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In Defense of the Property Tax

By Charles E. Gilliland, David Adame and Michael Oberrender

Texans despise taxes. Mere mention of the word invites a torrent of complaints about the confiscatory nature of taxes levied in the taxpayer's particular corner of the state.

Some say Texas might do well to focus revenue-raising efforts on consumption by foregoing property tax collections in favor of an expanded sales tax. That expansion would presumably include a sales tax applied to real estate transactions in place of annual property tax assessments. This alternate tax plan has stimulated interest despite a current sales tax that exacts a 6.25 percent state levy plus up to 2 percent more for local governments.

Conventional wisdom says Texas' property tax imposes a crushing burden on its citizens that is strangling economic growth. But facts suggest a different reality.

Tax Structure Analysis

The Tax Foundation, a nonpartisan tax research group, publishes a complete analysis of the tax structure for state and local tax collections in each state. This report allows businesses to compare tax climates from one locale to another. Entitled "Facts & Figures 2012: How Does Your State Compare," the report covers all taxes assessed, including individual income, corporate income, sales, property taxes, excise taxes, estate taxes and even implicit lottery tax revenue.

The report lists and ranks each of these revenue sources for each state and combines them to compare total tax burdens. The analysis reveals that Texas, at $3,197 in tax burden per capita, ranked 39th among the 50 states and was well below the national average of $4,160 per capita for the 2009 fiscal year. The total Texas state and local tax burden amounts to 7.9 percent of state income. By that measure, Texas ranked 45th nationally, well short of the 9.8 percent national average.

The foundation analysis continues with a calculated state business tax climate index designed to measure how the mix of tax laws in each state impacts business performance. The lower the number, the better the climate for businesses. Reflecting Texas' reputation for a business-friendly environment, the foundation index ranks Texas as the 9th best business tax environment among the states. However, the Texas corporate tax climate ranks 37th.

The much-maligned property tax places Texas 31st while the current sales tax actually places it 35th, making it less business friendly than the property tax. Unemployment tax checks in at 15th, and the franchise tax on partnerships and subchapter S corporations leads to a 7th place ranking on the individual income tax, behind the other six states without such a tax. These rankings suggest that sales tax is more of a problem for businesses than property tax.

Sales Tax–Property Tax Tradeoff

Advocates of the expanded sales tax in place of property tax cite a study, "Enhancing Texas' Economic Growth Through Tax Reform," published by the Texas Public Policy Foundation. The study suggests such a move would lead to a renaissance in Texas business formation, adding jobs to an already strong economy. Using sophisticated modeling, the authors conclude that adopting this unprecedented tax structure would provide the Texas economy a substantial boost.

Evaluations of the sales tax for property tax tradeoff suggest that purchasers of commercial properties would realize enough operating cost savings to more than compensate for the sales tax on the purchase of the property. Moreover, given an unprecedented expansion of the tax base, the move could be made with a sales tax rate of 11 percent according to the Texas Public Policy Foundation study. However, the analyses do not consider the effects an increased sales tax would have on other operating expenses in the economy.

Higher taxes on those items would tend to offset any property tax savings. Further, those estimates seem to ignore the tax avoidance behavior that unprecedented tax rate increases would undoubtedly inspire in the everyday conduct of commerce.

Other difficulties associated with such a move were identified in "A 'Big Idea' That's Bad for Texas," an article by Billy Hamilton, commissioned by Texas Tax TRUTH. Notably, the tax base would have to be expanded to include items and activities currently not taxed, including groceries, medicine, agricultural feed, seed, chemicals, supplies, and other items such as animals sold by nonprofit animal shelters. Presumably, all of the currently available exemptions and exclusions from the sales tax would be potential candidates for the expanded tax base.

The sale of real estate would also be subject to the expanded sales tax. Without such an expansion, the report estimates the proposed switch would require a 25 percent sales tax rate just to maintain revenues at recent levels.

> *One study suggests the property tax may well be more beneficial to economic growth than either the income tax or a consumption-based tax.*

A report from the comptroller's office to Representative Jim Keffer confirms that an estimated 23 percent rate would be needed to provide a $61.76 billion revenue stream, which approaches recent combined total property and sales tax revenues. Given the political difficulties of expanding the tax base and uncertainty surrounding the proposed shift, Hamilton describes the proposition as "a risky and untested experiment."

Property Taxes, Economic Growth

Before undertaking this strategy, Texans may find it prudent to consider the effects discovered in a study conducted by the Organization for Economic Co-operation and Development (OECD) entitled "Do Tax Structures Affect Aggregate Economic Growth? Empirical Evidence from a Panel of OECD Countries." Analysis of tax structures in 21 OECD countries found that property taxes may be the least destructive of the three major tax instruments (income, consumption and property).

The exhaustive study looked at the relationship between tax structures and economic performance measured by gross domestic product. The study findings note:

> The results of the analysis suggest that income taxes are generally associated with lower economic growth than taxes on consumption and property. More precisely, the findings allow the establishment of a ranking of tax instruments with respect to their relationship to economic growth. *Property taxes, and particularly recurrent taxes on immovable property, seem to be the most growth friendly* [emphasis added] followed immediately by consumption taxes.

This study suggests the property tax may well be more beneficial to economic growth than either the income tax or a consumption-based tax. Moving to a consumption-based tax from a property tax may actually have a negative effect according to these results.

Perhaps the property tax deserves another look. Despite being perceived as big, in your face, and not fair, the property tax has not vanished. Could it be that it has redeeming qualities?

Property taxes in the United States predate the Declaration of Independence by more than 130 years. That makes it the oldest of the three major tax bases for state and local governments. The tax emerged as the only form of tax available to fund local governments and provided all the revenues for local governmental operations.

Property owners benefited from the activities of local governments as they built and maintained infrastructure, provided legal services and regulated local activities. The relative values of the property owned by the citizens reflected the value of those benefits, thus serving as the basis for assessing each property owner's share of the cost. Moreover, the amount of that cost was decided by locally controlled governmental entities.

As societies and economies matured, other forms of taxation appeared to bolster local governmental operations. Sales taxes, income taxes and user fees emerged as alternative sources of revenue for local governments, increasingly taking on tasks far removed from providing basic services. Public services came to include an increasing variety of activities ranging from animal bites to youth workshops and public schools.

Despite other sources of revenue and nonproperty-related activities, the property tax continues to provide a substantial share of local government revenue. Because it has been such a consistent standby for local governments for so long, owners expect to pay property taxes each year, and they know where to go to appeal assessments. This locally administered source of funding leaves control of local government activies in the hands of community members.

The Hamilton study found year-to-year variations in sales tax collections, as measured by standard deviation, exceeded those in property tax collections by more than 40 percent between 2000 and 2011.

Stable Tax Base

Because property values change slowly, the property tax base is more stable than income and sales taxes. The Hamilton study found year-to-year variations in sales tax collections, as measured by standard deviation, exceeded those in property tax collections by more than 40 percent between 2000 and 2011. This suggests that local governments can depend on a more stable revenue stream from property taxes.

Property tax visibility, which is seen as a negative quality, also could be seen to have a positive influence on the supply of public goods and services. Because these assessments impose sizable outlays on an annual basis, citizens are reminded annually of the cost of these goods and services offered by their local governments. Each remittance may prompt citizens to evaluate the wisdom of continuing local activities at current levels given the expense. So the very quality that contributes to the property tax's unpopularity also enhances the efficiency of providing local government activities.

Critics often point out that rising values make taxes unaffordable for current owners. Owners faced with rising levies may decide to sell and move to more affordable properties. But even this pernicious aspect of the tax can have a positive effect on local community development. Take, for example, the owner of vacant land ripe for development. Rising market values feed rising property tax levies, motivating the owner to convert unused land to a higher-valued use. Without a property tax expense, a speculator could delay development indefinitely, potentially contributing to urban sprawl and depriving the community of needed housing and commercial properties.

These factors suggest that the property tax likely will continue as a major source of revenue in Texas for the foreseeable future.

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THE TAKEAWAY

Texas' property tax has few fans. Some argue that the tax has a negative effect on economic growth and should be replaced with an expanded sales tax. Research, however, suggests otherwise.

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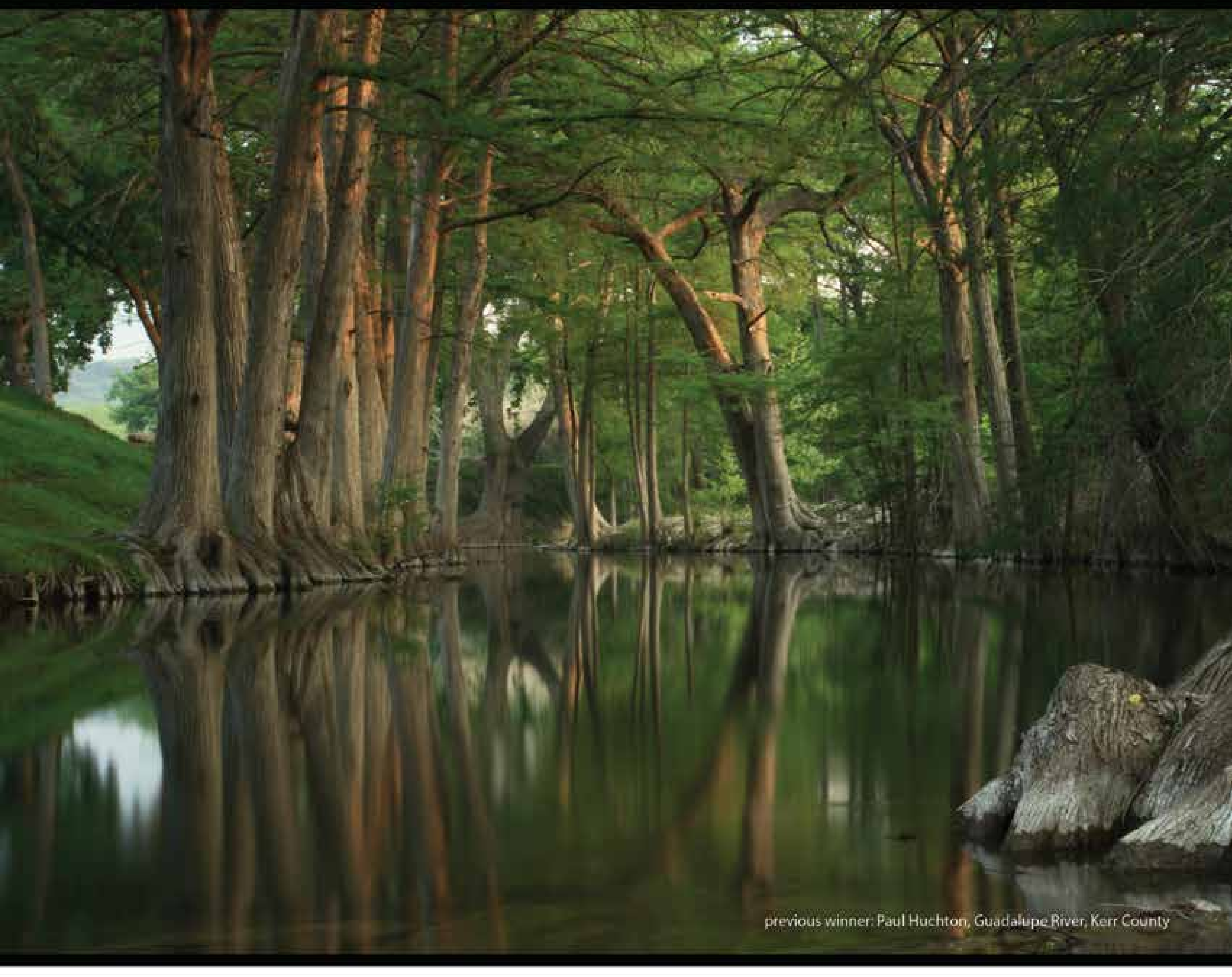

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