Distortions Under the Texas Margins Tax

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A 2005 Texas Supreme Court ruling curtailed the use of property tax to finance public schools. The state responded by replacing its longstanding franchise tax with a gross margins tax. The tax has deceptively low statutory rates of 0.5 to 1 percent. The rate is deceptive because it applies not to income, but to gross receipts less a partial deduction for expenses. Thus, a substantial share of gross receipts are tax multiple times, resulting in pyramiding tax rates -- where effective tax rates move up the pyramid as one approaches the latter stages of the production process. Gross receipt taxes are almost universally derided by tax experts, chiefly because the taxes distort the production process without regard to taxing capacity.

The Texas margins tax is better than a pure gross receipts tax in some respects, but worse in others. The fact that some allowances are made for business expenses reduces the degree of tax cascading. However, the generosity of these allowances varies greatly across industries (partly due to statute and partly due to the inherent nature of the activities) and the statutory rate for the service sector is generally twice that for retail and wholesale. For example, Viard (2014), in a simplified model of the Texas tax, shows that effective tax rates on labor could differ by a factor of 4 under a pure gross receipts tax, and by even more under some of the alternative partial deduction options. In many respects, allowed deductions actually exacerbate distortions in the production process beyond that of a pure gross receipts tax.

In this paper, we use data from various sources to quantify the the price distortions from the Texas margins tax. This includes measures for the tax burdens (as a share of income) on both capital and labor by industry, as well as comparison of effective tax rates at various stages of the production process. These results are then compared to alternative taxes, such as a VAT and a business income tax. We also use the differential implicit taxation on labor incomes in downstream relative to upstream industries to estimate potential incidence of the margins tax on wages.