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Paths to Real Property Tax Cuts

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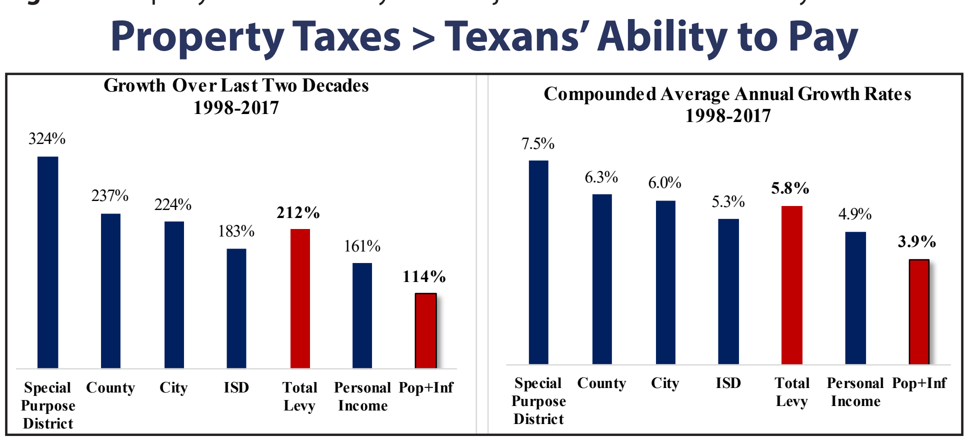
Key Points

- Despite the economic success of the Texas Model, skyrocketing local property taxes remain one of the state's most pressing policy challenges.
- Any path to permanently lowering school districts' M&O property taxes must be combined with limiting government spending and property tax reform.
- A combination of lowering school districts' M&O property taxes, limiting government spending, and property tax reform would shift Texas to a more efficient and fair sales tax-dominated system, assuring real property tax cuts and improving the Texas Model to sustain economic prosperity for generations.

Background

Despite the economic success of the Texas Model of fiscally conservative governance, the skyrocketing local property tax burden remains one of the state's most pressing policy challenges. **Figure 1** shows that property taxes have been growing faster than the average Texan's ability to pay for them, as best measured by the change in population growth plus inflation, increasing the need to eliminate them.

Figure 1. Property tax increases by local tax jurisdiction over the last 20 years



Texas has at least the sixth most burdensome property tax system in the nation. Too many property holders have been forced out of their homes and businesses because of skyrocketing property taxes. Texans want local property taxes eliminated as quickly as possible. For example, 67 percent of voters in the 2018 Republican primary election agreed that property taxes should be replaced with a sales tax. Eliminating just school districts' maintenance and operations (M&O) property taxes is rather straightforward because the state determines the funding formulas for the school finance system. Therefore, a good place to start eliminating property taxes is these M&O property taxes, which represent nearly half of the property tax burden across the state.

There are multiple options to eliminate school districts' M&O property taxes. One option would be to immediately eliminate M&O property taxes by increasing sales taxes. Another option would be to increase sales taxes to buy down a portion of the M&O property tax with continued cuts over time. A third option would be to limit government spending growth so that state "surplus" dollars could buy down the M&O property tax over time. No matter the option chosen, these must be real cuts to property taxes that lower Texans' property tax bills and slow their growth rate with a 2.5 percent election trigger.

The Sales Tax Option

The Foundation's previous research to eliminate property taxes by increasing sales taxes in a revenue neutral way has followed sound fiscal principles. This includes

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an ideal option of sales taxes raised, primarily by broadening the base but also increasing the rate, to immediately eliminate property taxes.

Problems With the Property Tax

Our research on the sales tax has determined several instances where the sales tax is superior to the property tax.

Property Taxes Are an Inefficient Type of Tax

Property taxes are based on primarily subjective valuations by appraisal review boards and tax rates determined by local tax entities with little to no feedback from citizens. They also can force people out of their homes and businesses if not paid, meaning Texans never truly own their property even if they pay off the principle because taxes will be owed forever. Given the rising property tax burden and its inefficient collection mechanism, property taxes should be eliminated. One option would be to replace them with a more efficient, slower-growing final sales and use tax based on objective market transactions, not including property (as long as there is a property tax). This would help appropriately remove taxes on capital (i.e., property), since capital formation and accumulation drive the wealth of states.

Property Taxes Can Be More Regressive Than a Sales Tax

Opponents of a sales tax say it is too regressive, whereby people with lower incomes pay a larger share of their income to taxes than those with higher incomes. A Texas Comptroller's recent report confirms that both Texas' sales taxes and property taxes are regressive but suggests property taxes are less regressive. According to the Comptroller's suits index, sales taxes are estimated to be -0.226 while the school districts' M&O property taxes are estimated to be -0.099, with a larger negative number representing a more regressive tax. However, this static analysis (and others like it) does not account for the fact that sales taxes are paid once at purchase, yet property taxes are paid annually, hurting low- and fixed-income Texans the most because the costs compound over time. A property tax also keeps some Texans and others from purchasing a home and forces many people out of their home and business. Appropriately accounting for these dynamic cumulative costs, the property tax can be more regressive than a sales tax.

Need for a Single-Legged Barstool in the Form of a Broad-Based Sales Tax

There has long been the idea of a three-legged stool of taxation. These legs include a sales tax, property tax, and a personal income tax. Because Texas appropriately does not have the latter, the argument is that there is a need for the other two. But that is incorrect because it is really a function of excessive government spending and not a need for poor forms of taxation. The evidence is clear that Texas should never have a personal income tax. There is also a growing consensus that Texas should eliminate property taxes that keep Texans renters forever. Texas needs the most efficient tax system possible to fund limited government. This can be done by expanding the sales tax base as wide as possible to not pick winners and losers and to keep the rate as low as possible.

Options for Eliminating School Districts' M&O Property Taxes Using the Sales Tax

There are multiple options to eliminate school districts' M&O property taxes. This could happen by swapping property taxes with sales taxes immediately, swapping property taxes with sales taxes over time, or practicing fiscal restraint to buy down property taxes over time.

Swapping School Districts' M&O Property Taxes Immediately

For this option, broadening the sales tax base would be best because it would provide a more efficient tax that limits the number of exemptions to provide the lowest tax rate possible, keeping it competitive with nearby states. **Table 1** shows that Texans paid a total of almost $63 billion to local school district M&O property taxes, local sales taxes, and state sales taxes in 2017.

Table 1. Tax collections by source, fiscal year 2017

Revenue Source (Millions of $)	2017
School District M&O Property Tax Collections	$25,638
Local Sales Tax Collections	$8,432
State Sales Tax Collections	$28,900
Total School M&O Property Tax Plus Local and State Sales Taxes	$62,970

Source: Texas Comptroller

We start with Texas' growth state product (GSP). We use total private industries and subtract multiple industries to determine different tax bases and total state and local tax rates needed to replace state sales tax and school M&O property tax collections of $53.5 billion. **Table 2** shows that using a static analysis provides a range of sales tax bases and tax rates for FY 2017.

The GSP base that collected the $37.3 billion in state and local sales taxes in 2017 is $452.5 billion ($37.3 billion divided by 8.25 percent) or the $28.9 billion in only state sales tax is $462.4 billion ($28.9 billion divided by 6.25 percent). More specifically, the Texas Comptroller notes that in 2017 Texas provided $42 billion in exemptions, exclusions, and discounts to the sales tax base in GSP, which is corporate welfare that contributes to a higher sales tax rate than necessary and should be eliminated. Broadening the sales tax base would also influence other local government

Table 2. Total state and local sales tax rate needed to replace school district M&O property taxes

Swap Sales Tax Base Options (Millions of $)	Gross State Product Base	State Tax Rate	Local Tax Rate	Total Tax Rate
Base Needed with No Change in Tax Rate	$763,272	6.25%	2.00%	8.25%
Reformed GSP Base	$637,098	8.56%	1.32%	9.88%
Rate Needed with No Change in Base	$452,509	12.05%	1.86%	13.92%

Notes: Sources are Bureau of Labor Statistics and author's calculations. Reformed GSP base is total private industries excluding real estate, health care, manufacturing, mining, wholesale, and construction.

jurisdictions' sales tax collections, but that should be addressed by lowering their rates to make it revenue neutral along with strict local spending limits. We recommend not raising the rate above the total tax rate of 9.88 percent.

While the base expansion means some sectors not currently under the sales tax, like many professional services such as lawyers and accountants, would be taxed, these suppliers would also see an associated elimination of nearly half of their property tax burden. By just expanding the base to most services, excluding physician and dental services as well as construction services, there could be an additional $5 billion in tax collections per year to go to property tax relief, which is the same as raising the state sales tax rate by a percentage point.

Swapping Property Taxes With Sales Taxes Until Eliminated Over Time

Another option is to finance the buydown of the M&O property taxes with state sales taxes over the same period. The increased collection of state sales taxes to buy down M&O property taxes could be achieved by raising the sales tax rate, broadening the sales tax base, or a combination of these two. Economists at the Baker Institute at Rice University studied the economic effects of this sales tax financed option. They found that a 3.6 percent decrease in property taxes could contribute to a $14.3 billion (0.8 percent) increase in economic output and 217,000 new jobs after the first year of reforms. These results occur because of the economic gains of such a transition to a more efficient economic system based more on sales taxes. While they did not model it, this option should be combined with strict spending limitations at the state and local levels to avoid rising tax bills other than for school districts which should be cut each session, and the state surplus should be used to provide tax relief.

The Full Swap Avoids Problems That Could Result From a Partial Replacement

The full swap can be a conservative reform because sales taxes tend to grow at a slower rate than the property tax and are based on objective metrics from mutually beneficial exchanges rather than the guess work of appraisal districts.

The other appeal of the complete replacement of the property tax by the sales tax is that it eliminates the possibility that the tax relief experienced by a swap would be only temporary. This has been one of the failures of property tax relief efforts of the past:

> *There have been three major legislative efforts to provide property tax relief since the system took its current form in 1979. Unfortunately, each of these efforts has proven to be ineffective in permanently reducing the rising property tax burden.*

Perhaps the most relevant example of how legislative action failed to bring significant property tax relief was the 2006 property tax-franchise tax swap:

> *In 2005, the Texas Supreme Court ruled the school finance system unconstitutional. The court found that the system violated the constitutional ban on a statewide property tax because school districts had very little discretion to set tax rates below the state's maximum allowable rate, violating the constitutional ban on a statewide property tax. In response, Gov. Rick Perry created the Texas Tax Reform Commission that devised a plan to reduce property tax rates while increasing state funding of education. Consequently, the Texas Legislature held a special session in 2006 to bring the school finance system into compliance. It did this by increasing the Texas franchise tax, the motor vehicle sales tax, and taxes on tobacco products and using the revenue to increase state funding for public schools. Combined with changes in the school funding formulas and property tax caps, the Legislature expected its actions to bring the system into constitutional compliance and provide significant property tax relief for taxpayers.*
>
> *However, this is not what happened. … the total property tax levy only declined by a little more than $400 million in 2007 and jumped by almost $5 billion over the next two years, despite the fact that the Legislature sent an additional $14 billion of taxpayer funds to public schools for the 2008-09 school years. So, instead of meaningful tax relief, the result was an increase in property taxes and state taxes in order to increase total public education*

spending. Additionally, homeowners and businesses have since watched their property tax burden continue to increase; it is up 58 percent since 2006.

The Fiscal Restraint Option

Another option is to limit the increase of general revenue spending per biennium and use 90 percent of the state surplus dollars generated to buy down school districts' M&O property taxes over time until they are eliminated. If revenue growth kept up with past trends and spending was limited to 4 percent per biennium, this process would take about a decade to eliminate districts' M&O property taxes. Economists at the Baker Institute studied the economic effects of this option as well. They found that a 3.4 percent decrease in property taxes could contribute to a $12.5 billion (0.7 percent) increase in economic output and an 183,000 increase in employment in the first year after the initial buydown and more thereafter.

A challenge with this option is that it allows the actions of local governments, including school districts, to diminish the property tax relief that would otherwise be experienced by property owners. So an important component of the replacement plan is managing this. Under these options, the maximum revenue growth by local tax jurisdictions should be 2.5 percent, and school districts should no longer be able to increase their M&O property tax rates in the buydown options. Instead, the state would essentially set the school districts' rates, lowering them each year, until the tax is completely eliminated. Similarly, it is important to limit the growth of property taxes by other local taxing entities. "Counties, cities, and special purpose districts would be able to set their property tax rates to generate no more than a 2.5 percent annual increase, over revenue from the previous year, in property tax revenue. However, similar to the current rollback system, local governments could petition voters to increase total property tax revenue more than 2.5 percent. The approval of the higher rate would require a majority of voters in an election with at least a 20 percent turnout."

Conclusion

Lowering the total tax burden on Texans should be the ultimate goal of this debate. Currently, there are paths to eliminating school districts' M&O property taxes. One is to exercise fiscal restraint to buy down the property tax with no additional taxes needed. The large revenue available to legislators would require minimal spending restraint to achieve significant property tax relief and reform. Using the Senate version of the 2020-21 budget, for instance, the Legislature could repurpose the $2.3 billion tentatively allocated to public education (TEA Rider 80) and the $2.7 billion currently dedicated to generic property tax relief (TEA Rider 81) to provide $5 billion of lasting property tax reductions through the buydown in the 2020-21 biennium. This could also keep the budget within the limits of the Conservative Texas Budget.

Another option involves replacing M&O property taxes with state sales tax collections by either broadening the base (preferred method for economic efficiency), raising the tax rate, or a combination of these. If this option is taken, the new state money should go only to property tax relief.

Given high taxes are always and everywhere a spending problem, whichever path is chosen must be paired with limiting government spending and property tax reform to put limitations on tax increases of, at most, 2.5 percent by local tax jurisdictions. By combining property tax reductions and reform with spending limitations, Texas could shift to a more efficient and fair sales tax-dominated system. In this way, Texans can be assured meaningful, lasting property tax relief and an improved Texas Model that will sustain economic prosperity for generations.

ABOUT THE AUTHOR

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