A project of the **TEXAS PUBLIC POLICY FOUNDATION**

ENHANCING TEXAS' ECONOMIC GROWTH THROUGH TAX REFORM



Repealing property taxes and replacing the revenues with a revised sales tax

EXECUTIVE SUMMARY

A sound tax system is simple to understand, not overly costly to implement, and minimizes economic distortions. Compared to other states, Texas' current tax system is sound, but it can be improved by repealing property taxes and replacing the revenues with a reformed sales tax.

Texas has one of the lowest overall tax burdens in the country measured as total tax revenues as a share of personal income. Consistently, the states with the lowest tax burdens experience faster economic growth, greater employment growth, and lower unemployment rates than the states with the highest tax burdens. Texas also does not impose an income tax. States that do not impose an income tax experience faster economic growth, greater employment growth, and lower unemployment rates than states with the highest top marginal income tax rate. Based on these measures, Texas is in an enviable position.

Despite these impressive results, there is still room for improvement. All taxes, by definition, impose a cost on the economy—what economists call the "tax wedge." While all taxes create a negative impact, property taxes create a larger tax wedge than consumption taxes, and are therefore inferior to consumption taxes. Specifically, property taxes:

- Are less stable than consumption taxes;
- Create larger economic distortions;
- Are less related to taxpayers ability to pay;
- Are costlier and more complicated to administer; and
- Discourage capital-intensive industries from locating in Texas.

One objection to repealing property taxes is the commonly held belief that states should rely on the three major state and local tax sources (income, sales, and property). However, just as products are not improved by mixing superior ingredients with inferior ingredients, tax systems are not improved by mixing superior taxes with inferior taxes. Instead, states with tax systems based on superior tax sources, which are truer to sound taxation principles, are better off. Stability in tax revenues is achieved through implementing a broad-based tax that is not progressive —thereby eliminating excessive revenue surges in good times and revenue droughts in bad times.

Empirically, property taxes impose a larger burden on a state's productive sector than a sales tax. Consequently, property taxes reduce overall economic performance more than necessary to raise the same amount of tax revenues. This larger cost created by property taxes compared to sales taxes creates a tax reform opportunity for Texas.

Because property taxes in Texas are more burdensome than most states, Texas can improve its tax system by repealing property taxes and replacing the revenues with a reformed sales tax. In fact, economic growth can be enhanced without reducing the total state and local tax dollars collected if the reliance on property taxes is reduced (or preferably eliminated) and replaced with a less distortionary tax source such as a consumption tax.

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If property taxes as a source of revenue were abandoned and that burden was placed on consumption, personal income in the state of Texas could potentially increase in the range of $3.1 billion to $3.3 billion in the first year. Over a five year period, if the property tax were replaced dollar-for-dollar with a higher sales tax burden, personal income could, on a cumulative basis, increase between $21.3 billion and $52.1 billion—or an increase of 2.0 percent to 4.3 percent higher than it would have been otherwise. **The proposed tax reform would lead to a net gain of new jobs; during a five-year horizon, between 127,700 and 312,700 over the job growth Texas would have had if no tax reform were implemented.**

Texas has several options available to repeal property taxes and replace the lost revenues with a sales tax. The major differences across the options depend on defining the sales tax base and the manner in which the sales or consumption tax will be levied. One option is to keep the current sales tax base. However, the current sales tax base is narrow compared to total annual consumption in the state of Texas. If the current sales tax base is used, then the sales tax rate would need to be around 14.5 percent in order for the property tax repeal to be statically revenue neutral.

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. The first expansion would incorporate property sales into the tax base. Taxing property only once—at the point of sale—would correct many of the problems associated with property taxes, as well as lower the tax rate burden on all other goods and services subject to the sales tax.

Currently, property taxes are assessed each year based on an imagined (taxable) value of the property; for many homeowners, these include unrealized capital gains. Levying a sales tax when the property is sold corrects for this problem because the sales tax will be based on the property's transaction price. The prospect of being taxed out of one's home is consequently removed. The entire property assessment structure is also no longer necessary as the value of the property no longer needs to be estimated. Consequently, broadening the sales tax to include property allows the total sales tax rate to be lower (due to the broader sales tax base) while still removing many of the adverse impacts from the property tax. Alternative tax rates and tax bases that include property sales in the sales tax base are:

- 12.5 percent if the current sales tax base is used;
- 9.0 percent if all services that are taxed in at least one state are taxed in Texas; and
- 6.5 percent if the sales tax base is the total value of goods and services in Texas' economy, with adjustments to remove non-taxable items (such as government purchases).

Tax policy matters because Texas must compete with other states for tomorrow's growth industries. Economists in general acknowledge that reduced tax rates and a competitive economic landscape improve economic incentives, thereby creating long-term benefits to a state. However, they tend to underestimate how quickly the economy responds to the economic incentives. Ignoring the incentive effects is perilous and leads to incorrect forecasts.

The reality is that the economic growth that follows the implementation of pro-growth economic landscapes often exceeds the most optimistic projections due to the dynamic impacts they generate. The longer a pro-growth economic landscape is in place, the greater these gains and the more prosperous a state's economy becomes. During prosperous times, when economic growth is greater, there is the added benefit of a decrease in demand for government social spending programs (e.g., unemployment, welfare, etc.) that further benefits a state's budget.

The current economic crisis enhances the benefits Texas can gain from reforming its tax system. Difficult times expose the stresses inherent in current tax systems. They also amplify the benefits from pro-growth tax reforms. In fact, the timing for a pro-growth tax reform in Texas could not be better. Texas has everything to gain from repealing its current property tax system as a repeal will significantly enhance Texas' already competitive landscape and ensure Texas' relative economic prosperity will endure.

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