I. FISCAL POLICY

Legislators' Guide to the Issues

State Tax System

THE ISSUE

Should the state tax system be reformed or entirely restructured? This question is hotly contested by the Texas Legislature, fueled by: an economic downturn, the resulting 2004 budget crisis, rising health care costs, demands to expand education funding, growing dissatisfaction with property tax rates, and increasing state reliance on local property taxes to fund public schools. Some policymakers claim the tax system is inflexible, fails to raise sufficient revenue, and unfairly burdens the poor because it depends on regressive sales taxes; they call for new, higher taxes – including a personal income tax. Others propose new taxes or want to raise old taxes to increase the state's share of education funding and decrease property taxes. Yet others suggest a complete overhaul is needed to improve the fairness and equity of tax burdens, particularly in the corporate sector.

The issue is complicated. First, property taxes are local, not state, taxes. State legislators can "buy down" rates that may provide temporary relief but, in the long term, legislators merely encourage local entities to raise property rates even higher, as was evident with tax "relief" enacted by former Governor Bush. Although property taxes are locally determined, state government has a real interest in property rates because rates strongly affect the state economy.

Second, the current tax system has served Texans well for decades. Revenue has kept pace with population growth and inflation. It has fallen short only when confronted by expansive spending on public schools and health care – particularly on Medicaid. State spending, not revenue, is the real problem.

Third, despite its strength, the state tax system could be improved. Businesses in Texas generally pay higher taxes than they would pay in many other states, and the tax burden is unequally shared among businesses. Texans pay higher property taxes per capita than residents of 34 other states, according to the Tax Foundation. Texas did not make the Tax Foundation's top 10 states for business tax climate in 2004. Lowering business and property taxes would bolster the economy and benefit all Texans.

Fourth, less than half of the total net revenue of Texas state government comes from taxes; the bulk of state revenue comes from federal monies and state fees (licenses, permits, and fines). Changing the proportional amount of state tax revenue will exert far-reaching economic impact.

THE FACTS

- ☆ Texas' overall fiscal status is ranked 4th nationally by the 2003 *Tax Foundation's State Business Tax Climate Index*
- ☆ Texas has the 2nd lowest state debt per capita in the nation
- ☆ Only 9 states have a higher state obligation bond rating than held by Texas
- ☆ At 8.1 percent, Texas ranks 45th lowest in the nation for state and local taxes as a percent of gross state product
- ☆ Texas has the 3rd lowest state tax collection per capita in the nation
- ☆ Average annual tax growth from 1992-2002 was 3.41 percent in Texas, compared to the national average growth of 3.07 percent
- ☆ Inflation-adjusted state revenues per capita from tax collections rose over 77 percent from 1978 to 2003
- ☆ Sales and general use taxes represent 50.8 percent of state tax collections – only 1 other state relies more highly on sales and use taxes than Texas
- ☆ Tax revenues represent only 44.8 percent of total net revenue for state government
- ☆ Other states' experiences demonstrate higher taxes mean lower economic growth
- ☆ In 2001, if Texas had the national average tax burden, family income would have been $1,724 lower for a family of four

RECOMMENDATIONS

- ☆ Prioritize state spending and increase efficiency of health care and education spending
- ☆ Increase tax equity and decrease the overall tax burden
- ☆ Introduce revenue-neutral reforms to lower state reliance on property taxes for education funding. A modest shift from the property tax to a sales tax on consumer items could positively impact employment, personal income, and state gross regional product
- ☆ Enact tax reforms cautiously and incrementally

RESOURCES

- *Effective, Efficient, Fair: Paying For Public Education In Texas* by Richard Vedder, Texas Public Policy Foundation, February 2004 (http://www.texaspolicy.com/pdf/2004-02-25-vedderhall-all.pdf)
- *Taxing Texans: A Six-Part Series Examining Taxes In The Lone Star State* by Richard Vedder, Texas Public Policy Foundation, September 2002 (http://www.texaspolicy.com/pdf/2002-02-28-tax-taxingtexans1.pdf)
- *Follow The Money: A 50-State Survey Of Public Education Revenues And Spending* by Chris Patterson, Texas Public Policy Foundation, October 2003 (http://www.texaspolicy.com/pdf/2003-10-22-sf-followmoney.pdf)
- *Weighing The Difference: An Evaluation Of The Unequal Burden Of State Taxes For Texas Businesses* by Milton H. Holloway, Texas Public Policy Foundation, May 2004 (http://www.texaspolicy.com/pdf/2004-05-sf-mh-weighingdifference.pdf)

Tax Reform Modeling: TEXAS-STAMP

THE ISSUE

Texans spend 8.7 percent of their annual income paying local and state taxes; residents of only four other states pay less, according to the Tax Foundation (*America Celebrates Tax Free Day*, 2004). Businesses, however, pay 18 percent of capitol income for local and state taxes, paying more than businesses in 14 other states, according to Ernst and Young (*Total State and Local Business Taxes*, 2004).

The issue is complicated. First, property taxes are local, not state, taxes. State legislators can "buy down" rates that may provide temporary relief but, in the long term, legislators merely encourage local entities to raise property rates even higher, as was evident with tax "relief" enacted by former Governor Bush. Although property taxes are locally determined, state government has a real interest in property rates because rates strongly affect the state economy.

The relatively low tax burden shouldered by taxpayers and businesses has enabled Texas to weather fiscal crises that have challenged most other states and to achieve a ranking of 4th best of 50 states in the Tax Foundation's Fiscal Balance Index.

While the state tax system has served Texas well, producing revenues that keep pace with inflation and population growth, it can be improved. It is clear that the corporate tax climate could be made more competitive with that of other states.

To help state leaders make informed decisions about tax reform, the Texas Public Policy Foundation developed the Texas State Tax Analysis Modeling Program (Texas-STAMP, produced by Beacon Hill Institute of Suffolk University). Accessed through the Internet, this computer-based model provides highly detailed information of the economic effects over time about a wide variety of state tax changes.

THE FACTS

- ☆ State-level tax increases have significantly negative effects on state economic activity
- ☆ The potential impact of proposed tax changes can be quantified by a computable general equilibrium model, such as Texas-STAMP
- ☆ Texas-STAMP can estimate the impact of implementing or changing the following state forms of taxation: sales, gross receipts, franchise, business activity, motor fuels, motor vehicle, personal income, cigarette, professional services for personal and corporate use, and property
- ☆ Texas-STAMP will estimate how tax reforms impact: gross wage rates, numbers of private and government jobs, disposable real income, and revenues generated by other state and local taxes

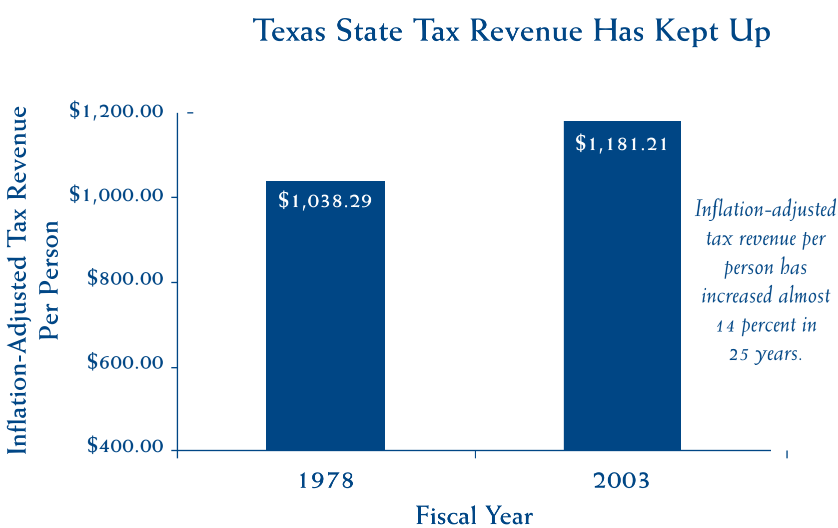
- ☆ For example, Texas-STAMP shows that job loss could exceed 500,000 and real disposable income would decrease by 2 percent if Texas enacted a state income tax with a 2 percent tax rate for income less than $10,000, 3 percent for $10,000-$75,000, and 4 percent for above $75,000

RECOMMENDATION

- ☆ Legislators should seek alternative measures of the quantifiable effects on taxable activities before tax reform is enacted to ensure that reform has a positive economic impact

RESOURCE

- *Texas-STAMP (State Tax Analysis Modeling Program): A Sophisticated Tax Model For Texas*, developed by the Beacon Hill Institute at Suffolk University, Texas Public Policy Foundation, March 2004 (http://www.texaspolicy.com/pdf/2004-03-10-stamp.pdf)



Sales Tax

THE ISSUE

Sales tax reform is widely proposed as the primary means to increase state revenue and improve tax fairness in Texas and throughout the nation. Without a personal income tax, Texas relies on sales taxation as the primary source of state tax revenue. Heavy reliance on sales tax, a tax that is both stable and elastic, has enabled Texas to weather economic downturns without enacting draconian reductions that other states depending on revenue from personal and corporate taxes have found necessary. As a tax on consumption, sales taxes have a less adverse impact on economic growth than taxes on production, such as the personal income tax or franchise tax.

However, many argue that the sales tax tends to be regressive; it burdens lower income people more than the affluent – although opinion polls indicate people prefer a tax on sales to a tax on income. Additionally, sales taxes are not uniformly levied for either businesses or consumers; some goods and services in Texas are exempt from the sales tax.

Proposals to expand the sales tax base to include more items of consumption could allow the tax rate to be reduced while increasing sales tax revenue as well as tax fairness. However, items of production should be excluded from any expansion of the sales tax base to prevent tax pyramiding. Piling taxes on taxes increases the cost of doing business, drives up consumer prices, depresses production, reduces capital investment, shrinks job creation, lowers wages, and, ultimately, results in lower state revenue.

Proposals to reform the sales tax by significantly raising the rate or reforms that result in a higher overall tax burden will result in economic harm. Alternatively, revenues raised from a tax base expansion to lower rates on the sales tax – or to reduce or eliminate taxes with more adverse economic impact, such as the franchise and property taxes – would likely enhance economic growth in Texas.

THE FACTS

- ☆ Texas' 8.25 percent sales tax rate, a combination of the state and maximum local rate, is the 14th highest sales tax rate in the nation
- ☆ Combined, sales and use taxes make up 51 percent of total state tax collections
- ☆ Texas' sales tax revenues rose over 87 percent from 1990-2000
- ☆ Sales taxes exert the least adverse economic impact of all forms of taxation
- ☆ Economic modeling suggests that shifting $5.6 billion of revenue in Texas from property taxes to an expanded sales tax, applied only to items of personal

consumption, could result in positive impacts on employment, personal incomes, and the state gross regional product.

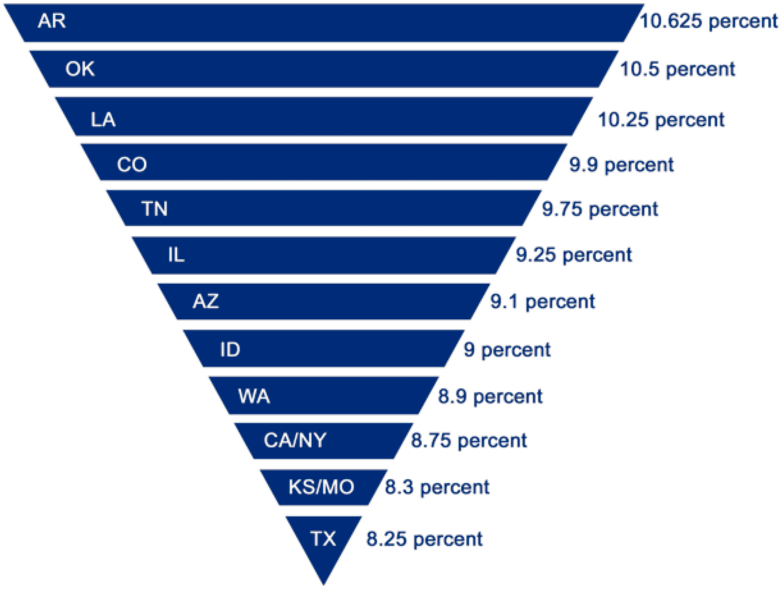
RECOMMENDATIONS

- ☆ If policymakers determine that additional revenues are required, expansion of the sales tax base coupled with reductions in the rate and/or reductions in business taxes should be enacted
- ☆ Any expansion of the sales tax base should be modest
- ☆ Sales tax reform should resist raising the tax rate
- ☆ Sales tax reform should result in revenue neutrality – the overall tax burden should remain unchanged or be lowered

RESOURCES

- *Effective, Efficient, Fair: Paying For Public Education In Texas* by Richard Vedder and Joshua Hall, Texas Public Policy Foundation, February 2004 (http://www.texaspolicy.com/pdf/2004-02-25-vedderhall-all.pdf)
- *An Economic Analysis Of Property Tax Relief Funded By A Sales Tax Increase* by Milton L. Holloway, Texas Public Policy Foundation, April 2004 (http://www.texaspolicy.com/pdf/2004-04-sales-property-tax.pdf)

Other States Have Higher Consumption Taxes Than Texas



Property Taxes

THE ISSUE

Property taxes are at the center of the tax reform debate because there is a close relationship between property taxes, the state economy, and public education. Unlike many other states', Texas' property taxes are levied entirely at the local level. From 1989 to 2000, property taxes increased 367.1 percent. This increase, primarily driven by demands from Texas public schools for increased funding, has fueled calls for property tax relief. Today, Texas' property tax burden is one of the highest in the nation and adversely affects economic development. How can Texans reduce property taxes?

The issue is complex. Local property taxes serve as the primary revenue for Texas public schools. Funding is shared by the state, the federal government, and local communities. The portion of school funding that the state provides has declined over the past decade and is projected to fall to 36 percent in fiscal years 2004 and 2005. Growing reliance on local property taxes to underwrite the major portion of public education has fueled legal challenges from more than 300 school districts. Some districts challenge the state's use of local property tax revenues to achieve funding equity by redistributing funds from property-wealthy districts to poorer districts, a practice known as "Robin Hood." Some districts argue that the state's reliance on local property tax revenues for public schools violates the constitutional prohibition against a state property tax.

Should the state reduce reliance on local property taxes and shoulder the greater share of school funding? This question is particularly difficult because research has demonstrated that a higher portion of local funding corresponds to improved student outcomes. Should the state eliminate Robin Hood? Questions about property tax reform open the door on a long history of school finance case law. Should the state lower local property tax rates to ensure the state's reliance on property tax revenues does not violate the constitutional prohibition against a state property tax? Should the state shoulder fiscal responsibility for educational equalizing now provided by local property tax revenues? All of these questions presume the collection of additional state funds for public education.

Policymakers are looking at property tax reform from several different perspectives. Some policymakers propose "buying down taxes" to offer property tax relief. However, this approach, as shown by tax reforms championed by former Governor Bush, likely will offer little or no relief and will, in the long term, merely encourage local taxing entities to raise property tax rates ever higher. Some policymakers have proposed creating a "split roll" property tax in which the state levies property taxes on business and local entities continue to levy taxes on residential property. Offering no clear economic advantage, this approach has gained little political purchase. Other policymakers propose sales, payroll, and business activity taxes to underwrite the cost of reducing state reliance on local property taxes and providing tax relief; these proposals are also examined in other sections.

Property tax reform raises fundamental, critical questions about the role of state government. If property taxes are levied locally, should the state "buy down" rates? In other words, should the state raise state taxes to lower local taxes? Is it proper for state government to cap local government tax rates? Lastly, should the state have greater control over property tax rates because high rates harm the state economy and all Texans?

Property tax reform also provokes equally important and critical economic questions. How can the state produce additional education revenues without raising the total tax burden on individuals and businesses? How can Texas introduce property tax reform in a way that will help, not injure, the state economy?

THE FACTS

- ☆ Texas ranks as the 15th highest state in the nation for local property tax collections per capita, according to the Tax Foundation
- ☆ Property taxes raise more money in Texas than any other tax, including sales taxes
- ☆ From 1989-2000, property taxes increased 367.1 percent for Texans
- ☆ School taxes represent more than 60 percent of Texans' property taxes
- ☆ Between 1997 and 2001, school property taxes paid by Texas businesses increased 38 percent while property values increased only 28 percent
- ☆ Texas businesses pay a 10 percent higher share of revenue from property taxes than the national average for businesses
- ☆ Only 12 states, including Texas, do not levy a state property tax
- ☆ Only Illinois surpasses Texas in reliance on property taxes to fund public education

RECOMMENDATIONS

- ☆ Maintain local property taxes as the primary source for education funding
- ☆ Increase the uniformity and fairness of property tax rates
- ☆ Enact property tax reform secondary to increasing the efficiency of school spending
- ☆ Create a state property tax only if educational accountability were increased by public school choice
- ☆ Substituting $1 billion in new sales tax for $1 billion in property tax would likely have a modestly positive impact on the economy

RESOURCES

- *Putting The Sides Together: Twelve Perspectives On Texas Public School Finance* edited by Chris Patterson, Texas Public Policy Foundation, December 2003 (http://www.texaspolicy.com/PTST/)
- *Splitting The Difference: Residential And Business Property Taxes In Texas* by Byron Schlomach, Texas Public Policy Foundation, January 2004 (http://www.texaspolicy.com/pdf/2004-01-26-sf-splitroll.pdf)
- *Effective, Efficient, Fair: Paying For Public Education In Texas* by Richard Vedder and Joshua Hall, Texas Public Policy Foundation, February 2004 (http://www.texaspolicy.com/pdf/2004-02-25-vedderhall-all.pdf)
- *The Lack Of Competition In Delinquent Property Tax Collections* by Byron Schlomach with Aaron Gibson, Texas Public Policy Foundation, May 2004 (http://www.texaspolicy.com/pdf/2004-05-sf-tax-delinquency.pdf)
- *Follow The Money: A 50-State Survey Of Public Education Dollars* by Chris Patterson, Texas Public Policy Foundation, October 2003 (http://www.texaspolicy.com/pdf/2003-10-22-sf-followmoney.pdf)

Corporate Taxes

THE ISSUE

High state and local taxes are discouraging creation and expansion of businesses in Texas. Businesses pay taxes in many forms – franchise, sales, property, and severance – and, combined, the total tax burden for businesses in Texas far exceeds that paid by businesses in many other states. In particular, property and sales taxes paid by Texas businesses are significantly higher than the national average.

Because businesses move from high to low-tax states, the state tax system exerts an adverse impact on consumer prices and choices, job creation, increased wages, and quality of life improvement for all Texans.

The problem is not just high taxes. High taxes are coupled with unequal tax burdens for different types of businesses. The franchise tax is not levied on corporate "partners" whose corporate franchise resides outside the state. Nor does it reach the profits of corporations that technically pay all their profits to out-of-state corporations as fees for the use of logos. The tax system exerts strong economic disincentives on capital-intensive businesses. The franchise tax, property taxes, and sales taxes fall more heavily on capital-intensive businesses (such as manufacturing) than on labor-intensive businesses (such as service and retail). The observable decline in Texas manufacturing during the 1990s can be partly attributed to the penalties levied on capital investment.

THE FACTS

- ☆ Texas businesses pay 55.3 percent of state and local tax revenues, a share far exceeding the national average of 42.6 percent
- ☆ The property tax burden is 9 percent higher for Texas businesses than the national average and 6 percent higher for sales taxes
- ☆ Businesses pay a higher share of taxes than individuals pay in Texas
- ☆ Businesses with the highest tax burden in Texas pay more than twice the taxes paid by those with the lowest burden
- ☆ Wholesale, retail, and service businesses in Texas pay less in taxes than businesses in industries such as construction, agriculture, mining, and manufacturing
- ☆ During the 1990s, capital per unit of labor in Texas manufacturing grew at less than half the national rate
- ☆ Texas ranked 13th nationally in the 2004 Tax Foundation's *Business Climate Index*

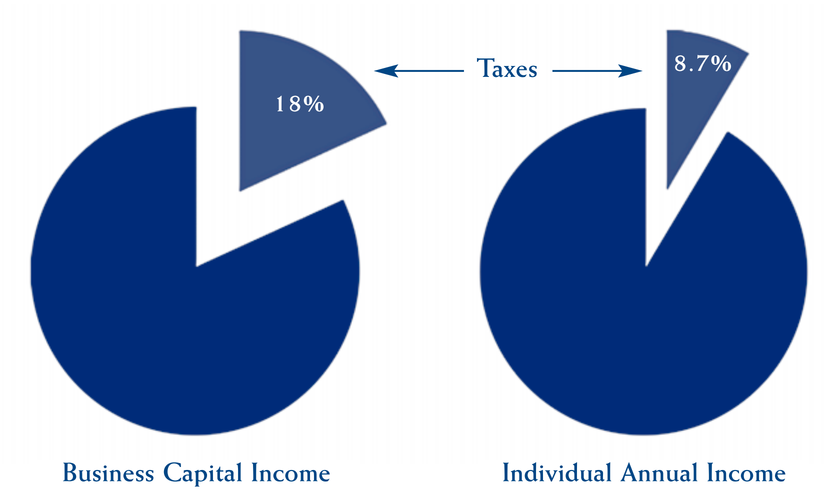
RECOMMENDATION

★ Reduce and equalize the overall corporate tax burden

RESOURCE

- *Weighing The Difference: An Evaluation Of The Unequal Burden Of State Taxes For Texas Businesses* by Milton H. Holloway, Texas Public Policy Foundation, May 2004 (http://www.texaspolicy.com/pdf/2004-05-sf-mh-weighingdifference.pdf)

Texas Businesses Pay More Than Their Fair Share



Income Tax

THE ISSUE

Some policymakers propose establishing an income tax to provide increased revenue for expanding government services. Advocates of the personal income tax claim that Texas' tax system is a "three-legged stool," but the third leg – an income tax – is missing. They claim the absence of an income tax prevents Texas from raising sufficient revenue and that current revenue sources are inflexible while spending needs grow. Although these claims are largely unfounded – as described in other sections – demands to increase state funding for health care and education stimulate periodic discussions about the efficacy of the income tax.

While it is certainly true that an income tax would increase state revenues, the adverse economic impact heavily outweighs what some may identify as its benefit. In fact, the absence of an income tax has been the primary reason for Texas' prosperity in recent decades. The experience of states with income taxes demonstrates that income taxes are particularly pernicious in their adverse economic impact. This experience is mirrored internationally; analysis of 23 other nations indicates the increase in revenue raised by taxing income has a direct and negative correlation with economic growth. The overall tax burden increases more rapidly in states with taxes on income, and state spending in income tax states exceeds that of states without an income tax, as income taxes raise state revenue.

Despite the interest of some policymakers, few Texans support creation of an income tax. In a 2003 poll of Texas voters, only 17 percent favored establishing an income tax.

THE FACTS

- ☆ Texas is one of six states without a personal income tax
- ☆ Twelve states that implemented income taxes during 1957-1999 experienced an average 37.2 percent overall tax increase, compared to 10.5 percent in states without income taxes
- ☆ States with income taxes spend more than states without an income tax
- ☆ Of all forms of taxation, taxes on income exert the most adverse economic impact – depressing capital investment, production, business expansion, job creation, wages, and living standards
- ☆ Income taxes encourage government to "crowd out" more productive economic activity
- ☆ In 2003, 76 percent of Texas voters stated they oppose establishing a state income tax

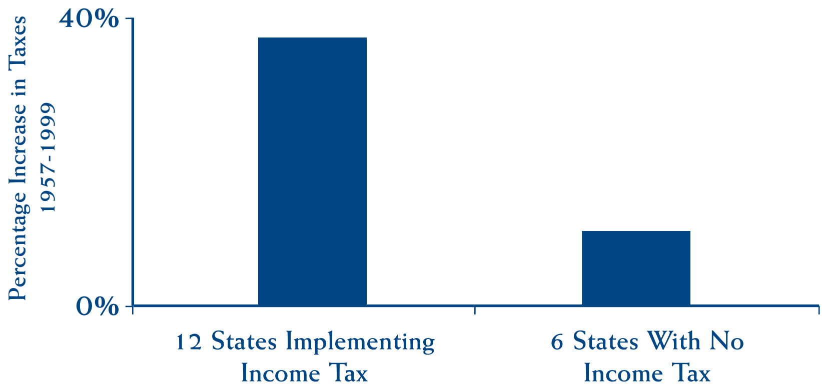
RECOMMENDATION

☆ Do not create a personal income tax

RESOURCES

- *Taxing Texans: A Six-Part Series Examining Taxes In The Lone Star State* by Richard Vedder, Texas Public Policy Foundation, September 2002 (http://www.texaspolicy.com/pdf/2002-02-28-tax-taxing-texans1.pdf)
- *Effective, Efficient, Fair: Paying For Public Education In Texas* by Richard Vedder and Joshua Hall, Texas Public Policy Foundation, February 2004 (http://www.texaspolicy.com/pdf/2004-02-25-vedderhall-all.pdf)

Taxes Rise Faster In States With Income Taxes



Business Activity Tax

THE ISSUE

Proposals to increase state revenues by introducing a business activity tax (BAT) in Texas should be carefully considered. The attractiveness of a BAT must be weighed against its potential for harming the state economy and adversely impacting public education.

Advantages:

- ☆ Potential replacement for the franchise, property, and severance taxes
- ☆ Universality of application and fairness
- ☆ Minimal economic distortions
- ☆ Simplicity
- ☆ Producing revenue necessary to eliminate "Robin Hood"

Disadvantages:

- ☆ Potential for increased spending
- ☆ Negative effect on economic growth
- ☆ Increased costs for businesses
- ☆ Lack of transparency for taxpayers
- ☆ Possibly unstable revenue

THE FACTS

- ☆ The BAT is a rare form of taxation in the U.S.
- ☆ In Michigan, the state with the largest-scale implementation of a BAT in the United States, the BAT is being phased out after a decade of mediocre economic results
- ☆ In Europe, the BAT corresponds to continuous and growing economic stagnation
- ☆ Increased government spending is bad for the economy – each new dollar of state spending means one less dollar of private-sector spending
- ☆ Higher levels of student performance in Texas public schools are directly proportional to the percentage of local funding
- ☆ Because a BAT would apply to all forms of business, a BAT would be more fair than the current tax structure and remove economic disincentives for more heavily taxed industries, such as manufacturing
- ☆ A BAT has the potential to significantly increase state revenue – a 1 percent BAT on the private sector could raise $4 billion

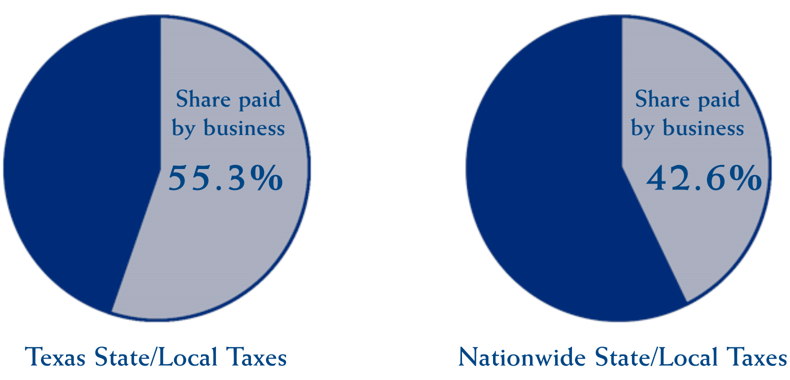
RECOMMENDATIONS

- ☆ The dynamic economic impact of BAT and experiences of both Michigan and Europe caution against large scale tax reforms for Texas
- ☆ State tax reform should reflect Texas' long term goals – economic growth, not simply increasing state revenues, should guide decision-making

RESOURCE

- *The Business Activity Tax: Is The BAT A Homerun Or A Strikeout?* by Richard Vedder and Byron Schlomach, Texas Public Policy Foundation, March 2004 (http://www.texaspolicy.com/pdf/2004-03-19-BAT.pdf)

Texas Businesses Bear A Larger Share Of Taxes In Texas Compared To The National Average



Payroll Tax

THE ISSUE

Proposals to increase state revenues by introducing a payroll tax in Texas could damage the state's economy by discouraging businesses, particularly labor-intensive businesses, from moving to or expanding in Texas.

Economic activity is directly, strongly affected by corporate taxes. Businesses, as well as wage earners, move from high to low tax states.

Today, businesses pay higher taxes in Texas than in 24 other states, according to the Tax Foundation. Instead of adding new corporate taxes, such as the payroll tax, Texans should reduce corporate taxes to increase economic prosperity.

THE FACTS

- ☆ A payroll tax increases costs of production, lowers wages, encourages hiring of unregistered workers, and increases unemployment
- ☆ Cuts in payroll taxes instituted in other states and nations have spurred economic prosperity with job creation and job growth
- ☆ Introduction of a 1.25 percent payroll tax in Texas with a maximum tax of $500 per employee would result in:
  - 62,000-71,000 private-sector jobs lost
  - 0.3 percent reduction in average wages
  - 0.4 percent decrease in real disposable income
- ☆ Businesses in Texas already pay 56 percent of state tax revenue, 13.4 percent higher than the average national share, according to Ernst & Young's *Total State and Local Business Taxes* (2004)

RECOMMENDATIONS

- ☆ A payroll tax should not be introduced in Texas
- ☆ Policymakers should balance the need to finance state programs with a tax structure that encourages economic growth

RESOURCES

- *Texas Payroll Tax: Searching For New Revenues To Fund Public Schools* by John Barrett, Texas Public Policy Foundation, May 2004 (http://www.texaspolicy.com/pdf/2004-05-sf-payrolltax.pdf)
- *Weighing The Difference: An Evaluation Of The Unequal Burden Of State Taxes For Texas Businesses* by Milton L. Holloway, Texas Public Policy Foundation, May 2004 (http://www.texaspolicy.com/pdf/2004-05-sf-mh-weighingdifference.pdf)

Projected Results Of A Payroll Tax:

- 62,000 to 71,000 jobs lost
- 0.3 percent drop in average wages
- 0.4 percent drop in real disposable income

Texas Fair Tax

THE ISSUE

Texans are displeased with the state's current tax system, especially when it comes to property taxes. Though property taxes are levied at the local level, school property taxes are widely considered a state issue and Texans are demanding change. Many alternatives to the current property tax have been considered. One alternative being considered is to broaden the applicability and increase the rate of the state's existing sales tax.

An even broader and bolder concept is to transform the Texas tax system into something more akin to the "Fair Tax" proposed at the national level. This proposal would replace all federal taxes with a single, nationwide sales tax levied on all final consumer purchases of goods and services.

A Texas Fair Tax could take many forms. The national Fair Tax proposal has as its major end the elimination of the national income tax. A Texas Fair Tax would at least replace a major portion of the school property tax that funds daily operations, as well as virtually all of the state's other taxes, including the corporate franchise tax.

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

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

The most modest econometric modeling results show that investment in the state would increase over current projections by a fifth in five years. Employment would not grow as quickly as currently projected, but employment growth would be put on a path to likely surpass what would otherwise occur in ten years. Real disposable income would exceed current projections by 2 to 3 percent.

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

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

THE FACTS

- ☆ In Texas in the 1990s:
  - Real per capita property taxes rose 17 percent
  - Real per capita property tax for public education rose 25 percent
- ☆ Almost half (47 percent) of Texas' current sales tax revenue comes from business purchases
- ☆ A Fair Tax would only tax final consumer purchases by Texans
- ☆ From 1980 to 2002, the percentage of Texas taxes represented by the property tax increased from 35 percent to 42 percent
- ☆ Texas' property tax burden increased by over $7 per $1000 in personal income while the property tax burden nationwide decreased by $2 per $1000 in personal income
- ☆ Relative to the rest of the nation, Texas' tax burden has risen
- ☆ According to economic modeling by the Beacon Hill Institute, replacing 50 percent of the school property tax and the bulk of state taxes with a Fair Tax would require a state tax rate of about 7.9 percent, and in five years would increase real disposable income per capita by 2.6 percent, increase investment by 21 percent, and decrease private employment by 0.6 percent

RECOMMENDATION

- ☆ Conduct a detailed study, using state expertise, of the possibility of instituting a Texas Fair Tax taking care to closely study how to properly define taxable transactions and how to enforce such a tax.

RESOURCES

- *Changing Texas' Tax Structure: A Fair Tax For Texas?* by Richard Vedder and Byron Schlomach, Texas Public Policy Foundation (Forthcoming 2005)
- *Tax And Expenditure Limitation Reform: Is It Needed In Texas?* by Byron Schlomach, Texas Public Policy Foundation, August 2004 (http://www.texaspolicy.com/pdf/2004-08-TEL.pdf)

Tax and Expenditure Limitations

THE ISSUE

Recent challenges to balance the state budget have refocused attention on fiscal discipline and the efficacy of Texas' tax and expenditure limitation (TEL), enacted constitutionally in 1978. Weaknesses of the Texas TEL have become clear, and in 2003, Representative Carl Isett proposed to strengthen the law by making Texas' TEL similar to Colorado's Taxpayer's Bill of Rights – the TEL considered the nation's most successful. Although the 78th Texas Legislature failed to amend Texas' TEL, there is still strong interest in and sound reasons for strengthening it.

Unlike Texas' TEL, Colorado's law has effectively limited government spending growth to a rate equal to population and inflation growth – a standard of government need that is widely recognized. Colorado's TEL has resulted in budget stabilization and tax rebates, and has helped the state cope with revenue shortfalls in the recent recession.

Texas' TEL is one of the weakest such statutes in the nation. Based on criteria for a strong TEL established by the Cato Institute, Texas' TEL falls short because it:

1. Lacks sufficient constitutional specificity;
2. Applies only to a small part of the state budget;
3. Caps only appropriations, not spending;
4. Limits appropriations growth to personal income rather than population growth and inflation;
5. Allows a simple legislative majority to overrule the statute;
6. Applies only to state, not local, governments;
7. Requires easily amended enabling legislation to be enacted;
8. Fails to allow taxpayers to hold the state accountable by not giving them standing to sue to enforce statutory provisions; and
9. Provides no provision for tax refunds or rebates.

THE FACTS

- ☆ Approximately 26 states have tax and expenditure limitations – Colorado's is the most effective and Texas' is one of the least effective
- ☆ Colorado's TEL resulted in $3.25 billion in tax rebates to Colorado residents from1997 to 2001
- ☆ Real, per capita, non-federal Texas state expenditures increased 28.5 percent from 1990 to 2003
- ☆ If real, per capita, non-federal Texas state expenditures in 2003 were the same as in 1990, Texas taxpayers could have saved $8.7 billion in state taxes in 2003 –

almost $1,600 for a family of four

- ☆ States with effective spending limitations experience lower tax increases in periods of recession than states without such limitations

RECOMMENDATION

- ☆ Enact a truly effective TEL in the Texas Constitution

RESOURCE

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