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# UNDERSTANDING TEXAS TAXES

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**People require many goods and services that cannot be provided efficiently or profitably by the private sector. One government function 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.**

**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 make sound decisions on taxes, Texans need to know the necessary information about the state's public revenue system.**

Tax collections make up around 45 percent of the state's revenue. **Sales tax** is the most critical tax for the state government, which has made up between 40 and 50 percent of the state's revenue over the past 20 years—holding steady at around 45 percent of revenue since 2010. Income from the federal government makes up around 35 percent of Texas' revenue over the past two decades. However, the federal share has increased during recessions. About 80 percent of the state's income comes from taxes or federal income.

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.* Texas has not had an inheritance tax since 2005.

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 portion of their income at Texas businesses. On the other hand, Texas has relatively high sales and *property tax rates* than other states. High state *sales taxes* can induce people to make large purchases in nearby states, reducing Texas businesses' competitiveness.

Historical data and analysis on state government revenues and expenditures by source are available at: *agecoext.tamu.edu/programs/community-programs/rural-communities/community-data-resources/*. Data from the Office of the Texas Comptroller are the source for the AgriLife Extension data analyses. The comptroller data is available at: *comptroller.texas.gov/transparency/*.

Table 1 shows significant 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 multiplied by the *tax base* to determine the dollar amount of the *tax levy* paid to the state. [Note: Terms in italics are defined in the Glossary.]

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

A critical 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.

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| Table 1. Significant taxes Texas receives revenue from. | | | |
|---|---|---|---|
| **Type of Tax** | **Tax Rate** | **Tax Base** | **Exemptions/Notes** |
| Sales and Use | 6.25% | Retail price of tangible goods and selected services | Unprepared food, prescription drugs, purchase of farm and ranch use |
| Motor Vehicles Sales and Rentals | 6.25% | | |
| Franchise | 0.75%, except 0.375% for wholesale and retail entities<br>0.331% EZ computation rate revenue <$20 million | | No tax due threshold $1,180,000 in gross revenue as of 2020-2020 (thresholds and limits are indexed for inflation and change frequently) |
| Motor Fuels | $0.20<br>$0.20<br>$0.15 | Gasoline per gallon<br>Diesel per gallon<br>CNG and LNG per gallon | Fuel for farm, ranch, and other off-road uses |
| Cigarette and Tobacco | $1.41–$1.76<br>0.1¢–1.5¢<br>$1.22 | Per pack of cigarettes<br>Per cigar based on weight<br>Per ounce of smokeless tobacco | |
| Natural Gas | Gas: 7.5%<br>Condensate production: 4.6% | Market value<br>Market value | |
| Oil Production | 4.60% | Market Value | |
| Alcoholic Beverages | | | |
| Beer | $6.00 (~19.4¢) | 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 | 6.7% (Mixed beverage gross receipt tax; permit holder pays)<br>8.25% (Mixed beverage *sales tax*; may be passed to consumer) | Gross receipts | A portion of mixed beverage taxes collected by the state are allocated to the cities and counties. |
| Hotel/Motel | 6.00% | Price paid | |

Adapted from Comptroller of Public Accounts' Texas Taxes and Fees website (Hegar, 2021): *comptroller.texas.gov/taxes/a-to-z.php*.

| Table 2. Characteristics of major local taxes (2020). | | | | |
|---|---|---|---|---|
| **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. | The state limits increases without voter approval to 3.5% higher than the previous year's *tax levy* (8% for certain taxing units). |
| Sales and Use | Maximum of 2% 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.<br>Tax is collected by the state and remitted to local jurisdictions. | Local s*ales taxes* may not exceed a 2% total.<br>Cities: 0.25–2%.<br>Counties: 0.5-1.5%.<br>Transit authorities: 0.25–1%.<br>Special districts: 0.125–2%. |
| Hotel/Motel | Cities: 9% maximum<br>Counties: 7% maximum | Room receipts (same as state) | Cities and counties collect the tax locally. | Cities: limit varies, maximum is 9%<br>Counties: limit varies, maximum is 7%. |

Adapted from Comptroller of Public Accounts' Texas Taxes and Fees website (Hegar, 2021): *comptroller.texas.gov/taxes/a-to-z.php*, and Property Tax Basics (Hegar, 2020b).

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.

## CRITERIA FOR EVALUATING TAXES

A state or society can tax virtually anything. The ideal is to develop taxes and tax systems that serve society's broad needs fairly, efficiently, and impartially. Several attributes of taxes are widely accepted as criteria for evaluating the impacts of taxes on society and the economy (Stiglitz, 1986). These attributes are used to evaluate the significant revenue-producing taxes in Texas.

No tax is ideal in all of 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 be 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 different circumstances (*vertical equity*).

To determine whether the tax system treats people fairly, people's circumstances can be compared in two ways: The *benefits received* and 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 providing a related good or service—generally does not apply to the benefits received principle. 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. However, 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 benefits can also evaluate the *equity* of the *motor fuels tax* received principal because it is used mainly to pay for roads. The person who uses the roads more buys more gasoline, and therefore pays more tax.

Theoretically, the tax system's fairness can be evaluated by calculating the total taxes paid and total benefits received. This approach's difficulties are in identifying the beneficiaries of a given public expenditure and 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. The criteria of *horizontal* and *vertical equity* can again be used to determine if the tax has been distributed according to the ability to pay by:

- *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. If people of lower incomes pay higher percentages of their incomes in taxes than people with higher incomes, the tax is *regressive.* If people of increasingly higher incomes pay an increasingly higher percentage of their 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 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 a given tax's *equity.* 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 about 90 percent of tax revenues.

### Property Tax

**Tax Description:** Although Texas' *property tax* 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 *property tax base* is the market value of all real estate and business personal property. The market value of a 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 local taxing jurisdiction's elected governing board, 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 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 (e.g., cash in the bank, individual personal property such as vehicles, furniture, and jewelry). Although some of this property has been exempted by Texas law, the *exemptions* usually are de facto because it is too difficult and expensive to assess and collect them.

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 property and taxpayers categories. 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 timberland, land for wildlife habitat (Hegar, 2020a), 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).

In all, legal *exemptions* and special treatments in property valuation have made up about 27 percent of the total assessed value of property taxed by school districts in recent years. This share has increased over time. As specified in Article VIII, section 1-d-1 of the Texas Constitution, the productivity valuation of agricultural and forestry land accounts for about 30 percent of the *property tax* revenue reduction in local jurisdictions (Hegar, 2021).

**Economic efficiency:** The *property tax* on land, which is a commodity with a fixed supply, generally does not cause

**Table 3. Major school district property tax exemptions and special valuations in Texas.**

| State Mandated |
|---|
| ✓ Basic $25,000 residential homestead exemption. |
| ✓ $10,000 for persons 65 or older or disabled. |
| ✓ Additional homestead exemption (including school *property tax* ceiling) for persons over 65 or disabled. |
| ✓ Homestead exemption for disabled veterans (depending on disability rating). |
| ✓ "Freeport" exemption, 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.) |
| ✓ Agricultural land is taxed based on *productivity value*, rather than market value, which is contingent upon an application filed by the landowner. |
| **Local option** |
| ✓ Additional exemptions of up to 20 percent of a residence's appraised value but not less than $5,000. |
| ✓ Additional exemptions of at least $3,000 for the disabled or persons 65 or older. |

Sources: Texas Property Tax Exemptions (Hegar, 2020a) and Tax Exemptions & Tax Incidence (Hegar, 2020c). For a complete list and explanation of exemptions, refer to Hegar, 2020a.

inefficiencies in the land market. However, in 1966 and 1979, constitutional amendments were passed, allowing differential treatment of farmland. 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.

**Economic competitiveness:** On average, Texans spend more of their income on *property taxes* than other states' residents. 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. It is also relatively easy for them to know the *tax levy.*

However, *property tax* is not simple to administer. Assessing values is time-consuming and requires well-trained appraisers. Local assessments are subject to review and may be legally challenged. Also, an extensive 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, county-based central appraisal offices (Potter and Randall are a combined office) appraise property for more than 4,000 taxing jurisdictions, according to the Texas Comptroller of Public Accounts.

**Table 4. Estimated average tax burden and relative burden by household income of selected state and local taxes (Fiscal Year 2023).**

| Tax Type | Household Income by Quintile | | | | |
|---|---|---|---|---|---|
| | Less than $31,951 | $31,951–$56,449 | $56,449–$91,375 | $91,375–$156,718 | $156,718 and Higher |
| **School property (local)** | | | | | |
| Average $ paid | $2,573.90 | $3,509.70 | $5,027.20 | $6,939.30 | $13,982.20 |
| % of tax receipts | 6.3% | 8.6% | 12.3% | 17.0% | 34.2% |
| % of income | 6.9% | 3.8% | 3.2% | 2.6% | 1.9% |
| Relative burden* | 3.6 | 2.0 | 1.7 | 1.4 | 1.0 |
| **General sales and use** | | | | | |
| Average $ paid | $2,563.90 | $3,823.50 | $5,050.20 | $6,548.60 | $10,596.00 |
| % of tax receipts | 7.1% | 10.6% | 14.0% | 18.2% | 29.4% |
| % of income | 6.9% | 4.1% | 3.2% | 2.5% | 1.5% |
| Relative burden* | 4.6 | 2.7 | 2.1 | 1.7 | 1.0 |
| **Motor vehicle sales and use** | | | | | |
| Average $ paid | $354.10 | $455.20 | $732.80 | $1,203.70 | $1,778.20 |
| % of tax receipts | 7.2% | 9.3% | 14.9% | 24.5% | 36.2% |
| % of income | 1.0% | 0.5% | 0.5% | 0.5% | 0.5% |
| Relative burden* | 2.0 | 1.0 | 1.0 | 1.0 | 1.0 |
| **Franchise** | | | | | |
| Average $ paid | $168.80 | $356.00 | $513.10 | $658.60 | $1,434.10 |
| % of tax receipts | 3.4% | 7.3% | 10.5% | 13.5% | 29.3% |
| % of income | 0.5% | 0.4% | 0.3% | 0.2% | 0.2% |
| Relative burden* | 2.5 | 2.0 | 1.5 | 1.0 | 1.0 |
| **Gasoline** | | | | | |
| Average $ paid | $241.80 | $315.70 | $473.80 | $593.90 | $661.40 |
| % of tax receipts | 9.4% | 12.3% | 18.4% | 23.1% | 25.7% |
| % of income | 0.6% | 0.3% | 0.3% | 0.2% | 0.1% |
| Relative burden* | 6.0 | 3.0 | 3.0 | 2.0 | 1.0 |

Adapted from Hegar (2020c).
*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.

**Adequacy:** The *property tax* base has not kept pace with Texas' economic growth, 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 with 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 is variable and generally declining, which was once a major part of the *tax base.*
- 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 adjust the rates to provide adequate revenues.

**Equity (or fairness):** The *benefits received* principle cannot be applied if revenues are going into cities and counties' general funds. For school and other special taxing districts, the tax can be evaluated based on whether those who pay the tax receive benefits from it concerning the tax they pay. Although all citizens receive benefits from others' education—for example, a cashier who can correctly make the 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 properties. *Exemptions* and special taxation provisions may lead.
- For example: Homeowners have the homestead exemption to some inequities in the *property tax,* but renters do not. Families and businesses with similar incomes will pay a different levy, depending on their property's value. Firms with similar profits and net worth pay widely varying tax levies depending on capital investments.
- **Vertical equity:** The lowest-income homeowners pay a higher percentage of their income in *property taxes* than any other income group (Table 4). Thus, the tax is 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. Relative to income, the *property tax* is the least regressive of the Texas taxes discussed in Table 4, except for the natural gas tax. The *property tax* is more highly correlated with income and wealth than are consumer purchases.

## Sales Tax and Motor Vehicle Sales Tax

**State tax description:** 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, non-residential 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 18 or persons 65 or older are also exempt from the sales and use tax.

**Local tax description:** 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 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. Conversely, the combination of all local *sales taxes* in a given area may not exceed 2 percent.

**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 on an August weekend exempts clothing and shoes from *sales tax*, but does not exempt repair items (e.g., patches, buttons) or repair services. Thus, consumers are encouraged to buy 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 non-taxed 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 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.* Additionally, Texas has relatively low local maximum *sales tax rates* than surrounding states, reducing the overall *tax burden* relative to other locations. *Exemptions* can also induce people to cross state lines. For example: Oklahoma's *sales tax* applies to unprepared foods while the Texas *sales tax* does not. This could induce some Oklahoma residents near the Texas border to purchase groceries in Texas. However, 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 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 exempt 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. Conversely, consumers usually do not know how much they pay in *sales taxes* per year because it would be time-consuming to keep track of each transaction's tax.

Businesses do not like to function as tax collectors. As local governments set different *sales taxes*, administering them is becoming more complicated for both private business and the public sector. The state's collection and remittance of local *sales taxes* are complex because local rates vary 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 laundry instead of taking it to commercial cleaners. With a few exceptions, annual revenues have increased even in downturns, but less rapidly than during growth periods.

Some services (e.g., 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 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.

**The 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 *sales tax* income (Table 4). They also consume more of the services, including medical, dental, legal, and architectural services, which are not subject to the *sales tax. Sales taxes* have a disproportionately larger effect on the poor than on the rich because the poor spend a more significant share of their incomes on taxable goods and services. Hence, the *sales tax* is regressive with regard to income.

## Motor Fuels Tax

**Tax description:** The *motor fuels tax* is an example of an *excise tax* levied on specific products. *Excise taxes* can be calculated as a dollar amount per unit, such as gallon or ton, or 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. The motor fuel tax is used to fund road construction and maintenance. *Excise taxes* provide relatively 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 fuels' price.

**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 will not 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 or electric vehicles. 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 below the volume-weighted U.S. average of 25.68 cents per gallon (API, 2021). However, because Texas does not exact additional taxes on gas, its total *tax rate* is lower than the effective volume-weighted national average rate of 36.83 cents per gallon as of January 2021 (55.23 cents including the 18.04 cent federal excise tax). This difference is not likely to affect the competitiveness of Texas businesses and the Texas economy because other factors are more critical 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. According to the Texas Comptroller of Public Accounts, the tax is the largest source of state funding for the state highway fund, which also receives from federal funding (Lowry and Costello, 2016). In the future, increased numbers of electric vehicles may affect adequacy.

**Equity (or fairness):** *Benefits received* can be used to evaluate the *motor fuels tax* because most tax revenue is allocated to roads. In general, the amount of gas that people buy reflects their road use; therefore 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

**Tax description:** 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). These fees are used to discourage consumption of the product and generating income for the state.

**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 alcohol and tobacco products' consumption 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, therefore the tax has little effect on competitiveness.

**Administrative simplicity:** Consumers know the tax exists, but they do not know the tax amount 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 and price, consumption is relatively stable, even in an economic downturn. The *tax rate* is a fixed amount per unit, rather than a percentage of the value, so revenues do not keep up with inflation. Raising the rate requires legislative action.

**Equity (or fairness):** *Benefits received* do 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 significant cause of cancer and heart disease, society may benefit in ways not measured directly in the market.

## Franchise Tax

**Tax description:** The Texas *franchise tax* is a privilege tax on each taxable entity chartered/organized in Texas, or doing business in Texas. Taxable entities include most Texas businesses that enjoy state liability protection, such as 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 a taxable entity. Examples are sole proprietorships, general partnerships owned directly by people or their estates, certain unincorporated passive entities receiving limited amounts of an active trade or business income, and entities such as non-profit organizations and cooperatives. Also exempt are businesses with no more than $1,180,000 in total revenue for the 2020-2021 biennium, indexed for inflation, and businesses that owe less than $1,000 in tax. Firms should check the Texas Comptroller's website (Hegar, 2021) for updated tax thresholds and compensation limits.

The *franchise tax* is determined by the business' total revenue, minus *deductions.* From the total revenue, the business deducts either the cost of its goods sold or its total compensation, up to $390,000 per employee (2020-2021), indexed for inflation. If the business' *margin* is more than 70 percent of its total revenue, it is taxed only on 70 percent of its total revenue. The business will then apportion to Texas the amount of revenue from business done in the state. It will subtract any other allowable *deductions* to determine its taxable *margin.* Once the business' taxable *margin* is determined, a rate of 0.75 percent is applied to that *margin* for all taxable entities that are not statutorily defined retailers or wholesalers. For the latter, a rate of 0.375 percent is applicable (Hegar, 2021).

**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 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. Alternatively, they may use a standard *margin* of 70 percent.

**Adequacy:** *Franchise tax* revenues did not grow with the Texas economy and other state revenue sources over the past decade. In fact, franchise receipts have actually declined over the past several years. Most of Texas' 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 tax. The tax thresholds, *deduction* limits, and even rates have changed numerous times in recent years. Changing the *tax rate* or base is not a routine decision. Frequent or significant 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 how 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 the inflation-adjusted tax threshold ($1,180,000 in 2020-2021) do not pay the tax.

## SUMMARY

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 Texas taxes 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.

**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 (i.e., land) into the asset's value. 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 agricultural and forestry land's *productivity value* 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 (i.e., land). The capitalization rate is the market rate of interest plus a risk allowance. 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 "used" and "worn out." The depreciation over the asset's lifetime 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 U.S. 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.

**Economic competitiveness** is the ability of firms within a state to compete with those in other states, including the state's ability to attract new business.

**Economic efficiency** occurs if the tax system does not distort consumers' and firms' choices 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 (Sanford, 1984).

**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 price increase.

**Equity** is the principle that the tax system is 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 different circumstances, there is *vertical equity.* There are two ways to compare people's circumstances: the taxpayer's *benefits* 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 (e.g., 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 businesses 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 business' size and industry. Smaller businesses have a reduced *tax burden.*

**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 difference between gross sales and the cost of goods sold. Margin is used to determine a business' *franchise tax levy.* For tax purposes, it is the lesser of (1) 70 percent of a taxable entity's total revenue or (2) the entity's total revenue is less than the cost of goods sold or compensation.

**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 wholesaler pays the motor fuels tax. Twenty-five percent of the tax is allocated to the permanent school fund. 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 the 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. Examples include income, payroll, sales, property, and other taxes.

**Productivity value** is calculating the *tax base* for qualified farms, timber, wildlife habitat, and other special-use lands. This is the single-use value of land that arises from its ability to earn income in agricultural or timber production, ignoring other forces contributing 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 primary revenue source 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 when 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 (i.e., *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 an extensive 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 land's market value.

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

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

**Tax burden** is the amount of 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. 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 the 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 tax base's value that must be paid. The tax rate is multiplied by the tax base to obtain the tax's actual amount 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 the 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, fewer expenses, for purchased inputs for production. It is a tax on the earnings of land, labor, owned capital, and business management.

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

## FOR ADDITIONAL INFORMATION:


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The primary source of data for this publication is the Texas Comptroller of Public Accounts website (Hegar, 2021). For more information, contact the Comptroller's office at: comptroller.texas.gov/.