LOWER TAXES, BETTER TEXAS

ELIMINATING PROPERTY TAXES

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Executive Summary

The way we assess and impose property taxes is not just unsustainable, it is unethical. Under the status quo, Texans are forced to rent their homes from the government and are denied the opportunity to ever truly own their property. This cuts against Texans who value property rights and limited government, and it begs for meaningful reform. Most Texans want action now, too. In fact, more than 70% of Texans say property taxes are a "major burden for them and their family" and crave change.

The hunger for a new direction goes beyond property rights. Local property taxes have been growing faster than the average taxpayer's ability to pay for them, which places an undue burden on Texans and stifles the growth of the economy. Elevated and rising property taxes limit Texans' opportunities to save, invest, and leave a legacy for future generations. They also pose an obstacle to prospective homebuyers on the front end and threaten to tax existing homeowners out of their properties on the back end. These problems are, of course, rooted in excessive local government spending, which continues to skyrocket largely uninhibited, keeping Texans from reaching their full potential.

It is time for bold action.

Based on the exploitative nature, cost, and inefficiency of Texas's property tax system, we recommend two aggressive options to substantially reduce and remove nearly half of this burden. First, we propose a two-pronged approach that immediately cuts property taxes in nearly half by eliminating the school district maintenance and operations (M&O) property taxes and redesigns our tax system to protect taxpayers, provide a fairer tax system, and grow our economy. The plan will not only give taxpayers immediate relief, but also make structural changes to our system that prevent year-to-year spikes in tax bills, allow for a more equitable and transparent form of taxation, and rein in spendthrift local governments. Second, we propose a buydown of school district M&O property taxes with state surplus general revenue-related funds over time until they are eliminated.

These options would help dramatically improve the state's overall tax system, thereby unleashing economic prosperity and moving Texas toward an ideal in which every person ultimately has an opportunity to truly own property.

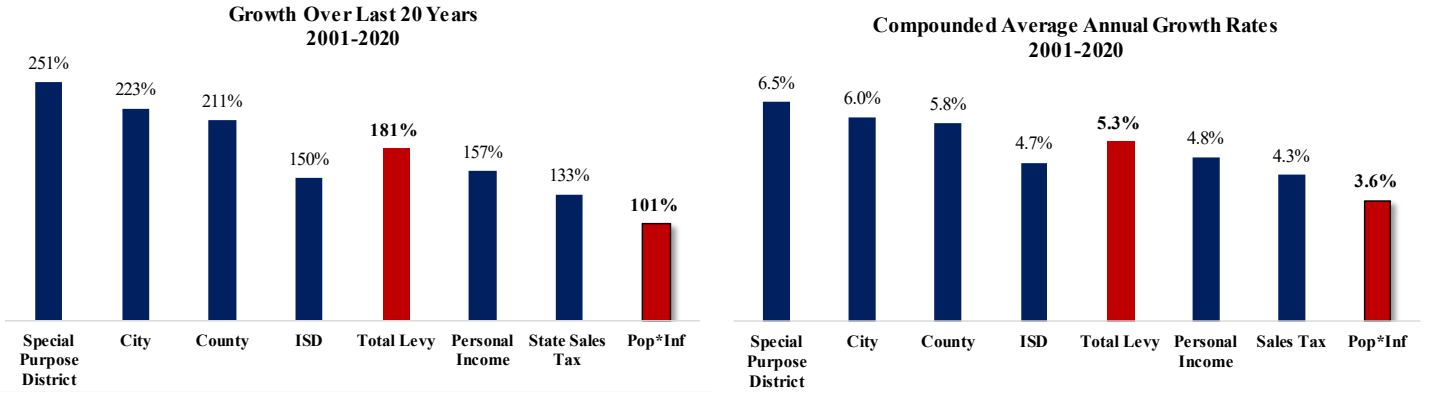
Key Points

- Local property taxes in Texas have been growing faster than the average taxpayer's ability to pay for them, which places an undue burden on Texans and stifles the state's economy.
- Elevated and rising property taxes limit Texans' opportunities to save, invest, and leave a legacy for future generations. They also too often stop Texans from purchasing a house or even force many out of their home.
- Based on the inefficiency, cost, and inequities of Texas's property tax system, we recommend a bold approach to substantially reduce and remove nearly half of this burden.
- Following the recommendations outlined here, Texas can unleash greater economic prosperity today and for generations to come.

Overview of Local Property Taxes in Texas

The Texas Model provides an institutional framework of mostly limited government that enables greater prosperity and economic success than frameworks in comparable states and the U.S. which generally foster overbearing, bloated governments (Ginn, 2018; Ginn, 2021a). But while that model has been successfully applied at the state level, there is still much progress to be made locally. **Figure 1** illustrates how local property tax levies (i.e., collected from special purpose districts, cities, counties, independent school districts [ISDs], and total)

Figure 1
Increases in Taxes and Economic Measures Over the Last 20 Years



Note. Data are from *Property Tax Survey Data and Reports*, Texas Comptroller of Public Accounts, n.d.-a (https://comptroller.texas.gov/taxes/property-tax/reports/index.php).

across the state have risen faster than the changes in personal income, state sales taxes, and the rate of population growth times inflation over the past 20 years.[1] Despite the Texas Legislature's attempts to buy down and reform property taxes in the past, they have continued to outgrow the average taxpayer's ability to pay for them (Greisinger et al., 2020).

Texas has the 15th worst property tax burden on businesses and the 6th most burdensome property tax on homeowners in the nation (Cammenga, 2021a). Soaring property taxes, which tend to have a disproportionately greater effect on lower-income earners due to the threat of housing foreclosure and unaffordable rent, threaten the livelihood of Texans (Priday, 2020; Texas Comptroller of Public Accounts, 2020a). Much of Texans' total property tax burden consists of school district maintenance and operations (M&O) property taxes, which constitute 42.3% of the total property taxes levied on Texans (Texas Comptroller of Public Accounts, n.d.-a; Texas Comptroller of Public Accounts, n.d.-b). The Texas Constitution puts the onus on the state "to establish and make suitable provision for the support and maintenance of an efficient system of public free schools" and the Texas Legislature determines the funding formulas for the school finance system. Because of these factors, school district M&O property taxes are a good candidate for considering how the state can provide lower property tax bills for Texans.

Figure 2 shows how ISD property taxes have grown at a faster pace than state sales taxes with similar levels of volatility (i.e., standard deviation of 0.047 for ISD compared with 0.056 for state sales taxes) since 2001. The similar volatility of ISD property taxes, which include both M&O and interest and sinking (I&S) that are property taxes financing debt, demonstrates that school district M&O property taxes could be replaced by sales taxes, whether immediately or over time as discussed below, to fully fund limited government without much more volatility and to grow at a slower pace to help limit the rising burden on Texans.

Moreover, eliminating school district M&O property taxes can lower tax bills for many Texans by cutting the property tax burden in nearly half while looking for options to move to an improved sales tax system. There is also the need to rein in excessive growth in local governments. These issues are discussed further in this paper, and recommended options to achieve these goals are provided. Any option chosen to improve Texas's tax system ought to include eliminating at least some property taxes and restraining government spending at the state and local levels. Fortunately, government spending at the state level has been more restrained in recent years as the average growth has been well below the Foundation's Conservative Texas Budget (CTB) based on population growth plus inflation for four straight budgets (Ginn et al., 2020b; Ginn, 2021b). Also, much of the CTB was put into statute in 2021 with SB 1336 (Ginn, 2021c) that updated the state's spending limit to be based on population growth times inflation. This limit should be applied to local governments as well, and revenue above this metric should be used to cut taxes at the state and local levels.

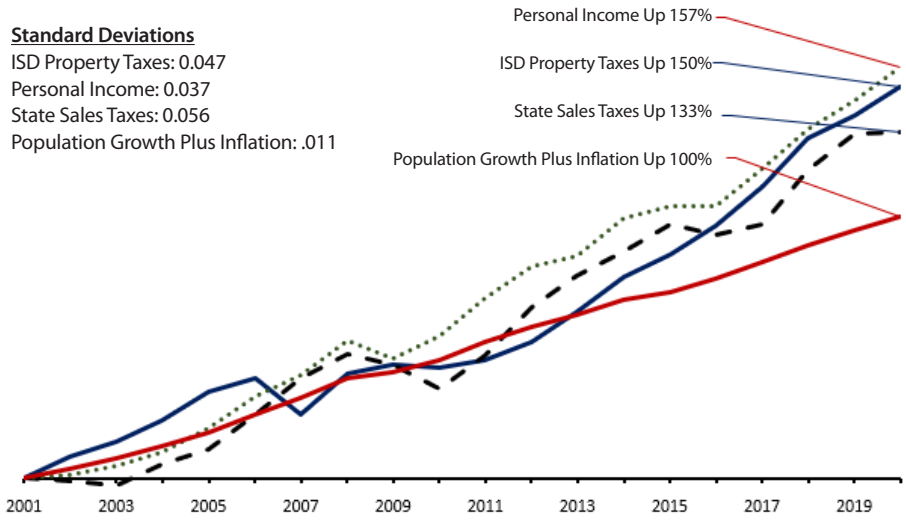
Problems With Texas's Property Tax System

Research highlights how the Lone Star State disproportionately depends on property tax revenues. In fact, it ranks as the fourth state relying most heavily on property taxes, accounting for approximately 44% of its total tax collections (Cammenga, 2021b).

1 Local property taxes have also increased faster than our preferred metric of the average taxpayer's ability to fund government spending measured by population growth plus inflation, which has increased by 100% overall and by 3.5% annually over this period (Ginn et al., 2020a).

Figure 2

Comparing the Growth and Volatility of Different Variables Over the Last 20 Years



Note. Data are from *Property Tax Survey Data and Reports*, Texas Comptroller of Public Accounts, n.d.-a (https://comptroller.texas.gov/taxes/property-tax/reports/index.php).

The Convoluted System of Property Tax Collection

In order to adequately fund programs and services, the governing bodies of local taxing entities—that is, local officials elected to cities, counties, school districts, and special districts—each determine the tax rate sufficient to collect the appropriate amount of tax revenue once the appraisal roll has been certified. State law requires these entities to post a public notice and hold a public hearing to discuss the budget and a proposed tax rate (Texas Comptroller of Public Accounts, n.d.-c). Certain entities that wish to raise an excessive amount of new tax revenue, above the voter-approval tax rate threshold, must hold an election on the subsequent uniform election date in November and obtain majority approval. Texas's property tax system is further complicated in that a landowner's property is located within the jurisdiction of multiple overlapping taxing units (Ginn, 2021d). Hence, even if a property holder pays off the mortgage, the holder will forever owe taxes to numerous local governments. Not only does this mean that local taxing entities can force people out of their homes and businesses if property taxes are not paid, but it also means that Texans never truly own their property (Hunker et al., 2015).

Property Taxes Are More Regressive Than Sales Taxes

The Texas Comptroller of Public Accounts (2020a) notes the regressive structure of Texas's sales and property taxes but suggests that the latter is less regressive. However, this incomplete analysis fails to consider that sales taxes are paid once at purchase while property taxes are levied in perpetuity. The compounding nature of annual property taxes ultimately leads to a greater adverse effect on low- and fixed-income Texans than sales taxes (Shan, 2010). In addition, a high property tax prevents many low-income earners from purchasing their first home and causes hardships for many homeowners who struggle to keep their homes. If the Comptroller's analysis appropriately accounted for these dynamic cumulative costs, the results would show that property taxes are more regressive than sales taxes. Lastly, lower-income earners tend to face the highest levels of unemployment during recessions and are least able to shoulder a tax burden. Given the property tax burden increases relative to their income even during most recessions, low-income earners who can least afford a rising tax burden during these economic downturns could better control a sales tax burden that falls more proportionately with incomes as it is based on market exchanges.

Property Taxes Are Less Connected With Economic Activity Than Sales Taxes

The "three-legged stool" model of taxation posits that state and local tax systems generate tax revenue through the combination of sales taxes, property taxes, and personal income taxes (Craymer, 2015). Texas, like only eight other U.S. states, does not burden workers with a personal income tax (Loughead, 2021), further contributing to its high economic competitiveness and individual freedom (Ginn, 2021a). While some argue that Texas's lack of a personal income tax justifies the need for elevated property and sales taxes, other states without a personal income tax, such as Florida, do not have such a high local property tax burden on businesses or homeowners (Cammenga, 2021a). Instead, the focus should be on controlling government spending and fostering tax policies that are the least obtrusive to growth. When comparing the states without a personal income tax to the states with the highest personal income taxes, the former perform much better in terms of growth in population, employment, and personal income, and in state and local tax revenues, over most 10-year periods (Laffer et al., 2021, p. 25).

Conversely, a final sales and use tax, which is imposed only on the end user of the good or service, empowers consumers to decide how to spend and save their money. Through the imposition of property taxes, government assumes to know what is in the best interest of each person, increasing the tradeoffs in the real estate market that distort outcomes. **Figure 2** demonstrates how state sales taxes stagnate and

drop below population growth times inflation during recessions. Sales taxes are more indicative of the economic activity within private markets than property taxes because a final sales tax can only grow as much as people are consuming. During a recession, school district M&O property taxes constantly remain above population growth times inflation and grow at a faster rate than personal income taxes. Property taxes typically cannot react to market events because they are predetermined by bureaucratic taxing units. Despite their decreased purchasing power during periods of economic downturns, property holders must still make hefty tax payments.

This "three-legged stool" approach is flawed, and Texas could be in a much better position to support prosperity by moving to a "single-legged stool" in which most state and local tax revenues are collected from a broad-based final sales tax.

People Prefer Sales Taxes Over Property Taxes

People have been fleeing 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 (Laffer et al., 2021, p. 8). An analysis of domestic migration over the last decade shows that people are leaving states with high income and property taxes in exchange for states with sales taxes (Antoni, 2020), even with relatively high sales taxes. This is true on both a percentage basis and in terms of total tax burden. Texas could further accelerate its historically prosperous economy by reducing and eliminating property tax burdens, thereby supporting more economic prosperity with more productive people and capital.

Three Types of Property Tax Limitation Options

There are three general types of levers that attempt to limit the rising burden of property taxes: appraisal limits, tax rate limits, and levy limits (Walczak, 2018).

Appraisal Limits

An appraisal limit is a form of government action that limits the appraised value of property in some capacity. Texas has an appraisal limitation for residence homesteads of a maximum 10% annual increase and imposes homestead exemptions of $25,000 for school districts. There are other types of appraised value limitations in the state depending on different demographics (Texas Comptroller of Public Accounts, 2020b). These have had mixed effects on limiting the amount paid in property taxes in the short run, but, over time, they have not effectively reduced the rising property tax burden, as noted in **Figures 1** and **2**. While considerations may be given to tweaking homestead exemptions, the economic effect of these is that, as long as local government spending continues to increase at a rapid rate, the amount of tax burden can be limited for select property holders, but the rest of the burden is redistributed to other property holders and renters who do not receive the homestead exemption. Instead, the focus should be on better limiting local government spending and reducing the tax rates such that the tax burden is reduced for everyone in that jurisdiction or state depending on whether the exemption is provided for school districts by the state or the local tax entity (Greisinger et al., 2020; Hunker et al., 2015).

The most prominent past example of property tax appraisal limits across the nation is California's Proposition 13, which was passed in 1978 to help rein in excessive local property taxes (Glyn & Drenkard, 2013). This constitutional change imposed a tax rate limit at 1% of the market value of residential and commercial property and limited the growth rate of appraisals to 2% per year. But when a property was sold, the new appraisal would reflect the property's market value. Proposition 13 reverted home values and property taxes to 1975 levels, and properties would be assessed at their base year value, either 1975 or the date of the latest sale, whichever was more recent. Furthermore, if a local government wanted to raise the property tax rate above 1% of market value in order to pay for special projects, such as schools, it required a two-thirds approval by voters (County of Santa Clara, n.d.).

Research finds mixed reviews on the effects of Proposition 13. It seemed to help limit tax increases over time but contributed to less turnover and more funds to local governments as they reaped revenue from property purchases at higher market values and new development fees, along with ratcheting up of the property tax rate to spend more.

One benefit of Proposition 13 was that it shifted local revenue away from property taxes and toward income and sales taxes (Glyn & Drenkard, 2013). Because Texas has no personal income tax, the shift would be more toward sales taxes if it adopted a similar measure. And because sales taxes are more equitable and efficient than property taxes, such a shift would be welcome. Proposition 13 helped bring inflation-adjusted (real) property tax rates below their pre-1978 values by 1990 (Galles & Sexton, 1998a). Proposition 13 favors longtime homeowners over frequent movers, lowering the tax burden on low-income homeowners, as these taxpayers tended to move less frequently (Sexton et al., 1999). Thus, Proposition 13 resulted in a less regressive property tax. However, Proposition 13 had many undesirable effects. For example, it caused similar properties to face very different tax rates due to the rate of appraisal growth being less than the rate of property value inflation. A house valued at $100,000 using the 1975 base-year value will have a taxable value of $121,899 after 10 years if not sold during

that time. But a similar property might sell for $150,000 after 10 years, at which point its taxable value would be $150,000. Thus, Proposition 13 favored those who do not sell their property over new property owners and discourages property turnover. This distortion can be undesirable because homeowners and business owners will tolerate a property with undesirable characteristics rather than move in order not to avoid what translates into a moving tax penalty (Sexton et al., 1999). Proposition 13 also encouraged local governments to raise fees and levies on new development, real estate transfers, business licenses, and utility use (Sexton et al., 1999). This further discouraged the development of new homes and placed the burden even more on frequent movers and business owners rather than longtime property owners. Additionally, Proposition 13 did not curb local spending over time, neither did it lower the total financial burden on taxpayers after accounting for non-tax fees and charges. By raising non-tax fees and charges, local governments were more than able to make up for the initial reduction in revenue growth due to Proposition 13, and by 1990, tax revenue and expenditures far exceeded pre-1978 levels (Galles & Sexton, 1998).

A similar appraisal cap in Texas would most likely create a situation whereby new properties are charged hefty fees, and longtime property holders benefit more than new property holders and frequent movers. Skidmore et al. (2010) find that keeping home price appreciation to the level of inflation creates a 19% disparity in effective tax rates between longtime homeowners and new homeowners. This horizontal inequity demonstrates a key flaw in appraisal limits which causes other market distortions, such as reducing the incentive for people to move, extending homeownership of current dwellings by 7.5 years (Hodge et al., 2015). While appraisal limits do have substantial structural flaws regarding the inequality of property tax savings, they can provide substantial reductions in property tax revenues and local government spending (Hill & Shone, 2007). Nevertheless, any attempt to limit appraisals should coincide with measures to limit local governments from raising fees and tax rates to circumvent the appraisal limit, because such increases can cancel any potential tax relief.

Tax Rate Limits

Tax rate limits restrict the authority of government to adopt a tax rate in excess of a predetermined amount (Walczak, 2018). These limitations can take the form of a restriction on rate increases in a given year, a cap on the maximum allowable tax rate, a requirement of voter authorization to increase rates, or an outright freeze on rates (Winters, 2008). Rate limits can encourage the uniform application of property taxes among different classes of property (Walczak, 2018). An example of a tax rate limit currently in effect is the limitation on school district debt. Since 1991, state law has held that school districts must "show they can repay their bonds with a [Interest & Sinking] tax rate of no more than 50 cents per $100 of assessed property value at the time of issuance" (Minton, 2016, para. 5). Only upon demonstrating to the Attorney General's office that its new and existing bonds can be repaid through an I&S tax rate that does not exceed 50 cents may a school district proceed with the sale of a new bond. While there have been attempts in the past to circumvent the 50-cent debt limit, using exotic public financing devices like capital appreciation bonds, the limitation has generally held up well, providing a modest safeguard against the over-consumption of public debt.

Rate limits do have their downsides. When not uniformly applied across all jurisdiction types, a limitation can lead to shifting responsibilities, as governments not constrained by the limit may be tempted to take on the roles and responsibilities of its restricted counterparts (Walczak, 2018). They also do not always shield landowners from paying more in property taxes due to different increases in property values among property holders. Further, rate limits can be applied selectively, resulting in local governments shifting responsibility for funding. Additionally, tax rate limits are also applied to many jurisdictions at different rates and thresholds. For example, cities with less than 5,000 residents can implement a property tax rate of $1.50 per $100 of valuation, while cities with more than 5,000 residents can implement a property tax rate of $2.50 per $100 of valuation (Texas Const. Art. XI, § 4-5). In practice, this amounts to different standards for urban and rural governments. In sum, rate limits create a system that is difficult for the average person to learn and navigate, with limited ability to address excessive property taxes.

Levy Limits

A property tax levy limit restricts the amount of funds allowed to be collected by a particular taxing unit. An example of a levy limit in effect today can be seen by studying SB 2 (2019), otherwise known as the "Texas Property Tax Reform and Transparency Act." Under SB 2, property tax revenue growth from existing property for cities, counties, and certain special districts is limited to 3.5% annually, unless voters approve a larger increase (SB 2 Bill Analysis, 2019). This historic reform empowers voters with the right to decide on big tax increases while still allowing for some revenue growth to fund limited roles for government. The levy limitation was strengthened in the Legislature's 2021 regular session (Ginn & Bordelon, 2021).

In 2020, certain local jurisdictions claimed that the statewide disaster declaration issued due to COVID-19 allowed them to raise property taxes by as much as 8% without voter approval, which was the rate before SB 2 passed in 2019.

Senate bills 1427 (2021) and 1438 (2021), passed during the 2021 regular session, eliminated this controversy (Johnson, 2021; Strake, 2021). The bills clarify that the exception in SB 2 only applies when physical damages occur to property, limit the duration of the increased tax rates, and stipulate that local governments may not use pandemics, epidemics, or droughts as justifications for raising property taxes without voter approval (SB 1438 Bill Analysis, 2021). Another bill, HB 1869 (2021), requires certain debts payable through property taxes to be included in the calculation of the voter-approval tax rate, which improves the 3.5% levy limit.

Even though more changes are needed to Texas's 3.5% limit—for example, apply the limitation to all taxing units regardless of type or population; reduce the voter-approval threshold below 3.5%, preferably to 0% (American Legislative Exchange Council, 2020); require taxing units to undergo an independent third-party audit prior to holding a tax increase election; instruct taxing units that a voter-approval tax rate election is not successful unless a super-majority of voters consent to the increase—the position of homeowners and businesses is improved because of it.

When structured properly, a property tax levy limit can be an effective tool for controlling the growth of local government.

Options to Improve Texas's Tax System by Eliminating School District M&O Property Taxes

We first cover the differences in types and efficacy of taxes and then consider two aggressive options to eliminate school district M&O property taxes in Texas. The first option is a redesign of final sales and use taxes by broadening the sales tax base and lowering the rate. This option would also rein in excessive governments spending at the state and local levels by using state general revenue-related (GRR) surplus funds to buy down state taxes and limiting total revenue by other local governments to population growth and inflation. The second option is a buydown of school district M&O property taxes using state GRR surplus dollars above the state's spending limit until those property taxes are eliminated.

Differences in Types of Taxes

The inefficiency of taxation is measured by the degree to which a tax causes distortions in the market. In economic terms, a per-capita tax causes only an income effect and no substitution effects and is considered the most efficient form of taxation. Any tax that is aimed at altering human behavior instead of raising revenue to fund a limited government is, by definition, a highly inefficient tax. Taxes on income discourage work and alter people's behavior by reducing their time spent in productive activities. Progressive marginal tax rates exacerbate this effect. Taxes on consumption also discourage working because people work in order to consume, but the tax does not decrease savings to the same extent as a revenue-equal income tax. A consumption tax is less economically distortionary. Because most consumption taxes have a constant tax rate independent of a consumer's income, this flat rate also increases the tax's efficiency. Taxes on investment and wealth are particularly egregious in terms of efficiency since these not only distort human behavior but also decrease net investment in the economy, which contributes to slower economic growth (Priday, 2020).

Property taxes are a kind of wealth tax that make it difficult and costly for people to keep property and leave a legacy for future generations along with the negative effects on economic growth (Ginn, 2021d). In contrast to alternative forms of taxation, including many other wealth taxes, property taxes are often either levied indirectly or in a quasi-hidden manner. A renter does not know the property taxes assessed for a dwelling but is paying those property taxes nonetheless; most if not all the tax is passed on in the rent charged by the property owner. Similarly, many homeowners pay their property taxes together with their mortgage, homeowners' insurance, and sometimes other bills via an escrow account. As such, it is not always apparent precisely how much is being levied in taxes (Cabral & Hoxby, 2012). Furthermore, because these factors contribute to the homeowner's ultimate concern—the total cost of owning a particular dwelling—potential and current homeowners are usually more concerned with the bottom line and less so with the individual component costs of owning the home. This situation has led to a general acceptance of the myth that renters do not pay property taxes. However, when a tax is levied on housing, including rental units, it becomes easier to pass the tax incidence, which is the ultimate burden, on to renters. This causes the tax to disproportionately be paid by those with lower incomes. Recent Census data show a wealth gap between homeowners and renters even when excluding home equity (Hays & Sullivan, 2020). Other aspects of the property tax, such as the homestead exemption, also cause the tax to be more regressive since homeowners tend to have higher incomes than renters, who do not receive a homestead exemption and instead pay the full tax levy.

In comparison to an income tax or a sales tax, a property tax may appear to be less regressive, but that is due to a fallacy wherein one observes only a single moment in time instead of examining important long-term factors such as lifetime earnings, savings, and intergenerational consumption. Over the course of an individual's lifetime, those with higher earnings tend to spend a lower portion

of their earnings on property taxes. Conversely, with either a broad-based sales tax or income tax, everyone will pay approximately the same proportion of their total income in taxes. With a sales tax, though, people with savings, which generate unearned income, will pay a higher tax rate relative to their earned income. Those with more savings tend to be those with more earned income (Dynan et al., 2004), which can make a sales tax progressive when considering the lifetime burden. While the same phenomenon can be observed under an income tax, the effect is mitigated by the reduction in income caused by the tax.

Efficiency of Taxes

There are two possible criteria to consider when assessing the efficiency of different taxes. The first criterion is the ability-to-pay principle, according to which taxes are paid based on an individual's ability to pay the tax. The greater one's ability to pay, the greater the tax. Contrarily, the second criterion is the benefits-received principle, according to which taxes are paid based on the benefits one receives from government spending on different programs and projects. For the sake of economic efficiency, the latter criterion would govern all taxation, but this is often not politically possible, and it is sometimes too difficult to determine precisely who has derived what benefits. Ultimately, taxes should fund only limited roles for government. Property taxes fail to meet these criteria. While it is true that those with more disposable income may tend to own more taxable property, it is not a universal rule. Rather, Texans have recently been faced with the reality that they cannot afford to stay in their homes because of the property tax increases levied upon them. There is surprisingly little connection between the assessed value of one's property and one's ability to pay property taxes. Secondly, there is very little relationship between the amount of one's property tax levy and the benefits one receives from the government functions funded by those taxes, primarily government-run schools funded partially by school district M&O property taxes. In fact, those with the highest property tax levies tend to have no children in government-run schools, either now or at any point in their lifetimes (National Center for Education Statistics, n.d.).

Many tax schemes would be preferable to the current property tax system in Texas. Because a per-capita tax is not politically feasible and funding education strictly based on the benefits-received principle violates Texas's Constitution, the next best tax would be the state's sales tax. Increasing the rate on the current sales tax would be preferable to existing property taxes. However, current sales taxes have a limited base that excludes many transactions, such as most services. These exemptions to sales taxes create inefficiencies compared to a broad-based sales tax without exemptions. Therefore, sales taxes with a broad base would be preferable to a property tax. A broader base does not reduce the total amount of taxes owed, and neither does using a sales tax instead of a property tax. Rather, a sales tax with the broadest base possible would drastically reduce the inefficiencies that stem from these exemptions and reduce the costs of the burdensome property tax system.

Principles of Expanding the Base of Sales Taxes

Two main principles govern the expansion of the base of sales taxes. First, the base should be as broad as possible in terms of final goods and services. When a sales tax base fails to cover all final goods and services, the result is an artificially high tax on a limited base and an artificial tax of zero on the excluded portion of the base. This difference creates distortions in the market, causing inefficiencies by picking winners (those items not taxed) and losers (those items taxed), and reduces the overall economic output and, therefore, the standard of living in the state. Second, the base should not be expanded to intermediate goods, which directly contribute to final goods. For example, sheet metal used in manufacturing automobiles would be an intermediate good and, thus, exempt from sales taxes. Likewise, a welding rod would be an intermediate good, even though it can be said to be consumed during the manufacturing process. Conversely, a conveyor belt would not be an intermediate good and, thus, would be subject to the sales tax. The distinction between intermediate and final goods is not always clear. Catalysts, which do not physically become part of a final good but are used up in the production process, are a kind of quasi-intermediate good, blurring the lines between intermediate goods and final goods. Generally, if the final good could not have been produced but for the exhaustion of the good in question, the latter can be considered an intermediate good. Since a case-by-case assessment is necessary to accurately define every good, generic rules cannot be comprehensive and will inevitably mischaracterize some goods. The preferable rule is the one that minimizes the impact of this mischaracterization.

Issues of efficiency notwithstanding, exemptions are sometimes made either to aid a particular industry or employer, or to lower the tax burden of one consumer relative to another. It is worth differentiating between the intention of these exemptions and their results. Food is very often exempted from sales taxes to lessen the tax burden on those with lower incomes. In some cases, this will make the sales tax more progressive, but not always, and it often benefits higher-income earners more than lower-income earners. Similarly, prepared foods and processed foods are often not exempt from sales taxes, with the intention being that lower-income earners purchase fewer of these products and thus bear less of the sales tax burden. In reality,

lower-income groups tend to purchase a disproportionate amount of these food products even when they have ready access to unprocessed, "healthier" foods (Allcott et al., 2019). Sales tax exemptions very often fail to achieve their stated objectives and always decrease the efficiency of the tax. If the goal is to make sales taxes less regressive, then the best tradeoff would be to have as broad a base as possible with as low a rate as possible—meaning no exemptions. Whether or not these exemptions are successful in any attempts at social engineering is another topic but suffice to say that the efficiency costs are substantial when attempting to alter consumer choices.

Final Sales Tax Is Not A Value-Added Tax

The value-added tax (VAT), also known as the goods and services tax, levies a tax at every stage of the supply chain where a product gains value. Since the burden does not fall exclusively on the consumer, the VAT has also been lauded as less regressive. For example, Andrew Yang, a 2020 presidential candidate and businessman, supported the idea of a 10% national VAT and claimed, "If you want to do business in America, you have to pay into America" (Yang 2020, n.d.).

Although not passed into law, HB 3770 (2021) was introduced during the Texas Legislature's 87th regular session to replace the ad valorem tax with a state VAT of 6.72%. The bill allowed local governments to impose a VAT of up to a combined total of 2% in a local area while also permitting school districts to levy an additional VAT not to exceed half of a percent. This bill would have created VAT exemptions for small businesses, government entities, and religious, educational, and public service organizations. Even though the bill added nuances that made it arguably stronger than Yang's VAT, aspects are still missing when considering the detriments of a VAT.

For a product to remain profitable through the various stages of taxation, its cost must be passed along according to the size of the VAT. Although a VAT directly taxes the supply chain, the imposition of a VAT still causes consumers to bear the burden of the added cost of production. Alternatively, firms could remain competitive by cutting costs within the market. This is often accomplished by cutting workers' wages or firing employees, depending on the relative costs of labor and capital. This makes workers and employers worse off. Furthermore, a VAT reduces economic activity and slows economic growth by distorting each stage of the production process, even if credits are applied later (Rothbard, 1972/2010). No taxing authority in the U.S. has implemented a VAT because of the destructive nature of this tax system. Unlike the prosperous Texas Model of relatively less spending, taxing, and regulating, European countries impose VATs, which have caused costly inefficiencies and increased government spending (Asen, 2021).

All tax systems have costs, but a final sales tax is the least burdensome and a fair and efficient form of taxation. A final sales tax would help 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 for spending while giving Texans the freedom to choose whether to save or pay taxes through spending.

Option 1: Redesigning Texas's Tax System to Immediately Replace School District M&O Property Taxes

Based on the factors discussed above and the Foundation's long history of research on this issue, broadening the state's sales tax base is preferable because it would provide both a more efficient tax that limits the number of exemptions and the lowest tax rate possible.

Although not passed into law, HB 59 (2021) and HJR 154 (2021) were introduced during the Texas Legislature's 87th regular session to accomplish this goal. This option should work toward keeping the rate competitive with nearby states, with the total state and average local tax rates being 9.52% in Louisiana (third highest in the nation), 9.51% in Arkansas (fourth highest), 8.95% in Oklahoma (seventh highest), and 7.83% in New Mexico (15th highest; Cammenga, 2021a).

Table 1 demonstrates that Texans paid a total of $72 billion in combined school district M&O property taxes (Texas Comptroller of Public Accounts, n.d.-b), local sales taxes (Texas Comptroller of Public Accounts, n.d.-d), and state sales taxes in 2019 (latest year with data available for our calculations and before the COVID-19 pandemic to reflect a more typical year than in 2020; Texas Comptroller of Public Accounts, 2021a).

Table 1

Tax Collections by Source, FY 2019

Tax Revenue Sources (Millions of $)	
School District M&O Property Taxes	$28,460
Local Sales Taxes	$9,449
State Sales Taxes	$33,961
School M&O Property Taxes Plus Local and State Sales Taxes	**$71,870**

Note. Data are from *Tax Rates and Levies,* Texas Comptroller of Public Accounts, n.d.-b (https://comptroller.texas.gov/taxes/property-tax/rates/index.php?lang=en-US), and *Sources of Revenue*, Texas Comptroller of Public Accounts, 2021a (https://comptroller.texas.gov/transparency/revenue/sources.php).

Estimating the Redesign's New Broader Base and Rate for Sales Taxes

Using a static model to estimate the effects of simultaneously reducing property taxes and increasing sales taxes will not capture how people respond to the new incentives created by these changes. Dynamic models consider how economic changes affect people's incentives and estimate how people will respond to them. For example, if an income tax were raised from 10% to 100%, then a static model would estimate income tax revenue to increase ninefold. This is inaccurate because no one would continue working if the entirety of an individual's earnings would be taken from taxes. A dynamic model seeks to capture this effect by estimating at what level an individual is incentivized to work or not, given what portion of income is kept and what portion is lost in taxes. As noted above, given an otherwise equal tax burden, people prefer to pay sales taxes rather than income or property taxes. In this way, it is not just the tax rate or the overall tax burden that influences people's choices but also the type of taxes levied. One of the most profound choices affected by state-level taxation is where to live. While overall higher tax rates will cause people to leave a state and migrate to another state, property taxes have an especially large effect in this regard. When overall tax burdens are equal, people migrate from the state with relatively more property taxes to the state with relatively fewer property taxes and more sales taxes.[2]

This analysis relies on a dynamic model to capture the domestic migration effects from people's tax preferences.[3] The model utilizes various tax data from all 50 states over a decade and accounts for the effects of the 2017 Tax Cuts and Jobs Act related to the imposition of the state and local tax deduction at $10,000 per year. Internal Revenue Service data are used to estimate the average income that domestic migrants add to a state's economy. The analysis shows that property tax rates are an order of magnitude worse than sales tax rates. That is not to say, however, that property taxes are worse than sales taxes on a dollar-for-dollar basis. Sales taxes usually apply to only part of an individual's annual income, but assets subject to property taxes are usually a multiple of that individual's annual income. Thus, a property tax rate that is lower than a sales tax rate can impose a larger burden than a higher sales tax rate because the individual's tax bases are different. This, in conjunction with the burdensome nature of wealth taxes, helps explain people's strong preferences against property taxes. Businesses are particularly susceptible to excess burden from property taxes, in part for this exact reason, and property tax increases prevent new businesses and jobs from being created (Enami et al., 2018). By shifting a tax burden away from property taxes and toward sales taxes, a state becomes more attractive to domestic migrants, on average. This causes a net inflow of domestic migration, which increases the state's population. Those people bring incomes and jobs with them, adding to the state's economy. The net effect is faster economic growth, more state income, and a larger tax base. As the economy grows, the state government can take a smaller slice of the growing pie and still raise the same amount of revenue. Thus, a more efficient tax system can increase economic growth and decrease the tax burden while maintaining tax revenue levels. The results from this model (regression coefficients can be found in **Appendix A**) find that a decrease in property taxes of 0.98 percentage points (the equivalent property tax decrease from eliminating the M&O) contributes to an increase in domestic migration of at least 745,000 people annually, and an increase in sales taxes of 1.72 percentage points (the equivalent sales tax liability increase to replace the M&O) causes a decrease of about 1,500 people in domestic migration. The net migration effect of the redesign is more than 743,500 additional people moving to Texas annually. The higher levels of domestic migration will increase private gross state product by more than $48 billion, thereby increasing the sales tax base by this amount annually. The removal of exemptions and the economic growth increase the tax base and allow the same revenue to be generated with a lower tax rate. This is true at both the state and local levels. Therefore, the local sales tax rate should be decreased to raise the same revenue as before the changes to the tax base.

Dynamic Results of the Redesign to Texas's Tax System

Four different scenarios are modeled, each with slightly different expanded tax bases. **Table 2** presents an overview and the dynamic results for each of the scenarios. **Appendix B** includes the currently exempted items that would be removed and therefore taxed under the most efficient scenario with no double taxation.

The four options expand the sales tax base to include the entire services sector. The first scenario has the broadest base possible and yields the lowest sales tax rate. The second option excludes food and all pharmaceutical drugs but includes manufacturing inputs, which results in double taxation in the manufacturing sector; this yields the second lowest tax rate. The third scenario eliminates all double taxation and includes food and drugs in the tax base; it has the second highest tax rate but is still slightly below the current

2 The main reason why people have demonstrated a strong preference for sales taxes over property taxes is in part the different nature of their bases but very likely also the lower excess burden imposed by sales taxes and the faster economic growth that follows from lessening excess burden. Sales taxes also allow for the exportation of tax burden to a greater extent than property taxes, further lessening the overall tax burden on the state.

3 Detailed results from the model are available upon request.

Table 2

Dynamic Modeling Results of Sales Tax Rate With Different Sales Tax Scenarios (Millions of Dollars)

Sales Tax Base: Inclusion/Exclusion	Broadest Base Possible, Includes Double Taxing	Manufacturing Double Taxed, Food and Drugs Excluded	No Double Taxation (Most Efficient)	Food Double Taxed, OTC Drugs Included
Implied Expanded Private Sector GSP Base after Dynamic Effects	$1,042,391	$930,341	$874,893	$835,229
State Tax Rate	5.99%	6.71%	7.13%	7.47%
Local Tax Rate	0.91%	1.02%	1.08%	1.13%
Total Tax Rate	6.89%	7.73%	8.21%	8.60%

Note. Private gross state product was $1.65 trillion in the third quarter of 2019. Data from *Regional Economic Accounts*, Bureau of Economic Analysis, n.d. (https://apps.bea.gov/iTable/index_regional.cfm). Authors' calculations based on a model that uses the effects of the tax reform on net migration to determine the changes to the private sector GSP and resulting sales tax bases and rates. This is based on a 2.92% increase in private sector GSP following the redesign of the Tax Code. A static analysis would have higher sales tax rates, resulting in a windfall of tax revenues to state and local governments from the broader-based sales taxes from increased economic activity.

rate of 8.25% (6.25% state rate and 2% maximum combined local rate). The last option eliminates the double tax on manufacturing but includes over-the-counter drugs in the tax base and creates a double tax on food by taxing agricultural inputs as well as food; this final scenario has the highest tax rate. An important point that merits repeating is that these scenarios, regardless of the tax rate, yield precisely the same revenue in the model. Therefore, the choice between them is not one of how much to tax but rather how to levy that tax. The most efficient option is the third scenario which avoids any double taxation or unnecessary exemptions. So, despite having the second highest tax rate, it has the lowest excess burden and generates the same revenue as the other three options. This analysis does not estimate the deadweight loss associated with double taxation due to data limitations. Consequently, the three scenarios with double taxation would require slightly higher rates than those that appear in **Table 2**. Because the economic losses from this excess burden are not estimated, the corresponding tax rates are not adjusted. Instead, this explanation serves as notice that those three estimates are somewhat imprecise, and the real tax rate needed will be marginally higher. However, the 8.21% tax rate from the scenario with no double taxation does not suffer from this limitation and, therefore, is a more rigorous estimate. In each scenario, economic growth captured in the dynamic estimates allows for a lower tax rate to generate the same revenue as compared to the static estimates. This is further illustrated in the size of the sales tax base, also listed in the same table.

These positive economic effects support the findings by economists of the Baker Institute at Rice University who studied the economic benefits of replacing property taxes with sales taxes (Barro & Diamond, 2018). They found that a complete elimination of burdensome property taxes would yield substantial economic gains through a more efficient, competitive framework more reliant on the sales tax. Although not modeled by Barro and Diamond, a combination of this option and strict spending limitations at the state and local levels to avoid rising tax bills would be an even better alternative. The resulting state surplus could provide tax relief, which would then stimulate the economy and yield even greater economic gains (Arduin, 2012). The full replacement is a conservative reform because sales taxes tend to grow at a slower rate than property taxes (see **Figure 2**) and are based on objective metrics from mutually beneficial market exchanges. In addition, they provide greater transparency to the taxpayer, especially renters, because their costs are not "hidden" in other payments, such as rent. Certain previous property tax relief efforts have failed by providing relief that has only been temporary (Belew et al., 2018). The complete replacement of school district M&O property taxes by sales taxes would eliminate this possibility.

To provide information of how the sales tax base and rates would look under different redesign options, **Table 3** shows data using a range of sales tax bases and sales tax rates for FY 2019. These data help determine different gross state product (GSP) bases and sales tax rates needed to cover the total taxes needed for the redesign while attempting to avoid a more burdensome VAT. Starting with total private industries that can be taxed, given the government sector is not taxed, we can subtract multiple industries to find the redesign necessary to replace school district M&O property taxes with sales taxes.

The GSP base that collected the $43.5 billion ($34 billion plus $9.5 billion) in state and local sales taxes in 2019 is about $527 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 $543 billion ($34 billion divided by 6.25%). There should be strict local spending limits to ensure local tax rates are only revenue neutral rather than allowing a windfall of taxes to local governments to spend and to hold the

Table 3
Sales Tax Rates Calculated to Replace School District M&O Property Taxes, 2019

Redesign Sales Tax Base Options	Private 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	$871,150	6.25%	2.00%	8.25%
Redesigned Sales Taxes GSP Base	$874,893	7.13%	1.08%	8.21%
Tax Rate Needed With No Change in Tax Base	$526,179	11.86%	1.79%	13.65%

Note. Private gross state product was $1.65 trillion in the third quarter of 2019. Sources are from *Regional Economic Accounts*, Bureau of Economic Analysis, n.d. (https://apps.bea.gov/iTable/index_regional.cfm), and authors' calculations. Redesigned GSP base is total private industries excluding most of real estate, healthcare, manufacturing, construction, and mining industries.

sales tax rate lower to keep the rate competitive with those in surrounding states.

Avoiding Double Taxation

The Texas Comptroller of Public Accounts (2018) reports that the Lone Star State would provide an estimated $42.9 billion in exemptions ($34.6 billion), exclusions ($8 billion), and discounts ($310.8 million) to the sales tax base in 2019. This tax bias effectively selects winners and losers within the Tax Code and contributes to a higher sales tax rate. It should be eliminated as much as possible. Broadening the sales tax base would also influence local jurisdictions' sales tax collections. In order to avoid any double taxation, the redesign of the tax system should move to sales taxes with a base of only final goods. For a sector like agriculture, that means livestock purchased for eventual sale as food should not be taxed. Farm machinery, conversely, should be taxed. Manufacturing goods that become part of a final product should not be taxed. Because the burden of double taxation is concentrated and the burden of an exemption is dispersed, double taxation should be more cautiously avoided than unnecessary exemptions. When categories likely contain some intermediate goods and some final goods, and it is not reasonable to distinguish the two subcategories, it is usually more prudent to exempt the category. By avoiding double taxation, the tax system can also avoid the costly effects of the VAT discussed above.

The Case for Taxing Food and Over-the-Counter Drugs

Exemptions for food and over-the-counter drugs may be championed as reducing the tax burden of low-income people, but those exemptions very often benefit high-income people even more. The tax savings, for instance, are far greater on a cut of prime steak than on corn. Furthermore, the same argument of a particular exemption being targeted at low-income earners can be made for a multitude of goods and services. In reality, higher-income earners still tend to purchase more of almost everything than low-income earners do, so the higher-income earners receive a larger tax reduction per capita than the lower-income earners. Compounding this problem is that lower-income earners buy non-tax-exempt food items at a disproportionate rate compared to higher-income earners, due in part to the myriad rules surrounding which food items are tax exempt. There are numerous examples of seemingly arbitrary and inexplicable distinctions between taxable and non-taxable food items in Texas laws. For instance, bakery items sold by bakeries are not taxable, but bakery items sold by non-bakeries are taxable when heated or sold with utensils. Baked items are taxable (muffins, cakes, scones, etc.), but baking products are not taxable (mixes, chips, sprinkles, icing). Soft drinks are taxable, but beverages that contain any amount of milk or are over 50% fruit or vegetable juice are not. Bottled and canned coffee and tea are taxable only when sweetened. Unprepared foods are not taxable whereas prepared foods are; but foods that are sold frozen are counted as food products and therefore not taxed. For instance, a frozen burrito sold in a supermarket would not be taxed even though it is highly processed and practically ready for consumption. Snack items are taxable when sold in individual-sized portions or from a vending machine, whereas snack items that are not individual-sized are not taxable. This means that one bag of chips would be taxable, but a box of a dozen bags of chips would not. In addition, dietary supplements (products with a Supplement Facts panel) sold in stores are not taxable. Taxable items purchased in a grocery or convenience store are exempt when legally purchased with Supplemental Nutrition Assistance Program (SNAP) benefits. Baby clothing and care products are taxable, but any kind of baby food (processed or unprocessed) is not. Condiments and spices are not taxable. Amid these confusing and inconsistent rules, it is vital to remember that removing the exemption on food does not represent a tax increase for lower-income earners in the context of eliminating nearly half of their property tax liability. For an overview of the potential net savings for families across Texas, **Table 4** provides examples of the average effects of this redesign on Texas families, which are substantial given the cuts in their overall tax burden.

Lastly, given that economic growth increases the living standards of everyone, including lower-income earners, a system that avoids the inefficiencies of double taxation

Table 4
Examples of Average Effects of Redesign on Texas Families

	Austin	Beaumont	Dallas	Houston	Lubbock	McAllen	San Antonio
Household Median Income	$71,576	$50,632	$52,580	$52,338	$50,453	$46,804	$52,455
Property Tax Burden Cut	-$1,977	-$1,859	-$2,183	-$2,246	-$1,851	-$2,132	-$2,141
Sales Tax Burden Increase	+$839	+$618	+$891	+$891	+$643	+$600	+$667
Net Savings	$1,138	$1,241	$1,292	$1,354	$1,208	$1,532	$1,474

Note. Data are from *Quick Facts*, Census Bureau, n.d. (https://www.census.gov/quickfacts/TX), and *Texas Income Tax Calculator*, Smart Asset, n.d. (https://smartasset.com/taxes/texas-tax-calculator#naEFnBN6gx).

will increase economic growth rates and benefit all income earners.

Option 2: Buying Down Taxes with Surplus State General Revenue-Related Funds

Another option that the Foundation has researched is limiting the increase of state GRR funds spending to less than population growth and inflation based on the state's new spending limit and use the surplus GRR funds to buy down school district M&O property taxes over time until they are eliminated (Belew et al., 2018; Ginn, 2021e). Using the biennial average from 2012 to 2021 of 9.02% in GRR funds revenue growth and 6.38% in population growth times inflation, **Table 5** shows how starting the process of using 100% of the surplus GRR funds in 2022-23 could result in the elimination of the school district M&O property taxes by the 2040-41 biennium. The 2020-21 school district M&O property taxes are an estimate based on the historical growth rate and the 2022-23 GRR revenue and spending are based on the latest figures available (Texas Comptroller of Public Accounts, n.d.-e; Texas Comptroller of Public Accounts, 2021b). The amount of GRR available for property tax cuts is the surplus of GRR revenue minus spending in each biennium and minus the cumulative amounts used for property tax cuts in prior years. The amounts used for tax cuts do not reduce GRR revenue in subsequent periods because the GRR revenue is needed to cover the continued compression of the school district M&O rates over time.

To provide a cut in Texans' property tax bill for the 2022-23 biennium, there would need to be at least $5 billion in additional GRR available such that the reduction in school district M&O property taxes will be enough to compensate for the rising property taxes by school districts of 2.5% and other local tax entities of 3.5% without a local election. The $5 billion—or some greater measure of relief—could come from GRR surplus that the Texas Comptroller of Public Accounts (2021) estimates to be $7.85 billion, funds available in the economic stabilization fund, or possibly the funds sent by Congress to Texas through the American Rescue Plan Act (ARPA; Ginn, 2021f). Although this GRR surplus buydown option is a productive path as it helps to restrain spending growth, spending being the true burden of government, it is based on major assumptions whereby any changes that reduce the surplus or reduce the share of the surplus used to cut taxes would mean less in cuts to M&O property taxes over time. In addition, if these assumptions hold true over time, the GRR surplus buydown would eliminate the school district M&O property taxes in about 20 years during the 2040-41 biennium, which would bring the average property tax burden down to about 1.3% of a house's value from today's roughly 2.3%. At the time of elimination if not before, there should be a constitutional amendment that prohibits school districts from reestablishing this tax.

The redesign of the tax system noted above would mean that school district M&O property taxes would be eliminated immediately, which also means that there should be

Table 5
Example of Surplus GRR Buydown Proposal if Started in 2022-23 (in Millions of Dollars)

	2020-21	2022-23	2024-25	2026-27	2028-29	2030-31	2032-33	2034-35	2036-37	2038-39	2040-41
GRR Revenue (9.02% increase)	116,130	123,020	134,122	146,227	159,423	173,811	189,497	206,599	225,244	245,572	267,735
GRR Spending (6.38%)	111,020	115,170	122,516	130,330	138,642	147,485	156,892	166,898	177,534	188,867	200,913
GRR Available for Tax Cuts (2.64%)		7,850	3,757	4,290	4,884	5,545	6,279	7,095	8,000	9,004	10,116
School District M&O Property Taxes	55,893	49,243	46,624	43,392	39,471	34,774	29,207	22,665	15,031	6,178	0

Note. Data are from *Property tax survey data and reports,* Texas Comptroller of Public Accounts, n.d.-a (https://comptroller.texas.gov/taxes/property-tax/reports/index.php), and *87th Legislature, first called session revenue estimate*, Texas Comptroller of Public Accounts, 2021b (https://comptroller.texas.gov/about/media-center/media-kit/87th-lege/).

Table 6
Example of Redesign with Buydown Proposal if Started in 2022-23 (in Millions of Dollars)

	2020-21	2022-23	2024-25	2026-27	2028-29	2030-31	2032-33	2034-35	2036-37	2038-39	2040-41
GRR Revenue (9.02% increase)	116,130	178,913	187,209	198,868	211,527	225,016	239,368	254,635	270,875	288,152	306,531
GRR Spending (6.38%)	111,020	171,063	181,973	193,579	205,926	219,060	233,032	247,895	263,706	280,525	298,417
GRR Available for Tax Cuts (2.64%)		7,850	5,236	5,289	5,601	5,956	6,335	6,740	7,169	7,627	8,113
School District M&O Property Taxes	55,893	0	0	0	0	0	0	0	0	0	0

Note. Data are from *Property tax survey data and reports,* Texas Comptroller of Public Accounts, n.d.-a (https://comptroller.texas.gov/taxes/property-tax/reports/index.php), and *87th Legislature, first called session revenue estimate*, Texas Comptroller of Public Accounts, 2021b (https://comptroller.texas.gov/about/media-center/media-kit/87th-lege/).

a constitutional amendment such as HJR 154 that removes any opportunity for school districts to reimpose this tax. By combining the GRR buydown option in this section with the redesign, there could be substantial cuts in state taxes over time. For example, **Table 6** shows that using the average of a 2.64% surplus in GRR funds moving forward and requiring it to cut state taxes (e.g., sales taxes, franchise taxes, etc.) could result in about $66 billion more in state tax cuts through 2040-41.

The result would be nearly half (42.3%) of local property taxes eliminated across the state and large state tax cuts over time thereby substantially improving the state's fiscal situation, bettering the state's competitive advantage, and boosting economic prosperity for Texans.

Limiting Local Government Revenue

Given this redesign would result in a reduction of 42.3% in property taxes across the state, other local tax entities may want to fill this void with higher taxes. This potentiality should be avoided by building on the historic reforms of the levy limitation in SB 2. This could be improved by reducing the voter-approval tax rate to 0% from its current 3.5% threshold and a new broader revenue limit applied that covers all types of local revenue collected by every local jurisdiction. This would mark a substantial improvement in the status quo.

To be more specific, we recommend that the state impose on local jurisdictions a total revenue limit based on the new state spending limit, which uses the state's population growth times inflation as the limiting factor. In addition, any governing body seeking to exceed the limit should be required to win a supermajority vote. Legislators might also consider including a voter-approval mechanism, similar to the one in SB 2 (2019), for total revenue increases beyond a certain level. From 2010 to 2019, local revenue growth averaged 4.72% annually whereas population growth times inflation averaged 3.37%. Accounting for compounding over time, this results in local revenue being 5.1% higher than if it had followed this spending limit. This amounts to Texans being taxed by $8.2 billion more in 2019 than otherwise, based on the excessive revenue above population growth and inflation over this 10-year period, which translates to an additional tax payment of nearly $1,100 more for an average family of four. Achieving the spending limit consistency at the state and local levels would better rein in excessive government spending across the state and help provide more tax relief. This would also provide an opportunity to require local governments to use their surplus revenue above population growth times inflation to provide tax cuts as noted in the state's buydown option above. Because the state has a constitutional amendment rejecting a statewide property tax, this revenue limitation must be combined with the benefits of SB 2 such that if a local tax entity desires to raise revenue above population growth times inflation, it would hold a local election to ask voters if it can raise property taxes on existing property in that jurisdiction. Collectively, this would provide a much-improved framework to effectively limit revenue by local governments while also better limiting property taxes across the state.

Recommendations

Lower Taxes

- Cut local property taxes in nearly half by eliminating school district M&O property taxes immediately through a redesign of the state's tax system or over time through buying those property taxes down using surplus GRR funds along with other monies that may be available, such as Rainy Day funds or ARPA funds. The process for cutting property tax bills in Texas should start in 2022-23 by the Texas Legislature using most if not all of the $7.85 billion surplus in GRR funds to cut school district M&O property taxes.

Better Texas

- Replace school district M&O property taxes with redesigned state sales taxes, including a 51.2% broader base and a lower combined state and local rate of 8.21%. This would include a 7.13% state sales tax rate to replace school district M&O property taxes along with a 1.08% revenue-neutral local sales tax rate. The local rate should be changed in statute as the new maximum rate from the current 2% maximum rate to avoid a windfall

of taxes by local governments from the broader tax base.

- Combine the redesigned tax system with spending restraint to use 100% of surplus GRR funds above the state's new spending limit of population growth times inflation to buy down state sales taxes or other taxes over time. This buydown of taxes should also be required at the local level to rein in excessive government spending. Many Texans will experience net savings, so more money stays in their pockets.
- Limit total local revenues of all other local tax entities to provide spending relief by requiring a limitation on total revenues from sales taxes, property taxes, and other revenues to no more than population growth times inflation. This should match the state's new spending limit on an annual basis such that the burden of government is limited consistently and for all Texans. In order to avoid a statewide property tax, local governments should be given the option to exceed the revenue limit by the body approving it with at least a three-fifths vote, as in the state's new spending limit along with the improvements in SB 2 that allows existing property taxes to increase based on approval by voters in a local election.

Conclusion

Texans are fed up with paying exorbitantly high local property taxes. Although attempts have been made over time to address these costly higher taxes, the result has been steady increases in property taxes with little to no expectation that it will change even with the historic reforms made by the Texas Legislature in recent years. By providing real tax cuts and a more vibrant economy with a fairer, more transparent, and efficient form of taxation immediately or over time through the elimination of nearly half of local property taxes, Texas will be the beacon of freedom and prosperity for generations to come.

Appendix A

Estimation Results: [Weighted Least Squares] Domestic Migration Coefficients

Intercept	0.0796	***
	(-0.0165)	
(δ_1)*Personal Income*$_{it}$	-0.2013	***
	(-0.0508)	
(δ_2)*Personal Income*$_{it}$	-0.351	***
	(-0.0928)	
Corporate Income$_{it}$	-0.1049	**
	(-0.044)	
(δ_1)*Property Taxes*$_{it}$	-2.0848	***
	(-0.2759)	
(δ_2)*Property Taxes*$_{it}$	-2.6025	***
	(-2.1556)	
(δ_1)*Sales Taxes*$_{it}$	-0.0033	***
	(-0.0006)	
(δ_2)*Sales Taxes*$_{it}$	-0.0031	***
	(-0.0009)	
Gas Taxes$_{it}$	-0.0002	
	(-0.0001)	
U6 Rate$_{it}$	-0.122	***
	(-0.0348)	
Regional Price Parity$_{it}$	0	
	(-0.0002)	

*** 0.001, ** 0.01, * 0.1

See Antoni (2020) for coefficient interpretations.

Appendix B

Sales Tax Base Expansion with Tax Code Number

Goods Related Additions

151.313 Prescription medicine and devices
151.313 Over-the-counter drugs
151.314 Food for home consumption
151.315 Water
151.316 Agricultural machinery and equipment
151.316 Horses, mules, and work animals
151.316 Commercial fishing ice
151.316 Timber items
151.317 Residential gas and electricity
151.318 Manufacturing machinery & equipment
151.318 Packaging and wrapping supplies
151.318 Certain property used in research and development activities
151.318 Property used in media production, recording, and broadcasting
151.318 Property used in cable television, internet access, or telecom services
151.319 Newspapers
151.319 Newspaper inserts
151.320 Magazines
151.322 Containers
151.326 Clothing & footwear for limited period
151.327 School supplies & school backpacks before start of school
151.324 Equipment used elsewhere for mineral exploration or production
151.328 Repair equipment and services for certain aircraft
151.329 Certain ships and ship equipment
151.329 Boats and boat motors
151.331 Railroad fuel and supplies
151.331 Rolling stock and locomotives
151.333 Energy-efficient products for a limited period
151.333 Water-efficient products
151.335 Coin-operated services
151.341 Items sold to or used by to construct, maintain, expand, improve, equip, or renovate media production facilities at media production locations
151.342 Agribusiness items
151.351 Information services and data processing services
151.355 Water-related exemptions
151.359 Property used in certain data centers; temporary exemption
151.429 Enterprise projects (refunds)

Services Related Additions

New residential construction
New nonresidential construction
Residential repair and remodeling
Barber and beauty
Funeral
Child day care
Miscellaneous personal services
Physician services
Dental services
Other health care
Legal services
Accounting and audit services
Architectural and engineering services
Management consulting and public relations
Contract computer programming
Research and development services
Marketing research and public opinion polling
Testing labs
Outdoor display advertising
Employment agency services
Temporary labor services
Financial securities brokerage
Other financial services
Real estate brokerage and agency
Freight hauling
Other transportation (except scheduled passenger)
Veterinary service
Automotive maintenance and repair
Car washes
Private vocational education
Other educational services

Note. Sales tax exemptions are from *Tax Exemptions and Tax Incidence Report*, Texas Comptroller of Public Accounts, 2018 (https://comptroller.texas.gov/transparency/reports/tax-exemptions-and-incidence/2018/96-463.pdf).

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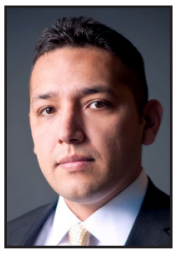

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