THE TEXAS TAX SYSTEM TODAY
A LEGISLATIVE OVERVIEW
AND CURRENT OPTIONS FOR CHANGE

75TH TEXAS LEGISLATURE
DECEMBER 1998
TEXAS HOUSE OF REPRESENTATIVES
SELECT COMMITTEE ON REVENUE
AND PUBLIC EDUCATION FUNDING

INTERIM REPORT

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A LEGISLATIVE OVERVIEW
AND CURRENT OPTIONS FOR CHANGE

75TH TEXAS LEGISLATURE
DECEMBER 1998
Select Committee On
Revenue and Public Education Funding

January 6, 1999

Paul L. Sadler
Chairman

The Honorable James E. "Pete" Laney
Speaker, Texas House of Representatives
Members of the Texas House of Representatives
Texas State Capitol, Rm. 2W.13
Austin, Texas 78701

Dear Mr. Speaker and Fellow Members:

The Select Committee on Revenue and Public Education Funding of the Seventy-Fifth Legislature hereby submits its interim report for consideration by the Seventy-Sixth Legislature.

Respectfully submitted,

Paul L. Sadler, Chairman

Paul L. Sadler, Chairman

Paul Hilbert, Vice Chairman

Kim Brimer

Warren Chisum

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Special thanks also go to Frank Battle of the Speaker’s Office for contributing to, editing, and coordinating the production of this report.
SELECT COMMITTEE ON REVENUE AND PUBLIC EDUCATION FUNDING

The Select Committee on Revenue and Public Education Funding was created by proclamation of House Speaker James E. "Pete" Laney on January 23, 1997. In general, the committee has jurisdiction over matters pertaining to public school funding and state and local revenue raised for that purpose. The committee was created to consider matters that, by the interwoven nature and complexity of state and local tax policy and public school funding, are best considered by a single committee drawing primarily from the membership of committees with related jurisdiction: Appropriations, Public Education, and Ways and Means.

During the interim, the committee was directed by Speaker Laney to continue its study of school funding and various state and local revenue issues and to report its findings to the 76th Legislature. Specifically, the committee was asked to:

- continue the committee's comprehensive study of the methods and formulas by which public schools are funded, with the goal of averting a constitutional crisis;
- review the laws, rules, and practices that govern the appraisal of property for purposes of ad valorem taxation (including the appraisal reform legislation enacted by the 75th Legislature);
- study the relative burden of all state and local taxes on major sectors of the state's economy;
- evaluate the effect of the tax burden on the competitiveness of each sector;
- review all issues related to economic development incentives that may reduce school property taxes, including tax abatements, tax increment financing, and 4B development corporations;
- review the state's laws, rules and practices for apportioning receipts from intangible assets under the state franchise tax (including an examination of the current location of payor rule, as well as alternatives and their effects on tax equity, business expansion and job creation, and opportunities for tax avoidance);
- continue the committee's comprehensive review of exceptions and exemptions under the various tax laws of the state; and
- monitor the implementation and effects of H.B. 4 and H.J.R. 4, 75th Legislature.

The committee held five meetings in Austin between December 1997 and October 1998 to address the assigned charges. During those meetings, the committee heard considerable expert
testimony on the tax system, the economy, and the future of the state. In addition, members of the committee were asked to prepare discussion papers on specific revenue topics. The result of the committee's interim work is presented in the following report.
I. INTRODUCTION

The Texas state and local tax system raises more than $44 billion annually to pay for a wide array of services, ranging from local police and fire protection to state hospitals for persons with mental illnesses. That represents $2,252 for every man, woman, and child in the state. In 1994, the most recent year for which comparative data are available, Texas had the 36th highest tax level among the states. State taxes accounted for 53 percent of the total and ranked 48th among the states. The remaining 47 percent is collected locally. The Texas local burden is comparatively higher than the state burden, ranking 15th among the states in 1994.

Over the past 15 years, this tax system has become broader and more complex, as state and local governments have struggled to balance the need to pay for services for a growing population with the economic ups and downs of the Texas economy.

During this period, taxes have been an ongoing source of concern to the Texas Legislature. The Legislature has had to deal with shortfalls in existing revenue sources caused by the economic difficulties of the 1980s and early 1990s, and it has had to find new sources of income to finance schools, highway construction, prison expansion, and a host of other needs. Often, as in the case of schools and prisons, the search for new revenue has been driven by court decisions or other outside factors sometimes more than by the policies and goals of state and local government.

There is little doubt, though, that while the tax system has been intensely studied, neither the legislative will nor the support of the public has ever materialized for an alternative to the current mix of sales, property, and business taxes. Improvements have been made, and there has been considerable change in who pays taxes, primarily as a result of five major tax bills enacted largely in the 1980s and in 1991, but also as a consequence of shifts in the economy and as result
of efforts to equalize school funding. However, there has been no true "reform" of the Texas tax system. Viewed from a high level of detail, the Texas tax system is basically the same today as it was in 1988—sales and property taxes predominate and business pays the largest share of taxes.

In large measure, the same is true of the problems that have been associated with the tax system. They are today much as they were a decade ago when the state conducted a full-scale evaluation of the tax system through the work of the Select Committee on Tax Equity, a group of business people, members of the Texas Legislature, and the comptroller. In its 1989 report, the committee provided an analysis of the "best" and "worst" of the tax system, which struck a now-familiar refrain:

> Though rates have risen and the importance of some taxes has shifted over time, the composition of the tax system today is remarkably similar to its composition 25 years ago.

This is not inherently bad. Predictable, consistent tax policy is one hallmark of a sound tax system. The Texas tax system served the state well for two decades. During that time, it embodied many principles of taxation beneficial to Texans and the state's economic development.

But after 25 years, the system has developed serious problems. The state economy has changed, but the tax system has not always kept pace. Like most tax systems, it has evolved slowly through a series of compromises dictated by the changing needs of each legislative session. These changes often represent patches and appendages to the system.... As [then] state Comptroller Bob Bullock told the Texas Senate in 1987: "We are developing a 21st Century economy, whether by design or by default. The question now is: Do you want a tax system that is in step with that economy?"1

In spite of a dramatic effort in the 1997 session, the question posed still remains unanswered.

The Texas tax system depends heavily on sales and property taxes. Both of these taxes are regressive in their impact on our citizens, taking more from low- and middle-income Texans than upper-income Texans. Moreover, rates of the two taxes have risen to levels that are undesirably high, particularly compared with rates of comparable taxes in other states. The state continues to impose a large share of its tax burden on business, and the overall system falls most

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heavily on the "older" portions of the economy—the capital intensive manufacturing industries, the utility industry, and the oil and gas industry. The rapidly expanding service sector of the economy is largely outside the tax system.

During the last decade, it has become increasingly clear that the tax system cannot be considered apart from its role in public school finance. A large percentage of our state and local tax revenues are used to fund schools, and the state has struggled since the 1960s with equity in its school finance system, due in large part to the use of the property tax to pay for more than half of school costs.

Moreover, the Texas economy is changing dramatically. A large part of the economy has become global in its operations. New forms of business are being created and new methods of doing business are evolving at an escalating rate. At the time the Select Committee on Tax Equity made its report in 1989, the Internet was not publicly accessible. Now it is a dominant feature of our lives, and it is likely to be the dominant path of future commerce. Much of this evolution, for good or ill, will occur outside our state and local tax system as it is currently constituted.

A fundamental question has been the center of our consideration of the tax system at the end of the 20th Century: Will the current system keep pace with the dramatic growth in our state and is it sufficient to meet the changing needs of Texas?

In large measure, the difficulty the state has had in answering this question is tied to the fact that tax reform is more easily supported in theory than in practice. For example, as members of the Texas Legislature and citizens of this state, we can agree that property taxes are too high, but there is no clear consensus on what should be done about that fact. The difficulty is compounded because of the link between education funding and property taxes. Moreover, the changing demographics of the state would suggest dramatic future increases in the cost of education and health care over the next two decades.

Despite the problems inherent in implementing fundamental tax reform, both the governor and Legislature have labored to find workable solutions to the perceived problems with the Texas state and local tax system. During the 1997 legislative session, Governor Bush proposed a significant overhaul of the school funding system, shifting more of the burden for paying for the system to the state level, altering our method of taxing businesses to a broader, more inclusive base, and reducing the burden of property taxes locally.
This committee was created at the beginning of the 75th Legislature to consider the governor’s proposals and to make its own recommendations, which ultimately were adopted by the full House of Representatives. The Senate passed a smaller tax package and a different school funding plan. Unfortunately, consensus could not be reached and eventually the Legislature adopted and sent to the governor a plan that reduced local property taxes by $1 billion. This was a significant step, but it was a step that left the basic underpinnings of the system unchanged. Consequently, even though the $1 billion tax reduction qualifies as the largest tax reduction in the history of the state, lower property taxes never materialized for many Texans due to increases in local tax rates or appraised values, neither of which are controlled by the Legislature. This experience clearly demonstrates the difficulty of providing meaningful property tax relief under this system.

During the legislative interim that is now ending, the committee heard considerable expert testimony on the tax system, the economy, and the future of the state. Our members have also produced a broad body of analysis on various aspects of the tax system. This report draws that work together in a single report. Our goal has been to illuminate the tax issues facing the state as the Legislature convenes in regular session in January 1999. It appears likely that taxes and taxation will again be prominent on the legislative agenda, and our goal is to provide background information for members as the issues emerge.

Texas currently does not face a revenue crisis. The Comptroller’s Office has indicated that the current two-year budget period will end with a sizable surplus, and that revenue growth should continue into 2000-01. Thus, there is little pressure for the sweeping tax reforms that have been discussed in the past. Nonetheless, Governor Bush has put forward a new plan for reducing property tax and making other changes in an effort to improve the fairness of the tax system for individual Texans and for small businesses across the state.

In this context, it is important to recognize that every change in tax law has broader implications for the overall fairness, simplicity, stability, and long-term adequacy of our state and local fiscal system. We may not find a comprehensive “reform” that makes sense to the Texas Legislature in 1999, but we should consider each proposed change in the state and local tax system in light of its larger impact on the current mechanism we use to pay for state and local services. Incremental change in the tax system does not have to be ineffective as long as it is done
with a clear eye to its consequences for the future and state and local government's ability to meet their obligations to the citizens of Texas.

This report provides a general background on the tax system and the issues related to it that are important for the Legislature and taxpayers to understand. Section II includes a discussion of the composition and performance of the current system. It also provides a discussion of the relationship of taxes and state economic development. It examines the tax system in terms of the basic standards of equity, efficiency, simplicity, adequacy and economic competitiveness. It presents an overview of some of the key tax issues likely to face the 76th Legislature in 1999. Finally, Section II reviews one of the most debated tax issues of the 75th Legislature, the franchise tax "location of payor" rule.

Section III provides summaries of the reports on specific revenue issues that were prepared by members of the committee over the course of the interim.

Section IV summarizes the invited testimony before the committee by various economic and tax experts who provide their own views on the performance and impact of the Texas tax system.
II. THE TEXAS STATE AND LOCAL TAX SYSTEM

Overview: The Tax System Today

Texans paid an estimated $44.5 billion in state and local taxes in 1998. The main sources of this revenue are the sales and property taxes, which dominate the state and local tax systems. Overall, three of every four tax dollars Texans pay come from the sales tax or the property tax (Figure 1). Since 1980, Texas taxes have increased from about 7.5 percent of total personal
income to just over eight percent (Figure 2). State taxes have remained in the range of 4.5 to 5.0 percent of personal income, while property taxes have fluctuated from three to four percent of income.

**The State System**

Texas state government revenues from tax and non-tax sources totaled $44.5 billion in 1998 (Figure 3). The $22.6 billion the state raised in taxes accounted for just over half of total revenues. Federal receipts, which are dedicated to specific programs, accounted for about 28 percent of the total. Licenses, fees, fines, permits and other miscellaneous revenues account for a little more than nine percent, and the lottery and investment income account for just over four percent. Other revenues, including income from state land holdings, made up the balance.

The sales tax is the dominant tax at the state level, although the state makes use of a wide variety of taxes (Figure 4). First enacted in 1961, the sales tax has grown consistently in importance in the Texas tax system for more than 30 years. In the 1980s, as oil and natural gas severance taxes generated less revenue because of the twin effects of falling production and prices, the role of the sales tax became more prominent. This trend was helped along by the fact
that the several tax increases adopted during that period of economic struggle included changes in the sales tax rate and base. Today, the sales tax accounts for 55 percent of all state tax revenue and 28 percent of state revenues from all sources.

The sales tax has numerous exemptions, exclusions, and discounts. In fiscal 1997, estimated value of sales tax exemptions was $3.37 billion. The exclusion of "services" from the sales tax base amounted to $2.6 billion that same year. While the continuation of many of these exemptions and exclusions keeps Texas competitive with other states, the benefit of other exemptions and exclusions may have been lost over time.

A major policy concern with sales taxes is the regressive nature of the tax. Even when carefully crafted to minimize its regressive nature, the tax takes more from low- and middle-income taxpayers than it does from taxpayers in upper income brackets.

Despite the criticism that the sales tax is regressive, polls show that Texans—and indeed most Americans—prefer the tax to other alternatives. Most state tax systems today make use of a general sales tax like Texas', although few depend as heavily on it as this state does. The Texas
sales tax has one of the broadest bases among the states, and its rate is also one of the highest in the country. In large measure, this dependence is a conscious decision of the Legislature and people of Texas. Most other states derive a significant portion of their state tax revenue from personal income taxes, which often make up a third or more of state tax collections. Texans have chosen, emphatically, not to follow that path. Our state tax system today relies on a mixture of sales taxes—the general tax and selective taxes on motor fuel, alcoholic beverages, motor vehicle sales, and tobacco products—and on business taxes, including the corporation franchise tax and the oil and natural gas production taxes.

A tax of central interest to the Texas business community is the corporation franchise tax, the state's primary business tax. This tax is levied on corporations and limited liability companies doing business in the state. The tax is, in essence, two different taxes—one based on capital or net assets and the other based on earned surplus or net income. The earned surplus base was added to the tax in 1991. Prior to that time, the tax was based only on net assets and fell heavily on capital-intensive corporations doing business in the state. A major concern the committee heard during the course of its work is the fact that the tax's narrow base—on the corporate business form—
and its reliance on assets taxation causes a significant bias in the tax system toward some business forms and industries compared with others. Partnerships, for example, are not subject to the tax. Additionally, there exist a number of exemptions, special rates, deductions, credits, and special accounting methods that impact the level of taxation. In fiscal 1997, the value of those exclusions was more than $700 million.

The Local System

The local tax system depends heavily on property taxes. The property tax is the primary means of financing Texas cities, counties, school districts, and its many special purpose districts. In total, about 3,477 local jurisdictions impose property taxes. Cities, counties, and a few special districts also have access to a portion of the sales tax, but by and large, the local tax system is much more limited than the state system. Cities and special districts also finance a portion of their budgets through user fees and charges, but these revenue sources are small relative to the role of the property tax.

The largest share of local property taxes is collected by school districts. Schools account for just 58.8 percent of property taxes statewide in 1998 (Figure 5). The school property tax statewide has grown faster in both dollar and percentage terms than did the levies in any other taxing unit (Figure 6). In fact, school tax rates have nearly tripled in the past 15 years. According to one analysis, this growth has been brought on by a combination of three factors:

1. The stagnant school property tax base has required districts to increase tax rates as they needed new revenue;
2. Recapture or “Robin Hood” has triggered dramatic increases in tax rates in high-wealth districts; and
3. State aid has not kept pace with the cost of education or growth in the number of school children.  

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Because of this rapid growth and its unique role in financing the state’s public school system, it is little wonder that the school property tax occupied much of the attention of the Legislature during the 1997 session.

Due to the three factors described above, plus a long period of relatively flat property values followed by the recent jump in values, Texas has gone from being a moderate state with respect to property tax burden to one that exceeds the national average. In 1982, Texas ranked 22nd overall in property taxes as a percent of personal income and levied property taxes three percent below the national average. By 1992, the most recent year for which national data are available, Texas’ rank had risen to 16th and Texas property taxes—at 4.0 percent of personal income—was above the national average of 3.7 percent.

While most Texans are familiar with the property tax on their homes, it is important to recognize that the property tax is also the state’s largest single business tax. Within the business sector, the nature of the property tax tends to make the tax fall more heavily on capital-intensive industries. More than a third of local property taxes is paid by the manufacturing and utility industries.
Property is taxed at market value unless a specific exemption exists or unless the property is subject to special appraisal (e.g., agricultural valuation). In addition to the more than 25 mandatory exemptions, local taxing units are allowed to grant optional exemptions for some purposes, such as providing additional relief to elderly taxpayers or exempting "goods in transit." Moreover, cities and other taxing units may grant property tax relief for property located in a reinvestment zone to encourage development or redevelopment—usually done through tax abatements or tax increment financing. Since school districts and other local taxing units control the tax rates, legislative efforts to provide property tax relief have frequently focused on adjustments to the property tax base.

*The Performance of the State Tax System*

A central concern at the beginning of each legislative session is the condition and growth of the state tax system. As we approach the 1999 legislative session, the tax system appears to be healthy and robust, closely tracking the health of the Texas economy.
As most Texans are aware, however, the state tax system has, over time, swung widely in its performance. During the 1970s, revenue growth was very strong, tracking the strength of the economy and the rapid rise in energy prices, which brought the state a temporary windfall of oil and gas severance tax income. During the 1980s, the boom was replaced by a bust, and tax collections grew sluggishly at best in most years, partly necessitating several major pieces of tax legislation over the period. Revenue during the 1990s has been more stable, particularly with the declining importance of the oil and gas production taxes, but it is only with the recent surge of the state economy that the state government has experienced a truly strong revenue situation.

Looking at the trends over this period, Texas taxpayers paid about $2.34 billion in taxes in 1972. By 1997, this total had grown to $21.9 billion, a 9.2 percent average annual increase.\(^3\) According to estimates by the Comptroller’s Office, economic and population growth accounted for 58.2 percent of the increase. Legislative changes, both increases in taxes and reductions, accounted for the remaining 41.8 percent.

These totals change significantly when the effects of inflation over the period are considered. According to the Comptroller’s Office, inflation accounted for about 79 percent of the growth in state revenues over the period from 1972 through 1997. In constant 1972 dollar terms, the tax system grew by an annual average rate of about four percent. Of the overall growth in revenues, population and economic growth accounted for only eight percent of total growth, while legislative changes accounted for 12.4 percent of the growth totals.\(^4\)

A reasonable conclusion that can be drawn from the general picture of the tax system presented in this report is that the Texas tax system has become less unique over the past 25 years. It is less dependent on natural resource based taxes, which have performed erratically throughout the state’s history, and has replaced them with the sales tax, which more closely tracks the state’s overall economic performance. This can be seen most clearly in the trends in the 1990s, during which revenue growth has tracked overall state economic growth almost exactly. During the 1989-97 period, the state’s economic output increased by 3.4 percent per year, and real (inflation-adjusted) tax collections similarly increased by 3.4 percent annually.\(^5\)


\(^4\) Comptroller of Public Accounts, p. 2.

\(^5\) Ibid., p. 3.
As Texas has become less dependent on natural resources taxes, the tax system has become more closely tied to the performance of the state’s overall economy. And as the state’s economy has become less tied to the natural resource based industries, the state economy has come to be more closely tied to the performance of the national economy. The committee heard testimony from economist Ray Perryman which indicated the general health of the Texas economy. “Texas has a growing workforce, competitive policies, a great location, and is part of the global economy,” Perryman said. This growth comes in sectors like high technology, manufacturing, and services, which are not as volatile as the oil and gas industry.

However, there are also reasons to be cautious about the economic future. The recent weakness in Asian markets and the slowing U.S. national economy will eventually be reflected in Texas’ economic performance. The widely feared Year 2000 computer problems may also affect the economic outlook in unpredictable ways. As Lieutenant Governor Bullock warned the members of the Legislative Budget Board in its November 1998 meeting, there may be “thorns among the roses” of what is presently a very positive revenue outlook.

Despite these concerns, our current situation looks favorable for having enough money to fund a responsible budget for Texas during the 2000-01 budget period. The state comptroller has predicted that the state can look forward to continued moderate economic growth during the course of the upcoming biennium, and the current performance of the revenue system is strong. It is clear that taxes are strongly linked to the economy and economic performance, and the linkage is not one way. Just as the tax system responds to economic changes, so, too, does the economy respond to changes in state and local tax policy.

**Tax Policy and the State’s Economy**

One key issue before the Select Committee during its interim hearings was the issue of how taxes affect the state’s business climate. We heard testimony that suggests clearly that our tax policy decisions have an effect—sometimes good, sometimes bad—on how businesses view

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6 Ray Perryman, Chief Executive Officer, The Perryman Group, testimony to the Select Committee on Revenue and Public Education Funding, December 1, 1997.
7 Bob Bullock, Lieutenant Governor, informal comments to the members of the Texas Legislative Budget Board, November 19, 1998.
our state as a location for investment and job creation. Therefore, tax policy must weigh not only the need to raise the money to finance state and local government budgets, but also its implications for the long-term health of the state economy.

The questions of how businesses make decisions, how taxes enter those decisions, and how taxes affect economic activity are imprecisely understood. Early studies of these issues found that taxes have little or no impact on economic activity. More recent studies have come to a different conclusion: taxes have an impact, especially in certain cases. The impact may finally depend on the particular situation of an individual industry or firm. Texas tax policy treats different industries differently—mostly for historical reasons as discussed earlier. By whatever measure, the Texas business tax climate, while it has some “sore thumbs,” is fairly positive, particularly for those industries, like the service industry, which have relatively modest tax burdens because of the state’s current tax mix. “Sore thumbs,” from a business perspective, include the taxation of business inventories under the property tax and the focus on capital intensive industries, again under not only the property tax but also the franchise tax.

Interjurisdictional tax competition has become more significant and sophisticated as state and local governments duel to attract economic development. The globalization of the world economy has made every cost factor important. Finally, as noted earlier, the mix of industries in Texas is changing. Today, industries can more easily respond to tax differentials. In older days, the key natural resource-based industries were closely tied to where the resources could be found. The growing service industry is much more “footloose.” It is possible to deliver many services from anywhere in the U.S., if not the world. The state must be mindful of this fact as it examines future tax policy changes.

Although Texas’ overall tax burden is low relative to most states, it is important to recognize that, from a business standpoint, the overall tax burden is less important than how the burden falls on a particular industry. Estimates by the Texas Taxpayers and Research Association indicate that in 1996, the initial impact of Texas state and local taxes fell 58 percent on business and 42 percent on individuals. Compared to other states, Texas’ business tax incidence is relatively high. According to a 1997 study by the Institute on Taxation and Economic Policy,

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9 Billy Hamilton, consultant and former Deputy Comptroller, testimony to the Select Committee on Revenue and Public Education Funding, December 1, 1997.

10 Craymer, p. 11.
Texas’ state and local tax system relied more heavily on business taxes than all but two other states.\textsuperscript{11} Looked at another way, in terms of business tax liability relative to gross state product, Texas ranks 13\textsuperscript{th} highest—almost 14 percent above the national average.

\textit{Who Pays Taxes on Business?}

The Texas state and local tax system has developed over a long period marked by significant shifts in the structure of the Texas economy. Some adjustments have been made in the tax system to reflect these shifts, but there are still clear imbalances. This can be seen in Table 1, which compares the share of state taxes paid by the major industries compared with their share of gross state product—the overall production of goods and services in the economy.\textsuperscript{12}

<table>
<thead>
<tr>
<th>Industry</th>
<th>Share of State Tax Burden</th>
<th>Share of Gross State Product</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture, Forestry</td>
<td>2.7%</td>
<td>1.8%</td>
</tr>
<tr>
<td>Mining</td>
<td>13.5</td>
<td>6.0</td>
</tr>
<tr>
<td>Construction</td>
<td>5.4</td>
<td>4.2</td>
</tr>
<tr>
<td>Transportation, Utilities</td>
<td>18.3</td>
<td>13.0</td>
</tr>
<tr>
<td>Wholesale Trade</td>
<td>5.5</td>
<td>8.0</td>
</tr>
<tr>
<td>Retail Trade</td>
<td>5.7</td>
<td>11.4</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>22.6</td>
<td>17.8</td>
</tr>
<tr>
<td>Finance, Insurance &amp; Real Estate (FIRE)</td>
<td>13.4</td>
<td>15.4</td>
</tr>
<tr>
<td>Services</td>
<td>13.0</td>
<td>22.5</td>
</tr>
<tr>
<td>\textit{Total, All Sectors}</td>
<td>\textit{100.0%}</td>
<td>\textit{100.0%}</td>
</tr>
</tbody>
</table>

Source: Comptroller of Public Accounts.

As the table shows, the agriculture, mining, construction, transportation, utility, and manufacturing industries bear a larger share of the state tax burden than their current relative share of the state economy. In contrast, the fast growing service industry and, to a lesser extent, the wholesale and retail trade industries carry a much smaller share of the state tax burden than

\textsuperscript{11} Ibid.
\textsuperscript{12} Although this discussion focuses on the distribution of taxes among industries, the committee also heard testimony that some taxes initially falling on business are ultimately borne by consumers.
their relative share of state economic activity. Much the same trend can be seen locally because of the property tax.

Addressing the "Tilt"

The "tilt" in the current tax system toward capital intensive industries is unlikely to be addressed directly by the Texas Legislature in the foreseeable future. This issue was extensively debated in the 1997 legislative session without final resolution. However, the Legislature may be called on to address some related tax policy issues that could impact the overall burden of the state and local tax system. Important among these will be proposals to implement research and development and investment tax credits under the franchise tax. These credits would give primarily capital intensive industries a chance to reduce their tax burden by making investments in jobs and facilities in the state. This is a more positive way of addressing the problems in the current system without forcing a difficult shift in the overall burden of the tax system.

Evaluating the Tax System

With a general overview of the Texas tax system in mind, it is useful to make an overall evaluation of where the system stands at the end of 1998. The best approach is perhaps pragmatic. There are acknowledged problems with the state tax system, many of which have been evident at least since the mid-1980s. Most have been inadequately dealt with—if at all—during the past 15 years and seven legislative sessions. To give some idea of this continuing confluence of views on the issues with the tax system, we need only consult the three major tax studies that have been conducted by the state since the 1980s. The conclusions of these studies are summarized in Table 2. Common issues identified in the studies include:

- Over-reliance on the sales tax as a source of state revenue.
- The need for local property tax relief.
- The need to address the property tax as the key source of funding for the state's public school system.
- Concerns about the equity of the tax system, both among individuals and among industries on the business side of the ledger.
- Concerns over the impact of various tax policies on the state's economic development.
On the other hand, the tax system is currently performing well, and the shift from a heavy reliance on resource-based taxes has made the tax system more stable and predictable.

### Table 2

**Key Statements from the Tax Studies**

<table>
<thead>
<tr>
<th>Tax Study</th>
<th>What They Said...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Select Committee on Tax Equity (1989)</td>
<td>[A] comprehensive look at [the tax system] reveals several areas of concern:</td>
</tr>
<tr>
<td></td>
<td>1. A major concern is the ability of the tax system to provide the revenues need to finance government without repeated tax increases.</td>
</tr>
<tr>
<td></td>
<td>2. Another major concern is the equity of the system, both for individual Texans and for businesses operating in the state. The tax system today takes a larger percentage of the income of low and middle income Texans than it does those in the upper income brackets. Moreover, the structure of the state's business taxes is such that it falls heavily on some types of business than others.</td>
</tr>
<tr>
<td></td>
<td>3. The committee also has concerns about some parts of the tax system as they affect the state economic growth and development.... [M]ore than 60 percent of the state's taxes are imposed directly on business, and there are several economic &quot;sore thumbs&quot; in Texas state and local tax policy which make it less attractive to business investment than might otherwise be the case.</td>
</tr>
<tr>
<td>Governor's Revenue Task Force (1991)</td>
<td>Texas current revenue system needs major reform:</td>
</tr>
<tr>
<td></td>
<td>1. Local property taxpayers need immediate relief.</td>
</tr>
<tr>
<td></td>
<td>2. Over-dependence on the sales tax must be reversed.</td>
</tr>
<tr>
<td></td>
<td>3. The Texas Legislature should implement personal and corporate income taxes coupled with meaningful property tax relief and containment of the sales tax rate.... Seventy-five percent of all revenue derived by the state from personal income taxes [should] be statutorily and permanently dedicated to education and that such dedication [should] be applied to first achieve a forty percent reduction in property taxes assessed by the state's school districts.</td>
</tr>
<tr>
<td></td>
<td>4. Restructuring of the tax system should include a movement toward a 50/50 split of the tax burden between business and individuals.</td>
</tr>
<tr>
<td>Citizens' Committee (1997)</td>
<td>1. Texas' current high level of school property taxes hampers capital investment and hampers the ability of Texans to buy and keep their own homes. Further, as a revenue tool, property taxes may not be well suited for providing long-term adequate revenues for our public schools. Finally, the committee finds that substantial public sentiment exists for property tax relief.</td>
</tr>
<tr>
<td></td>
<td>2. Based on the testimony received, there is not clear consensus for a particular solution.</td>
</tr>
</tbody>
</table>


Common criteria may be used to evaluate the impact of legislative proposals on the overall tax system. There have been many lists of such criteria over the years. The 1989 report of the Select Committee on Tax Equity, for example, examined the tax system in terms of nine different
THE TEXAS TAX SYSTEM TODAY

components of what it labeled a “good” tax system. The 1996 Staff Working Group on Property Tax Relief identified a more succinct list of five characteristics, and this list provides a reasonable framework for considering both the merits of the current system and of possible proposed changes that may arise during the 76th Legislature. The list includes the following characteristics:

- Adequacy,
- Equity,
- Economic efficiency,
- Economic competitiveness, and
- Simplicity.

Adequacy

By any measure, the Texas revenue system did not produce adequate revenue to finance even a current spending level of services in the late 1980s and early 1990s. The underlying tax base consistently under-performed the overall economy. This is true of both the state tax system and the local property tax, which accounts for the majority of local tax revenue.

This problem was compounded by the fact that during much of this period, the state was under enormous external spending pressures, which bore little relationship to the performance of the tax system, or of the general economy. Court-mandated increases in spending involving public education, prisons, mental health and mental retardation services, and the state’s juvenile detention centers help boost spending above the growth in the economy on an annual basis.

These spending pressures have continued, but a healthy state economy and some minor adjustments in taxes have allowed the state to meet most of its obligations. (Whether or not the state has met its obligations is always a debate, with a wide range of political views.) It is also true that under the state’s “pay-as-you-go” spending requirements and under the Texas Legislature’s aversion to new spending, the somewhat sluggish growth in revenues effectively

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13 Billy Hamilton, “What is a ‘Good’ Tax System,” Select Committee on Tax Equity, Rethinking Texas Taxes, Volume 2 Analysis of the Tax System (Austin, January 1989), pp. 7-14. The list included: adequacy, equity, efficiency, economic competitiveness, stability, simplicity, balance, broad base, intergovernmental linkages. In the Committee’s final report (volume 1 of the report), these categories were collapsed into adequacy, equity, economic efficiency, and simplicity.

14 Staff Working Group on Property Tax Relief, pp. 5-6.
THE TEXAS TAX SYSTEM TODAY

operates as an automatic "brake" on rapid spending growth, helping to maintain the Texas tradition of conservative fiscal policy. However, the tax system continues to be based on sectors of the economy—capital intensive industries, real estate, and so on—that are no longer the leading sectors of the economy in terms of income or job growth. Uncorrected, this fact may weigh heavily against the stable performance of the tax system in future years should the Texas and national economies slow markedly or sink into recession.

Equity

Because Texas relies so heavily on wealth and consumption taxes—the property and sales tax in particular—the overall tax system does not reflect Texas taxpayers' ability to pay, a common standard for judging tax system fairness. Because of its reliance on consumption and property taxes, the overall impact of the tax system is regressive. Within the confines of this system, there is little change that can be made that will significantly improve equity. In other words, the Texas tax system will continue to be regressive short of a complete overhaul. Poor and middle income Texans pay more as a share of their income than do people in the upper income brackets. This is not a novel insight. As long ago as 1980, one national study showed that the Texas state and local tax system was one of the three most regressive in the nation.16

While the impact of the tax system on individual Texans is a key concern, we also have seen that there are concerns with the fairness of the tax system with respect to various segments of the economy. As the Staff Working Group on Property Tax Relief observed: "Additionally, the state's existing business taxes have been deemed inequitable because much of the tax burden falls upon capital intensive industries; unincorporated firms escape business taxation entirely."17 Over time, this concern may again become a central focus of legislative consideration as it was in the 1997 legislative session. If the burden of business taxes is borne too heavily by any one industry or group of industries, the result will be a perception, if not the reality, of unfairness, potentially driving investment from Texas or leading businesses to devise various tax planning approaches to limit their tax burden.

15 Ibid., p. 6.
17 Staff Working Group on Property Tax Relief, p. 6.
Economic Efficiency

The principal area of potential economic inefficiency in a tax system is a high effective tax rate on savings or capital investment. Since Texas does not employ a personal income tax, the impact on personal savings is obviously not a problem. However, on the capital side, this report should make it clear that Texas still has problems in the area of burdening capital investment, largely because of the property and franchise taxes. The controversial 1991 reforms in the franchise tax, which added an income or earned surplus component to the tax, addressed this inefficiency to some degree, but it nonetheless remains a major problem with the Texas tax system.

Economic Competitiveness

Texas state and local governments have become heavily involved over the past 40 years in trying to lure jobs and investment to their jurisdictions. What they have learned from this experience is that taxes are one issue in any business decision (although often not the most important), and that tax policy is one of the most tangible tools that government can use to attract development. In this regard, the Texas tax system has both strong and weak points. The lack of a personal income tax is a strong attraction, as is the low effective tax rate on individuals. However, the high proportion of state and local taxes paid by business is a potential negative factor, particularly, again, the high effective rate on capital.

Simplicity

For individuals, the Texas tax system is relatively simple. The main complications come in understanding the workings of the complex property tax system and in divining the many differing sales tax rates that may be in effect across the state. For businesses, the tax system offers a fair amount of complexity. Multiple sales tax rates across jurisdictions may present problems for businesses that operate in more than one tax jurisdiction. The franchise tax, with the addition of the earned surplus base, has also become more complex.

As Texas has expanded its sales tax to a wide range of business services, the difficulty in defining what is taxed and what isn’t has risen sharply. Under the classic retail sales tax, a chair is taxable. It is tangible and easily identified. But what are “data processing services” or “repair and remodeling”? The current question of how to treat transactions and other commerce involving
the Internet is yet another example of the confusion and complexity in this area of state tax law. Both taxpayers and tax administrators continue to grope through the many gray areas in the sales tax where the law does not provide concrete guidance.

**Tax Issues in the 76th Texas Legislature**

No one can predict with absolute certainty what tax and public finance issues will come before the Legislature when it convenes in regular session in January 1999. The current positive revenue situation indicates that there will not be the sort of intense scrutiny of the tax system that occurred during the 1997 legislative session, but Governor Bush's fiscal proposals almost guarantee that taxes and tax policy will be toward the top of the legislative agenda. This section looks at the 10 key tax issues likely to be considered by the members of the House of Representatives and Senate.

1. Property tax relief and school finance

The very existence of the Select Committee on Revenue and Public Education Funding illustrates the House's recognition of the inextricable link between taxation and public school finance in Texas. In 1999, this issue will again be at the top of the legislative fiscal agenda. Governor Bush has already proposed a $2 billion reduction in school district property taxes to be offset by increased state aid. These dollars would not be raised through additional state taxes but would be financed, under the governor's plan, through the state budget surplus that has been projected by the comptroller. The Bush plan, at the time this report was prepared, does not specifically outline a plan for distributing this relief. Presumably, these details may come from the governor at a later date. In any case, the Legislature will have to consider this issue closely in light of the results of the property tax reduction made in 1997 and the other needs of the state budget.

In the ongoing discussion of possible changes in Texas school finance policies, one issue that may need to be addressed is what to do about property tax abatements, particularly with regard to school districts. Prior to 1993, school districts made significant use of abatements, usually as part of broader local efforts to attract business and industries to their areas. Before 1993, the comptroller exempted the value of abated properties when it calculated a school's taxable value. In other words, the value of a property subject to an abatement agreement would...
not count toward a school district’s taxable value and the state would offset local revenue losses resulting from the abatements with added state aid. Senate Bill 7, enacted in 1993, changed this methodology, eliminating the exemption of abated property from the school value calculation. Under current law, the Comptroller’s Office only exempts the value of property abated before May 31, 1993, when it calculates taxable value.

This change has greatly curtailed the granting of abatements by school districts; however, the practice has not stopped altogether. A 1996 report by the Senate Economic Development Committee examined abatement agreements in the time after the 1993 law change and found that more than 50 school districts have granted tax abatements since the passage of Senate Bill 7. Records from the Texas Department of Commerce’s reinvestment zone registry for the same period indicated that more than 130 school abatement agreements had been executed since Senate Bill 7 became effective in 1993. The majority of these abatements were granted by low wealth school districts (wealth per weighted average daily attendance under $210,000). More recent data, however, showed that only 19 of the 221 tax abatement agreements reported to the state comptroller in 1997 included school district participation. Before 1993, the participation rate had been more than 50 percent.

It is also important to note that the abatements that have been granted in the wake of Senate Bill 7 generally are for shorter time periods than in the past and the amounts abated are also smaller. Many provide for a declining value of the abatement over the term of the agreement. However, the fact that they continue at all has attracted legislative attention. A flat prohibition on school abatements was part of the House-adopted version of House Bill 4 in the last legislative session. It appears likely that the issue will also surface in any further consideration of changes in school funding in the 76th Legislature. If this occurs, the Legislature has several options. It can, of course, do nothing, signaling an approval of local choice in these issues. It can prohibit the abatements altogether. Or it can prohibit school abatements in concert with changes in other business tax incentives that may come before the Legislature (see below).

---

2. **Consumer relief**

The governor also has proposed eliminating the sales tax on a number of consumer items under the sales tax, including over-the-counter drugs ($150 million two-year cost), health aids ($50 million over two years), diapers ($110 million), and Internet access ($20 million). He has also proposed an annual two-week sales tax holiday to allow tax-free purchases of otherwise taxable items like school clothes, which would cost an estimated $75 million over two years.

The primary reason for adopting these exemptions would be to provide direct relief to individual Texans and to improve the overall equity of the sales tax. On the down side, these changes would remove relatively fast-growing items from the sales tax base, causing a limited reduction in the growth potential of the tax.

3. **Internet taxation**

Beyond the consumer issue of exempting Internet access is the larger issue of how so-called e-commerce should be treated under Texas tax law. Texas has one of the broadest sales taxes in the country, a result of the tax bills passed in the late 1980s. Two items included in the base expansions of this period were data processing services and information services. The state has also included telecommunications services in its tax base.

Under these broad—and somewhat vague—concepts, state tax administrators have considered Internet access and related services to be taxable for a number of years. However, nationally, many states have moved to exempt transactions over the Internet as a means of encouraging the development of Internet-related industries in their states. Beyond the simple issue of charges for access to the Internet, the Legislature is likely to face a more fundamental (and expensive) question of whether it wants to continue to tax data processing and information services. At least that is the apparent direction of a government-industry working group created by the comptroller to examine this issue over the last few months. It is important to note that these changes would not only affect the Internet but also a wide range of other services currently taxed under these definitions.
4. Flat premium tax rate

Under the current system of "retaliatory taxes," Texas is allowed to tax foreign (out-of-state) insurance companies the way the foreign company's home state taxes Texas companies. Likewise, other states are allowed to tax Texas companies the way Texas taxes their companies.

In Texas, insurance premium tax rates vary depending on such factors as the type of insurance a company sells, the company's place of domicile, and, in some cases, the level of investment a company has made in Texas-related securities. For property and casualty companies, the rates range from 1.6 to 3.5 percent. For title companies, the rates range from 1.3 to 2.0 percent. Nearly all states apply the highest Texas rate to Texas companies. The result is that Texas companies pay millions to other states in retaliatory taxes while Texas collects little in retaliatory taxes from foreign companies.

One remedy to this situation that may be considered by the Legislature in 1999 is to replace the current tiered structure with a flat premium tax rate. It is estimated that a flat rate of around 1.7 percent for property and casualty would be "revenue neutral"—meaning that it would raise the same revenue as the current tiered structure. For title companies, the revenue neutral flat rate is around 1.35 percent.

5. Business tax incentives

One issue that has received considerable attention from the Texas business community is the potential for enacting tax incentives for businesses that make certain investments in the state. Texas has not used this form of tax policy to any large degree in the past; however, business tax incentives have become much more prevalent in our competitor states in recent years as governments have struggled to find ways to attract jobs and capital investment to their states. These credits are normally provided as percentage reductions in state corporate income taxes or, less commonly, state sales taxes. The credits sometimes are only available in the single year after a qualifying investment is made. In other cases, the credit may be spread over several years of tax liability.
# Table 3
## State Credits for Economic Development, 1998

<table>
<thead>
<tr>
<th>State</th>
<th>General Investment Tax Credit? (1)</th>
<th>Employment-Related Credit? (1)</th>
<th>Research and Development Credit?</th>
<th>Education or Work Force Development Credit?</th>
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<td>-</td>
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<tr>
<td>Alaska</td>
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<td>Wyoming</td>
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<td>X</td>
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</table>

### Totals
- 33 states
- 33 States
- 22 States
- 8 States


1. Many states (including Texas) offer job creation or investment credits in connection with economically disadvantaged areas (usually called enterprise zones). This table is limited to general investment and employment tax credits only.

2. Credit is limited to a narrow list of industries or to certain investments—e.g., construction materials only.

3. Investment tax credit program has a job creation requirement. Overlaps with investment tax credit provisions.

4. Biomedical parks only.
The two most commonly discussed business tax investments are the *investment tax credit* (ITC), which provides a credit for investment in plant facilities, machinery and equipment in the state, and the *research and development credit*, which provides a tax credit for investment in R&D jobs and facilities. Some states also use a related credit that is tied to job creation, and in fact, there are any number of variations on these basic themes. As Table 3 shows, the majority of states currently use some form of credit, and many states have combined ITC and R&D credits. Table 4 compares the policies in the states with Texas’ policy on a range of economic development incentives.

**TABLE 4**

<table>
<thead>
<tr>
<th>Tax Credit Policy</th>
<th>Number of States</th>
<th>Treatment in Texas</th>
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</thead>
<tbody>
<tr>
<td>Investment Tax Credit</td>
<td>33</td>
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</tr>
<tr>
<td>Job Creation Credit</td>
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<td>Education Credit</td>
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<tr>
<td>Research and Development Credit</td>
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<tr>
<td>Enterprise Zone Programs</td>
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<tr>
<td>Sales Tax Machinery Exemption</td>
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</tr>
<tr>
<td>Sales Tax R&amp;D Exemption</td>
<td>33</td>
<td>None</td>
</tr>
<tr>
<td>States with ITC and R&amp;D Credits</td>
<td>18</td>
<td>None</td>
</tr>
</tbody>
</table>


Over time, these credits can have the dual effects of reducing the burden of the tax system on capital-intensive industries and can produce increases in jobs and investment in the state. The question, as with any tax exemption or tax credit, is the cost. Governor Bush has proposed a research and development credit—again with only limited detail available at this time—although R&D credits have been introduced in the Legislature several times in recent sessions. The governor has proposed setting aside $250 million during the 2000-01 budget period for this incentive. Depending on its provisions, the cost of the ITC is likely to be higher than the R&D credit, since more taxpayers typically qualify. However, the ITC has the advantage of being available to more taxpayers in a wider geographic area within the state, since not all taxpayers with sizable business tax bills in Texas will have research and development facilities in Texas, but they may be making regular capital investments and creating new jobs.
The cost and coverage of either the R&D credit or the investment tax credit can be affected by a range of policy components that would be part of any legislation implementing a credit program. These include:

- The rate of the credit
- The basis of the credit (total investment or incremental change from prior base period)
- Taxes the credit can be taken against
- Credit threshold requirements (i.e., minimum investment levels or minimum job creation requirements)
- Limits on the amount of tax liability that can be reduced
- Limits on the duration of the credit
- Carry back or carry forward provisions
- Eligibility of non-corporate businesses
- Geographic or economic limitations
- Other special provisions (e.g., start-up companies, special industries, etc.)

6. Small business exemption under the franchise tax

Another proposal made by Governor Bush in his fiscal plan is to exempt small businesses from the corporation franchise tax. The idea behind this proposal is that it costs more to collect the tax from these businesses than is raised from their taxation. This also provides a measure of tax relief to the small businesses. In total, the governor expects this policy change to reduce franchise tax collections by $57 million in 2000-01. Its main effect on the tax system beyond the revenue impact would be to release several hundred thousand small franchise taxpayers from the obligation to pay the tax.

7. Taxation of banks under the franchise tax

Another business tax question that is likely to come before the Legislature in 1999 deals with the franchise tax policy related to banks. Like other corporations, banks are subject to the franchise tax, but their tax calculations differ from other industries. When banks calculate their share of business done in Texas, they apportion their interest and dividend income based on the
commercial domicile approach, meaning that this income is attributed to the location of the bank's headquarters. If the headquarters is in Texas, the apportionment factor to Texas increases. This is, of course, the exact opposite of the sourcing of intangibles for every other type of corporation under the franchise tax, which is based on the location of the payor of the dividends and interest.

The reason for this difference relates to the circumstances under which banks were taken into the franchise tax in the mid-1980s. Prior to 1985, banks were subject to the bank shares tax, which was a local property tax on the value of each bank's share less the value of its real estate. In 1985, the Supreme Court invalidated this taxing approach, and the Legislature enacted the bank franchise tax to make up for the revenue loss to local governments. The income from the bank tax was allocated to local governments based on where the bank was located, thus making the commercial domicile approach the best way to insure that the income went to the right local government. However, in 1991, the bank franchise tax was repealed, and banks were brought under the regular corporate franchise tax. The commercial domicile rule for sourcing of interest and dividends received by banks was retained.

The commercial domicile approach for banks created no particular problems for the franchise tax until recently. In the past, banks were generally limited to a single location or at least confined to a single state. Thus, a bank doing business in Texas with Texas customers could expect to pay franchise tax. This began to change in 1994, however, when federal legislation permitted interstate branching. As the large interstate banks have consolidated their operations in their home states—often outside Texas—receipts that were once attributed to Texas will become receipts in the bank's home state and not subject to Texas franchise tax. It is estimated that franchise tax payments from banks will be reduced by as much as half as the pace of interstate branching quickens in the next few years.

There are two major policy options to allowing this loss to happen. One is simply to put banks under the same interest and dividend sourcing rules as other corporations. The other is to move to a more complicated three-factor apportionment approach that takes into account a bank's employment, property, and receipts in Texas. This latter approach has been used in a number of states. Both of these approaches would recover some of the income that is likely to be lost under the current method of taxation.
The three-factor approach offers the benefit of being consistent with many other states and providing the broadest approach to income apportionment. It would restore much of the revenue expected to be lost through interstate banking. However, it would significantly increase taxes on in-state banks with high concentrations of payroll and employment in the state. It may also concern other industries that favor the current location of payor approach under the main franchise tax.

The location of payor approach, on the other hand, would recover less of the revenue lost through interstate branching. However, it would put banks more in line with the tax policies affecting other types of business, including financial services companies that compete with banks in the financial markets.

8. Tax impact of electric utility deregulation

The Texas Legislature will also be considering the issue of whether—and how best—to permit the deregulation and restructuring of the electric utility industry in Texas. Beyond the complex public policy issues surrounding this issue generally, there are also a host of tax-related questions that the members of the House of Representatives and Senate will have to consider. A recent analysis by the Comptroller’s Office reviewed the tax implications of electric deregulation and found a broad range of tax impacts can be expected, including substantial effects on state utility taxes and local franchise fees, the sales tax, and the property tax.¹⁹

9. Reforestation incentives

Generally speaking, farm and ranch producers receive a number of tax advantages under property, sales, and other taxes that are not available to timber producers. Moreover, forest acreage in Texas is being consumed faster than it is being replanted.

An issue likely to come before the Legislature in 1999 is to improve the economic situation of the forest products industry through changes in tax policy. First, legislation may be proposed to bring the taxation of the forest products industry in line with other areas of agribusiness (which could include exemptions for common agricultural inputs like seed, fertilizer, and the machinery used to process raw logs to finished wood products). Second, legislation may

be proposed to establish tax incentive programs to encourage private landowners to reforest lands once the timber has been harvested. Several approaches could be used to encourage reforestation, including investment tax credits and property tax relief on acreage that is newly planted.

10. Miscellaneous state and local tax issues

The Legislature has had an ongoing interest in making improvements in the method of local property tax appraisal to make the system fairer and more understandable to taxpayers. There have been a number of proposals for reforming the current property tax system. Since these taxes continue to rise and Governor Bush has expressed an interest in further reductions in school property tax, it appears likely that various ideas for appraisal reform will also be considered by the Legislature in 1999. In addition, appraisal reform legislation from the 1997 session has resulted in some administrative difficulties for local taxing units and appraisal districts. It is likely that legislation to address these difficulties will be proposed.

The Legislature is also frequently asked to make various adjustments in the administrative procedures surrounding the operations of state taxes. One issue likely to surface in 1999 has already been raised by Comptroller-elect Rylander. This is the idea of paying interest on refunds of state taxes. The state currently charges interest on delinquent taxes, but paying interest on refunds was discontinued as a revenue raising measure in the 1980s.

Moreover, members are also likely to see proposed legislation involving the continuing process of clarifying past tax law for the benefit of taxpayers and state and local tax administrators. One issue likely to be discussed during the session in this context is further clarification of the legislative language needed to implement successfully House Bill 1855 from last session. This bill became effective on October 1, 1997. It was primarily a response to the Texas Court of Appeals decisions. These cases made significant changes in prior state interpretation of what constituted tax exempt manufacturing equipment under the sales tax, particularly as it applied to piping and conveyor systems. The Legislature’s intent was, as near as possible, to restore the original state interpretation of the law. To date, the Comptroller’s Office continues to work with industry to define the “gray” areas of the law and court rulings, but there

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20 Sharp v. Chevron Chemical Co., 924 S.W.2d 429, and Sharp v. Tyler Pipe Industries, Inc., 919 S.W.2d 157
is some likelihood that either the comptroller or industry will seek further legislative guidance on this issue. Because of the size and importance of the manufacturing equipment exemption under the sales tax, members may find that this highly technical issue also has very important policy and revenue implications.

**Franchise tax “location of payor” rule**

One of the most hotly debated tax issues to come before the Legislature in 1997 was a proposal to change the “location of payor” rule for establishing the source of a corporation’s income from intangibles—interest, dividends, and capital gains. Part of this discussion dealt with various means of franchise tax planning that used limited liability partnerships to reduce a firm’s franchise tax liability. The option considered by the Legislature was to shift to a sourcing rule based on the commercial domicile of the firm—the place where it has its corporate headquarters.

Information presented by the Comptroller’s Office suggests that the shift to commercial domicile sourcing would produce a substantial increase in tax income. The comptroller’s 1997 estimates indicated a gain of $145.4 million in the first year of implementation and $84.2 million in the second year. This total would drop in the third year to around $52 million (Table 5). The drop in collections reflects the comptroller’s view that corporations would adjust to the change in sourcing rules and would make other changes to reduce their franchise tax liability.

During the interim, the Texas Taxpayers and Research Association (TTARA) published an extensive review of this issue. The organization, which represents business taxpayers, found that while the general views on location of payor were correct—it is used by some firms for tax

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**TABLE 5**

**REVENUE IMPACT OF CHANGING FROM LOCATION OF PAYOR TO COMMERCIAL DOMICILE SOURCING OF INTANGIBLES**

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Revenue Impact</th>
<th>% Change</th>
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<tbody>
<tr>
<td>1998</td>
<td>$145,370,000</td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td>84,170,000</td>
<td>-42.1%</td>
</tr>
<tr>
<td>2000</td>
<td>52,050,000</td>
<td>-38.2%</td>
</tr>
<tr>
<td>2001</td>
<td>54,739,000</td>
<td>5.2</td>
</tr>
<tr>
<td>2002</td>
<td>60,481,000</td>
<td>10.5</td>
</tr>
</tbody>
</table>

planning purposes—there are other issues to be weighed in making a judgement about the policy. Location of payor sourcing allows firms to have their headquarters in Texas and to realize interest and dividend income from their operations in other states and other countries without being subject to Texas tax. Only Texas-based receipts are apportioned for tax under this approach and it avoids forcing the companies to face double taxation on their out-of-state intangible income (this income is typically subject to tax in the state where it is earned). TTARA concluded that this approach makes Texas attractive for the location of company headquarters, and although taxes are not generally the most important issue in a company’s decision of where to locate, they also are not ignored by a firm’s management, particularly if they have a significant financial impact.

One impact of shifting to commercial domicile sourcing would be to increase greatly the taxes of multistate firms headquartered in Texas, while reducing the tax on corporations headquartered in other states. Based on interviews with corporate tax specialists, TTARA summarized the likely response of Texas headquartered firms:

[T]he changes to be made would be fairly straightforward. Among the many strategies taxpayers may adopt, there are two major ones. In the first, the commercial domicile of the firm is simply reestablished in another state. Many Texas-based companies incorporate in Delaware in any case, and while would have to consider the impact of a move on taxes in other states, there are several states which would be attractive to relocating headquarters—either to a state with no corporate income tax or to one which offers significant tax incentives to attract business location . . . . A second, less obvious response would focus on Texas operations of the overall firm that could be relocated out of state to reduce tax liability in Texas. An example of this would be a Texas subsidiary that mainly conducts financial trading and lending operations, generating income from dividends and interest on its funds management operations. Such a subsidiary would be hard-hit by a shift to commercial domicile, and the parent might simply choose to relocate this business operation to another state.

Over time, the base of the franchise tax and who is subject to business taxation are likely to be an issue again in Texas. However, it appears unlikely that this will be the case in 1999.

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22 TTARA Research Foundation, pp. 55-56.
Nevertheless, these questions lie in the background of virtually any discussion of the state's main business tax.
III. SUMMARIES OF INDIVIDUAL REVENUE REPORTS

Committee members were asked to prepare discussion papers on various revenue topics and to present the papers to the committee. The topics assigned to members and the dates the papers were presented are listed below:

- Property Tax – Representative Williamson (April 22, 1998)
- Agricultural Exemptions – Representative Chisum (April 22, 1998)
- Insurance Taxes – Representative Brimer (August 24, 1998)
- Oil and Gas Taxes – Representative Craddick (August 24, 1998)
- Professional Fees – Representative Hilbert (August 24, 1998)
- Franchise Tax – Representative Junell (August 24, 1998)
- Sales Tax – Representative Stiles (October 27, 1998)

This section summarizes these papers. Edited versions of the papers appear in a separate document.

Property Tax

The property tax is the principal means of funding local governments in Texas. In 1996, property taxes generated more than $16 billion in revenue for Texas local governments. Public school districts levy almost 60 percent of property taxes; cities, counties, and other local governments levy the remainder. The property tax is authorized and regulated by the Constitution and laws of the state, but the tax is administered locally. Appraisals are performed by countywide central appraisal districts, while more than 3,500 individual local governments levy the tax. The Texas system has been described as one of the best in the country because of its centralized appraisal, taxation at market value, and professional standards. Nevertheless, the property tax is frequently identified as the least popular tax by opinion polls.
Agricultural Exemptions

Agriculture has a long tie to the history and economic development of Texas. Recognizing its special place, the Texas Legislature has, through the years, enacted laws designed to reduce the tax burden on farm, ranch and timberland with the goal of maintaining this important industry's role in the state. Agricultural exemptions can be found in virtually every major tax levied by Texas state and local governments. The most important of these exemptions can be found under the local property tax and under the state’s general sales tax. However, agricultural producers are also eligible for exemptions under the motor fuel taxes, and certain types of agricultural organizations have been exempted from the state’s corporation franchise tax and insurance gross premiums taxes. The single most important tax exemption granted to Texas farmers and ranchers is the open space land provisions under the property tax.

Insurance Taxes

The taxation of insurance companies under Texas law is one of the most complex parts of state tax law. All insurance companies are taxed primarily on their gross premiums earned in Texas. However, companies pay different rates depending on the lines of insurance they offer—life, accident, and health, property and casualty, title and so on—and there are other taxes and fees that also play a part in the overall structure of insurance taxation in Texas.

One of the more complex aspects of the insurance tax structure is the retaliatory tax. Essentially, this is a tax levied on out-of-state companies doing business in the state when the rates in their home states on Texas insurers are higher than Texas rates. A major issue with Texas insurers is the fact that, for property and casualty insurers in particular, the Texas tier-rate system is seen as penalizing Texas companies when they do business in other states. In addition to gross premiums and retaliatory taxes, insurance companies also pay maintenance taxes to help cover the state’s cost of insurance regulation and various other specialized assessments and fees. Taken together, the industry paid more than $770 million in taxes and fees in fiscal year 1997. The premiums tax and retaliatory taxes alone accounted for $610 million of this total.

Oil and Gas Taxes

The oil and gas industry is one of the top three taxpayers in state and local taxes. In addition to the severance tax on oil and gas, the industry also pays a disproportionate amount of
property taxes in the state. Texas is the only major producing state that assesses property taxes on oil and gas reserves. Thus, a molecule of hydrocarbon is taxed year after year until it is produced and then the producer pays a severance tax on it. If that molecule is converted into motor fuels, there are additional taxes due. In addition, the producer, if incorporated, pays a franchise tax on the income derived from the production and sales taxes on all purchases of tangible personal property and all taxable of services.

The oil and gas industry makes up 6.6 percent of the state’s Gross State Product (parts of the oil and gas industry like refining and pipeline are included in other industry categories such as, manufacturing and transportation), but account for ten percent of the state and local sales taxes, 6.6 percent of the franchise tax, 9.5 percent of the property tax, 11.4 percent of the motor fuels tax and 100 percent of the severance taxes.

Professional Fees

In 1987, Texas began collecting revenues from 12 of the 94 major, state-licensed professions, in addition to basic fees charged by each state regulatory agency for annual licensing purposes. While often referred to as “fees,” there is debate as to whether these assessments are actually taxes, an important legal distinction.

The assessments were allowed to expire for two years (fiscal years 1990-91), but were reinstated and made permanent beginning in 1992. In the current two-year budget period (1998-99), these additional professional “fees” will contribute an estimated $159.7 million to the state’s general revenue fund. The current assessment, at $200, will affect more than 798,000 licensees during this biennium. Whether these additional professional fees constitute “progressive taxation”—i.e., applies a higher tax rate as the income of the taxpayer increases—can also be debated. But, generally speaking, the professions that pay these fees are often more highly compensated than professions which are not subject to these fees. Tennessee is the only other state to adopt this approach to raising revenue. The outlook for state revenue from these additional assessments is relatively stable. The number of persons involved in the affected professions does not fluctuate substantially from year to year.
Lottery

Since its enactment, the lottery has become an important source of revenue for state government. The comptroller estimates that the state will collect $4.4 billion in lottery revenue for the 1998-99 biennium. After payments for prizes and administration, approximately $3.0 billion will be available for state spending during the two-year budget period.

Before fiscal 1998, net lottery proceeds, after deducting prizes and administrative expenses, were available for general state spending. House Bill 4, enacted in the last legislative session, dedicated lottery net proceeds to public education, thus curing a long-term misperception by a large portion of the general public that believed the lottery has always been dedicated to public schools.

Corporation Franchise Tax

The corporation franchise tax generated $1.8 billion in revenue in 1997, making it the state's third largest source of tax revenue. It is the state's primary business tax and is levied on an annual basis on corporations and limited liability companies.

Prior to the 1980s, the franchise tax had been a fairly stable revenue performer—accounting for between five and seven percent of state tax revenue. Tax increases and surtaxes imposed during the economic problems of the 1980s caused it to increase to nearly nine percent of state tax revenues; however, a series of court cases led to substantial refunds, resulting in a restructuring of the tax in 1991. The 1991 revisions lowered the tax rate on capital and added an alternative tax calculation based on "earned surplus"—essentially the sum of a corporation's net income and compensation paid to its officers and directors.

Sales Tax

State sales tax continues to represent the largest revenue source of the state's tax system. Since its enactment in 1961 at a rate of two percent, the sales tax rate has increased seven times while the base fluctuates with the establishment and/or annulment of exemptions, exclusions and credits. Sales tax revenues in the 1998-1999 biennium are projected to be $24.1 billion, 55.4 percent of total estimated tax revenues. Collections are expected to rise more modestly than in the previous biennium. Major economic indicators such as gross state product, personal income and employment indicate that the Texas economy will continue to expand at a faster rate than the
national economy. Texas has the 6th highest sales tax rate and the 19th broadest sales tax base of the 50 states. Texas' rate is 1.08 percent higher than the national average, but the absence of a personal income tax offsets this rate.
IV. SUMMARIES OF INVITED TESTIMONY

This section recaps the testimony of the expert witnesses who appeared before the committee at the committee’s request.

1. The Texas Economy (Perryman)

A presentation on the outlook for the Texas economy was given by Ray Perryman23 on December 1, 1997. The following summarizes his presentation.

U.S. Economy. In the short-term, the U.S. economy is expected to continue to grow, but at a modest pace. The Federal Reserve will most likely choke off any growth that goes beyond modest growth. If there is a recession, it will be a modest recession.

There are two major tax initiatives at the federal level: flat tax and national sales tax. Neither is likely to pass in the foreseeable future because: (1) there is no revenue crisis currently; (2) government deficits are down; and (3) there is not a focused, coalesced group advocating change.

Technology is having a dramatic effect on everything we do. Moreover, technology has significant implications for education, which raises the question: What type of education is appropriate? The education process must be updated to integrate technology throughout the curriculum. Another implication of technology is that the occupations of the future probably don't exist today. Computers are putting more emphasis on ability to learn and to relearn.

Texas in the Global Economy. The economic turmoil in Asia is having a significant impact on Texas, even though only a small part of Texas trade is with countries in Asia. The Asian crisis affects Texans with money in the stock market.

23 Chief Executive Officer, The Perryman Group.
Texas is the second largest state in dollar volume of exports. Over last four years, our exports have grown by 50 percent. That trend is likely to continue because: (1) we are well-located to emerging markets; and (2) we have a competitive infrastructure (highways, education system, transportation, communications systems, etc.). Two out of three jobs in Texas are linked to the global economy.

The U.S. balance of trade is currently running a $100 billion a year deficit, but the balance of trade in the service industry is running a $70 billion a year surplus and growing. Service is a significant export sector. Our costs are higher in manufacturing, particularly in "low end" manufacturing (due to the minimum wage). The U.S. imports more goods than services, partly because it has one of the most efficient distribution systems in the world.

It is impossible to say where globalization is going, but the U.S. economy is on a general trend of freer trade. The U.S. benefits more from reductions in tariffs than other countries, but loses some low-wage jobs. On balance, global free trade has been positive for the U.S.

In the past, Mexico pegged the peso to the dollar. As each Mexican president left office, the peso was devalued. When President Salinas left in 1994, the peso was not devalued, which drastically reduced the purchasing power of Mexicans. This is significant because 40 percent of goods purchased by Mexico are made in Texas. The peso is floating now.

**Texas Demographics.** Texas' population growth rate is higher than California. Net migration accounts for around 70 percent of the state's population growth, while births-over-deaths accounts for around 30 percent. There is a huge economic incentive to come to Texas from Mexico. People move to Texas from other states generally because of relative economic opportunity. Economic opportunity brings people to Texas, not education or social programs. Moreover, those migrating to Texas from other states tend to be young people or retirees. Births-over-deaths growth is concentrated in South Texas. Due to the younger population, which tends to have higher unemployment rates, the unemployment rate in South Texas is perpetually higher than the rest of the state. Moreover, Hispanics have higher unemployment rates all around the country. The illegal population also contributes to the unemployment rate.

The "working age population" is getting a little smaller. While the under-20 age group is stable, the group that is almost doubling is retirees. Historically, Texas has attracted lower- and middle-income retirees. (Arizona and Florida attract higher-income retirees.) That puts some
strain on the social system, particularly in health care. While some retired people are moving to Texas to avoid state income taxes, primary motivations are climate, proximity to children, and cost of living.

It is projected that in 2030, the white population will be smaller and the Hispanic population will be increasing, with Hispanic growth concentrated in South Texas.

We face a $200 million “net cost” annually in Texas because of illegal immigration. The only way to address illegal immigration in the long run is for the economic situation in Mexico to improve.

**Job Growth in Texas.** Texas is showing a net gain in high wage manufacturing jobs, but the predominant growth has been in services and trade, mostly at a lower wage. We’re not necessarily moving toward a lower wage economy. Increasingly, we’re going to see unskilled workers moving to service jobs. Also, “outsourcing” may inflate the number of service jobs. Net growth in manufacturing is a very positive phenomenon, because it overcomes the outsourcing.

On balance we are creating high wage jobs at a good pace, above that of most states. But we are also creating a significant segment of lower paid services jobs. On balance, wages are slightly lower when you adjust for inflation.

There is not a good way to measure whether migrants from other states are taking higher paying jobs and people from Texas are getting lower wage jobs. We’re not seeing a big immigration of unskilled workers.

**Texas Tax Environment.** We have a very heavy reliance on sales and property taxes. Both are efficient ways to raise revenue, but both have problems. Sales tax is regressive. Property tax caps are about to descend upon us. Neither is a good proxy of what’s going on in the economy.

There have been a number of surveys of states to determine what creates jobs. In terms of our business climate and tax structure, we’re in the middle of the pack. It’s neither a hindrance nor an aid.

Lack of a heavy tax load on the service sector does induce services to come to Texas, because anytime you have a relative advantage, it’s an incentive. One of the most studied issues is why companies locate where they locate, and the answer is nobody knows. But one thing we do know is that taxes are rarely a single determining factor.
Government can influence behavior through tax policy (examples are pollution, tobacco, and alcohol). The factors that influence job creation are related to the bottom line cost of doing business (transportation, labor, raw materials, and taxes). Typically on surveys tax policy comes in somewhere around seventh or eighth as a factor. It can be important at the margin—when a business is down to two locations competing for the same plant, for example. Tax incentives can become important. Other states are over the map on tax abatements.

**Texas Economic Outlook.** Texas has a growing workforce, competitive policies, a great location, and is a part of the global economy. The growth areas are high technology, manufacturing, services, and so on. They’re not as volatile as oil and gas, but they are cyclical.

Austin is growing rapidly because of the presence of high technology industries. Generally, the larger cities are where economic activities are concentrated. Dallas-Fort Worth and Houston combined is roughly 50 percent of the state’s economy. Most rural areas are seeing a decline in population. Areas dependent on oil and gas are doing well right now with no expectation for another major slump. Rural areas are generally in a state of decline. The problem is that the average age is increasing in rural areas. The border region will see high growth and high unemployment. San Antonio will make some readjustments because of the decline in military spending and that decline is expected to continue. Generally, growth is expected in every area except some rural areas, with significant growth in Austin, the border region, and major metropolitan areas.

**Deregulation.** Deregulation has implications for state tax policy. The state’s options on taxing a monopoly utility are wide open, but in a competitive situation, the way the state chooses to tax can have a significant distributional impact. Deregulation has been both a national and state trend.

2. **Tax Policy and the Economy (Hamilton)**

A presentation on the relationship between tax policy and the state’s economy was given to the committee by Billy Hamilton\(^{24}\) on December 1, 1997

Our understanding of how businesses make decisions, how taxes enter those decisions, and how taxes affect economic activity is limited. Early studies found that taxes have little or no

impact on economic activity. More recent studies have come to a different conclusion: taxes have an impact, especially in certain cases. The impact may ultimately depend on the particular situation of an individual industry or an individual firm. Texas tax policy treats different industries differently—mostly for historical reasons. Under whatever measure, the Texas business tax climate, while it has some "sore thumbs," is fairly positive. (The "sore thumbs" include taxation of business inventories, focus on capital intensive industries, and so on.)

**The Texas Economy Today.** Overall, Texas ranks sixth among the states in economic activity, having one of the most robust economies in the U.S. The Texas economy was very strong over the 1994-96 period. This economic strength is also reflected in state revenues. Currently, there is a surplus in the state treasury of $965 million. We have had extraordinarily strong growth in several state taxes.

**Do Taxes Matter to Business?** Earlier studies suggested that taxes didn't really matter to business decision-making, but more recent studies have suggested that they do matter in certain situations, depending on the company, the industry, and the period in the economic cycle. Taxes matter more for several reasons. The rising level of state and local taxes has made taxes a more important consideration for business. Interjurisdictional tax competition has become more significant and sophisticated as state and local governments duel to attract economic development. The globalization of the world economy has made every cost factor important. Finally, the mix of industries in Texas is changing. Today, industries can more easily respond to tax differentials. Services, for example, are in a better position to react to taxes.

**Comparing Business Tax Burdens.** Comparing business tax burdens is a murky area of tax policy analysis, with few satisfactory answers. There are two ways to measure tax burdens. Aggregate analyses compare tax systems over all industries. It is a general indicator of tax impact. This approach suggests that Texas tax policy is in good shape. Using the "ACIR methodology"—type of aggregate analysis—Texas has the sixth best tax climates among the states. Under the hypothetical firm approach, a hypothetical firm for an industry is used to compare the tax impact state by state. Results vary from industry to industry. State and local governments often hope to overcome negative aspects of their tax systems through tax incentives.

**Who pays taxes on business?** The imbalance toward mining, manufacturing, utilities is well established for the franchise tax. Efforts have been made to improve taxation of businesses.
Machinery and equipment are exempt under the sales tax. Special industry exemptions (e.g., oil and gas) have been provided to encourage economic activity. The franchise tax base has been revised to shift the tax away from capital intensive industries.

**Mail order sales.** When a good is purchased from an out-of-state source that doesn't have nexus with Texas (e.g., Land's End), the tax is owed by the person who makes the purchase. What states like Texas have wanted for some time is for companies that don't have nexus to remit the tax. Two U.S. Supreme Court cases\(^{25}\) have held that it's Congress's providence to handle this issue, not the states. However, many of these companies want to do more business in this state and have been negotiating for years to reach an agreement. Negotiations are still ongoing. Sales tax on catalog sales could produce an additional $100 million a year, depending on how many direct marketers participate. Many smaller out-of-state firms will never participate.

**Internet services.** Internet access services are taxable (similar to Nexis and Lexis). Sales of individual goods over the Internet are treated the same as catalog sales. Other activities such as development of web pages and advertising are subjects of discussions with the industry currently. There has been an effort to preempt state taxation of Internet activities at the national level.

**National sales tax.** This would have a significant impact on Texas revenues. The rate of the federal tax could as high as 40 percent, depending on the base and revenue to be replaced. It would be levied on top of the state rate. It could reduce state revenue by billions.

Mr. Hamilton's testimony also included five "good" things about the Texas business tax climate (Table 6a) and five "bad" things about the Texas business tax climate (Table 6b).

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THE TEXAS TAX SYSTEM TODAY

<table>
<thead>
<tr>
<th>TABLE 6A</th>
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<tr>
<td><strong>FIVE “GOOD” THINGS ABOUT THE TEXAS BUSINESS TAX CLIMATE</strong></td>
</tr>
<tr>
<td>1 Texas does not have a personal income tax, which helps attract service firms.</td>
</tr>
<tr>
<td>2 Texas has a low overall tax burden.</td>
</tr>
<tr>
<td>3 Texas has a sales tax exemption for manufacturing equipment.</td>
</tr>
<tr>
<td>4 Texas has a relatively low corporate tax rate and no tax on non-corporate businesses (although this may raise equity issues).</td>
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<tr>
<td>5 Texas has a strong, stable, diverse economy underlying the state and local revenue system.</td>
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<th>TABLE 6B</th>
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<tr>
<td><strong>FIVE “BAD” THINGS ABOUT THE TEXAS BUSINESS TAX CLIMATE</strong></td>
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<tr>
<td>1 Property taxes are relatively high in Texas.</td>
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<td>2 Texas is one of only a few states to tax business inventories.</td>
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<td>3 Texas has a high percentage of total taxes paid initially by business.</td>
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<td>4 Texas has skewed the tax burden toward certain industries.</td>
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<td>5 There is uncertainty with respect to future tax policy.</td>
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3. What is a “Good” Tax System? (Hazleton)

A presentation on “What is a ‘Good’ Tax System?” was given to the committee by Jared Hazleton26 on January 21, 1998.

A government never adopts a tax system in one move. It adopts taxes one at a time and builds a system piecemeal. When changing a tax, policymakers should look at the overall effect of the change. Taxes generally follow the path of least resistance. Government first taxes what is paid by someone else, such as exports. Then, on exhausting those opportunities, government taxes that which is fixed and immobile, such as railroads, utilities, or capital-intensive structures. These are more easily taxed if they are monopolies and the costs can be forwarded. Eventually government must broaden its tax base.

26 Professor, Texas A&M University.
Forms of Taxation to Broaden the Base. Income taxes have a flaw in that they tax savings, but a virtue in that they are broadly applied and the best measure of ability to pay. Consumption taxes such as sales or excise taxes have the advantage that the payer can decide how much he or she wants to be taxed. They have the disadvantage that they tax the poor more heavily than the rich, but that problem can be alleviated by exemptions. Property taxes are popular among taxing authorities because of ease of definition and the relative immobility of taxable property. Most states choose one or more from among these three. Only four states have no sales tax. Only seven have no income tax (or nine, counting two states that only tax interest and dividends, versus earned income).

Attributes of a Good Tax According to Adam Smith (1776). Taxpayers should contribute support to the government in proportion to their respective abilities, based on the personal revenue they enjoy under the government's protection. A tax ought to be certain and not arbitrary. The time, manner, and quantity of payment ought to be clear both to the tax contributor and to everyone else. A tax should be levied at the time it is most convenient for the contributor to pay it. That is, the tax ought to be easy to pay. A tax should be designed to remove from the pockets of the contributors as little as possible beyond what the tax brings into the public treasury. That is, taxes ought to be efficient. They can be inefficient in four ways. First, the tax may require too many administrators whose salaries drain the proceeds. Second, the tax may divert some of the community's capital and labor from more to less productive employment. Third, attempted evasion of the tax, and associated penalties and forfeitures, may ruin a taxpayer's livelihood and remove the taxpayer as a public benefactor. Finally, a tax may expose taxpayers to vexation and regulation, prompting such evasions.

<table>
<thead>
<tr>
<th>Year</th>
<th>Review</th>
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<tr>
<td>1983-85</td>
<td>Committee on Fiscal Policy</td>
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<td>1988-89</td>
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<td>1991</td>
<td>Governor's Task Force on Revenue (Connally Committee)</td>
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<tr>
<td>1996</td>
<td>Staff Work Group on Property Tax Relief and the Citizens' Committee on Property Tax Relief</td>
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Criteria for a Good Tax System. The following four criteria provide no blueprint, but are factors to consider.

1. A tax system should be adequate in yield. It should collect enough to support revenue needs—predictably, with stability, and without major fluctuations. It should be broadly based so as to ensure low rates. It should recognize interconnecting influences among federal, state, and local taxes.

2. It should be fair and equitable to businesses and individuals alike. There should be a level playing field among businesses without discrimination based on the type of business or the form of business structure. Taxes should be uniform and predictable in application and should avoid duplication or pyramiding.

There are two kinds of fairness. First, people ought to pay in proportion to the benefits they receive. Gasoline taxes in support of highway use approximate this goal. With other taxes, measurement of benefit and application of the principle are difficult. Second, taxes ought to be based on ability to pay. Those in equal positions ought to pay the same (horizontal equity). Those in different circumstances ought to pay differently. The problem is defining how much differently.

3. It should be efficient. Taxes ought to interfere with the market mechanism as little as possible and avoid unnecessary or unintentional damages. They should be competitive with taxes of other states. There should not be heavy reliance on tax incentives that favor certain businesses over others.

4. It should produce ease of administration and compliance.

Are There Any Other States or Nations Texas Should Emulate? No. States have arrived at their combinations of taxes based on particular political forces and the particular structures of their economies. None are worth emulating; all are compromises.

How Does Texas' Tax System Fare, Evaluated Against the Four Criteria? Both the Connally Committee and SCOTE judged Texas' system harshly. The Connally Committee found the state overly dependent on a regressive sales tax. (The comptroller's analysis finds the tax system mildly regressive because of the exemption of food and drugs.) The committee found business taxes highly inequitable. Franchise tax changes since then have slightly eased the burden on capital-intensive industries.
SCOTE reached many of the same conclusions and was concerned also about adequacy. Members felt the tax system to be too narrow in its bases. Since SCOTE Texas has broadened the sales tax base and has raised the rate. Yield is more responsive to growth of the economy than in 1989, but has yet to be tested by an economic downturn.

Other questions include whether the system is too regressive and whether Texas has removed enough of the business tax inequity with respect to capital-intensive industries and the growing service sector.

Relative Growth by Economic Sector. Economic growth nationwide has been in knowledge-based industries that rely more on people than on physical capital. The states that have grown the most are those with service sector growth. States such as Ohio with a history of heavy industry have been downsizing and restructuring to the extent that their industrial sectors are now very competitive.

Tax Incentives as a Factor in Growth. The evidence does not indicate that tax incentives for business locations have been significant in terms of overall growth. Growth of the knowledge sector, including the associated manufacturing component, had its genesis in California principally because of investment in quality higher education. Quality-of-life factors are important in attracting of new business. The availability of a good workforce is a plus, but one can attract a good workforce with a good location. There is little to support the idea that tax systems per se have affected location decisions. For instance, the Minneapolis area has an unattractive tax system but has other factors working in its favor.

At the margin, for a specific siting decision, once other determinants have been addressed and have narrowed the options, relative tax considerations can be a deciding factor. In some cases, tax considerations can be part of the initial narrowing. From a purely economics standpoint, it would be better generally to outlaw abatements. Their only justification is for areas such as inner cities with an absolute need for investment. Without any abatements whatsoever, siting would probably be very similar to siting with abatements. For practical purposes, abatements are awarded because other areas and regions are granting them. One cannot ignore the competition issue.
The state, however, needs to consider all other threshold siting factors and make sure it addresses them adequately. Otherwise, Texas won’t attract new industries no matter how much it offers in the form of incentives.

**Links Between Tax Adequacy and Tax Equity.** If the service sector is undertaxed and higher income groups are undertaxed, has Texas in effect hitched its wagon to the smallest horses? Texas’ tax structure has evolved from a history of taxing heavy industry, mainly oil and gas. Over time, the tax base has been broadened. The sales tax is difficult in many cases to apply to service industries, as evidenced by the examples of newspapers and advertising. Property taxes have little effect on the service industries because most such industries do not have a large investment in property. Franchise taxes have been broadened somewhat in applicability. New business tax proposals such as value-added taxes can cover certain portions of the service sector. If the goal is to tax service industries more, income taxes can accomplish that goal. Income taxes have the disadvantage that they operate against economists’ prescription to tax consumption rather than savings or earnings. There are potential virtues, however, in terms of equity. Texas’ current system is unfair not because it fails to tax the rich enough but, if anything, because it taxes the poor too much.

4. **State Workforce Issues and the Texas-Mexico Border Economy (Angelou & Roberts)**

A presentation on the Texas-Mexico border economy and state workforce issues was given to the committee by Angelos Angelou\(^{27}\) and Jon Roberts\(^{28}\) on January 21, 1998. Following is a summary of their presentation.

Texas has enjoyed a robust economy over the last five years. During the period, gross state product increased by 18 percent, and more than 1,500 manufacturing facilities were added or expanded. For the first time, the high-tech and export sectors have become leading growth engines. The Texas workforce has increased by more than a million, and unemployment has been reduced by nearly a percent.

**Workforce Development.** The state’s workforce development programs remain underutilized. Candidates for training are stigmatized, the private sector views participation as

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\(^{27}\) President, Angelou Economic Advisors.

\(^{28}\) Managing Director/Economic Development, Angelou Economic Advisors.
community development, and many programs do not pass a benefit-cost test. There is a major gap between training needs and the training actually provided.

A statewide strategy is needed. Retraining must benefit existing workers and target the needs of high-growth industries. It should use market-driven models. Skilled workers are essential to prosperity and competitiveness.

Workforce issues must address differences in technology utilization, demographic patterns (urban and rural), and relative employment needs—one size does not fit all. The role of universities needs to be reexamined. Major institutions do not necessarily respond to economic needs. There has been a decline in technology-related majors.

Technology has changed how we do business. Information content encompasses a higher and higher proportion of product value. Material content per dollar of gross domestic product has declined from 2.2 pounds in 1950 to 8 ounces presently.

Areas of labor need (e.g., southeast Texas) do not always match areas of labor availability (e.g., the Valley). Federal funding of workforce development limits state flexibility and can be too compliance-driven rather than employer-driven. The state needs to be more involved and adopt a private-sector model of operation. Locally, state agencies likewise are perceived as compliance-driven.

*Corporate Siting Decisions.* A skilled and available labor force is important. The emergence of technology clusters can pull in companies. The business climate, including offerings of tax incentives, is a factor. (Mr. Angelou disagreed with Mr. Hazleton's earlier comment on siting.) Other variables influencing new siting include infrastructure, the amount of homegrown industry, and local government attitudes and perceptions.

*Technology's Contribution to Economic Trends.* Electronics accounts for a third of current growth in gross domestic product. At 44 percent, technology is the number one staple of Texas exports. Technological employment has grown twice as fast as non-technological employment and has also provided higher wages. It has an economic multiplier effect of 3.8. Texas technology industries supplied 900,000 jobs as of the end of 1997. This equals 10 percent of the Texas workforce, a figure that ranges to 20 percent of the workforce in some regions. The average annual wage gap between a technology worker and non-technology worker is $20,000. The technology sector is an important part of the economy of every geographic region in Texas.
The Dallas-Fort Worth area, not Austin, is its center, with more than 45 percent of the state's high-technology assets.

Survey of Texas Technology and Information Companies. Mr. Angelou reported on a survey that was conducted to determine why companies locate where they do, to learn what kind of tax preferences they express, to gauge the impact of taxes on business decisions, and to investigate tax elasticity and the threshold at which technology industries are likely to relocate. The survey, employing methodology of the University of Texas Research Survey Center, was funded by Dell, Compaq, and Intel.

Surveyed businesses demonstrated great loyalty to the state. Businesses founded in Texas want to remain here. This finding argues for an entrepreneurial strategy to produce more such homegrown businesses. Small companies were more likely to raise prices as a first response to a tax increase. Large companies were more likely, instead, to cut their costs. Exporters were more likely to relocate.

Sales and use taxes were regarded as the least burdensome taxes. Franchise taxes were considered the most burdensome. For purposes of this preference, the survey did not sort out companies by type of business structure (e.g., corporations versus partnerships). That could be done from the raw survey data, but statistical significance would suffer.

A third of respondents considered Texas' tax burden higher than that of other states. Two-thirds considered it lesser or equal to that of other states. A separately compiled index of tax burden finds Texas' burden to be at 1.02 relative to an average state index value set at 1.00. The Texas figure does not take into account any incentives or rebates. The methodology, a two-phase process, assured respondent acquaintance with the tax definitions used.

State Economic Development Policy. A tax policy to encourage growth in Texas' technology and export sectors should promote businesses that create the greatest long-term positive economic impact. The state's economic development strategy should focus on engines of economic growth by promoting industries with a high economic return, creating technology enterprise zones, providing technology employment credits, benchmarking state technology growth, and monitoring what other states do. Technology exports drive growth. Texas leads the nation in high-tech job creation, but its tax policy is less competitive for certain technology
industries and its relative competitiveness in attracting technology companies is projected to diminish.

**Border Issues.** The realities of the border region include low levels of educational attainment among the population, the state's highest regional unemployment, and increasing competition from Mexican *maquiladoras*, both labor-intensive and capital-intensive. State support for economic development on the Mexican side is limited. The border area has a significant drug-related underground economy. The border area experiences high immigration and fertility rates. There is a lack of regional cooperation among border communities. The *colonias* are another serious reality.

The result is an unusual economic situation: the more jobs we create, the higher the unemployment rate. Average annual income in border counties is only 55 percent of incomes in non-border areas of the state. This income disparity exceeds Texas' urban-rural income disparity. The border has an average birth rate 50 percent higher than the state's non-border areas. However, half of border population growth comes from international immigration.

Mexico is home to 3,700 *maquiladoras*, which serve as assembly factories taking advantage of inexpensive labor and favorable tax and customs circumstances. Two-thirds are located on the border with Texas. More than 850 were built or expanded in 1997, at an investment of $700 million, creating 70,000 jobs. *Maquiladoras* exported $30 billion in value the same year. *Maquiladora* wages are significantly higher than other Mexican wages but significantly lower than wages in the United States. They are mostly unionized, but small wage differentials can produce high turnover. The turnover and associated training costs, as well as employee benefits, contribute to the total cost of labor above and beyond the wage costs. Nevertheless, they are an attractive option for U.S. manufacturers. Labor rates, as a ballpark estimate, are about $5 a day. U.S. investors own 38 percent of *maquiladoras*; Mexican investors own 44 percent.

Economic development north of the border alone will not solve unemployment, educational, and infrastructural problems on the Texas side. Improved conditions on the Mexican side may be the only way to assure Texas border counties of a check on heavy immigration and a stabilization of their workforce. U.S. firms are locating logistical, supply, and distribution operations on the Texas side of the border at higher wage levels, producing positive economic
spinoffs from the *maquiladora* activity on the Mexican side. The Texas jobs require higher levels of educational attainment.

Recommended projects include joint-venture *maquiladora* plants where infrastructural improvements, including transportation, are provided by the state and Mexican state governments and built into the project. This is not so much a case of substantial state investment in Mexico as it is a case of pursuing better international coordination. Too often, for example, new roads in Texas and Mexico don’t align well in terms of border-crossing efficiency.

The border economy, of course, is partly a federal problem, which is being addressed by entities such as the North American Development Bank. However, it is also a state and local problem. There should be a state-level NAFTA border strategy aimed at improving the quality of life, with links to education and training programs. There should be a Texas Gulf ports strategy and a state-driven regional strategy. The focus should be on business development and higher-wage jobs on the Texas side, and stabilization of the *maquiladoras* and improvement of their wage structure on the Mexican side.

5. **Texas Demographics (Murdock)**

A presentation on how demographic changes impact the Texas economy, the demand for state services, and tax revenues was given by Steve Murdock\(^\text{29}\) on January 21, 1998. The following summarizes his presentation.

**Population Growth.** In every decade since Texas joined the Union, the state’s population has grown faster than the nation as a whole. In the 1980s and 1990s, Texas has grown about twice as fast. Only California in the 1990s has had a larger numerical increase.

Texas growth of 2.4 million in the 1990s has added the equivalent of another Houston and another San Antonio. In percentage growth, Texas ranks eighth among the states. Texas also has some of the fastest growing metropolitan areas. Much of the state’s population growth is concentrated along the border and in the central corridor from Dallas-Fort Worth to Austin. Parts of East Texas, Southeast Texas, and West Texas are growing relatively slowly.

About 55 percent of the growth is due to natural increase. Another 20 percent is due to domestic migration, and the other 25 percent to international migration. Texas resembles

\(^{29}\) Professor, Texas A&M University.
California in some ways, but the international component of growth in California dwarfs our own (2,000,000 versus 600,000). About 80 percent of the natural increase, domestic migration increase, and international migration increase was accounted for by only 16, 9, and 10 counties, respectively.

*Age Patterns.* The median age in Texas has increased by almost three years in the 1990s, from medians of 27.9 and 28.0 in the 1970s and 1980s, respectively, to 30.8 now. This reflects the aging of baby boomers, who account for a third of the population. This aging will change the demand for services, and is reflected now in the national debate on Social Security. Many baby boomers will turn 65 about 2020 to 2030. In the meantime, we will be a middle-aged society.

There are differences in age patterns by ethnic group. In 1996, among Texans under 25 years of age, more than half were non-Anglo, whereas among those 65 or older, three-quarters were Anglo.

*Household Patterns.* The rate of household formation tends to exceed the rate of population growth. This trend was pronounced in the 1970s as baby boomers entered their household formation years. A key factor now is the declining size of the average household, from 3.7 members in 1940 to 2.7 now. About 30 percent of the household increase is due not to increases in population but to the fact that we are putting fewer people into each household.

Growth in non-family households exceeds growth in family households. This is both a Texas and a national trend. Only 28 percent of households in Texas in 1990 consisted of married couples with children. Among families, the fastest percentage growth is among single-parent households, particularly single-parent households headed by a male. Cohabitation of unmarried persons of the opposite sex is increasing.

*Ethnic and Socioeconomic Patterns.* Four of every ten Texans in 1990s were minorities. Numerically, Texas has the second largest Hispanic population, third largest African-American population, fourth largest Asian population, and eighth largest population of other ethnicities. Minorities are growing faster percentage-wise than Anglos, who increased by 10 percent in Texas in the 1980s. African-Americans increased by 17 percent, Hispanics by 45 percent, and all others by 88 percent. Viewing net increases during the 1980s, one of every two Texans added was Hispanic, and two of three were minorities. This pattern has continued in the 1990s. Minority births have increased statewide from 52 percent of the total in 1990 to 58 percent in 1996. Anglo
births have decreased from 43 percent to 32 percent, and Hispanic births have increased from 32 percent to 43 percent.

Demographic characteristics tend to be tied to socioeconomic characteristics such as income. The middle-age population is typically in its peak income-earning years. African-American and Hispanic incomes tend to be only 55-75 percent the levels of Anglo incomes, and incomes in female-headed households are only 40-45 percent of the level of married household incomes. In 1990, 57 percent of Hispanics in Texas had less than a high school education. SAT scores show that the higher the income, the higher the score. In the 1980s, the number of Texans living in poverty increased by a net of almost one million. This was a 47 percent increase. The increase affected all racial and ethnic groups, but three of four new additions were minorities. Texas, entering the 1990s, ranked 32nd in median household income, 31st in per capita income, 39th in its percentage of high school graduates, and 23rd in its percentage of college graduates. More than 10 percent of the Texas population is on food stamps.

Projections of Texas population suggest that by 2008, the state will be less than half Anglo. By 2030, the Anglo population will be 37 percent, compared to 46 percent Hispanic and 10 percent African-American. About 87 percent of the net 1990-2030 population increase will be among minorities. In 1990, just over 10 percent of the Texas population was 65 years of age or older. By 2030, the figure is projected to climb to 18 percent, but there will be ethnic differences. About 25 percent of Anglos will be 65 or older, for example, versus only 12 percent of Hispanics. Thus, in a sense it will be a case of younger Hispanics taking care of older Anglos.

**Implications.** Elementary-secondary and college populations will grow much less slowly percentage-wise, 1990 to 2030, than the Texas population generally. The prison population will grow somewhat less slowly, since demographic composition is important as an explanatory factor in fluctuating crime rates and the population on average is aging. The population in poverty is likely to grow faster percentage-wise than the population generally.

If socioeconomic differences do not change, the Texas labor force in 2030 will be less well-educated than today. Average household income will decline among all ethnic groups, by an average amount of $3,000 in constant 1990 dollars. Anglos in the labor force will decline to a third of the total in 2030, compared to two-thirds in 1990. By 2030, seven of ten children in public schools, and six of ten in colleges, will be minorities. Currently, the minority population in
public schools is 55 percent. By 2030, a majority of consumer expenditures will originate from households headed by a minority member.

Simulations suggest that while population by 2030 will have increased by 99 percent, the population of elderly receiving long-term care will have increased by 184 percent. This level of increase is moderated by an expectation that minorities will continue to be less likely to be subject to long-term care. Thus, ethnic diversification tends to lower associated costs.

Housing values differ by age group and minority group, and Texas residence homestead property taxes are frozen for those 65 in age or older. The aging of the Texas population, simulations suggest, will reduce property tax revenues by over $16 billion by 2030, compared to the case if the 2030 age structure were the same as now. This simulated loss equals 20 percent of the property tax revenue projected to be collected.

Demographic changes generally affect the demand for public services and the resources with which to pay for those services.

**Summary.** Texas population growth is likely to continue under nearly any economic scenario, because of natural increase. Births outnumber deaths by 190,000 annually. Growth will not occur everywhere. Planning for it must recognize growth differentials. The change away from traditional family types is likely to remain. In the long term, the state will have to deal with a substantially older population. The next 10-15 years present a demographic window, when, because of the greater earnings of middle-age baby boomers, it may be easier for governments to pay for public goods and amenities than it will be later when they are on fixed incomes.

Nothing is more important than increasing the ability of minorities to participate and compete effectively in an increasingly international labor force. The “Texas challenge” is to make all segments of the population as competitive as possible.

6. Regional Economic Outlook (Hoyte)

Written materials on Texas’ regional economic outlook were submitted to the committee by Don Hoyte\(^\text{30}\) on January 21, 1998. A summary of the materials follows.

**Overview.** The planning regions containing Dallas-Fort Worth and Houston account for more than half of the state’s 9.4 million jobs, but account for less than 10 percent of the state’s

\(^{30}\) Manager, State Economic and Fiscal Policy, Comptroller’s Office.
land. The planning region containing Del Rio and Eagle Pass has more land area than either the Dallas-Fort Worth planning region or the Houston-Galveston-Brazoria planning region, but has only one-half of one percent of the of the state’s employment. The Capital District planning region had the highest employment growth rate over the past seventeen years (1980-1997), averaging 4.7 percent a year. The Greater Austin area’s growth rate is more than 25 times higher than the growth rate seen in South East Texas over this period.

**Austin-San Marcos.** The high-tech/computer chip industry has driven the Capital District’s strong economic performance. As a result of this growth and the in-migration of a highly trained, computer literate workforce, the Austin region has seen strong growth in both construction and retail trade employment. From June 1996 to June 1997, 5,600 jobs were added in this region, representing a one percent growth rate. Overall, employment is 544,000. The Capital District planning region had the highest employment growth rate over the past seventeen years (1980-1997), averaging 4.7 percent a year.

**Dallas-Fort Worth.** The Dallas-Fort Worth area is the most diversified economy with industry sectors in telecommunications, wholesale trade, healthcare, financial services and air travel. Intel is building a $1.3 billion plant in the Fort Worth area and other corporations such as Blockbuster Entertainment, Union Pacific and GTE have relocated to this area. The planning regions containing Dallas-Fort Worth and Houston account for more than half of the state’s 9.4 million jobs yet account for less than 10 percent of the state’s land. The Dallas metro economy added the most jobs of any metro. Employment totaled 1.7 million, an increase of 69,600 jobs.

**Houston.** Houston’s recent employment growth rates rival Austin’s. By mid-1997, employment was up 2.2 percent from a year ago and metro employment has increased by 39,300 over the past 12 months to top 1.8 million. Compaq and other firms such as BMC software are driving the high tech revolution in the area. Managed health care has slowed healthcare employment growth. Metro employment in home health care services grew by 5,600 jobs in the last two years, while hospital based employment in Houston dropped by 4,500 jobs.

**San Antonio.** The growth in retail spending was a little slower in San Antonio than in other large metro areas but it has remained positive over the past two years. The metro’s employment base gained 12,900 jobs from June 1996 to June 1997 to reach an overall 646,700. The closure of Kelly Air Force base due to federal realignments could displace more than 10,000
West Texas Plains. This area is diversifying its job base away from oil, cattle and cotton but these industries will continue to provide a solid job foundation. The Amarillo Economic Development Corporation, with aggressive use of its economic development sales tax, has attracted 17 companies since 1991 in industries such as electronics, telemarketing and insurance. Other enterprises in the West Texas Plains area are planning to expand their operations and healthcare jobs in the Plains region is also expanding.

7. Revenue Adequacy (Lavine)

A presentation on the adequacy of the revenue system was given by Dick Lavine on October 27, 1998. The following summary incorporates comments and questions from committee members and the committee's invited participants.

An adequate tax system should be able to provide enough revenue to cover spending needs. Three approaches to measuring the adequacy of a tax system should be considered. First, an adequate tax system should keep up with personal income growth. Second, the revenue-raising capacity of a tax system should be tied to its current spending needs. Third, an adequate tax system should be able to grow to cover the future costs of current policies.

Personal Income Growth. An adequate tax system should keep up with growth in total personal income. Personal income growth reflects both inflation and population changes and parallels the increase in the cost of providing the same level of services year after year. It reflects the growth of the state as a whole—in population, the cost of services, and the ability of taxpayers to pay taxes. Implicit in this approach is the assumption that spending needs remain constant relative to personal income. Arguably, personal income growth captures changes in services government provides to its citizens over time—something inflation-adjusted per capita growth does not reflect.

Texas’ tax revenue has not kept up with personal income growth. Since 1992, personal income has grown by 47.6 percent while state sales tax revenue has increased by 45.7 percent. During the same period, total state tax collections grew by only 42.8 percent. Taxable property values lagged far behind personal income growth, increasing by only 13 percent since 1992. And, while property values increased by seven percent last year—a very dramatic increase by historical

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Fiscal Analyst, Center for Public Policy Priorities; invited participant of the committee.
THE TEXAS TAX SYSTEM TODAY

standards—personal income also grew by seven percent. Total state tax collections grew at a rate comparable to growth in personal income in 1993 and 1994, but the trend since then has been down.

Sales tax revenue is behind its 1992 proportion of personal income, despite a recent bounce. The sales tax, which applies mainly to goods, faces a long-term challenge of keeping up with an economy that is increasingly based on services. Moreover, sales tax enforcement difficulties have increased as more goods are sold over the internet or by mail order.

Elasticity measures the ability of a tax to grow with personal income. An elasticity of 1.00 indicates that the tax grows at the same rate as personal income. The sales tax lags slightly behind personal income, with an elasticity of .96. The motor vehicles sales tax and the franchise tax have grown 60 to 80 percent faster than personal income, however these revenue sources are expected to drop the fastest in a recession. Overall, Texas taxes grew 10 percent slower than personal income, with an elasticity of .90.

One concern with using personal income growth to measure revenue adequacy is that it may not necessarily match demand for services. That is, it may be more important to know what sources of revenue will be adequate in economic downturns, when demands on government will be greater. Moreover, the current tax system hasn’t been in place for an entire business cycle. Another concern is that this approach assumes that the proportion of personal income going to governmental services is appropriate. The Select Committee on Tax Equity study (1989) found that the Legislature had chosen to adjust the revenue system (through rate and base changes) to meet spending needs every 18 months.

Fiscal Comfort. A second indicator of the adequacy of a revenue system is “fiscal comfort.” Fiscal comfort measures the current ability of a state to raise revenue that meets the state’s spending needs. This approach standardizes tax rates and tax bases to measure “capacity”—the state’s economic ability to raise revenue. Under this analysis, Texas’ fiscal capacity is below the national average (30th), while its spending needs are above the national average (4th). This assumes each state matches national average workloads—e.g., spending per pupil. Since Texas has a higher percentage of school age population and a higher percentage population below poverty, its spending needs are above the national average. Texas would have
to spend 11.1 percent more than the national average to provide services at the national average, according to this analysis.

This approach boils down to an application of the state's demographics to the national average spending, which may not reveal much about the "true" adequacy of the revenue system. If Texas government is more efficient than other states, for example, this approach would overestimate the cost of providing governmental services. Also, this approach to determining adequacy does not reflect the fact that Texans have less government (and tax revenue is lower) than other states because that is what Texans desire.

**Structural Deficit.** The "structural deficit" is a long-term measure of a state's ability to meet spending needs. A state has a structural deficit if its anticipated revenue growth is less than what's necessary to maintain its current level of services. Texas needs 45.5 percent growth in revenue over the next eight years to maintain current spending. Texas' needs are expected to remain high: Texas will require above-average spending increases to maintain its current level of services over the next eight years. Our current revenue system will produce growth of 35 percent over the next eight years, leaving a structural deficit of 7.8 percent. In other words, projected revenues are 7.8 percent less than necessary to fund anticipated spending in eight years, assuming no changes in tax rates, bases or levels of services except caseload or workload increases and inflation.

Under this analysis, the deficit or shortfall is largely driven by population and inflation.