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Who Does NOT Pay Texas Taxes?

By Dick Lavine, lavine@cppp.org

A fair and adequate tax system would allow the state to invest in the building blocks of thriving communities – schools, health care, public safety, roads, and other public services. The type of tax system we need should provide enough revenue to maintain these public services and also divide up the responsibility for funding these services according to a household's ability to pay. Unfortunately, our tax system gives the wealthiest Texans and corporations a pass in contributing to state needs.

The Comptroller estimates that Texas state taxes will generate $122 billion to support public services in the 2020-21 budget cycle. School property taxes could raise another estimated $75 billion at the local level for public education during this period. But despite these large sums, Texas continues to rank near the bottom in investing in a prosperous future for its residents. The state's low ranking in state taxes per resident (48th in 2017) leads to fewer resources to invest in public schools, health care and other services.

In the search for new sources of state revenue to fund the much-needed remodeling of our school finance system, many observers have looked to the many exemptions and other tax breaks that reduce our state's ability to maintain public services. Texas will leave an additional $125 billion on the table in 2020-21 – $93 billion in state-tax exemptions and $32 billion in school property-tax exemptions. These exemptions are detailed in the Comptroller's newest Tax Exemptions and Tax Incidence report.

But before seizing on this enticingly large sum of exemptions, we need to carefully consider which reflect outmoded or wasteful exemptions that lawmakers should eliminate and which serve reasonable policy goals. Finding new revenue simply by repealing exemptions is not as simple as it looks.

Some Sales Tax Exemptions Make Sense

More than $34 billion in listed sales-tax exemptions are actually items taxed under a different law, such as motor vehicle sales, gasoline/diesel, and insurance premiums. In other words, businesses and people in Texas don't pay sales tax on these items because they are already paying taxes some other way.

Texas will lose another $24 billion in the 2020-21 budget cycle to exemptions that have strong theoretical and practical support. For instance, exempting raw materials used in manufacturing will reduce sales tax revenue by $20 billion. Not taxing manufacturing machinery and packaging supplies is responsible for another $1.8 billion in forgone revenue. But it is a well-accepted economic principle that we should not tax manufacturing inputs since the final product would be taxed again at final sale, leading to double taxation. For example, we pay motor vehicle taxes when we buy a truck, but automakers don't have to pay taxes when they buy each individual component that goes into that truck.

It would be unfair to tax the essentials of life, such as food, medicine, and residential utilities. For budget purposes, however, it's important to note that exempting groceries will reduce state revenue by $6.7 billion over the next two years, while the exemption for prescription medicine and over-the-counter drugs will cost the state $1.6 billion in lost revenue. The law also exempts residential gas and electricity for a biennial cost of $1.7 billion.

Some Tax Exemptions Don't Make Sense

Many sales tax exemptions favor robust industries that could be contributing more to supporting public services. Lawmakers should examine these exemptions to determine if they are cost-effective or whether we could use the revenue lost to them more productively to improve our public schools.

Examples of tax breaks for the technology industry include a franchise (or margins) tax credit for research and development activities ($210 million per year). The tech sector also benefits from exemptions for property used in research and development ($327 million), property used in cable television, information and data processing services ($182 million), internet access or telecommunications services ($100 million), and data centers ($32 million).

Repealing these few exemptions alone would not provide the funds necessary to remodel our school finance system, but they indicate the need for a more thorough review of all tax exemptions. Just as state agencies must face a periodic "sunset review" during which lawmakers examine the agencies for waste, duplication, and inefficiency, lawmakers should regularly review the tax code to eliminate wasteful or inefficient exemptions. Exemptions that might have made sense at the time they were adopted may have outlived their rationale or may not have accomplished their purpose.

Sales Taxes Exclude Too Many Services

When Texas adopted the sales tax in 1961, the state had a mid-century manufacturing economy, so the sales tax applied only to the sale of goods and not consumer services like cable TV or computer programs. Now, of course, we live in a 21st Century service economy, but many services are still not subject to the sales tax. These "service exclusions" will reduce state revenue by $17.3 billion in 2020-21.

By far the largest group of these excluded services are business and professional services, accounting for almost half of lost revenue. When Texans hire a lawyer or an accountant, there is no sales tax on the cost of that service. The sales tax would better track economic growth and grow along with the state population if it were to encompass fast-growing business and professional services, such as legal, architectural, accounting and brokerage services. Including such services (except health-care-related) could bring in $8.4 billion in the next budget period.

Sales Tax Collection Discounts are Outdated

Retailers get to keep a certain percentage of the sales taxes they collect to reimburse them for the expense of collecting those sales taxes. However, with modern technology, the additional expense has diminished, while the tax break has remained. Merely for reporting and remitting their collections, as required, retailers hold on to 0.5 percent of the taxes. In addition, if they pre-pay these taxes, they retain another 1.25 percent. These two outmoded breaks will reduce the amount available to fund public services in 2020-21 by $668 million.

A Mixed Bag on School Property Tax – Exemptions

School property tax exemptions reduce the amount received by school districts statewide by nearly one-third. Eliminating some of these exemptions could increase funding for public education. But, like repealing sales tax exemptions, increasing school revenue by eliminating property tax exemptions is not as easy as it looks.

Exemptions for residential homesteads will total $10 billion in 2020-21. These include the state-required $25,000 homestead exemption ($3.7 billion), the over-age-65 or disability-related school tax ceiling ($2.7 billion), and the 10 percent cap on the annual increase in appraised value ($685 million).

Reform the Local Option Homestead Exemption

However, one homestead exemption stands out as long past its sell-by date – the local-option percentage exemption. This allows school districts to exempt up to 20 percent of a home's value, in addition to the statewide mandatory flat-dollar exemption.

The Legislature created this option in 1981, when comprehensive property tax reform for the first time required appraisal of all homes at their full market value. The exemption was intended to cushion the "sticker shock" resulting from the rapid increase in appraisals in some communities. Thirty-eight years later, the rationale for the exemption is no longer applicable because of the 10 percent cap on appraisal values. The local option homestead exemption is now offered by fewer than 200 school districts.

A percentage exemption gives the largest dollar amount of tax break to the highest value homes. A 20 percent exemption reduces the taxable value of a $500,000 home by $100,000, but the same percentage exemption reduces the taxable value of a $250,000 home by only $50,000. The Comptroller calculates that more than half of the benefit of this exemption therefore goes to the one-fifth of Texas households with annual incomes over $150,000, who tend to own the most expensive houses.

The state currently replaces half of the property tax revenue foregone by districts granting the exemption, but only for Chapter 41 (property-wealthy) districts (this is currently under litigation). This is blatantly unfair to the majority of homeowners in Texas, not to mention non-homeowners. To make matters worse from a regressive tax standpoint, the exemption is expected to cost the state almost $1.7 billion in 2020-21.

Chapter 313 Corporate Tax Exemption Should Expire

Another large cost to the state comes from school property tax breaks given under Chapter 313 of the tax code. In the name of attracting employers to a region, school districts can sign agreements with companies to exempt all but a specified amount of property taxes for 10 years. If these projects, most of which would have located in Texas even without a tax break, were taxed on their real market value, school districts would bring in another $1.6 billion in 2020-21. This special treatment is one of the fastest growing exemptions, expected to reduce school revenue by more than $2 billion by 2022-23. Thankfully, Chapter 313 is due to expire in 2021, and lawmakers should not extend it.

Stop the Abuse of the Ag Exemption

The most costly loss of school property taxes comes from the special appraisal of agricultural and timber land (the "ag exemption"), which allows appraisal of farms according to the land's capacity to produce farm products rather than its real market value, as required of most other property. This special treatment, which is often abused, will cut school property tax collections by $8.4 billion in 2020-21.

If the state is serious about finding new revenue streams to support schools and other services important to Texans, the Legislature should seriously look at closing some of these loopholes. It would not only help close the gaps on education spending and improve outcomes but also reduce the impact of our state's upside-down tax structure.

Click here for a searchable and sortable Excel spreadsheet containing all major exemptions from the Comptroller's Tax Exemptions and Tax Incidence report.

For more on who **does** pay Texas taxes, click here.

For more information or to request an interview, please contact Oliver Bernstein at bernstein@cppp.org or 512.823.2875.