Taxing Texans:

A Six-Part Series Examining Taxes In The Lone Star State

by Richard Vedder, Ph.D.

Part 1

Executive Summary

It makes sense to pursue tax policies that can provide for essential government services while limiting the growth of government and increasing real income. Is instituting an income tax the best way for the Lone Star State to achieve that balance?

History shows that income taxes have been an important factor in the growth of state governments.

History shows that income taxes have been an important factor in the growth of state governments. The average overall tax burden (measured by taxes per $1,000 of personal income) rose by 37.2 percent in states that instituted an income tax in the past half-century, compared to 10.5 percent in states with no income tax. One reason for this is that the income tax takes in more revenue than other types of taxes, which translates into more government spending.

Income taxes also act as a significant drag on personal income growth. Real personal income growth was *more than twice as high* in low- or no-income tax states, compared with the states with the biggest increase in tax burden. Income taxes also have a clear effect on population growth, which helps fuels tax revenue.

But what about other forms of taxation – can they spur growth while raising the revenues necessary to provide essential government services? Studies show that sales taxes do significantly less economic damage than income taxes, while encouraging savings and investment, the primary engines of economic growth. By contrast, property taxes have a larger negative effect on personal income growth, though not as large as the damage done by the income tax.

What can we conclude from this comparison between different tax systems? Four principles become clear:

1. Keep the overall tax burden low and government expenditures modest.
2. Make relatively heavy use of sales and other forms of consumption taxation, and make little or no use of income taxation. Try to keep property tax burdens moderate as well.
3. De-emphasize a reliance on federal grants-in-aid.
4. As much as possible, charge user fees directly to those who use governmental services.

The Worst Tax For Texas?

Comparing Income, Property, Sales & Corporate Taxes

Does Texas need an income tax? To answer that question, you have to define what you want from a tax system. Everyone can agree that some taxation is necessary to pay for the cost of providing government services, including schools, roads, law enforcement, and social services. But providing those services must be balanced against the need to keep the rate of economic growth rising. It would be counterproductive to raise taxes to the point that the drop in personal income and the expansion of government costs lead to no or even negative economic growth.

Services must be balanced against the need to keep the rate of economic growth rising.

And tax policy certainly can affect growth. This was clearly established by economists Robert J. Genetski and Young D. Chin, who used a simple regression model to show that economic growth was negatively correlated with changing rates of state and local taxation.[1] I replicated and expanded upon their conclusion in two studies for the Joint Economic Committee of Congress in 1981 and 1995.[2] Meanwhile, other economists were showing how high taxation had an adverse impact on states or territories such as Illinois,[3] Puerto Rico,[4] and Massachusetts.[5]

So it makes sense to pursue tax policies that can provide for essential government services while limiting the growth of government and putting as much money as possible into the pockets of consumers. And that leads us back to our original question: **Is the income tax the best way for the Lone Star State to achieve that balance?**

1 Robert J. Genetski and Young D. Chin, "The Impact of State and Local Taxes on Economic Growth," Harris Bank, Chicago, IL, November 1978.

2 Richard Vedder, "State and Local Economic Development Strategies: A 'Supply Side' Perspective," Staff Study, Joint Economic Committee of Congress, Government Printing Office, Washington, DC, 1981; and "State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform," Joint Economic Committee of Congress, Washington, DC, December, 1995.

3 James A. Heins, *Illinois Growth Study*, University of Illinois, Urbana, IL, July 1976.

4 Victor A. Canto and Arthur B. Laffer, "Report to the Governor: Recommendations for Economoic Reforms in Puerto Rico," H.C. Wainwright & Co., Boston, MA, 1979.

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

Expanding Government

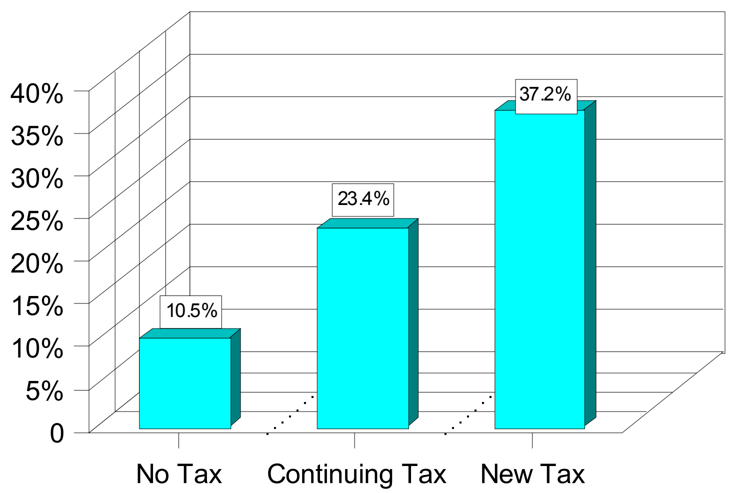
Texas certainly wouldn't be alone if it enacted an income tax. Forty states in the continental United States now have an income tax, and for 12 the enactment has been within the past 40 years. What has the effect been in these jurisdictions?

Not surprisingly, the cost of government has exploded in states that instituted an income tax in the past 40 years. Divide the 48 contiguous states into three categories: 1). those that had no income tax in 1957 and did not enact one in the following 40 years ("no income tax states"); 2). the 28 states that had an income tax already in 1957 and maintained it continuously ("continuing income tax" states); and 3). the 12 states that had no income tax in 1957 but enacted one over the next 40 years ("new income tax" states).

The cost of government has exploded in states that instituted an income tax in the past 40 years.

Figure 1-1 shows that the average overall tax burden (measured by taxes per $1,000 of personal income) rose by an astonishing 37.2 percent in the new income tax states, compared with a much more reasonable 10.5 percent in the no income tax states, while continuing income tax states had a tax burden rising 23.4 percent. The conclusion is the same looking at absolute increases in the tax burden. Taxes per $1,000 of personal income went up by an astonishing $30.46 in the states instituting income taxes – more than three times the much more modest $9.64 increase for those states that had no income taxes throughout the period.

Figure 1-1
Increase In Overall Tax Burden, 1957-97



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

Contracting Income

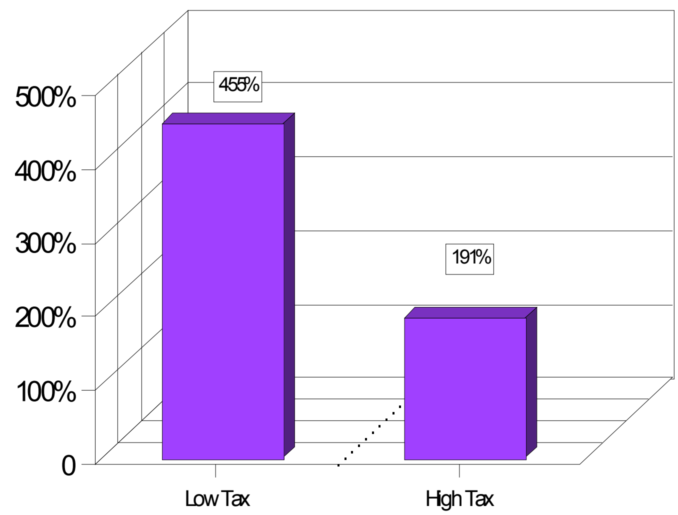
As income taxes are fueling the explosive growth of government, they also act as a significant drag on personal income growth. I compared the 10 states with the greatest income tax burden from 1957 to 1997 to the 10 states with the smallest increase in burden (in several cases, zero, as they had no income tax throughout the period).

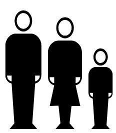
Income taxes are the fastest growing large tax revenue source of state and local governments.

The findings are startling: Figure 1-2 shows that real personal income growth was *more than twice as high* in the states raising their income taxes the least (or not at all), compared with the states with the biggest increase in tax burden. Most of that reflected larger population growth in the low or no income tax states. However, real income *per person* also grew faster on average in the low tax states, a group that, of course, includes Texas.

Figure 1-2

Growth In Income,1957-97, 10 States Raising, Lowering Income Taxes Most





Income taxes also have a clear effect on population growth, which fuels tax revenue. During the 1990s, some 2,849,310 people moved *from states with income taxes into states without income taxes.* That means that excepting Sundays, some 1,000 people moved into states without income taxes every day for nine years – more than the number of people who moved from East to West Germany during the Cold War.

It's clear, then, that income taxes tip the balance between economic growth and government growth, a balance that should be the objective of every tax system, for indeed income taxes prove to hinder growth and are thus counterproductive. But are there any alternatives? Can any other kind of tax raise the revenue required to run a modern government in a dynamic state like Texas?

Taxing Consumption

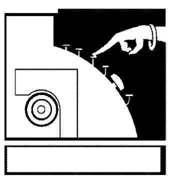
Income taxes are the fastest growing large tax revenue source of state and local governments, but general sales taxes still provide more revenue in many states. Of course, there are a wide variety of sales taxes among the 50 states, with several states having no general sales taxes at all (for example,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

Also, the sales tax base varies dramatically; some states, for example, exclude food and drugs.

States with no income taxes often have relatively high sales taxes.

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

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



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

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

Second, high sales tax rates are relatively more successful in states with large tourist and convention business, especially Louisiana, Florida, and Hawaii. These states in a sense export part of their tax burden to those living out of state by collecting revenues from those who only draw on government services in a limited way. The economic damage of sales taxes is likely to be higher in states like Iowa or Alabama, with relatively less tourist and convention business, than in states like Nevada and Louisiana which export much of the burden to conventioneers and tourists going to Las Vegas and New Orleans. The same principle applies to some extent with severance and production taxes on minerals: producers in Texas pay these taxes, some of which are passed along to out-of-state consumers in the form of higher product prices.

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

Paying for Property

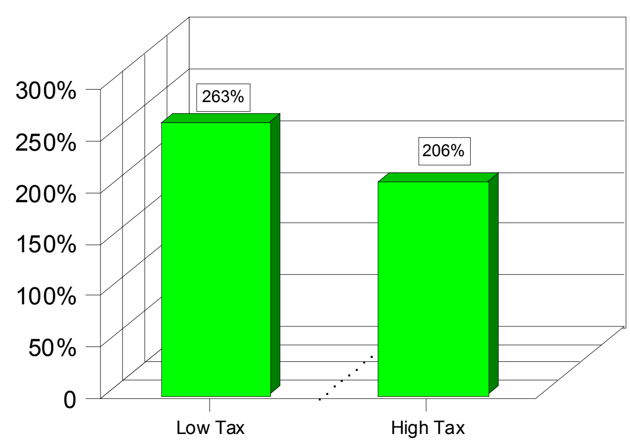
The most important source of revenue for local governments historically has been the property tax. Most jurisdictions finance a large part of their public school budget through property taxes, though recent attacks on the equity of property tax financing have led to the decline of the importance of the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

Again, I took the 10 states with the highest average property tax burden as a percent of personal income in the period 1957 to 1997, and compared them with the 10 states with the lowest average burden. As Figure 1-3 shows, property taxes have sizable adverse effects.

The 10 high property tax states (Maine, Massachusetts, Montana, Nebraska, New Hampshire, New Jersey, New York, South Dakota, Vermont, and Wyoming) had personal income growth of 206 percent, compared with 263 percent in the low property tax states (Alabama, Arkansas, Delaware, Kentucky, Louisiana, New Mexico, South Carolina, Oklahoma, Tennessee, and West Virginia). Texas was right in the middle (24th) in this ranking.

Figure 1-3

% Growth in Income, 1957-97,10 High,10 Low Property Tax States



I also did some more sophisticated analysis using several different regression equations to look at economic growth related to the three major taxes as well as other non-tax factors. In general, the results were stronger with respect to total personal income growth than to personal income growth per capita.[6] In most tests, the income tax had the most severe adverse impact on personal income growth, followed by the property tax (whose adverse impact on income growth, dollar for dollar, was about three-quarters as large as the income tax), and lastly by the sales tax, whose impact was negative but not very large in magnitude.

Other Tax Sources

There are other taxes and non-tax revenue sources that have economic effects. While space considerations prevent detailed examination, it's interesting to look at just a few of these other revenue sources. Again, my procedure was to look at the 10 states with the highest and lowest average use of the revenue source, as measured by the average of the source's share of personal income as of three years: 1957, 1977, and 1997. More sophisticated analysis is needed, but a few findings seem to hold: First, corporate income taxes have an adverse effect on the growth of total personal income over time, but not necessarily on per capita income growth. This implies that states with low corporate taxes have higher population growth. It is possible that low corporate taxes induce capital formation and investments, which in turn stimulates people to move into a state. On balance, Texas' policy of having relatively low corporate taxes is thus a pro-development move, although not so obvious as having low or no income taxes.

Texas' policy of having relatively low corporate taxes is thus a pro-development move.

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

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

---

[6] This is to be expected. Suppose a state is wealthy and thus attracts many migrants. The new arrivals may be less productive, even retired, than existing residents. The newcomers raise total personal income, but may actually lower personal income per person.

Fourth, states relying relatively heavily on fees and user charges tended to have higher growth. Correctly levied, a fee or user charge is a price for a government service, whereby the beneficiary of the government service pays. Good examples include university tuition fees or charges for use of public parks. Fees and charges attempt to use a market solution to finance activity rather than general taxpayer subsidy, and as such tend to be more efficient than taxes. The cost makes fee payers more conscious of the costs of the service and thus providing an incentive to reduce waste. This, of course, makes perfect sense: nothing is so little valued as when it's free.

Principles to Live By

What can we conclude from this comparison between different tax systems? Four principles become clear.

❶ Keep the overall tax burden low, since higher taxes fuel government growth, which almost always equals less economic growth. This means, of course, keeping governmental expenditures modest.

❷ Make relatively heavy use of sales and other forms of consumption taxation, and make little or no use of income taxation. States without an income tax should under no circumstances create one. Try to keep property tax burdens moderate as well.

❸ De-emphasize securing federal grants-in-aid, and especially do not engage in increased local spending in order to "match" federal funds.

❹ Use the benefit principle of public finance where appropriate, employing user fees or charges aggressively.

After all the tests are run and the results analyzed, the conclusion is clear: income taxes are nowhere near as efficient and effective as other forms of taxation, especially sales taxes. They harm income growth, discourage savings and investments, and fuel unproductive increases in the size of government. They are bad economic policy and bad politics, and Lone Star State lawmakers should say loud and clear to those who advocate them: **Don't mess with Texas.**

References

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

Genetski, Robert J. and Young D. Chin. 1978. "The Impact of State and Local Taxes on Economic Growth." Chicago: Harris Bank, November.

Heins, A. James. 1976. *Illinois Growth Study*. Urbana, IL: University of Illinois, July.

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

United States, Bureau of the Census. Various Years. *Census of Governments.*

__________________________. Various years. *Governmental Finances.*

__________________________. 2000. *Poverty in the United States: 1999.* Washington, D.C.: Government Printing Office. September.

Vedder, Richard. 1981. "State and Local Economic Development Strategies: A 'Supply Side' Perspective." Staff Study, Joint Economic Committee of Congress. Washington, D.C.: Government Printing Office.

__________________________. 1995. "State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform." Washington, D.C.: Joint Economic Committee of Congress, December.

About the Author

Richard Vedder is Distinguished Professor of Economics at Ohio University. Educated at Northwestern University and the University of Illinois, Dr. Vedder has served as an economist with the Joint Economic Committee of Congress and has taught at several other universities, most recently as John M. Olin Visiting Professor of Labor Economics and Public Policy at the Center for the Study of American Business at Washington University in St. Louis.

The author of more than 200 scholarly papers and articles and six books or monographs, Professor Vedder writes and speaks frequently on tax and other public policy issues. His commentary has appeared in such leading newspapers as the *Wall Street Journal*, *Christian Science Monitor*, *Washington Post*, *Investor's Business Daily*, *USA Today*, the *Chicago Tribune*, and the *Dallas Morning News*. He has also advised political leaders in more than 20 states and several nations on fiscal policy issues. His most recent books include: *Can Teachers Own Their Own Schools* (Oakland, CA: Independent Institute, 2000), and, with Lowell Gallaway, *Out of Work: Unemployment and Government in Twentieth-Century America* (New York: New York University Press, 1997).

About The Texas Public Policy Foundation

The Texas Public Policy Foundation is a 501 (c)(3)(h) non-profit, non-partisan research institute guided by the core principles of limited government, free enterprise, private property rights and individual responsibility. The Foundation's mission is to improve Texas government by generating academically sound research and data on state issues, and by recommending the findings to opinion leaders, policy makers, the media and general public.

The work of the Foundation is conducted by academics across Texas and the U.S. and is funded by hundreds of individuals, charitable foundations and corporations. The Foundation conducts no contract research and accepts no contributions to influence outcome of research. The public is demanding a different direction for their government and TPPF is providing the research that enables policy makers to chart that new course.

Materials published by the Texas Public Policy Foundation are for educational purposes only. The views of the authors are their own and do not necessarily reflect those of the Foundation. Nothing written herein is an attempt to aid or hinder the passage of any legislation.