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Texas Payroll Tax: Searching for New Revenues to Fund Public Schools

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Local property taxes fund a substantial portion of public education in Texas today. As the Texas Legislature provides property tax relief, a new source of education revenue must be found. This report examines the viability of creating a payroll tax to fund Texas public schools. Payroll taxes, the author finds, have proven damaging to businesses, employees, and citizens - increasing the cost of doing business, reducing employment, depressing wages, reducing economic competiveness, and obstructing economic growth. Consequently, many cities, states, and nations are reducing payroll taxes today. The report identifies how Texans would be adversely affected by a new payroll tax, based on information from STAMP, the Texas Public Policy Foundation's dynamic computerized program that projects the economic impact of tax changes.

I. Payroll Taxes: Use and Impact

Payroll taxes, in the form of mandatory contributions by employers, are used in most developed and developing countries to finance the provision of pensions, healthcare benefits for disability and maternity, and compensation for work injuries incurred by employees. In Europe, payroll taxes and other mandated contributions are as high as 30 percentof the payroll in countries such as Sweden, Belgium, France, and Italy. In contrast, in the less-regulated British and North American labor markets these contributions are between 15 and 20 percent

Numerous empirical studies on the effects of payroll taxes on the economy support theoretical ideas about the destructive nature of these taxes. Payroll taxes are a cost of production and are at least partially reflected in product prices. These taxes make labor more expensive and divert resources from more efficient uses. In his statement on "Payroll Taxes and Wage Subsidies" before the National Commission on Economic Growth and Tax Reform, Edmund S. Phelps claims that "… Repeatedly the economics profession has found evidence that the so-called incidence of such taxes fall preponderantly – indeed, virtually entirely – on the wage net of tax received by the

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employee. Recent research, reported in the 1994 monograph Structural Slumps (Harvard University Press) by Phelps, also finds a negative effect on employment – in particular, an increased unemployment rate.[1] The World Bank defines and explains payroll taxes as a "…tax on labor, and they tend to raise unit cost of production, which reduces competitiveness. This effect may have adverse consequences for the poor who rely on their labor as their primary asset. In the long run such taxes may encourage factor substitution away from labor and induce employers to curtail output."[2]

Despite their significant economic development costs, payroll taxes constitute a substantial portion of revenues in many countries. But many policymakers question the wisdom of relying so heavily on a tax that increases hiring costs and hobbles job and economic growth, especially in the wake of one of the worst employment slumps in the United States. Cuts in payroll tax are now seen as an instrument for encouraging job creation and job growth. Several U.S. cities and states are experimenting with payroll tax relief. Indiana has a program of tax credits, called Economic Development for a Growing Economy, that refunds state payroll taxes for 10 years. In 2001, the program helped attract 14 companies and nearly 5,600 jobs to Indiana.

II. Trend: Reducing and Eliminating Payroll Taxes

Meanwhile, several European nations have cut, or are poised to cut, payroll tax rates, including Belgium, Denmark, France and Germany. In Australia and Canada, state and provincial governments are cutting payroll tax rates to attract new industries. Developing economies are also wrestling with the job-suppressing effect of high payroll taxes, from Tanzania to Brazil. Brazilian President Luiz Inacio Lula de Silva proposed changing the way government finances worker pensions by shifting from corporate payroll taxation to a new tax on gross corporate revenue. This would not only eliminate hiring disincentives that lead many companies to hire "unregistered" workers, it would also boost overall employment. University of Texas labor economist Daniel Hamermesh estimates that cutting payroll taxes by 10 percentage points would increase U.S. employment by 3 percent in the short term and as much as 10 percent in the long term. Economists Adriana and Maurice Kugler find that "…a 10 percent increase in payroll taxes lowers employment by about 4 percent."[3] The federal deficit is expected to exceed $400 billion in 2004 and remain high for years, making such traditional job-creation options as straight tax cuts or spending hikes less feasible.

The opponents of heavy payroll tax burden propose tax shifting as a solution to the problem of finding the right balance between sufficient revenue to finance state programs and payroll taxation that only minimally hampers economic growth. Robert Walker believes that "…By lowering payroll taxes and offsetting them with other taxes, for example on undesirable natural resource consumption such as energy inefficiency or pollution, policymakers can profoundly change price signals that influence private-sector business decisions. Making labor relatively

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[1] http://www.columbia.edu/~esp2/taxcomm.pdf
[2] http://www.worldbank.org/poverty/safety/design/financing.htm
[3] credpr.stanford.edu/pdf/credpr134.pdf

cheap and natural resources relatively dear encourages a less natural resource-intensive, more human resource-intensive economy, creating far more jobs."[4]

This view is supported by academics who compare the effects of taxes that can be used as substitutes for payroll taxes. Researchers at the University of Aarhus, Denmark find "… perhaps somewhat surprisingly given the result that payroll taxes lead to more wage restraint than employment taxes, that more extensive use of employment taxes instead of payroll taxes, balancing the government budget, increases the level of employment and decreases unemployment."[5]

III. Texas Payroll Tax: Projecting the Cost

Beacon Hill Institute used the Texas CGE-STAMP model to measure the consequences of an introduction of a 1.25 percent payroll tax in Texas with the maximum tax amount per employee of a $500.

Table 1. Results of Instituting a Payroll Tax in Texas

	FY 2005	**FY 2006**	**FY 2007**	**FY 2008**	**FY 2009**
Employment	jobs	jobs	jobs	jobs	jobs
Change in employment	-8,062	-8,038	-8,028	-8,370	-8,433
Out of which: Private employment	-62,491	-64,070	-65,858	-69,097	-71,332
Government employment	54,429	56,032	57,830	60,727	62,899
% change in employment relative to baseline	-0.08%	-0.07%	-0.07%	-0.07%	-0.07%
Gross wage rates	$/wkr/yr	$/wkr/yr	$/wkr/yr	$/wkr/yr	$/wkr/yr
Change in wage rate, nominal $	-119	-120	-122	-124	-127
% change in wage rate relative to baseline	-0.29%	-0.28%	-0.28%	-0.28%	-0.28%
Investment	$m	$m	$m	$m	$m
Change in nominal investment ($m)	-185	-201	-221	-246	-276
% change in capital stock relative to baseline	-0.12%	-0.12%	-0.12%	-0.12%	-0.12%
State Personal Income, nominal	$m	$m	$m	$m	$m
Change in nominal SPI ($mn)	-2.254	-2.432	-2.640	-2.882	-3.178
% change in nominal SPI	-0.29%	-0.30%	-0.30%	-0.31%	-0.32%
Disposable Income, real	$m	$m	$m	$m	$m
Change in real DI ($mn)	-2.699	-2.875	-3.076	-3.372	-3.663
% change in real DI	-0.39%	-0.39%	-0.39%	-0.40%	-0.41%
Disposable Income per capita, real	$	$	$	$	$
Change in real DI/capita ($)	-101	-106	-112	-121	-129
% change in real DI/capita	-0.337%	-0.336%	-0.338%	-0.347%	-0.353%

[4] http://www.getamericaworking.org/press/StaffandCouncil/2003/ChicagoSunTimes_Walker_July52003Payrolltaxcutsneeded.htm
[5] http://www.econ.au.dk/afn/abstr97/08.htm

The findings confirm the dominating view that payroll taxes cause a reduction in employment and business activity. Private industries would lose between 62,000 and 71,000 jobs. Contrary to what could be expected, nominal average wages would decrease by a relatively small 0.3%, but, more importantly, real disposable income would fall by 0.4%. The tax would slow down investment and economic growth in Texas. In general, these results are in line with the results obtained by other researchers studying the effects of payroll taxes on the economy.