Texas Public Policy Foundation

Taxes

Legislator's Guide to the Issues 2017-18

Margin Tax

The Issue

Simply put, businesses don't pay taxes; consumers do in the form of higher prices, lower wages, and fewer jobs available. Given that taxes exist to fund essential government services, the least burdensome taxes should fund conservative budgets that grow by no more than population growth plus inflation.

No matter how you evaluate the margin tax, it fails the least burdensome tax test, fails to meet revenue expectations, and fails to allow Texans the opportunity to reach their full potential. Texans would be best served by eliminating this onerous tax.

The margin tax is inherently complex with multiple calculations to determine the lowest tax liability, two tax rates depending on business type, and the $1 million gross revenue exemption. Complying with it is also markedly different than complying with the federal corporate income tax, so many firms must keep separate financial books. Because of these substantial costs, firms can spend more on compliance than their actual tax liability.

This broad-based, gross receipts-style margin tax is far more complex and unique among all taxes nationwide—with only Nevada having a similar gross receipts-style tax. Since the margin tax's inception in January 2008, the Texas Comptroller's office has had difficulty accurately estimating its revenue, as noted by the cumulative $2.8 billion less in actual collections than estimated through FY 2015.

Fortunately, the 84th Texas Legislature made valiant steps to reducing the margin tax's burden. This was accomplished by cutting the tax rates by 25% and raising the ceiling to file with the E-Z computation to $20 million at a lower tax rate. These beneficial changes for a total value of $2.6 billion took effect on January 1, 2016. These cuts not only had the benefit of reducing the size of government, but employers also have more money to invest to boost the economy.

Studies modeling the dynamic economic effects of phasing out or repealing the margin tax find substantial economic benefits, including thousands of net new private sector jobs and billions in net new personal income statewide.

The Foundation's recent research includes a dynamic economic model that accounts for the private sector drain to pay for annual margin taxes and firms' cost of complying with the tax. The estimated results of full elimination before the margin tax changes made last session include:

- More prosperity: Texas could gain $16 billion in new real (inflation-adjusted) total personal income within five years compared with the baseline.
- More jobs: Net new private sector nonfarm employment could increase by 129,200 net new jobs five years after eliminating the margin tax compared with the status quo.

While eliminating the margin tax will enhance Texans' prosperity, the stakes are much higher than just one state. This transformational policy would make Texas a leader in America—and even the world—in tax policy. For example, this would allow Texas to join just three other states (i.e., Nevada, South Dakota, and Wyoming) without a corporate or individual income tax.

Slower economic growth statewide may leave a tight budget in the 2017 Legislature. However, this should not negate taking additional steps to achieve the ultimate goal of eliminating the margin tax. While cutting the tax results in a short-run drop in tax revenue, the associated dynamic increase in economic activity will likely generate additional tax revenue through other taxes that could replace some of the drop.

Depending on the fiscal and political environment, eliminating the margin tax in the next budget cycle may not be an option.

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Therefore, a valuable alternative is to pass legislation that would phase it out over the next two budget cycles. While phasing it out with certainty is a good option, it does reduce the potential economic gains, particularly by leaving in compliance costs. In addition, if the phase out path is chosen, it is preferable to lower the tax rates for everyone instead of raising the revenue exemption threshold that forces the burden on fewer firms.

The Facts

- Texas' margin tax is complex, costly, and difficult to comply with, giving rise to a less competitive business tax climate, for which the Tax Foundation ranks Texas 10th.
- The margin tax fails to be anything similar to a least burdensome tax, fails to meet revenue expectations, and fails to allow Texans the opportunity to reach their full potential.
- Texas does not have a revenue problem. From the 2004-05 to the 2016-17 budgets, the state's estimated total tax collections increase is 75%, much faster than the 51% growth rate of population plus inflation.

Recommendations

- Eliminate the business margin tax. An option is to phase it out over two biennia by cutting the rates. The combination of potential budget surpluses, increased tax revenue from economic growth, and modest spending restraint could fund this without imposing a new tax.
- Pass legislation requiring a supermajority (two-thirds) vote of each chamber to raise taxes or create a new tax.

Resources

Failure of Texas' Business Margin Tax by Talmadge Heflin and Vance Ginn, Texas Public Policy Foundation (Dec. 2015).

Economic Effects of Eliminating Texas' Business Margin Tax by Vance Ginn and Talmadge Heflin, Texas Public Policy Foundation (March 2015).

The Texas Margin Tax: A Failed Experiment by Scott Drenkard, Tax Foundation (Jan. 2015).

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Personal Income Tax

The Issue

Although no one likes to pay taxes, they are an inevitable part of funding core government functions. A policymaker's challenge is to develop an efficient tax system that provides necessary revenue while doing the least economic harm. A policymaker should take care, however, as not all methods of raising revenue are created equal.

While each tax affects behavior and distorts choices differently, the personal income tax is among the most pernicious because of the negative effects it has on earnings, productivity, and wage gains. As a consequence of these adverse effects, people are generally not able to save and consume as much as they would have otherwise. What's more, a personal income tax requires a particularly large bureaucratic apparatus for tax collection purposes, much more so than for the collection of a sales tax. With more bureaucracy comes additional costs for taxpayers which results in higher taxes and fees.

The absence of a personal income tax is ideal for state lawmakers as there are other ways to raise revenue without incurring such harmful economic effects or enlarging the bureaucracy. And to its credit, Texas is one of only nine states without a personal income tax.

While some argue that a broad-based personal income tax is needed to improve the state's overall outlook, this raises the question: How has Texas' economy performed without a personal income tax?

Texas' state and local tax burden ranks 46th nationally, according to the Tax Foundation's latest report, placing it among the very best states for taxpayers. Because of the state's comparatively friendly tax environment, Texas' private sector economy has surged forward, outperforming the nation as a whole in a number of key areas, such as:

Nine States with the Lowest and Highest Marginal Personal Income Tax (PIT) Rates (10-Year Economic Performance)

	1/1/15	2004-2014	2005-2014	2004-2014	2004-2014	2004-2014	2002-2012
State	Top Marginal PIT Rate**	Population	Net Domestic Migration†	Non-Farm Payroll Employment	Personal Income	Gross State Product	State & Local Tax Revenue‡
Alaska	0.0%	11.7%	-2.9%	11.2%	65.5%	60.7%	318.8%
Florida	0.0%	14.2%	4.4%	4.6%	43.1%	31.8%	44.0%
Nevada	0.0%	21.0%	7.0%	5.4%	35.9%	27.7%	65.1%
South Dakota	0.0%	10.7%	2.8%	10.3%	57.4%	49.0%	57.2%
Texas	0.0%	20.4%	5.4%	21.7%	75.9%	78.6%	65.7%
Washington	0.0%	14.3%	4.3%	12.3%	54.5%	57.2%	50.8%
Wyoming	0.0%	14.7%	4.9%	14.6%	76.4%	86.4%	111.5%
New Hampshire^	0.0%	2.8%	-0.3%	3.3%	43.0%	34.6%	46.5%
Tennessee^	0.0%	10.8%	4.5%	4.0%	45.6%	36.3%	54.0%
Average of 9 No Income Tax States*	0.0%	13.4%	3.3%	9.7%	55.3%	51.4%	90.4%
50-State Average*	**5.6%**	**8.8%**	**0.7%**	**6.1%**	**48.4%**	**43.6%**	**63.0%**
Average of 9 Highest Income Tax States*	10.4%	6.8%	-2.1%	4.7%	44.3%	40.1%	58.4%
Kentucky	8.2%	6.4%	1.3%	3.9%	42.7%	38.7%	39.4%
Maryland	9.0%	7.7%	-2.5%	4.0%	42.1%	40.9%	52.0%
Vermont	9.0%	1.1%	-1.5%	2.3%	41.8%	31.4%	63.6%
Minnesota	9.9%	7.3%	-1.3%	4.9%	41.7%	36.4%	52.3%
New Jersey	10.0%	3.5%	-6.0%	-0.9%	36.5%	29.5%	55.5%
Oregon	10.6%	11.2%	5.1%	7.2%	46.7%	51.3%	64.3%
Hawaii	11.0%	11.5%	-2.6%	7.2%	52.9%	45.2%	74.8%
New York	12.7%	3.0%	-7.5%	7.4%	47.3%	47.2%	70.7%
California	13.3%	9.1%	-3.4%	6.3%	47.1%	40.6%	52.5%

** Equal-weighted averages.*
*** Top marginal PIT rate is the top marginal tax rate on personal earned income imposed as of 1/1/2015 using the tax rate of each state's largest city as a proxy for the local tax. The deductibility of federal taxes from state tax liability is included where applicable.*
† Net domestic migration is calculated as the ten-year (2005-2014) sum of net domestic in-migrants divided by the mid-year (2010) population.
‡ 2002-2012 due to Census Bureau data release lag.
^ Tennessee and New Hampshire tax interest and dividend income but not ordinary wage income.

Source: Laffer Associates, U.S. Census Bureau, Bureau of Labor Statistics and Bureau of Economic Analysis

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- Texas' economy grows faster than the national average. In 2014, Texas' real gross domestic product grew by 5.2%, more than twice as fast as the national average of just 2.4%;
- Texas creates jobs at a faster rate than the rest of the nation. From 2000 to 2015, average annualized nonfarm employment increased by 1.6% in Texas while the U.S. average increased by only 0.6%;
- Texas creates a large share of U.S. jobs since the Great Recession. Texas replaced the total civilian jobs lost during the recession by December 2009; however, the rest of the U.S. did not reach its pre-recession level until January 2015 and did not surpass Texas' job creation until November 2015; and
- Texas has had a lower unemployment rate than the U.S. average. From 2000 to 2015, Texas' average unemployment rate of 5.8% was lower than the U.S. average of 6.3%, and through March 2016, Texas' rate had been at or below the U.S. average for 110 consecutive months.

Research finds clear differences among the nine states without a personal income tax compared to the nine with the highest marginal personal income tax rates and the 50-state average. The table on page 1 shows that in every category examined the states without an income tax performed better than those with the highest income tax rates. In addition, the nine states without a personal income tax outperformed the national average in every category, often by a wide margin. Based on economic principles and empirical data, Texas' economic prospects for its citizens are best served by its current low tax, pro-growth approach rather than a new income tax.

The Facts

- Texas is one of nine states without a personal income tax.
- Personal income taxes substantially damage a state's economy because they discourage savings, investment, productivity, job creation, and economic expansion.
- The nine states without a personal income tax outperformed the nine states with the highest marginal income tax rates and the 50-state average in nearly every important economic area from 2004 to 2014.

Recommendations

- Never create a personal income tax in Texas.
- Encourage economic growth by keeping taxes low and adopting pro-growth reforms.

Resources

A Labor Market Comparison: Why the Texas Model Supports Prosperity by Vance Ginn, Texas Public Policy Foundation (Oct. 2015).

Rich States, Poor States by Arthur B. Laffer, Stephen Moore, and Jonathan Williams, American Legislative Exchange Council (Oct. 2015).

How Big Government Hurts the Economy by Chuck DeVore, Nicholas C. Drinkwater, Arthur B. Laffer, and Stephen Moore, Texas Public Policy Foundation (Nov. 2013).

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Taxes

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Property Tax – Sales Tax Swap

The Issue

Texas' local property tax burden ranks 14th highest nationally and weighs heavily on homeowners and businesses statewide; but research suggests that relief may be only a few modest reforms away.

Local property taxes levied across the state increased by 101.1% compared with only a 70.3% increase in compounded population growth plus inflation from fiscal years 2000 to 2013. This substantial increase in property taxes has increased property owners' mandated tax liability by almost 30% to 9.8% of the state's median income during this period. Meanwhile, state sales tax revenue, supported by discretionary purchases, rose by 86.2%. Voters also recently indicated their concern about the mounting property tax burden by their response to Proposition 1 on the March 2016 Republican primary election ballot that read: "Texas should replace the property tax system with an alternative other than an income tax and require voter approval to increase the overall tax burden." It passed by a wide margin with 69.5% in favor.

According to a Texas Public Policy Foundation study *The Freedom to Own Property: Reforming Texas' Local Property Tax*, Texas can entirely eliminate the property tax burden by replacing it with a reformed sales tax.

Of all the major taxes, a consumption tax (or sales tax) is the most preferable for three reasons: it is simple, transparent, and levied only at the end-user, which provides some discretion over one's tax liability. In terms of simplicity, the sales tax is among the easiest for taxpayers to understand and pay since the rate is generally known beforehand and levied automatically at the time of purchase. This unique feature sets the sales tax apart from most other taxes laden with time-consuming paperwork and other compliance costs.

The study highlights a revenue neutral swap by reasonably adjusting the state sales tax base and rate outlined in the Foundation's publication authored by the famed economist Dr. Arthur Laffer. Abolishing local property taxes and changing the current 8.25% maximum state and local sales tax rate to achieve the swap could include a reformed sales tax rate of:

- 15.7%, if the current sales tax base is used including the sale of property; or
- 11%, if all services that are taxed in at least one state are taxed in Texas including the sale of property.

One of these swaps would provide meaningful tax relief for property owners, and it would have the added benefit of strengthening the state's economy by encouraging capital investment—the primary driver of economic growth and job creation.

Based on the property tax-sales tax swap, with the 11% sales tax rate option, the Foundation estimates over a five-year period personal income could increase by as much as $63 billion, or 4.7%, higher than under the current tax system. This increase in economic activity could contribute to 337,400 net new jobs statewide compared with no tax reform. Put simply, Texans are not able to reach their full potential from the current property tax system.

Perhaps the greatest incentive for property tax reform has nothing to do with tax relief, creating wealth, or adding new jobs; it has to do with liberty. So long as Texas' property tax remains in place, no person who lives in a home, operates a business, or has property of any kind, will ever truly own any of these. Right now, Texans effectively rent from the government, indefinitely.

The evidence supports the case for replacing property taxes with a reformed sales tax; now the political will is needed to enact such a prosperity-generating reform.

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The Facts

- Repealing local property taxes and replacing the revenues with a reformed sales tax would provide meaningful tax relief, generate added wealth, spur job creation, and protect the rights of property owners.
- Over a five-year period, the Foundation's property tax reform proposal would help create tens of billions of dollars in net new personal income and hundreds of thousands of net new jobs.

Recommendations

- Abolish local property taxes and replace them with a reformed sales tax that includes an adjusted tax base and rate.
- Ideally, the reformed sales tax would closely resemble an 11% sales tax rate and an adjusted base that includes all services taxed in at least one other state, including the sale of property.

Resources

The Freedom to Own Property: Reforming Texas' Local Property Tax by Kathleen Hunker, James Quintero, and Vance Ginn, Texas Public Policy Foundation (Oct. 2015).

Enhancing Texas' Economic Growth through Tax Reform by Donna Arduin and Arthur Laffer, Texas Public Policy Foundation (Aug. 2012).

Texas' Property Tax Challenge: The True Cost of Owning Property in Texas by Talmadge Heflin and James Quintero, Texas Public Policy Foundation (Aug. 2008).

The Case for Converting from Property Taxes to Sales Taxes by Talmadge Heflin, Texas Public Policy Foundation (March 2008).

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Supermajority Requirement to Raise Taxes

The Issue

Since an increase in taxes burdens Texans, the Legislature should not raise taxes unless there is a broad consensus. Whether the state's coffers are flush or tight each session, taxpayers would benefit from a mechanism that appropriately checks the growth of government tax collections.

The challenge for conservatives is to develop a tax system that generates sufficient revenue to pay for essential government services while doing the least economic harm to consumers and employers.

The state's current tax system is expected to collect $93.1 billion in 2016-17, 75% more than the $53.3 billion it collected in 2004-05. By comparison, the compounded rate of population growth plus inflation over this period is only 51%, indicating that the tax system brings in more revenue than necessary to fund essential services.

The sales tax is expected to represent 64% of total tax collections in 2016-17 and has increased by 89% since 2004-05. As compared with the other major forms of taxation, research finds that the sales tax has been the least intrusive, the easiest to understand and pay, and is generally well-guarded against manipulation. To put it succinctly, a sales tax is the most efficient. For these reasons, the sales tax is by far the most preferable form of taxation to do the least economic harm.

Fortunately, Texas does not have a personal income tax. Research shows that the past 10-year economic performance of the nine states without a personal income tax clearly surpasses the economic performance of the nine states with the highest personal income tax rates and the 50-state average. This includes higher growth rates of gross state product, nonfarm employment, population, and state and local tax revenue.

To adhere to prudent policy that limits a rising tax burden on Texans, legislators should consider passing legislation requiring a two-thirds supermajority of the Legislature to raise taxes instead of the current simple majority requirement. Texas should be leading the way on this issue; instead, it lags behind 17 states that have some form of this requirement, according to the Washington Policy Center.

For the last two sessions, Senate Joint Resolution 27 would have achieved the goal of requiring a supermajority vote "for passage of a bill that imposes a new state tax or increases the rate of an existing state tax above the rate in effect on the date the bill was filed." But it died in committee both times.

Considering that taxes affect us all and with so much at stake—jobs, the economy, and Texans' financial well-being—legislators should conduct prudent public policy by enacting a higher threshold to raise taxes or pass a new tax.

The Facts

- A sales tax is preferable because it is simple, transparent, and levied only on the end-user.
- The 10-year economic performance of the nine states without a personal income tax clearly surpasses the economic performance of the nine states with the highest income tax rates.
- Since an increase in taxes burdens Texans, taxes should be raised with only a broad consensus.

Recommendations

- State and local governments should continue to rely on the sales tax as their main source of revenue.
- Pass legislation to require a supermajority (two-thirds) vote of each chamber to raise taxes or create a new tax.

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Resources

The Freedom to Own Property: Reforming Texas' Local Property Tax by Kathleen Hunker, James Quintero, and Vance Ginn, Texas Public Policy Foundation (Oct. 2015).

How Big Government Hurts the Economy by Chuck DeVore, Nicholas C. Drinkwater, Arthur B. Laffer, and Stephen Moore, Texas Public Policy Foundation (Nov. 2013).

Testimony Regarding Senate Joint Resolution 27 by Talmadge Heflin, Texas Public Policy Foundation (April 2013).