed, locking the tax gains into place by requiring (1) spending to grow no faster than the sum of population growth and inflation and (2) all surplus revenues to be returned to the taxpayers.

In March of 1978, I (Arthur Laffer) wrote an economic analysis which was used by the United Organization of Taxpayers, detailing my support for the passage of Prop 13. This analysis included my forecasts of what the initiative's effects would be, and almost all were spot on. In the aftermath of this tax revolt the previously chronically depressed California enjoyed a remarkable economic resurgence, outperforming the nation in nearly every conceivable measure. Naturally, the state's high tax burden fell like a stone, from $124.57 to $95.19 just one year later. In 1977, California per capita personal income was 15 percent above the national average. Three years later, it was 18 percent above the national average. California's unemployment rate was 1.2 percentage points higher than the U.S. rate in 1977; in 1980 the California rate was lower than the national rate by 0.4 percentage points. Between 1978 and 1988 the number of jobs in California increased by 32 percent, twice the 16 percent increase in jobs nationwide. The population in California increased by 24 percent from 1978 to 1988, over twice the national increase of 10.7 percent.

And housing prices in the state soared. As we describe in our State Competitive Environment model, there is perhaps no better barometer for changes in the after-tax rate of return on assets than the price of the ultimate immobile factor: housing. In the second quarter of 1978, right before Proposition 13's passage, the median home price in California was $70,677, which was 7.4 times per capita personal income in the state and 21 percent more expensive relative to the U.S. Over the decade of the 1980s absolute and relative housing prices in California took off and never looked back. In the third quarter of 1981, the median home price in California was $108,455, or 8.1 times per capita personal income and 42 percent more expensive relative to the U.S. By the end of the decade, per capita personal income-adjusted housing prices in California were nearly double those for the U.S.

Given what transpired following Proposition 13's implementation, my forecast for a falling California tax burden might not seem particularly noteworthy. One must remember the times, however, and remember that this tax burden decline occurred in the face of critics' predictions that other taxes would have to be increased to offset the effects of Proposition 13.

Proposition 13 did what it was advertised to do. The historical record also shows that Proposition 13 did not have any long-term deleterious effect on the finances of the state's various levels of government. The Great California Tax Revolt more than paid for itself.

The private sector of the economy fared beautifully in the aftermath of Proposition 13, but opponents questioned whether this private sector success might have come at the expense of the public sector. They feared that post-Proposition 13 revenues would be absolutely gutted, forcing expenditure cuts well beyond the elimination of wasteful spending. Vital services, they said, would suffer, schools would have to close, fire and police protection would no longer be adequate. But the fears of citizens concerned about maintaining adequate levels of state and local government services were allayed very soon after the changes were enacted.

Let's first look at revenues. Proposition 13 passed on June 6, 1978, one month prior to the end of FY1978. State and local property tax revenues fell $5.0 billion, from $11.0 billion in FY1978 to $6.0 billion in FY1979, far short of the static revenue loss forecasts of $7 billion. In addition, this drop was largely offset by higher revenues in every other major tax category. Total state and local revenues fell by only $1.1 billion that first year.

Looking at the bigger picture, the combined state and local tax burden per $1,000 of personal income fell from $124.57 in FY1978 to $94.93 in FY1982, a 24 percent reduction. Yet in spite of the precipitous fall in the state's average tax rate, state and local revenues did not fall proportionately. In fact, total tax revenue grew by 19 percent from $27.4 billion in FY1978 to $32.5 billion in FY1982. The tax base expanded by more than enough to offset the reduction in tax rates. Even after adjusting for inflation, which can distort economic data during this high inflationary period, tax revenues fell much less than the reduction in the state and local tax burden.

Economic expansion and higher property values led to healthy property tax growth over the following years, and by FY1985 property tax collections were back to their FY1978 $11.0 billion level. The disruptive shortage of funds so widely anticipated never materialized.

Turning our attention to spending, total state and local direct general expenditures were not slashed between FY1978 and FY1979 as skeptics had predicted; in fact, expenditures increased 1.6 percent from $36.9 billion to $37.5 billion over this period. The tax reduction which had invigorated the state's economy so profoundly did not impose any significant reduction in government services.

The state's balanced budgets during this period reflect the remarkable success of combining lower tax rates and increased output, employment, and production with restrained spending.

If a significant property tax cut is implemented in Texas, an immediate effect will be a decrease in the after-tax cost of home ownership in Texas. As a result, demand for single-family houses will increase, and the market value of housing will rise. Higher property values, in turn, will spur new housing construction. Thus, in short order, the higher value of houses and the lower after-tax cost of home ownership will increase both the supply and demand for single family houses.

Table 11
Sluggish Residential Housing Price Appreciation in Texas
(through 1Q2005)

	Cumulative Price Appreciation		
	1-yr	**3-yr**	**5-yr**
Texas	3.8%	10.6%	23.0%
Austin	2.0%	4.8%	21.1%
Dallas	3.0%	9.1%	21.7%
Houston	4.4%	13.3%	26.4%
San Antonio	5.3%	13.8%	24.8%
California	25.4%	63.1%	103.0%
Florida	21.4%	51.2%	80.5%
New York	13.5%	40.9%	70.6%
Arkansas	7.0%	17.1%	27.6%
Louisiana	5.8%	17.1%	27.4%
Oklahoma	4.1%	14.1%	25.1%
New Mexico	9.4%	22.0%	30.7%
U.S.	11.6%	28.5%	46.6%

Source: Office of Federal Housing Enterprise Oversight

Similarly, the cost of rental housing will fall, and the supply of multi-family units will rise. Current rents reflect, in part, the rent versus-buy cost trade-off to the household and the alternative uses of capital for rental unit owners. Thus, the cost reduction of home ownership will reduce rents until the cost trade-off is restored. Just as important, the property tax rate cut will increase the after-tax rate of return on rental units. Since capital employed in rental housing is a close substitute for capital employed elsewhere, this increase will attract more capital and lead to the construction of more apartment units until the profitability of rental units returns to its market-determined equilibrium level. The increased supply of rental units also will cause rents to fall. Again, both the supply and demand for rental units will rise to a new equilibrium level.

Businesses also will be affected by the property tax cut. The after-tax cost of locating offices or plants in Texas will fall, thereby increasing demand for Texas real estate. And the after-tax returns to owners of commercial property will jump, leading to increased construction of commercial and industrial facilities.

Combined, the expected increase in supply and demand for residential and commercial construction will expand the property tax base in Texas significantly. Such a building boom will be but the leading edge in a surge of economic activity that will, in turn, produce more income, sales, and other tax revenues to the state and local governments. For example, higher levels of employment among construction workers and among workers in other businesses supporting the building industry will directly boost total income and sales levels in the Texas economy. In addition, the Texas economy will benefit by luring economic activity away from other states. With property taxes lower, other businesses will expand existing activities or locate new activities within the state, creating still more jobs, more investment, higher real wages, and a new, high equilibrium level of economic activity

Finally, this significant cut in property taxes can be expected to reduce significantly the level of government expenditure for social welfare programs. The improved economic performance of the state implies directly higher levels of employment and lower levels of state expenditures for unemployment, rent subsidies, aid to families with dependent children, and medical and other social welfare programs.

Our research allows us to estimate the impact of a property tax cut in Texas. A cross section of 20 states was analyzed for the impact of changes in property taxes on the relative growth in personal income. The 20 states with the largest property tax revenues according to state and local governments were used in the sample.

Theoretically, any increase in a marginal tax rate in one state relative to other states would slow economic activity and result in a lower aggregate personal income. Thus, the states with the largest increase in marginal tax rates would be expected to have the smallest growth in personal income over the 10-year period. Consistent data on marginal tax rates were not available, so changes in the level of the tax burden were used as a proxy for changes in tax rates. This analysis suggests that, on average, for each one-percentage point increase in the property tax burden, personal income drops about 16 percent below its no-tax increase level. Likewise, for each one-percentage point reduction in the property tax burden, personal income increases 16 percent above its no-tax-increase level.

Of course, there are many variables not quantified in this analysis—such as the differences in climates; average age of plant and equipment; skill of labor force; changes in tax burdens of neighboring states; and wide variations in the distribution of state and local expenditures among

such competing budget items as schools, police and fire departments, welfare and social services, unemployment compensation, and highways. But the results were nonetheless significant and impressive.

Our proposed property tax cut in Texas would lead to an 11 percent reduction in the total property tax burden, or a decline in property tax revenues from 4.56 percent to 4.13 percent of personal income. Therefore, we feel confident in forecasting that this one-half percentage point decline in the property tax burden in Texas would have the dynamic effect of eventually boosting Texas personal income by approximately 8 percent above and beyond where it otherwise would have been. Given our estimate that Texas personal income in 2005 will be $709.4 billion, and given that total state and local taxes in Texas equal approximately 9.8 percent of personal income, an 8 percent increase, or $57 billion, in personal income would result in a $5.6 billion increase in total state and local tax revenues over a period of years.

The increases in the property tax base, personal income, and other tax revenues would flow, in part, from improved allocations of existing capital and labor within Texas made possible by the reduction in the property tax wedge and increased incentives to work and invest. In addition, increased amounts of both capital and labor can be expected to flow to Texas from other states and abroad.

As a direct consequence of this growth in economic activity, social welfare spending should decline. The combined effect implies that Texas governments would, in short order, be back in surplus and that there is little cause for sharp reduction in spending, especially for such constitutionally mandated programs as schools and essential services such as fire and police protection.

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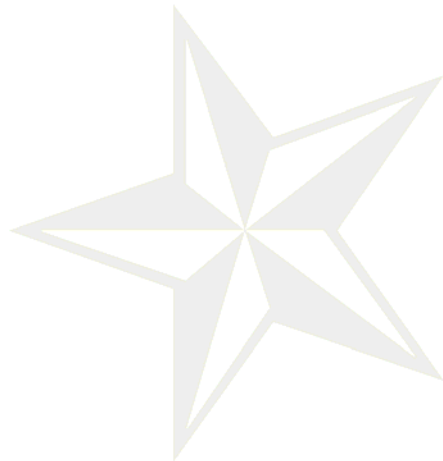
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About This Report

In this report, economists Stephen Moore, Arthur Laffer, and Donna Arduin describe the many factors that determine a state's economic outlook. Fully a quarter of a state's economic future is in its policymakers' hands through their fiscal and regulatory policies. States inevitably compete for economic activity, and those with low tax burdens and no income tax perform better economically than those with high taxes. In fact, low-tax states experience greater economic and population growth and those with no income tax enjoy greater fiscal stability.

Of the 50 states, Texas has the 19th best economic outlook according to the State Competitive Environment model developed by the authors. Texas earns high marks for recently reducing overall tax burden relative to personal income, for not levying personal income tax, and for low direct taxation on all forms of income. Additional high marks result from the reasonable level of government debt, the absence of a state minimum wage, and Texas' relatively low number of government employees.

Texas earns low marks, however, because of an above average property tax burden, a tort liability system that is still considered risky, and high costs of the workers' compensation system. The high property tax burden has significantly retarded the increase in Texans' home values compared to the rest of the nation.

The authors recommend five policy changes to boost Texas' economic outlook from good to rosy. First, cut school property taxes by 25 cents and freeze other property taxes. Second, abolish the state's corporate franchise tax. Third, cut the sales tax rate by one quarter to one-half percentage point. Fourth, broaden the sales tax. And fifth, increase the cigarette tax by $1 per pack.

The authors calculate that these recommendations would result in enough added economic activity that within two years Texas state government would see a net increase in yearly revenues of some $4.2 billion, even with the larger cut in the sales tax.