

## A “Big Idea” That’s a Bad Idea for Texas

A policy idea is being shopped around legislatures across the country that may look, on its surface, like a good idea to taxpayers and lawmakers. Call it a “Big Idea” with capital letters because if it was adopted in Texas, it would fundamentally change the way cities, counties and school districts are financed. It may sound like a Big Idea, but it’s a bad idea for the state and its local governments.

The Big Idea is to repeal all local property taxes and replace them by raising the sales tax rate or by expanding the sales tax base to include a broader range of goods and services. Other versions of this idea have surfaced this year in Oklahoma, Kansas, Missouri, and North Dakota. At times, the idea is to eliminate property taxes and in other cases to eliminate state income taxes, but the idea is basically the same—a large tax swap, usually based on the concept of moving the state and local tax system toward a much heavier reliance on taxing consumption.

Since polls show that most Americans generally prefer the sales tax over property or income taxes, it sounds like a promising idea. In reality, the swap would be a very bad idea for anyone who cares about having local governments—cities, counties and school districts in particular—that actually work and can do their own business for their own citizens free of controls from the state capital. It raises other issues as well. Among the issues that aren’t mentioned when supporters describe the supposed benefits of the tax swap are the following:

- The swap would be a risky and untested experiment and much more difficult to accomplish than generally is portrayed.
- The swap would hand control of funding for cities, counties and schools over to the Legislature in Austin, whether that is the intent or not.
- The swap would give Texas the highest sales tax rate in the country—in fact, the tax rate very likely would have to be triple the current state and local rate—about 25 percent based on state estimates for fiscal year 2011, compared to the current state and local rate of 8.25 percent in most Texas cities. It would be more than double the highest sales tax rate in the nation.
- To reduce the new sales tax’s rate, it would be necessary to tax more “consumption,” which could mean taxing groceries, water, health care, medicine and other “big ticket” goods and services that aren’t taxed now.
- Funding for cities, counties and schools would be more vulnerable to economic ups and downs than it is now.
- Lacking the population to generate sales tax revenue to support local needs, rural Texas and small towns in Texas would be losers in this shift.
- The new tax would be more regressive in its effect on low- and middle-income Texans than the current tax system in that even if the consumption sales tax is “revenue neutral,” it could be a tax increase for many working and retired individual Texas taxpayers.
- The swap would make Texas less economically competitive, not more.

Replacing the property tax is often misrepresented as a strategy for inducing a dramatic, nearly immediate surge in the state’s economy. These claims are overblown. In reality, the change would damage the state’s economic potential by crippling its local governments and by imposing a staggering new tax on almost every item individuals or businesses buy in the state. Taxes work best with broad tax bases and low rates. Tax policy works best when it is predictable and balanced. The tax swap would work against nearly all those goals and would create a host of complications for Texas local governments in the bargain.

## Uncharted Waters

Most people realize that they pay substantial property taxes on their homes and businesses. What they may not realize is just how important the tax is to Texas local government finances. It is a key revenue source for cities, counties, school districts and special districts. As Table 1 shows, almost 4,000 local governments rely on the tax statewide. That total represents 84 percent of all local governments in the state.

TABLE 1: Texas Local Governments by Type and Major Taxes				
Type of Unit	Number	Major Tax Sources		
		Property	Sales	Hotel
Counties	254	254	123	20
Cities	1,196	1,059	1117	392
School Districts	1,037	1,025	0	0
Transit Agencies	10	0	8	0
Special Districts	2,245	1,639	191	5
<b>Totals</b>	<b>4,742</b>	<b>3,977</b>	<b>1,439</b>	<b>417</b>

According to the most recent statewide data:

- The property tax accounts for almost a third of all local government general revenue, including state and federal aid, fees, fines and other taxes.
- It represents more than 80 percent of all taxes that Texas local governments collect.
- It accounts for half of all of the revenue that funds Texas school districts, more than 40 percent of county revenues and a sizable share of city revenues as well.
- The property tax brings in almost double the revenue of the sales tax, the most important state revenue source.

Texas local governments rely on the property tax because it is the best—and largest—of a limited number of local funding options at their disposal. Most state and local tax systems impose a range of taxes and fees, but typically rely on what is sometimes referred to as the “three-legged stool” of sales, income and property taxes. Texas does not impose a personal income tax, and as a result, the third leg of the state’s three-legged stool is made up of a mix of severance taxes on oil and natural gas and excise taxes on goods like tobacco products, alcohol and motor fuel, all state tax sources.

Under the Texas system, the state makes the greatest use of the sales and severance taxes, along with a business franchise tax and various excise taxes. The one large tax source left exclusively for local governments is the property tax, and it is a vital part of their revenue mix. In addition, Texas, in contrast to many other states, provides little in the way of direct aid to its local governments outside of its share of school funding. The components of local government funding in Texas are shown in detail by type of local government in Table 2. The data cover fiscal year 2007, the most recent year for which complete comparative data are available.

Type of Revenue	Cities		Counties		School Districts		Special Districts		All Local	
	Total	Percent of Total	Total	Percent of Total	Total	Percent of Total	Total	Percent of Total	Total	Percent of Total
Property Tax	\$5,109	13.9%	\$6,189.60	41.8%	\$21,870	52.0%	\$1,024	9.3%	\$34,193	32.7%
Sales and Gross Receipts	\$5,083	13.8%	\$447.20	3.0%	\$0	0.0%	\$999	9.0%	\$6,529	6.2%
Licenses	\$531	1.4%	\$345.20	2.3%	\$0	0.0%	\$1,443	13.1%	\$2,319	2.2%
Intergovernmental Revenue	\$2,168	5.9%	\$2,452.30	16.6%	\$19,562	46.5%	\$874	7.9%	\$25,056	23.9%
Utility Revenue	\$7,961	21.7%	\$0.00	0.0%	\$0	0.0%	\$2,661	24.1%	\$10,622	10.1%
Charges, Business and Other	\$12,420	33.8%	\$5,326.10	35.9%	\$653	1.6%	\$4,041	36.6%	\$22,440	21.4%
Insurance Trust	\$3,464	9.4%	\$57	0.4%	\$0	0.0%	\$5	0.0%	\$3,526	3.4%
<b>Total</b>	<b>\$36,734</b>	<b>100.0%</b>	<b>\$14,817</b>	<b>100.0%</b>	<b>\$42,085</b>	<b>100.0%</b>	<b>\$11,047</b>	<b>100.0%</b>	<b>\$104,684</b>	<b>100.0%</b>

Source: U.S. Census Bureau, Census of Local Government Finances

While cities, transit districts and some counties can levy a sales tax, state law limits total local sales taxes to two percent, of which cities and some counties have access to a one percent tax. (In some areas, transit authorities can levy a sales tax in place of the county.) Cities and counties also have other charges, fees and taxes that they levy, but those sources only go so far in producing the dollars needed to provide and maintain streets and roads, provide public safety, maintain jails and provide other common local public services.

Schools are the local governments that are most heavily dependent on the property tax, with half of their total revenue coming from the tax. Much of their funding beyond the property tax comes from state and federal aid, but districts have limited control over these sources of aid. They can change based on decisions made in Austin or in Washington, D.C. During the most recent legislative session, school districts relearned this lesson as state budget problems forced lawmakers to reduce state funding of schools by \$4 billion below current law funding levels.

Most special districts—whether they pay for water supply, mosquito control or junior colleges—also rely on the property tax, along with the sales tax (transit authorities) and state and federal aid.

Taking away the one critical funding option that is common to all local governments would be a mistake. It is not possible to eliminate this funding without major disruptions to local governments across the state. The tax swap would throw Texas local governments into uncharted financial waters. Every state has a property tax, often established at statehood. No other state has eliminated the tax, and on the few occasions where legislatures or voters have been given the option, they have decided against such a drastic step.

The most recent example of this caution can be found in the case of Measure 2, a referendum initiative considered by North Dakota voters in June. The voters were asked to decide whether they

avored eliminating the property tax, which funds schools, cities and counties, and replace it with an undefined set of state taxes, likely depending heavily on the state's booming oil and natural gas taxes. The voters rejected the measure by a margin of almost 3-1, not because they liked the property tax but because they were rightly concerned about the impact that eliminating the tax would have on their communities.

## Loss of Local Control

One of the likely byproducts of the tax swap would be to transfer control of local government funding to the Legislature in Austin. Supporters of the concept will argue that the expanded sales tax would work like the current sales tax, with collections allocated to cities, counties and, presumably, school districts (which don't receive sales tax now) based on their share of monthly tax collections. That sounds reasonable until you consider the potential problems with the concept.

First, revenue from the sales tax and the property tax are not distributed in the same pattern across the state. The sales tax would favor areas where there are people and businesses that make taxable purchases—namely the large Texas cities and the suburbs surrounding those cities. While it is true that property values also are highest in urban areas, the distribution is not the same, and there would be major winners and losers. For example, areas of the state that are rich in mineral reserves but have relatively small populations would see their revenues plummet. One option would be to let the chips fall where they may, allowing some local governments to gain enormously and others to lose. More likely, though, the Legislature would be forced to intervene to ensure a workable transition. In other words, lawmakers in Austin would have to decide how much revenue each local government will receive under the new system.

Areas of the state with strong property taxes and limited sales taxes could not simply be abandoned to a major reduction in their revenue base, and large windfalls could be equally problematic. This would mean that the Legislature would be put into the position of working out allocation formulas to strike some sort of balance, probably including holding local governments harmless for at least some period of time. Proposals like this have been raised in the past for the sales tax, and they have gone nowhere because it proved almost impossible to develop a distribution formula that every area of the state would view as fair. The difficulties the state has had allocating school district funding is evidence of that fact.

School funding likely would represent a particular problem. A single consumption tax would do nothing to fix the uneven distribution of revenues among school districts, an issue that has, in part, provoked six separate lawsuits against the state in the past year and which has been the source of ongoing litigation against the state for almost four decades. It would be the Legislature's responsibility to make the decision of what revenues would go to which school districts in order to preserve the constitutionally mandated equity of the school system. Simply allocating revenue from the new sales tax based on where it is collected would have uncertain results that should be studied long and hard before the state takes the leap into this new policy. The one point that wouldn't have to be studied long and hard is who would control school purse strings. Once the Legislature stepped in to decide the allocation of local sales taxes for education, it would effectively control virtually all of the funding for public schools, and the idea of local control of public schools would be over.

One final point is worth mentioning in this area. The property tax in Texas is locally levied, locally administered and locally collected. Local officials answer to local voters for their tax and budget choices. If it is replaced with a sales tax, the new tax would be wholly in the control of the

state. It would control how much local governments receive and when. It would control what is taxed and at what rate. While it is unlikely in Texas, it wouldn't be hard to imagine that a state, pressed to solve its own budget crisis, might simply divert a portion of the local tax to cover its own budget. A variation of this scenario has played out nationally over the past three years as state after state has slashed or eliminated state aid programs for local governments to help balance state budgets. Certainly, lawmakers would not take this step lightly, but as school districts have learned, even statutorily established school funding formulas can be laid aside if there is a need for lawmakers to meet their statewide budget obligations and avoid raising taxes. If such a situation did arise, local governments would have few options but to cut their budgets and lobby the Legislature for the funding to be restored. Tax decisions would be made in Austin, and all the local governments would be able to do is ask. Local control with local voter oversight would be a thing of the past.

## How High a Sales Tax Rate?

Setting aside the issues that would plague local government finance if the property tax were repealed, it is also important to consider what sort of "consumption" tax would replace it. One thing is certain. The tax rate would be eye-popping. The property tax currently produces more than \$40 billion a year in Texas for all local governments. The state sales tax in 2011 produced about \$21.5 billion at a tax rate of 6.25 percent.

This implies that unless the current tax base is changed, the rate of the new sales tax would have to increase—dramatically. Some estimates of the necessary tax rate indicate that a large hike might not be necessary; however, those estimates are based on broad measures of economic activity and not on the actual Texas sales tax base, which is much more narrowly defined. If the actual tax base is used in a rate calculation, the results are far less promising.

Here is a simple example. Using a straightforward calculation based on relative collections and rates, the minimum rate on the current tax base would have to be *at least* 17.85 percent (6.25% state rate + 11.6% new local rate) to replace the property tax. In addition, it has to be assumed in the absence of other information that cities, transit authorities and counties would be allowed to keep their current sales tax revenues, so an additional two percent would have to be factored into the new combined state and local tax rate. That implies that the combined state and local sales tax rate in most Texas urban areas would have to be *at least* 19.85 percent (16.75% + 2% current local tax) to produce the current levels of property tax revenue.

Is this a high sales tax rate? Yes, it is. Texans currently pay a maximum of 8.25 percent on their taxable purchases. This includes the 6.25 percent in state tax and two percent in local tax. The revised tax would, at a minimum, be more than double the current rate. It would be far higher than any other sales tax in the country. Right now the highest combined sales tax rate in the country can be found in Birmingham, Alabama, where state and local tax rates add up to 10 percent. In New York City, often held up as a standard for steep taxes, the sales tax rate is 8.875 percent.

Here is another way to look at the impact. When you buy \$100 in taxable goods now, the tax is \$8.25 in most cities in the state, including state and local taxes. Under this change, the tax would be a minimum of \$19.85.

In reality, though, the likely tax rate would be higher than the rate implied by simple calculation. The Comptroller's office has estimated that for fiscal year 2011, the state sales tax rate necessary to have replaced \$40.3 billion in total local property taxes—including all taxing

jurisdictions—and continue state sales tax revenues at their \$21.5 billion level would have to have been 23 percent—that is, an increase of 16.75 percent from the current 6.25 percent rate. *If you add the current two percent local sales tax to that amount, the total necessary tax rate to replace all local property taxes would be 25 percent, based on state estimates.* That means that every purchase of a taxable good or service would be a full one-quarter of its price more expensive as a result of this change.

Further, the sales tax rate necessary to have maintained state general revenue and replaced only school taxes of \$21.6 billion—another idea that is sometimes discussed—would have to have been 14.0 percent—an increase of 7.75 percent over the current sales tax rate. If you once again add in the current two percent in local sales tax, the total rate that would result if school taxes alone were replaced with a sales tax would be 16 percent, based on state estimates.

The difference between the Comptroller’s estimate and a simple estimate based on the current revenue productivity of the two taxes lies in how taxpayers would respond to such a radical new tax. A tax rate of this magnitude would make it worthwhile for taxpayers to go to considerable lengths to avoid tax. In many cases, this could mean simply crossing into a neighboring state to purchase big-ticket items like refrigerators and furniture. Of course, these goods would be subject to use tax under Texas law, but as a practical matter, the state would not have the resources or the information to trace every piece of furniture bought in Oklahoma, Louisiana, Arkansas or New Mexico and hauled back to Texas.

This situation is common in high-tax states like Massachusetts and New York, which have surrounding states with lower tax rates. They lose considerable tax revenue to consumer purchases across state lines by their residents in neighboring states. The problem Massachusetts has with border alcohol sales in New Hampshire is well known and longstanding. New York has had similar problems with its sales tax. In the past, for example, New York has sent tax agents to large furniture stores in New Jersey to take down the license plate numbers of New Yorkers shopping out of state to avoid sales tax. It isn’t hard to imagine a 25 percent tax encouraging the building of a ring of large retail outlets just across the border from Texas in all of our neighboring states. At a difference of a percent or two on the purchase price of even an expensive item, there’s no incentive to drive many miles to save tax, but when the difference is ten percent of the purchase price or more, many shoppers will be tempted to make the trip north, west or east across the state line.

The tax rate would also boost online shopping. Again, use tax would be due on sales by what are called “remote sellers”—retailers located in other states, who sell into a state mainly over the Internet. However, once again, the states don’t have the resources or information to collect use tax from any but the largest business taxpayers who are routinely audited. Current estimates suggest that Texas already loses more than \$400 million a year to Internet sales, and that number would almost certainly increase significantly under a 25 percent tax. Even with the state’s recent agreement with Amazon.com under which the company began collecting tax in Texas effective July 1, the state would see a sharp increase in online shopping and would therefore lose more revenue as a result.

Other, more elaborate forms of tax evasion also would be encouraged. Texas likely would see a sharp upswing in activity in the underground economy. The underground economy involves the exchange of goods and services, which are hidden from official view. Underground activities can range from babysitting “off the books” to selling narcotics. Since these transactions generally are based on cash payments and aren’t reported to the state, they go untaxed. Over time, the underground economy has changed as lawmakers redefine what is legal or what is to be taxed. How far

“underground” an activity is depends not only on whether it is legal but also on the capacity of government to enforce its laws and collect taxes. Again, the state simply lacks the resources to chase down every instance where an unscrupulous vendor sells taxable goods or services for cash—and therefore “off the books.” More revenues would leak from the system.

Once again, there is ample evidence of this sort of tax evasion from current issues in tax administration. For example, states differ widely in the tax rates on motor fuel and cigarettes. Because of the differences, state tax administrators fight an ongoing battle with cigarette and gasoline smugglers who bring low tax product into the state and sell it at higher prices and pocket the difference. The same problem would plague the sales tax for at least some goods at the new higher rate.

Finally, many businesses may simply decide to leave the state. Despite the fact that people view the sales tax as a tax on consumer purchases, the reality is that more than 40 percent of the tax comes from business-to-business sales. At an 18.75 percent tax rate, there would be a great incentive for at least some businesses to move out of the state—or to make capital investments in facilities in other states—as a way to avoid the high tax burden in Texas. It’s difficult to predict exactly how individual businesses would react, but it seems certain that the disincentive posed by a sales tax with such an extreme rate would offset a sizable percentage—if not all—of the economic benefits that supporters claim will be created by the tax swap.

Is there an alternative to the problem of a potentially extreme sales tax rate? Clearly, the best idea is to lower the rate in some fashion. One alternative would be for lawmakers to simply set the tax rate lower than 25 percent, produce less local revenue and “starve” local governments of revenue compared to current levels. If that is the goal, supporters should be open about the fact. Local governments are, for better or worse, defined by their local communities where voters have more direct and intimate input into taxing and spending decisions than they do at either the state or federal levels. If the idea is to create a funding crisis that will compel a shift in those local decisions based of actions in Austin, then that agenda should be made clear.

If that is not, in fact, the goal—if the legitimate goal of this proposal is to simply create a dollar-for-dollar tax shift—then the other way to reduce the tax rate is to expand the tax base to which that rate is applied.

## **What Consumption Would Be Taxed?**

One study of the idea of repealing the property tax observed, correctly, that “expanding the tax base, which is a desirable tax reform in its own right, can significantly lower the necessary sales tax rate for static revenue neutrality” under a tax swap scenario.<sup>1</sup> What this means is that it would be possible to tax a wider range of goods and services and thereby reduce the likely tax rate for the new sales tax.

That point is certainly true, but an equally important question is: What goods and services could actually be added to the tax base? The report from which the quote above was taken offers one concrete suggestion—tax property at the time it sells. Taxing all property sales certainly would be a large addition to the tax base.

---

<sup>1</sup> Texas Public Policy Foundation, “Enhancing Texas’ Economic Growth Through Tax Reform,” prepared by Arduin, Laffer & Moore Econometrics, April 2009.

Take residential housing sales only as an example. The Real Estate Center at Texas A&M University recently reported that the total value of home sales in Texas in 2011 was \$40 billion.<sup>2</sup> If this base were subject to the current 6.25 percent state sales tax rate, it would produce about \$2.5 billion in tax, assuming no taxpayer response to the imposition of the tax. If the new local sales tax was applied to this new base, it would produce about \$6.7 billion without taking into account any economic responses like fewer home sales. This might allow the local portion of the tax to be decreased to around 10 percent, meaning the combined rate could be lowered to 18.25 percent (6.25% state + 10% new local + 2% current local).

The base change would also produce a sizable windfall in state sales tax unless some rate adjustment was made, which presumably it would be. Roughly, the state rate could be reduced to around 5.6 percent and still maintain the current level of revenue, implying that the overall rate of 18.25 percent could be further reduced to around 17.6 percent, although state revenue estimators would have to calculate the level needed for revenue neutrality based on their reading of the economic consequences of this policy change.

Supporters believe this approach would have real benefits for those purchasing property. Rather than pay property taxes annually, property owners would pay one tax upfront when they buy a property. They wouldn't be taxed on unrealized capital gains—the increase in value of the property over time.

The problem, though, is that the upfront tax would be a stiff barrier to actually buying property in the first place. According to estimates by the Real Estate Center at Texas A&M, the median home sale price in Texas in 2012 will be about \$152,000. At a 17.6 percent tax rate, this means the expanded sales tax would add \$26,752 to the purchase price of the home, presumably due at closing or otherwise wrapped into the financing of the property.

That is the real trade off that must be weighed. The new homeowner would be free of property taxes, and the sales tax possibly would be deductible from federal taxes. (The sales tax deduction depends on federal tax policy. At present the tax deduction is scheduled to end as of last tax year, but there is a good chance Congress will extend it.) However, even allowing for federal tax deductibility, the upfront sales tax would still be a large amount to add to the cost of a home when most people are struggling to get together the dollars necessary to meet the down payment and fees associated with a sale in any case. The policy's effects also would radiate through the home building and real estate industries, since the sales tax would price at least some people out of the market or force them to buy less expensive homes than they otherwise might.

The tax rate possibly could be lowered further still by taxing commercial and industrial property sales. It is, however, difficult to imagine the Legislature moving in such a direction. Taxing business property would effectively be taxing property that is being purchased to generate economic activity and create jobs. It would be a tax on capital investment and would be roughly parallel to imposing sales tax on production machinery, which Texas long ago eliminated. While it is true that Texas does tax many business-to-business transactions, it is unlikely that lawmakers would want to impose a steep sales tax on capital investment, even if the net result was to lower property taxes over time.

---

<sup>2</sup> Mark Dotzour, "More Evidence of Texas' Housing Market Strength," Real Estate Center of Texas A&M University, July 2, 2012. Available at: <http://blog.recenter.tamu.edu/>



In addition to property sales, there is a long list of other items that are either *exempt* from the sales tax or *excluded* from tax owing to the nature of the tax. The distinction is relatively simple to understand. Groceries are similar to many consumer items that are taxed under the sales tax. However, food for home consumption is *exempted* from tax because the Legislature decided in 1961 when the tax was first enacted that it should be excluded so as not to impose a burden on Texas families.

On the other hand, materials used in the manufacturing process—essentially raw material inputs like the wood used to make chairs—are *excluded* from the tax base because the sales tax is designed to be a tax on final consumption, and buying wood to make a chair is certainly not the last step in the production process. If tax were imposed on raw materials used in the manufacturing process, the effect would be to what is known as “tax pyramiding.” Tax pyramiding refers to the phenomenon of taxing an input when purchased and taxing it again when the cost is passed on to the consumer. When businesses pay more for inputs, consumers pay more at the cash register. Economists recommend against taxing business-to-business sales, as it leads to the pyramiding problem.

In any case, the Comptroller of Public Accounts publishes a list of exemptions and exclusions from the sales tax and other state taxes every two years at the Legislature’s direction. This list receives considerable attention because of the large dollar value of items exempted from the sales tax in particular. In the most recent version of the study, which was published in February 2011, the Comptroller estimated that sales tax exemptions and exclusions will total about \$32.3 billion in 2012 at the current state sales tax rate of 6.25 percent.<sup>3</sup>

It is tempting at first blush to imagine that a liberal pruning of the Comptroller’s list could yield considerable revenue for the state and dramatically lower the sales tax rate necessary to make the property tax swap possible. Unfortunately, that generally has proven not to be the case in the past. The last period of extensive sales tax base expansion in Texas occurred in the 1980s, about a quarter of a century ago, when a number of goods and services were added to the tax base to help resolve school finance issues and state fiscal problems associated with the sharp decline in oil and gas taxes in that period.

Since then, the Legislature has mainly changed the tax law to reduce the tax base through the addition of new exemptions like non-prescription drugs and extension of various sales tax holidays. The overall sales tax rate has not changed since 1990, and the last major adjustment to the rate was an additional two percent tax added to fireworks in 2001. In the intervening years, some members of the Legislature have periodically discussed the need to expand the base, possibly to include more services, but in the end, this has never happened.

Even if the Legislature changed its tax direction for the purposes of this tax swap, the result would almost certainly fall far short of eliminating every item on the Comptroller’s \$32 billion list. In fact, it wouldn’t even come close—nor in the interest of sound tax policy should it.

Lawmakers would be forced to make extremely difficult decisions. Looking down the list of exemptions and exclusions, it is quickly apparent that many of the items would raise especially difficult policy issues. For example, material used in manufacturing—raw materials—makes up almost a full third of the \$32 billion total at \$10.16 billion. Items taxed under separate laws, such as oil

---

<sup>3</sup> Texas Comptroller of Public Accounts, *Tax Exemptions and Tax Incidence*, February 2011. Available at: <http://www.window.state.tx.us/taxinfo/incidence/96-463TaxIncidence02-11.pdf>

and gas, motor fuel and motor vehicles, account for an additional \$9 billion in exemptions. Production machinery accounts for \$571.6 million. Food for home consumption is estimated at \$1.5 billion, and taxing medicine accounts for about \$713 million. There also is a long list of agricultural exemptions, including agricultural feeds, seed, fertilizer and equipment, that totals about \$375 million in exemptions. The list of major services includes physician charges—\$922.6 million—and dental services at \$352 million. Other health care services total about \$500 million. Legal services add up to about \$443.5 million.

If all of those items were taxed at the current state tax rate of 6.25 percent, sales tax revenue would be increased by \$24.5 billion, according to the Comptroller’s estimates. In other words, the short list of items above accounts for *76 percent* of the dollar value of the sales tax exemptions and exclusions in the Comptroller’s study. If taxed, they would produce more revenue in total than the current sales tax produces annually. However, it is difficult to imagine lawmakers taxing almost any of the items in the list described above. In fact, in past legislative sessions, efforts have been made to tax some of the items—notably legal services—and the ideas have been rejected by the Legislature. (Lawyers do pay a fee in lieu of tax.)

And even if all of these goods and service were taxed, the sales tax rate would still have to be increase substantially, and the resulting rate would still be far higher than the sales tax rates found in any other state.

In addition, even if the list of goods and services were substantially expanded to these items or to the dozens of others on the list, it would create new problems for state tax administrators and for taxpayers in defining exactly what is to be taxed and in what situations. So long as the sales tax is applied to consumer goods, it is a fairly simple tax; however, once the tax is extended to new services—for example, construction labor or professional services, a whole host of definitional questions are raised. These issues would have to be addressed administratively and would make the Texas sales tax difficult for multistate taxpayers to understand in the context of traditional sales taxes.

Despite the argument that the swap could be accomplished by a modest expansion of the current list of services and a small rate increase, that outcome is simply impossible, and creating the sort of “consumption” tax necessary to make the swap workable at even relatively lower rates and without cutting local revenues would create a Frankenstein monster of a sales tax that would make Texas less competitive than its current property tax does already.

## **A Stable Tax Versus a Volatile Tax**

Swapping the property tax for the sales tax would also be a risky move since the sales tax is a more volatile revenue source than the property tax. In broad terms, revenue volatility refers to fluctuations in tax collections over time. Of special concern is the level and frequency of variation in tax growth. Ideally, a tax’s growth pattern should be relatively stable and therefore predictable on an annual basis. It is one thing for a fiscal crisis to result from an economic recession and another for it to be caused by a “revenue surprise” caused by unanticipated fluctuations in tax receipts. The performance and impact of severance taxes on the Texas budget in the 1980s is a classic example of the impact of how volatility can affect a state’s budget for the worse.

Volatility depends in large part on how a tax responds to changes in the broad economy. Some taxes, like the sales tax, are more responsive than others. The sales tax responds quickly to changes in consumer and business spending. In contrast, the property tax tends to be much slower to change in

response to changes in the economy, and the changes lag in time because the tax is based on prior year assessed values. This gives local governments the ability to see problems coming and to make budget adjustments without the threat of a “revenue surprise.”

Table 3 compares the change in the statewide local property tax levy and collections with the performance of the state sales tax over the past decade. Over the decade, the sales tax grew at a slower rate and was also more volatile. State sales tax collections actually declined in four of the dozen years shown in the table, corresponding to the two major recessions of the first decade of the 21<sup>st</sup> Century. In fact, the sales tax has been far more volatile in its performance in the past decade than at any time its history. Up to the recent decade, the tax had only recorded negative growth in one year since it was adopted in 1961—during the oil price bust of the 1980s. But now it has declined four times in 10 years, and its growth pattern was erratic. Overall, the sales tax grew at an average annual rate of under four percent over the period, although annual growth rates ranged from -6.6 percent to a high of 12 percent, a swing of 18.6 percent in a matter of a few years.

**TABLE 3: Volatility of the State Sales Tax Versus Statewide Property Tax 2000-2011**  
 (Thousands of Dollars)

Fiscal Year	State Sales Tax		Statewide Property Tax Collections		Statewide Property Tax Levy	
	Collections	% Change	Collections	% Change	Levy	% Change
2000	\$13,976,657	6.9%	\$19,817,072	---	---	---
2001	\$14,663,068	4.9%	\$22,169,031	11.9%	\$25,310,416,025	---
2002	\$14,516,341	-1.0%	\$24,520,989	10.6%	\$27,319,767,524	7.9%
2003	\$14,277,286	-1.6%	\$26,348,659	7.5%	\$28,893,411,036	5.8%
2004	\$15,417,156	8.0%	\$28,176,329	6.9%	\$30,973,635,241	7.2%
2005	\$16,312,811	5.8%	\$30,289,045	7.5%	\$33,478,989,315	8.1%
2006	\$18,275,210	12.0%	\$32,426,070	7.1%	\$35,552,907,030	6.2%
2007	\$20,270,476	10.9%	\$34,150,646	5.3%	\$35,114,596,621	-1.2%
2008	\$21,604,090	6.6%	\$33,503,636	-1.9%	\$38,979,969,545	11.0%
2009	\$21,014,065	-2.7%	\$36,218,566	8.1%	\$40,034,355,798	2.7%
2010	\$19,630,306	-6.6%	N/A	---	N/A	---
2011	\$21,478,983	9.4%	N/A	---	N/A	---
Ave. Annual Growth		3.98%			6.93%	5.23%
Annual Volatility		5.8%			3.9%	3.7%

Source: Texas Comptroller of Public Accounts and U.S. Bureau of Census.

There are several possible explanations for this trend. One contributing factor is Internet sales, but those sales, while substantial, explain only a limited amount of the problem. Of greater importance, consumer and business spending was considerably more volatile in the past decade because of two speculative bubbles in the national economy which burst during the period. The first was the tech boom of the 1990s, which ended in 2001. Following the tech bust, the sales tax declined in 2002 and 2003. The second was the housing bubble, which burst in late 2007, helping to trigger the recent recession. Although Texas was less hard hit by the recession than other Sunbelt states, it nonetheless felt the impact on consumer and business spending, and the sales tax followed these consumption patterns with declining revenue collections in 2009 and 2010. The second of these years produced the worse performance by the sales tax in its 50-year history.

By contrast, the property tax is less volatile. It is, therefore a more stable and predictable revenue source. While levies have risen over time, there was only one year in the past 13 when values actually fell statewide. That decline was also a result of the housing market slowdown that affected the entire country, and it was considerably more modest than the sales tax declines. Overall, statewide

property tax collections grew at an average annual rate of nearly seven percent a year, carried up by growth in the tax levy and increases in tax rates.

It is possible to compare the relative volatility between the sales and property taxes in the past decade. The shaded panel in Table 3 shows this comparison. In this case, volatility is measured by the standard deviation between annual growth rates for each item over the period. A higher value for any given factor implies a greater degree of volatility over time. As the table shows, the volatility for the sales tax was substantially higher than the property tax.

The problem with the tax swap is that substituting a local, own-source and stable revenue for a state-controlled and increasingly volatile tax will introduce added layers of uncertainty in funding local public services that don't exist now. The state's recent budget problems during the 2011 legislative session demonstrate the issues that can result for leaning too heavily on one revenue source—and particularly on the sales tax—which accounts for around 60 percent of the state general fund tax revenue.

A large share of sales tax receipts is generated by sales of big-ticket consumer durables like cars, household furniture, and appliances. Purchases of such items often decline sharply during economic downturns as consumers decide to make do with their current possessions. Conversely, purchases of such items often accelerate around the peak years of economic expansions as consumers gain confidence about their long-term job prospects and decide they can afford to buy a new car, renovate their homes or invest in new home electronics and other consumer products. Businesses can follow a similar pattern in their expenditures on goods that are taxable under the Texas sales tax.

In fairness, there is evidence that broadening the sales tax base to include more services and possibly other goods could reduce the year-to-year volatility of sales tax revenue as the economy goes through its cycles of rapid expansion, slow growth and contraction. Thus, an expanded sales tax makes sense as policy and would be the better approach for the tax swap. However, picking that strategy would still not make it a good policy choice, merely a somewhat less problematic one. The sales tax would be less volatile, but it still would be susceptible to economic changes, except that in this case, the entire structure of state government finance and the finances of the state's 3,977 local governments would be tuned to the same cyclical rhythm. In many years, that might make little difference, but in some years, like what Texas experienced in 2010, it could mean an overwhelming, statewide fiscal crisis for both state and local government with no simple solution.

## How Fair Would the New Tax Be?

One problem that economists often raise with the sales tax is its regressivity—meaning that it falls more heavily on low- and middle-income taxpayers than on more well-to-do taxpayers who spend less of their income on taxable goods and services. The property tax is also regressive in its impact, and critics worry that it imposes a high tax on some individuals based on the unrealized capital gains associated with their property, whether that the rising value of a home or the growing value of oil and gas resources that have yet to be produced.

There are ways to deal with this problem in the case both of the sales and property tax. A primary reason for not taxing goods and services like groceries and medical care under the sales tax is to make the tax less regressive. Similarly, the Legislature has, through the years, provided Texans with a range of exemptions from the property tax—homestead, disabled, elderly and so on—to improve the regressivity of the property tax. These exemptions have a substantial impact on tax burden. For 2012,

the Comptroller has estimated that the various residential homestead exemptions are worth about \$1.8 billion a year. The state has also limited the taxable growth in the value of residential homesteads, which also provides a break for many taxpayers, and in 2006, lawmakers approved a sizable cut in school property taxes, although that change only eased the overall burden and did nothing to address the fairness of the tax.

In its biennial study of tax exemptions and tax incidence, the Comptroller's office examines the incidence of various major taxes, meaning that it examines the degree to which they burden taxpayers at different income groups. Specifically, the Comptroller used a standard calculation to measure the overall equity of each major tax—that is, the degree of progressivity or regressivity. This calculation, known as the “Suits Index,” ranges from +1.0 to -1.0, with a 0.0 indicating that the tax burden is perfectly proportional to income at all quintiles—that is, everyone pays the same share of their income in taxes. At the extremes, a +1.0 would indicate an extremely progressive tax, and a -1.0 would indicate an extremely regressive tax, (i.e., with the entire incidence borne entirely by the lowest quintile).

In the analysis, the Comptroller includes Suits Index calculations for the sales tax, school property tax, franchise tax, motor vehicle sales tax, oil production tax and cigarette tax. According to the report, the property tax had a Suits Index of -.09, meaning it is regressive, but only marginally so. It is fairly close to proportional in its impact on different income levels, mainly because of the effect of various homestead exemptions. The Suits Index for the sales tax was reported to be -.261, meaning it is almost three times as regressive as the property tax. In fact, among the taxes analyzed, the only taxes that were more regressive were the cigarette and gasoline taxes, a common finding of studies like this one.

Supporters of relying more heavily on consumption taxes counter the charge that the tax is regressive by arguing that consumers can choose to pay or not by simply not making a taxable purchase. This is true up to a point, but there are many items that people buy that are taxable and which it is difficult to simply forego—clothing, for example, utilities in the areas of the state that still tax them, some types of food and so on. This problem could be compounded if the tax swap depended on a general broadening of the sales tax base and that expansion included items like groceries, water and medical services. Much depends on what is part of the base expansion and what isn't.

## Impact on the Economy

Supporters of the tax swap strategy argue that the shift would cause an explosion of new investment and jobs in the state. It is certainly true that the property tax in Texas is higher than in most states—again because of the absence of a reliable third leg to the traditional three-legged stool of state and local tax systems—but it is by no mean certain that the Texas economy would be dramatically better because of this change.

For one thing, Texas' economic growth is already among the strongest in the country, and the state was just named the number one state for business by CNBC based on its ranking on a series of factors that include cost of doing business, transportation, quality of life and technology and innovation. The state was one of the few major Sunbelt states to escape the Great Recession with only limited economic damage. Improvements in the state's economic standing area are always possible, but it is difficult to see exactly what in the state's current economic situation justifies a radical shift in tax policy that could end up disrupting public schools and other local governments and making the state less competitive in certain critical areas. It is like recasting a beautiful statute in the effort to

make it even better. The question is not only what is at risk because of the change but what will be lost because of it?

A huge boost in economic growth won't necessarily be the result of the property tax swap. The actual effect of the swap depends how the net tax swap affects individual companies and individuals. For one thing, companies and individual homeowners may not use their property tax savings in ways that help the state economy. Companies typically make hiring and investment decisions based on their perception of current or future demand. If they don't see demand for their goods or services improving, they probably won't hire more people or invest in additional facilities or equipment, even if they have more money available to invest. These companies likely would add the property tax savings to their profits, some of which would flow to investors in other states. Wealthy individual property owners also are unlikely to change their spending patterns much. They already have adequate funds to meet their needs, and the added income won't necessarily prompt them to buy more. Instead, they likely would save the extra money, putting it in the stock market or in their bank account, where it won't help grow the state economy.

In addition, much of the saving from reduced property taxes would, for many companies and individuals, be offset by higher sales tax on many of the goods and products they purchase. This may cause them to actually consume less or move operations out of state where sales tax rates are more in the range of reason. Whatever is the case, at least some of the benefit of the property tax reduction will go out of state and some will be absorbed by higher sales taxes, neither of which will add one percent of growth to the Texas economy.

Some proponents of the tax swap also argue that it would boost the economy by attracting a flood of new businesses to the state, but that's unlikely. Businesses make location decisions based primarily on fundamentals such as proximity to markets and suppliers and the availability of qualified workers. As evidenced by the CNBC rankings, Texas already scores well in those areas.

Total state and local taxes, including property taxes, are just 2.3 percent of business expenses for the average corporation, according to data from the Center on Budget and Policy Priorities. These costs are far less than much more important business costs such as labor, energy and transportation. Moreover, businesses typically have strong economic and social ties to their existing locations, making relocation costly. It is difficult to see why a business, given the choice, would move to Texas to take advantage of no property taxes when it and its employees also would be paying a 25 percent tax on even the most common purchases. States have long worried about creating "sore thumbs," tax policies that make a state stand out from the rest. What could be a larger "sore thumb" than an absurdly high sales tax rate that funds virtually all government in a state? Any business assessing such a situation would have to recognize the risk of fiscal crisis with the unpredictable results that businesses work hard to avoid.

## Conclusion

One thing Texas has always offered to businesses and its citizens is stable, predictable tax policy that puts a premium on keeping the overall level of taxes as low as possible. It's true that there are problems with the tax system that should be addressed, just as most states have certain problems with their taxes that need to be reformed. However, nothing in the state's current policies or in its economic situation could possibly justify the radical departure in policy that swapping the property tax for a sales tax on steroids would constitute.

This idea is one that should be left where it was hatched—in academic studies, consultant reports and think tanks. It isn't a real world strategy. It would put Texas local governments at risk. It would force the Legislature to make difficult—and potentially impossible—decisions about the allocation of taxes to 4,000 units of government around the state. It would undermine any hope of local controls of schools, of cities and of counties. In return, Texans would avoid having to pay property tax, but they would pay a 25 percent tax on just about every product or service they buy. No one likes the property tax, but is this really a tradeoff Texas wants to make?