

# Texas Tax Conundrum

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Everyone hates Texas’ property tax. It extracts large sums from property owners annually and spirals endlessly higher with rising values. Taxpayers complain, school officials plead for more funding, and politicians scramble to reduce school property tax burdens but still generate enough funding to cover the increasing costs of public education.

Many envision imposing higher property taxes on businesses to allow reductions in residential taxes. Franchise tax reform was intended to provide relief by generating revenue from this “margin tax.” The new franchise tax was applied to a broadened tax base at a lower rate to “buy down” local school tax rates, reducing school taxes throughout Texas. However, relief was short-lived, with rising values and expanding development generating sizable increases in school taxes in 2013.

The total property tax levied between 1994 and 2015 by special districts, counties, cities, and schools is shown in the figure (p. 2). Amounts are expressed in billions of inflation-adjusted 1994 dollars. A flat line corresponds to no real increase in taxes while a rising line indicates

## The Takeaway

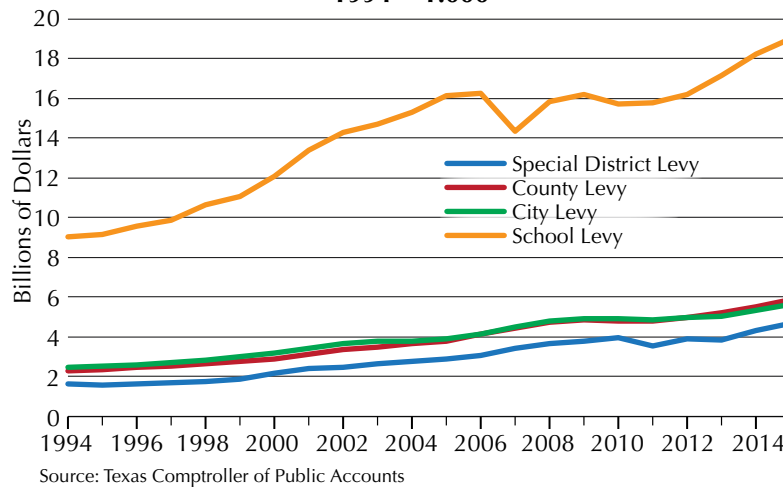
According to the nonprofit Tax Foundation, Texas property taxes and sales taxes both rank 37<sup>th</sup> among U.S. states for business tax climate. The franchise tax ranks 49<sup>th</sup>.

increasing real taxes. With the exception of the temporary reversal in 2007 following legislative school tax relief measures and a dip following valuation adjustments inspired by the Great Recession in 2010 and 2011, school taxes have expanded in real terms for the past 20 years. City, county, and special district levies generally increased during that time as well, backtracking only in 2010 and 2011.

## Higher Business Tax Eyed

Seeking to further lighten the tax burden, many see businesses as the preferred potential revenue source needed to fund education. The Texas business tax climate ranks 14<sup>th</sup> among the states according to the Tax Foundation,

**Texas Deflated Tax Levies By Taxing Unit  
1994 = 1.000**



a nonprofit, nonpartisan research institution in Washington, D.C., indicating a generally benign business tax climate. Advocates of higher business taxes perhaps view that ranking as evidence that increasing business taxes might not harm Texas’ competitive position.

However, business location decisions involve consideration of all business levies in the competing venues. To get a clearer picture of the impact of potential tax changes requires an analysis of all the different taxes levied in each state in search of an optimal climate for starting or expanding a business. The 2017 Tax Foundation study provides an extensive comparison. Digging into the details of the analysis reveals some surprising conclusions for the various taxes considered by the foundation. The analysis concentrates on corporate tax, individual income tax, sales tax, and unemployment insurance tax, as well as property tax (see table).

In the report, rankings range from 1 to 50 with 1 being the best tax climate and 50 the worst. The Texas property tax system ranks 37<sup>th</sup> nationally, meaning that only 13 states currently rank lower. In fact, the report notes that the Texas property tax score slipped from 33<sup>rd</sup> in 2016 and that drop primarily caused a slight drop in the state’s overall ranking from 2016. That suggests that shifting the property tax burden to businesses could cause both the property tax and overall rankings to deteriorate even further.

### Personal Income Tax Ranks Sixth

Proposals have targeted sales taxes as a preferred alternative revenue source for property taxes. However, the current Texas sales tax also ranks 37<sup>th</sup> among the states. The 2017 ranking did improve from 38<sup>th</sup> in 2016. All

this suggests that shifting tax liabilities to sales taxes could cause that ranking to deteriorate.

Texas fares well versus other states on personal income taxes, ranking sixth. However, Texas misses the number one ranking conferred on other states that do not have a personal income tax because the franchise tax also applies to partnerships and subchapter S corporations that are considered individuals in the study. The unemployment insurance tax ranks 12<sup>th</sup> nationally.

The foundation’s score for the Texas corporate tax ranks 49<sup>th</sup>. This ranking focuses entirely on the franchise tax and

applies despite a 21 percent reduction in the franchise tax rate in the last legislative session. Only Delaware ranks lower. Further, Texas has consistently ranked 49<sup>th</sup> on this measure since 2014, having dropped from 37<sup>th</sup> in 2011.

### Searching for Property Tax Solutions

Although it has been dubbed the margin tax, the franchise tax is regarded as a “complicated gross receipts tax” by the Tax Foundation. The economic inefficiencies associated with a gross receipts tax along with the complicated nature of the franchise tax contribute to this ranking. In its 2015 analysis, *The Texas Margin Tax: A Failed Experiment*, the Tax Foundation estimated Texas would move up seven spots in the overall state business tax climate index ranking from tenth to third in the nation if the margin tax was repealed.

The search for a solution to spiraling property taxes must weigh tradeoffs among different tax bases when substituting revenue from an alternate tax base or class of taxpayer for current property tax revenues. The Tax Foundation recognizes six principles of sound tax policy that can serve as a guide in evaluating those alternatives. The principles are simplicity, transparency, neutrality, stability, no retroactivity, and broad bases with low rates. Simplicity refers to reducing administration costs by minimizing the complexity and eliminating incentives to avoid taxation. Transparency refers to “sound legislative procedures and careful analysis” (Tax Foundation, 2012). The public should have a good understanding of how the tax system works. Neutrality means the tax system should not favor certain industries and the system should not influence economic decisions.

## 2017 State Business Tax Climate Index Rankings, and Component Tax Rankings

	Overall Rank	Corporate Tax Rank	Individual Income Tax Rank	Sales Tax Rank	Unemployment Insurance Tax Rank	Property Tax Rank
Alabama	32	14	22	48	14	16
Alaska	3	27	1	5	29	22
Arizona	21	19	19	47	13	6
Arkansas	38	40	29	44	30	24
California	48	33	50	40	16	15
Colorado	16	18	16	39	42	14
Connecticut	43	32	37	27	21	49
Delaware	19	50	34	1	3	20
Florida	4	19	1	28	2	10
Georgia	36	10	42	33	35	21
Hawaii	26	11	31	23	24	17
Idaho	20	24	23	26	46	2
Illinois	23	26	10	35	38	46
Indiana	8	23	11	10	10	4
Iowa	40	47	33	21	34	40
Kansas	22	39	18	30	11	19
Kentucky	34	28	30	13	48	36
Louisiana	41	36	27	50	9	30
Maine	30	41	25	8	44	41
Maryland	42	21	46	14	26	42
Massachusetts	27	37	13	18	49	45
Michigan	12	8	14	9	47	25
Minnesota	46	43	45	25	28	33
Mississippi	28	12	20	38	5	35
Missouri	15	5	28	24	7	7
Montana	6	13	21	3	19	9
Nebraska	25	29	24	12	8	39
Nevada	5	34	1	41	43	8
New Hampshire	7	46	9	2	41	43
New Jersey	50	42	48	45	25	50
New Mexico	35	25	35	42	17	1
New York	49	7	49	43	32	47
North Carolina	11	4	15	19	6	31
North Dakota	29	16	36	34	15	3
Ohio	45	45	47	29	4	11
Oklahoma	31	9	38	36	1	12
Oregon	10	35	32	4	33	18
Pennsylvania	24	44	17	20	45	32
Rhode Island	44	31	39	22	50	44
South Carolina	37	15	41	31	37	26
South Dakota	2	1	1	32	40	23
Tennessee	13	22	8	46	23	29
Texas	14	49	6	37	12	37
Utah	9	3	12	17	22	5
Vermont	47	38	44	16	20	48
Virginia	33	6	40	11	39	28
Washington	17	48	6	49	18	27
West Virginia	18	17	26	15	27	13
Wisconsin	39	30	43	7	36	34
Wyoming	1	1	1	6	31	38
District of Columbia	47	31	43	33	27	47

Note: A rank of 1 is best, 50 is worst. Rankings do not average to the total. States without a tax rank equally as 1. D.C.'s score and rank do not affect other states. The report shows tax systems as of July 1, 2016 (the beginning of fiscal year 2017).

Source: Tax Foundation

Stability means tax policies should not fluctuate with the whims of the political system and economic shocks. Short-term measures make long-run planning impossible. No retroactivity is similar to stability. It means that taxpayers should be able to rely on the current tax climate when negotiating transactions. Broad bases and low rates mean that tax revenue will be more stable with fewer incentives to avoid taxes with costly litigation.

Currently, both the sales tax and property tax apply to limited tax bases with relatively high rates. Because a personal income tax appears to be out of the question, the search for an adequate substitute tax base continues. ➤

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