

Research Report

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Weighing the Difference

An Evaluation Of The Unequal Burden Of State Taxes For Texas Businesses

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ABOUT THE TEXAS PUBLIC POLICY FOUNDATION

The Texas Public Policy Foundation is a 501(c)3 non-profit, non-partisan research institute guided by the core principles of limited government, free enterprise, private property rights and individual responsibility.

The Foundation's mission is to improve Texas government by generating academically sound research and data on state issues, and by recommending the findings to opinion leaders, policy makers, the media and general public. The work of the Foundation is conducted by academics across Texas and the nation, and is funded by hundreds of individuals, corporations and charitable institutions.

EXECUTIVE SUMMARY

A number of state tax reforms are presently being considered by Texas policymakers. A universal concern is that businesses are not equally taxed by the current system. It is important for tax reform to improve equity and economic efficiency.

Burden Of State Business Taxes: Taxation is not equally levied on different types of businesses in Texas. Businesses bearing the highest tax burdens pay more than twice the taxes levied on the group of businesses paying the lowest taxes. While Texas ranks well overall in the level of total taxation per gross state product among the states, some business pay more taxes in Texas than do businesses in many other states. High taxes on export industries have favored the growth of labor intensive industries at the cost of capital –intensive industries.

Economic Distortions Of Business Taxes: Business do not bear the total burden of taxation. They adjust activities to minimize the adverse impact on profitability by raising product prices if consumers will pay the price, reducing wages and benefits paid to employees, cutting jobs, reducing capital investments, and decreasing dividends and other returns paid to stockholders and owners. Often businesses move investment and production to a more tax-friendly location. Economic growth in Texas is discouraged by economic distortions caused by the state tax system:

- the total tax burden is magnified because businesses are required to pay sales taxes on inputs and there is a cascading effect,
- when property, franchise, and sales taxes are combined, capital intensive businesses pay a significantly higher tax burden than labor-intensive businesses,
- the franchise tax is not uniformly levied on all businesses, and
- businesses pay a higher share of taxes than individuals pay.

State Tax System Reform To Improve Economic Efficiency And Growth:

These reforms would significantly improve the efficiency of the state tax system and promote economic growth that would benefit all Texans:

- reduce Texas' reliance on property taxes, particularly property taxes paid by businesses,
- in order to result in revenue neutrality once reduction in property taxes occurs, increase state revenues from sales taxes on consumer items, and
- level the playing field for business by levying equal taxes on different business sectors.

INTRODUCTION

A number of tax structure modification alternatives are under consideration by the political officers of Texas. One concern that is common among the various plans is the distribution of tax changes among business and individuals, among business types and among individuals by income class. That is, there is concern about the distribution of the tax burden. The purpose of this paper is to examine the patterns of Texas business taxation from the perspective of equity and economic efficiency and to assess the prospects for reform. This paper represents the final installment of a series of reports on state taxes, revenues and school finance reform published by the Texas Public Policy Foundation.

THE ECONOMICS OF TAXATION

The most important contribution that economics makes in the debate over tax policy is an understanding of how taxation affects the economy. The economics literature provides an understanding of how firms and individuals are expected to react to tax policy. Econometric models of the economy built and operated by economists provide measures of the economic effects of taxation translated into indicators of economic health such as jobs, incomes and gross product. Both of these sources are used here to provide perspective and evaluation of the distribution of the tax burden in Texas.

The primary concern of the economics of taxation is the degree of tax induced market distortion. A good tax system from an economics point of view is one that has a neutral effect on the economy. The most efficient tax system is one that does not distort economic decisions of businesses or of consumers. In a closed economy a tax system that places the initial burden of taxation directly and equally distributed on consumption will distort market decisions the least.

If government taxes capital, other things equal, capital will flee; if government taxes labor, other things equal, labor may flee; if government taxes land, it will not move out of state. That is, among the principal inputs to production -- land, labor and capital -- capital is very mobile, labor is less mobile than capital, and land is fixed, or immobile. When taxed, mobile capital and labor will, of course, tend to move to other locations and/or other enterprises.

The micro-economics literature on the behavior of firms supports the contention that the imposition of state and local taxes can have an important influence on the expansion and location of capital investment and the economically efficient mix of land, labor and capital, and thus the growth of economic activity. Likewise the unequal taxation of consumption distorts consumer choices thereby stimulating the wrong markets.

Loss of economic efficiency due to taxation is important because the result is a distortion of the allocation of productive resources in the state. By reducing the productivity of the state's factors of production (land, labor, energy and capital) and distorting consumer choices, income levels of residents are reduced and economic growth stifled. Of course,

as a practical matter, there is no perfectly efficient tax system—all tax systems have some degree of economic distortion. Therefore, analysts of tax policy changes are always in a position of evaluating whether a proposed change is an improvement over the current policy rather than a comparison to an optimum tax policy that does not exist in practice.

Assessment Criteria: The Definition of A Good Tax Policy

There are several recognized characteristics of good tax policy. These characteristics form important criteria used by public finance experts to evaluate tax policy. Although the specific lists of criteria will differ among analysts the essential ideas are the same. A good tax policy should respect goals of economic efficiency, equity, simplicity, stability and deductibility.

Economic efficiency has to do with the degree of economic distortion discussed above. Equity, which may be measured a number of ways, has to do with whether the system is perceived as fair—an equal sharing of the tax burden. Simplicity has to do both with the cost efficiency of collection and administration and minimizing the creation of incentives for tax avoiding behavior. Stability has to do with the extent to which the tax system avoids large fluctuations that cause a number of difficult management problems in a political decision-making setting. The last criterion, deductibility, is a simple and very important matter. The federal policy regarding which state and local taxes are deductible from the federal income tax can have an important influence on the economic consequences of state taxation. The importance of deductibility in the current analysis is clear in the analysis section of the paper.

Another consideration is whether or not the revenues collected are likely to keep pace with the growth of the public service functions supported by the tax system. This consideration is not listed here as a criterion, however, since it assumes that the public services growth is not a choice, but a “need” that has to be met. A more reasonable test of adequacy of funding might be whether or not the tax policy in question can be expected to produce revenue growth to support public services in proportion to overall economic growth.

For a thorough discussion of the criteria for evaluating tax policy see Zodrow, George R., *An Economic Evaluation Of Alternative Sources Of Tax Revenue For The State Of Texas*, (Draft), The Joint Committee on Public School Finance, November 2003 and The State of Texas Select Committee on Tax Equity (January 1989), [Rethinking Texas Taxes, Volume 1, Findings and Recommendations](#), Final Report of the Select Committee on Tax Equity.

The use of the above five criteria for evaluating a Texas tax proposal, however, is complicated by the tax policy of other governments. Since many levels of government (federal, state and local) set tax policy, the rules vary widely among taxing entities. In fact, tax policy is often used as a policy tool for economic development and other reasons. As a result firms and individuals locate businesses and residences so as to avoid taxation. The most important example for Texas policy-makers is the so-called

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“Delaware Sub” effect where corporations’ subsidiaries are organized as partnerships to do business in a number of states, but where the corporate partner lacks “nexus” (physical presence) in Texas and thereby avoids the Texas franchise tax. Individuals and firms also purchase goods and services from sellers in other jurisdictions in order to avoid taxes, such as cross-border and Internet purchases. These intergovernmental complexities may be thought of as a part of the simplicity criterion. In any case they are an important part of the overall assessment of a tax policy.

Another complication is that some taxes will be paid in part by out-of-state purchasers. A tax that might otherwise be a bad idea is acceptable because it can be exported. Caution should be exercised, however, in consideration of exportability because producers often do not have the ability in a competitive market to pass on a tax increase in the form of higher product price which is a condition that must prevail in order to export a tax change.

THE ESTIMATE OF TEXAS BUSINESS TAX BURDEN

Texas Ranking Among the States

Texas has a total state and local tax burden that is among the lowest in the nation. When measured as total state and local taxes relative to GSP Texas ranks 46th among the 50 states. Furthermore, the size of the Texas tax burden at 8.1% of GSP is significantly below the highest taxing state of New York at 12.2%. Texas also has a lower state and local tax burden than its neighboring states of Oklahoma (10.2%) and New Mexico (9.5%) and comparable with Louisiana (7.9%). (See Table 1.) These measures do not include federal taxes, however and if they did the Texas ranking would be less favorable because Texas' second largest tax--the sales tax--is not deductible against the federal individual income tax whereas many other states have a personal income tax which is deductible. Inclusion of Federal income taxes in Table 1 would reduce the Texas ranking.

From a point of view of competition for economic growth among states (especially competition for high tech industry growth) Texas also ranks well among the states including Arizona (9.9%), Colorado (8.8%), California (9.8%), North Carolina and Florida (10.2%).¹

Table 1
Texas Ranking: State & Local Taxes as Percent of GSP (1995-1997)

State	State & Local Taxes/GSP	Rank	State	State & Local Taxes/GSP	Rank	State	State & Local Taxes/GSP	Rank
New York	12.2	1	Florida	10.2	18	Missouri	9.1	35
Minnesota	12.0	2	Massachusetts	10.1	19	South Carolina	9.0	36
Wisconsin	11.8	3	New Jersey	10.1	20	Arkansas	8.9	37
Maine	11.8	4	Alaska	10.1	21	North Carolina	8.9	38
Rhode Island	11.1	5	Pennsylvania	9.9	22	Colorado	8.8	39
Vermont	11.1	6	Arizona	9.9	23	Nevada	8.8	40
Connecticut	10.8	7	California	9.8	24	Georgia	8.7	41
Hawaii	10.7	8	Oregon	9.8	25	Virginia	8.6	42
Washington	10.6	9	Idaho	9.8	26	New Hampshire	8.2	43
Maryland	10.5	10	Nebraska	9.7	27	Alabama	8.1	44
North Dakota	10.4	11	Mississippi	9.7	28	Texas	8.1	45
West Virginia	10.4	12	Ohio	9.6	29	Louisiana	7.9	46
Michigan	10.3	13	Utah	9.6	30	South Dakota	7.9	47
Montana	10.3	14	Kentucky	9.5	31	Delaware	7.8	48
Iowa	10.2	15	New Mexico	9.5	32	Tennessee	7.5	49
Kansas	10.2	16	Illinois	9.3	33	Wyoming	7.2	50
Oklahoma	10.2	17	Indiana	9.3	34			

Note: Percentages of local taxes for 1995 added to percentages of state taxes for 1997.
Source: Texas Comptroller's Office @<http://www.window.state.tx.us/taxbud/overview/txtax18.html>.

Texas state and local tax burden ranking among the states is not the whole story, however. While firms deciding where to locate and where to produce no doubt consider the total tax burden, including the individual tax burden, the more relevant comparison is the direct tax burden on industry. By the measure of business tax burden relative to GSP

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contribution, Texas ranks 21st among the 50 states (see Table 2) as compared to 46th when personal taxes are included (see Table 1).

A major contributing factor in the ranking of business taxation among the states is the influence of severance taxation of natural resources, namely oil, natural gas, coal, and timber. These taxes are often believed to be highly exportable and states having major endowments of natural resources therefore rely on severance taxes regardless of the overall efficiency of such taxes. The states of Alaska, Montana, Louisiana, New Mexico, Oklahoma, Texas, Wyoming, Kentucky and West Virginia are all states that rank relatively high in state and local tax burdens and also have relatively high production levels for oil, natural gas and/or coal. The belief is that the rest of the nation ends up paying a significant share of the state's tax burden. This belief is often misplaced, however, since the tax in these natural resource states is not exported unless producers are able to raise prices to pass on the tax. Texas oil producers, for example have little if any ability to pass on taxes because the market price is set in the international market. The severance tax therefore just becomes a tax on production borne by Texas resource owners.

Texas does not rank well in terms of the share of state and local tax burdens on business relative to individuals. The national average share of taxation of business is 42.6% while the Texas share is 55.3% (see Table 3). The primary reason for the high tax share of taxation on Texas business is that the property tax falls 56% on business and the sales tax applies to 46.8% on business—the total of the two major taxes falls 51.9% on business. Adding the franchise tax and severance taxes pushes the share mostly to the 55.3% level. Most other states have lower business shares because they rely on the individual income tax.

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Table 2
State and Local Business Taxes per Dollar of Private Sector Economic Activity, FY2003

State	Business Tax	Private Economic Activity	Taxes Per \$ of Economic Activity	Rank	State	Business Tax	Private Economic Activity	Taxes Per \$ of Economic Activity	Rank
Alaska	1,799	22,478	8.00%	1	Hawaii	1,735	31,483	5.50%	20
Wyoming	\$1,223	\$17,072	7.20%	2	Texas	33,195	652,419	5.10%	21
Montana	\$1,299	\$17,697	7.30%	3	Michigan	14,027	265,322	5.30%	22
Maine	2,172	29,535	7.40%	4	Nebraska	2,388	45,824	5.20%	23
West Virginia	2,364	32,667	7.20%	5	Iowa	3,727	74,743	5.00%	26
North Dakota	1,017	15,187	6.70%	6	Texas wo Sev	32,228		4.94%	27
Washington	11,452	182,351	6.30%	7	Wisconsin	7,139	144,652	4.90%	27
Vermont	966	15,497	6.20%	8	California	50,312	1,132,887	4.40%	39
New Hampshire	2,433	41,974	5.80%	9	Connecticut	6,075	140,978	4.30%	40
Rhode Island	1,851	30,423	6.10%	10	Maryland	6,353	147,093	4.30%	41
Mississippi	3,108	51,886	6.00%	11	Colorado	5,804	144,802	4.00%	42
Louisiana	7,335	125,788	5.80%	12	Missouri	6,104	150,256	4.10%	43
South Dakota	1,130	20,142	5.60%	13	Indiana	6,476	158,690	4.10%	44
New Mexico	2,511	42,878	5.90%	14	Georgia	9,939	247,179	4.00%	45
New York	38,338	687,845	5.60%	15	Massachusetts	9,540	245,909	3.90%	46
Oklahoma	4,000	73,086	5.50%	16	Virginia	8,198	210,569	3.90%	47
Illinois	21,241	403,849	5.30%	17	Utah	2,134	55,968	3.80%	48
Florida	21,861	407,895	5.40%	18	North Carolina	8,410	225,077	3.70%	49
Arizona	7,080	132,487	5.30%	19	Oregon	3,399	99,084	3.40%	50

Robert Cline, William Fox, Tom Neubig and Andrew Phillips, *Total State and Local Business Taxes: A 50-State Study of the Taxes Paid by Business in FY2003, Prepared for The Council On State Taxation* QUANTITATIVE ECONOMICS & STATISTICS, January 2004.

Table 3
State and Local Business Taxes, Texas & U.S.
(billions of dollars)

Business Tax	U.S.	U.S.	Texas	Texas
	FY2003	Distribution FY2003	FY2002	Distribution FY2002
Property taxes on business property	\$156.1	16.5%	\$15.3	25.2%
General sales taxes on business inputs	100.1	10.6%	10.1	16.7%
Corporate income tax	34.6	3.6%	1.9	3.2%
Payroll taxes	30.5	3.2%	0.1	0.2%
Gross Receipts Taxes	29.8	3.1%	1.0	1.6%
Insurance premiums	12.0	1.3%	1.0	1.7%
Public utility taxes	17.7	1.9%	0.3	0.5%
Excise taxes	14.7	1.6%	1.2	2.1%
Business license	10.3	1.1%	0.5	0.8%
Corporation license	6.0	0.6%	2.0	3.3%
Other taxes	\$22.2	2.3%	\$0.1	0.1%
Total state and local business taxes	\$404.1	42.6%	\$33.6	55.3%
Non-Business Taxes	\$544.0	57.4%	\$27.2	44.7%
Total State and Local Taxes	\$948.1	100.0%	\$60.7	100.0%
Business Share		42.6%		55.3%

Sources: Tax Foundation, E&Y tax calculations and Texas Comptroller's Office @<http://www.window.state.tx.us>. and U.S. Census @<http://www.census.gov/prod/2001pubs/statab/>

The Distribution of the Business Tax Burden within Texas

The major taxes and their distribution among individuals and businesses, as well as the distribution among businesses are shown in Table 4. The sales tax and the property tax dominate the taxation of both businesses and individuals in Texas. The property tax falls heavily on capital intensive industries and lightly on the labor-intensive industries. The retail sector has 20% of the employment but pays 5.1% of the business property tax; the services sector has 36.6% of the employment but pays 11.2% of the business property tax.

The distribution of the sales tax burden within the business sector also falls heavily on the capital-intensive industries and lightly on the labor-intensive industries. The retail sector has 20% of the employment but pays 6.7% of the business sales tax. The service sector has 36.6% of the employment but pays 14.3% of the business sales tax.

The franchise tax also falls more heavily on capital than on labor. Services with 36.6% of the employment pay 13.8% of the tax. Retail with 20% of the employment pays 11.8% of the tax. Manufacturing with 13.5% of the labor pays 22.7% of the tax.

Since there is not a payroll tax in Texas and since service industries are able to legally organize to avoid the franchise tax, labor intensive industries do not share the tax burden equally.

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Table 4
Initial Tax Burden on Individuals and Businesses: Major State & Local Taxes
(in Millions)

Industry	Sales Tax (1)	Franchise Tax	Oil & Gas, Utility and Insurance Tax	Property Tax (2)	Total State & Local Tax (3)
Individuals	11,506			12,026	23,866
Agriculture	65	15		816	896
Mining	676	200	967	594	2,438
Construction	924	62		501	1,487
Manufacturing	2,660	440		3,175	6,275
TCU (4)	1,492	312	311	3,469	5,585
Wholesale	536	177		534	1,247
Retail	675	228		780	1,684
F.I.R.E. (5)	1,644	234	1,046	3,714	6,638
Services	1,449	266		1,710	3,426
Totals	21,628	1,936	2,324	27,320	53,542

(1) Includes hotel & motel tax distributed in same proportion as sales tax and the motor vehicle tax distributed by the Comptroller's estimates.

(2) Includes school districts, counties, cities and special districts. The distribution of the property tax among industry SIC classes is based on the Comptroller's projection of initial incidence of the the school property tax and estimates of distribution of the other jurisdictions per a model developed for the Governor's Office of Budget and Planning in 1997 and updated in 1999. See Texas Comptroller, Tax Exemptions & Tax Incidence, January 2003 @ <http://www.window.state.tx.us/taxinfo/incidence/limit.html> and *Documentation of Sources and Procedures for Texas Property Tax Model: A Report to the Governor's Office of Budget and Planning* by Resource Economics, Inc., Austin, Texas, 1997.

(3) Includes inheritance tax as tax on individuals.

(4) TCU = transportation, communications and utilities

(5) F.I.R.E. = finance, insurance and real estate

A principal of taxation is that a tax system ought to be fair. A reasonable interpretation of this principal is that to the extent that business is taxed, the burden ought to be proportional to the economic contribution of the business. A direct measure of the equity of the business taxation in Texas is the tax share of the industry contribution to GSP. Table 5 shows the tax percent of GSP for the major economic sectors of the current system. The taxes included are the franchise, oil and gas, utility, insurance, sales tax, hotel/motel tax and total property taxes. The estimated distribution results in an average tax burden of 4.4% of GSP contribution. There is considerable variation around the average, however. Agriculture, mining, manufacturing, TCU, and F.I.R.E. are significantly above the average. The wholesale, retail and service industries are substantially below the average.

A shift in the tax burden from capital-intensive to labor-intensive industries would improve economic efficiency. The current distribution of the property tax plus the sales

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tax encourages investment and production in the labor-intensive industries to the exclusion of the capital-intensive industries. The paper by Lori Taylor referenced above (p. 4) points out that Texas employment in manufacturing grew nine percent during the 1990's while the rate was a negative three-percent for the nation. But the capital stock in manufacturing grew at the same rate as the nation at 12 percent. Therefore, the capital per unit of labor in Texas manufacturing increased at less than half the national rate. The Texas tax system that penalizes capital investment is no doubt a major contributor to this trend.

Table 5
Equity of the Texas Tax System on Business
(million dollars for GSP and tax values)

Industry	GSP 2002 (1)	Tax Burden Under Current System (2)	Current System Tax Burden per Unit of GSP	Change to Equalize the Tax Burden per Unit of GSP
Agriculture	10,370	896	8.6%	-443
Mining	42,824	2,438	5.7%	-569
Construction	37,474	1,487	4.0%	149
Manufacturing	95,902	6,275	6.5%	-2,090
TCU (4)	82,023	5,585	6.8%	-2,006
Wholesale	54,188	1,247	2.3%	1,117
Retail	75,640	1,684	2.2%	1,617
F.I.R.E.	120,647	6,638	5.5%	-1,373
Services	160,977	3,426	2.1%	3,599
Totals	680,045	29,676	4.4%	0.0

(1) Comptroller's year 2002 estimate, adjusted to actual total.

(2) Includes all property tax, franchise tax, oil & gas severance, utility, insurance, state and local sales tax and hotel/motel tax.

A shifting of the tax burden to equalize the tax burden at 4.4% of GSP would require increasing the tax burden on wholesale, retail and service industries by \$6.3 billion and reducing taxes on manufacturing, TCU and F.I.R.E by a like amount.

ECONOMIC DISTORTION OF THE MAJOR TEXAS TAXES

Economic distortion comes in several forms. Property taxes encourage investment in labor-intensive enterprises rather than capital intensive industries and thus the economically efficient balance of investment and production among industries. Within firms the property tax discourages labor saving capital investments. When matched with the franchise tax, which is a tax on capital income, the combination tilts the balance of investment significantly toward labor intensive industries. The interregional outcome is to discourage the economically efficient Texas share of capital intensive industries. For a recent discussion of this topic, see Taylor, Lori L. "Undue Taxes and Unintended Consequences," in Chris Patterson (ed), *Putting the Sides Together: Twelve Perspectives on Texas Public School Finance*, Texas Public Policy Foundation.

There are other problems with the property tax. The taxation of mining property distorts the timing of production. The property tax on oil and gas in the ground encourages production earlier than is otherwise economical since the commodity will be taxed again and again until produced, at which time it will be taxed again by the severance tax. And then, of course if the producer is not a LLP by legal status, franchise taxes will be due. Further, firms are discouraged from exploration as early as would otherwise be optimum because the discovery will create a taxable value. The property tax applied to mining enterprise property is like an inventory tax.

At the consumer level the property tax distortion is concentrated in the effects on the housing market. Housing is a major component of household consumption expenditures. Property tax rates that are out of line with competing places to live and work distort consumer choice in both the level of housing purchased and the location of people.

The sales tax in its pure form as an equally applied tax on consumption is an ideal tax from an economic efficiency point of view. Applied equally across all consumer products, and not applied to goods used in production, the sales tax avoids most forms of economic distortion. The sales tax has significant distortion effects, however, as it exists in Texas. First, 46.8% of the current direct sales tax burden falls on businesses. A tax-on-tax effect often results from sales taxes on business inputs. Since the costs of intermediate products, including the sales tax add-on, gets passed on in the price of the product, which is often also taxed by the sales tax. This tendency of multiple taxation is known as a "cascading" effect. That is, a product that is finally delivered to consumers may encompass in the price multiples of the 6.25% sales tax rate. Therefore, the taxation of various products may have effectively very different tax burdens, the result of which is to distort the economically efficient production and consumption of Texas economic goods.

At the consumer level the sales tax presents a different set of distortion problems. Many goods are exempt from the sales tax for a wide variety of equity and humanitarian reasons. This unequal taxation of consumer products distorts the economically efficient mix of consumption. Rebate systems that return tax revenues to the favored consumer or income supplements are means of avoiding this unfortunate effect of the sales tax.

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The franchise tax is for the most part a corporate income tax. If the asset test is met then the tax acts like a tax on capital. (The Texas franchise tax burden is the larger of 0.25 percent of taxable equity capital or 4.5 percent of net taxable earned surplus, equal to approximately the firm's federal taxable income). There are two major problems with the franchise tax. The first problem is that it applies to corporations but not partnerships, sole proprietors, or professional associations. Therefore, there is a great incentive for firms to change legal form to avoid the tax. The Comptroller estimates that about 1000 firms per year convert to LP forms.²

The other major problem with the franchise tax is the so-called "Delaware sub" loophole. The statute setting up the franchise tax provides an exemption for firms doing business in the state who do not have "nexus" (physical presence) in Texas. Corporations' subsidiaries organized as partnerships to do business in a number of states, but where the corporate partner lacks "nexus" (physical presence) in Texas thereby avoids the Texas franchise tax.

The severance tax on oil and gas has a different rationale from other taxation. One rationale is that these resources are natural endowments in trust and will one day be depleted. Therefore, the state, on behalf of the citizens, is justified in taxing the flow of value as it is produced in order that the public trust will be preserved. Another rationale is that the state and communities where resources are produced incur a unique social, environmental and governmental cost associated with the activity. Therefore, the state is justified in taxing the removal of the resource to offset these costs. Given the general need for tax revenues to support the government, the states also tend to over tax their major natural resource. It is often believed, incorrectly, that large portion of such taxes are exported to other states. The average severance tax rates are shown below for the major natural resource states.

Average Severance Tax Rates for Top Oil, Gas and Coal Producing States		
State	1000 Bbls COE*	Average Severance Tax Rate**
Alaska	685,634	12.6%
Montana	135,411	10.8%
Louisiana	443,378	8.0%
New Mexico	406,913	6.7%
Oklahoma	489,796	6.5%
Texas	1,743,962	5.7%
Wyoming	816,315	4.5%
Kentucky	903,600	3.0%
West Virginia	858,342	2.7%
* Oil, gas and coal in crude oil energy equivalent terms.		
** Based on 1994 revenues, prices and estimated Btu values.		

For a detailed discussion of the severance tax in its various forms, see Holloway, Milton L., *State Severance Taxes in the U.S.*, A Report to Philip Morris Management Corporation, November 1997.

For a detailed discussion of the economic distortion effects of various tax forms, see Zodrow, George R., *An Economic Evaluation Of Alternative Sources Of Tax Revenue For The State Of Texas*, March 2004.

The Problem of Exportability and Deductibility

A practical problem in the design of a good state tax system is consideration of how much of the tax can be exported to out-of-state purchasers of Texas products and services. In addition, the lack of deductibility of the sales tax on individual federal income tax reduces the yield that the sales tax generates. Ideas for modification of the tax system to correct the economic efficiency and equity problems evident above are immediately met with these two practical considerations for minimizing the total tax burden on Texans.

From an overall economic efficiency point of view the Texas tax system needs to shift taxation away from business and toward an equally distributed consumption tax. But if the only acceptable tax option for accomplishing this is an increase in the sales tax to replace the revenue lost from a business tax reduction, exportability is likely to suffer. According to the Comptroller's assumptions, the capital based business taxes (the property tax and the franchise tax) reviewed above are more exportable than the sales tax (see Table 6).

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Table 6
Taxes Initially Paid by Business:
Distributional Assumptions for Final Incidence

	Borne by Texas Residents				
	Consumer	Labor	Capital	Exported	Total
Limited Sales and Use Tax	59%	23%	3%	15%	100%
Motor Vehicle Sales and Use Tax	54%	23%	1%	22%	100%
School Property Tax					
rental property	75%	2%	16%	7%	100%
agricultural property	12%	59%	11%	18%	100%
commercial property	59%	23%	3%	15%	100%
industrial property	28%	43%	2%	27%	100%
utility property	52%	21%	3%	23%	100%
mining property	1%	37%	9%	54%	101%
Gasoline Tax	59%	23%	3%	15%	100%
Franchise Tax					
agricultural sector	12%	59%	2%	27%	100%
mining sector	1%	37%	4%	59%	100%
construction sector	89%	8%	1%	2%	100%
manufacturing sector	28%	43%	2%	28%	100%
utility sector	52%	21%	2%	25%	100%
trade sector	80%	7%	1%	12%	100%
finance sector	42%	16%	3%	40%	100%
services sector	63%	21%	1%	15%	100%

Note: Totals may not add due to rounding.

Source: Comptroller of Public Accounts, Tax Exemptions and Tax Incidence:
A Report to the Governor and the 78th Legislature

The assumptions in Table 6 imply that the property tax and the franchise tax are exportable in a range from about 27% to 59% while the sales tax share is only 15%. Therefore, one might conclude that a dollar per dollar shift in the initial tax burden from a capital tax reduction to a sales tax will need to produce considerable economic growth to overcome a 12% to 44% loss from reduced exportability. A shift from a deductible business property tax of approximately 30% to individual non-deductible sales taxes would result in an even larger loss in exportability. The column labeled “Exported” in Table 6 are likely to be significantly overstated, however. For example, as mentioned earlier, Texas oil producers have little or no ability to pass on a tax in higher product prices, so the mining sector assumption of 54 to 59 percent are not realistic estimates of tax exportability.

ECONOMIC INCIDENCE OF THE TAX BURDEN

The measure of the final burden of taxation is known as the economic incidence. This measure is an estimate of the final burden of direct taxation and price (including wage) adjustments and reductions in dividend and other payments to business owners, after accounting for marginal income tax rates and percentages of the taxes that are exported to out of state purchasers. The most common of such tax burden measures is the ratio of the tax incidence to current income. There are two alternatives that are more difficult to

estimate, but arguably better measures. One is to relate tax incidence to lifetime earnings and the other is to relate incidence to current consumption. For a thorough treatment of the topic see Don Fullerton and Diane Lim Rogers, Who Bears the Lifetime Tax Burden?, The Brookings Institution, Washington, D.C., 1993.

The main point of Fullerton's work is that current income will not be a good representation of a person's long term income so that a better measure of tax equity is to make the calculation over a person's expected life time earnings rather than current income. The alternative of measuring tax burden based on current consumption is that, like life-time income, consumption is a better measure of a person's welfare than current income, and therefore tax incidence as a percentage of consumption is a better measure. Either of these measures produces a pattern of tax burden that is much less regressive than the measure relative to current income which the Comptroller's office uses in their analysis of tax incidence.

The Comptroller's Office estimates the tax incidence of business taxation by way of a studied set of estimates of how businesses pass on a tax. The ways a business may pass on a tax include a change in the price of the product, a change in wages paid, and a change in dividends and other returns to ownership. The particular market within which the firm operates determines how much of the tax will be exported to out-of-state purchasers. In the case of the mining sector, for example, the estimate is that 50% to 60% of taxes on the industry will be exported. The next highest is the finance sector which is estimated to export 40% of the initial tax burden. Agriculture, manufacturing, and utilities are estimated to export from 25% to 28%. The service sector exports about 15% of initial taxes. On the other hand, the construction sector is expected to export only 2% of the initial tax burden. In the practical world of tax policy these export estimates are a powerful influence on decisions about the relative merits of alternative taxes and exemptions. These assumptions need to be reviewed since it is clear that the ability of Texas producers to raise market prices in national and international markets is limited or non-existent.

Table 7 summarizes the incidence effects for all income groups for two of the major Texas taxes—the sales tax and the school property tax. The tax burden of both of these taxes is estimated to be highly regressive when measured as a share of income. The lowest income group for example is estimated to bear over 3% of the two taxes, which is 7 to 9.2% of income, respectively. The highest income group (\$124,699 and above) bears 15% of the sales tax and 20.8% of the property tax burden, but only 0.9% and 1.5% of income, respectively.

Changing the tax system to decrease the property tax by increasing the sales tax would not change the distribution of the tax burden among income classes significantly since both are about equally regressive. Such a shift would, however, shift the total burden of such a dollar per dollar change toward Texas taxpayers because the property tax is more exportable. A major shift of the property tax to a business activity tax (BAT) would probably improve the regressive nature of the tax system since the effect of the BAT would be likely to fall heavily on labor and near proportional to wages. Any estimate of the effects of the BAT on regressivity, however, will depend on assumptions about how

each industry affected will pass on the tax. Projected effects of the BAT, however, are more theoretical than with estimations about some other taxes because there is limited experience with the BAT in the United States.

CONCLUSIONS

Texas has a tax system that imposes a high initial tax burden (55.3%) on businesses when compared with other states in the nation (42.6%). The Texas tax system is also heavily biased against capital intensive industries when compared with labor intensive businesses. This outcome is a direct effect of the political choice of major tax forms—the property tax, sales tax and franchise tax—along with the set of exemptions and exclusions that have been adopted over time. These three factors—the choice of tax form, the tilt toward business taxation and a focus on capital intensive industry taxation—make the Texas tax system economically inefficient.

A significant change to improve the economic efficiency of the Texas tax system is hampered by the practical considerations of exportability and deductibility. A shift of initial tax burden away from capital intensive industries will probably mean a loss of exportability of the tax load, but true exportability is difficult to establish. The Comptroller's numbers on exportability, appropriately labeled "assumptions," appear to be over statements. A shift away from the franchise and property taxes to a consumer sales tax would mean a loss of deductibility against the federal income tax.

Failure to reform the tax system because of these surface observations, however, would be short sighted. A reduction in the property tax replaced by a sales tax imposed only on consumer items would improve the efficiency of the tax system and also promote economic growth. (See Holloway, Milton L., *An Economic Analysis of a Texas Property Tax Relief Plan Funded by a Sales Tax Increase*, A Report to the Texas Public Policy Foundation, Austin, March 2004 and Holloway, Milton L., *An Economic Analysis Of The Proposed Texas Business Activities Tax (Flat Bat)*, A Report to The Lone Star Foundation, January 2004. A carefully designed business activity tax large enough to replace the franchise tax and a major portion of the property tax is likewise expected to improve economic efficiency by changing the balance between capital and labor taxation, and at the same time promote economic growth. As with any new tax, however, exemptions, exclusions and other special treatments over the course of implementation might make the fact of the tax differ from expectations, and result in a bad experience as is reported in the Michigan example. Both of these options could be augmented by increased user fees of several types and could result in further improvements in economic efficiency. Establishing any new tax, however, should be undertaken with great caution, as noted in the Texas Public Policy Foundations companion report *The Business Activity Tax*.

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ENDNOTES

¹ The high tech industry importance to Texas growth is indicated by the fact that it now matches the economic contribution of the oil and gas sector (see <http://www.window.state.tx.us/comptrol/fnotes/fn9808/fn.html>).

² Conversation with James LaBas, Texas Comptroller's Office, April 13, 2004.



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