

# Testimony

## HB 958

# Replacing School District M&O Property Taxes in Texas

## Testimony in Support to Texas House Appropriations Committee

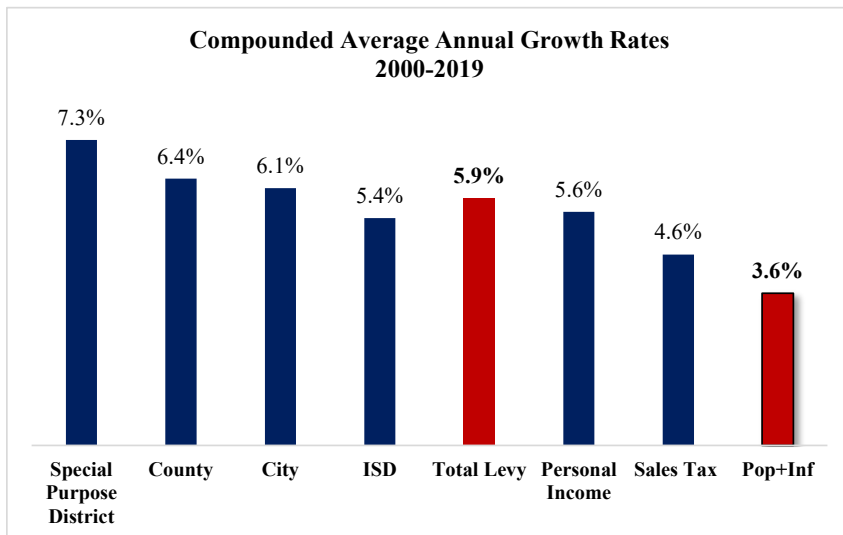
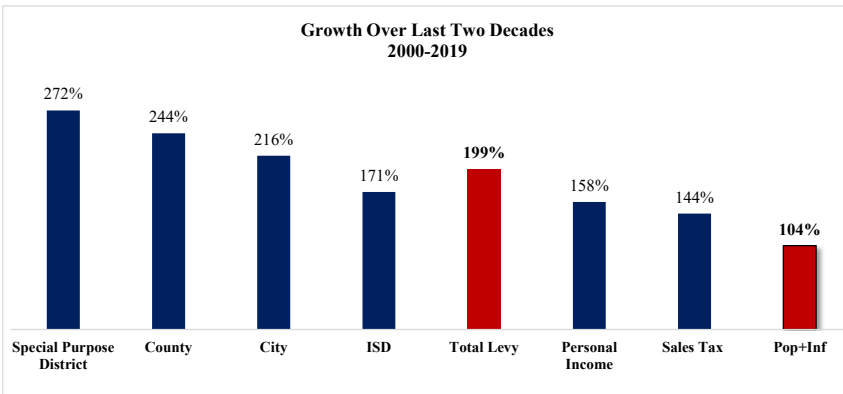
by Vance Ginn, PhD, Chief Economist

Chairman Bonnen and Members of the Committee:

My name is Dr. Vance Ginn, I am chief economist at the Texas Public Policy Foundation. I appreciate the opportunity to testify today in support of [HB 958](#). I would like to provide the costs of local property taxes in Texas, options for how to eliminate school districts’ maintenance and operations (M&O) property taxes, and the benefits of this fundamental tax reform with limiting government spending—the true burden of government.

### Figure 1

*Increases in Taxes and Economic Measures Over the Last 20 Years*



Note. Data are from Texas Comptroller and author’s calculations.

While there are [several valuable bills](#) and ideas available this session to achieve this goal, HB 958 would do this by limiting state spending and using most of any surplus dollars to buy down the school district M&O property taxes until they are eliminated. If the Legislature remains vigilant to the goal, the buydown to elimination could take about a decade and be even faster depending on how much elected officials can limit state and local government spending. Eventually, the buydown would cut local property taxes nearly in half while adhering to the state’s constitutional responsibility of funding government schools.

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 over the last 20 years have been growing faster than the average taxpayer’s ability to pay for them, as commonly measured by the change in population growth plus inflation, even with reforms and types of buydowns over time.

According to the Tax Foundation, Texas has the [7th most burdensome property tax on homeowners](#) and the [15th worst property tax burden on businesses](#) in the nation. Too many property holders have been forced out of their homes and businesses because of skyrocketing

*continued*

property taxes. There is a valuable argument to eliminate all property taxes, which hurt lower-income earners the most, so Texans can stop effectively renting from the government forever. A good start in that process would be to eliminate school district M&O property taxes which account for nearly half of the total property tax burden on Texans. Eliminating just these taxes is rather straightforward because the state determines the funding formulas for the school finance system, and it represents [nearly half](#) of the [property tax levy](#) across the state.

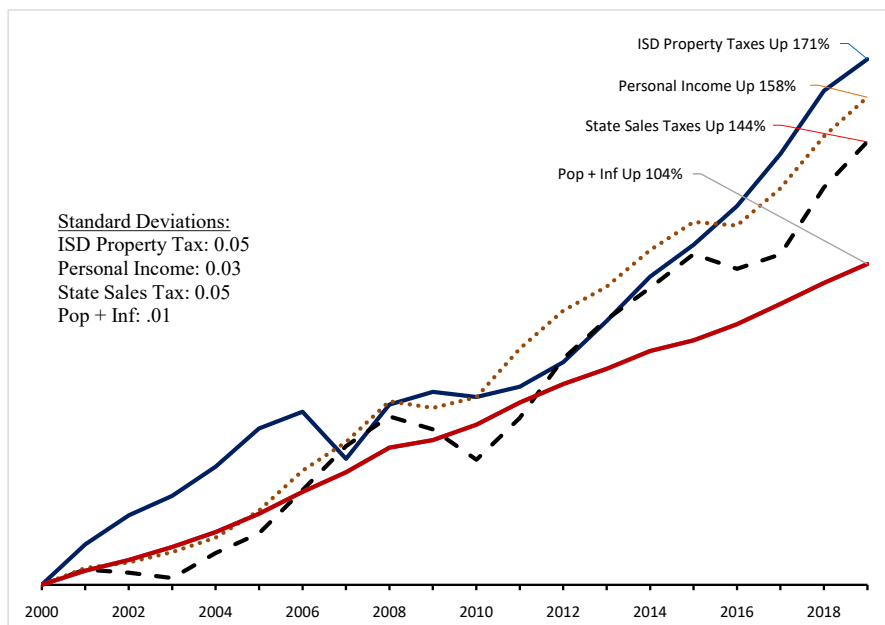
**Figure 2** illustrates how state sales taxes have grown far less than property taxes, less than personal income, and more closely to population growth plus inflation. This indicates that moving to a system based on the sales tax better aligns with the average taxpayer's ability to pay for these taxes that fund government spending. In addition, ISD property taxes are just as volatile as state sales taxes over time, as measured by standard deviation (0.05). This demonstrates that sales taxes could replace school district M&O property taxes with potentially less burden and similar volatility.

There are multiple options for eliminating school district M&O property taxes, thereby moving the state closer to a final sales and use tax system:

1. Limit government spending growth so that most state surplus dollars would buy down the M&O property taxes over time until they are eliminated in about a decade, and even faster if state and local officials are diligent about limiting government spending ([HB 958](#) and [HB 2074](#)).
2. Replace them with a more efficient, slower-growing, broader-based final sales and use tax system. Combining this with limiting state and local spending to use most surplus dollars to cut sales taxes and other taxes would provide a substantially improved fiscal and economic situation ([HB 59](#) and [HJR 154](#)).

No matter which option is chosen, it must include spending restraint and elimination of taxes.

**Figure 2**  
Comparing Economic Variable Growth and Taxation Over the Last 20 Years



Note. Data are from Texas Comptroller and author's calculations.

## Problems With Texas's Property Taxes

Research highlights how property taxes are more burdensome than sales taxes in Texas.

### Property Taxes Are Less Efficient Than Sales Taxes

[Property taxes](#) in Texas are based primarily on subjective valuations by appraisal review boards and tax rates determined by local tax entities with little to no feedback from citizens, creating a [highly inefficient collection mechanism](#). They can force people out of their homes and businesses if not paid, meaning Texans never truly own their property, even if they pay off their mortgage, because taxes will be owed annually forever. On the other hand, sales taxes are based on objective determinations from exchanges in the marketplace, have a less bureaucratic process to collect them, and are paid only once at purchase.

### ***Property Taxes Are More Regressive Than Sales Taxes***

A Texas Comptroller's recent report notes that both Texas's [sales taxes and property taxes are regressive](#), meaning lower-income earners pay a larger share of their income on taxes than higher-income earners, but suggests property taxes are less regressive. However, this static analysis 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 high property tax also prevents many low-income earners from purchasing their first home and forces many others who do purchase to struggle to keep their home—they may even lose it. Neither of these outcomes are considered in the Comptroller's or most analyses. Appropriately accounting for these dynamic cumulative costs, the property tax would be more regressive than a sales tax, which tends to grow at a similar rate as personal income growth and population growth plus inflation over time (see **Figure 1**). Lastly, during recessions, lower-income earners tend to face the highest levels of unemployment and are least able to shoulder a tax burden. Their property tax burden, however, would increase relative to their income, while their sales tax burden would fall more proportionately with their income, helping them to better deal with their situation.

### ***Property Taxes Are Less Connected With Economic Activity Than Sales Taxes***

The idea of a [three-legged stool](#) of taxation implies that taxation rests upon a sales tax, a property tax, and a personal income tax. Because Texas appropriately does not have the latter, helping to [improve our economic competitiveness and individual freedom](#), the argument is that there is a need for the other two. But the focus should be on government spending, which determines the level of taxation, and taxation should be the least obtrusive to growth. When considering the states without a personal income tax compared to states with the highest income taxes, [states without a personal income tax perform much better](#) in terms of growth in population, employment, and personal income over most 10-year periods. Texas should move toward a single-legged barstool with a broad-based final sales tax. No state employs this tax system yet, giving Texas an ample opportunity to be the beacon of freedom and prosperity for generations.

A final sales tax is money that comes directly from the choices of consumers. It ensures that all financial power remains within their control, whereas property taxes are a burden that is forced upon all taxpayers with little means of working around it. If we observe **Figure 2**, it should be noted that during periods of recession (the early 2000s and the Great Recession), the state sales taxes stagnate and drop below population growth plus inflation whereas ISD property taxes do not. This is to say that sales taxes are more indicative of the economic activity within private markets, as a final sales tax can only grow as much as people are participating in the marketplace. In addition, the sales tax growth rate is always near or below personal income and only increases once personal income has attained a steady growth itself. The same cannot be said for growth of ISD property taxes where it not only always remains above population growth plus inflation but also grows at a faster rate than personal income despite periods of economic struggle.

### ***People Prefer Sales Taxes Over Property Taxes***

Analysis of domestic migration over the last decade shows that [people are leaving states with high property and income taxes](#) for states with sales taxes, even relatively high sales taxes. This is true on both a percentage basis and in terms of total tax burden. In other words, a person would prefer to pay \$1 in sales tax than \$1 in property tax, and he or she also prefers the economic prosperity in a state with a

less burdensome consumption tax instead of a property tax. These facts help explain why people have been leaving states like Illinois, California, and New York in droves to states like Florida, Tennessee, and Texas, all three of which have no personal income tax and relatively low overall tax burdens. Texas could accelerate this trend by reducing and eliminating property tax burdens, thereby supporting more economic prosperity with more productive people and capital.

## Options for Eliminating School District M&O Property Taxes

### 1. Replacing School District M&O Property Taxes With a Buydown Over Time

This option would [limit the increase of general revenue spending](#) per biennium and use 90% of the state surplus dollars generated to buy down school district M&O property taxes over time until they are eliminated. If revenue growth kept up with past trends and spending was limited to 4% per biennium, this process would take about a decade to eliminate these property taxes. Similar options are available in [HB 958](#) and [HB 2074](#) this session.

#### Example for How the Buydown Could Work

In order to eliminate school district M&O property taxes, estimated to raise [\\$53.2 billion](#) during the state's 2018-19 fiscal biennium, Texas would need to restrain spending growth to generate a surplus of state revenue to be used to replace these property taxes with state taxes over time. To reduce the time this elimination process would take, biennial increases in general-revenue-related (GRR) appropriations growth would be limited to 4%. Within this limit, the Legislature could appropriate additional funds for any purposes for which it can legally do so, including for increases in education funding to cover enrollment growth and other purposes. **Table 1** shows that the appropriations limit of 4% growth would create a surplus of state funds as it is substantially below the historical average of state GRR growth.

Thus, the spending restraint would create a surplus of state funds averaging 5.59% per biennium. Ninety percent of this surplus would be used to cut school districts' M&O property taxes. **Table 2** shows projected surpluses under an average revenue growth scenario for upcoming biennia that could be used to replace local property tax revenue.

**Table 2** shows that, with average growth in GRR funds, the \$53.2 billion in school district M&O property taxes could be eliminated in about a decade. Once the replacement is complete, there would be more than \$11 billion on the table annually to deal with contingencies or eliminate or reduce other taxes, such as the business margins or sales taxes.

**Table 1**  
Biennial GRR Growth Rates  
from 2004-05 to 2018-19

Biennium	GRR Growth Rate
2006-07	19.9%
2008-09	13.9%
2010-11	-11.1%
2012-13	19.0%
2014-15	22.3%
2016-17	-1.2%
2018-19	11.60%
<b>Average</b>	<b>9.59%</b>

Note. Data are from Texas Comptroller and author's calculations.

**Table 2**  
10-Year School Property Tax Replacement Scenario (in Thousands of Dollars)

	2020-21	2022-23	2024-25	2026-27	2028-29	2030-31
<b>GRR Revenue</b> (9.59% increase)	126,048,054	138,130,848	151,371,881	165,882,181	181,783,418	199,208,927
<b>New GRR Available for State Spending</b> (4% increase)	4,600,887	4,784,923	4,976,320	5,175,373	5,382,388	5,597,683
<b>New GRR Property Tax Replacement Payment</b>	5,782,483	7,146,331	8,152,875	9,216,722	10,388,637	11,683,906
<b>Property Tax Replacement %</b>	10.86	15.06	20.23	28.67	45.30	93.14
<b>School M&amp;O Property Taxes</b>	47,448,497	40,302,165	32,149,290	22,932,568	12,543,931	860,024

Note. Data from Texas Comptroller.

At the local level, each year school districts would set their M&O tax rate to reduce property tax revenue by the amount they received from the state's replacement funding. On average, property taxpayers in districts across the state would see the same percent reduction in their taxes, though that might vary from one district to another. At the end, though, every taxpayer's M&O property tax burden would be identical: zero. To the extent the reduction raises constitutional questions of equal tax revenue for equal effort, the amount of replacement funding for each district can be adjusted each biennium. Ideally, school districts [should no longer be able to increase their M&O property tax rates](#) in the buydown option to shorten the elimination process. Instead, the state would essentially set the school districts' rates, lowering them each year, until the taxes are eliminated, while fully funding school district M&O based on school finance formulas. Districts could only exceed the replacement rate with the approval of a majority of voters in an election with at least a 20% turnout. However, additional funds raised through a voter-approved tax increase would be fully recaptured by the state. So, increases in education funding each year would come from the state. The system would work much as it does today, with districts having the flexibility to set rates with much of the revenue being recaptured by the state.

An important component of the replacement plan is limiting the growth of property taxes by other local taxing entities. Counties, cities, and special purpose districts would be able to set their property tax rate to generate no more than a 2.5% annual increase over the previous year's revenue in property tax revenue. However, just like with the current rollback system, local governments could petition voters to increase total property tax revenue more than 2.5%. The higher rate would require the approval of a majority of voters in an election with at least a 20% turnout. The limits on counties, cities, and special purpose districts do not directly affect the buydown of the school district M&O property taxes. Instead, it keeps other local governments from taking advantage of the lower school district property taxes by raising their tax rates. This is what they did in 2006, when school property taxes decreased by more than \$1 billion, but increases by counties, cities, and special districts wiped out over \$600 million of the school property tax cut.

### **Economic Effects of the Buydown Option**

Economists at the Baker Institute [studied the economic effects of this option](#). They found that a 3.4% decrease in school M&O property taxes could contribute to a \$12.5 billion (0.7%) increase in economic output and an increase in employment of 183,000 jobs in just 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. Managing this is an important component of the replacement plan to eliminate the school district M&O property taxes.

### **2. Replacing School District M&O Property Taxes With Sales Taxes Immediately**

For this option, a version of which could be provided in the enabling legislation to [HJR 154](#), broadening the sales tax base would be best because it would provide both a more efficient tax that limits the number of exemptions, which effectively pick winners and losers, and the lowest tax rate possible.

### **Example for How the Sales Tax Replacement Could Work**

**Table 3** shows that Texans paid a total of \$72 billion to [school district M&O property taxes](#), [local sales tax](#), and [state sales tax](#) in 2019 (latest year with data available for our calculations and before the COVID-19 pandemic to reflect a typical year).

**Table 3***Tax Collections by Source, FY 2019*

Tax Revenue Sources (Millions of \$)	2019
School District M&O Property Taxes	\$28,457
Local Sales Taxes	\$9,449
State Sales Taxes	\$34,040
<b>School M&amp;O Property Taxes Plus Local and State Sales Taxes</b>	<b>\$71,949</b>

Note. Data are from Texas Comptroller.

**Table 4** shows data using a static analysis for a range of sales tax bases and sales tax rates for FY 2019. Let us start with total private industries that can be taxed, given the government sector is not taxed, and then subtract multiple industries to determine different gross state product bases and tax rates needed to cover state and local sales taxes and school district M&O property taxes while attempting to avoid a more burdensome value-added tax.

The GSP base that collected the \$43.5 billion in state and local sales taxes in 2019 is about \$527.1 billion (\$43.5 billion divided by the highest rate of 8.25%). The tax base of the \$34 billion in state sales taxes is about \$544.6 billion (\$34 billion divided by 6.25%). The Texas Comptroller's 2018 report notes that Texas would provide an estimated \$43 billion in exemptions, exclusions, and discounts to the sales tax base in 2019, which is effectively [picking winners and losers within the Tax Code](#).

This tax bias in the code contributes to a higher sales tax rate and should be eliminated as much as possible to practice sound tax policy of the broadest base and lowest rate possible to fund limited roles for government. Broadening the sales tax base would also influence local government jurisdictions' sales tax collections. This should be addressed by lowering their rates to make it revenue neutral along with strict local spending limits.

**Table 4***Sales Tax Rates Needed to Replace School District M&O Property Taxes, 2019*

Replacement Tax Base Options	Gross State Product Base (Millions of \$)	State Tax Rate	Local Tax Rate Max	Total Tax Rate
Tax Base Needed With No Change in Tax Rate	\$872,110	6.25%	2.00%	8.25%
Reformed Gross State Product Base	\$845,192	7.40%	1.10%	8.50%
Tax Rate Needed With No Change in Tax Base	\$527,140	11.86%	1.79%	13.65%

Note. Sources are [U.S. Bureau of Economic Analysis](#) and author's calculations. Reformed GSP base is total private industries excluding real estate, healthcare, manufacturing, mining, management, and construction industries.

### Replacing Property Taxes With Slightly Reformed Sales Taxes

**Table 4** notes in the second row that the total state and local sales tax rate in Texas would be only 0.25 percentage point higher than the current maximum rate of 8.25%, which would help the state's Tax Code remain competitive while cutting the total local property tax levy by nearly half. While Texas could have the highest state sales tax rate (California is currently at 7.25%), the full sales tax burden is derived from the [total state and local sales tax rate](#). Texas currently has the 14th highest total sales tax rate at 8.19%, and, with a broader base, the total state and local sales tax rate would be 8.5%, which would be the 11th highest in the nation. This would help [keep the rate competitive with nearby states](#) with the total state and average local tax rates being 9.52% in Louisiana (2nd highest in nation), 9.51% in Arkansas (3rd highest), 8.95% in Oklahoma (6th highest), and 7.83% in New Mexico (15th highest). Of course, this would be combined with a [substantial cut in the high property tax burden](#) as it would be cut in half, helping to provide gains for Texans across the income spectrum.

The broadened sales tax base should not include items that are already taxed or items whose taxation would create a system that resembles a destructive value-added tax. The reformed base should remove sales tax exemptions on items like most services, over-the-counter drugs, containers, and more, but continue to exclude things taxed by other taxes, unprocessed food, physician services, new

residential and non-residential construction, real estate transactions ([while there is a property tax](#)), and more. While the base expansion means some sectors not currently under the sales tax would be taxed, like many professional services such as lawyers and accountants, under the reformed sales tax, the total tax burden of Texans would decrease and would be distributed more equitably. For those paying rent, reduced property taxes will result in lower rent payments through competition in the marketplace, as well as slower growth in rental prices over time. By combining this with government spending restraint, such as [limiting spending to less than population growth plus inflation](#) and using 90% of the state surplus dollars to buy down the sales tax rate each biennium thereafter, the state could quickly cut sales taxes to lower the sales tax rate to where it was before the tax replacement occurred and possibly even lower thereafter. The excess state funds could also be used to cut other taxes in Texas.

### **Economic Effects of the Reformed Sales Tax Option**

Economists of the Baker Institute at Rice University also studied the [economic effects of replacing property taxes with sales taxes over time](#). They found that a 3.6% decrease in school district M&O property taxes could contribute to a \$14.3 billion (0.8%) increase in economic output and 217,000 new jobs after just the first year of reforms and more thereafter. These results occur because of the economic gains of such a transition to a more efficient economic system based more on sales taxes. Extrapolating to a complete elimination of these property taxes would support substantially more gains in prosperity through a more efficient and competitive economic framework based more on a sales tax system. 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, and the state surplus should be used to provide tax relief, [supporting even more economic gains](#). The full replacement is a conservative reform because sales taxes tend to grow at a slower rate than property taxes and are based on objective metrics from mutually beneficial exchanges rather than the guess work of appraisal districts. They are also more visible to the taxpayer, especially renters, because their costs are not “hidden” in other payments, such as rent. The other appeal of the complete replacement of school M&O property taxes by sales taxes is that it eliminates the possibility that the tax relief experienced by a replacement would only be temporary. This has been one of the [failures of property tax relief efforts of the past](#).

### **Alternative Consumption Tax to Replace Property Taxes: Value-Added Tax**

The Value-Added Tax (VAT), otherwise known as the goods and services tax, is a tax at every stage of the supply chain where a product gains value. The main argument in favor of this tax is that it incentivizes businesses to control costs, encourages savings, and simplifies administration. It is also lauded as less regressive since the burden does not exclusively fall on the consumer. For example, Andrew Yang, a 2020 presidential candidate, promoted the idea of a [10% national VAT](#) with the notion that “if you want to do business in America, you have to pay into America.” Similarly in Texas, [HB 3770](#) was filed this session in favor of a state VAT of 6.72% that would replace the ad valorem tax. In addition, under the bill, local governments may impose VATs that, combined, may not exceed 2%, and school districts cannot levy a VAT above half a percent. The bill would create VAT exemptions for small businesses, government entities, and religious, educational, and public service organizations. Despite HB 3770 adding nuances that likely make it better than Yang's VAT, there remain missing aspects when considering the detriments of a VAT.

While the supply chain is taxed and the final marked price for the consumer is not taxed under a VAT, the consumer still must bear the burden of the added cost from taxation at each stage of production. This is because in order for a product to remain profitable through these stages of production, most if not all of the cost of taxation must be passed along according to the size of the VAT so that firms may continue to operate. Alternatively, firms would have to cut costs to remain competitive within the market, with a high likelihood that they would start by cutting worker wages or laying off employees depending on the relative costs of labor and capital. This makes the situation worse for workers and employers and slows economic growth. Moreover, a VAT [distorts each stage of production](#) thereby creating an inefficient and more costly production process that reduces economic activity and slows economic growth. No VAT is imposed by any level of government in the U.S. because of the destructive nature of this tax system. [Countries in Europe impose VATs](#), but that has contributed to less economic growth and much larger government spending over time, unlike a prosperous Texas Model of relatively less spending, taxing, and regulating.

### Summary for Immediately Replacing Property Taxes

In short, there is a cost to any tax system, which is why it is so important to limit the role of government so spending and therefore taxing can be less than otherwise. The [value-added tax](#) (VAT), [carbon tax](#), income tax, and property tax each have their own problems and are much more inefficient, costly, and distort economic activity more than a final sales and use tax. Given these costs of any tax system, the least burdensome, fair, and efficient form of taxation is a final sales tax that would help to limit government's growth over time and would be based on market exchanges in the private sector that better reflect the average taxpayer's ability to pay over time while giving Texans the freedom to choose whether to save and pay fewer state taxes by reducing their spending.

### Recommendations to Strengthen the Texas Model

- School district M&O property taxes should be eliminated, which multiple bills, including HB 958, would help achieve.
- Options to replace school district M&O property taxes include
  - Limiting state spending to 4% and using most state surplus dollars to buy down these property taxes over time until they are eliminated, along with limiting growth in local property taxes.
  - Reforming the sales tax system with a broader base and slightly higher rate to immediately provide a revenue-neutral replacement so that the total state and local rate increases from 8.25% today to only about 8.5%. This should be combined with a [stronger state spending limit](#) and using most surplus dollars to cut sales taxes and other taxes over time.
  - Passing a constitutional amendment prohibiting school districts from imposing another M&O property tax for any option, such as [HJR 154](#).

### Conclusion

Given that high taxes are always and everywhere a spending problem, whichever path is chosen must be paired with limiting government spending at the state and local levels. By combining property tax reductions and reform with spending limitations, Texas could shift to a more efficient and fairer sales tax 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

**Vance Ginn, PhD**, is chief economist at the Texas Public Policy Foundation. He served as associate director for economic policy at the White House's Office of Management and Budget, taught at several universities, and earned his doctorate in economics at Texas Tech University.

### About Texas Public Policy Foundation

The Texas Public Policy Foundation is a 501(c)3 non-profit, non-partisan research institute. The Foundation's promotes and defends liberty, personal responsibility, and free enterprise in Texas and the nation.

