

The Takeaway

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Stop Playing Favorites with the Tax Code

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The Great Recession has punched a gaping hole in state government budgets. California has a projected budget deficit of \$21.3 billion for the 2012 fiscal year. Illinois has a projected shortfall of \$17 billion; New Jersey's is \$10.5 billion. Texas may have a \$10 billion dollar hole to fill in each year of the upcoming biennium.¹ Fortunately, there are solutions that could not only narrow the state's budget gap, but also reduce the distortions imposed by its current system of taxation.

Texas' fiscal outlook is not the worst among the fifty states, but there is no denying the seriousness of its budgetary problem. A fiscal crisis like the one we face today can tempt legislators to abandon good governance practices in favor of across-the-board spending cuts and ill-advised

tax increases. If they give in to this temptation, they could severely damage Texas' ability to attract workers and firms and risk a permanent deterioration of the standard of living in the Lone Star state.

A fundamental principle of tax policy and good governance is that



WHAT'S THE TAKEAWAY?

An inconsistent tax code hurts all consumers and firms, especially small businesses

Via the Lone Star card system, Texas can help poor households at much lower cost

Tax breaks for some firms and industries necessarily mean higher tax rates for others

Sales taxes on business-to-business transactions is a particularly harmful form of playing favorites with the tax code

“Governments should not play favorites with the tax code.” Keeping rules as consistent as possible appeals to our sense of equity and promotes economic efficiency. Taxes distort economic decision-making away from that which is taxed. Some of those distortions can be desirable in the sense that they can discourage socially unhealthy behaviors (think cigarette or alcohol taxes), but most are not. Everyday consumer choices are distorted when only some of those choices are subject to the sales tax. For example, a busy family’s choice whether to eat dinner at a restaurant or eat at home is distorted when the sales tax applies to food prepared at the restaurant but not to food prepared at home.

Lowering taxes for a favored few leads to a larger distortionary burden for the state

Good governance means minimizing undesirable distortions. Economic research tells us that, as a general rule, the distortion from a \$1 tax increase is larger than the reduction in distortion from a \$1 tax cut for the favored group.² Tax breaks for some firms and industries necessarily mean higher tax rates for others, so lowering taxes for the favored few leads to a net larger distortionary burden for the state as a whole.

HOW “PLAYING FAVORITES” PLAYS OUT

The Texas sales tax code is riddled with exemptions and exclusions that favor some industries over others. Massages are taxable,

but manicures, facials, and other spa services are not. Repair and remodeling services are tax exempt if the building is a residence, but taxable if the building is a business. Laundry services such as clothes washing are taxable, but the car washing industry is tax exempt. Dishwasher repair is a taxable service, but auto repairs are not. Lawn maintenance is taxable, but only if the service provider is between the ages of 18 and 65. Cable television is taxable, but monthly internet access is not. Carpet cleaning is taxable; house cleaning is tax exempt. The list goes on and on.

Gross receipts taxes and sales taxes on business-to-business transactions are a particularly pernicious form of playing favorites, because these frequently look like equity to the casual observer. Consider, for example, two firms. One is a large business; the other is a mom and pop small business. Both need legal services. The large business has an in-house lawyer while the small business hires outside counsel as needed. A sales tax on legal services to business would fall on mom and pop and their outside lawyer, but not on the large firm or its in-house lawyer. Thus, small businesses pay higher taxes than other firms for no other reason than that they are small. Taxes on business-to-business transactions encourage large firms to become vertically integrated, offering internal services on which they otherwise would be taxed. Small businesses do not have this option.

EXEMPT PEOPLE, NOT SPECIFIC GOODS OR SERVICES

Sometimes, legislators have granted sales tax exemptions out of concern for the poor. For example, Texas exempts food purchased at grocery stores and medical care from the state’s sales tax. The goal is admirable but the tool is clumsy. Most of the people affected by the tax break are not the

intended beneficiaries. So the tax exemption for groceries, for example, gives the same tax break for filet mignon purchased by a millionaire as it does to the cheapest ground beef purchased by a welfare recipient. There is no economic reason why grocery or medical care purchases by affluent households should be tax exempt.

But if we want to broaden the sales tax, how do we lighten the tax burden for low income earners? There is a simple solution. Texas issues a debit card called the Lone Star Card to low income families participating in the welfare or food stamps programs. All food purchases made with this card are already sales tax exempt, and could remain so even if the general exemption for food were removed. Other purchases made with Lone Star Cards could also be exempted from sales tax. Or equivalently, sales tax rebates could be deposited onto the cards. Either way, Texas could make use of the Lone Star system to provide targeted tax relief for poor households at much lower cost - and without distorting the economic behavior of other consumers.

Broadening the sales tax by eliminating the exemptions and exclusions would go a long way towards solving our budget problem. The Texas Comptroller of Public Accounts estimates that removing the sales tax exemptions and exclusions for food and medical care would raise \$4 billion in sales tax revenue, per year.³ Removing the exemptions and exclusions for consumer purchases like spa treatments and residential electricity could raise another \$2 to \$3 billion. Texas could almost plug the hole in its budget. In the future, when the economy recovers, we could lower the sales tax rate by nearly a third and return revenues to current levels—simply by following the basic principles of good governance and refusing to play favorites with the tax code.

Texas could almost plug the hole in its budget simply through better governance—and refusing to play favorites with the tax code

A BENEFIT TO CASH-STRAPPED LOCAL GOVERNMENTS

Removing the distortions in the sales tax code would have the added benefit of providing fiscal relief to local governments throughout Texas. Cities, counties and other local governments in Texas have the option of piggybacking on the state sales tax by adding a couple of pennies to the sales tax rate. Broadening the sales tax base would help local governments increase revenues and allow them to lower their local sales tax rates, lower their property tax rates, or balance their budgets without cash infusions from the state.

CONTINUE TO SHIELD B-TO-B PURCHASES

Broadening the sales tax to include business-to-business transactions could raise almost as much money as removing the distortionary exemptions and exclusions, but it would be a grave mistake. Taxes on these transactions discriminate against small businesses. Small businesses cannot pass their higher costs along to their customers when their larger, vertically integrated competitors are effectively tax exempt. Nor can small businesses afford

simply to take one for the team. If the cost of doing business in Texas gets too high, small businesses will either close shop, or set up shop someplace else. Either way, Texas loses. To avoid the economic distortions that arise from discriminating against small businesses, the legislature must resist the temptation to remove all of the sales tax exemptions and exclusions we have now. Services to businesses should be treated as “sales for resale” and remain tax exempt.

TREAD, BUT WISELY

This is a perilous time for the Texas legislature. The budget must be balanced; the tools for doing so are unpopular. “Higher taxes” normally is not a winning re-election pitch, and the currently favored industries will not give up their privileges easily. At the same time, legislators have a unique opportunity to fix a flawed tax system and replace it with a simpler system with long-term benefits.

Removing the distortionary exemptions and exclusions in the sales tax code would be

good policy even if the budget were balanced, because it would allow us to buy down the sales tax rate and lower the distortionary burden of state government. It is a very good response to a budget crisis. By eliminating this hodge-podge of exemptions for certain products and services, we can encourage better consumer choices, keep Texas a business-friendly state, and look to a better future. All we need to do is stop playing favorites with the tax code.

1. http://s.wsj.net/public/resources/documents/st_STATEBUDGET100414_20100414.html

2. *All other things being equal, the distortionary burden of a tax depends on the square of the tax rate. Therefore, if you double the tax rate, you quadruple the distortionary burden, and if you cut the tax rate in half, you lower the distortionary burden by 75 percent. For details, see Public Finance and Public Policy by Jonathan Gruber, 2009.*

3. <http://www.window.state.tx.us/taxinfo/incidence09>

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