Texas Taxes: Who Bears the Burden?

By Jason Saving

ABSTRACT: Texas' reliance on sales and property taxes makes its revenue-raising methods more regressive than those in most other states. Texas lawmakers, facing increasing demands for services, confront a desire to maintain the state's attractiveness to business even as inequities continue in how the taxpaying burden is shared.

In recent years, income inequality has become an increasingly prominent issue nationally and in Texas. Statistics suggest a significant number of people face financial stress in their day-to-day lives. Texas has more inequality than the median U.S. state, a poverty rate 1.6 percentage points above the national average and the highest rate of residents lacking insurance (*Chart 1*).

When it comes to state and local taxes, Texas' burden is widely viewed as relatively low and attractive. Yet such a characterization may not hold for everyone, especially those at the lower end of the income distribution. Lawmakers balance competing interests when determining optimal tax policy.

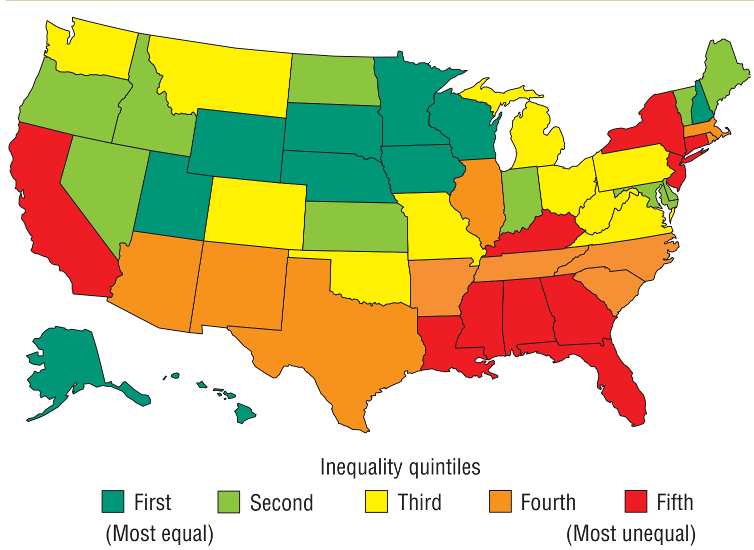
Understanding the state and local tax burden—both how large it is on average and who bears it—is necessary to evaluate the current tax structure.

Taxes Texans Pay

While Texas assesses a wide variety of taxes on its residents and businesses, the largest by far is the state sales tax, which now provides nearly 60 percent of state tax revenue (*Chart 2*). The sales tax applies to most goods and some services purchased in the state. The tax rate is relatively steep—the 12th highest in the nation—because Texas does not have an income tax.[1]

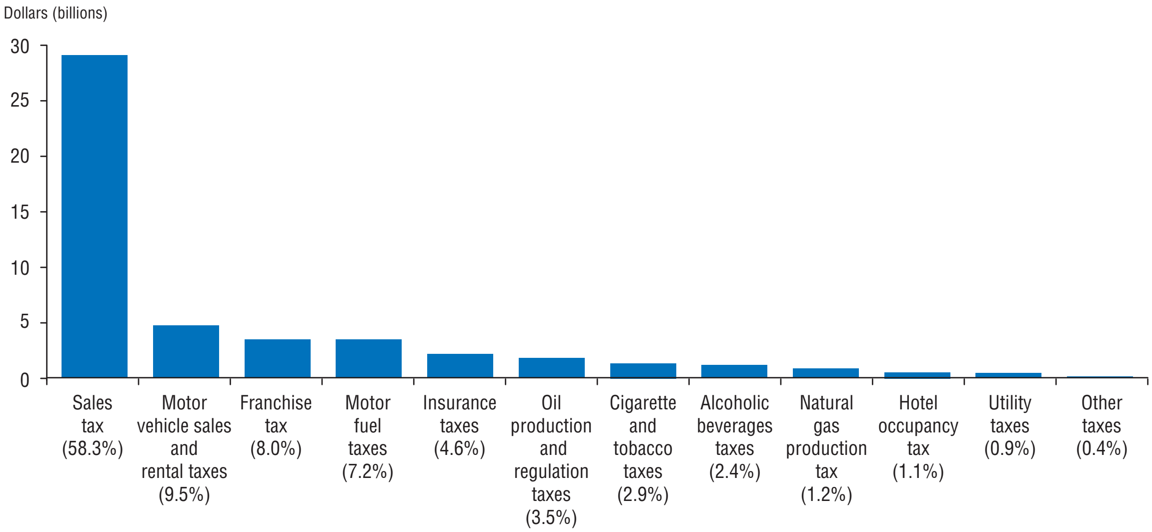
Texas also assesses a variety of other taxes that are functionally similar to the sales tax. The motor vehicle sales tax (9.5 percent) is a sales tax on cars, fuel taxes (7.2 percent) are a sales tax on gasoline, and some of the state's industry taxes are tied at least in part to how much of a particular good or service is purchased. All told, most state tax revenue comes from sales taxes in some form or fashion.[2] A key economic feature of sales taxes is that they come from what

Chart 1 Texas Income Inequality Above Median, Below Other Large States



NOTE: Map is based on calculation of the Gini coefficient, a widely used measure of inequality.
SOURCE: Census Bureau, 2016 data.

Chart 2 General Sales Tax, Smaller Sales Taxes Provide Most of Texas' Tax Revenue



NOTES: Data are taxes paid to the state for fiscal year 2016. Values in parentheses reflect shares of total tax collection.
SOURCE: Texas Comptroller of Public Accounts.

people consume rather than what they earn. Thus, sales taxes provide more of an incentive for individuals to save and provide a relatively stable income stream for state government (because an individual's consumption will typically vary less than their income in any given year).

Sales taxes are, accordingly, regarded as among the most efficient forms of revenue generation. A side effect is that people who are able to save a lot face a lower sales tax burden as a share of income. There are also issues with how best to collect the sales tax in the age of e-commerce, though efforts are underway to address these concerns.[3]

The property tax is the other significant tax Texans pay. By law, the state cannot impose or collect property tax, though local jurisdictions can and do. School district levies are perhaps the most noticeable, but cities, counties, hospital districts, community college districts, water districts, development/improvement districts, emergency-services districts and other special-purpose districts can also assess property taxes.[4]

While property taxes might seem inefficient because they exclude those who don't own property, studies suggest renters pay as well in the form of higher apartment rents. Moreover, high property taxes cannot easily be avoided because moving from one jurisdiction to another can be costly.

Property taxes are an assessment on housing capital, and research suggests wealth taxes could potentially discourage wealth accumulation—though the effects are muted when it comes to housing because of numerous offsetting tax benefits and because one cannot easily do without housing. It's also possible, as with sales taxation, that high-income people can mitigate their tax liability by doing less of what is being taxed—in this case, living in a lesser house.

About 40 percent of Texans' state and local tax burden went to property taxes in fiscal year 2014, the latest year for which data are available. While this is not quite as large as the 50 percent for sales and use taxes, it is still a large proportion of the overall tax burden. It also reflects Texas' average property tax rate of 1.9 percent, the sixth highest in the nation and almost double the 1 percent national average.[5]

If property taxes are only assessed at the local level, why are they higher in Texas than in most other states? Localities provide services that are intensively used by residents on a daily basis, such as public schools, public hospitals, roads and public parks. Texas has historically delegated more power to localities than most other states. A corollary to this is that Texas transfers a relatively small amount of state revenue to localities, requiring them to raise revenue themselves.

Assessing the Tax Burden

With high sales and property tax rates, one might expect Texas taxpayers to shoulder a high average burden. Yet this is not the message conveyed by site-selection firms and chambers of commerce, which routinely cite Texas' low tax regime as a reason for businesses to relocate to the state.

Just how low is the Texas tax burden? The annual per capita state and local tax burden of $4,067 is about 15 percent below the national average, while income is only 2 percent below the average (*Chart 3*). Relative to the nation's other two largest states, the gap is even starker: Texas stands 26 percent below California and 52 percent below New York.

While the average burden in Texas is low, not all portions of the tax bill are. The local share of Texas' per capita tax burden is slightly higher than the national average and, perhaps surprisingly, higher than the local burden in California. This in part reflects Texas' heavier reliance on local jurisdictions and public policy choices in California, such as Proposition 13, which have somewhat limited local taxes in favor of state taxes. (A similar debate played out in Texas in 2015, when the state reduced school property taxes but held school districts harmless by providing offsetting transfers from state tax revenue.)

To be sure, there is no single correct answer for what a state's tax burden should be or how much of it should be borne by localities rather than the state. If a state wishes to offer an expansive array of services of a much higher quality than in other states, a higher-than-normal tax burden may be necessary. Individuals wouldn't be incentivized to move elsewhere if they found the improved government services worthwhile.

Likewise, if a state wishes to delegate substantial responsibilities to the local level, it may be desirable for a higher share of taxes to be raised by local jurisdictions so that they can sync desired public services with needed tax rates.

However, these choices may significantly affect the distributional impact of state and local taxes. With Texas tax revenue largely comprised of sales taxes but localities relying to a substantial degree on property taxes, pushing government responsibilities toward localities would likely put greater emphasis on the property tax vis-à-vis the sales tax.

The consequences would be potentially significant if the property tax were highly regressive—that is, the poor shouldering a larger share of taxes as a percentage of their income. Similarly, shifting responsibility from localities to the state would put greater emphasis on the sales tax and thereby potentially shift who bears the greatest burden.

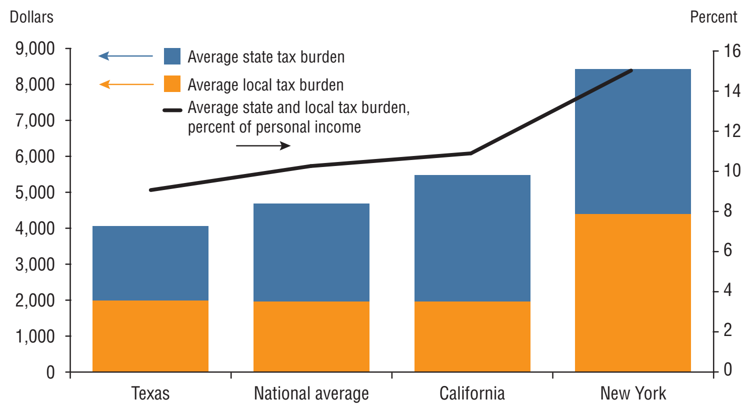
Paying the Piper

State and local taxes in the United States are on average slightly regressive. Families earning less than $19,000 per year—the lowest fifth of the income distribution—pay about 10.9 percent of their income in state and local taxes (*Chart 4*). This declines to 9.4 percent for the middle fifth of the population and to 6.7 percent for the top fifth, those earning more than $93,000 per year.

At first glance, it might seem surprising that state and local taxes have this pattern, but two factors help explain it. First, economic research suggests income redistribution is most efficiently performed at the national level because high-income individuals can more readily "vote with their feet" and leave states or (especially) localities whose tax burdens on the rich are high.

Second, state and (especially) local governments tend to provide easily visible services for which a "user fee" model may appear appropriate, in contrast to the federal government's focus on sometimes less-visible services such as national defense. Of course, these factors don't imply that state and local

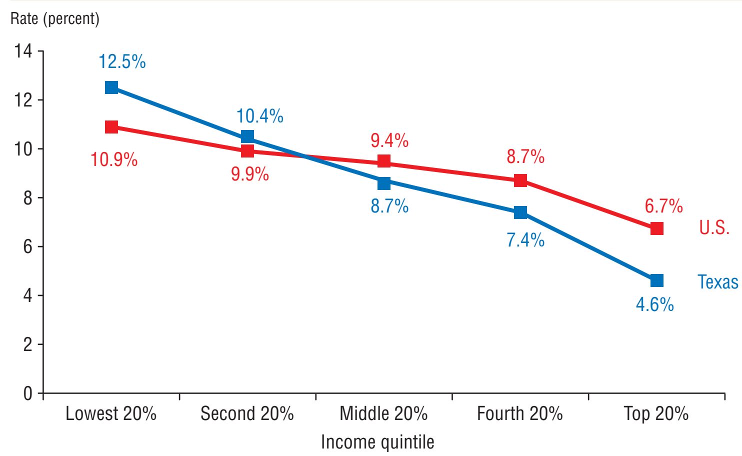
Chart 3 Texas Per Capita Tax Burden Lower than National Average



NOTES: Per capita calculations are made using averages of quarterly population and income data from fourth quarter 2013 through third quarter 2014.

SOURCES: Census Bureau; Bureau of Economic Analysis; author's calculations.

Chart 4 Texas Tax Burden More Unequal than National Average



NOTES: Each point represents state and local taxes paid as a share of household income in that quintile. Net tax rates are derived from sales and excise, property and income tax rates, after the federal deduction offset.
SOURCES: Institute on Taxation and Economic Policy; author's calculations.

taxes should be regressive—only that, other things being equal, one would expect the federal government to do more redistribution than states and localities.

How does Texas' tax progressivity compare with the national average? Texans in the lowest fifth of the income distribution pay 12.5 percent of their income in state and local taxes, which is about 2 percentage points above the national average, as seen in Chart 4.[6] This declines to 8.7 percent for the middle fifth of the population and 4.6 percent for the top fifth, which pays about 2 percentage points less than the national average.

Overall, the state's tax system is less equal across income quintiles than the national average. A key reason is the state's reliance on the sales tax, which as a share of income is 8.6 percent for those in the bottom quintile but only 2.2 percent in the top quintile (*Chart 5*). The property tax burden as a share of income is almost identical across the five quintiles, hovering around 3 percent, except for the poorest quintile at 3.8 percent.

Put another way, Texas' two main taxes work at cross-purposes as far as progressivity is concerned—cuts to one tax inevitably change how progressive the overall tax system becomes. The passage of time can do this as well, though. When property values rise rapidly, for example, one could reasonably expect the state and local tax burden in Texas to become somewhat less regressive (though perhaps larger overall) as property tax payments gradually become a larger share of individual tax burdens.

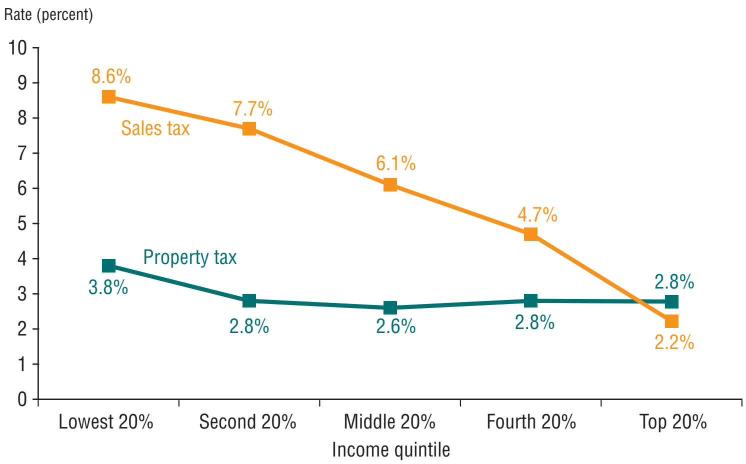
The Texas tax system is different from systems in most other states in one other respect. Sales and property taxes together account for nearly 90 percent of Texans' state and local tax burden, compared with just less than 70 percent nationally (*Chart 6*). The reason: Texas' lack of a state income tax.

While income tax rate structures vary widely across the 45 states that tax income, marginal rates commonly start at 0 percent and top out at 13.3 percent (in California). Some localities (like San Francisco) also impose local income taxes on high earners. As a result, the average state income tax collects only 0.2 percent of income from families in the poorest quintile but 3.7 percent from those in the richest quintile—making the tax vastly more progressive than average state sales and property taxes (*Chart 7*).

This helps explain why states with income taxes have more progressive tax regimes than those without. There are, however, consequences to consider. For example, economic research suggests income taxes are relatively inefficient because they contain built-in disincentives to save and invest.[7] The income tax is also a more volatile revenue source than the sales tax, creating large windfalls during times of plenty but significant shortfalls during recessions. Furthermore, there is the ever-present risk that high earners will leave relatively high-income-tax states.

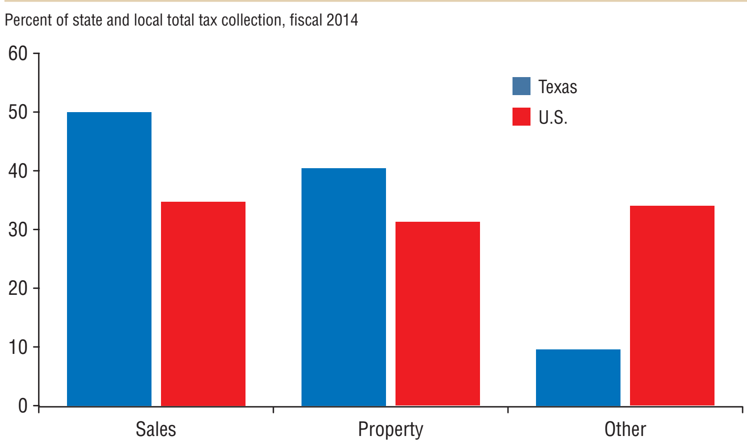
This balancing act does not happen in Texas, which outlawed income taxation in Article 8 of its constitution and has maintained the ban despite periodic attempts to reconsider it. The inevitable consequence is that the state's tax system is relatively regressive, with all the pluses and minuses that entails.

Chart 5 Distributional Impact of Sales, Property Taxes Differs Greatly in Texas



NOTE: Each point represents taxes paid as a share of household income in that quintile.
SOURCES: Institute on Taxation and Economic Policy; author's calculations.

Chart 6 Texas Relies More on Sales, Property Taxes than U.S. Overall



SOURCE: Census Bureau.

Chart 7 State Income Taxes More Progressive than Sales and Property Taxes

NOTE: Share of income paid in tax by quintile and type of tax.
SOURCES: Institute on Taxation and Economic Policy; author's calculations.

Implications and Challenges

Texas imposes a relatively low per-capita tax burden on citizens but a relatively large portion of that burden on low-earning households. In recent years, both sides of that tradeoff have been called into question.

Texas faces significant challenges from the combination of demographic changes, middle-of-the-pack school quality rankings, a state highway system that receives average grades from civil-engineering groups, and the highest percentage of people without health insurance in the nation. Lawmakers could address these issues through some combination of raising taxes, devising more efficient ways to provide state services and passing public policies to foster faster economic growth.

Dealing with these challenges may also provide an opportunity to reassess the distributional burden of Texas taxes. In doing so, conflicting values will no doubt collide in Texas just as they have in other states.

On the one hand, the state's lowest-performing schools disproportionately serve the poor, who are also more likely than other Texans to lack health insurance.[8] This suggests many of the state's challenges are borne disproportionately by the poor. On the other hand, the combination of low taxes and relatively favorable treatment of high-earning families has likely helped bring jobs and economic activity to the state. To some degree, changing the tax system to impose a heavier burden on the highest-earning quintile could discourage working and job creation and thereby risk shrinking the available economic pie.

States and the nation face a fundamental tax dilemma—the trade-off between the quintessential Texas and American values of equality and growth.

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Notes

[1] The statewide sales tax is 6.25 percent. Localities may add another 2 percentages points.

[2] For more on state revenue sources, see "Budget Balancing Act: Health and Education Stretch Texas Resources," by Jason Saving, *Southwest Economy*, Third Quarter, 2014.

[3] See "Texas Retail in the Doldrums; Brick-and-Mortar Stores Bear the Brunt," by Amy Jordan, *Southwest Economy*, Third Quarter, 2017.

[4] All told, more than 3,900 local government entities collect property taxes in Texas. Payments are based on the assessed value of property, though there are exceptions for land that is used for certain purposes (such as agriculture, which is sometimes eligible for taxation at a lower rate) or owned by certain classes of people (such as the elderly, who are sometimes eligible to freeze their payment levels).

[5] See "How High Are Property Taxes in Your State?" by Jared Walczak, Tax Foundation, Aug. 13, 2015, taxfoundation.org/how-high-are-property-taxes-your-state.

[6] Data used for these comparisons is taken from "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, Fifth Edition," Institute on Taxation and Economic Policy, January 2015.

[7] Income taxes may also discourage work.

[8] See "Texas Health Coverage Lags as Medicaid Expands in U.S.," by Jason Saving and Sarah Greer, *Southwest Economy*, Fourth Quarter, 2015.