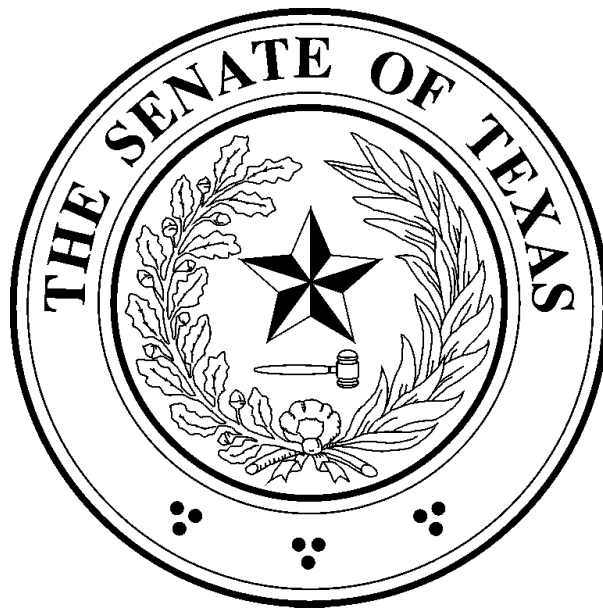


Texas Borderlands 2009

*“The Texas Tax System:
Inadequate and Inequitable”*
Taxes



Texas Senator Eliot Shapleigh
District 29
El Paso, Texas
December 2008

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Overview of Texas taxes

A good tax system should distribute tax burden equitably and grow to meet increasing needs. A balance among different sources of revenue allows the shortcomings of any single tax to be offset by the strengths of another.¹ These two principles are among the nine criteria listed in the table below from the report devised by the bipartisan Texas Select Committee on Tax Equity in 1989.²

Criteria for Evaluating the Texas State and Local Tax System

ADEQUACY: Should produce the necessary revenue.

EQUITY: The state and local tax burden should be distributed fairly. Everyone pays their share according to ability to pay.

EFFICIENCY: The tax system should not unnecessarily or unintentionally interfere with private economic decisions.

ECONOMIC COMPETITIVENESS: To the extent possible, the tax system should be designed to enhance state and local economic development.

STABILITY: The tax system should be able to withstand shifts in the economy and promote certainty, or consistency, for taxpayers and government.

SIMPLICITY: The tax system should be simple enough to require minimal compliance and enforcement costs.

BALANCE: Government should avoid over-reliance on any one tax or set of taxes. The tax system should be balanced among a number of taxes.

BROAD BASE: There should be an even-handed treatment of all tax payers so as to keep tax rates low.

INTERGOVERNMENTAL LINKAGES: Those who make decisions on the tax system should recognize the connections between state and local tax systems.

Source: Select Committee on Tax Equity

According to this model, the Texas tax system needs to change. Our tax system fails the people of Texas in two ways:

- Texas taxes are not equitable.
- The current tax system does not provide adequate funding to meet Texans' basic needs.

Texas' tax system is extremely regressive, meaning it takes a higher percentage of the income from a low- or middle-income family than from a high-income family.³ This is simply due to the fact that low- and middle-income families spend a greater proportion of their limited

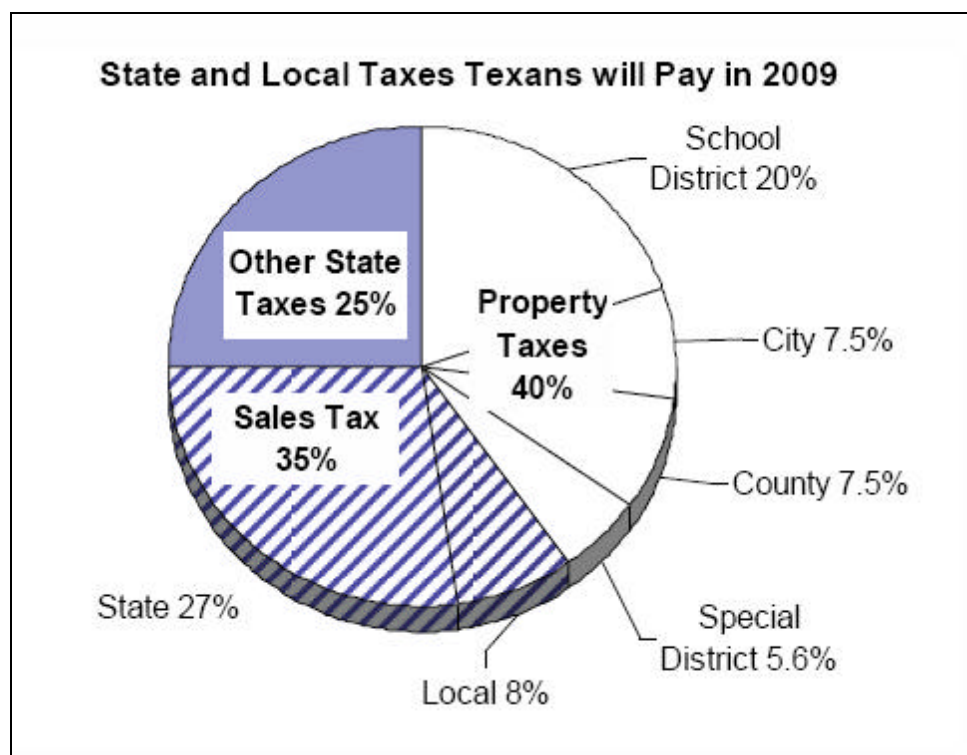
incomes on items such as clothing, food, and school supplies for their children than families with higher incomes.⁴ A tax system that imposes a higher tax burden on families whom are least able to bear it is not a fair way to pay for essential public services.

Texas' tax system also fails to raise adequate revenue to fund essential public services that are needed to help Texans prosper. All Texans want to provide the best possible education for our children. They also want access to affordable health care, excellent police and fire protection, well-maintained roads and parks, and a safety net for those who have fallen on hard times.

The state has relied on essentially the same structure of state and local taxes for the past 40 years: tax revenue is generated primarily by the sales and property taxes. The rates of these two taxes have been raised repeatedly to stretch this antiquated system to meet the needs of a growing population and a modern society. Because Texas' sales and property taxes are among the highest in the nation, raising them further would be difficult. The entire structure must be updated to facilitate fairness and to support efforts to improve the future for all Texans.

What taxes do we pay?

Three quarters of our state and local tax load is comprised of just two taxes: the property tax and the sales tax.⁵ Other taxes include the franchise tax, gasoline tax, cigarette tax, and alcoholic beverage tax. The chart below, State and Local Taxes Texans will Pay in 2009, illustrates that the property tax alone will account for an estimated 40 percent of all state and local taxes paid by Texans in 2009. State and local sales taxes will account for another 35 percent.



Source: Center for Public Policy Priorities⁶

As the chart above indicates, the estimated taxes an average Texan will pay in 2009 are split relatively equally between state and local taxes.⁷

Property tax

The largest individual tax paid by most Texans is the local property tax. Texas has the 13th highest property tax revenue per capita in the nation.⁸ Property taxes may be levied by school districts, cities, counties and special districts such as junior colleges, hospitals and flood control districts. Over 3,700 local governments in Texas collect and spend property taxes.⁹ It is important to note that only local governments can assess and collect property taxes, as a statewide property tax is constitutionally abolished in Texas.¹⁰

With the exception of two counties that form a single appraisal district, each of Texas' 254 counties have their own appraisal district that assesses and values the county's property.¹¹ Local governments then tax the appraised values with tax rates that are set according to their budgetary needs.¹² In tax year 2006, almost 59 percent of property taxes went to the state's school districts, as indicated in the chart below.¹³

Property Taxes Reported by Unit Type – 2005 and 2006

Unit Type	2005 Number of Units	2005 Tax Levy	2005 Percent of Levy	2006 Number of Units	2006 Tax Levy	2006 Percent of Levy	Percent Change from 2005 to 2006
School Districts	1,029	\$ 20,194,915,813	60.3%	1,027	\$ 20,918,122,059	58.8%	3.6%
Cities	1,043	\$ 4,901,791,597	14.6%	1,044	\$ 5,322,985,519	15.0%	8.6%
Counties	254	\$ 4,772,652,208	14.3%	254	\$ 5,339,613,542	15.0%	11.9%
Special Districts	1,376	\$ 3,609,629,697	10.8%	1,433	\$ 3,972,185,910	11.2%	10.04%
Total	3,702	\$ 33,478,989,315	100.0%	3,758	\$ 35,552,907,030	100.0%	6.2%

Source: Texas Comptroller of Public Accounts¹⁴

Sales and use tax

The sales tax accounts for over a third of all state and local taxes paid by Texans.¹⁵ The state imposes a tax of 6.25 percent on purchases of most goods and some services, such as cable television, debt collection, and insurance services.¹⁶ Cities, counties, transit authorities, and some special districts may impose an additional local sales tax of up to 2 percent.¹⁷ Combining the state and local tax rates, Texans can potentially pay a maximum sales tax rate of 8.25 percent. The chart *Sales Tax Rates in the Ten Most Populous States* shows where Texas ranks in comparison to the largest states in the nation. Overall, Texas' per capita state and local sales tax revenue ranks 19th nationally.¹⁸

Sales Tax Rates in the Ten Most Populous States

State	State Rate	Maximum Local Rate	Maximum Total Rate
1. Illinois	6.25	3.00	9.25%
2. New York	4.00	5.00	9.00%
3. California	6.00	2.75	8.75%
4. Ohio	5.50	3.00	8.50%
5. Texas	6.25	2.00	8.25%
6. Georgia	4.00	4.00	8.00%
7. North Carolina	4.25	3.00	7.50%
Florida	6.00	1.50	7.50%
9. Pennsylvania	6.00	1.00	7.00%
10. Michigan	6.00	----	6.00%

Source: Individual states' taxing authorities.

The state also levies a 6.25 percent sales tax on the sale of motor vehicles, in addition to taxes on alcohol and tobacco.¹⁹ The sales and use tax is considered a "consumption tax," since the amount an individual pays is linked to the amount that individual consumes.

Franchise tax

In 2006, the Legislature dramatically changed the state's franchise tax, which is also called the "margins tax."²⁰ Approved as part of a package of bills designed to lower the state's property tax rates, the franchise tax was amended to "close the loopholes ... by extending coverage to certain active businesses."²¹ The tax is paid by any legal entity that does business in Texas and is organized to have some form of limited liability protection, including corporations and limited liability partnerships.²²

The franchise tax fell \$1.2 billion short of its estimated forecast, which initially placed the figure raised during the 2008 fiscal year at \$5.9 billion.²³ Based on 2007 business activity, the tax brought in approximately \$4.7 billion.²⁴ As a result of the shortfall, the Legislature will have to rely on other revenue sources to make up the difference, likely dipping into the \$10.7 billion in unspent revenue that had been considered a surplus.²⁵

The tax will likely be altered again during the 81st Texas Legislature. Numerous organizations have vocally opposed the effects of the recent expansion of the tax, citing its onerous impact on small businesses.²⁶

Other taxes

Taxes other than property, sales, and excise taxes are estimated to account for about a quarter of all state and local taxes to be collected in Texas in 2009.²⁷ Other state taxes, in order of revenue raised, include insurance taxes, natural gas production tax, oil production tax, utility

taxes, hotel tax, and inheritance tax.²⁸ Local governments also impose utility, hotel/motel, mixed beverage, and other minor taxes.²⁹

The inheritance tax in Texas is a “pick up” tax on the federal inheritance tax; instead of having a distinctly separate inheritance tax, Texas piggy-backs on the federal inheritance tax.³⁰ Thus, the tax due to Texas is equal to the federal credit allowed for state inheritance taxes paid. This system takes advantage of the federal credit to reallocate part of the total tax from the federal government to the state. However, with current federal laws phasing out the federal estate tax, the inheritance tax revenue that Texas has enjoyed will soon diminish and eventually be eliminated completely if Texas’ tax laws are not amended.³¹ The chart below shows the tax revenue collected via the inheritance tax. Currently, 22 states continue to levy a tax on inherited wealth.³²

Texas Inheritance Tax Collections

Fiscal Year	Actual Texas Inheritance Tax Collections	Percent of Total Tax Collections	Percent Change from Previous Fiscal Year	Number of Estates that Filed a Return
2008	\$5,580,142	0.01%	5.5%	168
2007	\$5,291,127	0.01%	(60.4%)	288
2006	\$13,360,123	0.04%	(86.9%)	1,334
2005	\$101,674,348	0.34%	(32.7%)	3,126
2004	\$151,131,249	0.54%	(19.1%)	3,891
2003	\$186,844,211	0.72%	(44.1%)	4,573
2002	\$334,190,915	1.27%	3.7%	6,254
2001	\$322,354,926	1.18%	15.8%	6,002
2000	\$278,485,511	1.10%	8.7%	6,238
1999	\$256,276,550	1.09%	(21.6%)	5,358
1998	\$326,820,325	1.44%	57.4%	5,626
1997	\$207,588,651	0.98%	29.6%	5,178
1996	\$160,143,199	0.81%	(6.7%)	5,040
1995	\$171,605,722	0.91%	12.6%	4,635

Source: Texas Comptroller of Public Accounts³³

How does Texas compare?

The chart below, *Why Are Texas' Sales and Property Taxes So High?*, illustrates that most states attempt to avoid relying too heavily on any one or two sources of revenue. A balanced tax system provides a steady source of support for public services and protects states from economic downturns that can affect a single type of tax.³⁴ So while other states have a balanced system designed to safeguard public revenue, Texas' system is more easily subject to large shifts in the economy. Texas’ weakness is its reliance on only two major taxes—sales and property taxes. As a result, Texas now ranks sixth in the nation in sales tax dependency.³⁵

Why Are Texas' Sales and Property Taxes So High?

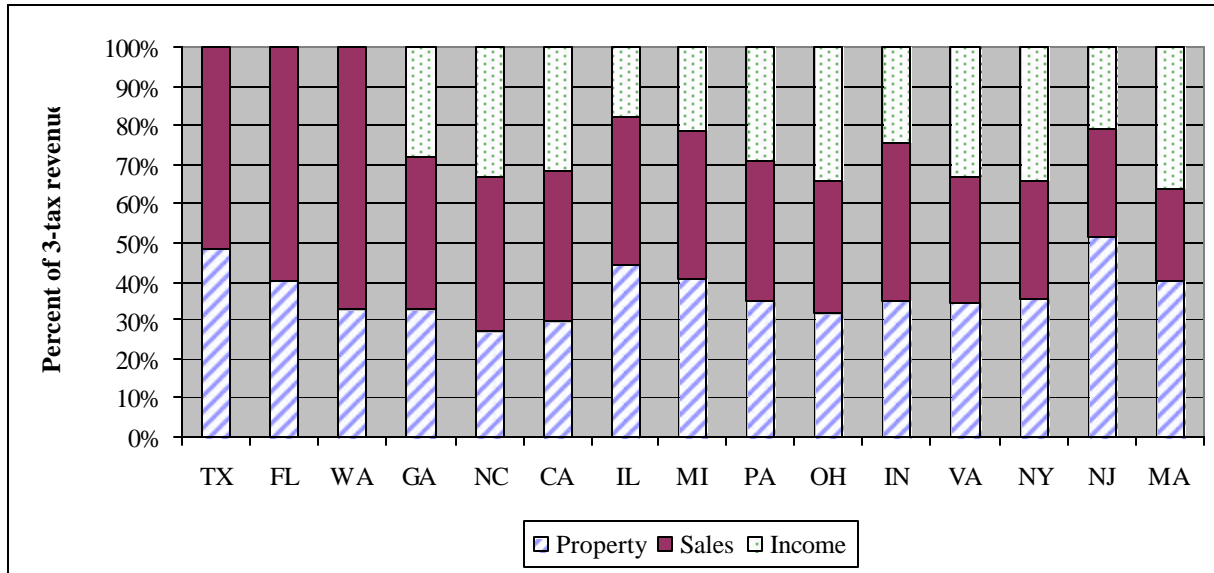
<u>Relative Sources of Revenue, FY04</u>			
	Property	Sales	Income
Texas	48.7	51.3	0.0
Florida	40.3	59.7	0.0
Washington	32.9	67.1	0.0
Georgia	32.6	39.1	28.3
North Carolina	27.0	39.7	33.3
California	29.7	38.9	31.4
Illinois	44.2	37.9	17.8
Michigan	40.7	37.6	21.6
Pennsylvania	35.0	36.1	28.8
Ohio	31.4	34.5	34.1
Indiana	35.1	40.4	24.5
Virginia	34.5	32.4	33.2
New York	35.7	30.3	34.0
New Jersey	51.5	27.6	20.9
Massachusetts	40.2	23.5	36.2

Source: Hovey and Hovey³⁶

The responsibility for services that should be the obligation of the state to fund, such as public education and health care, has thus shifted to the local tax base. This over-reliance has distorted the state and local tax system, and Texas now ranks 49th among the 50 states in total state taxes per capita, but 13th in local taxes per capita.³⁷ The distortion is only exacerbated in areas along the Border because low property values are unable to generate adequate revenue to fund public education.

All but seven states, including Texas, have a third source of revenue—a state personal income tax—to help balance their revenue systems.³⁸ Texas is one of only three of the 15 most populous states that do not tax personal income, the others being Florida and Washington.³⁹ Thus, the majority of states attempt to divide the responsibility for funding government services equally among sales, property and income taxes. The chart below, *Most States Have a Balanced Revenue System*, indicates that the twelve most populous states with an income tax receive an average of 36.5 percent of revenue from the sales tax, 34.8 percent from the property tax, and 28.7 percent from the income tax.⁴⁰

Most States Have a Balanced Revenue System



Source: Hovey and Hovey⁴¹

The contrast between a balanced tax system and a distorted tax system are most visible along the Texas-New Mexico Border in El Paso, Texas. As the chart *Per Capita Tax Comparisons of New Mexico and Texas* demonstrates, even with a state income tax, the total per capita taxes in New Mexico are approximately \$350 less than those in Texas.

Per Capita Tax Comparisons of New Mexico and Texas

	<i>New Mexico</i>	<i>Texas</i>
Income	\$529	N/A
Sales	\$1,381	\$1,319
Property	\$441	\$1,253
Total	\$2,351	\$2,572
Difference		+\$221

Source: Hovey and Hovey⁴²

What taxes support state government?

The chart *Texas Revenue by Source, 2007* shows that our state taxes provide less than half of state government revenue.⁴³ The federal government currently supplies 31.6 percent of Texas' total revenue, while fees and interest provide the majority of the remainder. The state lottery has a minor role in state finances, accounting for only 2 percent of total net revenue in 2007.⁴⁴

Texas Revenue by Source, 2007

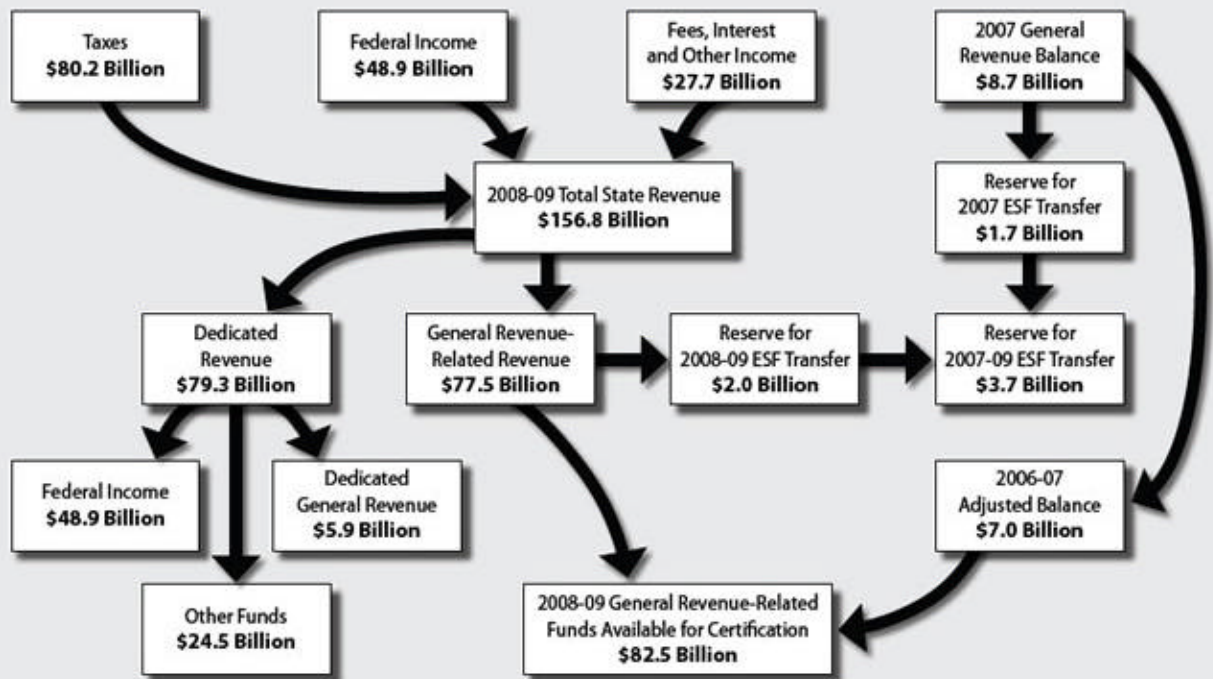
		Percentage of total revenue
Tax Collections	\$36,955,629,884	47.9%
Federal Income	\$24,376,052,502	31.6%
Net Lottery Proceeds	\$1,551,975,844	2.0%
Licenses, Fees, Permits, Fines and Penalties	\$6,914,295,978	9.0%
Interest and Investment Income	\$2,372,705,358	3.1%
Sales of Goods and Services	\$538,835,356	0.7%
Settlement of Claims	\$537,942,295	0.7%
Land Income	\$751,358,474	1.0%
Contributions to Employee Benefits	\$237,887,499	0.3%
Other Revenue Sources	\$2,952,608,025	3.8%
Total Net Revenue	\$77,189,291,215	

Source: Texas Comptroller of Public Accounts⁴⁵

The chart *Flow of Major Revenues* details how the major revenue sources relate to one another in the 2008-09 biennium.

FIGURE 1

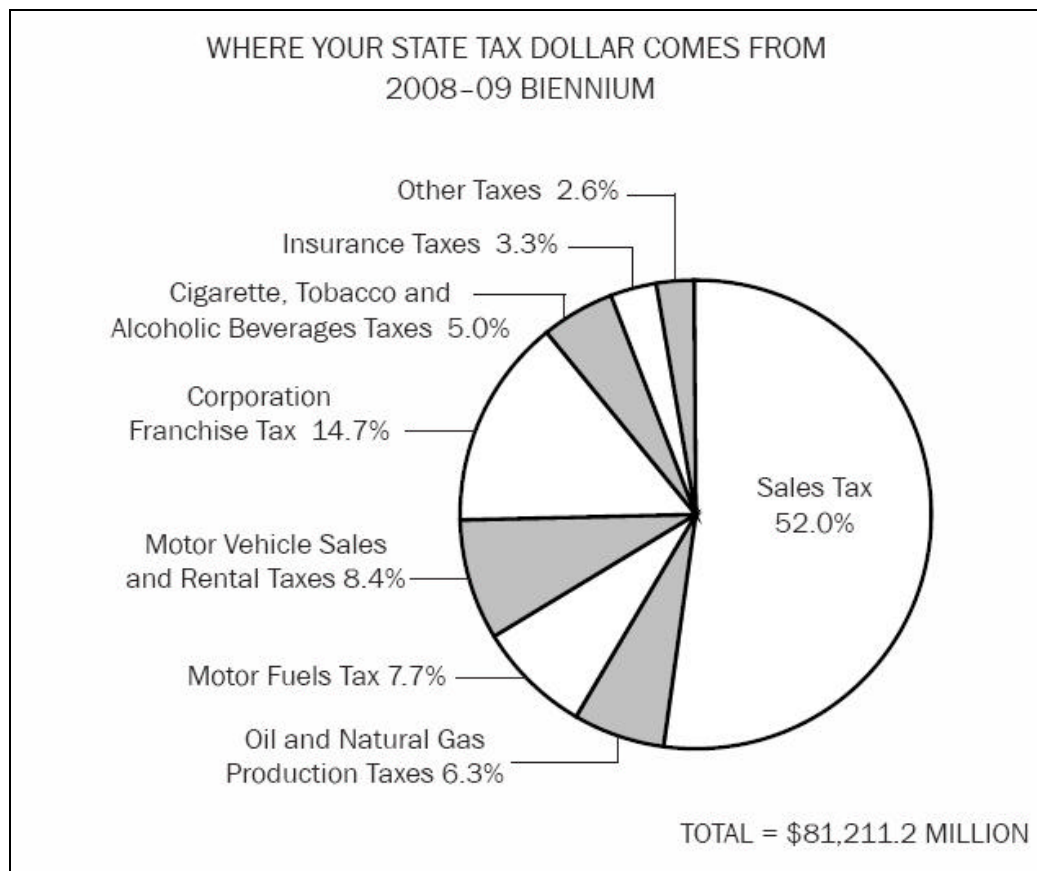
Flow of Major Revenues For the 2008-09 Biennium



Note: Totals may not sum because of rounding.
Source: Susan Combs, Texas Comptroller of Public Accounts.

Source: Texas Comptroller of Public Accounts⁴⁶

The chart below, *Where Your State Tax Dollar Comes From*, reveals that Texas funds state government primarily through consumption taxes. In addition to the sales tax, Texas state government counts heavily on the motor vehicle sales and rental tax (8.4 percent of tax revenue), motor-fuels tax (7.7 percent), and “sin taxes” on alcohol and tobacco (5 percent). Consumption taxes account for almost three quarters of all tax revenue collected by Texas state government.⁴⁷

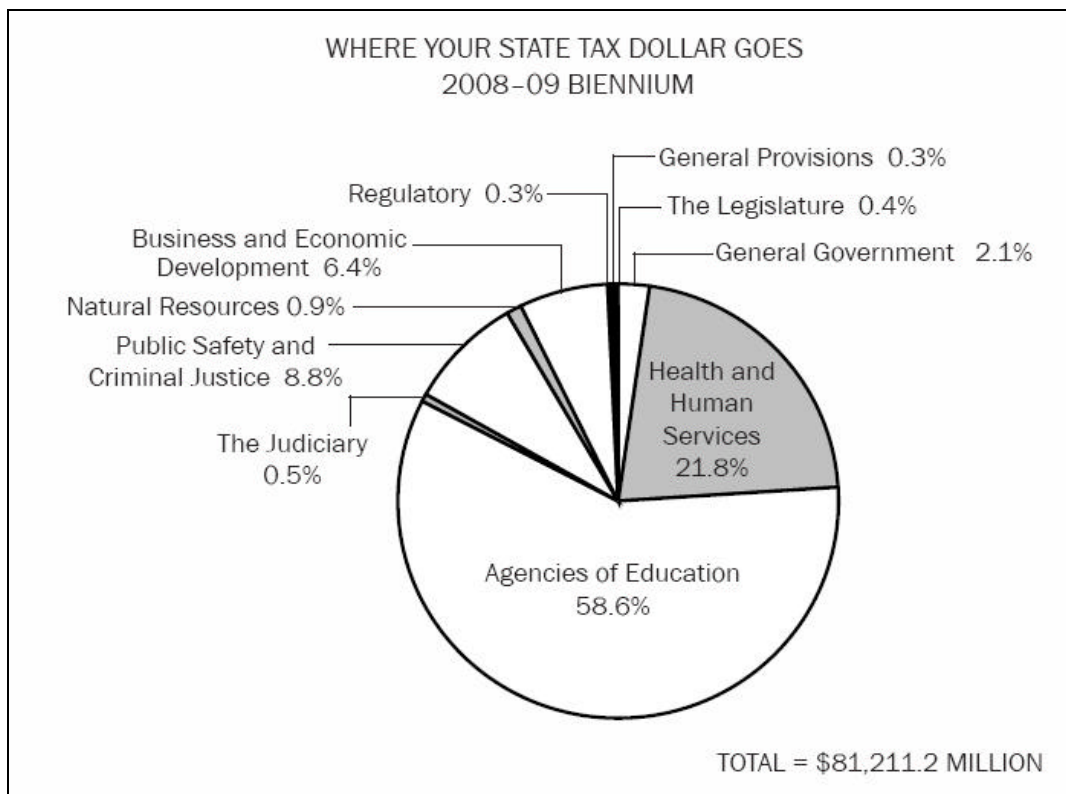


Source: Texas Legislative Budget Board⁴⁸

How does the state spend our money?

Recent efforts at increasing transparency and accountability in state government have created new ways to examine state spending. Via an Internet-based search program, Texans can now see exactly where their state money is spent.⁴⁹

The bulk of state spending goes toward education and health and human services, which together account for approximately 80 percent of the state budget.⁵⁰ The majority of state education spending goes to public schools, which alone accounts for nearly 30 percent of all state expenditures.

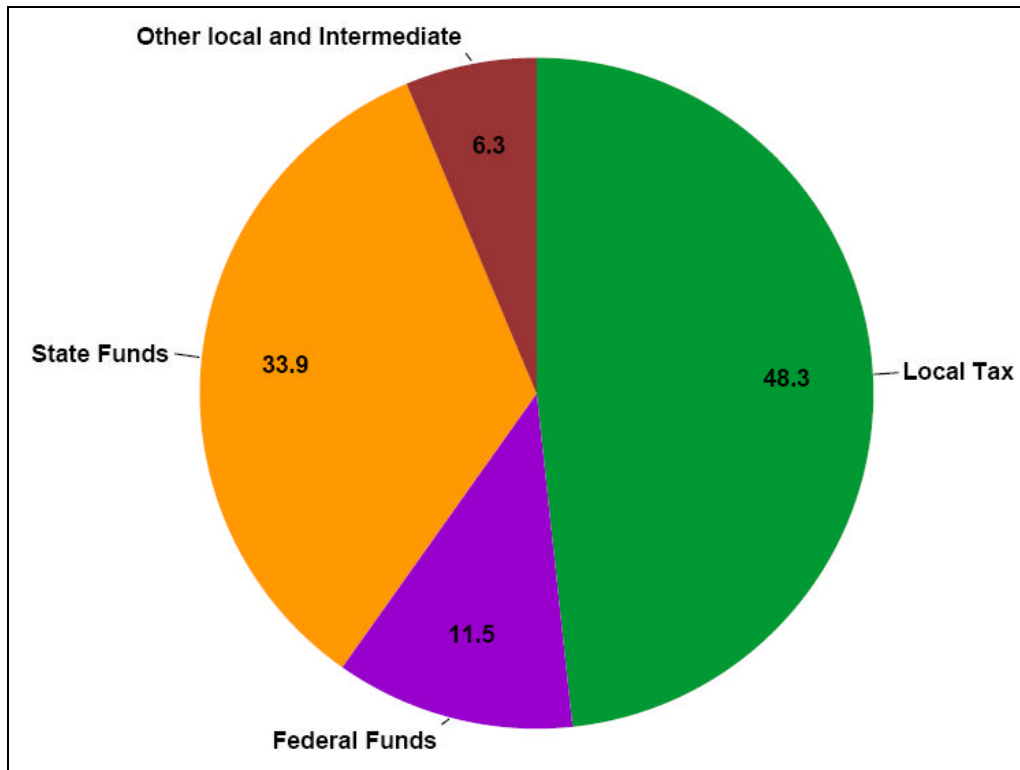


Source: Texas Legislative Budget Board⁵¹

Who pays for public schools?

Texas public schools are funded primarily by a combination of state and local funds, as can be seen on the chart, Texas Public Education Revenue. During the 2005-06 school year, which is the most recent data available, local revenues comprised 54.6 percent of total school revenue and were the largest source of school districts' budget. The state's contribution of 33.9 percent provided most of the remainder of public school support. The federal government contributed only 11.5 percent of total school revenue.⁵²

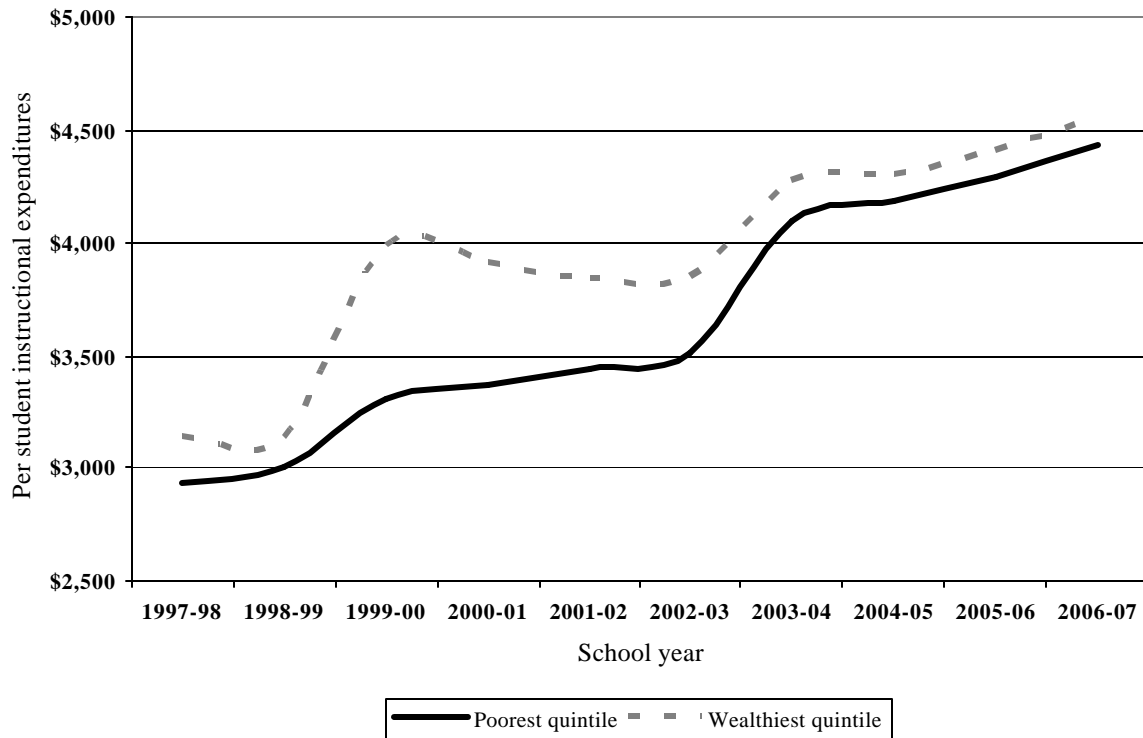
Texas Public Education Revenue



Source: Texas Education Agency⁵³

Public school finance has always been a major issue facing Texas. But within the school finance issue there has been the question of how to ensure that all Texas children are well-educated while funding that education through a local property tax. Because property wealth is not evenly distributed across the geography of the state, some school districts had the advantage of taxing a larger tax base than others. In essence these districts are property-wealthy, relative to other school districts that do not have as large a tax base. This has led to some school districts being able to provide a more comprehensive and rigorous education for their students than other school districts. The chart below, *Per Student Instructional Expenditures*, highlights the difference in per student instructional expenditures between the wealthiest quintile of school districts and the poorest quintile of school districts.

Per Student Instructional Expenditures
Property Wealthiest Quintile v. Property Poorest Quintile



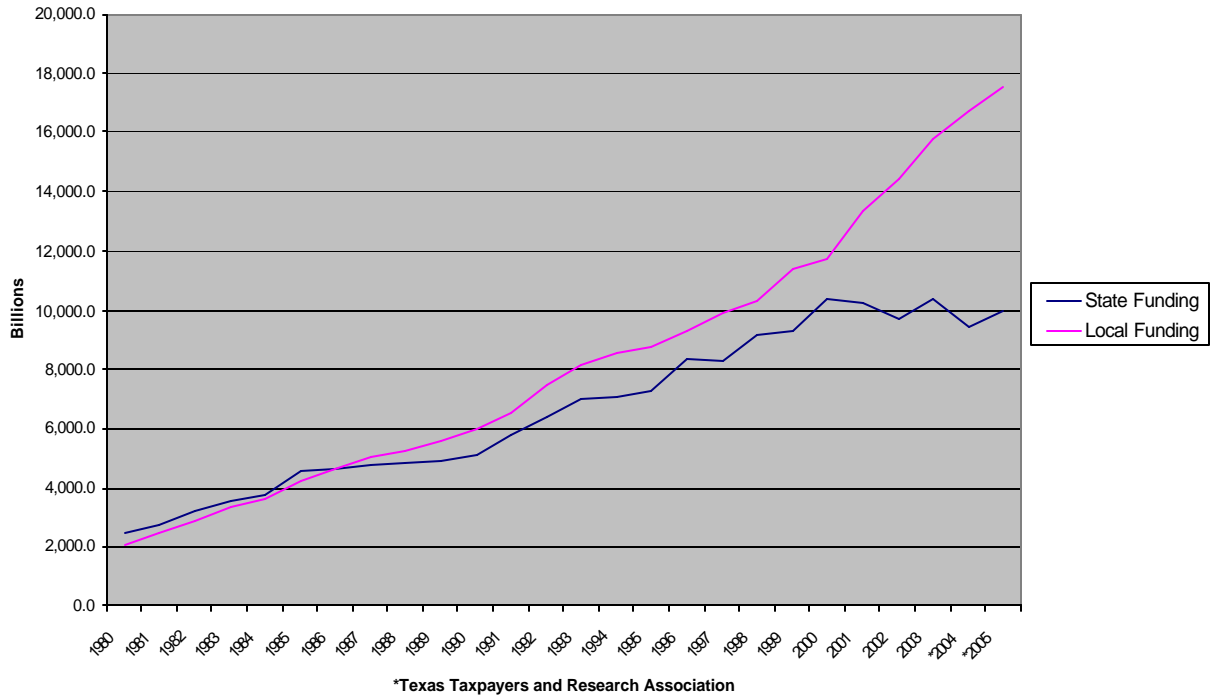
Source: Texas Education Agency⁵⁴

As a result, a series of legal challenges were raised against the state's school finance system to force the state to provide more equitable public school funding. These challenges resulted in the Texas Supreme Court ruling that at a minimum, "districts must have substantially equal access to similar revenues per pupil at similar tax effort."⁵⁵

In response to that decision, the state developed a school finance system that took into account the characteristics of the districts themselves, such as size, as well as the characteristics of the students each district educated, such as a student's risk of dropping out. This formula driven system made use of recapture, also known as "Robin Hood," that requires school districts over a certain threshold of property-wealth to share their property-tax revenue with property-poor districts.⁵⁶

However, as can be seen in the chart below, beginning in the year 2000, the state failed to provide increased funding for public education and instead used increases in property values at the local level to fund higher costs in public education from factors such as additional state requirements, enrollment growth, and inflation. In order to make up for the lack of state support, many school districts gradually raised their local tax rates to or near the maximum of \$1.50 per \$100 of property valuation.

Twenty Five Years of State and Local Funding for Texas Public Schools

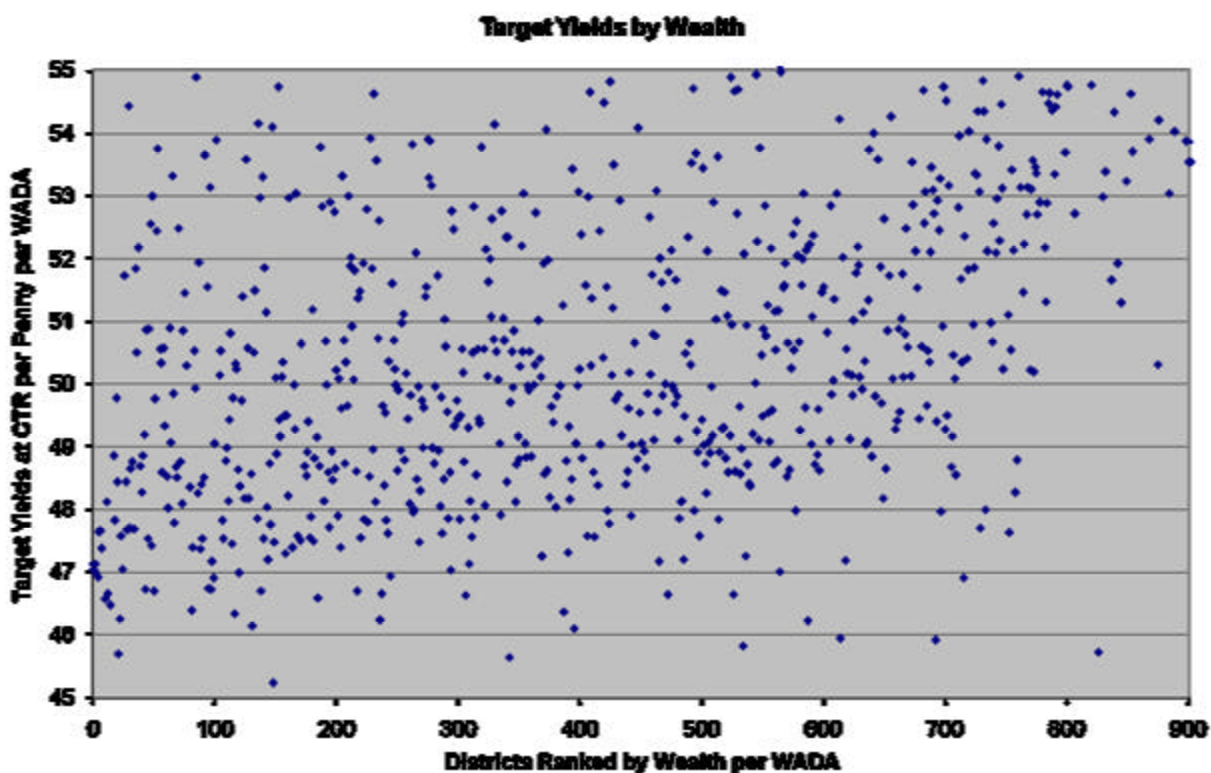


In 2001, both property-wealthy and property-poor school districts sued the state, alleging that they were forced to adopt higher rates in order to meet state requirements. Therefore, they argued, the local property tax had become a de facto state property tax, which is prohibited by the Texas Constitution.⁵⁷ Other districts joined the suit, alleging that the state had failed to support an adequate level of funding. They point to the provision in the Texas Constitution that requires the state to “make suitable provision” for an education system that ensures “a general diffusion of knowledge.”⁵⁸ On November 22, 2005, the Texas Supreme Court, in a 7-1 opinion, found that the school finance system had evolved into an unconstitutional state property tax and gave the Texas Legislature a deadline of June 1, 2006 to correct the constitutional violation.

In response, the 79th Legislature entered what was then the fourth special session on public education finance to address the opinion of the Supreme Court. That session eventually passed House Bill (HB) 1, which made adjustments to the state school finance system that included provisions to increase equity and infused additional state dollars into the system to reduce the local property tax to \$1.00 per \$100 of the value of a property.⁵⁹

However, because it was possible under the new finance system established under HB 1 for some school districts to receive less funding than they were receiving prior to the passage of HB 1, the Legislature enacted a “hold-harmless” provision in the bill.⁶⁰ The hold-harmless provision basically assured that no district would receive less money per student in future years than it did in either the 2005-06 school year or the 2006-07 school year, whichever provided higher funding levels. However, this provision was meant to be temporary until the state was able to provide formula funding in excess of the amounts districts received through the hold-harmless funding levels.

As a result, the school finance system established under HB 1 has not been fully-implemented and school districts are currently funded through hold-harmless funding. No mechanism was established in HB1 to eliminate the hold-harmless funding method, nor has the state provided additional funding above those levels established in the hold-harmless. This has led to a complete abandonment of a formula driven school finance system, and little rhyme or reason as to the funding levels a district receives. The chart below, *Target Yields by Wealth*, shows the wide-ranging and almost random levels of funding school districts receive through the hold-harmless provision despite the fact that all districts are evaluated using identical criteria. For example, for the 2007-08 school year, Clint ISD's maintenance and operations revenue on a weighted average daily attendance basis is \$5,164 per student. In Highland Park ISD, however, they receive \$5,906 per student. This allows Highland Park to access much more revenue than Clint. Clearly, the return to a formula driven, equitable school finance system is one of the single biggest challenges facing public school finance in Texas today.



Is our tax system fair?

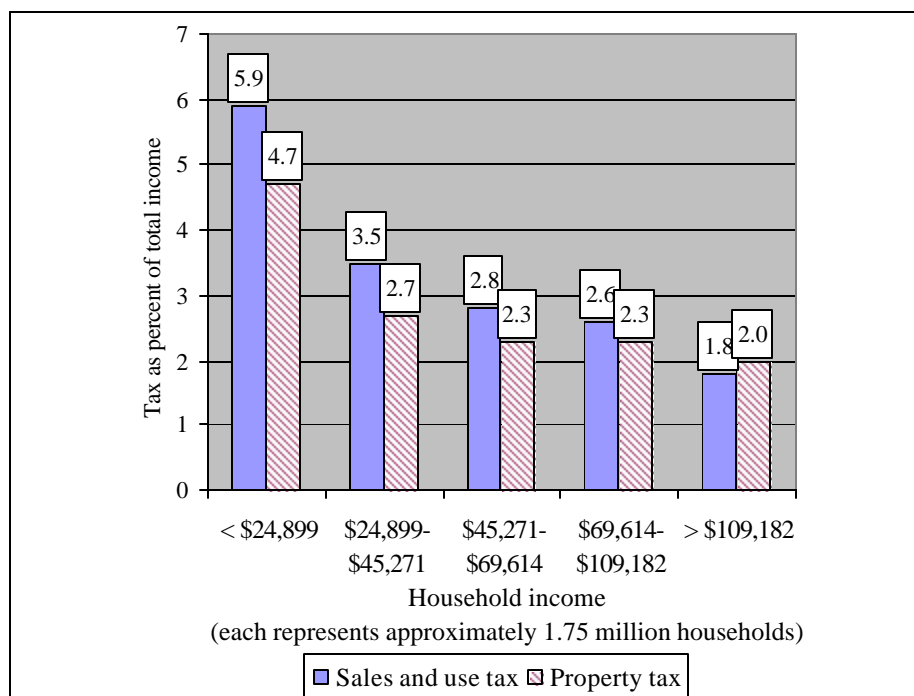
There are certain principles of good tax policy that are consistently recognized by tax groups, academic, and governmental studies.⁶¹ The Texas tax system does not measure up in two of the key criteria of a good tax policy: it does not distribute the tax burden equitably and it does not provide a stable source of adequate revenue from a balance of sources.

An equitable tax system distributes the burden of paying taxes according to the ability of each taxpayer to bear that burden. A generally accepted measure of ability to pay is the current

income of the taxpayer. An equitable system would require individuals to pay the same share of taxes as the share of income earned.

A tax system that takes a larger share of the income of higher-income taxpayers is known as progressive, while a tax system that takes a larger share of the income of lower-income taxpayers is known as regressive. The Texas tax system is regressive, primarily because it relies so heavily on the sales tax, which takes a larger proportion of income from a low-income family than from a high-income family. The chart below, *Sales and Property Taxes Paid as a Percentage of Income*, reveals the regressive nature of both the sales and property taxes.

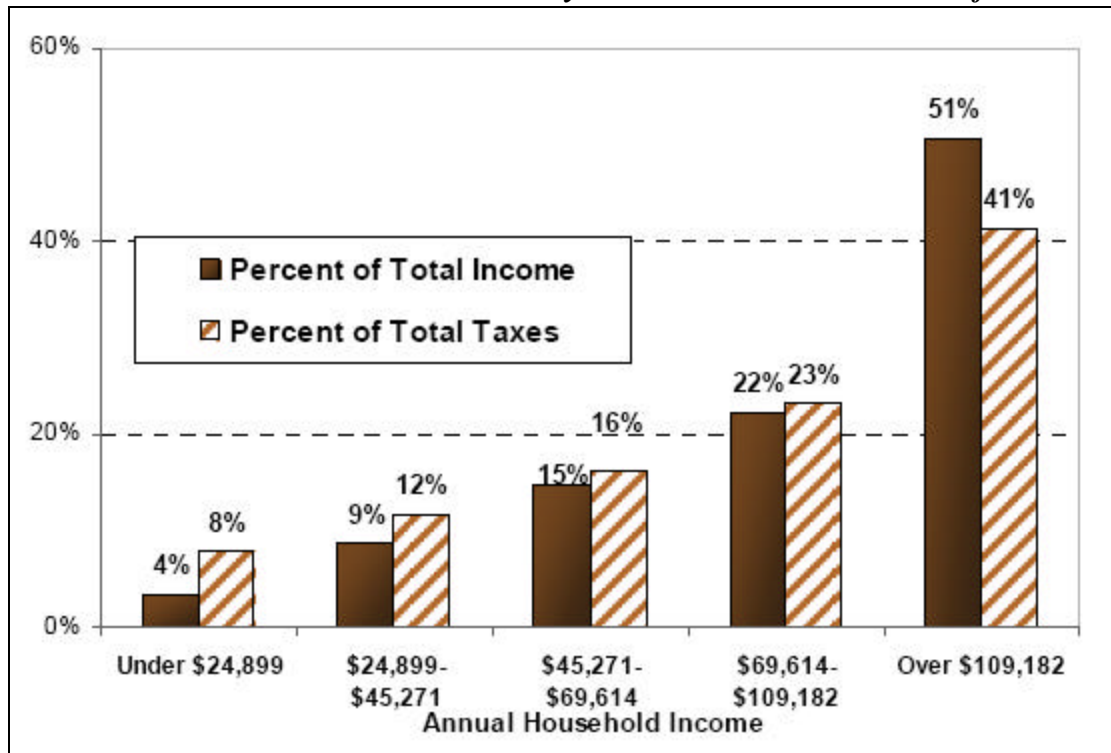
Sales and Property Taxes Paid as a Percentage of Income



Source: Texas Comptroller of Public Accounts⁶²

A regressive tax system results in lower- and middle-income families paying more than their fair share of taxes.

Lower- and Middle-Income Texans Pay More than their Fair Share of Taxes



Source: Center for Public Policy Priorities⁶³

As previously discussed, most states rely on a personal income tax to balance their tax systems and to counteract the regressivity of sales and property taxes. An income tax can be designed to ease the burden on lower- and middle-income families by exempting all persons below a certain level of income or applying a lower tax rate to persons with lower incomes.

Does our tax system provide adequate revenue?

In order for Texas to compete, the tax system must produce an adequate revenue base to support needed services. Texas, after all, faces an uphill battle. The state is currently:

- 50th in the percentage of the population with health insurance;⁶⁴
- 50th in the percentage of children with health insurance;⁶⁵
- 7th in the percentage of children living in poverty;⁶⁶
- 50th in the percentage of the population over 25 with a high school diploma;⁶⁷ and
- 43rd in home ownership rate.⁶⁸

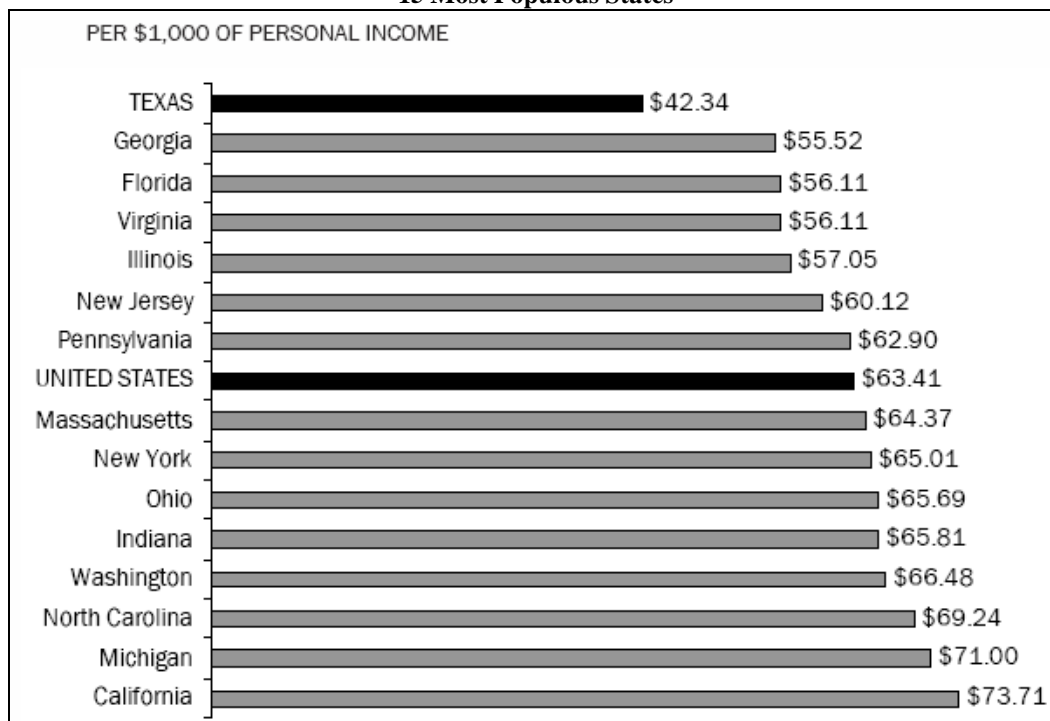
At the same time, however, Texas ranks last in the country in state government per capita expenditures. In other words, the programs that exist to help reverse the above trends are funded with less revenue than any other state.

State Government Expenditures Per Capita 15 Most Populous States

50 State Ranking		2005 State Expenditures Per Capita (in millions)
4	New York	\$7,082
9	Massachusetts	\$5,911
11	California	\$5,802
14	New Jersey	\$5,657
19	Ohio	\$5,279
20	Washington	\$5,254
23	Michigan	\$5,090
24	Pennsylvania	\$5,065
32	North Carolina	\$4,553
36	Illinois	\$4,361
37	Virginia	\$4,335
40	Indiana	\$4,221
47	Florida	\$3,963
49	Georgia	\$3,702
50	Texas	\$3,549
United States Average		\$4,959

Source: Texas Legislative Budget Board⁶⁹

State Tax Revenue 15 Most Populous States



Source: Texas Legislative Budget Board⁷⁰

Texas, as discussed previously, relies primarily on sales and property taxes. A good tax system should reflect all sectors of a state's economy, so that revenue grows naturally along with

the economy, without frequent increases in tax rates. The mainstay of the Texas tax system, the sales tax, has not evolved to match the changing nature of the Texas economy. When the sales tax was adopted in 1961, a larger portion of Texas' economy involved the sale of goods—i.e., items that had been manufactured. However, the fastest growing sectors of the modern Texas economy are related to services, not goods.⁷¹ The service-producing sectors are now responsible for approximately 80 percent of the states' employment and 63 percent of output.⁷² For example, just one area—professional services such as accounting, engineering, management, legal, and healthcare—provides 28 percent Texas' nonagricultural employment.⁷³

The tax system should not rely too heavily on just one or two types of taxes, but should divide the burden among different sources of revenue to preserve balance in the system over the long-term. Texans need a more equitable state and local tax system to support their government as it meets the challenges of the 21st century. Revenue should be collected from Texas families and businesses in an equitable manner to ensure that all citizens pay a fair share. Texans deserve a tax system that contributes enough revenue to provide our students with a world-class education, to give our citizens a transportation system that will help stimulate economic growth, to keep our cities safe and clean, and to help less fortunate citizens in times of need.

¹ David Brunori, *State Tax Policy: A Political Perspective*, The Urban Institute Press, Washington, D.C. 2001.

² Select Committee on Tax Equity, *Rethinking Texas Taxes*, Vol. 2, *Analysis of the Tax System*, Table 1, page 8 (1989).

³ See, e.g., Center for Public Policy Priorities, "The Best Choice for a Prosperous Texas: a Texas-Style Personal Income Tax" (January 2006). Online. Available: <http://www.cppp.org/files/7/Texas%20Trilogy%202%20-%20The%20Best%20Choice%20for%20a%20Prosperous%20Texas.pdf>. Last accessed: October 22, 2008.

⁴ *Id.*

⁵ Center for Public Policy Priorities, "Paying for a Better Budget for Texas in 2010 and 2011" (July 2008). Online. Available: <http://www.cppp.org/files/7/Tax%20Revenue%20339r.pdf>. Last accessed: October 23, 2008.

⁶ *Id.*

⁷ *Id.*

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