



# Texas Tax Policy Responses to the COVID-19 Pandemic

by Benjamin Priday, PhD

*Economist*

## Key Points

- Taxation exists on three planes: what you earn, what you own, and what you buy. Corporate taxation is often treated differently within each of these categories.
- Taxes are necessary to fund government activity, but they can distort economic behavior.
- Raising taxes in a recession is especially problematic because households already have less income, business revenues are lower, and employment opportunities are restricted.

## Introduction

The COVID-19 pandemic and mandatory shutdown of nonessential businesses by most state and local governments led to a sudden, dramatic contraction in the U.S. economy. Between February and April 2020, the U.S. unemployment rate jumped from a 50-year low of 3.5% to 14.7%—the highest since the Great Depression ([FRED, n.d.](#)). The economy has started to recover as states cautiously lift restrictions but still has a long way to go to return to the health it had in February.

The sudden economic halt placed a massive strain not only on families' budgets but also on local, state, and federal budgets. Surges in unemployment claims overwhelmed state systems ([Hsu & Bernard, 2020](#)) and dramatically increased federal government spending ([Committee for a Responsible Federal Budget \[CRFB\], n.d.](#)). The Coronavirus Aid, Relief, and Economic Security (CARES) Act, passed by Congress in March, had an unprecedented price tag of \$2.2 trillion for the budget authority ([CRFB, 2020a](#)). The federal deficit was \$3.1 trillion in fiscal year 2020 ([U.S. Department of the Treasury, 2020](#)), at which point the U.S. national debt held by the public exceeded gross domestic product (GDP) ([CRFB, 2020b](#)). In Texas, a \$4.6 billion budget shortfall is expected at the end of the state's current 2020-21 biennium ([Hegar, 2020](#)).

Government activities—like funding unemployment and so-called stimulus checks—are funded by levying taxes. As former United States Supreme Court Justice Oliver Wendell Holmes said, “Taxes are what we pay for civilized society” ([Compania General de Tabacos v. Collector, 1927](#)). Taxation is not without consequences, though. Each dollar removed from use in the private sector by taxing authorities has some distortionary effect on the economy. There is always a tradeoff between increasing government tax receipts to meet budgetary demands and minimizing negative distortions on economic behavior, which is why it is important for appropriators to carefully determine how much to appropriate. This relationship is dynamic and context-dependent; good tax policy in times of economic growth is not necessarily the same as good tax policy during a recession. Taxable entities—individuals and businesses—may be more sensitive to increases in taxes during recessionary periods. This means, for example, that if raising corporate tax rates in an economic expansion disincentivizes capital investment, the negative effect will be even stronger in an economic recession.

In this brief, I describe broadly the types of taxes levied by governments. I also summarize existing research on the effect of different taxes on economic recovery in a recession, with a special focus on application to the state of Texas.

## Types of Taxes

Taxes can be broadly categorized into three groups: taxes on what you earn, what you own, and what you buy. Corporate and noncorporate businesses typically receive a different tax treatment in each of these categories than individuals, so I consider them separately.<sup>1</sup>

### *Taxes on What You Earn*

The first group includes taxes on what you earn, which can be generally described as “income.” The various types of income are taxed differently. For example, long-term capital gains taxes are paid on returns from the sale of certain assets (e.g., stocks). These sources of income are taxed at a lower rate than wage or salary earnings. Wage and salary income are subject to both payroll and income taxes, the former of which is usually remitted by employers on behalf of their employee and is calculated irrespective of marital status, age, or any other taxes paid. Income taxes, however, are much more complex and account for all these characteristics as well as business expenses, education expenses, the number of dependents, and more.

There is a federal income tax in the U.S., as in almost every other developed country in the Organization for Economic Co-operation and Development ([OECD, 2020](#)). Our federal income tax is progressive, meaning that the marginal tax rate increases as you move up tax brackets ([IRS, 2019](#)). Texas is one of seven states in the U.S. that does not have a state individual income tax ([Cammenga, 2020c](#)).<sup>2</sup> In 2019, Texans voted to approve Proposition 4, which amended the Texas Constitution to ban a state income tax ([Ballotpedia, n.d.](#)). This makes it even less likely that Texas will institute a tax on individual earnings soon.

### *Taxes on What You Own*

Taxes on what you own can be broadly grouped into real estate property (land and land improvements), personal property (movable objects), and intangible property. Examples of intangible assets include patents, copyrights, and trade secrets. Some intangible assets are quantified for tax purposes while others are not.

In the U.S., property taxes are levied by state and local governments, special districts, and school districts. While each state has separate laws governing if and how property taxes are calculated, they generally take the same pattern: Property values are independently assessed, and taxing authorities (government or district) determine a rate to tax that value. Importantly, this tax is not levied once—as with income or consumption taxes—but every year for the

duration of ownership and is independent of the taxpayer’s liquid assets with which to pay that tax. I return to this “ability to pay” problem below.

Unlike some other states, the Texas state government is prohibited by its constitution, [Article VIII §1-e](#), from levying property taxes. Instead, that authority is divested to (currently) over 4,200 overlapping, local tax jurisdictions ([Texas Comptroller of Public Accounts, n.d.-d](#)). The largest component of property tax bills in Texas is school districts’ tax levy, accounting for 54% of all property taxes levied in 2017 ([Texas Comptroller of Public Accounts, 2018a](#)). In fiscal year 2017, property taxes accounted for 50.6% of Texas’s total state and local tax collections, the fourth largest proportion out of all U.S. states.

### *Taxes on What You Buy*

Taxes on what you purchase are broadly called consumption taxes, although the person consuming a good is not necessarily the person paying the tax. For example, when I buy flowers for my mother, I pay the sales tax, but she gets to enjoy them. Consumption taxes can take the form of sales taxes, excise taxes, tariffs, and more.

Sales taxes are familiar to anyone who has purchased something in the U.S. They are levied by state and local governments, usually concurrently, on the sale of goods and services. Alaska, Delaware, Montana, New Hampshire, and Oregon are the only states that do not collect a statewide sales tax. The combined state and average local sales tax rate in Texas was 8.19% as of January 1, 2020, ranking the 13th highest in the country ([Cammenga, 2020a](#)). There is also cross-state variation in the sales tax *base*—what is subject to the tax. For example, the [Texas Tax Code Section 151.314](#) exempts unprepared groceries from sales taxes, as do 31 other states and Washington, D.C. ([Loughead, 2018](#)). This means that Texas exempts from the sales tax base a fresh chicken to cook but not a rotisserie chicken.

Excise taxes are used to target specific goods or services and are added on top of existing sales taxes. The goal with excise taxes is not only to raise tax receipts but also—and possibly even more importantly—to affect specific consumer behavior. For example, a gas tax may be implemented to decrease driving time and ease traffic congestion while funding transportation infrastructure. “Sin” taxes are excise taxes that target behaviors that might have a negative effect (or externality) on the consumer or others. Examples of this include taxes on tobacco, alcohol, and soda.

1 Individuals pay taxes when they purchase something alone or file tax returns as single or the head of household. While the distinction between individuals and households is important, I use the two terms interchangeably here for generality.

2 Alaska, Florida, Nevada, South Dakota, Washington, and Wyoming have no individual income taxes. New Hampshire and Tennessee tax dividend and interest income but not wages or salaries, though Tennessee will fully repeal all income taxes by 2021 ([TN Department of Revenue, 2017](#)).

### ***Taxes on Corporate and Noncorporate Businesses***

Businesses, both corporate and noncorporate, are also subject to taxes on what they earn, own, and purchase. However, they are subject to different tax rules. For example, at the federal level, businesses are taxed on their profits (income less expenses) instead of income and at a flat rate (21% in 2020) instead of a progressively graduated rate, like individuals. Tax treatment also varies across business types: Sole proprietorships may have different rules than C-corporations, depending on the tax. For example, both sole proprietorships and C-corporations pay state and local sales taxes on purchases, but they pay income taxes differently—sole proprietorship owners can “pass through” income to be taxed individually, while C-corporations pay corporate income tax rates. It is outside the scope of this paper to enumerate all the ways business taxation deviates from individual taxation. Instead, I highlight a few important ways in which business taxes differ.

As of 2020, 44 states and the District of Columbia also impose corporate income taxes ([Cammenga, 2020b](#)). In addition to federal and state taxes on income, some states require businesses to pay a “franchise tax” for the “privilege” of doing business in the state ([Kagan, 2020](#)). This is expressed differently across states. While businesses do not technically pay a state income tax in Texas, many are required to submit a franchise tax that functions similarly to a gross receipts (or “margin”) tax that resembles an income tax. This is a tax on an “entity’s margin” ([Texas Comptroller of Public Accounts, n.d.-b](#)). The taxable margin is calculated in four ways, and one of two tax rates, depending on the type of business, is levied on the smallest of these four calculations. Smaller firms are eligible to file with an “EZ computation,” but the calculations for most filers are difficult and costly to adhere to.<sup>3</sup>

Additionally, businesses pay into unemployment benefits systems through federal and state taxes ([Employment and Training Administration, n.d.](#)). The federal tax rate is 6% of the first \$7,000 paid in wages to each employee in a calendar year. Up to 5.4% can be credited back if businesses pay state unemployment taxes, meaning the federal tax could be as low as \$42 per employee per year.<sup>4</sup> State unemployment taxes vary. In Texas, the rate is between 0.31% and 6.31% on the first \$9,000 of each employee’s wages ([Texas Workforce Commission, n.d.](#)) in 2020, very similar to most other states. Businesses also pay half of the federal payroll tax (7.65%) on employees’ income; as mentioned above, the other half is levied on the employee. However, the

consensus among tax researchers is that most of the business-side payroll tax is passed on to employees in the form of lower wages ([Tax Policy Center, n.d.](#)).

### **Taxation in a Recession**

Good tax policy introduces the least amount of disruption in civil activity (e.g., market interactions) while balancing a government’s budget with sufficient tax receipts. There is a tension between these two constraints: Raising taxes is likely to distort economic behavior while increasing tax receipts. Similarly, recessions are times with decreased tax receipts but often increased government expenditures, likely leaving a budget deficit in the absence of other changes.

Economic contractions are characterized by periods of raised unemployment, lower gross productivity, and reduced personal income that depresses consumer demand. Fiscal policy, and specifically tax policy, should be tailored to these conditions: What is appropriate in times of economic expansion may not be appropriate in recessions. In general, raising taxes is a costly endeavor—even more so in a recession because it distorts behavior at a time when the economy is weak, delaying recovery and leading to even greater economic stress ([Alesina & Ardagna, 2010](#)). Paulson Gjerde et al. (2019) show that states that raised sales, income (corporate and personal), and property taxes sped up their states’ entry into the Great Recession. However, some taxes are worse than others.

### ***Personal Income Taxes***

Personal income is characteristically volatile in recessions, especially for low- and middle-income households, as workers become temporarily or “permanently” unemployed. Households that experience an income shock may change their budget composition by decreasing savings to maintain consumption levels, especially for essential goods like groceries. Government payments—such as unemployment benefits and stimulus checks—are intended to insulate households from extreme shocks and smooth consumption over time, which then allows households to maintain (or increase) savings. If a recession continues, households may increase savings rates even more as a precautionary measure ([Mody et al., 2012](#)).

Income volatility means personal income tax revenues will fall during recessions ([Walczak, 2020a](#)). Incomes from wages, salaries, and investments decrease, and government transfers that temporarily prop up some households are not all taxable.<sup>5</sup> Raising income taxes during a recession would generate less revenue than anticipated because

<sup>3</sup> In 2016, the revenue limit for businesses to use the EZ computation was raised from \$10 million to \$20 million. As a result, in 2017, approximately 20% of filing businesses used the EZ method ([Texas Taxpayers and Research Association, 2017](#)).

<sup>4</sup> A full credit would imply a federal tax rate of 0.6% (6.0% - 5.4%) on the first \$7,000 of wages paid, which is \$42.

<sup>5</sup> Unemployment benefits are included in taxable income, but other social assistance programs including Supplemental Security Income (SSI), Temporary Assistance for Needy Families (TANF), and Supplemental Nutrition Assistance Program (SNAP, formerly called food stamps) are not.



taxable incomes are already lower for households across the income distribution ([Hodge, 2012](#)), though there is some evidence that the progressivity of the federal income tax could act as an economic stabilizer ([Auerbach & Feenberg, 2000](#)). Higher income taxes would also take an even larger cut from households' budgets when they are already constrained, which could translate to even more social program spending on low- and middle-income households. Raising income taxes also raises the cost of seeking wages or salaries as sources of income relative to government assistance programs that are not taxable, decreasing incentives to work.

### **Corporate Income Taxes**

Corporate income tax revenues are similarly volatile in recessionary periods. Taxes are typically levied on businesses' profits, which can fall below zero if losses exceed income in a year. This is even more likely to happen during economic contractions when economic activity slows. For example, corporate tax revenues in 2009 were less than 80% of 2008 revenues ([Walczak, 2020a](#)). Ljungqvist and Smolyansky ([2014](#)) show that raising corporate tax rates reduces employment and wage income significantly and that corporate tax cuts increase economic activity in recessions.

While Texas does not have a corporate income tax, businesses must submit the above-mentioned franchise tax. This could be a tempting source of increased tax revenue for the state government. In 2019, 5.1% of the state's general revenue-related funds and 3.3% of all funds came from the franchise tax. As of October 2020, the Texas Comptroller noted that fiscal-year-to-date sales tax revenues were down 4.8% year-over-year, and total tax collections were down 8.3%, potentially leaving an appetite for legislators and taxing authorities to find ways to boost tax receipts ([Texas Comptroller of Public Accounts, n.d.-c](#)). However, raising the franchise tax rates would likely be a net harm to the Texas economy.

In recessionary periods, businesses' revenues go down because there is less economic activity and lower disposable personal income for households to spend. In calculating their taxable "margin," Texas businesses deduct the largest of four amounts—\$1 million, cost of compensation, cost of goods sold, or 70% of revenue—from their total revenue. Shrinking revenues means the taxable margins are significantly smaller, so tax receipts will decrease. The franchise tax consistently accounts for around 6% of all state tax receipts, so raising rates during the recession will not significantly impact total tax receipts unless the rate increase is large. This, however, would raise the cost of doing business in Texas when businesses are already struggling, and it would reduce their available capital to expand. Conversely, Ginn and Dang ([2017](#)) highlight different studies that find

that repealing the margins tax would help support substantially more economic activity resulting in increased employment, more investment, and higher household incomes.

### **Unemployment Taxes**

The unemployment rate in Texas was 8.3% as of September 2020 ([Texas Workforce Commission, 2020](#)), compared to a low of 3.5% in February 2020 and a high of 13.5% in April 2020 ([Ginn, 2020](#)). The CARES Act passed by Congress in March extended eligibility for unemployment insurance (UI) beyond the standard 26 weeks. The government lockdowns and other health-related restrictions have continued to restrict economic activity, causing persistently high demand for unemployment compensation. Texas's unemployment insurance compensation trust fund was depleted by June ([Walczak, 2020b](#)) and is now depending on federal loans. As of October 30, 2020, the state had an outstanding loan balance of over \$5.2 billion with the federal government used to fund its unemployment insurance program ([U.S. Department of Labor, n.d.](#)).

The trust fund is funded by unemployment taxes paid by employers. It is a relatively small amount compared to other taxes: The maximum per-employee payment is about \$570 per year. However, this is a tax on employing someone, meaning it raises the cost of hiring additional employees or retaining existing employees. Though the unemployment tax rate is currently small in magnitude, raising the rate would make it comparatively more expensive to hire and retain workers, which could result in slower job growth, re-employment, and economic recovery.

### **Property Taxes**

Property taxes are a relatively stable source of income for government entities. In Texas, the total property tax levy has grown almost every year for two decades, with almost a 6% average annual increase ([Texas Comptroller of Public Accounts, 2018a](#)). Between 2008 and 2011, during the Great Recession and the decline in some housing values across Texas, the tax levy growth as measured across the state was essentially flat. Property taxes are comparatively less affected by economic recessions for two reasons: The amount of taxable property is mostly constant over time, and tax rates are endogenous. The latter means that local officials can dictate, within certain constraints, how much property tax revenue they collect.

Due to taxpayer concerns over rapidly rising property taxes, this ability was restricted following the passage of Senate Bill 2 (SB 2) by the 2019 Texas Legislature. SB 2 implemented a "vote trigger" for property tax growth—if a city, county, or special purpose district with a population of 30,000 or more wants to increase property tax revenues on

existing property by more than 3.5% from the prior year, there must be a majority vote by the public.

Property taxes are distinct from other types of taxes in Texas that vary more with individual or business behavior. They are also unavoidable regardless of whether you own or rent. Not only do property owners pay taxes, but renters pay at least a portion of the taxes in the form of higher rental prices. Put together, this highlights an important problem with property taxes—they are detached from an ability to pay.

Property ownership and property value are not necessarily attached to income levels.<sup>6</sup> This means that a person's property value (and therefore property tax burden) may grow over time while their income grows at a slower rate, stays constant, or decreases. As a result, people can be priced out of the home they own because they cannot afford to pay the persistently rising property taxes. Naturally, this is exacerbated during an economic contraction when incomes are temporarily low.

Property taxes are regressive, meaning low-income households pay a larger proportion of their budget on the tax than households at higher income levels. The Texas Comptroller estimated that in 2018 households making less than \$37,630 paid 6.4% of their income in school property taxes alone, compared to just 1.9% by households making over \$150,000 ([Texas Comptroller of Public Accounts, 2018b, p.67](#)). Low-income households are also more likely to rent instead of own their home, but renters are not insulated from property taxes. The same report estimates that renters paid about 20.5% of the total school property tax.

Raising property taxes during a recession places a significant financial burden on already constrained property owners, especially low-wage workers who are more likely to be unemployed during economic downturns like the current one ([Akers, 2020](#)). Because they are a stable source of revenue, it is tempting to look to property taxes for additional government tax receipts. However, the economic cost is high and disproportionately impacts low-income households. Instead, tax loopholes should be fixed to alleviate the burden of rising property taxes on Texas families. For example, SB 2 from the 2019 legislative session should be maintained and strengthened by clarifying the disaster declaration as only natural disasters that cause physical damage ([Texas Public Policy Foundation, 2020](#)).

### **Sales Taxes**

Sales taxes are the largest source of tax collections and the second largest source of all-funds revenue (behind federal

transfers). Since 2013, they have consistently accounted for 26% of total annual revenue Texas ([Texas Comptroller of Public Accounts, n.d.-c](#)). Texas has a state sales tax rate of 6.25%, and local jurisdictions can impose up to (combined) an additional 2% for a maximum sales tax rate of 8.25% across the state. Currently, over 400 jurisdictions add on 2% ([Texas Comptroller of Public Accounts, n.d.-a](#)).

Sales—and sales tax revenues—directly fluctuate with consumption which, as mentioned above, can decrease in recessionary periods when household budgets temporarily decline. Increased government spending on social programs—especially at the federal level—or direct stimulus checks provide an opportunity for constrained households to smooth consumption over time. Coibion et al. ([2020](#)) show that this was the case for CARES Act stimulus checks but primarily for households “facing liquidity constraints” ([p. 2](#)).

In the absence of such programs, sales would drop even more dramatically. Government transfers that help smooth consumption reduce the volatility in sales tax receipts ([Walczak, 2020a](#)). This makes raising sales taxes a potentially more viable, albeit imperfect, source of additional tax revenue compared to other state and local taxing options. A similar option is to broaden the sales tax base (i.e., expand what goods and services are taxable), which would increase sales tax revenue without increasing tax rates per se. These are not costless tax options, though. The sales tax base in Texas currently excludes items that consume the majority of low-income households' budgets: grocery and SNAP purchases, healthcare, and utilities (see Texas Tax Code §§ [151.314](#), [151.3141](#), [151.313](#), and [151.317](#)). Extending the tax to these items would disproportionately impact low-income households who are already under stricter budget constraints. Comparatively, raising tax rates would more equally distribute the additional tax burden because the composition of taxable versus nontaxable items in household budgets vary across income levels. However, higher rates do raise the cost of consumption, which could encourage more savings in the short run if households expect sales tax rate hikes to be temporary. A potentially less distortionary and revenue-neutral approach to higher sales taxes could include decreasing property or franchise tax burdens.

Another potential tax revenue source is the motor fuels (“gas”) tax. This is an excise tax of 20 cents on each gallon of fuel—gas or diesel—levied by the state on top of what the federal government imposes. State gas tax receipts are mostly directed to fund transportation and infrastructure development along with education in Texas and are

<sup>6</sup> It is easy to conjecture that income and wealth are more strongly correlated with the intensive margin (property value) than the extensive margin (homeownership), though the correlation is imperfect: elderly homeowners whose property value has increased over time may be “low-income” but high-asset.

therefore not a reliable source of additional government revenue for general-fund activity. Further, gas tax receipts have been mostly decreasing (in real terms) for the past two decades due to increased fuel efficiency ([Halbrook & Donald, 2019](#)). COVID-19-induced restrictions have decreased mobility ([Glanz et al., 2020](#)), meaning people are not currently purchasing as much fuel. Taken together, raising the gas tax would not be a reliable source of additional tax revenue nor good for households during a depressed economic situation.

## Conclusion

The recession induced by government restrictions following the spread of COVID-19 has placed a financial constraint on taxpayers and tax collectors. Increased demand for services provided by the government has increased the strain on the state's budget, but the means to raise additional

funds (taxes) have real adverse consequences for Texans. Legislators may consider several taxing options, but most have serious economic costs that often disproportionately fall on already-constrained households. When possible, budget makers should strive to decrease expenses to relieve the burden on taxpayers instead of raising taxes—the details of doing so are beyond the scope of this brief, but Ginn et al. ([2020](#)) outline several specific budget lines to reduce. Taxing authorities should also consider decreasing more burdensome taxes, such as property taxes and franchise taxes, that are detached from the current financial situation of taxpayers. Instead, the Texas Legislature should consider moving to a more sales tax-based system, which allows for households to respond to changes in their budgets and restrain spending to match the expected decrease in tax receipts. ★

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## ABOUT THE AUTHOR



**Benjamin Priday, PhD**, is an economist at the Texas Public Policy Foundation, researching state and federal policies around taxation and social welfare reform. He has appeared in academic journals including *Tax Policy & the Economy*, *Journal of Private Enterprise*, and *Games*, as well as the *Economist*, *Philanthropy Daily*, the *NonProfit Times*, *The Conversation*, and *EconoFact*.

Priday earned his PhD in economics from Texas A&M University and a BA in economics from Rhodes College.

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