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Policy Brief

Texas Public Policy Foundation

State Fiscal Health: Diagnosis And Prognosis For Texas

An Examination Of Texas' Economic State

Synopsis by Byron Schlomach

The Texas Public Policy Foundation recently commissioned Stephen Moore, Donna Arduin, and Arthur B. Laffer to evaluate the state's fiscal health. Some serious problems were diagnosed by the economists. Texas' property tax is too high. The state's tort system is still perceived as presenting extra risk compared to most other states. The costly workers' compensation system also exerts an adverse economic impact. Nevertheless, Texas ranks 19th in economic outlook among the 50 states: a ranking which likely has much to do with the fact that Texas is the sixth fastest growing state in the nation today.

Most of what determines a state's economic health is outside its policymakers' direct control. However, fully a quarter of a state's economic health is determined just by state fiscal policy—spending and taxes. As much as 14 percent is determined by other state policies. Seventeen percent is determined by neighboring states' fiscal policies. Forty-four percent is determined by national and world economic trends.

Economically, the states are in competition with each other, a fact that state policymakers must bear in mind. State tax policies play a major role in a state's competitiveness and directly affect the profitability of developing a state's resources—which include its people. Excessive taxes and increasing taxes work to inhibit economic growth and well-being.

Uncertainty regarding tax policy, especially if it is likely changes will negatively impact business, reduces a state's economic competitiveness, thereby hurting investment and growth. This implies that recent legislative sessions in Texas, with the talk about payroll taxes, gross receipts taxes, business activity taxes, and "reformed" franchise taxes have hurt Texas' economy. On the other hand, Texas has implemented few significant tax changes over the last 15 years—stability that greatly helps the state's outlook.

Texas enjoys a significant advantage from being one of the nine states without a personal income tax. The presence of a state personal income tax is a sure way to hurt a state's economy. Compared to the nine states with the highest marginal personal income taxes, the nine states without a personal income tax showed over a decade: 16.2 percentage points greater output growth, 17 points more personal income growth, 10.1 points more job growth, 2.2 points more personal income per capita growth, and slightly lower unemployment.

The nine states with the highest personal income tax rates have experienced many more budget difficulties in recent years than the nine without personal income taxes. States with low or no personal income tax tend to have more stable budgets and fewer revenue shortages. This is probably because disciplined taxation leads to disciplined spending, making any shortages that might occur much more manageable. Texas has grown its budget over the last ten years at a rate 1.2 percent above inflation and population growth, a slow rate compared to most other states.

Texas also enjoys the advantage of being a relatively low-tax state. At $97.89 in state and local taxes per $1,000 of personal income, Texas has the 12th lowest tax burden among the states—a burden only 65 cents higher than the state with the 10th lowest burden.

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In comparing the ten states with the lowest tax burden to the ten states with the highest tax burden over ten years, the low-tax states: had 9.3 percentage points more output growth, 9.8 points more personal income growth, 6.4 points more population growth, 4.3 points more job growth, slightly higher personal income per capita, and a slightly higher unemployment rate.

The relatively slight differences in income per capita and unemployment between states with personal income taxes and those without, and between high-tax and low-tax states can be explained by the movement of people. In 10 years, high personal income tax states suffered out-migration while those with no personal income tax enjoyed in-migration. While high tax states suffered out-migration, low-tax states enjoyed in-migration. While the U.S. population increased 93 percent since 1950, Texas' population increased 189 percent. People vote with their feet—in droves—for low taxes and small governments.

Texas has the 13th lowest total state and local spending per $1,000 of personal income among the states, ranking just behind Florida. It has the 12th lowest state and local taxation per $1,000 of personal income. From 2000 to 2004, Texas cut state and local taxes by $0.26 per $1000 of personal income in absolute terms and $1.52 compared to the rest of the states. Texas' tax burden has also been relatively stable, ranging between fifth and 20th lowest in the nation since 1977.

By far, the two most important taxes in Texas are the property tax ($32.3 billion in local revenue) and the sales tax ($16 billion in state and local revenue). These relatively stable revenue sources, absent the volatile personal income tax, helps Texas avoid the instability inherent in other states' tax systems. This along with relative spending restraint means Texas, more than most states, is influenced by national economic trends. Texas has opted for long-term economic prosperity over larger state and local government.
The authors recommend five policy changes to boost Texas' already good economic outlook to a rosy one. 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 their recommendations would result in enough added economic activity that the state would see a net increase in yearly revenues of some $4.2 billion within two years—even if proposed sales tax reductions are enacted.

Due to school finance litigation, Texas might well be on the cusp of major tax reform. The direction chosen by the Texas Legislature in addressing this critical issue will impact Texans more broadly than just in the education system. It will also significantly determine the future of Texas' economy.

* This is not consistent with previous recommendations by Texas Public Policy Foundation's chief economist, Byron Schlomach..

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