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December 12, 2007 Contact: Dick Lavine, lavine@cppp.org, ext 101 No. 07-307

# REPLACING PROPERTY TAXES WITH SALES TAXES WOULD BE BAD FOR TEXAS BUSINESSES, FAMILIES, AND PUBLIC EDUCATION

Public education is the foundation of our democracy and the engine of our economy. Texans have a collective responsibility to ensure that public education is adequately supported. This responsibility needs to be fairly distributed among Texas families in a way that supports economic growth. Recently, some have proposed that Texas replace local school property taxes by increasing the rate of the state sales tax or expanding the sales tax to more goods and services.[1] Such a tax swap would be a bad deal for businesses, families, and public education. 1) The swap would make Texas businesses less competitive because the higher sales tax would raise the cost of Texas goods and services. 2) Taxes on most Texas families—including middle-class families—would actually go up. Only the wealthiest families would see a tax reduction. 3) At the same time, public education would be hurt. Schools would have one source of revenue, sales, which is less stable than property. With the state paying all the bills, more decisions would be made in Austin, and the link between local taxpayers and public schools would be broken. In addition, local communities could no longer supplement the basic education provided by the state.

Texans need to ask what problem we are trying to fix? Are property taxes too high? Even if Texas eliminated school property taxes, Texas would still have to raise the same amount of tax dollars. Are we worried that some residents aren't paying their fair share? In fact, everybody pays the property tax either as owners or as renters (with the tax reflected in the rent). Are we worried that property taxes discourage homeownership? Texas already has laws on the books to ensure that property taxes do not undermine homeownership. Are we worried that property taxes don't correspond to our ability to pay? Generally this is not true, but for those families for which it is true, most states address the problem through a tailored tax break called a circuitbreaker. Texas could provide a circuitbreaker too. As we discuss in this paper, trading property taxes for sales taxes does not solve any real problems, but it does create some.

## Replacing property taxes with sales taxes would hurt Texas businesses

School districts levy property taxes for both annual operating costs ("maintenance-and-operations" or M&O) and debt service ("interest and sinking fund" or I&S). The M&O tax is expected to bring in about $15 billion for the 2007-08 school year. The state sales tax is projected to produce $20.8 billion in fiscal year 2008.

To generate $15 billion from the current sales-tax base, the tax rate would have to be raised from 6.25 percent to about 11 percent. The highest state tax rate in the U.S. is 7 percent. Including the 2-percent local sales tax levied in most large Texas cities, the total sales tax rate would be 13 percent; the highest total rate in the U.S. is 12 percent. Thus, if the state raised the sales tax to eliminate property taxes, Texas businesses would have trouble selling their goods and services because we would have the highest sales tax in the country.

Instead of raising the rate, the state could expand the sales tax base by extending the sales tax to currently untaxed goods and services. Increasingly, Texans make their money selling services, but the sales tax is primarily a tax on the sale of goods. Texas needs to fairly tax services. Our new franchise tax (the "margins tax"), tries to do just that by including all but small businesses and taxing the service sector like other businesses.

Expanding the sales tax on top of the franchise tax would present several problems for businesses. Items that are essential for farms and businesses that are currently exempt would have to be taxed to raise the amount needed. The following table shows some of the largest items that would be affected.[2]

| Exemption | Potential Revenue |
|---|---|
| Manufacturing gas and electricity | $723 million |
| Manufacturing machinery | $560 million |
| Packaging, wrapping supplies | $298 million |
| Agricultural feed, seed, chemicals | $255 million |
| Water | $244 million |
| Containers | $104 million |
| Mining gas and electricity | $68 million |
| Agricultural machinery | $65 million |
| Drilling equipment | $64 million |

Taxing these and similar items currently exempted from the sales tax would generate only $5.9 billion—not enough to replace school property tax revenue.

Business and professional services would also be subject to taxation:

| Exclusion | Potential Revenue |
|---|---|
| Legal services | $423 million |
| Architectural, engineering | $358 million |
| Real estate brokerage | $237 million |
| Freight hauling | $207 million |
| Financial services brokerage | $199 million |
| Accounting, auditing | $192 million |
| Management consulting | $155 million |
| Computer programming | $131 million |
| R&D laboratory services | $113 million |

Construction labor would also have to be taxed:

| Exclusion | Potential Revenue |
|---|---|
| Residential construction | $455 million |
| Nonresidential construction | $236 million |
| Residential repair | $121 million |

But taxing all personal, business, professional, and construction services currently excluded from the sales tax would raise only $5.4 billion. Combined with the exemptions discussed above, the total new revenue would be $11.3 billion—still $3.7 billion short of replacing the lost school property tax revenue.

There are two remaining potential sources of sales tax revenue. First would be to tax items that are also taxed by some other law. This chart shows the potential revenue of adding a sales tax on top of the tax already applied to these items. Some of these items could be selected to produce the remaining revenue necessary.

| Exemption | Potential Revenue |
|---|---|
| Motor vehicles | $2.714 billion |
| Insurance premiums | $2.467 billion |
| Motor fuels | $1.883 billion |
| Aviation fuel | $418 million |
| Mixed drinks | $225 million |
| Oil well servicing | $85 million |

Materials used in manufacturing are also exempt from the sales tax. Taxing these items could raise another $9.6 billion. Of course, the additional cost of the tax on these inputs would be added to the cost of the final product, which would then also be taxed, undermining Texas competitiveness.

## Replacing property taxes with sales taxes would hurt Texas families

The sales tax, which is based on consumption, is extremely regressive, meaning it takes a much larger percentage of the income of a low- or moderate-income family than of a higher-income family. An average low-income family pays

5.9 percent of its income under the current sales tax system, while an average high-income family pays only 1.8 percent of its income in sales taxes.[3]

Why is a regressive tax system bad? First, even though wealthier families have larger and faster growing incomes, they are asked to contribute a smaller percentage to supporting public services than are lower-income families, producing inadequate revenue. Second, it stifles economic advancement, because taking a higher percent of income from low-income households makes it harder for them to move into the middle class and to accumulate assets such as a car and a house. Finally, it is simply unfair to take more of the income from those less able to pay, and less of the income from those more able to pay.

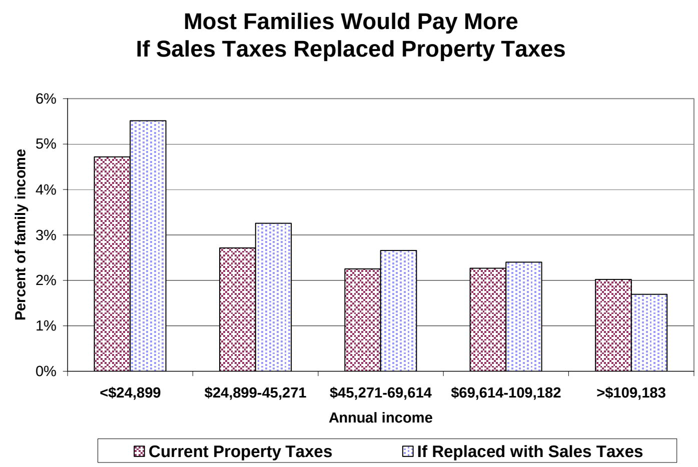
Even though consumption taxes are, by their very nature, regressive, the current exemptions for groceries, residential utilities (gas, electric, water), health care, and medicine help ease their impact on struggling families. Eliminating these exemptions would exacerbate the unfairness of the sales tax.

For instance, taxing groceries would cost lower-income families 0.6% of their income, but would take only 0.1% of the income of the highest income families. Eliminating the exclusion of health care services would have a similar negative impact.

Taxing services that are currently excluded from the sales tax would also raise the cost of personal services used by families:

| Exclusion | Potential Revenue |
|---|---|
| Groceries | $1.337 billion |
| Physician services | $804 million |
| Residential gas and electricity | $782 million |
| Other health care | $416 million |
| Prescription medicine, devices | $389 million |
| Dental services | $317 million |
| Auto repair | $246 million |
| Over-the-counter drugs | $193 million |
| Child day care | $184 million |
| Educational services | $77 million |
| Barber, beauty | $73 million |
| Funerals | $58 million |
| School lunches | $44 million |
| Car washes | $29 million |
| Religious writings | $11 million |

The effect on most Texas families of replacing the school property tax with a higher rate on the sales tax is clear: 80 percent of families would pay more; while only those families with incomes over $110,000 would benefit.




It might be possible to protect some very-low-income families from the worst effects of this proposed shift by rebating their increased tax payments through the Lone Star Card, the electronic benefits card used by the state for food stamps and TANF. In 2005, the Senate passed a provision to reimburse card holders for proposed sales-tax increases.[4] However, even this rebate would assist only the poorest 10 percent of families (those earning less than roughly $2,000 a month), still leaving the vast majority of Texas families facing a tax increase.[5]

## Replacing property taxes with sales taxes would endanger stable funding for public education

When it comes to something as important as public education, Texas should not put all its eggs in one basket. Using both property taxes and sales taxes buffers our schools from economic downturns. While the sales tax is the major source of state tax revenue, collections can be quite volatile. In fact, sales tax revenue fell in 2002 and 2003, leading to severe cutbacks in state services. In contrast, property tax values are much more stable, so can provide a better base of support for public education.

## Replacing local taxes with state taxes would endanger local control and end local supplementation

Eliminating local school property taxes would sever the link between a community and its public schools. Under the current system, if a community wishes to raises its own property taxes in order to improve their local schools, it can vote to do so. In fact, in November, voters in three-quarters of the 120 school districts seeking higher tax rates approved rate increases of up to 17 cents.

If school funding were centralized into the state sales tax, this opportunity for local decisionmaking would be cut off. Schools would have only the amount per student assigned by the state to all school districts. Communities could no longer add to this basic level of funding with local property taxes to supplement the basic state program.

California imposed severe limits on local property taxes under Proposition 13 in 1978, moving from a system in which each school district determined its own revenue through local property taxes to a system in which school revenues were controlled at the state level. Largely as a result, school funding stagnated and student achievement plummeted.

## What's the problem?

### Everyone pays property taxes

One alleged advantage of the sales tax is that everyone would pay, unlike the property tax. But everyone does, in fact, pay property taxes. Homeowners write checks directly, but renters also pay property taxes, which are passed on to them by their landlords in the form of higher rents. Businesses also pass on their property taxes to families and individuals in the form of higher prices, lower wages, or lower profits.

### Property taxes do not imperil home ownership

Generally, Texas families buy homes based upon their annual income, giving the tax a rough correlation to the ability to pay. While rising appraisals and property tax rates are often blamed for the recent increase in the number of foreclosures in Texas, families generally fall behind in their home-related payments for other reasons, including high utility rates, expensive homeowners insurance, boosts in adjustable rate mortgages, and poor underwriting, which puts them into more house than they can afford. The focus of efforts to reduce foreclosure rates and keep families in their homes should be on what is causing the problem, not on property tax rates and appraisals.[6]

Texas laws already provide homeowners many protections against increasing property taxes. Homeowners age 65 or older have additional protections that ensure that they never have to leave their homes because of school property taxes.

- Homeowners qualify for a $15,000 exemption for school taxes, with an additional $10,000 exemption for homeowners age 65 or older or persons with disabilities.

- The *amount* of school taxes paid on a homestead is "frozen" when a homeowner reaches 65 years old.

- Over-65 or disabled homeowners may *defer paying any property taxes at all* on their home for as long as they own and live in it.

- The taxable value of a homestead may not increase by more than 10% a year, not including improvements.

- Homeowners have the option to defer paying taxes on any increase in their home's appraisal that is more than 5%.

- Veterans who were disabled while serving in the military and the surviving spouse or minor child of a disabled veteran or serviceperson killed on active duty may receive an exemption of from $5,000 to $12,000. Totally disabled veterans receive a full exemption.

- An owner of a home valued at less than $1 million may appeal an unfavorable ruling by the Appraisal Review Board by binding arbitration, rather than an expensive suit in district court.

- Local taxing unites are permitted to allow taxes to be paid in two payments or by credit card.

## Texas has better choices for reducing property taxes than trading for more sales taxes

Earlier we said that for home values are roughly related to a homeowner's income, but property taxes are not directly related to a family's ability to pay the tax bill. For some, the difference in family income and property taxes presents a real hardship. Most states address the problem by offering a "circuitbreaker program," which cuts off property taxes that exceed a certain percentage of a family's income.[7] Texas could adopt a circuitbreaker too.

Of course, the tax that best reflects a family's ability to pay is a state personal income tax. With a personal income tax, school property taxes could be reduced to next to nothing, families would contribute to supporting schools directly in keeping with their ability to pay taxes, and we could make the investments we need in the future of Texas by meeting the educational needs of our children.[8] If Texas is not yet ready to adopt a personal income tax, however, our state should at least not make our tax system worse by an ill-advised trade of property taxes for sales taxes.

[1] Texas Conservative Research Coalition Research Institute, *TCCRI Statement on the M&O Property Tax* (December 7, 2007), at http://www.txccri.org/publications/MO_Statement_2-7-07.pdf.
[2] All data in this Policy Page are from the Comptroller's biennial report, *Tax Exemptions & Tax Incidence,* February 2007, at http://www.window.state.tx.us/taxinfo/incidence07/. Potential revenue is for fiscal 2008.
[3] For more information, see *Who Pays Texas Taxes?* at http://www.cppp.org/research.php?aid=638
[4] HB 3, 79th Legislature, First Special Session, which later died in conference committee.
[5] See: *Senate Has Opportunity to Protect Families Hit Hardest by House Version of HB 3, the "Tax Relief Bill"* at http://www.cppp.org/files/7/POP234.pdf.
[6] See: *Why Are There So Many Foreclosures?* at http://www.cppp.org/files/7/POP271Foreclosures.pdf.
[7] See: *Property Tax Circuit Breakers,* at http://www.itepnet.org/pb10cb.pdf.
[8] See: *The Best Choice for a Prosperous Texas: A Texas-Style Personal Income Tax*, at http://www.cppp.org/research.php?aid=591&cid=7