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# Policy *Perspective*

From the Texas Public Policy Foundation

## A Tax on One Is a Tax on All Efforts Aimed at Business or “The Rich” Merely Spiderweb

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**T**exas’ current tax system, including local property taxes that support public schools, is considered by many to be broken. Although Texas’ tax system has served the state very well, with revenues increasing faster than inflation and population growth, criticism comes from multiple quarters. Some complain that the current system is not adequate to finance the needs of the state’s citizens. Others complain that property taxes are just too high. Another complaint is that the tax system is not fair to those with low incomes. And it is often argued that some aspect of the tax system is simply outdated, that it does not fit today’s more service-oriented economy, or that it discourages economic development.

Almost all of these criticisms could be leveled on virtually any tax system, depending on one’s viewpoint. The one considered here is the fairness issue for those with low incomes. A common complaint regarding the Texas tax system is that it is regressive. Despite the connotation, this is a *technical* term that simply indicates how one’s tax

bill varies in proportion to one’s income.

Economists, though, have looked at the issue more deeply by studying *tax incidence*, which inquires as to the true economic impacts of a tax throughout the economy rather than just on those who directly pay it.<sup>1</sup>

When it comes to the question of who pays Texas’ taxes, the simple fact of the matter is that we all do. Exactly who really pays more or less is impossible to accurately gauge, because every tax is shared by all of us. Any tax that is aimed

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particularly at “business” or “the rich” is a tax that impacts us *all*. While it might be politically convenient or somehow satisfying to pretend that a tax only negatively affects a certain class of people, it must be understood that every tax negatively affects everyone. Business owners, the individuals they hire, and those who buy from them are all people negatively affected by a tax, whether it is a



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sales tax, an income tax, or a head tax.

Usually by looking at initial tax incidence – i.e., who cuts the checks to pay taxes – tax systems or particular taxes are categorized as progressive, proportional, or regressive. A tax is progressive when a rising income results in a higher percentage of that income being paid in the tax. A regressive tax is the opposite – a rising income results in a lower percentage of income being paid in tax. A proportional tax is one for which the percentage of income paid in tax does not change with changes in income. However, economists have discovered that no tax is so straightforward that its burden is borne only by those who initially pay it.

Despite the difficulties involved in measuring actual tax incidence, attempts are made to do so. In fact, the Texas Legislature requires the Texas Comptroller of Public Accounts to produce a report that tries to measure tax incidence.<sup>2</sup> It tends to look more at financial impacts rather than comprehensive economic impacts of taxes, but it is the best measure available. Table 1 below is derived from data contained in the 2003 edition of that report, which

looks at the comptroller’s measure of tax incidence of five major Texas state taxes: the sales and use tax, the franchise tax, the gasoline tax, the motor vehicle sales and use tax, and the school property tax. For each of these taxes, the comptroller’s office estimates the financial burden for each of 10 income deciles.

An *income decile* is a group of households, representing 10 percent of all households in the state, with all households ranked by household income. The *first* decile is the 10 percent of households at the *lowest* end of the income spectrum. The *tenth* decile is the 10 percent of households at the *highest* end of the income spectrum.

Table 1 shows that according to the comptroller’s methodology, each of Texas’ five major taxes is regressive. This can be seen by looking at the % *Income* column under each tax where the percentages fall with higher income deciles. Also for each tax, the table shows the percentage of the tax paid by each decile, taking into account the fact that a portion of each tax is *exported*. Twenty-three percent of the sales tax, for example, is borne by individuals outside the state.

The last two columns of Table 1 are calculated

**“No tax is so straightforward that its burden is borne only by those who initially pay it.”**

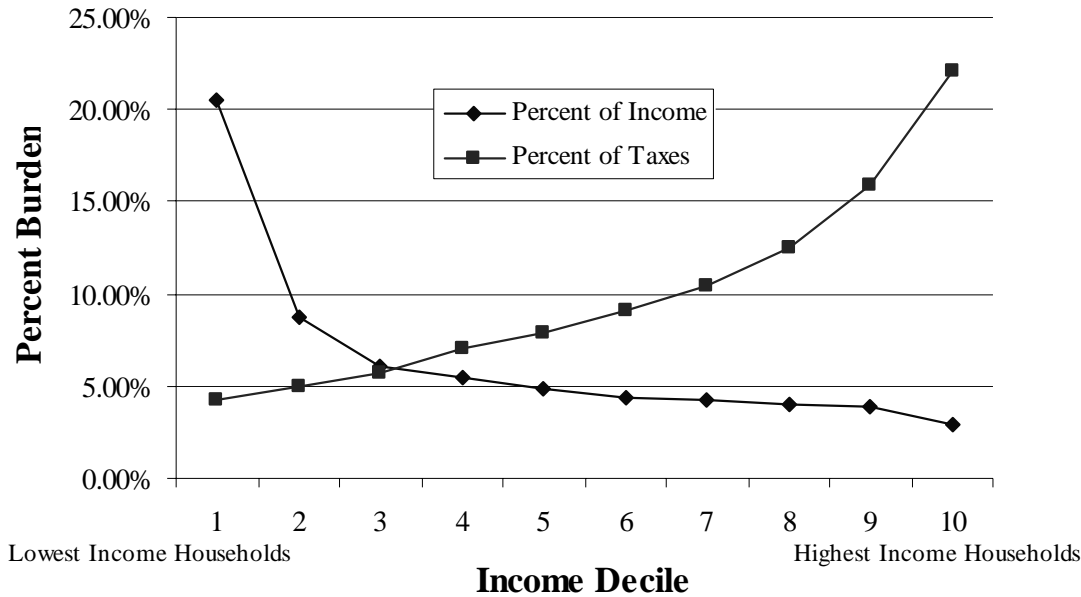
**Table 1**

<b>Tax Burden of Major Texas Taxes</b>												
Income Decile	Sales/Use Tax		Franchise Tax		Gasoline Tax		Motor Vehicle Sales/Use Tax		School Property Tax		All Major Taxes	
	% of Tax	% Income	% of Tax	% Income	% of Tax	% Income	% of Tax	% Income	% of Tax	% Income	% of Tax	% Income
<b>1</b>	3.1	7	5	1.4	5.1	1.8	2.8	1.1	3.3	9.2	4.3	20.5
<b>2</b>	3.8	3.1	5.4	0.5	6	0.8	3.8	0.5	3.7	3.8	5.0	8.7
<b>3</b>	4.3	2.2	5.5	0.3	6.7	0.5	4.6	0.4	4.3	2.7	5.7	6.1
<b>4</b>	5.7	2.1	6.4	0.3	8.2	0.5	6.4	0.4	4.9	2.2	7.0	5.5
<b>5</b>	6.5	1.9	6.5	0.2	8.7	0.4	7.5	0.4	5.5	2	7.9	4.9
<b>6</b>	7.4	1.7	6.9	0.2	9.7	0.3	8.3	0.3	6.5	1.9	9.1	4.4
<b>7</b>	8.4	1.6	7.3	0.2	10.7	0.3	9.4	0.3	7.7	1.8	10.4	4.2
<b>8</b>	9.8	1.5	8.1	0.1	11.2	0.3	11.6	0.3	9.6	1.8	12.5	4
<b>9</b>	12.6	1.5	8.8	0.1	12.4	0.2	13.7	0.3	12.6	1.8	15.9	3.9
<b>10</b>	14.9	0.9	11.5	0.1	13.8	0.1	15.7	0.2	20.8	1.6	22.1	2.9
	76.5		71.4		92.5		83.8		78.9		100.0	
<b>Exported</b>	23.3		28.6		7.6		16.2		21.1			

Source, Texas Comptroller, *Tax Exemptions & Tax Incidence*, January 2003. Author’s calculations

Figure 1

## Major Texas Taxes by Income Deciles



from the comptroller’s estimates and look at the five taxes as a whole. In the second to last column, the percentage of each tax paid by each decile is calculated. The exported portion of each tax is disregarded, so the percentages reported look at the proportion of the Texas-paid portion of each tax. The very last column is simply the sum of the individual taxes’ % *Income* columns.

The last column of Table 1 shows that the proportion of income paid in these taxes falls as income rises. It also shows just how questionable any tax incidence measurement or estimate is likely to be. The comptroller’s analysis indicates that over 20 percent of the income of households in the lowest income decile is burdened with Texas’ five major taxes. This is very difficult to believe intuitively.

The lowest income decile includes household incomes between \$0 and \$11,172. While it is not impossible for 20 percent of this group’s income to be paid in state taxes, it seems highly unlikely given that there is no sales tax on food, which would constitute a high proportion of expenses, and that the highest sales tax rate, at 8.25 percent,

is half the incidence percentage calculated. The percentage rate of taxation on fuel is around 20 percent, but that is not likely to be the bulk of the household budget. The property tax will add to the percentage paid and rent will be a very significant expense, but even at \$400 per month, if the property tax is 20 percent of the rent, it ends up being less than 10 percent of

\$10,000 in income. It seems like the only way to get to a 20.5 percent incidence level for the five major Texas taxes would be if *all* items were sales taxed, rent were more than half of income, and property taxes constituted 20 percent or more of that rent.

Nevertheless, let us take the comptroller study’s numbers as completely accurate. Table 1 reveals, in the second to last column, that the highest percentage of Texas’ major taxes is paid by the households in the highest income decile, despite the reported regressivity. This seemingly startling fact is shown in Figure 1. For each decile, the percentage of income paid in taxes (Percent of Income) is compared to the percentage of each tax paid by each decile (Percent of Taxes). In other words, the last two columns of Table 1 are plotted in Figure 1.

Despite the fact that the lowest income decile is estimated to pay over 20 percent of its income in Texas taxes, that decile pays less than 5 percent of those taxes, easily the lowest percentage of all the income deciles. The highest income decile, despite paying the lowest percentage of total income, pays

by far the highest percentage of total taxes.

Figure 1 strongly hints that if Texas' tax system were proportional, the percentage of taxes paid by high-income deciles would be even greater. If Texas' tax system were progressive, even less of Texas' taxes would be paid by low-income deciles. A progressive tax system would result in the vast bulk of all taxes being paid by only the two or three highest-income deciles. Some would argue that those who get the most ought to pay the most. However, such reasoning ignores several important points.

It should not be forgotten that the 10 income deciles are looking at *household* income. A household could be a single person or it could be a family of nine. Also, incomes of individuals in a specific household change over time. A single person working his or her way through college might be in the first or second decile. Soon after graduation, that individual might be in the fourth or fifth decile. A two-earner household with modest incomes might be in the fourth decile, but with two or three children, no better off than a single individual in the first decile.

The fact is that those in the lower deciles are more likely to be single and young or elderly (and likely relatively wealthy). Those in the upper deciles are more likely to be middle-aged two-

earner households with children. And, few stay in any one of the income deciles for a lifetime.

Those in the lower income deciles are also more likely to use the services that are generated through taxes. They tend to benefit from the taxes they pay more than those in higher deciles. They are more likely to use Medicare, Medicaid, public education, public colleges, and a variety of other social services that now make up the bulk of the state's budget.

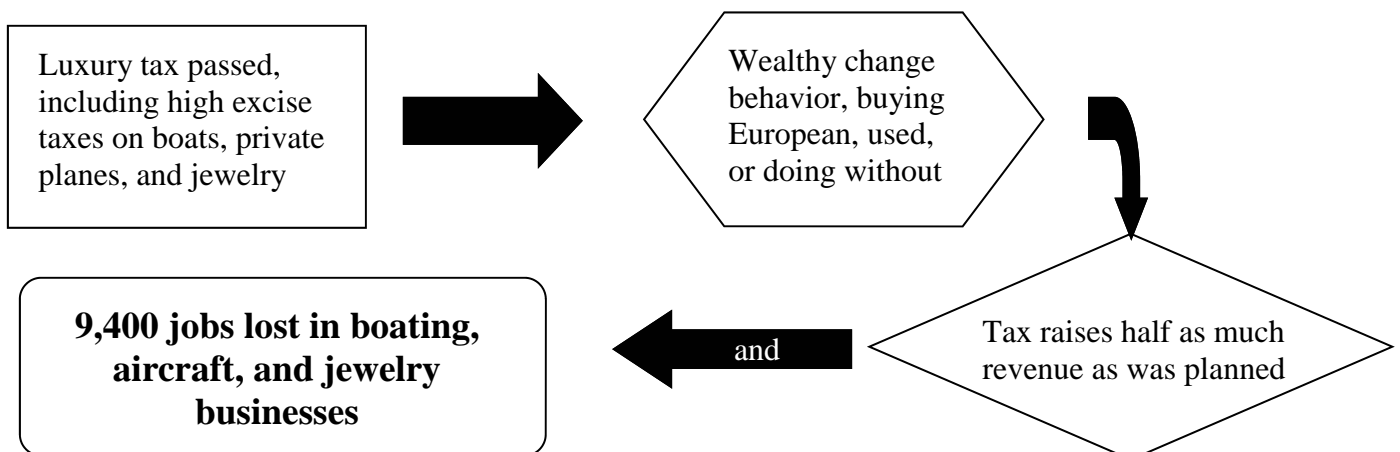
Fairness, always a vague term, is no less vague when applied to tax systems. While it is certainly a fact that Texas' tax system is considered regressive, this statement of fact is by no means an objective description of the fairness of the state's tax system. It also ignores the fact made obvious by the analysis above, that *the bulk of Texas taxes are paid by those households with higher incomes.*

Additionally, economists have learned, and practical experience has taught us, that just because a person cuts the check for a tax does not necessarily mean that person truly bears the burden of the tax. This sounds odd, but it is absolutely true. Where the burden of a tax lies – or who ultimately pays it – is determined by how people's behavior is affected by the tax, *and taxes always have the potential of changing behavior.*

Consider this real-world example (See Figure 2).

Figure 2

### Results of a 1990 Federal Luxury Tax



In 1990 a so-called “luxury tax” was passed at the federal level that included high excise taxes on boats, private aircraft, and jewelry. One of the major reasons for passing the tax was to “make the rich pay their fair share.” Projected to result in \$31 million in new revenues in 1991, the new excise taxes actually took in roughly half that – \$16.6 million. Rich people changed their behavior. They did without. They bought used. They bought European. As a result, 7,600 jobs were lost in the boating industry along with 1,470 and 330 in the aircraft and jewelry industries, respectively. Unemployment benefit costs outstripped the added revenue by \$7.6 million, causing the federal government to *lose* money on the tax.<sup>3</sup>

So, who really paid the luxury tax? The answer is that about 9,400 workers paid the tax, along with their families and the people they used to do business with before they lost their jobs. Although the tax was supposed to make the rich “pay their fair share,” it resulted in a number of middle-class, blue-collar workers losing their livelihoods. In other words, the luxury tax was a tax on middle-class workers more than it was a tax on the rich.

Consider another example. Suppose a one dollar per unit tax is imposed on DVDs, which sell now for about \$15. The usual assumption is that the tax will be entirely passed on to consumers, implying that the price of DVDs, including the tax, will rise to \$16. The reality, though, is that some consumers will buy fewer DVDs as a result of the upward price pressure caused by the tax. Producers, anxious to sell DVDs, will do so by lowering their net, with the new price of DVDs ending up somewhere between \$15 and \$16. This means the tax is *shared* by producers and consumers.

A DVD tax might be considered regressive since a lot of relatively low-income people buy DVDs and the rich do not buy that many more of them, but the rich owner of a DVD retail store will see the store’s profit fall. Some might celebrate the hidden progressive nature of this tax, but

remember that when people buy fewer DVDs, fewer individuals are employed in that industry. The effect is much like the more obvious effects of the luxury tax.

This example and the real-world luxury tax show that all taxes are shared, and they are all paid by people. In one way or another we are *all* producers as well as consumers. It is often said that corporations do not pay taxes; people do. This statement is exactly correct. What should be understood as well, though, is that a tax on one person or a group of people is a tax on *everybody*. Unfortunately, there is a tendency to judge taxes

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and tax systems by initial incidence rather than on their actual economic effects.

Based on initial incidence, for example, the federal income tax is purposely designed as a progressive tax. Income tax rates rise as income rises, from a 10 percent tax rate on the lowest incomes to 35 percent on the highest incomes. The Social Security payroll tax, though, is regressive. Every dollar earned is taxed at the same rate up to \$87,900, but no dollars beyond this cutoff are taxed, meaning that the percentage of total income paid into the Social Security tax falls as income rises above the \$87,900 cutoff. The Medicare payroll tax, at 2.9 percent for every dollar earned with no limit, is a proportional tax.

Initial incidence, though, is not the full story. As noted in the luxury tax example, the effects of that tax were not limited to the rich, but were probably even more profound for those who

worked in luxury industries. Then, of course, those who worked serving and selling to those who once worked in luxury industries were negatively affected as well. The jobs lost, as enumerated above, likely represent only a small percentage of that tax's negative effects. Remember, consumers also pay the tax, meaning they cannot buy as many other things as they did before the tax, negatively affecting other industries not luxury-taxed in the first place.

When it comes to the overall tax burden borne by Texans, it is useful to consider federal taxes. Consideration of other states' taxes would make the analysis of Texans' tax burden even more complete, but such a comprehensive analysis is not available. Federal taxes, however, have been extensively analyzed. Unfortunately, the

terms of time, though.

Traditionally, the federal tax burden and national income distribution are measured and compared by looking at income *quintiles*. A quintile looks at a fifth, or 20 percent, of households, ranked by income from lowest to highest so that there are five quintiles. Two deciles can be summed to produce a quintile. Unfortunately, the federal data are not divided precisely along the same income lines as the state data. Federal data, representing the whole nation, do not precisely reflect percentages of federal taxes paid by various Texas households, either.

Despite the flaws in doing so, it is still somewhat useful to combine Texas' first and second income deciles, the third and fourth deciles, and so on to look at Texas' tax incidence by

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methodology used does not exactly mirror that used by the Texas comptroller in analyzing Texas' taxes<sup>4</sup>, but tax incidence analysis, as noted above, is not an exact science. The data available from the Congressional Budget Office do come close to matching those from the comptroller's office in

household income in quintiles and then compare that to the national federal tax incidence as measured by the Congressional Budget Office. Though fraught with imprecision, it is still useful to sum the various percentage tax burdens for each of the quintiles for state and federal taxes to get some picture of the overall Texas state and federal tax burden for Texans, depending on household income. The result is Table 2.

Table 2 demonstrates that federal taxes have a decidedly progressive nature to them. In fact, so progressive are federal taxes, the combined state and federal tax incidence, as measured, tends to be rather progressive. This is despite the comptroller's estimated rather extreme regressivity of the Texas state tax system. Nevertheless, neither the state nor

**Table 2<sup>5</sup>**

Quintile	% of Income Paid in Taxes		
	State Taxes	Federal Taxes	Total Taxes
1	11.8	5.4	17.2
2	5.8	11.6	17.4
3	4.6	15.2	19.8
4	4.1	19.3	23.4
5	3.2	26.8	30.0

“Truly progressive policy is that which encourages wealth formation that benefits everyone rather than that which risks making everyone worse off in order to punish a few in the name of social justice.”

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federal measures of tax incidence according to household income really matter when it comes to fundamental principles of how taxes actually work because we are *all* negatively affected by them.

So, a fundamental question is that if government is necessary – and it is – how can the citizenry finance it without damaging themselves and the economy? The answer is that we cannot. We have to balance the benefits of government with the costs and carefully weigh the alternatives. Since both the benefits and the costs of any given government activity are probably unknowable with any great degree of accuracy, care must be taken to make sure the benefits are obvious and large because the costs are usually so much more difficult to identify. If we succeed with attempts to tax the rich and destroy incentives for people to innovate and take risks in an effort to get rich, we will all be poorer.

The tax system, though it can be used to further social goals, should not be used in this way. The ultimate effects are too uncertain. Instead, the focus should be on economic efficiency, and that means taxing in the least distorting way. In other words, productive economic activity should be taxed as little as possible, and equally across the board. Ideally, that means a tax system that looks more like a comprehensive sales tax than one that looks like an income tax. Truly progressive policy is that which encourages wealth formation that benefits everyone rather than that which risks

making everyone worse off in order to punish a few in the name of social justice.

### About the Author — Byron Schломach

*Byron Schломach, Ph.D., is chief economist at the Texas Public Policy Foundation. Prior to joining the Foundation, he served on the staff of the Texas Education Agency and as chief of staff to State Representative Kent Grusendorf, chairman of the House Committee on Public Education. Dr. Schломach has also been a researcher in the Office of the Comptroller, where he studied transportation and education. He has taught economics at Texas A&M University, his alma mater, and at Austin Community College.*



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### Notes

<sup>1</sup> For a very good, but somewhat technical, introduction to tax incidence analysis, see Don Fullerton and Gilbert Metcalf, *Tax Incidence*, [www.eco.utexas.edu/~dfullert/papers/fim-hndbk-pe02.pdf](http://www.eco.utexas.edu/~dfullert/papers/fim-hndbk-pe02.pdf).

<sup>2</sup> Texas Comptroller, *Tax Exemptions & Tax Incidence: A Report to the Governor and the 78th Texas Legislature*, Publication #96-463, January 2003. This excellent document contains a very lucid and simple introduction to the problems associated with measuring tax incidence.

<sup>3</sup> National Center for Policy Analysis, *The Luxury Tax*, [www.ncpa.org/ea/eama92/eama92k.htm](http://www.ncpa.org/ea/eama92/eama92k.htm). The tax was quietly repealed shortly after Clinton became president.

<sup>4</sup> The Congressional Budget Office takes a less circumspect approach to tax incidence, assuming taxes are entirely borne by those who actually remit the funds to the government.

<sup>5</sup> Derived from Texas Comptroller, *Tax Exemptions & Tax Incidence*, 2003 and Congressional Budget Office, *Effective Federal Tax Rates: 1979-2001*, April 2004, [www.cbo.gov/showdoc.cfm?index=5324&sequence=0](http://www.cbo.gov/showdoc.cfm?index=5324&sequence=0).

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