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*The views expressed in this article are solely those of the author, and should not be attributed to either the Federal Reserve Bank of Dallas or to the Federal Reserve System.

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Until recently, Texans did not think much about tax policy or economic growth. A strong energy sector made such thoughts unnecessary. From 1972 to 1982, expansion of the energy extraction industries and associated multiplier effects accounted for 45 percent of the total growth in Texas employment.^{1/} In 1982, oil and gas severance taxes accounted for 18 percent of state government revenue.

Since 1982, however, lower oil prices and declining energy industry employment slowed economic expansion. The \$10-per-barrel drop in oil prices from those prevailing in early-November 1985 to the current levels will eventually mean 3.3 percent fewer jobs in Texas.^{2/} To some extent, a smaller energy industry will free resources for other uses, promoting diversification and providing new sources for future economic growth.^{3/} Nevertheless, state and local government fiscal policy could greatly affect future economic development in Texas.

Though fiscal policy in Texas compared favorably with that of the average state in 1984, changes in state fiscal policy brought about, in part, by lower oil prices have generally lessened the advantages evident in that year. Deficit spending, reduced severance tax revenues, and a weak state economy in 1986 and 1987 led to increased tax rates. Tax revenues from sources other than the severance tax are projected to grow 45 percent from 1984 to 1989. On the other hand, state spending for government services that attract the business investment and work force necessary for economic growth is projected to increase only 10 percent over the same five-year period.^{4/}

State tax policy can greatly influence future economic growth in

Texas. The key to economic growth in Texas, or any state for that matter, is attracting new business investment and labor to the state while keeping the existing capital investment and work force in the state. States compete with each other to attract these mobile resources. And though climate, location, industry mix, and natural resources generally are more important determinants of state economic performance, a good fiscal policy can give a state a competitive edge in attracting and keeping business investment and able workers. These mobile resources are more attracted to the states that provide highly valued government services. On the other hand, they are less attracted to the states in which they would incur higher taxes. The most attractive fiscal policies strike a balance between the provision of government services and the taxes required to finance those services.^{5/}

Today, we will examine how state tax policy can contribute to achieving that balance in Texas. After reviewing some economic principles that relate state and local fiscal policy to economic performance, we will analyze how the composition of state revenue affects economic growth. Finally, we will consider how tax policy influences the size of the state government and how its size affects economic development.

HOW STATE AND LOCAL FISCAL POLICIES AFFECT STATE ECONOMIC GROWTH

In recent years, economists have conducted a number of studies to find the determinants of regional economic growth.^{6/} In this section we draw upon that research and the broader economics literature to develop 11 principles that relate state and local fiscal policy to regional economic performance. Five of the principles (4, 5, 6, 7, and 11) are used directly in our analysis of tax policy and Texas economic development.

A common element links the 11 principles. Each principle can be used to assess the effects of state and local fiscal policy on a state's attractiveness to capital and labor. The attractiveness of a state to these mobile resources largely determines its economic growth.^{7/} Capital and labor are generally attracted to states where they can earn and retain the largest income--both pecuniary and nonpecuniary. State and local government expenditures and taxation greatly affect both the pecuniary and nonpecuniary income of mobile resources located within a state. In doing so, they help determine the attractiveness of a state to mobile resources.

Principle 1. In the absence of an offsetting expansion of public services, increased taxation of mobile resources within a state is harmful to the state's economic growth. Such taxation reduces the pecuniary income of mobile resources in the state.

Principle 2. If they are provided without increased taxes on mobile resources, enhanced provision of some public services within a state encourages economic growth in that state. Expenditures for some public services increase the nonpecuniary income accruing to mobile resources in a state.

Principle 3. When the additional revenue is used to finance enhanced public services within a state, the improvement in public services may more than offset the harmful effects that increased state and local taxation of mobile resources has on economic growth in that state. However, the increased taxation of mobile resources retards economic growth when used to finance welfare or other transfers.^{8/}

Empirical research indicates that, at the margin, expenditures on educational services, health, hospitals, roads, and highways enhance economic

growth the most. The stimulus to economic growth arising from state and local government expenditures on these public services greatly outweighs the detrimental effect of any taxes required to finance the expenditures. On the other hand, additional expenditures on sewerage and sanitation, natural resources, parks and recreation, transportation other than roads and highways, and public safety only moderately enhance economic growth. The stimulus to economic growth arising from state and local government expenditures on these public services outweighs the detrimental effect of any required taxes to a lesser degree.^{9/} Expenditures on transfers may further some social goals other than economic growth, but at the state and local level, these expenditures harm a state's overall economic performance.

Principle 4. When broad-based taxes are the alternative, state and local government reliance on taxes that are narrowly applied to mobile resources (such as the corporate franchise tax) is harmful to economic growth in the state where the narrow taxes are applied. This is true unless the revenue is used to finance public services that exclusively benefit the ownership of the mobile resources from which the revenues are obtained. Broad-based taxes (such as income and sales taxes) are less harmful to economic growth because they do not alter the relative prices of productive resources; that is, no one particular use of a given mobile resource is discouraged relative to other uses and other resources.^{10/}

Principle 5. When taxes on mobile resources are the alternative, state and local government reliance on user fees or narrow taxes that are like user fees (such as motor fuel taxes) to support government services for the benefit of the taxed individuals can foster economic growth in the state where such fees or taxes are used. Reliance on user fees to fund a government

service both provides a method for monitoring the demand for the service so financed and assures that individuals who do not use and value the service do not have to pay for it.

Principle 6. As the size of the government grows relative to the taxpayers' ability to pay, the value of additional government spending declines. This is the result of three factors. As is the case for all goods, the value of an additional unit of a given government service declines relative to other goods as more of the service is provided.^{11/} Also, the growth of government may be associated with the provision of less desired goods. Finally, if increases in tax progressivity are required to fund additional state government spending, the cost to economic growth of additional taxation will rise as taxes are increased.^{12/} Beyond a certain point, therefore, growth in the size of a state government that is greater than growth in the taxpayers' ability to pay will retard economic growth by reducing the state's attractiveness to business investment and labor.

Principle 7. It follows from the first two principles that increased tax revenue from immobile resources promotes economic growth, provided the additional revenue is used to reduce taxation of mobile resources and/or to fund enhanced public services that benefit the owners of mobile resources.

Severance taxes fall largely on immobile resources, while property taxes fall largely on mobile resources. Although a small portion of severance taxation falls on the capital used to develop the immobile resources, most of the tax falls on ownership of the immobile resources themselves. On the other hand, property taxes fall largely on the capital used to develop real property, not on the immobile factor--land.

Principle 8. Economic growth is discouraged in a state when its state or local governments engage in deficit financing of current expenditures.^{13/} This type of financing probably discourages economic growth in a state because it represents potential tax liabilities for mobile resources in the future for which there will be no offsetting future benefits. State and local government borrowing to fund capital spending does not have the same implications, however. In that case, future tax liabilities may be offset by future benefits.^{14/}

Principle 9. Selected reductions in state and local government expenditures for administration could foster greater economic growth in a state. The low accountability of government agencies, combined with economic incentives, suggests that such bureaucracies tend to grow unnecessarily large.^{15/} If cuts in administrative expense are made without reducing the quality of the services of state and local governments, these governments can offer lower taxation to mobile resources, a greater provision of public services, or both.

Principle 10. Introducing market incentives into the production of some public services, while maintaining public funding, could foster greater economic growth in a state. Market incentives could be introduced by allowing private producers to compete with each other to supply the publicly funded services. In education, for example, state and local governments could issue vouchers redeemable at the school of the parent's choice. Competition between suppliers could lead to improved services, lower costs, or both. In addition, competing suppliers could meet more readily the diverse tastes of individual consumers.

Principle 11. A greater reliance on taxes that are deductible

against the federal income tax, and a reduced reliance on those that are not, could improve economic growth in a state. State and local government reliance on deductible taxes permits the same level of public service at a lower effective cost for the average taxpayer or a greater level of public service at the same effective cost. Revenue raised through a deductible tax costs roughly 10 percent less for the average taxpayer in Texas than the same amount of revenue raised through a nondeductible tax. The figure is about 30 percent for the average itemizer in the state.^{16/}

THE COMPOSITION OF STATE REVENUE AND TEXAS ECONOMIC DEVELOPMENT

Is there room to make state tax policy more conducive to Texas economic development? To answer this question we will examine the composition of revenue and expenditures jointly in the light of the economic principles presented in the preceding section. We will consider severance taxes, user fees (and taxes like user fees), narrowly applied taxes, and broad-based taxes. In addition, we will look at the corporate franchise tax, the sales tax, and the income tax.

Severance taxes. In the recent past, oil and gas severance tax revenues offered Texas a considerable advantage in maintaining a fiscal policy conducive to economic development. The severance tax falls primarily on oil and gas resources that cannot move to avoid the tax. Very little of it seems to fall on the capital and labor used to develop and produce the oil and natural gas.^{17/} As recently as 1982, the severance tax contributed nearly 18 percent of state government revenue in Texas, allowing the state government to provide a higher level of government services than the relatively low level of taxes on mobile resources would suggest.

Unfortunately, declining severance tax revenue has been eroding this advantage in Texas fiscal policy. In the 1988-89 budget, severance taxes are expected to contribute about 5 percent of state revenue.^{18/} Further declines are to be expected after 1989. Apparently, little can be done to reverse or prevent falling severance tax revenue. Lower energy prices and reduced production of oil and natural gas account for the decline in this tax revenue.

User fees. User fees--or taxes like user fees--are among the best ways to raise a given dollar amount of government revenue. This method of funding assures that individuals who do not use and value a particular government service will not have to pay for it. In addition, user fees provide a method for monitoring public demand for the government service so funded, allowing the government to better supply the most desired quantities of it.

Motor fuel and vehicle taxes are like user fees for roads and highways. As the data in Table 1 show, state and local governments in Texas have done a better job of covering expenditures for roads and highways with revenue from these taxes than is the case for the average state. Federal highway funding closes the gap a little further. As the last column indicates, the state government does an excellent job of matching revenue from motor fuel and vehicle taxes to its expenditures for roads and highways.

As is true nationally, user fees collected by state and local governments in Texas for education and for health and hospitals fall far short of government expenditures on these services. As is the case with roads and highway funding, the state does a somewhat better job than do the local governments of matching revenue to expenditures in these categories. Nevertheless, some room may remain for the state government to increase

reliance on user fees for education, health, and hospitals. There may also be room to increase reliance on user fees for state provision of natural resource services, parks, and recreation.

Narrow and broad-based taxes. In many cases, it is impossible or undesirable to assess user fees or taxes like user fees to fund government expenditures. Other taxes must be imposed. These taxes may fall narrowly on a few resources or activities, as does the corporate franchise tax, or they may fall more broadly, as does the general sales tax. Either approach to taxation is likely to be less conducive to state economic growth than user fees are because costs may be imposed on some mobile resources that do not receive benefits from the corresponding expenditures. Nevertheless, a broad-based tax, such as the sales tax, is less harmful to economic growth than a narrow tax because a broad-based tax falls less heavily on any one resource or activity for a given amount of revenue raised. Therefore, a broad-based tax has less effect on private decisions and, thus, on economic growth.^{19/}

Nationally, state and local governments rely quite heavily on narrow tax instruments that cannot be construed as user fees. These instruments include property taxes, the corporate franchise tax, and other narrow taxes. As Table 1 shows, per capita revenue from these taxes and other current charges greatly exceeds a very liberal interpretation of the tax-related benefits.

The situation is somewhat worse in Texas. The heavy reliance of state and local governments in Texas on narrowly applied taxes on mobile resources that are not like user fees probably discourages economic growth in the state. The problem is largely at the local level, however. Local governments in Texas rely very heavily on property taxes to finance their expenditures; yet very little of their expenditures benefits property

ownership.

As the table shows, the state government also relies on narrow taxes for general financing to some extent. The corporate franchise tax (a tax that is assessed on the capital value of Texas businesses) is the largest single source of state revenue in this category--accounting for more than 20 percent of the revenue. Other taxes in the same category include those for cigarettes, tobacco, and alcohol.^{20/} The state government likely would improve the fiscal environment in Texas by reducing reliance on some narrow taxes, like the corporate franchise tax, and increasing reliance on user fees and broad-based taxes.

A corporate income (profits) tax might be considered as a substitute for the franchise tax. A corporate income tax likely would be less harmful to economic growth than is the corporate franchise tax. For a given amount of revenue, the corporate franchise tax discourages business investment in Texas more than would a corporate income tax. A corporate franchise tax is assessed directly on the capital that business investment builds, regardless of the firm's profits. In contrast, the corporate income tax falls more broadly across the productive assets of the firm, with less discouraging effect on business investment. I should add, however, that though the corporate income tax is broader than the corporate franchise tax, it is not nearly as broad as either a general sales tax or a personal income tax.

Which broad-based tax? The two broad-based tax instruments are the personal income tax and the general sales tax. Both tax instruments have advantages and disadvantages as sources for state government revenue.

The principal advantage of a state personal income tax over a general sales tax is that it currently remains deductible against the federal

income tax. Because sales taxes are not currently deductible, revenue raised through a state income tax would cost the average taxpayer in Texas about 10 percent less than the same amount of revenue raised through sales taxes. The figure would be about 30 percent less for the average itemizer in the state. The 30-percent figure may be more significant. Some economists have argued that high-income individuals, who are more likely to itemize tax deductions, make the decisions about business location.21/

Texas also may be nearing the practical limits for sales taxation. As state sales tax rates climb, residents will find it increasingly worthwhile to buy goods outside Texas to avoid sales taxation.22/ A state income tax is much more difficult to avoid.

A flat tax rate of 2.5 percent on total gross personal income would raise about the same revenue as does the current Texas general sales tax of 6 percent.23/ A higher rate would be required if deductions, such as those on the federal income tax return, were permitted in the calculation of personal income.

A state income tax is not without drawbacks, however. Nearly all high-tax states rely heavily on income taxation. Income taxes are easily made progressive, and progressivity seems to discourage economic growth by pushing taxable resources from the state.24/ Furthermore, adoption of an income tax could lead to a growth-hindering tyranny of the majority, in which excessive growth in the size of the state government is funded by increasingly progressive income taxes.25/

TAX POLICY, THE SIZE OF GOVERNMENT, AND TEXAS ECONOMIC DEVELOPMENT

State officials would naturally be concerned that tax policy provide enough

revenue to meet growth in the demand for government services. Taxpayers would naturally be concerned that tax policy not allow the government to become bloated. A mistake in either direction, however, would make fiscal policy less conducive to economic development than it could be. If government services are too low or taxes are too high, Texas will not be as attractive to business investment and labor.

An often-used rule of thumb is that the growth of state government expenditures and tax revenues ought to keep pace with the growth of the taxpayers' ability to pay, as measured by personal income. Thus, declining severance tax revenues suggest a recurring problem in state funding. It appears that the state government must continually raise taxes or become too small.

This analysis may be wrong in fact and theory. The state government may already be growing too fast. Adjusted for inflation, state government expenditures are projected to grow at an annual rate of 2.5 percent over the five-year period from 1984 to 1989, while state personal income is projected to grow at an annual rate of only 1.4 percent. Given recent tax hikes, state revenue is projected to grow at a 3.2-percent annual rate over the same five-year period. When the state's outstanding tax anticipation bonds are retired, the growth of state government expenditures could accelerate.26/

At the same time, the reduction in severance tax revenues and elimination of the deduction for state sales taxes against the federal income tax have made state government services in Texas relatively more expensive than they were in 1984. Consumers normally seek to reduce their consumption of goods that have become relatively more expensive. Perhaps state government expenditures should be growing slower than Texas personal income, and future declines in severance

tax revenues should be met with slower government growth--not increased taxes.

SOME CONCLUDING REMARKS

As should be obvious from my remarks today, state tax policy can be an important determinant of state economic development. As part of a sound fiscal policy that balances state government expenditures against taxes on businesses and individuals, tax policy can help attract and retain the business investment and work force necessary for sustained economic growth. For it is these mobile resources that are the key to economic development.

The apparently irreversible decline in state severance tax revenues hurts Texas in that regard--as do local government tax policies. But reduced state reliance on narrow taxes, such as the corporate franchise tax, and increased reliance on user fees, taxes like user fees, and broad-based taxes, such as the sales tax, could improve the attractiveness of state fiscal policy from the perspective of capital and labor.

Substitution of a corporate income tax for the corporate franchise tax would broaden taxes only slightly. More broadly based taxes would be preferred. As a replacement for the sales tax, the personal income tax has advantages and disadvantages.

Declining severance tax revenues and the fact that sales taxes are no longer deductible against the federal income tax mean that the effective price of state government services has increased in Texas. Nevertheless, the growth of state government spending has exceeded growth of personal income over the past five years. Together, these developments suggest that tax measures allowing the growth of state revenue to keep pace with that of personal income may lead to excessive growth of the government, slowing the overall rate of economic growth in the state.

NOTES

- * An earlier version of this paper was presented to the State of Texas Select Committee on Tax Equity, January 21, 1988.
1. See John K. Hill, "Energy's Contribution to the Growth of Employment in Texas, 1972-1982," Federal Reserve Bank of Dallas Economic Review, May 1986, 11-18.
 2. See S. P. A. Brown and John K. Hill, "Lower Oil Prices and State Employment," Federal Reserve Bank of Dallas Research Paper no. 8706 (Dallas, August 1987).
 3. See Douglas E. Booth, "Long Waves and Uneven Regional Growth," Southern Economic Journal 53 (October 1986): 448-60.
 4. See Stephen P. A. Brown, "The New Fiscal Environment in Texas: What It Means for State Economic Growth," Federal Reserve Bank of Dallas Economic Review, January 1988, 1-9.
 5. See Stephen P. A. Brown, "New Directions for Economic Growth: Redesigning Fiscal Policies in Louisiana, New Mexico, and Texas," Federal Reserve Bank of Dallas Economic Review, July 1987, 13-20.
 6. For example, see Thomas Romans and Ganti Subrahmanyam, "State and Local Taxes, Transfers and Regional Economic Growth," Southern Economic Journal 46 (October 1979): 435-44; Robert J. Newman, "Industry Migration and Growth in the South," Review of Economics and Statistics 65 (February 1983): 76-86; Thomas R. Plaut and Joseph E. Pluta, "Business Climate, Taxes and Expenditures, and State Industrial Growth in the United States," Southern Economic Journal 50 (July 1983): 99-119; L. Jay Helms, "The Effect of State and Local Taxes on Economic Growth: A Time Series-Cross Section Approach," Review of Economics and Statistics 67 (November 1985): 574-82; and Michael Wasylenko and Therese McGuire, "Jobs and Taxes: The Effect of Business Climate on States' Employment Growth Rates," National Tax Journal 38 (December 1985): 497-511.
 7. See Mancur Olson, The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities (New Haven and London: Yale University Press, 1982); "The South Will Fall Again: The South as Leader and Laggard in Economic Growth," Southern Economic Journal 49 (April 1983): 917-32; and "Maintaining a Healthy Business Climate: A Broader Perspective on the Rates of Economic Growth and Unemployment in the Southern and Southwestern States," in Energy and the Southwest Economy (Dallas: Federal Reserve Bank of Dallas, 1987), 271-304.
 8. Empirical research contradicts the intuition that federal funding of state and local expenditures would foster state economic growth. Though federal funding would seem to permit greater provision of state and local government services and/or lower taxes on mobile resources, most of the federal funds provided to state and local governments finance transfers

and require matching state and/or local effort in financing.

See Helms, "The Effect of State and Local Taxes on Economic Growth."

9. Much of the state and local government expenditures found to enhance economic growth provides services that economists would regard as private goods. That is, nonpayers can be excluded from using the services, and the cost of providing service to additional consumers is positive. Economic theory predicts that the private sector could provide these goods more efficiently. To date, however, empirical research has not addressed the issue of whether private provision of those private goods now provided by state and local governments would better promote economic growth. Instead, empirical research has taken a pragmatic approach and has addressed the issue of whether increased expenditures on publicly provided private goods enhance or harm economic growth--given the reality that most state and local government expenditures provide private goods.
10. For a more complete discussion, see Arnold C. Harberger, Taxation and Welfare (Boston: Little, Brown and Company, 1974).
11. See Armen A. Alchian and William R. Allen, University Economics: Elements of Inquiry, 3d ed. (Belmont, California: Wadsworth Publishing Company, 1972), 18-29.
12. See Romans and Subrahmanyam, "State and Local Taxes, Transfers and Regional Economic Growth."
13. By "deficit financing" we simply mean that current expenditures exceed current revenues. Under this definition, the State of Texas engaged in deficit financing in fiscal years 1986 and 1987.
14. Empirical research verifies that it harms economic growth for state and local governments to finance current expenditures by borrowing; see Helms, "The Effect of State and Local Taxes on Economic Growth."
15. See William A. Niskanen, "Bureaucrats and Politicians," Journal of Law and Economics 18 (December 1975): 617-43.
16. These figures are derived from 1982 data from the Office of Tax Analysis, Office of the Secretary, U.S. Department of the Treasury, "Tabulations from the 1982 Statistics of Income File for the Fiscal Relations Study," 14 December 1984, as cited by Daphne A. Kenyon, "Federal Income Tax Deductibility of State and Local Taxes," in Federal-State-Local Fiscal Relations: Technical Papers, vol. 1 (Washington, D.C.: U.S. Department of the Treasury, Office of State and Local Finance, September 1986), 449.
17. See Dale S. Bremmer and John R. Moroney, Texas A&M University, "Outlook for Texas Oil and Gas: A Progress Report," (Paper presented at the 62nd Annual Western Economic Association International Conference, Vancouver, B.C., Canada, July 1987).
18. Severance tax revenues still offer Texas a fiscal advantage over the

average state. The average state government receives little more than 1 percent of its revenue from severance taxes.

19. See Brown, "New Directions for Economic Growth," and Harberger, Taxation and Welfare.
20. Taxes on alcohol, cigarettes and tobacco might be construed as user fees because the abuse of these products may result in some government expenditure. For the average consumer, however, they are primarily user fees.
21. See Romans and Subrahmanyam, "State and Local Taxes, Transfers and Regional Economic Growth."
22. Legally, residents of Texas owe tax to the State of Texas for goods purchased out of state and imported to the state for personal use. These taxes are largely uncollected.
23. Local taxes have pushed sales tax rates higher than 6 percent in most areas of the state.
24. See Romans and Subrahmanyam, "State and Local Taxes, Transfers and Regional Economic Growth."
25. See Dennis C. Mueller, "The Growth of Government: A Public Choice Perspective," International Monetary Fund Staff Papers 34 (March 1987): 115-49.
26. Brown, "The New Fiscal Environment in Texas."

TABLE 1

ELEMENTS OF STATE AND LOCAL GOVERNMENT BUDGETS:
 UNITED STATES AND TEXAS, FISCAL YEAR 1985
 (Dollars per capita)

<u>Selected budget element</u>	<u>United States</u>	<u>Texas</u>	<u>Texas State Government</u>
Revenue from <u>MOTOR FUEL AND VEHICLE TAXES</u>	\$ 89.65	\$100.21	\$ 94.36
Expenditures on ROADS AND HIGHWAYS	190.37	164.89	101.82
Revenue from <u>CURRENT EDUCATIONAL CHARGES</u>	92.75	93.39	58.75
Expenditures on EDUCATIONAL SERVICES	826.17	885.13	231.75
Revenue from <u>CURRENT HOSPITAL CHARGES</u>	91.38	78.51	14.99
Expenditures on HEALTH AND HOSPITALS	210.20	192.02	85.50
Revenue from PROPERTY TAXES, CORPORATE FRANCHISE TAX, OTHER NARROW TAXES, OTHER <u>CURRENT CHARGES</u>	756.67	850.62	230.09
Expenditures on FIRE PROTECTION, TRANSPORTATION OTHER THAN ROADS AND HIGHWAYS, SEWERAGE, SANITATION, NATURAL RESOURCES, PARKS, RECREATION	211.18	199.44	21.10
Revenue from SEVERANCE TAXES, BROAD-BASED TAXES, FEDERAL GOVERNMENT, OTHER SOURCES	1359.83	953.25	746.69
Expenditures on PUBLIC SAFETY, TRANSFERS, ADMINISTRATION, OTHER	759.89	461.88	246.37
Revenue from SEVERANCE TAXES	29.82	134.49	134.49
Revenue from SALES TAXES	356.42	320.66	263.93
Revenue from INCOME TAXES	377.40	0	0

SOURCE OF PRIMARY DATA: U.S. Department of Commerce, Bureau of the Census.