

# Choices for Texas

Over the past several months, tax reform options have been under consideration in the Texas legislature. Two bills, one passed by each house, together containing more than 70 separate tax provisions, have emerged from that process. Now, a conference committee is meeting to consider what legislation will be presented to both houses for final consideration and transmittal to the governor.

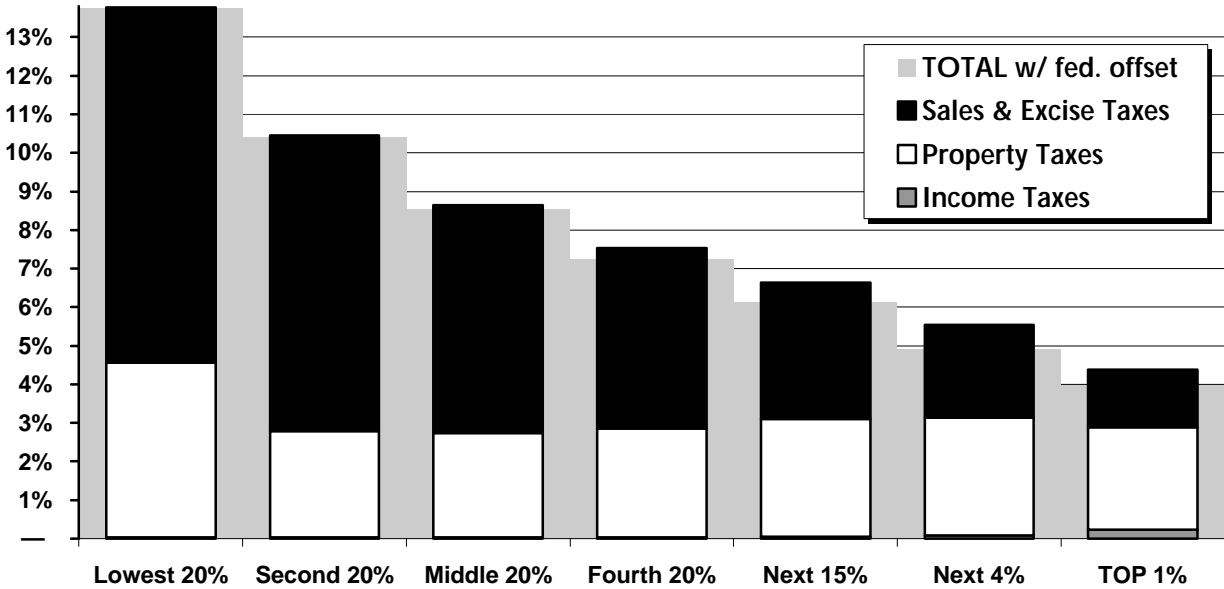
A critical issue for the conference committee to consider is the equity of the Texas tax structure. In a national study released in June 1996, Citizens for Tax Justice found Texas to have the third most regressive tax system in the country.<sup>1</sup> The study found that low-income families paid 13.8% of their income in Texas state and local taxes, middle-income families paid 8.6% and the best-off one-percent paid only 4.4%.<sup>2</sup>

A significant flaw in the two tax bills already passed is that neither addresses this important equity issue. In fact, as has been documented elsewhere, these bills leave the wealthy even better off relative to middle- and low-income families than under current law.

These bills fail in other ways as well. Both bills cost Texas governments substantial revenue—funds that could be used to address public service needs. In addition, these bills give substantial tax cuts to non-Texans and result in higher federal personal income taxes for Texans.

## Texas State & Local Taxes in 1995

Shares of family income for non-elderly married couples



<sup>1</sup>Who Pays, A Distributional Analysis of the Tax Systems in All 50 States, Citizens for Tax Justice (Ettlinger, McIntyre, O’Hare, King, Fray and Miransky), June 1996.

<sup>2</sup>The figures reported here, and shown in the chart, are for Texas non-elderly married couples.

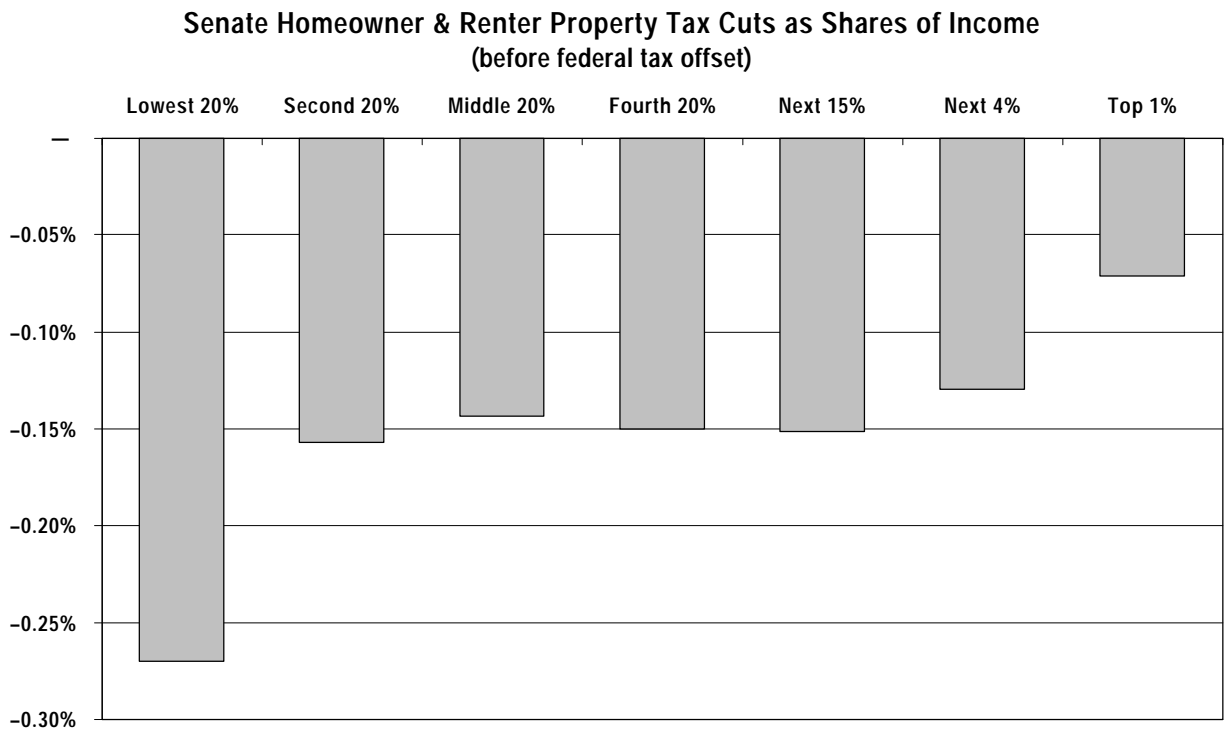
Not all of the individual provisions in the bills, however, have these failings. Some of the provisions are progressive and would be of significant benefit to Texans.

The challenge for the conference committee is to ensure that any final legislation be the best possible one for Texas. By choosing provisions that are progressive, that provide for adequate government revenues and that give tax relief primarily to Texans, the conference committee can pave the way for useful tax reform. On the other hand, if the committee chooses regressive taxes, adopts extreme cuts in revenues or sends major tax relief out of state, then the final measure could be a very bad deal for most Texas families.

## The Property Tax

Texas residential property taxes are regressive. They are, however, far from being the state's most regressive type of tax. In fact, across middle-income groups, residential property taxes take similar percentages of income. Only the lowest income group pays a significantly higher share of income than average and only the highest income group pays noticeably less.

Thus, cutting residential property taxes would be, by itself, somewhat progressive. The chart shows, for example, the Senate-passed reduction in taxes as a percentage of income for residential property taxes borne by occupants. This includes relief that renters will receive in lower rents and rebates from their landlords. Both bills require that a portion of the property tax cut received by landlords be passed through to renters for three years. Once these provisions expire, the relief for renters will probably not be as great as shown—making the property tax cuts less progressive.



The residential property tax cut is also offset by an increase in federal personal income taxes. Because property taxes are deductible on federal tax returns, when property taxes are lowered, deductions are less. This causes federal taxes to go up. We estimate that the House-passed property tax proposal would result in an offsetting federal tax increase for Texans of \$165 million a year.<sup>3</sup> The Senate bill property tax cuts would raise federal taxes on Texans by more than \$65 million a year. Thus, more than 16 percent of the property tax relief for homeowners would be offset by higher federal taxes. The table below shows the offsetting impact of this federal tax increase on the Senate property tax provision, by income level.

Residential property taxes are, however, only half of the issue. Businesses pay a substantial share of the property tax. It is generally believed that most of the business property tax is ultimately paid by owners. This is reflected in the table which shows better-off households benefitting the most from business property tax cuts.

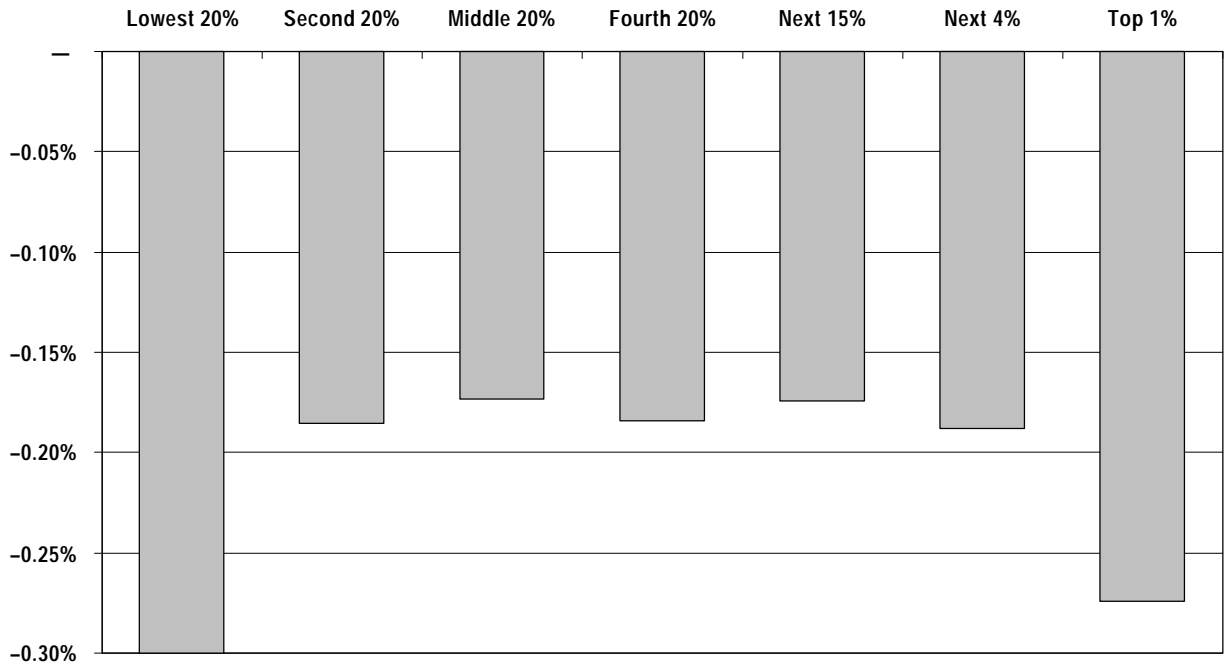
Note, however, that not all of the proposed business property tax cuts would go to Texans. A substantial portion of the tax cuts would leave the state. An analysis of the Senate bill by the Center for Public Policy Priorities demonstrates this. The Center identified several large, nationally owned, companies that would receive substantial tax breaks. H. L. & P., Southwestern Bell, Exxon, DuPont and Amoco would, for example, get \$21.5 million in combined property tax cuts. Since the shareholders of these companies reside throughout the world, most of that \$21.5 million in tax cuts would benefit non-Texans.

<b>All Senate Property Tax Cuts</b>					
<b>Effects on Texans as Shares of Income</b>					
	Homeowners & Renters (before offset)	Increased Fed. Inc. Taxes	Net Homeowners & Renters	Cuts in Business Taxes	Net Tax Change
Lowest 20%	-0.27%	+0.00%	-0.27%	-0.03%	-0.30%
Second 20%	-0.16%	+0.00%	-0.16%	-0.03%	-0.19%
Middle 20%	-0.14%	+0.00%	-0.14%	-0.03%	-0.17%
Fourth 20%	-0.15%	+0.01%	-0.14%	-0.04%	-0.18%
Top 20%					
Next 15%	-0.15%	+0.03%	-0.12%	-0.05%	-0.17%
Next 4%	-0.13%	+0.04%	-0.09%	-0.10%	-0.19%
Top 1%	-0.07%	+0.03%	-0.05%	-0.23%	-0.27%
<b>ALL</b>	<b>-0.14%</b>	<b>+0.02%</b>	<b>-0.12%</b>	<b>-0.08%</b>	<b>-0.20%</b>

Source: Institute on Taxation and Economic Policy  
Microsimulation Tax Model, May 1997.

<sup>3</sup>Unless otherwise noted, all numbers in this analysis represent the proposal fully effective (after any phase-in) but evaluated at 1997 levels—i.e., in today’s dollars at today’s income levels.

### Total Senate Property Tax Cuts on Texans as Shares of Income (before federal tax offset)



Overall, the proposed property tax cuts offer the greatest tax relief to the richest and the poorest. Low-income families benefit because they are currently paying the most, as a share of their income, in residential property taxes. High-income households benefit from the substantial business tax cut being offered in both the Senate and House bills.<sup>4</sup>

A more equitable sharing of the property tax cut could be achieved by targeting it to residential property. This could be accomplished by lowering rates only for residential property, or using a relief mechanism that only applies to residences, such as a homestead exemption. Targeting the tax cut to residential property would make the cut truly progressive. It also could reduce the revenue loss and avoid providing tax cuts to people who live outside the state. Any property tax relief for homeowners would, however, cause higher federal taxes on Texans.

## Sales and Excise Taxes

Both the House and Senate plans rely on sales and excise taxes to pay for their property tax cuts. This is, essentially, why both plans are regressive. Replacing a somewhat regressive property tax with extremely regressive sales and excise taxes guarantees a regressive outcome.

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<sup>4</sup>The Senate bill offers substantially less property tax relief overall, and a higher share of the relief offered goes to business than the House plan. The distributional pattern of the House plan is not, however, substantially different.

The table shows the distribution of the sales and excise increases under the House-passed bill. Low-income families pay more than 9 times as high a share of income as do the best-off one-percent in the state under the House sales and excise tax proposals. Middle-income families pay five times as much in higher taxes as a share of income as do the wealthy. Thus, much—indeed, for many people all—of the property tax cuts are offset by these higher sales and excise taxes.

The largest components of the sales and excise tax increase are utility taxes, tobacco taxes and insurance taxes. Each of these is quite regressive, with the heaviest burdens falling on low- and middle-income families. Even the least regressive of the three, the insurance tax hike, takes more than three times as much from middle- and low-income families as from the wealthy. The many other smaller sales and excise tax increases in the House bill are also very regressive.

Note that sales and excise taxes are not deductible on federal tax returns. Thus there is no offsetting reduction in federal taxes as these state taxes are increased.

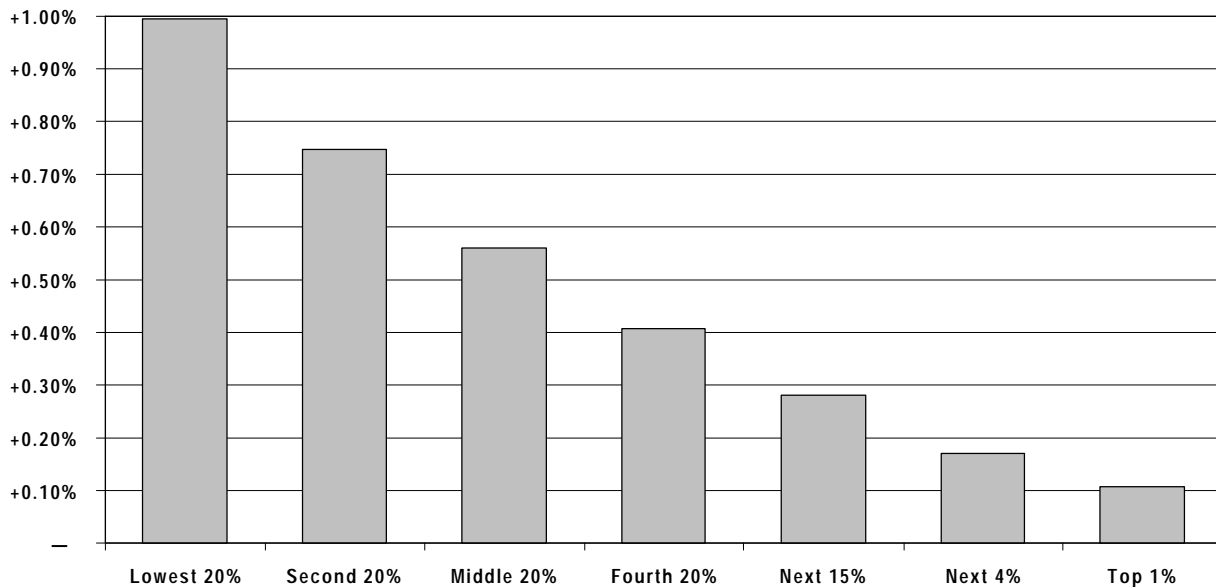
**Sales & Excise Tax Increases in the House Tax Bill  
Effects on Texans as Shares of Income**

	Utility Taxes	Tobacco Taxes	Insurance Taxes	Other Sales & Excise	Net Sales & Excise
<b>Lowest 20%</b>	+0.20%	+0.39%	+0.11%	+0.30%	<b>+1.00%</b>
<b>Second 20%</b>	+0.16%	+0.20%	+0.11%	+0.28%	<b>+0.75%</b>
<b>Middle 20%</b>	+0.12%	+0.13%	+0.09%	+0.22%	<b>+0.56%</b>
<b>Fourth 20%</b>	+0.09%	+0.08%	+0.07%	+0.17%	<b>+0.41%</b>
<b>Top 20%</b>					
Next 15%	+0.06%	+0.05%	+0.05%	+0.12%	<b>+0.28%</b>
Next 4%	+0.04%	+0.03%	+0.03%	+0.07%	<b>+0.17%</b>
Top 1%	+0.02%	+0.01%	+0.03%	+0.05%	<b>+0.11%</b>
<b>ALL</b>	<b>+0.08%</b>	<b>+0.08%</b>	<b>+0.06%</b>	<b>+0.14%</b>	<b>+0.36%</b>

Source: Institute on Taxation and Economic Policy  
Microsimulation Tax Model, May 1997.

## Franchise Tax

House Sales & Excise Tax Increases as Shares of Income for Texans



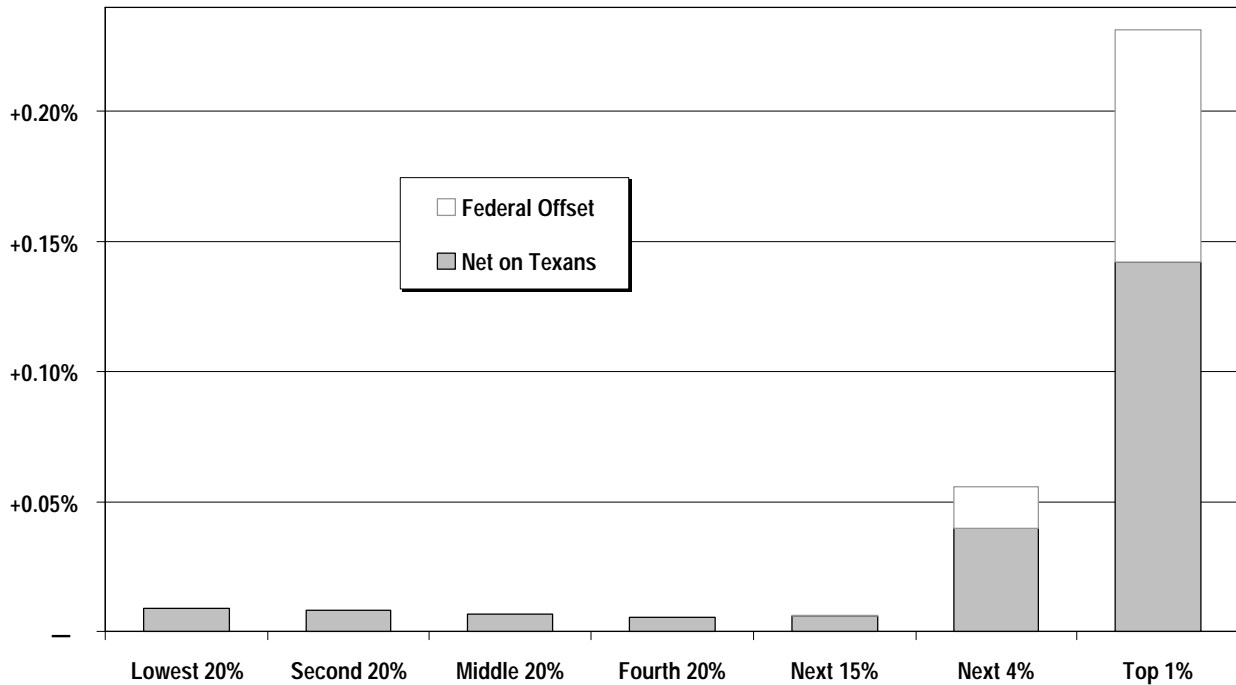
The Senate and House bills both include increases in the State's Business Franchise Tax. Most of the increase is attributable to an expansion of the tax to include partnerships.

Because owners of businesses are, in general, better off than others, the Business Franchise Tax is very progressive. Thus, an increase in the business franchise tax hits wealthier individuals much more heavily than most people.

Even those who pay this tax, however, get some relief from its burden. A substantial portion of the proposed franchise tax increases will be deductible from the federal personal income tax. Federal income taxes on Texas business owners under the House plan would be reduced by \$55 million (in 1997 dollars)—equal to about 25 percent of the new revenues from expanding the franchise tax to non-corporate businesses. Under the Senate plan, federal income taxes on Texas business owners would go down by \$33 million.

Another advantage of the Business Franchise Tax is that a substantial portion of it is borne by owners of businesses who live outside of Texas. Thus the franchise tax allows Texans to benefit from government services without having to pay for them entirely by themselves. It is also a way to require out-of-state owners of businesses to pay for the benefits that they receive from the business opportunities that Texas offers.

House Franchise Tax Increases as Shares of Income for Texans



## Texas Tax Cuts for Texans

In this analysis, we have referred several times to the benefits and burdens that the different tax provisions will give to non-Texans. We have also discussed the federal tax consequences of some of the proposed changes. These are important factors to consider in evaluating any state and local tax proposal. After all, it does Texans little good to give tax breaks to non-Texans or to increase their own federal tax liability. In these situations, Texans lose government services without benefitting in lower taxes.

In fact, these factors represent significant flaws in both the House and Senate tax plans. We estimate that of the total net revenues lost to Texas government, between 40 and 60 percent will not actually be experienced as a net tax cut for Texans. This is partly a result of substantial tax cuts for businesses. Most business today is conducted by corporations that operate in a multitude of states. When a particular state gives a business a tax break, the benefit of that flows to owners and customers throughout the country.

The fact that a substantial portion of the proposed tax cuts will either be exported to non-Texans or offset by federal tax increases on Texans would have a meaningful impact on Texas. For every dollar in decreased government spending that these bills will cause, Texans could get as little as 40 cents of tax relief. Money that could be spent to provide needed services will instead be sent out of Texas—either in higher federal taxes or to out-of-state owners and customers of businesses.

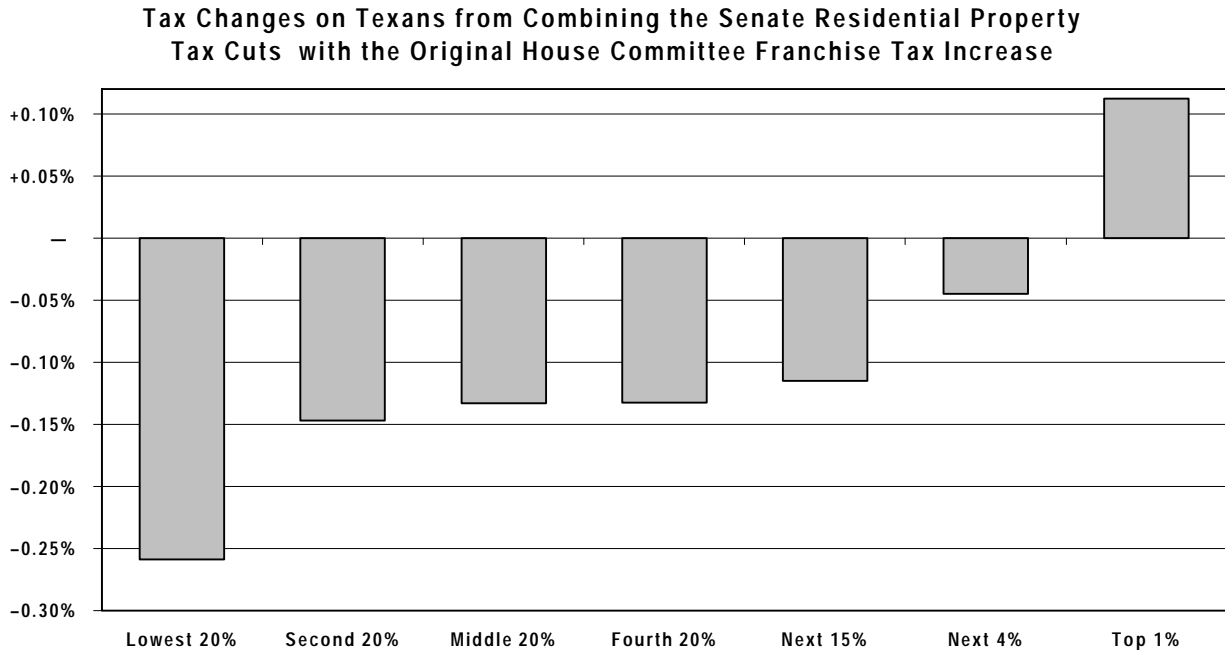
The conference committee can mitigate this by choosing to give its tax cuts in taxes that benefit Texans directly. Or the committee can simply reduce the overall tax cut so that needed government services can be provided.

## An Example of a Different Approach

Even within the limited menu of tax provisions that have been considered by the legislature thus far, there are approaches that would give tax relief to those who need it most without requiring Texans to pay more in federal taxes or giving substantial tax breaks to non-Texans. The conference committee could, for example, provide residential property tax relief and pay for it with higher franchise taxes. The committee could adopt the level of property tax relief proposed in the Senate bill, but limit it to residential property. This would cost \$520 million in Fiscal Year 1999. The broader Business Franchise Tax proposal adopted by the House select tax committee could be included. This raises \$375 million in 1999.<sup>5</sup> Thus, the net tax cut would be \$145 million—leaving substantially more for government services than either the House or Senate passed plans. Virtually all of the tax cuts would go to Texans while a significant portion of the tax increase would fall on non-Texans. Net federal taxes paid by Texans would go up only slightly, relative to the Senate and House passed bills. The distributional impact would be progressive, as shown in the following chart.

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<sup>5</sup>This includes about \$100 million that was removed from the bill when it went to the House floor—mostly from a provision changing the sourcing rules for interest and dividend income.



## Conclusion

The conference committee is in a position either to make the third most regressive tax system in the country even more regressive, or to provide relief to those Texans who need it most. So far, the bills that have passed the House and Senate would make the Texas tax system more regressive. Within these bills, however, are elements of progressive tax reform. Thus, the conference committee has before it the tools it needs to adopt a progressive tax reform plan.

The conference committee also can avoid other failings of the House and Senate plans. Specifically, raising federal income taxes on Texans should be avoided. If state and local governments are going to cut taxes in Texas, it does Texans little good if they have to remit a substantial portion of their tax cuts to Washington, D.C. Conversely, raising taxes that are deductible from the federal income tax softens the blow for Texans by reducing their federal income taxes.

Also, the tax cuts should be for Texans, not residents of other states. Cutting taxes for people who don't live in Texas makes little sense. Texans would get less from their government but fail to get a commensurate benefit from tax cuts.

Thus far, the legislative process has not produced legislation that makes the grade in these important areas. In fact, the trend has been in the opposite direction. As each bill has proceeded through its house's committee and eventually passed on the floor, the progressive Business Franchise Tax has been—perhaps not surprisingly, considering who it affects—scaled back. This has been paid for by increases in regressive consumption taxes, or will be paid for in reduced government services.

The conference committee has the opportunity to reverse this trend. If the conference committee pays attention to the issues outlined here, there is hope that the final legislation will be better in all respects than the Senate and House bills that have preceded it.

# APPENDIX

## Texas Incomes in 1997 All Families & Individuals

Income group	Income Range	Average Income	% of Total Income	
Lowest 20%	Less than \$12,200	\$ 7,200	3.4%	
Second 20%	\$12,200 to 21,800	16,900	7.9%	
Middle 20%	\$21,800 to 33,900	27,300	12.8%	
Fourth 20%	\$33,900 to 56,500	43,900	20.6%	
Top 20%	Next 15%	\$56,500 to 107,900	74,800	26.3%
	Next 4%	\$107,900 to 252,800	149,400	14.0%
	Top 1%	\$252,800 or more	658,600	15.2%
ALL		\$ 42,600	100.0%	

Source: Institute on Taxation and Economic Policy  
Microsimulation Tax Model, May 1997.

### About Citizens for Tax Justice

Citizens for Tax Justice is a non-profit, non-partisan research group that works to inform policy makers and the public about the effects of current tax laws and proposed changes thereto, at the federal state and local levels.

### About the Estimates of the Effects of the House and Senate Tax Plans

The estimates of the effects of the provisions of the House and Senate tax plans included in this report were conducted using the Institute on Taxation and Economic Policy's Microsimulation Tax Model. ITEP's tax model, which is based on a 750,000 record sample of state-by-state federal tax, Census and Consumer Expenditure Survey data, supplemented and extrapolated using many other data sources, is one of the largest and most comprehensive tax models in existence. It is frequently relied on by government officials and the media in evaluating tax proposals. All the estimates shown in this report are in 1997 dollars at 1997 income levels.