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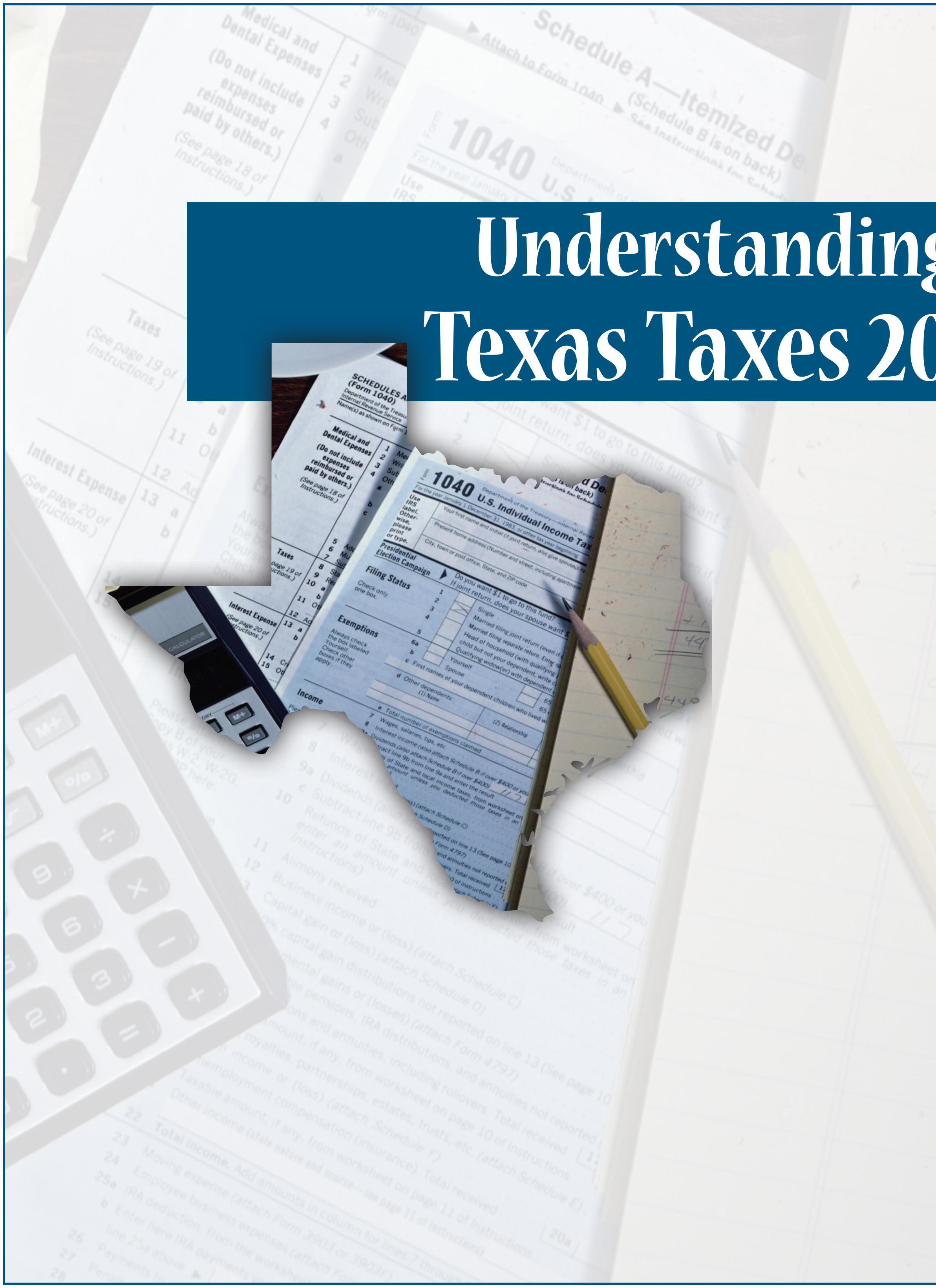
Understanding Texas Taxes 2011



Understanding Texas Taxes

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Contents

To make sound decisions on taxes, Texans need to know basic information about the state's public revenue system. The state's tax system affects different households and businesses in various ways, influencing the decisions made by both individuals and businesses.

For example, many retirees and military families choose to live in Texas because the state has no personal income tax. Those retirees bring additional income to the state. They pay sales, property, and other taxes in Texas, and they spend a good deal of their income at Texas businesses. On the other hand, Texas has relatively high sales and property tax rates as compared to other states. High state sales taxes can induce people to make large purchases in nearby states, reducing the competitiveness of Texas businesses.

From a business perspective, the franchise tax exemptions for wind energy production can encourage the development of renewable wind energy in the state. Schools benefit from wind energy royalties. However, the franchise tax treats businesses differently depending on their size, industry, and organizational structure. Business owners may consider the franchise tax rules when choosing an organizational structure to minimize their *tax burden.* [Note: Terms in italics are defined in the Glossary.]

The Texas tax system was developed through years of decisions made by citizens, the courts, and the legislature. It may change with the next court decision, legislative session, or taxpayer referendum.

To determine whether, when, and how to change the tax system, citizens and legislators need to know how much Texans pay in state taxes, who pays what share, and how the money is spent. They need to understand the *tax base*, *rate*, and *levy* of its major taxes—the state sales tax, motor vehicle tax, motor fuels tax, alcohol and tobacco tax, and franchise tax. It is also helpful to know common ways of evaluating the effects of taxes so citizens can determine how the state's various taxes measure up according to those criteria.

State expenditures

In 2010, Texas generated revenues of $117 billion and expenditures of $115 billion, according to the Texas Comptroller of Public Accounts.[1] Taxes and other revenue sources pay for the state's roads, education system, justice system, and other services.

Texas's largest expenditure category is public assistance, which includes medical services, unemployment benefits, and disaster relief payments (Fig. 1). Public assistance has increased as a share of Texas expenditures by 4 percent (about $5.8 billion) since 2008 as a nationwide recession has lingered. Intergovernmental transfers—mostly to schools, cities, and counties—and interfund transfers also make up large shares of state expenditures.

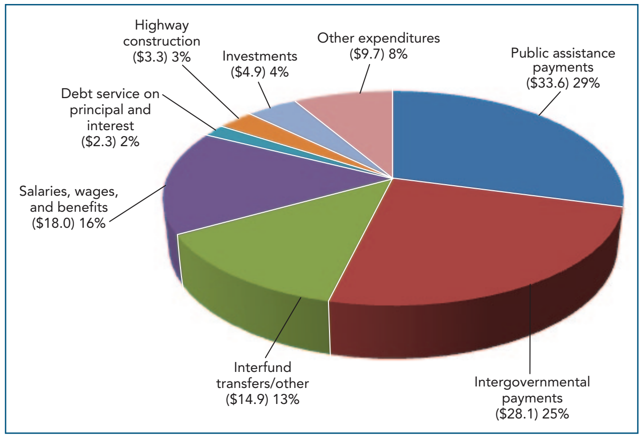

Figure 1. Expenditures, fiscal year 2010 (billions of dollars). For more detailed information, see the Texas Comptroller of Public Accounts' Texas Transparency website. Source: Combs, 2010.

State revenue sources

In 2010, 35 percent of state government revenues came from the federal government (Fig. 2). Federal income surpassed tax collections (31%) as Texas's largest source of revenue, partially as a result of increased federal spending to stimulate a lagging

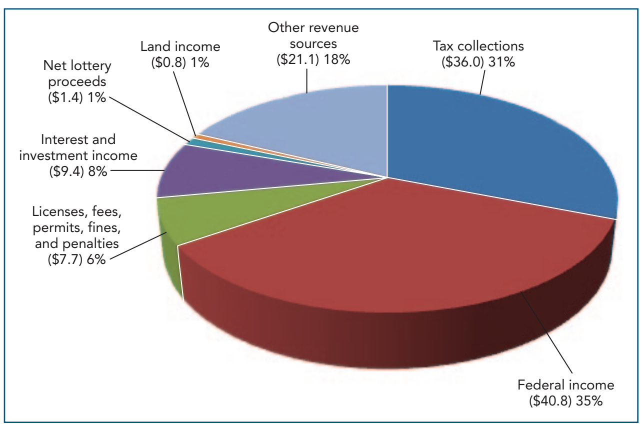

Figure 2. Texas revenue by source, fiscal year 2010 (billions of dollars). For more detailed information, see the Texas Comptroller of Public Accounts' Texas Transparency website. Source: Combs, 2010.

U.S. economy. Meanwhile, overall tax collections decreased by $6 billion between 2008 and 2010.

Since the mid-1980s when the oil and gas price boom began to wane, the share of total state revenue from taxes has declined, from about 60 percent to 45 percent in 2009 (Fig. 3).[2] The share of revenue from interest, investments, and land has also declined. Meanwhile, the percentage of revenue from the federal government, fees, and other sources has increased.

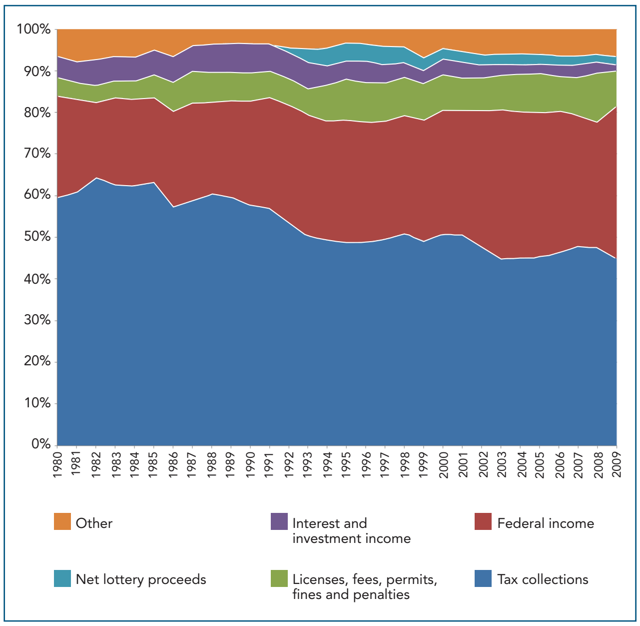

Figure 3. Major sources of revenue for the Texas state government, 1980–2009. For more detailed information, see the Texas Comptroller of Public Accounts' Window on State Government website. Source: Combs, 2010.

The most important state tax in Texas is the sales tax (Fig. 4). The general sales and use tax accounts for 54 percent of state tax revenue. However, special sales taxes on motor vehicles, motor fuels, tobacco, and alcohol increase the share of sales and gross receipts taxes to about three-quarters of state tax collections. The franchise tax on business margins accounts for 11 percent of revenues.

Although oil and natural gas *severance taxes* were previously major contributors to state revenue, they have declined over the past three decades. During the global oil price increases of the late 1970s and early 1980s, oil and gas severance taxes rose to nearly a third of all state tax revenue. However, despite high energy prices in recent years, oil and natural gas taxes contributed only about 10

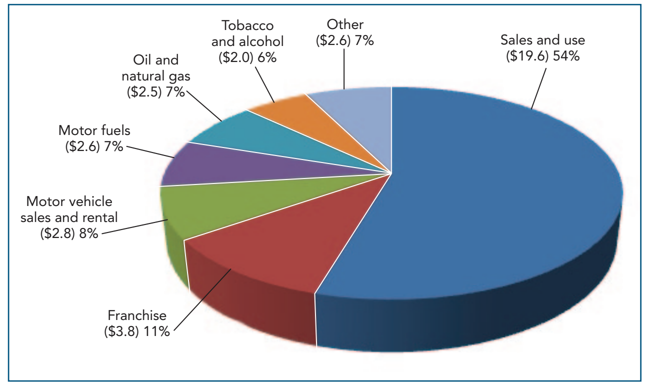

Figure 4. State tax revenue by source, fiscal year 2010 (billions of dollars). For more detailed information, see the Texas Comptroller of Public Accounts' Texas Transparency website. Source: Combs, 2010.

percent of state tax revenue in 2010 (Fig. 4). This source of revenue is greatly affected by price swings in the oil industry.

Minor taxes not discussed in this publication include utility, hotel, and insurance taxes, the cement tax, oil and gas well servicing tax, bingo tax, sulfur tax, and the coin-operated amusement tax. Combined, these taxes make up about 7 percent of total state tax collections. Also not included are fees, which include drivers' licenses fees, fishing permit fees, and road tolls.

Local tax revenue sources

Compared to the state, local government entities are more limited in the sources and amounts of taxes they can levy. The most important local tax for schools, counties, municipalities, and special taxing entities is the property tax.

In 2008, local property taxes made up 87 percent of local tax collections. In fact, local property taxes were the largest single tax paid by Texans, totaling more than $34 billion, or almost half of all tax collections in the state (Fig. 5).[2] Although Texas has not had a state property tax since 1980, property taxes are collected by almost 3,800 separate local taxing jurisdictions across the state, according to the Texas Comptroller of Public Accounts.[3]

The property tax is the sole source of local tax revenue for schools and many special districts, including hospital, airport, irrigation, rural fire prevention, and community college districts.

It is also the primary source of revenue for cities and counties. Although most cities have adopted a

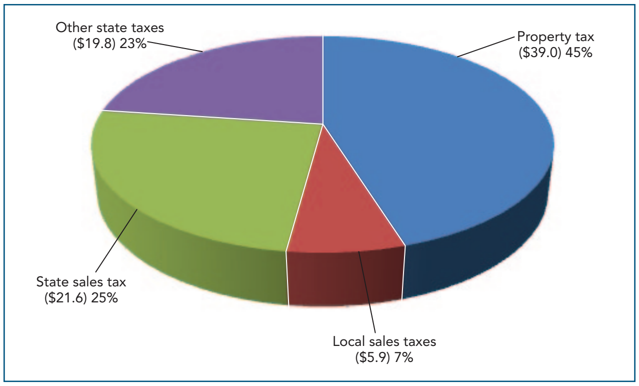

Figure 5. State and local taxes by type, fiscal year 2008 (billions of dollars). For more detailed information, see the Texas Comptroller of Public Accounts' Window on State Government website. Source: Combs, 2010.

sales tax of 0.5 to 2 percent, the revenue from property taxes is more than twice that from sales taxes. Cities earn revenue from other sources including utility sales, fees, and fines. Although counties and some special districts may also adopt a limited sales tax, their main source of revenue is property taxes.

State-level tax structure

Table 1 shows the major taxes from which the state receives revenues. It includes the type of tax, tax rate, tax base, *taxing entity*, and major *exemptions*. Tax rates are usually expressed as a percentage or dollar amount, which is multiplied by the tax base to determine the dollar amount of the tax levy paid to the state.

Texas is one of few states to have neither a corporate nor a personal income tax. This has been a selling point for the state in attracting businesses and new residents. However, maintaining this advantage brings certain costs to taxpayers. Texas makes up for having no income tax by having relatively high sales and property taxes.

Sales taxes have a disproportionately larger effect on the poor than on the rich because the poor spend a greater share of their incomes on taxable goods and services. Hence, it is known as a "regressive" tax.

To a lesser degree, property taxes are also regressive. Taxable property makes up a larger share of the poor's income since items of wealth such as bank deposits, stocks, bonds, and other personal property are not taxed. The property tax is more highly correlated with income and wealth than are consumer purchases.

An important facet of any state tax structure is the way it interacts with federal tax structures. Individual taxpayers may deduct sales taxes and local property taxes from federal taxable income. Business taxes can be deducted from income on the federal tax form. This *deduction* lowers the *effective tax rate* for businesses.

General sales and motor vehicles taxes

The state general sales and use tax (an *ad valorem tax*) is collected at a rate of 6.25 percent of the retail value of taxable goods and services. This rate also applies to the *excise tax* on motor vehicles and manufactured homes. That means 6.25 percent—or 6.25 cents of each dollar—of taxable sales is collected from the consumer by the seller at the point of retail sale. The retailer, or final service provider, then remits the tax to the Texas Comptroller of Public Accounts.

The sales tax is levied on most goods, unless specifically exempted. Goods exempt from sales tax include unprepared foods for home consumption; prescription drugs; utilities; motor fuels, which are subject to a special fuels tax; purchases for farm and ranch use; raw materials, machinery, and equipment used in manufacturing; and items sold for out-of-state use.

The tax base for services is much narrower than for goods; only specific services are subject to sales tax. Services taxed include non-automotive repair services, laundry and dry-cleaning, amusements, cable television, garbage collection, exterminating, most data processing, nonresidential repair and remodeling, custom software, and security and information services.

Exempt services include legal, accounting, and advertising services. Lawn and yard services performed by persons under the age of 18 or persons 65 or older are also exempt from the sales and use tax.

Other state taxes that are based on a percentage of some dollar value (an ad valorem tax) include oil and gas severance taxes, insurance occupation taxes, utility taxes, hotel/motel taxes, and the franchise tax. Texas has not had an inheritance tax since 2005, although the tax and interest still apply to estates with a date of death before January 1, 2005.

Motor fuels, alcohol, and tobacco taxes

Excise taxes are levied on specific products such as cigarettes, beer, and motor fuels. Excise taxes can be calculated as a dollar amount per unit, such as gal-

Table 1. Characteristics of major state-level taxes, 2010.

Type of tax	Tax rate	Tax base	Exemptions
Sales and use	6.25%	Retail price of tangible goods and selected services	Unprepared food, prescription drugs, purchases for farm and ranch use
Motor vehicles sales and rentals	6.25% 10% if less than 30 days; 6.25% if 30-180 days; interstate carrier rates jurisdiction-dependent	Sales: sale price less trade-in value Rentals: rental rate	
Franchise	1%, except 0.5% for wholesale and retail entities 0.575% E-Z calculation if revenue <$10 million	Business margin (as defined in text) Business revenue	Sole proprietorships, nonprofits, etc.
Motor fuels	$0.20 $0.20 $0.15	Gasoline: per gallon Diesel: per gallon Liquefied gas: per gallon	Fuel for farm, ranch, and other off-road uses
Cigarette and tobacco	$1.41–$1.76 0.1¢–1.5¢ $1.13 until 8-31-2011, increases by 3¢ per fiscal year to $1.22 in FY 2014	Per package of cigarettes Per cigar based on weight Per ounce of smokeless tobacco	
Natural gas	Gas: 7.5% Condensate production: 4.6%	Market value of gas produced in the state	
Oil production	4.60%	Market value	
Alcoholic beverages			
Beer	$6.00 (~19.4 cents)	Per barrel (per gallon)	
Liquor	$2.40	Per gallon	
Wine	20.4¢–51.6¢	Per gallon, based on alcohol content	
Malt liquor and ale	19.8¢	Per gallon	
Mixed drinks	14.00%	Receipt value (price)	
Insurance companies			
Life, accident, and health	1.75% plus 5.7¢ per policy	Texas investments	
Property and casualty	1.6% plus 5.7¢ per policy	Texas investments	
Title	1.35% plus 5.7¢ per policy	Texas investments	
Unauthorized and surplus lines	4.85%	Texas investments	
Utilities tax			
Public utilities	1/6%	Gross receipts	
Gas, water, and electric	0.581%–1.997	Gross receipts based on population	
Hotel/motel	6.00%	Price paid	

Adapted from Comptroller of Public Accounts' Window on State Government website. Source: Combs, 2010. *http://www.window.state.tx.us/taxinfo/taxrates.html*.

lon or ton, or as ad valorem, which is a percentage of the item's value, as in the motor vehicle sales tax.

Excise taxes are often used to recover the governmental costs associated with the sale of some product. An example is the motor fuels taxes, which are used to fund road construction and maintenance. In some cases, these fees—such as alcohol and tobacco taxes—are used to discourage consumption of the product.

These taxes provide fairly stable sources of revenue. The state motor fuels tax rate is 20 cents per gallon for gasoline and diesel and 15 cents per gallon for liquefied gas, regardless of the price of the fuels. The so-called "sin taxes" on alcoholic beverages and tobacco products are excise taxes of a dollar amount per barrel, gallon, or package, regardless of the price of the good (Table 1).

Franchise tax

The Texas franchise tax is a privilege tax on each taxable entity chartered/organized in Texas or doing business in Texas. Significant changes were made to the franchise tax in the 79th and later sessions of the legislature. The definition of a taxable entity was expanded to include most Texas businesses that enjoy state liability protection. Such businesses include limited liability companies (LLCs), partnerships, corporations, trusts, and other legal entities that protect the owners from incurring personal liability for the actions or debts of the company. The tax base of a taxable entity was defined as its *margin,* as explained below.

Some entities have been excluded from the definition of taxable entity. Examples are sole proprietorships, general partnerships owned directly by people or their estates, certain unincorporated passive entities receiving limited amounts of active trade or business income, and entities such as nonprofit organizations and cooperatives. Also exempt are businesses with no more than $300,000 in total revenue, indexed for inflation, and businesses that owe less than $1,000 in tax. The $1 million revenue exemption was raised from $300,000 in the 81st regular session, and the exemption is set to fall to $600,000 in 2012.

The franchise tax is determined by the business's total revenue, minus deductions. From the total revenue, the business deducts either the cost of its goods sold or its total compensation, up to $300,000 per employee, indexed for inflation.

If the business's margin is more than 70 percent of its total revenue, it is taxed only on 70 percent of its total revenue. The business then will apportion to Texas the amount of revenue from business done in the state and will subtract any other allowable deductions to determine its taxable margin.

Once the business's taxable margin is determined, a rate of 1 percent is applied to that margin for all taxable entities that are not statutorily defined retailers or wholesalers. For the latter, a rate of 0.5 percent is applicable.[2, 4]

Local tax structure

The four local taxes in Texas—property, sales, hotel/motel, and mixed drinks—are all ad valorem taxes (Table 2). Sales and hotel/motel taxes are paid to both the state and local governments. Property and mixed drink taxes are paid only to local governments.

Property tax

The property tax base is the market value of all real estate and business personal property. Although the property tax in Texas is uniquely local, the taxing jurisdictions operate under a complex system of legislation and regulations that are created and revised at the state level.

The market value of real estate and business personal property is assessed in each county by the chief appraiser, who is the chief executive officer of the county central appraisal district. Once the jurisdiction's tax base is determined for a tax year, the tax rate is set by the elected governing board of the local taxing jurisdiction, such as the city council, county commissioners court, and school board. Taxpayers then pay a tax levy, which is the assessed value of their taxable property multiplied by the tax rate.

In theory, the property tax could apply to the market value of all property. However, in Texas, a large amount of property is not taxed because of exemptions, exclusions, and special treatment in determining taxable value. Property tax does not apply to intangible personal assets such as stocks, bonds, and other non-real estate investments; cash in the bank; and individual personal property such as vehicles, furniture, and jewelry. Although some of this property has been exempted by law in Texas, the exemptions usually are de facto because it is too difficult and expensive to assess and collect them.

Table 2. Characteristics of major local taxes, 2010.

Type of tax	Tax rate	Tax base	Taxing entity	State imposed rate limits
Property	Set by taxing jurisdiction elected officials. (Rate applies per $100 of value.)	Market value of all real estate and business personal property	All property taxes are collected locally by cities, counties, school districts, and special districts.	Cities: $2.50 per $100 of value; $1.50 for general law cities Counties: $0.80 per $100 of value for general purposes; $0.15 for special roads and bridges; $0.30 for optimal road or flood control School districts: $1.50 for operation and maintenance Special districts: variable; $0.75 for hospitals and airports, $0.03 for rural fire prevention, $1.00 for community colleges
Sales and use	2% maximum of local sales taxes. Taxes are optional for each jurisdiction.	Retail price of tangible personal property and selected services (same as state)	Cities, counties, and transit authorities. Tax is collected by the state and remitted to local jurisdictions.	Local sales taxes may not exceed a total of 2%; Cities: 0.25-2%; Counties: 0.5-1.5% Transit authorities: 0.25-1%; Special districts: 0.125-2%
Hotel/motel	Cities: 9% maximum Counties: 7% maximum	Room receipts (same as state) Same as city and state	Cities and counties collect the tax locally.	Cities: limit varies, maximum is 9% Counties: limit varies, maximum is 7%
Mixed drinks	3% divided equally between cities and counties	Mixed drink receipts	Tax collected by the state and remitted to cities and counties allowing sales of "liquor by the drink"	Included as part of the 14% state tax

Adapted from Comptroller of Public Accounts' Window on State Government website. Source: Combs, 2010. *http://www.window.state.tx.us/taxinfo/taxrates.html.*

The Texas Legislature has adopted several legal exemptions and *special valuation* rules to give tax relief to some categories of property or taxpayers. These exemptions either reduce tax revenue to local jurisdictions or shift the tax burden to other categories of property and taxpayers.

Major exemptions and special treatments include limited value exemptions for homesteads, a freeze on the tax levy for homeowners older than 65, industrial tax abatements granted by local jurisdictions, productivity valuation of agricultural and timber land, land for wildlife habitat, freeport (which waives the tax on certain goods, wares, ores, merchandise, and tangible personal property held for manufacture, assembly, repair, or storage in the state for 175 days or fewer), and other exemptions (Table 3).[5]

In all, legal exemptions and special treatments in property valuation amount to about 15 percent of the total assessed value of property statewide. The productivity valuation of agricultural and forestry land, as specified in Article VIII, section 1-d-1 of the Texas Constitution, accounts for about one half of the property tax revenue reduction in local jurisdictions.[5]

Local sales tax

Cities, counties, and some special districts may collect a sales tax. The base for the local sales tax is the same as that of the state. However, local sales tax rates are lower, and maximums are set for local

Table 3. Property tax exemptions in Texas.

Constitutionally mandated
✓ Basic $5,000 residential homestead exemption
✓ Tax freeze for persons 65 or older, so long as the person lives in the home and does not add significant improvements
1997 constitutional amendment
✓ Increased homestead exemption by $10,000 to $15,000
✓ Tax freeze for homeowners over 65 can be transferred, with adjustments, to a new home
Constitutionally allowed with legislative approval
✓ Additional homestead exemption for persons over 65 or disabled (The Legislature may exercise the option to specify the amount and condition of eligibility based on economic need.)
✓ $5,000–$12,000 homestead exemption for disabled veterans, depending on disability rating
✓ "Freeport" optional exemption instituted in 1992, waiving tax on certain goods, wares, ores, merchandise, and tangible personal property held for manufacture, assembly, repair, or storage in the state for 175 days or fewer (Oil, natural gas, and petroleum products do not qualify.)
✓ Pollution control exemption, begun in 1995, for property used to control pollution
Local option
✓ Additional exemptions of up to 20 percent of a residence's appraised value
✓ Additional exemptions of at least $3,000 for the disabled or persons 65 or older

Sources: Adapted from Comptroller of Public Accounts' Window on State Government website (Combs, 2010) and Tax Exemptions & Tax Incidence (Combs, 2009). For a complete list and explanation of exemptions, refer to Combs, 2009.

jurisdictions. The state dictates an overall local sales tax maximum of 2 percent. Incorporated cities may levy up to a 1 percent sales tax for general revenue, with the option of an additional 1 percent for special purposes, such as reducing property taxes. Counties also can collect up to 1 percent in sales tax to reduce property taxes.

Cities and counties may levy an additional 0.5 percent for economic development. Transit authorities may collect up to 1 percent. Crime prevention districts may enact up to a 1 percent sales tax, and counties with populations of fewer than 50,000 may enact a 0.5 percent sales tax for health or hospital services. However, the combination of all local sales taxes in a given area may not exceed 2 percent.

Other local taxes

Cities and counties can levy other local taxes, including hotel/motel taxes and mixed drink taxes. Local hotel/motel taxes apply to the same base as the state tax—the amount paid for room rental. The state tax rate is 6 percent. The maximum rates are 9 percent for cities and 7 percent for counties.

Local hotel/motel taxes are collected by cities and counties, the only local jurisdictions authorized by the legislature to use the tax. Mixed drink taxes are collected by the state and remitted to the counties and cities permitting sale of liquor by the drink.

Criteria for evaluating taxes

Individuals buy many goods and services that cannot be provided efficiently or profitably by the private sector. One function of government is to provide these goods and services—such as police, courts, education, roads, and economic security. To pay for these services, the government must tax the citizens.

A state or society can tax virtually anything. The ideal is to develop taxes and tax systems that serve the broad needs of society fairly, efficiently, and impartially. Several attributes of taxes are widely accepted as criteria for evaluating the impacts of taxes on society and the economy.[7] These attributes are used to evaluate the major revenue-producing taxes in Texas.

No tax is ideal in all these criteria, and each criterion has a different importance to different groups of citizens. Consequently, selecting taxes and designing a tax system for state and local revenues involves trade-off and compromise.

Tax attributes

The most common criteria for evaluating the effects of taxes are *economic efficiency, economic competitiveness*, *administrative simplicity*, *adequacy*, and *equity* or fairness.

- **Economic efficiency:** A tax system should not interfere with the efficient allocation of resources and consumer choices. A broad-based tax is more efficient than one with a narrow base.
- **Economic competitiveness:** A tax system should not impair a firm's ability to compete with those outside the state or the state's ability to attract new business.
- **Administrative simplicity:** A tax system should be easy for the taxpayer to understand and relatively easy and inexpensive for the taxpayer to comply with and the government to assess and collect.
- **Adequacy:** A tax system should generate enough revenue to meet public needs. For example, as population and demand increase, the tax base will grow enough for revenue to meet public demands.
- **Equity or fairness:** The tax system should treat people fairly. It should bear equally on people in similar circumstances *(horizontal equity)* and differentially on people in dissimilar circumstances *(vertical equity).*

To determine whether the tax system treats people fairly, people's circumstances can be compared in two ways—by the *benefits received* and by their *ability to pay.*

Benefits received: Under the benefits received principle, individuals pay taxes in proportion to the benefits they receive from public services. People who receive the same benefits pay the same taxes. If individuals contribute in this manner, the result is horizontal equity.

In Texas, the vertical equity principle, in which the revenue from a tax is tied to the provision of a related good or service, generally does not apply to the benefits received principle. That is because most tax dollars paid to the state government go to general revenue, not to fund a specific service.

The benefits received principle can be used to evaluate the fairness of licenses and fees such as a driver's license, car registration, hunting license, or road tolls, although many people do not even consider these fees to be taxes. In general, everyone who wants to hunt or get a driver's license pays the same amount for the same benefit.

The equity of the motor fuels tax can also be evaluated by the benefits received principal because the tax is used mainly to pay for roads. The person who uses the roads more buys more gasoline and therefore pays more tax.

Theoretically, the fairness of the tax system can be evaluated by calculating the total taxes paid and total benefits received. The difficulties of this approach are in identifying the beneficiaries of a given public expenditure and in putting a value on the benefits of public goods, such as police protection, clean air, and pure water.

Ability to pay: Taxes also may be distributed according to the capacity to pay. Ability to pay is typically measured by income.[8] The criteria of horizontal and vertical equity can again be used to determine if the tax has been distributed according to ability to pay:

- Horizontal equity means that individuals with the same income pay the same tax levy.
- Vertical equity compares the percentage of income paid in taxes by persons of varying incomes.[8] If people of lower incomes pay higher percentages of their incomes in taxes than do people with higher incomes, the tax is *regressive*. If people of increasingly higher incomes pay an increasingly higher percentage of their incomes in taxes, the tax is *progressive*. If persons of all income levels pay the same percentage of their incomes in taxes, the tax is *proportional*.

The vertical equity criterion does not specify how large a difference in income is considered a different ability to pay, or how different the percentages should be between income levels. These matters are left to public opinion or to the political process.

It is a subject of debate as to which of the two characteristics of taxpayers—benefits received or ability to pay—is appropriate for evaluating the equity of a given tax. Often public opinion determines which principle is appropriate in a given case. In the following sections, each tax will be evaluated using both characteristics, if possible.

Evaluation of major state and local taxes in Texas

The criteria discussed above can be used to evaluate the state's various taxes. The taxes evaluated here account for 90 percent of tax revenues (Fig. 4).

Sales tax and motor vehicle sales tax

Economic efficiency: The sales tax is broadly based on consumer goods, except for prescription medicines and unprepared foods for home use. However, the tax is not broad based on services.

A narrow-based sales tax might lead consumers to substitute goods and services without tax for those with tax. For example, a consumer might decide to buy a pet from an animal shelter rather than a pet store to avoid sales tax. The sales tax holiday that occurs annually in the third weekend of August exempts clothing and shoes from sales tax but does not exempt repair items (patches, buttons) or repair services. Thus, consumers are encouraged to by new goods rather than repair used items.

Businesses also pay sales tax on purchases, except for raw materials and machinery and equipment used in farming, manufacturing, and residential utilities. Businesses also might substitute nontaxed goods and services for taxed goods and services. For example: A business needing to collect debt might choose to contract with a lawyer rather than a debt collector because legal fees are tax exempt but debt collection is taxable, even though the same basic service is performed. Similarly, an insurance company might use a tax-exempt in-house adjuster rather than pay use tax on an independent adjuster.

Economic competitiveness: Texas has one of the highest sales tax rates in the nation. However, except for residents living close to state lines, most Texans do not buy goods in other states to avoid the higher Texas sales taxes. Moreover, most personal services do not compete with businesses in other states. Thus, the sales tax does not impair the economic competitiveness of businesses that sell directly to consumers.

As of 2006, sales taxes paid by consumers are deductible on their federal tax forms. The sales tax deduction can be taken in place of the state income tax reduction available to residents of other states.

Because businesses in Texas pay higher sales taxes than do businesses in most other states, Texas firms face higher costs. Some of these costs are passed on to consumers through higher prices. However, sales taxes are exempted for raw materials, machinery, and equipment used in farming and manufacturing, which helps keep these industries competitive with those in other states.

Administrative simplicity: Consumers understand the sales tax, are readily aware of the tax on any given purchase, and invest no additional time or resources to pay the tax. However, consumers usually do not know how much they pay in sales taxes per year because it would be time consuming to keep track of the tax on each transaction.

Businesses do not like to function as tax collectors. As local governments set different sales taxes, administering them is becoming more complex for both business and the public sector. The state's collection and remittance of local sales taxes is complex because local rates vary widely across the state.

Adequacy: The sales tax has generally provided adequate revenue throughout business cycles. Revenues have grown with the economy.

In economic hard times, consumers may change their purchases of goods—such as buying fewer new cars—and perform more services for themselves, such as doing their own laundry instead of taking it to commercial cleaners. With a few exceptions (in 2002 and 2003), annual revenues have increased even in downturns, but less rapidly than during growth periods.[2]

Some services, including Internet, security, and locksmith services, have been added to the tax base, which has helped keep the sales tax in line with the growing importance of services in the state's economy. Only an act of the legislature can change the sales tax rate, resulting in revenue lags during times of rapid economic adjustment.

Equity or fairness: The *benefits received* principle cannot be applied to the sales tax because sales tax revenues go into the general revenue fund and are not directed to a specific use. However, *ability to pay* can be used to evaluate the sales tax.

Horizontal equity: People with the same income generally have similar consumption patterns and probably pay similar levies. As people consume more they pay a higher levy (Table 4).

Vertical equity: People with higher incomes pay a lower percentage of their income in sales tax (Table 4). They also consume more of the services, including medical, dental, legal, and architectural services, that are not subject to the sales tax. Hence, the sales tax is regressive with regard to income.

Property tax

Economic efficiency: The property tax on land, which is a commodity with a fixed supply, generally does not cause inefficiencies in the land market. However, in 1966 and 1979, constitutional amendments were passed allowing differential treatment of farm land. These changes may cause inefficiencies in the land market, particularly near urban areas.

Property tax inefficiencies arise primarily because some types of property are not taxed, which changes investment patterns. Individual personal property is not taxed, nor is intangible property held as financial instruments, including bonds, stocks, cash, and savings. This is an efficiency issue because it shifts investment away from real property and toward financial instruments.

Table 4. Estimated average tax burden and relative burden by household income of selected state and local taxes, Fiscal Year 2011.

	Household income by quintile				
Type of tax	Less than $27,088	$27,088 to $49,112	$49,112 to $75,402	$75,402 to $117,899	More than $117,899
General sales and use					
Average $ paid	$1,499	$2,213	$3,070	$4,230	$6,849
% of income	5.4	3.2	2.7	2.4	1.7
Relative burden*	3.18	1.88	1.59	1.41	1.00
Motor vehicle sales and use					
Average $ paid	$137	$212	$360	$520	$851
% of income	0.5	0.3	0.3	0.3	0.2
Relative burden	2.50	1.50	1.50	1.50	1.00
Franchise					
Average $ paid	$221	$337	$481	$711	$1,314
% of income	0.8	0.5	0.4	0.4	0.3
Relative burden	2.67	1.67	1.33	1.33	1.00
Gasoline					
Average $ paid	$196	$298	$417	$525	$680
% of income	0.7	0.4	0.4	0.3	0.2
Relative burden	3.50	2.00	2.00	1.50	1.00
Natural gas					
Average $ paid	$25	$79	$140	$220	$472
% of income	0.1	0.1	0.1	0.1	0.1
Relative burden	1.00	1.00	1.00	1.00	1.00
School property					
Average $ paid	$1,333	$1,943	$2,751	$4,206	$9,188
% of income	4.8	2.8	2.4	2.4	2.3
Relative burden	2.09	1.22	1.04	1.04	1.00

Adapted from Tax Exemptions & Tax Incidence. Source: Combs, 2009.

*Relative burden expresses the percentage of income paid for the tax by each household income quintile as a ratio to the percentage of the income paid for the tax by the highest income quintile.

Economic competitiveness: On average, Texans spend more of their income on property taxes than do residents of other states. Most of the burden falls on real estate. This tax handicaps capital-intensive firms located in Texas and may deter firms that are considering moving to Texas. (However, firms will look at the total tax bill, including other business taxes.)

Administrative simplicity: The property tax is relatively easy for taxpayers to understand, and it is relatively easy for them to know the tax levy.

The property tax is not simple to administer, however. Assessing values is time consuming and requires well-trained appraisers. Local assessments are subject to review and may be legally challenged. Also, a large database is needed on all categories of property. Appraisal of complex properties, such as industries, utilities, and minerals, typically is contracted to professional appraisal companies. Assessing business personal property is particularly difficult because of items unique to the business.

In Texas, 254 central appraisal offices appraise property for almost 3,800 taxing jurisdictions, according to the Texas Comptroller of Public Accounts.

Adequacy: The property tax base has not kept pace with economic growth in Texas, necessitating increases in tax rates to provide adequate revenues, especially for public schools. Several factors account for this lag:

The base is not growing as fast as the economy because most of the economy's growth has been in service businesses that have low capital investments.

Lawmakers have been generous in granting exemptions to a wide variety of properties.

The value of oil, gas, and other mineral lands, once a major part of the tax base, is variable and generally declining.

Although property values move up and down with the business cycles, there is no automatic mechanism for changing assessed values. Taxing jurisdictions must constantly readjust the base to market values and then adjust the rates to provide adequate revenues.

Equity or fairness: The *benefits received* principle cannot be applied if revenues are going into the general funds of cities and counties. For school and other special taxing districts, the tax can be evaluated on the basis of whether those who pay the tax receive benefits from it in relation to the tax they pay. Although all citizens receive benefits from the education of others—for example, a cashier who can correctly make change—families with children in public school receive higher direct benefits than families without. Even among families with children, the tax levy varies with the value of the property owned.

Ability to pay can also be used to evaluate the property tax:

- *Horizontal equity:* Tax assessors try to evaluate similar properties similarly, and the same tax rate is applied to all property. Exemptions and special taxation provisions may lead to some inequities in the property tax—for example, homeowners have the homestead exemption, but renters do not. Families and businesses with similar incomes will pay a different levy, depending on the value of their property. Firms with similar profits and net worth pay widely varying tax levies depending on capital investments.
- *Vertical equity:* School property taxes made up 53.8 percent of total property taxes in 2007. The lowest-income home owners pay a higher percentage of their income in property taxes than any other income group (Table 4). Thus, the tax is regressive. Relative to income, the property tax is the least regressive of the Texas taxes discussed in Table 4, except for the natural gas tax.

Motor fuels tax

Economic efficiency: This tax applies to all businesses and individuals who use roads. Because there are few alternatives to using fuel-burning vehicles for transportation, the tax is not likely to distort economic decisions within the state. Also, individuals and businesses are not likely to cross state lines to avoid the tax.

Increases in price because of taxes affect fuel consumption very little in the short term. In the longer run, people decrease fuel consumption by buying smaller or more fuel-efficient cars. The higher fuel prices also create incentives for creating and using alternative fuels. Thus, the tax may indirectly help reduce pollution from the use of fuels.

Economic competitiveness: The Texas excise tax rate of 20 cents per gallon on gasoline and diesel fuel is slightly above the volume-weighted

U.S. average of 18.6 cents per gallon.[10] However, because Texas does not exact additional taxes on gas, its total tax rate is lower than the effective weighted average rate of 29.3 cents per gallon (as of July 2010). This difference is not likely to affect the competitiveness of Texas businesses and the Texas economy because other factors are more important in determining regional fuel prices.

Administrative simplicity: The consumer is aware of and understands the tax. Tax rates per gallon are often displayed on fuel pumps. However, most consumers are not aware of their yearly levy. The tax is relatively easy to administer.

Adequacy: Because the tax rate is a fixed amount per gallon, it does not keep pace with inflation. In times of rapid growth or inflation, the revenues may not keep pace with the needs.

In Texas, the tax was raised several times during the 1980s but has not been raised since 1991. Seventy-five percent of the tax revenue is allocated to roads and 25 percent to schools. Currently, the tax funds 100 percent of road maintenance in Texas, according to the Texas Comptroller of Public Accounts.[6]

Equity or fairness: *Benefits received* can be used to evaluate the motor fuels tax because most of the tax revenue is allocated to roads. In general, the amount of gas that people buy is a reflection of their road use, so the benefits received are related to tax payments.

Ability to pay can also be used to evaluate the motor fuels tax:

- *Horizontal equity:* People with the same income pay varying amounts of tax, depending on their road use.
- *Vertical equity:* In general, those with less income spend a higher percentage of their income on the motor fuels tax (Table 4).

Alcohol and tobacco taxes

Economic efficiency: Because alcohol and tobacco taxes are not broad-based, they can distort consumer choices away from a taxed item and toward untaxed items. However, the demand for these products is relatively inelastic—the amount sold does not decrease as rapidly as the price increases. In other words, a 1 percent tax on beer results in people reducing their beer consumption by less than 1 percent. Beer and sweet tea are not perfect substitutes.

Nevertheless, people do substitute away from taxed goods such as alcohol to a certain extent. Governments often impose these taxes to influence consumer decisions. These "sin taxes" may discourage the consumption of alcohol and tobacco products with an external benefit of improving health and reducing public costs of health care.

Economic competitiveness: The tax rules apply to all alcohol and tobacco sold in the state. Few people cross state lines to buy these items, so the tax has little effect on competitiveness.

Administrative simplicity: Consumers know the tax exists, but they do not know the amount of tax on an individual item because it is included in the price. They also do not know how much tax they pay yearly. The tax is relatively easy to collect.

Adequacy: Because demand is inelastic to income as well as price, consumption is relatively stable, even in an economic downturn. The tax rate is a fixed amount per unit, rather than a percentage of value, so revenues do not keep up with inflation. Raising the rate requires legislative action.

Equity or fairness: *Benefits received* does not apply because the taxes go into general revenues.

Ability to pay can be used to evaluate these taxes:

- *Horizontal equity:* People with the same income pay different amounts depending on their use of these products.
- *Vertical equity:* Lower income groups pay a higher percentage of their income in cigarette and alcohol taxes. Alcohol and tobacco taxes are regressive relative to income.

Tobacco taxes increased dramatically both in Texas and at the federal level in recent years, causing some consumers to stop using tobacco. Because tobacco use is considered to be a major cause of cancer and heart disease, society may benefit in ways not measured directly in the market.

Franchise tax

Economic efficiency: The franchise tax is paid by corporations, limited-liability companies, and other legal entities. Sole proprietorships and some partnerships do not pay the franchise tax. As a result, some firms will pay this tax and others that provide the same product or service will not. This is a cost advantage to firms that are not organized as tax-paying entities. Because these taxpayers must keep their prices competitive, they may not be able to pass the full cost of the tax to customers.

Economic competitiveness: Some unincorporated Texas businesses have a competitive advantage. Businesses in many states pay a corporate income tax. The competitive impact on incorporated Texas businesses depends on how the Texas franchise tax compares with the corporate income tax in other states.

Administrative simplicity: The accounting is complex because businesses must determine their tax rate based on their industry and revenue level. Businesses can elect to calculate their deduction based on either cost of goods sold or compensation. Or, they may use a standard margin of 70 percent.

Adequacy: Franchise tax revenues did not grow with the strong Texas economy during the past 10 years. Most of Texas's growth has been in service industries that are not capital intensive, are often unincorporated, and were not reached by the old corporate franchise tax. Also, firms could reorganize their business structures to avoid the tax.[4]

The franchise tax was modified substantially in 2006 to increase revenues by including service industries and additional types of legal entities. Changing the tax rate or base is not a routine decision. Frequent or major modification of the tax rate is an indication of inadequacy.

Equity or fairness: *Benefits received* cannot be applied because the tax goes into general revenues.

Ability to pay can be used to evaluate this tax:

- *Horizontal equity:* Because the tax is based on the way a business is organized, firms with similar products, net worth, and net incomes are taxed very differently.
- *Vertical equity:* Firms with very different net incomes may pay the same percentage of that income in tax. However, small firms pay a reduced percentage, and firms with total revenues less than $300,000 do not pay the tax.

Summary

Tax revenues have declined from 60 percent of total state revenues in 1989 to 45 percent in 2009. The percentage of state revenues from federal funds, fees, and other sources has increased. The sales tax currently is the largest source of state tax revenue. The property tax is the largest source of revenue for all levels of local government.

No tax is ideal. The various state and local taxes affect different groups in various ways. Thus, choosing a tax, or set of taxes, is part of the political process. Knowing the basics of taxes in Texas can provide a common starting point for citizens and elected officials as they debate the appropriate taxes for state and local government.

Glossary

Note: Italicized terms within definitions are also defined in this glossary.

ability to pay is the tax *equity* principle that taxes be distributed according to the taxpayer's ability to pay them. Ability to pay is usually measured by income.

ad valorem tax is calculated as a percentage of the value of the good or service. The tax levy is the *tax rate* multiplied by the value of the good or service. The sales tax, motor vehicle tax, and property tax are all ad valorem taxes. The Texas Constitution uses "ad valorem" to refer to the property tax.

adequacy is the ability of a tax system to be flexible and generate enough revenues under changing economic circumstances.

administrative simplicity occurs if a tax system is easy for a taxpayer to understand and relatively easy and inexpensive for the taxpayer to comply with and the public sector to administer.

benefits received is the tax *equity* principle that taxpayers contribute to the support of the government in proportion to the benefits that they receive from public services.

business activity tax is levied on business organizations and is a modification of a *value-added tax.* The tax base of the Texas business activity tax, which was proposed by Gov. George Bush in 1997, begins with net income from Internal Revenue Service forms and adds labor costs, employee benefits, and *depreciation*. The business pays a percentage of this amount as its *tax levy* (1.25 percent was proposed). The first $500,000 of *tax base* was exempt from taxation, and firms were allowed to deduct new capital investments.[11] This tax has been replaced by the *franchise tax*.

business gross receipts tax has a base of all revenues (all business and investment income) of all businesses. The *tax rate* is a percentage of gross revenues.

capital gains (or losses) are the changes in value of an asset. Capital gains (or losses) are realized when an asset is sold. The base of a capital gains tax is the amount of capital appreciation (or loss) from the time of purchase to the time of sale or transfer of ownership through inheritance.

capitalization is a financial method of converting the annual income from a perpetual investment (land) into the value of the asset. The formula is V=I/R, where V is value, I is annual net income from the investment, and R is a *capitalization rate*. In Texas, capitalization is used to estimate the *productivity value* of agricultural and forestry land for taxation purposes.

capitalization rate is used to estimate the value of an asset by dividing the capitalization rate into an expected perpetual income stream from the asset (land). The capitalization rate is the market rate of interest plus an allowance for risk. In Texas, the capitalization rate used to estimate the *productivity value* of agricultural and forestry land is 10 percent or the current Federal Land Bank interest rate on long-term loans plus 2.5 percent, whichever is greater.

deduction is the amount of qualified expenses that can be subtracted from taxable income, thus decreasing the tax owed.

depreciation is the decline in value of durable equipment and buildings that occurs as they are used and wear out. The depreciation in value over the lifetime of the asset is equal to the total value of the asset.

depreciation allowance is the portion of the cost of depreciable or durable assets that can be included in production expenses and deducted from income for tax purposes.

double taxation occurs when the same activity is taxed more than once by different taxes or jurisdictions. For example, in the United States, corporate profits are taxed twice—first by the corporate income tax and second by the personal income tax when corporate profits are distributed as dividends.[12]

economic competitiveness is the ability of firms within a state to compete with those in other states and to the ability of the state to attract new business.

economic efficiency occurs if the tax system does not distort choices made by consumers and firms among goods, services, and investments. A broad-based tax causes fewer inefficiencies than a tax with a narrow base. How much the consumption of the taxed product will change depends on the *elasticity* of that product—how consumer purchases react to changes in the price of that good. Tax A is more efficient than tax B if it generates the same revenue with less loss of satisfaction to the consumer.[13]

effective tax rate is the ratio of actual taxes paid to the *tax base*. The effective rate differs from the adopted rate because of *exemptions* and *deductions*. For example, Texas property law requires that both the adopted rate and effective rate be published. The effective rate is calculated as the levy from the previous year divided by the current year's base. If, for the current year, the property taxing district raises both the *tax rate* and reappraises property to a higher value, the effective tax rate is lower than the newly adopted rate. Another example: The *property tax* can be deducted from income on the federal income tax, so the effective tax rate for the individual property owner is lower by an amount that depends on his or her federal tax bracket.

elasticity describes how consumer purchases react to a change in the price of a product or service. With inelastic demand, consumption will decrease proportionately less than the price increase. For example, if the price increases 5 percent and consumption declines less than 5 percent, demand is inelastic. With elastic demand, consumption decreases proportionately more than the increase in price.

equity is the principle that the tax system be fair in its relative treatment of different individuals. If the tax system bears equally on people in similar circumstances, there is *horizontal equity.* If the tax system differentiates appropriately among people in dissimilar circumstances, there is *vertical equity.* There are two ways to compare people's circumstances—the *benefits received* by the taxpayer or the taxpayer's *ability to pay.*

excise tax is a tax on the sale of a specific product or service. Both *per unit* and *ad valorem* excise taxes are used to discourage consumption of particular goods, such as alcohol and tobacco, or to pay for government costs associated with private consumption, such as motor fuels for road construction.

exemptions are special provisions in the tax code that reduce or eliminate the *tax burden* for qualifying business or individuals.

franchise tax is a tax on corporations, limited-liability companies, and some other legal entities for the franchise, or privilege, of conducting business in a state. In Texas, the tax is on *margin* and varies based on the size and industry of the business. Smaller businesses have a reduced *tax burden*. Retail and wholesale businesses pay a 0.5 percent tax instead of the general 1 percent franchise tax.

horizontal equity is the principle that the tax system bears equally on people in similar circumstances. Individuals with the same income pay the same *tax levy.*

investment tax credit allows businesses to deduct a percentage of new investment costs from their tax bill.

margin is the lesser of 70 percent of a taxable entity's total revenue or the entity's total revenue less the cost of goods sold or compensation. Margin is used to determine a business's franchise *tax levy.*

margin tax is an alternative name for the *franchise tax.*

motor fuels tax is a tax on the sale of gasoline, diesel, and liquefied gas. The Texas *tax rates* are 20 cents per gallon on gasoline and diesel fuels, and 15 cents on liquefied gas. The motor fuels tax is paid by the wholesaler. Twenty-five percent of the tax is allocated to the permanent school fund, and the rest is allocated to road construction and maintenance.

net to land is the annual net returns after payments for purchased inputs, labor, capital use, and management. In Texas, an average of net to land for the most recent 5-year period is calculated, then *capitalized* into a *productivity value* of land for property taxation.

per unit tax is a tax of a specified dollar amount per unit of an item sold. Many *excise taxes* are per unit taxes. The alcohol, tobacco, and motor fuels taxes are per unit taxes.

personal taxes are all taxes paid by individuals—income, payroll, sales, property, and other taxes.

productivity value is calculating the *tax base* for qualified farm, timber, wildlife habitat, and other special-use land. This is the single-use value of land that arises from its ability to earn income in agricultural or timber production, ignoring other forces that contribute to market value. Productivity value is less than market value.

progressive tax is one in which the ratio of tax to income is higher at higher income levels than at lower ones—the *tax rate* increases as income increases. A progressive tax evaluation is based on applying the *vertical equity* criterion to the ability to pay.

property tax is an *ad valorem tax* on real estate and business personal property. This tax is the major source of revenue for local governments, school districts, and special districts in Texas.

proportional tax is one in which the ratio of tax paid to income is the same for all income levels. A proportional tax evaluation is based on applying the *vertical equity* criterion to the *ability to pay.*

rate limit is the maximum *tax rate* the state allows local jurisdictions to adopt. The State of Texas sets a rate limit of 2 percent for local *sales taxes*.

regressive tax is one in which the ratio of tax paid to income is higher at lower income levels than at higher income levels. A regressive tax evaluation is based on applying the *vertical equity* criterion to the *ability to pay.*

sales tax is a tax on purchases of goods and services. The tax is a percentage of the purchase value (*ad valorem*) and is paid to the seller at the time of sale. The seller is responsible for paying the tax to the state. There are several types of sales taxes, those that apply to a large range of goods and services and those that apply to specific goods and services, such as motor vehicles.

severance tax is on the value of natural resources such as oil, gas, minerals, or raw materials at the point of extraction. It is separate from the *property tax* on real estate, land, or minerals.

special valuation refers to different valuation criteria used for tax purposes. For example, land used for agriculture and forestry may be taxed on *productivity value* instead of the market value of the land.

tax is a payment imposed by the government—federal, state, local, or special taxing district—on personal or business income, on goods and services purchased, or on wealth. Taxes are used to raise revenues, to alter the distribution of income and wealth, to control the level and structure of consumption in the economy, and to alter consumption preferences.

tax base is the taxable value to which the *tax rate* is applied. Tax bases include sales, income, value-added, market value of land, value of capital, and quantity sold.

tax burden is the amount of a tax paid by an individual. It can also be used to refer to the total revenue from a tax. In addition, the tax burden is sometimes defined as the *effective tax rate* or the percentage of income paid as taxes.

tax credit is a reduction in the amount of taxes owed. A credit differs from a *deduction* in that it affects the *tax levy* but not the calculation of taxable income.

tax incentive is a special provision of the tax code that promotes a particular activity such as investment or charitable giving. Among tax incentives are *deductions*, *exemptions*, and *tax credits*.

tax incidence is the ultimate distribution of the *tax burden*, which may differ from the point of collection. For example, the state collects the sales tax from retailers, but the incidence is on consumers.

tax levy is the dollar value of tax paid by an individual, usually in 1 year. It is the *tax base* multiplied by the *tax rate.*

tax rate is a dollar amount per unit or a percentage of the value of the *tax base* that must be paid. The tax rate is multiplied by the tax base to obtain the actual amount of tax to be collected.

taxing entity is the government agency or jurisdiction—state, county, city, or special district—with the legal right to impose and collect the tax.

tobacco and alcohol taxes are levied on purchases of alcohol and tobacco products. In Texas these items are subject to per unit excise taxes. Sometimes taxes on these products are called "sin taxes."

transactions tax applies to each transaction as raw materials move from initial production, through processing, to final sale of the finished product. This tax applies to the total value of each transaction.

value-added tax is based on the value added during the production process. Value-added is the gross receipts, less expenses, for purchased inputs for production. It is a tax on the earnings of land, labor, owned capital, and management used in the business.

vertical equity is the principal that the tax system differentiates appropriately among parties of unequal means. Individuals with different incomes often pay different percentages of their incomes in taxes.

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