

# PROPERTY TAXES



# THE BAD THE GOOD AND THE UGLY

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# **Property Taxes: The Bad, The Good, and The Ugly**

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# Property Taxes: The Bad, The Good, and The Ugly

**A**rguments about funding public schools in Texas quickly turn to making changes to the existing property tax system. Funding of the Texas education system is broken and broken badly, according to John Dietz, the district judge presiding over the trial in a lawsuit decided in Travis County in February 2013. After months of testimony, the judge found the state's funding mechanism wanting.

The ruling said the system, which leans heavily on local property taxes to support schools, does not provide enough revenue to local districts, and because of rate limits and specified program requirements the current state of affairs really amounts to imposing a state property tax. The latter ruling is especially disturbing because the Texas Constitution prohibits the state from levying property taxes. This all means that substantive changes lie ahead in Texas tax policy. So school funding issues become property tax issues for the legislature.

## The Bad

Property taxes are unpopular. Indeed, most studies of public sentiment about alternative tax programs consistently find the property tax to be the most disliked tax. Unlike personal income taxes or sales taxes collected in small increments as wages are paid or purchases are made, most taxpayers must remit a large sum all at once to satisfy their property tax liability. This makes the tax highly visible compared with the stealthy collection mechanisms of most other taxes. Property taxpayers have an annual payment, painfully reminding them of the cost of the public services supported by the tax.

Moreover, that payment must be made without regard to the property owner's current financial condition. With a sales tax or an income tax, the taxpayer has some control over the amount of their tax liability. They voluntarily make taxable purchases or work extra hours for extra taxable income. The property tax liability depends on the budget requirements of local governments and the aggregate value of taxable property. Only by becoming involved in local politics can the individual hope to influence the amount they will be forced to pay.

In addition to these immediate concerns, the passage of time alters relative tax burdens. Owners of properties that appreciate faster than the average growth rate see their share of the total levy increase. In addition, areas in a community experiencing rapid growth see their burden increase. All of this shifting results from the operation of market dynamics beyond the property owner's control. In some communities, redevelopment activity in areas of

older homes have fueled more rapid increases than those seen in more fashionable, established areas. In many locations, these dynamics have reassigned more and more of the local tax bill to residential properties, the very people who vote in those local elections.

Acceptance of the property tax depends on citizens' perceptions of fairness. Taxpayers normally expect similar tax liabilities for similar properties. Ideally, property tax liabilities are a uniform percentage of market value for all taxpayers. Achieving parity among effective tax rates for all properties establishes the fairness of the tax. Widely divergent burdens among properties of equal value make it an unjust system. However, the value used to assign tax liabilities relies on an appraisal of the subject property on the date of assessment.

To ensure equity, a tax administrator needs a fresh, accurate appraisal for every property in their jurisdiction each year. Establishing annual appraisals would require an army of appraisers with access to mountains of sales data. In addition, an appraised value technically only applies on the date of appraisal. In a sense, all bets are off the very next day. Besides, an appraisal is an opinion that invites protestations from affected parties with a different opinion.

Changing physical, legal, economic and societal conditions can fundamentally alter a property's appeal, thereby impacting its market value. The value on the assessment date depends on the appraiser accurately ascertaining the vagaries of local markets. Suspicions of favoritism or questionable competence make the basis for an assessment a controversial quantity each year. Assembling the information needed to defend value estimates approaches the boundary of acceptable public inquiry into private affairs. Besides, when market trends change, transactions frequently come to a standstill. That means appraisers often do not have access to information, and tax values depend on sketchy, uncertain and sometimes erroneous data.

When taxpayers get hints of impropriety or incompetence, confidence in the system erodes. Although tax laws provide remedies for citizens suspecting unfair treatment, many come away from the system with a sense that they have been singled out for over-assessment. Thus, even with the best intentioned assessment system, the murky nature of appraisal can create an appearance of conspiracy.

A single disgruntled citizen can present problems for local governments. Sometimes disputes proceed to district court. However, the amount of tax at stake balanced against the costs and intricacies of the process of litigation often precludes legal action. Consequently, taxpayers often fume in silence until they begin to encounter similarly

alienated taxpayers. Then fueled by their collective anger, public outcries demand reform to the abusive system.

The litany of taxpayer grievances tends to converge on a time-honored set of remedies. Particularly aggrieved classes of taxpayers or properties receive partial or complete exemptions from the tax. Owners of designated residential homesteads are the most prevalent example of such measures.

In addition, targeted groups of citizens such as the disabled, veterans or the elderly frequently can participate in further exemptions. Secondly, tax deferrals guard against forcing elderly taxpayers from their homes. Finally, special use-value provisions limit tax liabilities by prescribing techniques of establishing appraised values falling far short of market value for favored property classes. Despite implementation of such measures, the property tax continues to be the most unpopular tax.

## **The Good**

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 taxes supporting state and local governments. The tax began as the only form of funding for local governments. Property owners benefited from local infrastructure, government provided legal services and policing of local activities. The value of an owner's property reflected market judgments about the value of those benefits. Consequently, that market value formed the basis for assessing each owner a share of the cost of local government. Moreover, the total amount of that cost resulted from locally settled political decisions. Because of these origins, the property tax is easily the oldest and most familiar of the three major taxes.

As societies and economies matured, other forms of taxation emerged to bolster local governmental operations. Sales taxes, income taxes, and user fees became added sources of revenue for local governments that increasingly took on tasks far removed from the most basic services. Current local government activities include an increasing variety of services ranging from "animal bites" to "youth workshops." Public schools are considered a local governmental activity. The property tax still provides a substantial share of the local government revenues. 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 moderate excessive assessments. With the possible exception of school districts, this local source of funding leaves local entities in control of their activities.

Visibility identified earlier as a negative quality also has a positive impact. Because assessments impose sizable outlays on an annual basis, citizens have periodic reminders of the cost of the goods and services they expect from local governments. Each remittance provides an opportunity to evaluate the continuation of local activities at current levels. So the very quality that contributes to its unpopularity also enhances the economic efficiency of local governments.

## **The Ugly**

Increasingly, as school funding issues have come to the forefront, Texans' attention to property taxes has switched from local venues to the state level. High tax rates driven by school funding needs have made the property tax the most despised tax in the state. The increased real tax burden has spawned numerous proposals designed to reduce the bite of taxes on Texas property owners.

Measures enacted have traditionally identified targeted groups of property owners for relief. For example, all homeowners have viewed rising tax bills with dismay. The aging of the baby boom population poses an especially difficult dilemma as seniors struggle to maintain homeownership. Many Texans approaching retirement worry that a rising property tax liability may force them from their homes. In addition, property taxes take a large bite out of the net income of Texas commercial and industrial entities. These factors sparked demands for reductions in property taxes that continue today. In fact, the current property tax code resulted from specific measures drafted in response to public displeasure with the system.

## **Property Taxes Prior to Reform**

Prior to 1978, the Texas Constitution required all owners of nonexempted property to pay taxes. Exemptions were few. Government property, churches, schools and properties exempted by federal law were excused from taxation. In addition, agricultural land could qualify for valuation based on agricultural productivity if the owner could meet stringent income tests. Texans over age 65 could qualify for a limited partial exemption from some taxes on their homes. However, the Texas Constitution imposed a tax liability on most other real and personal property owners. Consequently, the legal definition of taxable property included such items as automobiles, household furniture, stocks, bonds and cash in the bank. Because of the difficulty and expense of locating, valuing and collecting taxes on such items, much technically taxable property escaped assessment.

The constitution also required taxation to be equal, uniform and based on market value. Litigation had validated the practice of fractional assessment (establishing a taxable value that is a percentage of market value). However, no uniform statewide assessment level applied. Local control allowed each taxing unit to set its own assessment ratio, and local tax offices operated with little direction from the state. Oversight came from instructions and limitations imposed by judicial decisions and the occasional state attorney general's opinion. Each jurisdiction could legally employ an assessor to appraise all properties for taxation. Although the constitution defined market value on Jan. 1 as the basis for taxation, no statutes effectively forced assessors to ever revalue properties. Local taxing authorities often acted independently in administering local tax policies keeping residential and rural land values unrealistically low while boosting commercial, industrial, utilities, oil and gas, and minerals each year.

Tax offices proliferated under this system. Most cities, schools and numerous special districts each employed

their own assessor/collector to exert maximum control over their revenues. Each of these assessors established a separate appraised value for assessing taxes. Strapped for cash and heavily dependent on property taxes, school assessors typically pursued the most aggressive valuation regimens. Counties, with assessors periodically running for election, often adopted the most passive approach. Other taxing jurisdictions tended to lie between the two extremes. Consequently, property owners often faced widely varying arrays of appraised value for the same property. For example, a school tax office might have had an appraised value of \$100,000 on a home for which a county assessor had assigned a value of \$35,000 while the city assessor had appraised the same home at \$50,000.

Protests of each of these tax values were conducted independently at a board of equalization hearing in each of the separate tax offices. Under this system, reappraisals occurred infrequently, if at all. Once established, frequently at low levels of market value, assessors seldom updated appraised values on locally owned property. A new building or expansion of an existing improvement might prompt a reworking of the appraised value, but no legal authority mandated systemwide revaluations. The need for additional revenue most frequently prompted taxing units to undertake reappraisals.

Aggressive valuations often prompted localized attempts to rein in tax office reappraisals. Specifically, lawsuits by disgruntled owners sought to impose control over local tax administration by overruling reappraisals. These actions typically followed an attempt to revalue all of the properties in the taxing unit. Frequently, the suit sought to prohibit the taxing authority's use of the new appraisals to collect taxes. Citing unfair practices as the grounds, successful actions stopped tax collections based on the new values. Frequently, these actions focused on illegal omission of automobiles and other legally taxable personal property as grounds for invalidating the new tax base. Assessors learned to forestall litigation by keeping appraised values low and avoiding increasing owner's taxable value from year to year.

## **School Finance Prompts Reform**

Funding of Texas schools relies on a system that combines state revenues with locally raised property tax levies. Designed to provide a minimum foundation of education to all schools in Texas, the system supports part of that base and requires the local school district to fund the remainder through the local property tax. The proportion supplied by the state varies inversely with the amount of revenue available from the local property tax base. Specifically, if a district is endowed with an ample amount of property wealth per pupil, that district receives less funding from the state's general fund than a district with an impoverished tax base. Disparities in wealth among school districts had prompted legal actions aimed at equalizing access to resources for property poor districts. The state used values generated by this system to allocate non-property tax funding to local school districts.

Obviously, a local school district could increase the amount of funds received from the state by systematically undervaluing local properties, effectively understating the taxable wealth per pupil. Locals could gain more state funds by appearing to be property poor. As the state responded to the disparities among districts in an attempt to equalize access to revenues, authorities found it necessary to focus on appraisal practices at local school tax offices. Only when school assessors accurately appraised property could the state's funding system assure equality of opportunity among districts. The state initiated a ratio study to verify that school assessment practices resulted in appraised values that accurately reflected the current market value of the local tax base.

That study functions like a report card on the operation of the local tax office. The study compared assessed values with actual sale prices to ascertain the accuracy of the appraisal. A reasonable, representative sample of sales for each category of property provides statistical evidence of the efficacy of tax appraisal practices. If the statistically established ratio approached 100 percent with acceptable levels of variance, appraisals were deemed to be accurate. When the ratio strayed from this ideal, the results suggested problems in local assessment practices. For example, a ratio of 50 percent provided evidence of a concerted effort to underestimate available taxable wealth. Those ratio study results could then be used to estimate the actual value of the local tax base available to support education. The state could then reduce its contribution to the district and force the assessor to reappraise properties to raise more funds locally. The Governor's Office for Education Resources conducted the first study in the late 1970s. The Property Tax Assistance Division (PTAD) of the Office of the Comptroller continues that study for each school district in Texas.

Other than court decisions from taxpayer lawsuits or attorney general's opinions, the ratio study was the only real state-level control of local appraisal practices for years. Obviously, that control remained indirect. In theory, if the local school assessor systematically undervalued local homes, land and businesses, an accurate ratio study would reveal the bias. Then, the state would use those results to calculate an independent estimate of the amount of taxable value that accurate appraisals would have yielded. The state could then substitute those alternate figures for the locally appraised values when calculating the amount of state revenue to allocate to local schools. Obviously, higher state-estimated numbers would result in lower state contributions for the affected local schools. Thus the penalty for discovered systematic underassessment was partial loss of state funding.

Partly prompted by this ratio study revenue effect on funding, schools began to systematically reappraise their tax bases. A growing awareness of the inequities of the old practices added to the impetus to revalue. Specifically, accelerated rises in property values in the 1970s magnified the appraisal differences between comparable properties in a system based on never-changing values. Homes built in the 1950s often had much lower tax appraisals than recently

built homes of equal value. Taxpayer discontent spread. In addition to these forces, taxpayers began to object to dealing with so many different offices and values. Policy-makers fretted over the possibility of lawsuits challenging the legality of the unequal system given a constitutional requirement of equal and uniform property taxation. The public became convinced that a complete and honest reappraisal would reduce homeowner taxes. Sentiment for reforming the system grew. This reasonable expectation would ultimately turn out to be badly flawed.

## Property Tax Code Adopted

When the legislature adopted the Texas Property Tax Code (code) in the late 1970s, the balkanized array of tax offices ended. The code consolidated the appraisal function for all taxing units into one office in each county. (Since Amarillo straddles county lines, Potter and Randall Counties share a single district.) Known as the Central Appraisal District (CAD) and headed by a chief appraiser, this agency appraises each parcel of property in the county. Individual taxing units use those values to calculate tax liabilities for their jurisdictions. The chief appraiser organizes a staff, prepares budgets, administers applications for exemptions and generally oversees day-to-day district operations. This arrangement ended the practice of each taxing district appraising and exempting properties independently.

Replacing the various assessors with a single CAD initially created numerous problems. The CAD official value would replace an array of assessed values that had been used by the various tax offices. That first year, the CAD could choose any one of those individual values as the official taxable value or completely reappraise each property to assign a new official value. Either option necessitated a notice to each property owner because the result represented a revaluation from the previous valuations. As they approached the task of merging the separate property rolls, many chief appraisers faced a choice among outdated appraisals and mis-identified properties. Thus, reappraisal of all properties in the county was the most practical solution to problems encountered at the CAD. These reappraisals substantially increased total taxable values throughout the state. Many taxing units were able to cut their tax rates and still realize a sizeable increase in tax revenues because of the expanded tax base.

As taxpayers had anticipated, reappraisal shifted property taxes. However, that shift from categories of property that had endured appraisal at relatively high levels of market value (commercial, industrial, oil, gas and minerals) to those that had enjoyed low level appraisals of market value (single-family residences and land) increased taxes on homes and rural land. In fact, the shift tended to reduce taxes on properties often owned by nonresidents while increasing taxes on the local homeowners and landowners. Studies by the Real Estate Center at Texas A&M University predicted these precise results. To enact the reforms, the state needed homestead exemptions and the open-space valuation provisions for rural land to soften this blow to these property owners. In addition to the initial reshuffling, the code also required each chief appraiser to devise a

plan to reappraise all properties in the district at least once every four years. This ensured a continuing revamping of taxable values.

Local governments found it easy to increase property tax revenues by keeping the same tax rate and applying it to substantially increased taxable values. It appeared that taxes had remained constant (same tax rate) even though nearly all owners' tax liability increased (higher reappraised value). Mindful of taxing jurisdictions' penchant for surreptitiously raising revenue, the state legislature created so-called "truth-in-taxation" measures. These provisions were designed to notify taxpayers when taxing units increased their revenue intake beyond a calculated limit. Revenue growth beyond that specified limit authorized local residents to petition for a roll back to that limit. Taxing jurisdictions confronted with a valid petition must call an election to allow voters to approve the rollback. Currently, these provisions have been tightened so that virtually any increase in the calculated effective tax rate from the previous year makes the local taxing unit vulnerable to a rollback petition. Even with these safeguards in place, the Texas property tax burden has grown from approximately 1 percent of value in the early 1980s to rates routinely in the 2 to 3 percent range. With large sums in controversy, ad valorem litigation has expanded and taxpayers have increasingly complained about deficiencies in administration of the property tax.

## Appraisal District Operation Reforms

The Texas property tax system relies on chief appraisers to shoulder responsibility for appraising millions of parcels of property for taxation. Although the PTAD provides resources for chief appraisers to guide them in developing estimates of taxable value, chief appraisers have historically retained a substantial degree of authority to interpret and apply Texas property tax laws as well as applications of appraisal theory and techniques. Consequently, property owners in different counties may encounter a variety of different interpretations as they deal with the CADs.

In appraising this massive inventory of properties, many CADs have used methods to estimate market value that are at odds with sound appraisal practices. As the Texas Taxpayers and Research Association explained in May 2012, ". . . for many years these offices have operated with inadequate oversight." The inconsistencies resulted in appraisals that frequently differed from market value, the standard specified in Texas property tax law. To remedy this situation, the legislature added Section 5.102 to the code in 2009. That section instructs the comptroller to review operations in each appraisal district every other year. Dubbed the Methods and Assistance Program (MAP), this initiative seeks to reduce inconsistencies in appraisal district operations.

Under MAP, PTAD reviews CADs in four dimensions of their operations:

- governance,
- taxpayer assistance provided,
- operation and procedures and
- appraisal standards, procedures, and methodology.

The PTAD conducted the first round of assessments in 2010 and 2011, identifying a host of issues. Deficiencies in maps and records appeared as the studies progressed. Most CADs have taken steps to remedy shortcomings identified in the process. Further, the MAP program requires the PTAD continue oversight of CAD operations with ongoing reviews. This initiative aims to standardize operations among CADs and ensure a more consistently professional application of appraisal techniques.

## Proposed Funding Change

Given the state of affairs in assessments, namely high effective tax rates and uneven administration, public sentiment rallied round various suggested funding changes for schools that promised to reduce property taxes. Proposals ranged from implementing a personal income tax to fill state coffers and allow a reduced reliance on property taxes to caps on value increases to substituting various other taxes for property taxes. The income tax plan envisioned using all of a personal income tax for education and allowing a tax credit to homeowners for property taxes paid. Tax caps limited value increases from year to year. In 2006, faced with an unfavorable court ruling, Texas adopted a gross margins tax on corporations and partnerships designed to reduce the school property tax rate by a third.

Despite these efforts, the property tax continued to grow in dollar volume and unpopularity. By 2011, property taxes topped \$40.4 billion with schools accounting for 54.4 percent of that total. A surplus in the state treasury allowed the system based on the new gross margins tax to produce a pronounced drop in the total school property tax levy in 2007. But the 2008 school property tax levy reached a new high of \$21.2 billion and has continued to grow since as the margins tax has failed to produce enough revenue to provide for meaningful property tax reductions.

This turn of events has sent policy makers scrambling in search of a solution to the high property tax problem. They continue to seek an elusive friendly tax that will reduce dependence on property taxes. Each suggested plan meets a chorus of protest that the proposal is unfair, inadequate and unworkable. A recent proposal is to tax "consumption" through a sales tax designed to entirely replace the property tax for all local governments. Would this proposal relieve the pain of the property tax and enhance the Texas economy, or would it merely substitute a soon-to-be vilified sales tax for the property tax? Addressing that question requires specialized knowledge of economics in public finance.

## How to Evaluate Alternate Tax Programs

The study of the effect of taxes on economic activity has a long historical record. In his seminal work, *The Wealth of Nations*, Adam Smith described the impact taxes have on both production and consumption. As the theory of tax incidence has progressed, economists have identified a number of dimensions designed to evaluate alternative tax policies. This section describes a number of measures vari-

ous theorists have presented to evaluate plans for taxation and identifies the consensus set of measures an analyst should consider when evaluating tax policy.

In his article "An Economic Evaluation of Alternative Sources of Tax Revenue for the State of Texas," George Zodrow acknowledges three primary criteria to evaluate alternative tax plans for Texas. He identifies efficiency, equity and simplicity as the most effective measures of alternative revenue plans for supporting state government in Texas.

The efficiency measure evaluates on "the extent to which taxes distort decisions made by businesses, individuals and governments" (Zodrow, 9) as well as their impact on economic growth. An efficient system should minimize the intrusion of tax-inspired decision making while enhancing growth by providing a desirable array of public goods and services.

The equity criterion addresses the perceived "fairness" of the tax, which Zodrow acknowledges to be a very subjective metric. The equity principle comes to be evaluated in terms of the benefits received by taxpayers as well as their ability to pay the tax. These concepts capture disparate notions about the burden imposed to finance government. The benefits criterion harkens to the results of exchange in the private market where a consumer pays for the benefit gained from securing a good. The ability to pay principle introduces judgments about relative shares of government costs borne by individuals. Both concepts present challenges to analysts seeking noncontroversial measures of the criteria.

The simplicity dimension concentrates on the total cost of assessing and collecting the tax. That total encompasses not only the administration of the tax assessment and collection apparatus of government, but also the infrastructure developed by taxpayers to comply with the system. A desirable tax system should minimize the total of these costs.

A report prepared by Arduin, Laffer and Moore (Laffer) for the Texas Public Policy Foundation (TPPF) identifies four principle measures used to evaluate alternative tax systems: adequacy, simplicity, efficiency and accountability.

The report describes adequacy as a measure that evaluates the stability and reliability of the revenue stream. Revenue streams remain stable from one period to the next instead of fluctuating. In addition, the revenue stream should provide adequate revenue growth over time.

Simplicity includes compliance and administration, and consistency (Laffer, 5). Under this concept, a simple tax system should minimize the cost to the public for complying, minimize the government's administration cost, and reduce the amount of confusion for both parties. Additionally, taxing jurisdictions should be consistent with their definitions, rules and procedures.

For Laffer, efficiency implies neutrality and a broad tax base (Laffer, 5). Efficiency means that economic considerations are primary drivers for investment decisions and that the tax code has minimal influence on economic decisions. This principle implies as well that the government should only rarely alter the tax system to avoid affecting

business decisions. Constant tinkering with tax code provisions can create winners and losers resulting from tax considerations rather than economic merit. To avoid this distortion, Laffer argues that a tax should apply to a broad base to minimize rates. A narrow tax base with high rates can result in winners and losers when the tax code includes provisions allowing some to avoid the tax.

The Laffer study's final criterion is accountability. The concept refers to the transparency of the tax. All taxpayers should easily understand how a tax system works. Laffer's final comment warns that double taxation should be avoided. Double taxation introduces complexity to the system, distorting the allocation of economic goods and services.

The Tax Foundation, a nonprofit, nonpartisan research institution in Washington, D.C., recognizes six principles of sound tax policy: simplicity, transparency, neutrality, stability, no retroactivity and broad bases with low rates. In their view, simplicity refers to reducing administration costs by minimizing the complexity of the system, eliminating incentives to avoid taxation. Transparency refers to "sound legislative procedures and careful analysis" (Tax Foundation, 2012). The public should have a good understanding of how the tax system works. Neutrality means that the tax system should not favor certain industries and the system should not influence economic decisions. Stability means tax policies should not fluctuate with the whims of the political system. Short-term measures make long-run planning impossible. No retroactivity is similar to stability. It means that taxpayers should be able to rely on the current tax climate when negotiating for transactions. Broad bases and low rates mean that tax revenue will be more stable. Furthermore, in 2005 the Tax Foundation released "Ten Principles of Sound Tax Policy." The ten principles listed were: transparency, neutrality, broad base, simplicity, stability, no retroactivity, keep tax burdens low, do not inhibit trade, ensure an open process, state and local taxes matter (TF 2005).

The Institute on Taxation and Economic Policy (ITEP) notes five principles: equity, adequacy, simplicity, exportability and neutrality. Equity refers to fairness and can be viewed two ways. First is vertical equity which evaluates how different people are affected in a tax system (from poor to very rich). Three terms that measure vertical equity are regressive, proportional and progressive. Horizontal equity measures whether people with the same income, family, age and other similar traits pay the same amount in tax. Adequacy refers to a tax system generating the proper amount of revenue to fund the public services demanded by citizens and policymakers. Stability and elasticity contribute to the adequacy of a tax. Stability refers to constant growth, allowing the officials to effectively budget. "Elasticity is a measure of whether the growth in tax revenues keeps up with the economy" (ITEP, 2011). Simplicity refers to the ease at which taxpayers can understand, and the ability of the government to monitor and collect taxes. Exportability refers to the ability of the tax to make residents and companies from other states pay their share of taxes. Neutrality means that the tax system

should not interfere with economic decisions, and thus not favor any certain industry.

The National Conference of State Legislatures (NCSL) references the following: reliability, equity, compliance and administration, responsiveness to interstate and international competition, economic neutrality and accountability. Reliability incorporates the concepts of stability, certainty and sufficiency. Stability refers to constant revenues. Certainty refers to constant tax policies, and sufficiency "requires that revenue sources provide the revenue growth necessary to finance the desired rate of spending growth" (Fiscal Affairs Program, 2). Equity refers back to horizontal and vertical equity as mentioned earlier. Compliance and administration refers to minimizing the time and effort that are needed to comply with the tax law, and also minimizes costs. Responsiveness to interstate and international competition means that states should be aware of other states and countries' policies that effect revenue potential. Economic neutrality refers to the ability of a tax to favor one product over another. Thus, these effects should be minimized as much as possible. Finally, accountability means that "tax burdens should be explicit, not hidden" (Fiscal Affairs Program, 3).

These diagnostic criteria focus on four essential aspects when evaluating alternative tax programs. First, the tax base must be capable of producing enough revenue to cover the budgeted activity at an acceptable rate. Second, the operation of the tax should inflict a minimal amount of distortion to the signals guiding economic decision making. Third, citizens should readily understand the mechanics of assessment and collection of the levies. Finally, the tax policy must pass the nebulous test of "fairness." All of these criteria have come into play as Texas legislatures have grappled with proposals to deal with revenue requirements throughout many decades.

## Replacing Property Taxes with Sales Tax

Texans despise taxes. Indeed, mentioning the word will likely invite a torrent of complaints about the confiscatory nature of taxes levied in the taxpayer's particular corner of the state. Suggestions have circulated that 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 return for no annual property tax assessments. Because the property tax engenders an especially virulent level of scorn, this alternate tax plan stimulated interest despite a current sales tax that exacts a 6.25 percent state levy plus up to 2.0 percent more for local governments. Texas, so it would seem in the conventional wisdom, has imposed such crushingly high state and local tax burden on its citizens that it is strangling economic growth. The facts suggests a different reality.

The Tax Foundation publishes a complete analysis of the tax structure for state and local tax collections in each state. This report is designed to allow businesses to



compare tax climates from one locale to another. “Facts & Figures 2012: How Does Your State Compare,” covers all taxes assessed in each state, 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 39<sup>th</sup> among the 50 states and sat 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, the Texas burden ranked 45<sup>th</sup> 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 maintaining a business friendly environment, the foundation index ranks Texas as the ninth best business tax environment among the states. With a ranking of 37<sup>th</sup>, the Texas corporate tax climate lags behind 36 other states. The much maligned property tax places Texas 31<sup>st</sup> while the current sales tax actually places Texas 35<sup>th</sup>, making it less business friendly than the property tax. Unemployment tax checks in at 15<sup>th</sup> and the franchise tax on partnerships and Subchapter S corporations leads to a seventh ranking on the individual income tax behind the six other states without such a tax. These rankings suggest that the sales tax represents more of a problem for businesses than the property tax does.

## Tax Base and Rates

Advocates of the sales tax for property tax switch point to the Laffer study, which argues such a move would lead to a renaissance in business formation in Texas. That transformation would engender expanding employment and add jobs to an already strong economy, the report argues. Using sophisticated modeling, the authors conclude that adopting this unprecedented tax structure would indeed provide the Texas economy a substantial boost.

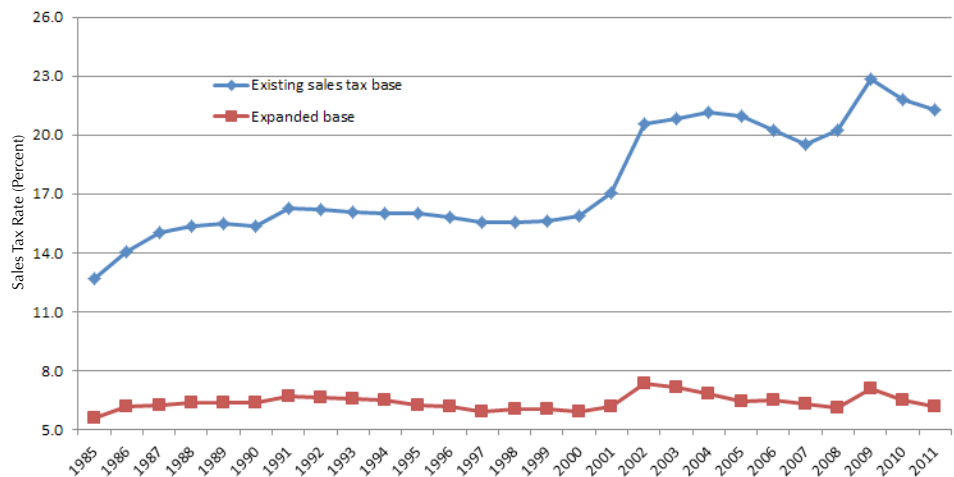
Comparisons of the tradeoff of sales tax for no property tax suggest that purchasers of commercial properties would realize enough operating cost savings from not paying property taxes to more than compensate for the sales tax on the purchase of the property. Moreover, given an unprecedented expansion of the tax base, the move could be made with a sales tax rate of 11 percent according to the TPPF study. However, the analyses do not consider the effects that an increased sales tax would inflict

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 everyday conduct of commerce.

Responding to this proposal, in a 2012 Tax Policy Report (*A “Big Idea” That’s Bad for Texas.*), Billy Hamilton, former Deputy Comptroller of Texas, identified a list of difficulties associated with such a move. Notably, the report focuses on the need to expand the tax base to include items and activities currently not taxed. That list includes groceries and medicine, as well as specific items like animals sold by nonprofit animal shelters and agricultural feed, seed, chemicals and supplies. 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 that the proposed switch would require a 25 percent sales tax rate just to maintain revenues at recent levels. A report from the comptroller’s office to Representative Jim Keffer confirms that an estimated rate of 23 percent 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 . . . .”

How reasonable are these competing estimates, and which scenario is more likely? Figure 1 presents required sales tax rates for alternative plans based on a straight substitution of sales taxes for all property taxes in an historical context. Rates shown based on the existing sales tax base result from dividing the combined total of all state sales taxes and all property tax levies by the existing sales tax base as reported by the comptroller plus 2 percent for existing local sales taxes. The resulting rates range from a low of 12.7 percent in 1985 to a maximum of 22.8 percent in 2009, nearly an 80 percent increase. The series includes

Figure 1. Texas Sales Tax Rates Needed to Replace Property Taxes



Source: Texas Comptroller of Public Accounts

a startling increase from 17 percent in 2001 to 20.5 percent in 2002, followed by another increase from 20.2 in 2008 to 22.8 in 2009. This simple calculation suggests that the Hamilton study results are indeed plausible.

The expanded base (red line) reports the results when the total retail sales reported to the comptroller replaces the sales tax base in the calculation. That would roughly approximate the available tax base when all exempted sales would have been subject to sales taxes. Those rates fluctuate between 5.6 percent and 7.4 percent during this interval, suggesting that rates calculated by the Laffer study also would be possible. That straightforward observation masks potentially bruising battles to eliminate or preserve existing sales tax exemptions. The final tax rate will critically depend on the outcome of those confrontations. A move to eliminate exemptions and/or otherwise expand the tax base implies a risk that the resulting tax regimen will fall short of expected revenue yields, especially when taxpayers likely would change their behavior to avoid paying the tax.

## Adequacy

One measure of a proposed tax policy change is the ability of the new tax base to deliver enough revenue to effectively support the public activity targeted by the collections. Figure 2 shows the total state sales tax compared with total school property taxes in millions of dollars per year. Property tax totals for 1978–2004 and 2010–11 were not available.

The comparison reveals several interesting historical facts. First, school property tax levies roughly equal total state sales tax levies during most of this interval, suggesting that it would have required a doubling of the state sales tax levy to cover school taxes. Second, although the two levies tracked well prior to 2000, sales tax collections unexpectedly dropped well short of the property tax in 2002. The shortfall persisted until tax relief measures caused a dip in local school property tax levies in 2007.

Without that relief, school property taxes probably would have expanded in line with the trend set from 2001–06.

Given such a trend in property taxes, the historical sales tax receipts suggest that a sizable increase in sales tax rates would have been required to cover local school expenditures, assuming use of the existing tax base. Alternatively, local school operations would have faced funding deficits if school sales tax rates approached the existing state rate. That shortfall would have ranged from almost \$592 million in 2001 to nearly \$3.9 billion in 2005. From 2001 through 2006, the shortfall would have amounted to more than \$15 billion.

Third, shortfalls would have appeared at the onset of major recessions. Only in the 1990 recession would Texas schools have avoided such a shortfall. In fact, the 2009 economic downturn would have presided over another \$766 million shortfall.

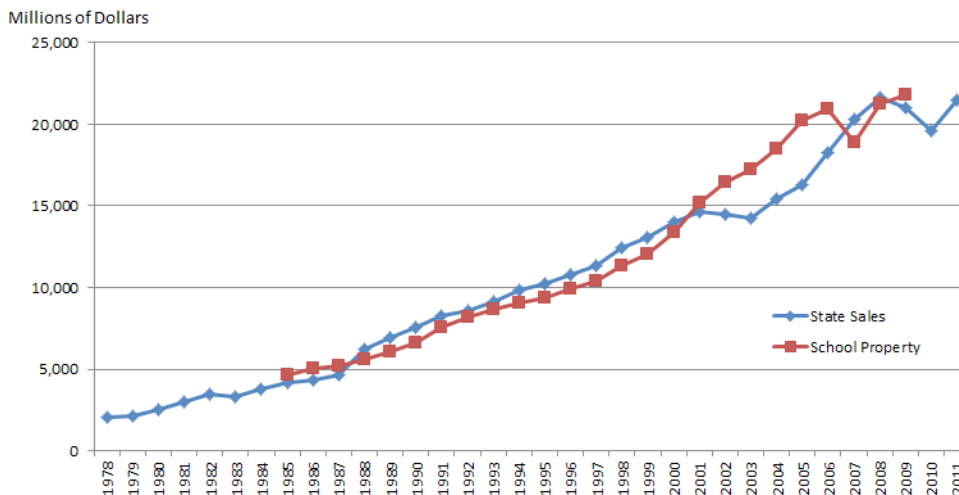
These results reflect the realities that would have applied had the sales tax replaced the school property tax at a rate roughly doubling the official rate. The analysis assumes use of the current sales tax base. The Laffer study does presume a sizable expansion of the sales tax base and argues that sales taxes should be more stable and related to changes in personal income than a property tax. However, reviewing the history of the two taxes in Texas suggests school tax inadequacies would likely have occurred just when policy makers were scrambling to cover revenue shortfalls in other areas.

As the Laffer study points out, sales taxes vary with changes in income while property taxes do not. The latter fact traces to the nature of the tax base, namely market value. Market value does not fluctuate quickly with economic reversals. Indeed, real estate markets often require time to adjust to negative economic events. If the events are transitory, values remain unchanged; if they persist, values eventually fall. That dynamic provides policy makers and school administrators time to adjust to the new realities. The sales tax adjustment is much quicker, leaving governments to scramble to find the means to fund

their programs in the midst of a crisis. While the sales tax may be a reliable revenue source over the long run, this analysis casts doubt on its efficacy in times of turmoil.

Therefore, before undertaking a risky strategy, Texas may find it prudent to consider the effects discovered in a study conducted by the highly respected Organization for Economic Co-operation and Development (OECD) entitled “Do Tax Structures Affect Aggregate Economic Growth? Empirical Evidence from a Panel of OECD Countries.” This analysis of the tax structures in 21 OECD countries found that property

Figure 2. Texas Taxes



Source: Texas Comptroller of Public Accounts

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 (GDP). 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 that 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 impact, according to these results.

Given 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 the monstrous tax has redeeming qualities? If so what might they be?

Because property values change slowly, the property tax base offers a more stable tax base compared with the income and sales tax. 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. That suggests that local governments can depend on a more stable revenue stream from property taxes.

Critics often point out that rising values make taxes unaffordable for current owners. Indeed, an owner faced with rising levies may decide to sell and move to a more affordable property. This pernicious aspect of the tax can also have a positive effect on local community development. Take for example the owner of vacant land that is 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.

# Appendix

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# Study of Alternative Tax Plans for Public Education in Texas

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A Micro-Level Analysis

March 10, 2004

Charles E. Gilliland Ph.D.

Research Economist

# Study of Alternative Tax Plans for Public Education in Texas

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## Executive Summary

March 10, 2004

School tax reforms designed to reduce property tax burdens through sales tax expansion and caps on value increases have many potential consequences. The regressive nature of the sales tax concentrates higher taxes on the moderate to low income categories of taxpayers. Analysis of a specified plan to extend sales and use taxes to cover services and a 5 percent cap on reappraisals suggests that:

- Many homeowners will pay higher net taxes in nearly all income classes.
- There would be especially large proportionate increases for a majority of Texas households.
- The measures would reduce economic and development activity. Past studies suggest that Texas could lose as many as 56,000 jobs from imposing a tax on services.
- Many Texans would face reductions in expected housing quality.
- Home values could decline or not rise as fast.
- The system would create incentives for tax avoidance behavior, possibly driving some business activity out of state and causing vertical integration in some business activities.
- Part of the current tax burden that is exported through reduced Federal income tax liability would remain in state as the non-deductible sales tax replaces a deductible property tax.
- Tax revaluation caps could actually cause assessed values to rise during times with declining real estate markets.

In many cases typical Texas taxpayers would be left with less disposable income when these assumed reforms were enacted.

# Study Of Alternative Tax Plans For Public Education In Texas

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## A Micro-Level Analysis

Spring 2004

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### **REAL ESTATE AND TEXAS SCHOOL FUNDING**

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Responding to public dissatisfaction with increasingly burdensome school property tax levies, policy makers have begun to debate a wide array of alternatives designed to diffuse public concerns. Many efforts to provide meaningful property tax relief while maintaining and enhancing the level of support for public schools largely focus on identifying an alternative tax base that can support required levels of expenditures. Others have focused on providing relief to homeowners saddled with rising property tax bills. Two notable efforts propose to: firstly, substitute sales tax gained from expanding the sales tax base and increasing the sales tax rate for approximately half of the current school property tax burden. Secondly, plans have been advanced to arbitrarily limit increases in the taxable value of properties to 5 percent per year. Both of these measures would impact the financial situation of many Texas citizens. In particular, shifting the tax burden to a non-real estate related base could substantially impact property owners. This paper examines some of the implications of these measures.

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### **EXPANSION OF THE SALES AND USE TAX**

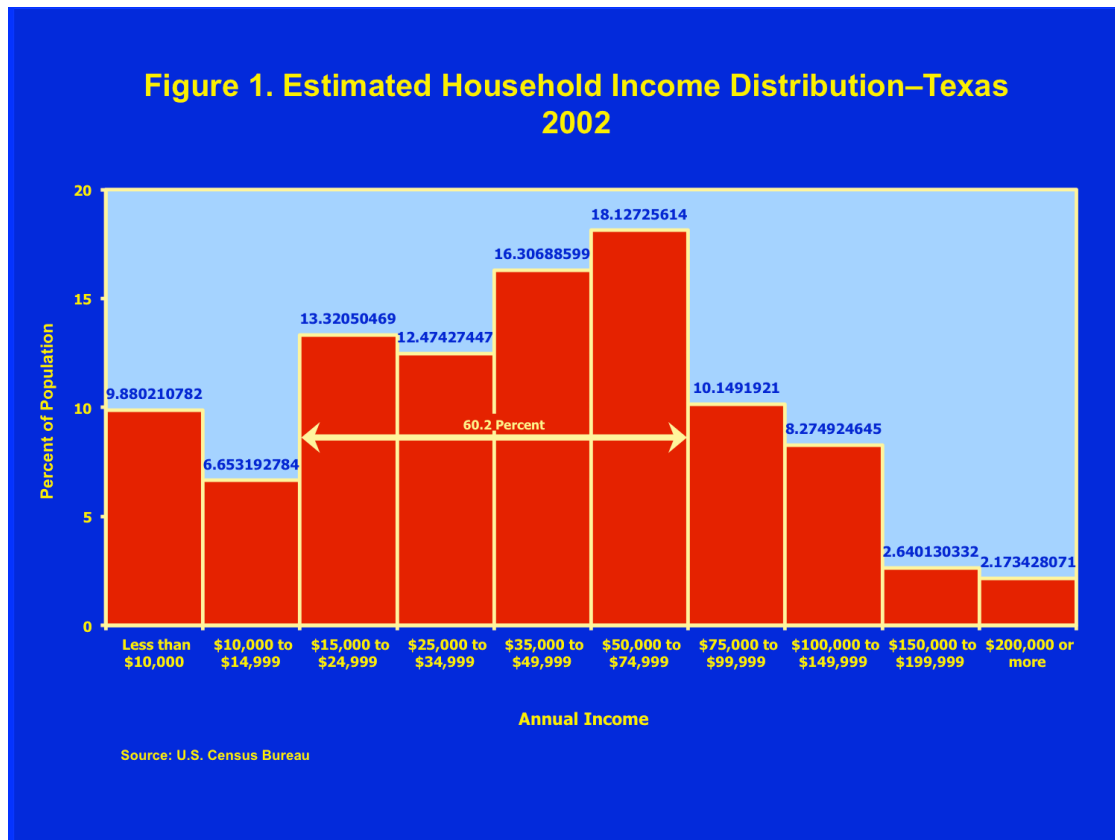
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Since the first successful litigation forced policymakers to redesign the system of finance for Texas schools, some have proposed widening the sales tax base to take in the ever-expanding service sector of the economy. As the Texas economy has migrated from a focus on natural resource development to dwell on services, much economic activity has taken place beyond the traditional reach of sales and use taxes. Similarly, exemption of intangible assets has transformed the property tax into a tax mainly applied to real estate. The maturation of the modern economy into a service driven engine fueled by intangible assets prompts some analysts to advocate extending the reach of the sales and use taxes to apply to all services.

### **ANNUAL EFFECTS FOR TEXAS TAXPAYERS**

Various measures have surfaced over the years to address those concerns. Indeed, the compromise that produced the current school funding plan also presided over extension of the property tax base to cover some services in Texas as early as 1993. However, extending the tax to cover nearly all services in Florida failed after precipitating chaotic conditions in the state's economy. The legislature subsequently repealed that measure and Massachusetts repealed a similar measure before it took effect. Students of public policy have offered numerous analyses of the wisdom of applying a general sales tax to businesses including the issue of exportability through deductions from the Federal income tax and a host of other potential financial and equity issues. Because those issues have been exhaustively addressed, this analysis focuses on the effects of a proposed sales tax expansion coupled with a simultaneous reduction in property tax burdens on particular classes of individual households.

A proposed expansion of the sales tax base that applies the 7.25 percent tax rate to virtually all individual household expenditures save medical expenses and expenditures on shelter would significantly alter current patterns of taxation. The projected burden from this expanded sales tax contrasts with a current tax burden based on a tax rate of 6.25 percent that applies to roughly 45 percent of typical household income<sup>1</sup> That percentage varies at various income levels based on differences in consumption patterns. Specifically, lower income households necessarily expend a larger percentage of their income on consumption while households at higher levels routinely save and invest a greater proportion of their income. In exchange for the expanded sales tax liability, households would enjoy a property tax reduction from current levels to \$0.75 per hundred dollars of value plus \$0.10 per hundred dollars of value for local enrichment, almost halving the property tax burden for many homeowners paying school taxes at rates of up to \$1.50 per hundred dollars of home value.<sup>2</sup> The difference between total sales and property tax burdens before and after shifting to the new tax base provides a measure of the change in the wellbeing of each type of household across the spectrum of income levels. Figure 1 shows the distribution of household incomes in Texas estimated for 2002 by the U.S. Census Bureau. Figure 2 shows changes in sales and property tax burdens for different household incomes based on Census Bureau statistics relating income to consumption and home values. Figure 3 reflects the combined impact of property tax reductions and sales tax increases for those households based on Census Bureau estimates.



<sup>1</sup> Household income used is based on income and expenditure levels for Dallas and Houston as estimated by the U.S. Bureau of the Census.

<sup>2</sup> Although many Texas school districts have not yet reached the limit of \$1.50 per hundred dollars of assessed value, many are rapidly approaching that mark. In addition, several districts that have reached the limit have filed a lawsuit to overturn the current system. This analysis examines the situation in districts that have reached the limit.



As Figure 1 reveals, income levels for more than 60 percent of Texas households fall between \$15,000 and \$74,999 annually. In fact, more than 76 percent of Texas households make less than \$75,000 annually. At the upper end of the income spectrum, approximately 13 percent of Texas household incomes exceed \$100,000 with less than 5 percent making more than \$150,000 annually.

The Census provides estimates of the value of homes owned by households at various levels of income as well as an estimate of the typical expenditures for those households. Combining these statistics allows an estimation of the value of the home for a specific income class and its associated property tax burden. Using the income and expenditure information facilitates an approximation of the sales and use tax burdens both before and after the envisioned tax base expansion. Those estimates produce the results displayed in Figures 2 and 3.

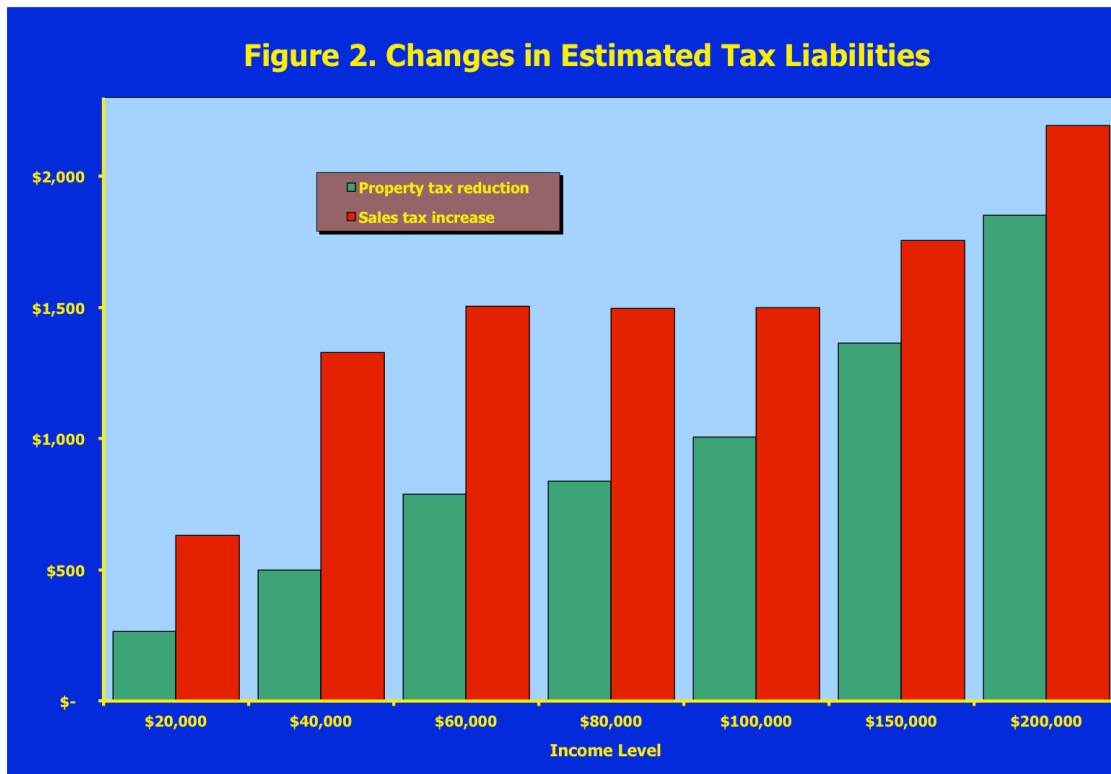
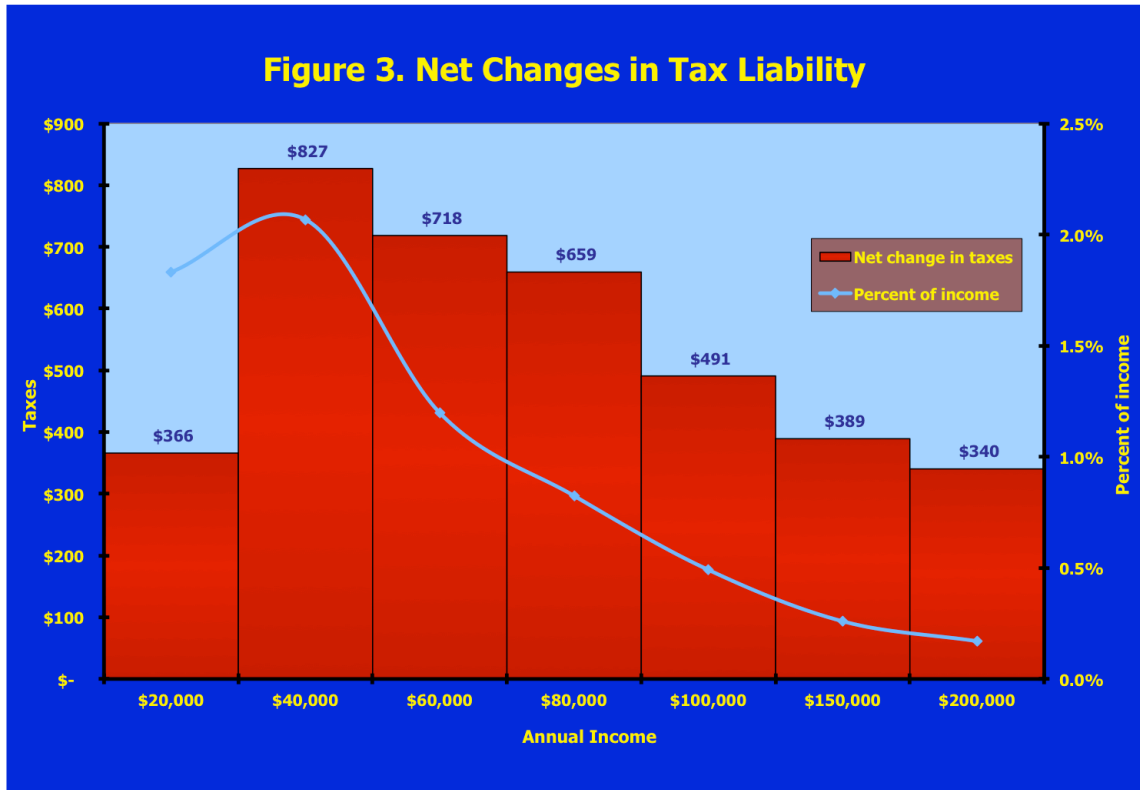


Figure 2 reports the dollar amounts of the property tax reduction following the downward adjustment in the rate and associated increase in sales taxes for seven categories of household income. Figure 3 shows the net dollar effect of combining those figures along with the percentages that the tax increase represents for each income level. As the chart reveals, Texans at all levels face an increase in taxes following expansion of the sales tax base. Those households in the \$40,000 to \$80,000 range face annual increases of \$645 and \$454 respectively. The increases ranged from a low of approximately 0.02 percent of income for the \$200,000 household to more than 1.6 percent of income at the \$40,000 level.

These charts illustrate the regressive nature of a sales tax. Because households at the lower income levels spend a larger percentage of their income on taxable consumption, a tax that targets consumption necessarily falls disproportionately on those households. Even if the upper income levels consumed a higher proportion of their income raising their net tax burden, the increase would still comprise a small percentage of their income. Further, consumption at the higher income levels (more than \$99,999) would have to fall below 30 percent of income before those households would

realize a significant net tax reduction. Therefore, this analysis suggests that, without special preferences, it is unlikely that any Texas households would experience tax reductions in the shift from property taxes to sales taxes. Further, because of home valuations and consumption patterns with respect to income levels, the shift would fall disproportionately on middle income households. In short, the Texas homeowner targeted for tax relief would more likely face a net increase in taxes. Additionally, that increase would substitute the sales and use tax that does not allow Texans to directly export part of the tax burden through Federal tax deduction for the property tax that does facilitate exporting the burden. This action may risk transforming dissatisfaction with high levels of property taxation into disgust with high levels of sales and use tax.



#### ADDITIONAL EFFECTS FOR HOMEBUYERS

Many Texans buy their homes so the added effect of taxing the services provided during a purchase would occasionally impact those citizens. That effect for active homebuyers could be substantial. Figures 4 and 5 demonstrate the estimated impact of the combined tax on real estate closing costs and the annual net impact of the shift from the property tax to the sales tax for the sale of an existing home and a new home. Figure 4 reflects sales tax on closing services while Figure 5 reflects those taxes, plus an added tax on the labor, involved in producing a new home.

Home buying involves a host of activities designed to ensure the quality of the house as well as the soundness of its legal title. Each of these many activities involves fees for services that add to the cost of moving into a new home. These closing costs act as a major impediment to home purchases by reducing the amount of cash available for purchase. Thus, any addition to the level of these fees makes a home less affordable. The services behind these costs have traditionally been excluded from the general sales and use tax. Therefore, extending the tax to cover those services would increase the

cost of moving into the home. Homebuyers' ability to purchase a home would be adversely affected by any net increase in tax liability arising from the shift from property taxes to taxes on most consumption. Affordability would be reduced by both the tax on closing costs and the reduction in income following expanding taxes on normal household expenditures. Figures 4 and 5 contain those combined effects.

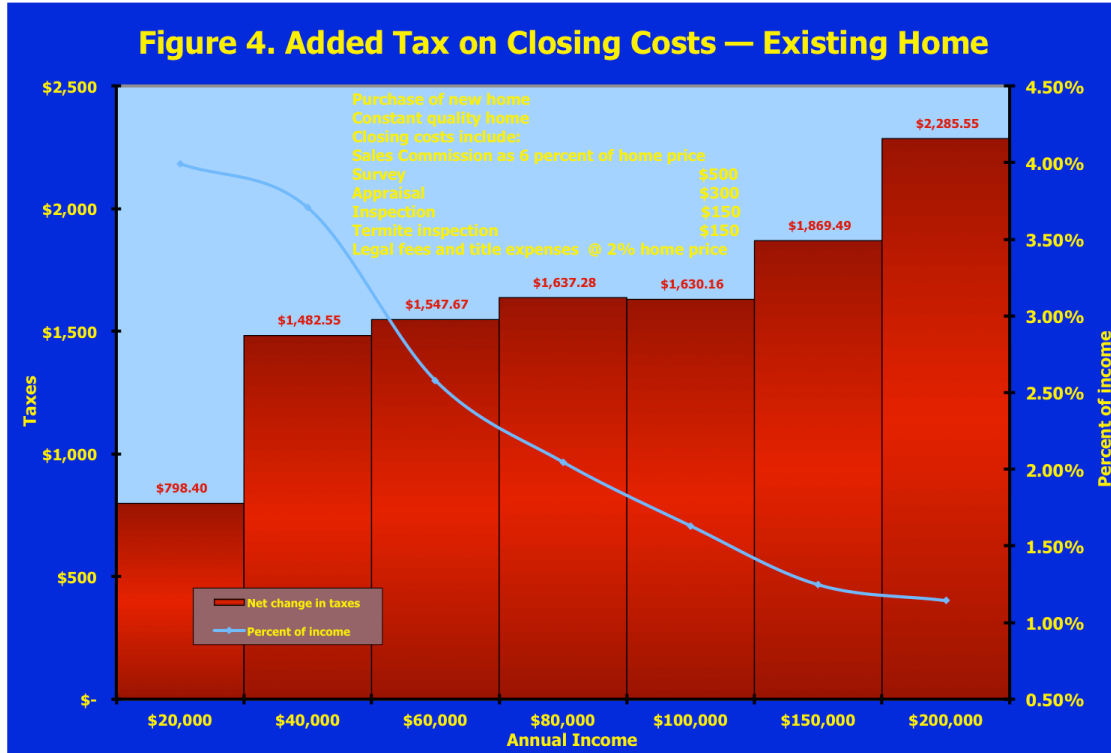
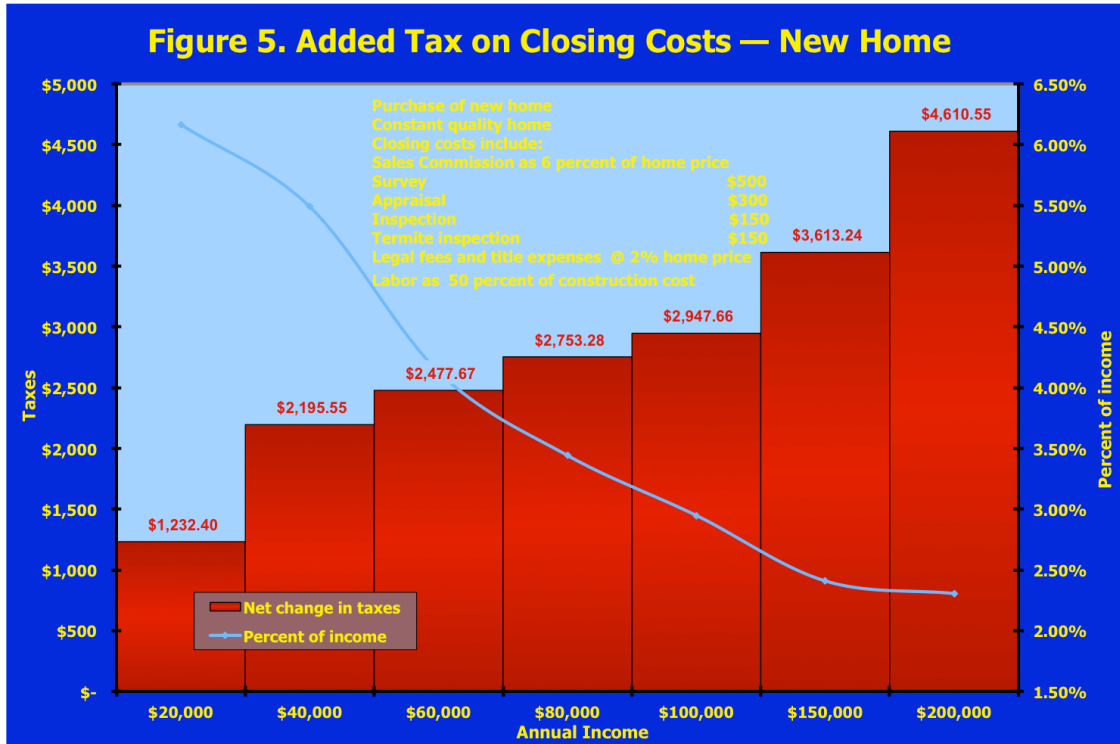


Figure 4 shows the situation of homebuyers that incur both the tax on closing services and the reduction in disposable income resulting from the increase in sales tax liability less property tax saving. The chart reveals an addition of more than \$683 in combined tax burden for households in the \$20,000 income range as they purchase the typical existing home for that income bracket.<sup>3</sup> That amount rises to \$1,860 for the \$200,000 income household. The total tax effect, both taxes on closing services and the added tax on normal consumption expenditures, composes a diminishing relative proportion as incomes rise, as evidenced by the blue line in Figure 4. Indeed, the burden for buyers at the \$20,000 income level amounts to approximately 3.5 percent of income while those at the \$200,000 level would face increased taxes of about 1 percent of income. Figure 5 shows the situation faced by homebuyers purchasing a newly built home sold by a real estate agent. The difference between Figures 4 and 5 arise from the tax on labor services used to construct the new home.<sup>4</sup> Lower income households face an addition of \$1,090 in costs with the upper income home category registering an increased tax of \$4,035 in costs in the year of the closing. Those amounts compose more than 5.5 percent of income for the lower income category and 2.0 percent of income in the upper income category.

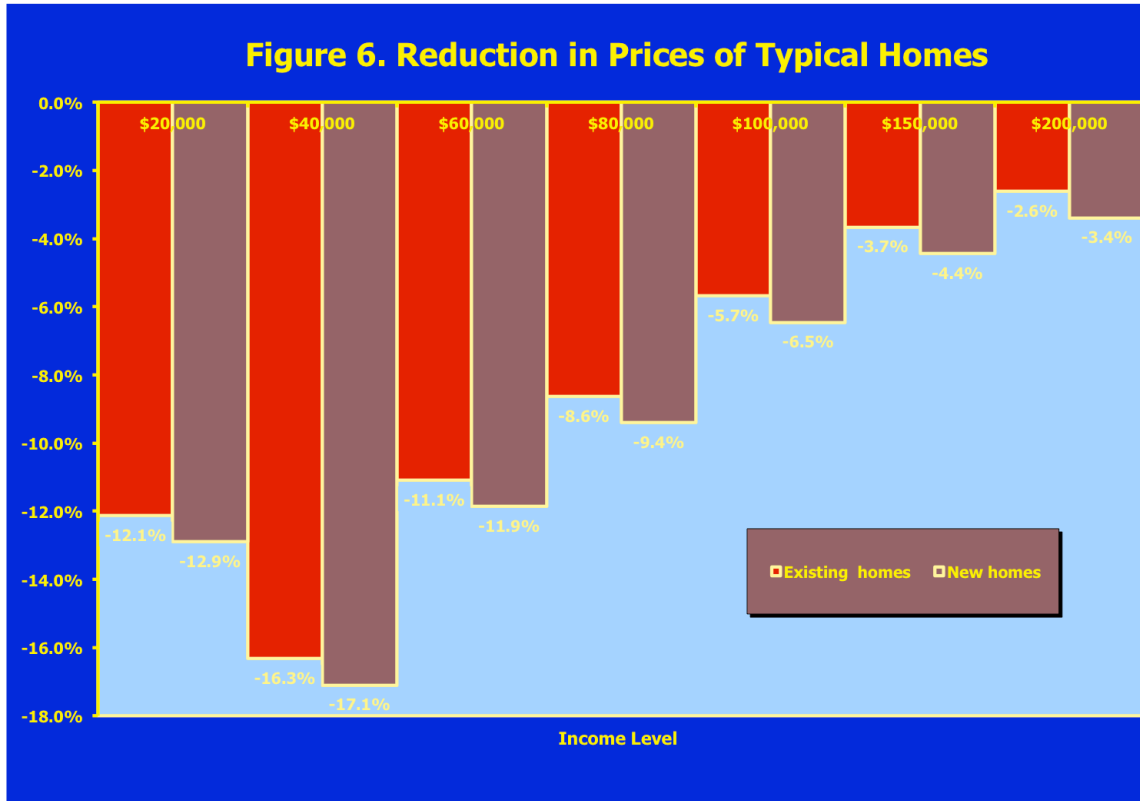
<sup>3</sup> The home value used was estimated using the most recent 2000 Census Bureau of the Census figures relating home values to given income levels.

<sup>4</sup> We assumed that labor represented 50 percent of construction costs for a new home.



Undoubtedly, this increase in closing costs will impact home buying decisions at all income levels with the greatest proportionate impact occurring at the lower income levels. Figure 6 shows the anticipated influence that the added tax on services at closing plus the ongoing net increases in taxes for schools would exert on home prices for typical homebuyers in the various income categories. The results apply to an owner with an 80 percent loan-to-value ratio and a 6 percent mortgage. The analysis assumes that these buyers' ability to make monthly payments would decline by the net tax shifts identified in the above analyses. The combined effect would result from the reduction in income available for monthly house payments and the added lump-sum liability due at closing. The former effect would reduce the amount of mortgage that the buyer could support because of reduced monthly payments. The latter effect, taxes on services at closing, would reduce the amount available for a down payment, further reducing the dollar amount that could go toward the home purchase.

As the red bars in Figure 6 report, the value of the existing home purchased by the typical buyer in the \$40,000 income category would fall by 12.9 percent in response to reduced affordability. Because of variations in the levels of income expended on consumption and home value-to-income ratios, the percentage effect diminishes as incomes range higher than \$40,000 with the \$200,000 income household sustaining a 0.8 percent drop in home affordability. Because of the tax on the labor in new construction, new homes would fall more than 13.6 percent for the \$40,000 household and 1.6 per cent for the \$200,000 household.



These results will vary for those households who choose a 95 percent mortgage and pay 25 percent more for a home. The \$40,000 household would experience a 10.9 and 11.7 percent reduction respectively for an existing and new home. The \$200,000 income household would actually enjoy a small net tax reduction and resulting value decline of 0.8 percent under those circumstances when buying an existing home. Increased closing costs from taxes would force the purchase price of a new home for these taxpayers to drop by about 1.5 percent.

These estimates vary considerably with income and the financial parameters used in the analysis. Further, they do not capture all of the anticipated effects of the tax changes. Specifically, the impact would be affected by the loss of the deduction from Federal income taxes as sales taxes substitute for deductible property taxes. Declining values would tend to further reduce the property tax burden. This analysis concentrates only on the immediate effects that would follow from the envisioned changes. Nonetheless, these results indicate that the anticipated tax shifts will disproportionately impact households in lower income levels. Although the actual situation for individual taxpayers would likely vary from the estimated amounts, these results suggest that the envisioned changes will reduce the numbers of buyers who can qualify to buy the home that they could afford under current conditions. Given the level of tax increase, the Center estimates that as many as 75,000 potential homebuyers may no longer be able to afford the median-priced Texas home.<sup>5</sup> Thus, many buyers would settle for less home than they could currently afford. Further, the differential between the added taxes for a new home compared to an existing one would tend to steer buyers toward existing homes. Additionally, some potential buyers at the low end of the income spectrum may find themselves being forced to abandon or postpone their plans to own a home. The National Association of Realtors has estimated that the a sales tax on services could precipitate a 2.7 percent

<sup>5</sup> Jack C. Harris, Research Economist, Real Estate Center, Texas A&M University.

decline in home sales in Texas leading to a more than \$200 million decline in home sales with an associated loss of economic activity in allied businesses.<sup>6</sup> A study examining the expansion of the Texas sales tax to cover services in Texas in similar circumstances in 1987 concluded that the expanded tax would cause an increase in unemployment of 0.6 percent in its first year. Approximately 28 percent of that loss would occur in finance, insurance, and real estate with the remaining 72 percent coming from services.<sup>7</sup> Given January 2004 Texas employment, that would result in a loss of more than 46,000 jobs in the current economy.<sup>8</sup> Given the vital role that home construction and buying in keeping the economy moving through difficult times, these effects could point to lower levels of economic activity and employment in Texas.

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### CAPPING PROPERTY TAX VALUE INCREASES

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A series of sizable and continuous increases in taxable values on homes in California in the 1970s moved residents to arise in protest. This spiral in property taxes undoubtedly was the major contributing factor facilitating passage of the famous Proposition 13, a tax limitation rebellion. Part of that rebellion limited growth of property tax values so long as ownership continued. This provision guaranteed that assessed values on homes would lag behind the market value in rising housing markets. Further, it also perversely ensured that assessed values would continue to rise after housing markets had begun to fall since the reduced market value continued to exceed the assessed value. Homeowners, faced with a diminished home value angrily demanded to know how their taxable value had risen, only to learn that the passage of time had produced unintended consequences from Proposition 13 upon them.

With more of the burden for Texas public schools migrating to the local property tax, Texas homeowners have faced escalating tax levies. These increases have come through rising school tax rates and, more recently as schools reached the tax rate limit of \$1.50 per hundred dollars of value, through rapid property value growth. Even sporadic revisions of homestead exemptions have done little more than temporarily reduce the increasing tax burdens on homeowners. The idea of capping value increases has again arisen as Texans face these escalating property tax liabilities with dismay.

Figures 7 and 8 illustrate the long-term implications of limiting tax value increases to 5 percent per year in a market where market values are rising at a 7 percent annual rate. In Figure 7, the gold line corresponds to the taxes that a homeowner would face with a constant tax rate of \$1.50 per hundred dollars of value. Beginning in 2004 with a home valued at \$100,000 the burden escalates each year as the assessed value matches the 7 percent rise in market value. The blue line traces the experience of an owner of an identically valued home when appraisal increases are limited to 5 percent per year. In 2030, the owner of the home where limits did not apply (the gold line) would face a tax burden of \$8,711 while the owner of an identical home subject to the limit would pay \$5,334 (the blue line). The owner of the non-limited home would pay 1.5 percent of property value in taxes while the limited home would pay less than 1 percent of market value in taxes. The pink line corresponds to the case of a homeowner who acquires a new home every seventh year. That

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<sup>6</sup> Research Division, *Potential Impacts of Sales Taxation of Services on the Real Estate Sector*, National Association of Realtors, August 2003, p4.

<sup>7</sup> House, Donald R.; Morgan O. Reynolds; Vincent L. Wiggins, *The Economic Impact of the New Taxes on Services in Texas*, RRC, Inc. February 27, 1987

<sup>8</sup> Texas Workforce Commission estimated seasonally adjusted non-farm employment in Texas of 9,388,500 in January, 2004.

homeowner would enjoy declining taxes for five years, paying 1.36 percent of value in the sixth year. The moving homeowner would then face taxes at 1.5 percent of value in the seventh year. These examples illustrate the inescapable fact that identical properties would bear vastly different tax burdens as time passes under a plan limiting increases in taxable value.

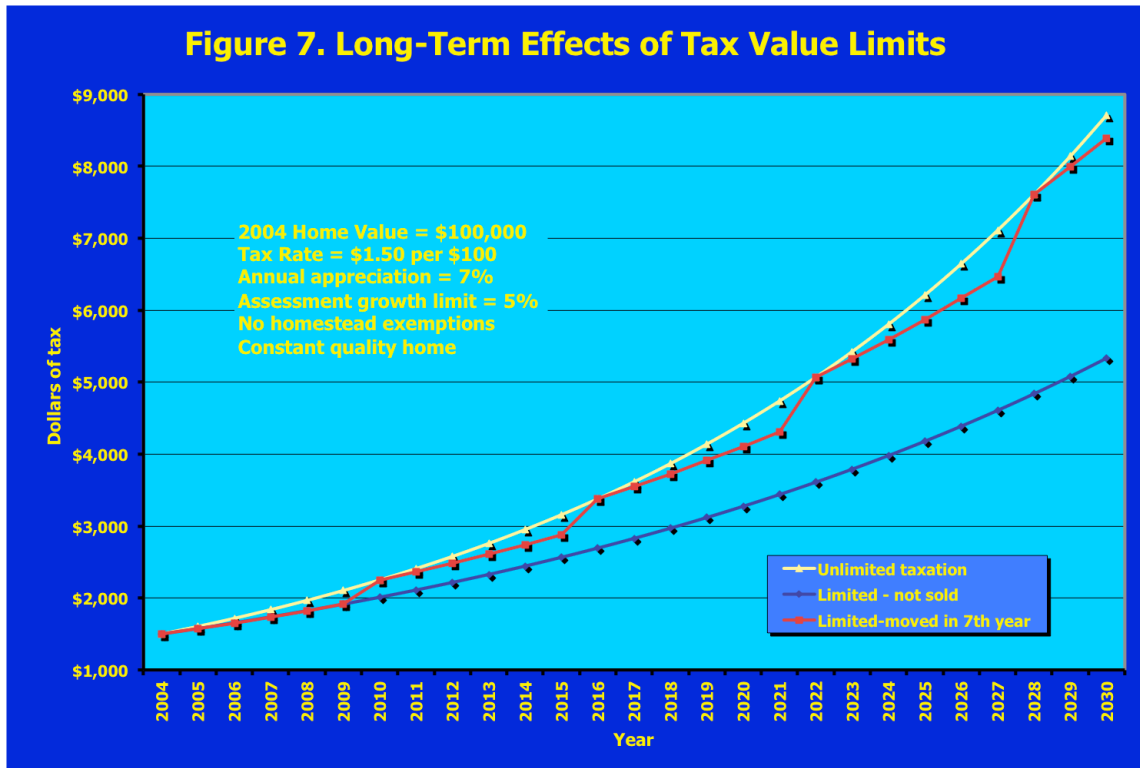
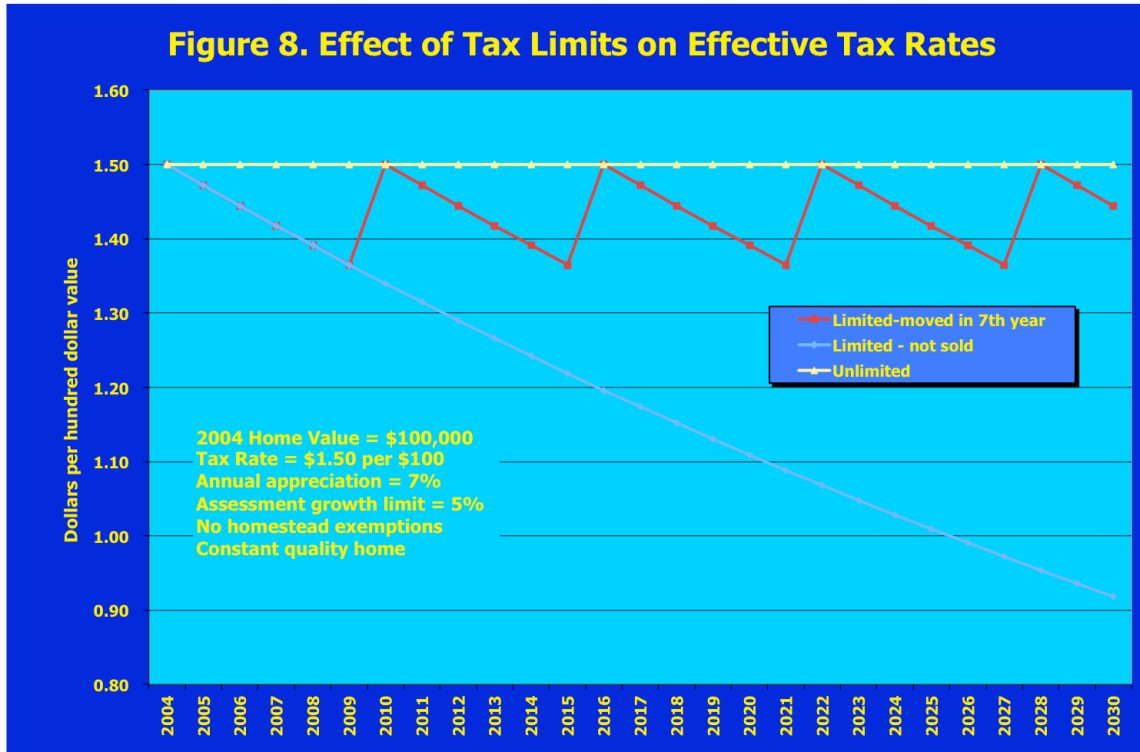


Figure 8 illustrates how these circumstances work to distort owner incentives. Specifically, the gold line shows the effective tax rate at a constant level of \$1.50 per hundred dollars of value for the uncontrolled property. Again, the pink line represents the effective rate for a property owner that moves every seventh year while the blue line shows the declining effective rate paid by a homeowner that remains in the same home. The gap between the blue line and the gold line indicates a penalty of sorts for moving from a protected home to one taxed without limits. As time passes, that gap widens until the homeowner faces a potential of more than a 60 percent increase in tax burden for moving from a protected home to another of equal value. From that homeowner's perspective, it becomes much more expensive to move than for the trading homeowner who would only face a 10 percent jump every seventh year. The longer the limit applies the greater the potential distortion and the greater the incentive for the homeowner to stay put. Thus, the limitation could reasonably be viewed as an impediment to the market for homes with a dampening effect on new construction and development.



## CONCLUSIONS

The drive for school tax reform aims to relieve the crushing property tax burden faced by Texas homeowners while maintaining adequate revenues to support public education. The foregoing analysis of some suggested solutions to the problem illustrates the regressive nature of the sales tax option and suggests that an expansion of the tax base to cover virtually all consumption expenditures would visit proportionately large tax increases on the lowest income households. Under the assumed conditions, nearly all households in Texas would face a net tax increase even after property tax reductions act to offset the sales tax increase. On balance, past studies suggest that Texas could lose as many as 56,000 jobs to a sales tax on services. High-income households with relatively expensive homes would probably see a net tax saving.

A proposal to cap value increases at 5 percent per year similar to the California Proposition 13 model offers a promise of relief from climbing taxes, but the cure could produce undesirable side effects in the long run. In an escalating market, the cap would work to distort housing purchase decisions by keeping property taxes low for long term residents. Even moving after as few as six or seven years would inflict a 10 percent increase in the level of taxation for a homebuyer. Maintaining ownership for longer periods would cause the rate to rise much higher when moving to another home. Further, the cap could act to keep effective tax burdens rising even after markets had softened or declined inflicting more pain when taxpayers could least afford it.

The combination of these measures threatens to impact the marketability of new homes and retard demand for new development by increasing the burden of purchasing new homes or even moving to another existing home. As time passes that impediment would continue to grow into a sizable distortion of the housing market. Although it is important to find a method of easing the tax



burden on homeowners, policy makers should consider all of these important implications as they choose a path designed to accomplish reforms.

Finally, the study did not address an analysis of some other implications of distorting the price system through an expanded tax on services. That kind of measure could impact the economy in a variety of ways. Firstly, business could move out of Texas. Multi-state firms could begin to conduct meetings in their offices beyond Texas borders. That business would escape taxation and would further impact revenues by reducing the other commerce following from that activity. Secondly, larger business would see an advantage in directly employing consultants, attorneys, accountants, brokers, and others to avoid the expense of paying taxes on their services. Homebuilders may even directly employ the laborers to avoid paying taxes on their services. Presumably, a homebuilder's directly employed sales staff would not be subject to the services tax while a listing with a real estate agent would incur a tax on services. At some point it may become beneficial to hire a sales staff rather than use an outside broker. It would be impossible to realistically estimate the extent of this kind of behavior, but the incentives for such activity would emerge as the measures took effect.

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### ASSUMPTIONS AND LIMITATIONS

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The above analyses are subject to the following assumptions and limitations:

No secondary effects were estimated.

The analyses represent “typical” cases. Homeowners with homes that are a larger multiple of their income, that is those with more expensive homes, could experience smaller tax increases or even net gains. The extent of gain depends on the amount of property tax saving on the high valued home.

Consumption patterns for upper three income levels were estimated from those reported by the U.S. Bureau of the Census for lower income levels.

The numbers shown are based on the best available data. However, the dollar amounts shown may differ from the actual shifts because of factors outside the scope of this study. Nevertheless, because low-income homeowners will experience a relatively small property tax reduction and consumption represents a large portion of the household budget, the general patterns of tax burden liability shifts will quite likely remain the same.

Deductions from the Federal income tax are not addressed. The shift from property tax would include an added expense for losing that deduction. Thus, the results tend to understate the actual out of pocket expense of the tax shifts. This is probably especially relevant to individuals in the upper income categories.

Estimated consumption, home value, and income characteristics are based on statistics obtained from the U.S. Department of Commerce – Bureau of the Census and the following assumptions:

Property tax:

- Home values are a multiple of income as specified by the US Bureau of the Census.
- Property tax rates are \$1.50 per hundred dollars of value before reform and \$0.75 after the reform with an added \$0.10 local enrichment

- The analysis includes the mandatory \$15,000 homestead but no other local option exemptions

Sales tax:

- Based on analysis of typical expenditures for Dallas and Houston and current sales taxes related to total state income, approximately 45 percent of income is subject to current state sales tax at the typical income level. That percentage was adjusted for the lower and higher income levels according to relative levels of consumption expenditures.
- Sales tax base after reform will include all consumer expenditures less medical and shelter expenditures
- Current state sales tax rate is 6.25 percent
- Proposed state sales tax rate will be 7.25 percent

Census Bureau figures provide a reliable indication of the percentage of income dedicated to taxable expenditures

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