FINAL REPORT OF THE TCCRI PROPERTY TAX TASK FORCE

February 2009

A PRINCIPLED APPROACH TO GOVERNMENT

Primary Recommendation:

Enact immediate property tax relief measures and set the state on a path to a fairer way of funding public education.

Other Recommendations:

- Lower the appraisal cap and apply it equally to all real property.
- Impose revenue caps on local taxing entities
- Make locally elected officials directly accountable for appraisal increases.
- Provide that property tax bill cannot exceed 25 percent of annual mortgage payment and end property tax liability once a mortgage is paid off.
- Increase the permitted margin of error between local appraisals and the Comptroller's Property Value Study.
- Require local taxing entities to adjust their tax rates to account for appraisal growth.
- Limit appraisals to once every two years.
- Establish that residential use should determine the "market value" of a property for appraisal purposes.
- Prohibit increased appraisals on improvements to property covered by the senior freeze.
- Make all property tax relief measures apply equally to businesses.

PROPERTY TAX TASK FORCE
FINAL REPORT

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ABOUT TCCRI TASK FORCES

The Texas Conservative Coalition Research Institute's Task Forces are the backbone of the Institute's research and education efforts. Based on the conservative principles of limited government, individual liberties, free enterprise, and traditional values, the Institute's Task Forces develop legislative leaders and sound public policy ideas by bringing together legislators, experts, industry leaders, and stakeholders in a unique forum that fosters discussion and debate among public and private sector leaders. This approach has proven to be very successful.

THE 2007-08 PROPERTY TAX TASK FORCE

Chaired by State Representative John Otto (R-Dayton), the TCCRI Property Tax Task Force met throughout the 2007-08 Interim. The Task Force was convened because despite legislatively-mandated school district property tax rate relief, property tax bills across the state continue to rise, highlighting the pernicious nature of the property tax and accelerating the next legal challenge to the system. Property taxes are the root of a growing social crisis in Texas, making homeownership unaffordable for many and creating a greater disincentive for business expansion among capital-intensive industries.

The Task Force considered both short- and long-term steps to provide meaningful tax relief by reducing the administrative and fiscal burdens posed by the property tax and finding a fairer, more reliable way to fully fund public schools.

FINAL REPORT OF THE TCCRI PROPERTY TAX TASK FORCE

Executive Summary

School district property taxes place an enormous financial burden on homeowners and businesses. Texas' property tax burden on owner-occupied housing is the highest in nation, and, as a result, Texas' home ownership rate is 43rd of the 50 states. As a mortgage crisis continues to grip the nation, legislators in Texas can help families stay in their homes by reducing this property tax burden.

While short-term relief is imperative, there are also a number of long-standing, fundamental problems with the property taxes generally, and the maintenance and operations tax specifically, including:

- The property tax, unlike any other form of taxation, is assessed in perpetuity regardless of the property owner's ability to pay the tax or economic conditions.
- The property tax abridges private property rights: if one can never take full ownership of land or a house, the constitutional right to private property is a false promise.
- A costly and intrusive bureaucracy exists to appraise the taxable value of properties and oversee the collection of taxes from each property owner;
- The property tax will keep the state perpetually in court because the system of school finance lacks the meaningful local discretion that is required by the Texas Constitution and is rigged in such a way as to guarantee more state intervention in school district operations;
- The property tax has so many exemptions and loopholes that the businesses and homeowners who do not qualify for any of the exemptions bear an excessive and undue portion of the total burden; and,
- Property tax rate relief financed by the Legislature is undermined by appraisal increases or school district tax rate elections, as well as increases in local debt.
- Property taxes are the remnants of an antiquated system of taxation that was necessitated because wealth was tied directly to the land: farming & ranching, primarily. As Texas has urbanized and the economy has shifted largely to retail and other sectors, the system of taxation remains outdated and inefficient. Indeed, wages and economic activity produced by agriculture are dwarfed by other industries.

Many of these problems are inherent to property taxation and are exacerbated by the extent to which the property tax burden has increased over the past two decades. As result, legislators should set the state on a path toward a fairer system for funding public education that does not rely primarily on taxation of property.

Introduction

The recent near-collapse of the mortgage industry has brought into sharp focus the issue of home ownership and the role it plays in American life. Having already enacted one $750 billion bailout, another even larger bailout package is currently being debated by Congress: the federal government will likely end up spending over $1.5 *trillion* to address an economic crisis that has its roots in the collapse of a financial sector that was over-exposed to so-called "toxic" mortgage assets that were either in default or at risk of default.

The mortgage crisis is driving foreclosure rates up and forcing individuals and families from their homes. In Texas, where home ownership is already relatively low and property taxes among the highest in the nation, the impact of the mortgage crisis has the potential to be severe.

Against this backdrop, the single best thing legislators can do to keep people in their homes is to meaningfully reduce property taxes. Reducing property taxes will give home owners the financial freedom to continue making mortgage payments; in turn, this will help keep mortgage lenders solvent, and is an effective way to arrest the financial downturn without resorting to taxpayer-funded bailouts.

Statistics from the U.S. Census Bureau show that Texas already has one of the lowest home ownership rates in the nation, ranking 43rd of the 50 states:

HOME OWNERSHIP RATES BY STATE (2007)

State	Home Ownership Rate	Rank
Washington	66.8%	40
Alaska	66.6%	41
North Dakota	66.0%	42*
Texas	**66.0%**	**43***
Oregon	65.7%	44
Rhode Island	64.9%	45
Massachusetts	64.3%	46
Nevada	63.3%	47
Hawaii	60.1%	48
California	58.3%	49
New York	55.9%	50

Source: U.S. Census Bureau, Housing Vacancies and Homeownership Annual Statistics: 2007

**North Dakota has had a higher home ownership rate than Texas every year since 2003.*

Texas' low home ownership rate can be at least partly explained by the state's extraordinarily high property tax burden, as compared to other states. Research published in December 2008 by the Tax Foundation reveals that the burden of Texas' property taxes on owner-occupied housing is the highest in the nation:

PROPERTY TAXES ON OWNER-OCCUPIED HOUSING BY STATE (2007)

State	Median Property Taxes as a Percentage of Home Values	Rank (50=Highest Tax Burden)
Michigan	1.38%	41
Pennsylvania	1.39%	42
North Dakota	1.40%	43
Illinois	1.53%	44
Vermont	1.55%	45
New Jersey	1.63%	46
New Hampshire	1.68%	47
Wisconsin	1.72%	48
Nebraska	1.74%	49
Texas	**1.84%**	**50**

Source: The Tax Foundation: "Property Taxes on Owner-Occupied Housing by State" (2007).

Texas' low home ownership rate is clearly linked to its high property tax burden, which is the most severe in the nation. Legislators must address Texas' low home ownership rate by reducing the property tax burden; this will be vitally important in the context of the unfolding mortgage and financial crisis. A 2006 report by the Texas Department of Housing and Community Affairs highlighted the problem, arguing that "[m]any people are able to acquire a loan and buy a house but are unable to keep up with payments on the loan because of high property taxes."

The scale of the problems that plague the mortgage industry are an indication of the extent to which politicians, regulators, and financiers were willing to overlook sound financial practices in order to sustain the unprecedented growth in home ownership that occurred throughout the 1990s and early 2000s. For the "American Dream" to be attained, homeownership was extended to low and moderate income groups who would not normally have qualified for mortgage loans. As the *New York Times* described in 1999:

> Fannie Mae, the nation's biggest underwriter of home mortgages, has been under increasing pressure from the Clinton Administration to expand mortgage loans among low and moderate income people…the Department of Housing and Urban Development proposed that by the year 2001, 50 percent of Fannie Mae's and Freddie Mac's portfolio be made up of loans to low and moderate-income borrowers. Last year, 44 percent of the loans Fannie Mae purchased were from these groups.[i]

Increasing home ownership rates is a laudable goal, and the extent to which that goal was pursued is a testament to its quintessential role in the American Dream. Before the onset of the Great Depression, home ownership rates in the U.S. were beginning to approach 50 percent. However, once the Depression had taken its toll, the home ownership rate declined to 43 percent.[ii] Throughout the 1950s, 60s, and 70s, home ownership grew steadily; mirroring the nation's renewed prosperity and sustained economic growth.[iii] Even with a period of stagnation during the 1980s, America's home ownership rate was almost 70 percent by 2004 before the mortgage crisis began to hit.[iv]

The latest figures from the U.S. Census Bureau reveal that in the fourth quarter of 2008, the home ownership rate in the U.S. declined to 67.5 percent from its 2004 historical high of 69.2 percent. This drop has set home ownership in the U.S. back eight years, exactly mirroring the rate in the fourth quarter of 2000.[v]

Historically, the U.S. has had higher home ownership rates than comparable countries in Europe and around the world. A 2002 study, for example, noted that U.S. home ownership rates have been consistently 27 percentage points above that of Germany, and that, when adjusted for density averages, home ownership in Mexico is estimated to be around 30 percent – well below half the rate in the U.S.[vi]

Research demonstrates that home ownership is positively correlated nationally with a strong financial sector[vii]. At the individual level, home ownership is considered fundamental to the American family: home owners are more likely to be married and have children than those who do not own their homes.[viii]

The decline in the home ownership rate that was triggered by the mortgage crisis that began earlier this decade will have a severe impact on the economic stability of families across the nation and Texas in particular.

While Congress and the federal government will end up spending more than $1.5 trillion on a bailout, eliminating school property taxes in Texas would cost less than $20 billion. Eliminating maintenance and operations property taxes would also be significantly more effective than the federal government's misdirected bailout: homeowners would be able to keep their homes and banks would continue to receive mortgage payments.

High property taxes are not confined to Texas. According to the U.S. Census Bureau, the growth of property tax collections outstrips that of home values and personal income. On April 26, 2008, *The Wall Street Journal* reported that property tax collections nationwide have risen 62 percent since 2000, while median home values have risen 48 percent and personal income has risen 28 percent. This underscores the burden that property taxes place on homeowners, and strengthens the case for significant property tax relief.

In Texas, the Legislature has worked for decades to make property taxes less burdensome but to no avail. For instance, despite more than $14 billion in legislatively appropriated property tax rate cuts in 2007, increases in local rates, appraisals, and bond debt continue to push property tax bills ever-higher. In 2007, 115 school districts held tax rate elections to increase their tax rates from the cap of $1.04 to $1.17. On top of these rate increases, 197 school districts held bond issue elections in 2007, which issued at least $7.4 billion of new debt.

The problem, however, is much deeper than high tax bills. The property tax crisis is also a property rights crisis. Property taxes are perpetual, abrogating the right to own property in the truest sense. If one must pay local taxing authorities every year, then property ownership is reduced to nothing more than a form of renting from the government.

This report explores these arguments and lays out a path to school property tax elimination in Texas. In brief, the path to school property tax elimination will rest on these four approaches:

- **Constitutionally dedicate surplus revenues** to help reduce and eliminate school district property taxes.
- **Enact a stricter constitutional spending limitation**. A stricter spending limit will help grow state budget surpluses and maximize the funds available for property tax relief.
- **Consider ending certain exclusions to the state sales and use tax to raise revenue**. To avoid pyramiding, no exemption that involves a business-to-business transaction should be closed.
- **If necessary, raise consumption-based tax rates**, including the sales and use tax to ensure that schools are fully funded accounting for current needs and future enrollment growth

The report also discusses a range of options for delivering short and medium term property tax relief, these measures include:

- Continued devotion of surplus state tax revenues to property tax relief;
- Bringing accountability to the appraisal system; and,
- Ensuring that all relief and reform measures are applied to both homeowners and businesses.

Protecting Taxpayers

Taxpayers deserve a fairer, less-intrusive system that is robust enough to fully fund public education. While local school officials continue to impose ever-larger tax burdens on home owners and businesses, despite huge increases in state appropriations to public education, the state can eliminate school district property taxes and establish the permanent, reliable, dedicated, broad-based source of revenue that the public education system needs.

Under the current scheme of ad valorem taxation, homeowners ultimately rent their property from the government. Article 16, Section 50 of the Texas Constitution allows for the seizure of homes for non-payment of taxes, though those taxes are perpetual and always rising. Property taxes are rigged against homeowners and businesses. The current system allows local officials to undercut substantive and lasting property tax relief.

In 2007, the Legislature voted to devote more than $14 billion to property tax rate relief over two years as a consequence of the third special session of the 79th Legislature, in which a one-third reduction of school district property tax rates by 2008 was ensured through the creation of the Property Tax Relief Fund.

Despite the efforts of the Legislature, the property tax rate relief has already been effectively wiped out for many home and business owners because of rising appraisals, school districts petitioning to raise their tax rates above the maximum amount, and costly bond propositions. A new report underscores the problem:

> Since the tax relief initiative took effect, additional school taxes have gone on the books, either authorized by local school boards or local voters; appraisals of property—both that of homeowners and of businesses alike—have risen at unusually high rates; and, cities, counties and special districts have approved substantial tax hikes. All of these factors combined to produce a total property tax bill for Texans $1.7 billion higher than came due in 2005, just before the school property tax relief initiative was undertaken.

That local school district officials specifically, and appraisal districts generally, wiped out rate relief in short order is unacceptable, and unjustified in the face of increased appropriations for public education over and above enrollment growth. This problem is further underscored by property tax data from the first half of this decade:

	2000				2006				Dollar Increase	Percent Increase
	County	City	ISD	Total	County	City	ISD	Total		
Austin	$ 613	$ 695	$2,100	$3,408	$ 933	$ 799	$2,720	$4,452	$1,044	30.6
Dallas	$ 186	$ 683	$1,428	$2,297	$ 341	$ 966	$1,989	$3,296	$ 999	43.5
Fort-Worth	$ 250	$ 493	$ 901	$1,644	$ 501	$ 751	$1,334	$2,586	$ 942	57.3
Houston	$ 295	$ 567	$1,324	$2,186	$ 588	$ 732	$1,896	$3,216	$1,030	47.1
San Antonio	$ 225	$ 395	$ 600	$1,220	$ 357	$ 604	$ 852	$1,812	$ 592	48.6
Average	**$ 314**	**$ 566**	**$1,271**	**$2,151**	**$ 544**	**$ 770**	**$1,758**	**$3,072**	**$ 921**	**42.8**

Source: Paul Bettencourt, Harris County Tax Assessor-Collector

The chart above summarizes the increase in average property tax bills between 2000 and 2006 in the state's largest urban areas. Most notable is the fact that property tax bills in Texas' largest urban areas increased by almost 43 percent between 2000 and 2006. It is also worth noting that school property taxes account for a greater proportion of the total property tax bill than do city and county taxes combined in each urban area except San Antonio.

The Appraisal Problem: doubling the tax burden every 8 years

Property tax relief funded by the Legislature required school districts to reduce M&O property tax rates. Even with this rate relief in place, skyrocketing appraisals in many parts of the state—which are controlled at the local level—have left many homeowners with higher tax bills.

Although annual appraisal increases for residential properties are capped by the state at ten percent, an appraisal increase negates rate relief. Harris County Tax Assessor-Collector Paul Bettencourt pointed out that because of rising appraisals "Houston area homeowners are still paying slightly more in property taxes on their combined bill."[ix]

In Dallas County, according the *Dallas Morning News,* taxable value for the 2007 tax year is up 20 percent compared to the 2006 tax year. The *Austin American-Statesman* reported in June that appraisals across Travis County are up, with some areas of Austin seeing appraisals increase by 43 percent since 2005. With the current ten percent appraisal cap, the tax bill on a residential property can double every seven-and-a-half years *even if the tax rate remains the same*.

The table [see right] shows this doubling effect based on a starting tax bill of $3,072, which is the average property tax bill in the state's five largest urban areas. However, the specific numbers used are immaterial, since the doubling effect will take place whether a homeowner's tax bill is $100 or $10,000.

Effect of the 10 percent Appraisal Cap

Starting Tax Bill	**$3,072**	
		+ 10 percent ($307)
Year 1	**$3,379**	
		+ 10 percent ($338)
Year 2	**$3,717**	
		+ 10 percent ($372)
Year 3	**$4,089**	
		+ 10 percent ($409)
Year 4	**$4,498**	
		+ 10 percent ($450)
Year 5	**$4,948**	
		+ 10 percent ($495)
Year 6	**$5,443**	
		+ 10 percent ($544)
Year 7	**$5,987**	
		+ 10 percent ($599)
Year 8	**$6,586**	

That such growth is built into the property tax system is simply unacceptable and unsustainable: in no other tax structure do tax bills rise relentlessly without regard for the taxpayers' ability to pay, and without regard for whether the increases are justified. In effect, property tax bills are tied to an artificial and unreasonably high inflation index putting property taxes on auto-pilot rather than moored to any economically or fiscally recognized standard.

The Short-Term: Property Tax Relief

The elimination and replacement of the school district property tax with a fairer source of revenue is a long-term goal. To provide further property tax relief in the short and medium term, legislators should also consider the following proposals:

- **Lower the appraisal cap and apply it equally to all real property.**

The appraisal cap must be lowered to provide property owners with immediate relief from rampant appraisal increases. Lowering the appraisal cap to three percent and applying the cap to residential and business properties will ensure that all property tax payers are treated equally. Since the current appraisal cap does not apply to business properties, business owners in Texas are forced to bear a larger burden of appraisal increases then would be the case in an equitable system of property taxation.

However, businesses have legitimate concerns about the impact of appraisal caps in general. Caps may have the effect of distorting valuations and creating discrepancies within the appraisal process. While caps restrict appraisal increases, they are purely arbitrary and do not allow market value to be fairly reflected. For instance, the current 10 percent cap gives local taxing entities free access to 10 percent appraisal increases (and hence revenue increases) even if this does not reflect market trends and without regard to whether the money is needed.

In short, appraisal caps are an imperfect remedy for an afflicted tax system. The problems associated with appraisal caps simply underscore the need to eliminate property taxes altogether. However, until that goal can be achieved, lowering the appraisal cap to 3 percent and applying it uniformly to homes and businesses will provide immediate, short-term relief.

Even when the current appraisal cap is lowered, local governments and school districts still have a generous window for growth. A lower appraisal cap will promote greater transparency and accountability because it will limit the extent to which local officials can raise tax revenues without directly raising the rates at which local property taxes are levied. The high appraisal increases that are permitted by the current 10 percent cap allow tax bills to be raised by stealth, without the tax rate having to be raised.

Opposition to lowering the current appraisal cap from the business community is a function of the distortion that is created when an appraisal cap is applied only to residential properties. Any appraisal cap must apply to all real property to prevent shifting of the tax burden between residential and business property owners.

[Please note: the following legislation that reduces the current 10 percent appraisal cap is currently filed for consideration by the 81st Legislature: HB 127 & HJR 21 by Callegari;, HB 700 & HJR 42 by Zerwas; and SB 299 by Patrick & SJR 13 by Patrick. HB 46 by Riddle proposes a local option appraisal cap.]

- **Impose revenue caps on local taxing entities.**

Revenue caps limit the amount of revenue a local government is allowed to raise to population growth plus a certain percentage to adjust for inflation. Under the current system of property taxation, the tax burden is affected by property appraisals (which can increase up to ten percent per year), the tax rate, rollback elections, and bond issues and debt. Imposing revenue caps on local taxing entities would simplify the system and provide one simple method by which taxpayers are protected from increases in tax burden over and above population growth plus inflation.

- **Make locally elected officials directly accountable for appraisal increases.**

Direct accountability must be brought to the appraisal process, which is a cause of rising property taxes. As M&O rates fall, the pressure to maintain the growth of property tax revenues through the appraisal process will only increase. This pressure is most likely to be resisted by elected officials who are answerable and accountable to voters.

Specifically, composition of County Appraisal Districts (CADs) aggravates taxpayer frustration with the property tax. A CAD is comprised of five directors, appointed by taxing units within the county. The five unelected directors then appoint a chief appraiser who, despite being several steps removed from any elected official, has a direct impact on the tax bills property owners receive. Whether perceived or real, this lack of accountability for appraisal increases must be addressed.

Indeed, the continued rise in appraisals and property tax revenues demonstrates that directors of the appraisal boards are not responsive to the concerns, complaints and comments of property owners when they demand fair and equitable appraisals. Instead, appraisal district directors serve the taxing entities, leading to the unreasonable and unsustainable rise in appraisals.

Accountability for appraisals would best be achieved by having the elected heads of the various taxing entities serve as directors of the CAD and directly approve appraisals in lieu of directors appointed by taxing entities.

By not only electing appraisal board directors, but by making the already-elected taxing entity officials serve, real and long overdue accountability and responsiveness would be injected into the administration of the property tax. Since these officials are already elected, voters will not have to educate themselves about another set of candidates, but will benefit because the appraisal process would become a subject for debate during election campaigns, with the members of appraisal boards having to defend their records.

[Please note: HB 386 by Miller (81R) proposes expanding appraisal district boards from five to seven members, and requires that the two new members be directly elected; this legislation would bring a greater level of accountability to appraisal boards .]

Accountability can also be brought to the appraisal process by moving appraisal authority back to the tax assessor-collector. In 1979, the Legislature enacted Senate Bill 621 (66R) – the so-called "Peveto Bill" sponsored by State Rep. Wayne Peveto – which created the Property Tax Code. Before these reforms, county tax assessor-collectors had been responsible for property tax appraisals. However, the new Property Tax Code gave appraisal authority to newly-created County Appraisal Districts which were phased in during the early 1980s.[x]

Unlike the elected tax assessor-collectors, the County Appraisal Districts are comprised of appointed representatives of the taxing entities in the district. Specifically, Section 6.03 of the Tax Code requires that "[t]he appraisal district is governed by a board of directors. Five directors are appointed by the taxing units that participate in the district as provided by this section."

Since these reforms, the property tax burden in Texas has risen significantly. Statistics from the Comptroller show that property tax revenues have increase by about 500 percent since 1982: Around $6 billion in local property tax revenues were collected in 1982 while $36 billion was collected in 2007.[xi] The vast majority of this revenue increase can be attributed to school district property taxes, which, according to the Texas Association of Counties is a result of school boards' influence within appraisal districts:

> [T]he average school share of appraisal district budgets is about 60 percent. Typically, that number also reflects the school board dominance of appraisal district boards, as required by state law. If school property taxes drop, school district representation on the board will decrease also.[xii]

Removing appraisal authority from elected tax assessor-collectors to appointed appraisal districts can be linked directly to the increase in the property tax burden that has occurred over the past two decades or more. Because they are unelected, appraisal districts lack accountability to taxpayers and have little incentive to restrain appraisal increases. In contrast, the willingness of elected tax assessor-collectors to continually increase appraised values would be constrained by their accountability to voters. Under the old system, Taylor County chief appraiser Richard Petree notes that "sometimes appraisals were not updated for as long as 20 to 30 years." Similarly, Harris County chief appraiser Jim Robinson, recalled that assessor-collectors "either didn't reappraise homeowners or they appraised them real low."[xiii]

Putting appraisal authority in the hands of elected tax assessor-collectors would bring genuine accountability back to the appraisal process and would likely result smaller and less-frequent appraisal increases.

- **Provide that property tax bill cannot exceed 25 percent of annual mortgage payment and end property tax liability once a mortgage is paid off.**

The school property tax constitutes a crippling financial burden for many Texans; this recommendation limits this burden to a maximum of 25 percent of the annual mortgage (or loan) payments due on a property. In practice, this means that school property tax bills cannot exceed the value of three months of mortgage or loan payments.

This recommendation also redresses the most fundamental grievance of the property tax: that it never ends, thus depriving citizens of their property rights. Putting a time and monetary limit on property taxes – in this case linking an end to the property tax to the paying off of a mortgage or other loan – would allow home and business property owners to genuinely own their property once all payments have been made. This concept encourages the paying down of debt, increases bank liquidity, and also dramatically increases disposable income at the end of the term of a loan.

- **Increase the permitted margin of error between local appraisals and the Comptroller's Property Value Study**

Currently, school districts' taxable value determination must come within 5 percent of the taxable value as determined by the Comptroller's annual Property Value Study. This places pressure on school districts to assign property values that are at least 95 percent of market value for the property in their district. If a school district's valuation falls outside the allowable margin of error, it is determined to be "invalid," which triggers an appraisal standards review for the district. If the school district's valuation is not at or above 95 percent of the Comptroller's valuation in the third year of an appraisal standards review, a school district could receive a reduction in funding.

Raising the permissible margin of error to 10 percent would relieve pressure on local appraisers and property tax payers because it would allow appraised property values to be 10 percent less than the Comptroller's valuation.

- **Require local taxing entities to adjust their tax rates to account for appraisal growth.**

Under the current property tax system, local taxing entities can rely on appraisal increases to grow their tax revenues even if they do not raise the rate at which property taxes are levied. This feature of the property tax system undermines the principle of truth-in-taxation and allows tax burdens to grow by stealth.

Truth-in-taxation would be applied to the property tax system if local taxing entities were required to adjust their tax rates to account for appraisal growth. Taxing entities should then be required to obtain voter approval for any increase in the effective tax rate that is over and above the rate of population growth plus inflation.

- **Limit appraisals to once every two years.**

Section 23.23(a) of the Tax Code currently restricts appraisal increases as follows:

> …an appraisal office may increase the appraised value of a residence homestead for a tax year to an amount not to exceed the lesser of:

(1) the market value of the property for the most recent tax year that the market value was determined by the appraisal office; or

(2) the sum of:

(A) 10 percent of the appraised value of the property for the preceding tax year;

(B) the appraised value of the property for the preceding tax year; and

(C) the market value of all new improvements to the property.

Amending current law so that appraisal districts are only permitted to appraise a property once every two years would have the practical effect of lowering the annual appraisal cap from 10 percent to 5 percent. This is the intent of House Bill 209 (81R) by Bohac, which would retain the existing 10 percent appraisal cap but would only allow appraisal districts to appraise a property every two years, at which time the cap is applied to the previously appraised value.

- **Establish that residential use should determine the "market value" of a homestead property for appraisal purposes.**

Homeowners should be protected from appraisals that do not reflect the residential use of their property. Currently, the Tax Code, Section 23.01(b) simply requires that:

> The market value of property shall be determined by the application of generally accepted appraisal methods and techniques. If the appraisal district determines the appraised value of a property using mass appraisal standards, the mass appraisal standards must comply with the Uniform Standards of Professional Appraisal Practice. The same or similar appraisal methods and techniques shall be used in appraising the same or similar kinds of property. However, each property shall be appraised based upon the individual characteristics that affect the property's market value.

Appraisal standard typically include a provision for "highest and best use," which is the use of a property that would yield the highest probable property value possible. In many instances this use would be commercial rather than residential. However, for the purposes of property taxation, it is not appropriate to appraise a homestead property for its potential commercial value if the owner is currently using the property for a residential use. House Bill 2 (81R) by Otto proposes adding the following requirement to Section 23.01 of the Tax Code:

> The market value of a residence homestead shall be determined solely on the basis of the property's value as a residence homestead, regardless of whether the residential use of the property by the owner is considered to be the highest and best use of the property.

This legislation would protect home owners from appraisal increases and would establish a consistent basis for the appraisal of residential property.

- **Prohibit increased appraisals on improvements to property covered by the senior freeze.**

Allowing appraisals to increase the tax bill on a property that would otherwise be covered by the senior freeze creates a conspicuous disincentive for seniors to improve their homes. If a senior on a fixed income decides to fix the roof on their home or install insulation, they should not be penalized by government.

- **Make all property tax relief measures apply equally to businesses.**

Every recommendation should be applied equally to residential property and business property. Currently, many aspect of the property tax – such as the appraisal cap and certain exemptions and reductions – apply only to residential properties. This treats businesses unfairly and has helped create an unbalanced tax system in which businesses have fewer protections and bear an disproportionately large share of the property tax burden.

The Long-Term: Finding a Fairer Way to Fund Public Education

State legislators have made repeated attempts to reform the property tax. Efforts have been made to reform the appraisal process, lower the appraisal cap, lower the maximum allowable tax rate, improve the accountability and transparency of school districts, and increase public participation in school district decisions. While some of these efforts have been successful around the edges, the system is structured in a way that will always work against property owners.
Every factor points to the same conclusion: Taxpayers deserve a fairer, less-intrusive system that is robust enough to fully fund public education. While local school officials continue to impose ever-larger tax burdens on home owners and businesses, despite huge increases in state appropriations to public education, the state can eliminate school district property taxes and establish the permanent, reliable, dedicated, broad-based source of revenue that the public education system needs, using four tools:

- The state should dedicate surplus revenues to help reduce and eliminate school district property taxes.
- To expedite this process, a stricter constitutional spending limitation should be imposed. A stricter spending limit will help grow state budget surpluses and maximize the funds available for property tax relief.
- Consider ending certain exclusions to the state sales and use tax and consider imposing a sales tax on real estate transactions to raise revenue.
- If necessary, raise consumption-based tax rates , including the sales and use tax to ensure that schools are fully funded accounting for current needs and future enrollment growth.

The Legislative Budget Board projects that in 2009, local school district property taxes will generate around $19.2 billion.[xiv] This figure includes revenue from both the maintenance and operations (M&O) and interest and sinking (I&S) or debt portions of school district property taxes. In the most recent edition of its *Annual Property Tax Report*, the Office of the Comptroller reported that M&O revenues account for slightly more than 90 percent of all school district taxes. On this basis, it is clear that it will cost around $17.5 billion per year to completely eliminate school district M&O taxes through dedication of budget surpluses, spending restraint, and consumption taxes.

Consumption Taxes

By utilizing consumption taxes to fully fund public education the state can achieve three goals: Elimination of a bureaucratic, fiscally burdensome tax on property; get the state out of court; end the unfair Robin Hood system; and, create a system for funding public education that grows with an economy that long-ago shifted away from land as the primary economic engine.

Consumption taxes as a source of revenue to finance public schools meets those goals. The advantages of consumption taxes are many:

- **Consumption taxes build on the fact that consumers almost always pay all the taxes, and in that way, they are fair and broad-based**. The Comptroller's 2001 "Tax Exemptions & Tax Incidence" report reinforces this very important point:

> It should be recognized that any tax levied directly on a business will ultimately be paid by real, live people—if not consumers via higher prices, then business owners via reduced profits or employees via reduced wages ... In any case, or in any combination where the tax burden is borne jointly, the old cliché is true: 'Only people pay taxes.'

Consumption taxes are paid directly by consumers; they are not hidden.

- **Consumption taxes are transparent to the general public, making them fair and predictable.** Sales tax liability is easily calculated. In March of 2005, then-Chairman of the Federal Reserve Alan Greenspan testified before Congress:

> A principle that I believe is important now—but appears not to have weighed so heavily on those involved in the earlier reforms—is predictability in the tax code. By this I mean creating a tax system in which households and businesses can look into the future and have some reasonable degree of certainty about the future tax implications of decisions made today."[xv]

Sales taxes meet that criterion. They are predictable because a person can calculate their tax liability prior to the purchase of a taxable good or service.

- **Consumption taxes are generally positive for job creation**. Consumption taxes are a superior form of taxation because they do not penalize work, savings or investment. A tax on consumption is most desirable for that very reason. In 2005, then-Federal Reserve Board Chairman Greenspan testified to the following economic benefits of consumption taxes: "…many economists believe that a consumption tax would be best from the perspective of promoting economic growth… because a consumption tax is likely to encourage saving and capital formation."[xvi]

All businesses benefit because investment in new facilities, for instance, would be encouraged; all homeowners benefit, for example, because homeownership would achieve its socially desired end rather than being a tax machine for government. A growing, healthy economy is required to provide for the future funding needs of our educational system. The state's consumption tax revenue has grown with the Texas economy.

- **Consumption taxes are far less costly to administrate than the property tax.** According to the Comptroller's 2004 Property Tax Report, County Appraisal Districts spent $280 million appraising more than 16 million properties in the state [*NOTE: we do not believe that the Comptroller's report accounts for all costs of administration and compliance, though it is good starting point*]. Similarly, the Legislative Budget Board reports that the state spends $9.5 million each year on the Property Value Study[xvii], which appraises the value of all property in the state to ensure equitable distribution of school funding.

With costs approaching $300 million per year, the property tax is clearly a very expensive tax to administer. The Comptroller's Office spends just $156 million per year to administer all state taxes[xviii] including the sales and use tax. This highlights the gross inefficiency of the property tax, which requires six times this amount simply to verify the total taxable value of property in the state. Indeed, at $191 million, the entire annual budget of the Comptroller's Office is less than the cost of administering the property tax. In the light of these figures, elimination of M&O property taxes becomes a fiscal imperative.

Both the Senate and the House have previously considered and/or passed school finance plans that relied upon the sales and use tax to reduce property taxes: House Bill 4 (75R),
House Bill 5 and Senate Bill 2 (78R), and House Bill 1 (78S4).

Reliable Revenue

While many tax plans have been considered by the Legislature since then, consumption taxes appear consistently as a reasonable alternative to the property tax.

Consumption taxes have been a remarkably reliable source of revenue. According to the Comptroller of Public Accounts, sales and use tax collections totaled $2 billion in fiscal year 1978. By comparison, in fiscal year 2007, the state collected $20.3 billion in sales tax revenue. From 1978 to 2007, the biennial revenues from the sales tax have increased without exception, despite economic downtowns in the late 1970's, 1980's and earlier this decade. By relying on sales taxes as the primary source of revenue for public schools, the Legislature can ensure a reliable and growing base of monies for education.

The amount of revenue that would have to be generated from existing consumption taxes will depend heavily on the availability of surplus revenues and the amount of revenue generated by the new gross margins tax that is devoted to property tax relief. In its 2008-09 *Certification Revenue Estimate*, the Office of the Comptroller estimated that the new gross margins tax will generate $11.9 billion over the 2008-09 biennium. Of this total, $6.1 billion, or $3.05 billion per year is dedicated for property tax relief. In addition to this revenue from the gross margins tax, the Property Tax Relief Fund receives revenue from the motor vehicle sales and use tax, the cigarette tax, and the cigar and tobacco products taxes, all of which were revised during the Third Called Session of the 79th Legislature.

In total, the Property Tax Relief Fund will receive:	$3.715 billion in 2008
	$3.851 billion in 2009

These revenues are dedicated for future property tax relief and will therefore decrease the amount of additional revenue that consumption taxes would have to raise in order to eliminate school district M&O taxes. How this will affect the amount of new revenue that is needed to completely replace school district M&O taxes is currently unclear. There are no projections of the amount of revenue that school district M&O taxes will generate statewide beyond the first two years of legislatively-mandated property tax relief. However, from the revenue that has been dedicated to the Property Tax Relief Fund in 2008 and 2009, it can be reasonably assumed that around $4 billion will be available for property tax relief in each of 2010, 2011, and 2012. This will reduce the extent to which revisions to the sales and use tax must made to replace school district M&O taxes by around $4 billion per year.

In response to a request by the Texas Conservative Coalition Research Institute, the Office of the Comptroller confirms the increased revenue that could be generated if sales and use tax rates were increased:

STATE SALES AND USE TAX RATES AND NEW REVENUE PROJECTIONS 2009 - 2013

State Sales and Use Tax Rate	Fiscal 2009 (million)	Fiscal 2010 (million)	Fiscal 2011 (million)	Fiscal 2012 (million)	Fiscal 2013 (million)
6.50 percent	$738.5	$770.3	$803.9	$837.2	$871.5
6.75 percent	$1,473.3	$1,538.8	$1,603.8	$1,670.2	1,738.7
7.00 percent	$2,204.5	$2,299.6	$2,399.8	$2,499.1	$2,601.6
7.25 percent	$2,932.1	$3,058.5	$3,191.9	$3,323.9	$3,460.2
7.50 percent	$3,656.0	$3,813.6	$3,979.9	$4,144.6	$4,314.6
7.75 percent	$4,376.3	$4,565.0	$4,764.0	$4,961.1	$5,164.6
8.00 percent	$5,092.9	$5,312.5	$5,544.2	$5,773.5	$6,010.4
8.25 percent	$5,806.0	$6,056.3	$6,320.3	$6,581.8	$6,851.8
8.50 percent	$6,504.1	$6,784.5	$7,080.3	$7,373.2	$7,675.7
8.75 percent	$7,196.1	$7,506.4	$7,833.6	$8,157.7	$8,492.3
9.00 percent	$7,882.1	$8,229.1	$8,580.4	$8,953.4	$9,301.9
9.25 percent	$8,562.0	$8,931.2	$9,320.6	$9,706.1	$10,104.3
9.50 percent	$9,235.9	$9,634.1	$10,054.2	$10,470.1	$10,899.6
9.75 percent	$9,903.8	$10,330.8	$10,781.2	$11,227.3	$11,678.8
10.00 percent	$10,565.7	$11,021.3	$11,501.8	$11,977.6	$12,469.0
10.25 percent	$11,221.7	$11,705.5	$12,215.9	$12,721.3	$13,243.1

Source: Texas Comptroller of Public Accounts.

Closing some of the current exemptions and exclusions to the sales and use tax would also help generate additional revenue to fund property tax relief. Ultimately, the magnitude of the sales and use tax rate increase and the value of the exemptions and exclusions that could be ended will depend upon the amount of surplus revenue that is also available for property tax relief. For example, raising the rate of all sales and use taxes to 8 percent would generate $6.6 billion in new money. This figure, with the addition of $4 billion from the new gross margins tax, would provide a total of $10.6 billion for property tax relief. In this scenario, a budget surplus of $7 billion per year would provide $17.6 billion in total for property tax relief, which would likely be sufficient to completely eliminate M&O property taxes without the need to end any of the exemptions or exclusions from the sales and use tax.

This underscores the importance of dedicating surplus revenues to property tax relief and enforcing strict constitutional spending restraints. Every dollar of surplus revenue accrued through spending restraint will reduce the extent to which the sales and use tax rate would need to be raised, or the base expanded in order to fund property tax elimination.

Reliable Revenue

The perception of the regressivity of sales taxes is frequently used to argue against additional reliance on the tax. There are many ways, however, to address this perceived regressivity. According to the bill analysis of SB 2 (78R), the bill:

> [R]equired local revenue from state sales tax base expansion to be used for tax relief, unless another use is authorized by local voters. There is a 40 percent sales tax exemption for certain financial assistance and food stamp recipients (i.e., Lone Star Card recipients). Additionally, health care services are exempt from sales tax.[xix]

Dr. George Zodrow of Rice University affirms the prospect that regressivity could be overcome:

> Concerns about the distributional effects of reducing or eliminating sales tax exemptions on goods consumed disproportionately by the poor could be addressed by introducing highly targeted means-tested sales tax rebate, perhaps involving expanded utilization of the Lone Star Card.[xx]

While it is true that lower income Texans spend great proportion of their incomes on sales taxes, there are three factors worth noting:

1. Higher income Texans spend more money on consumable items both in terms of quantity and cost, and therefore pay more sales taxes overall. This is not an insignificant feature of the sales and use tax. While upper income Texans can resort to tax strategies that limit their income tax or property tax liability, it is more difficult to escape consumption taxes except for buying goods over the Internet.

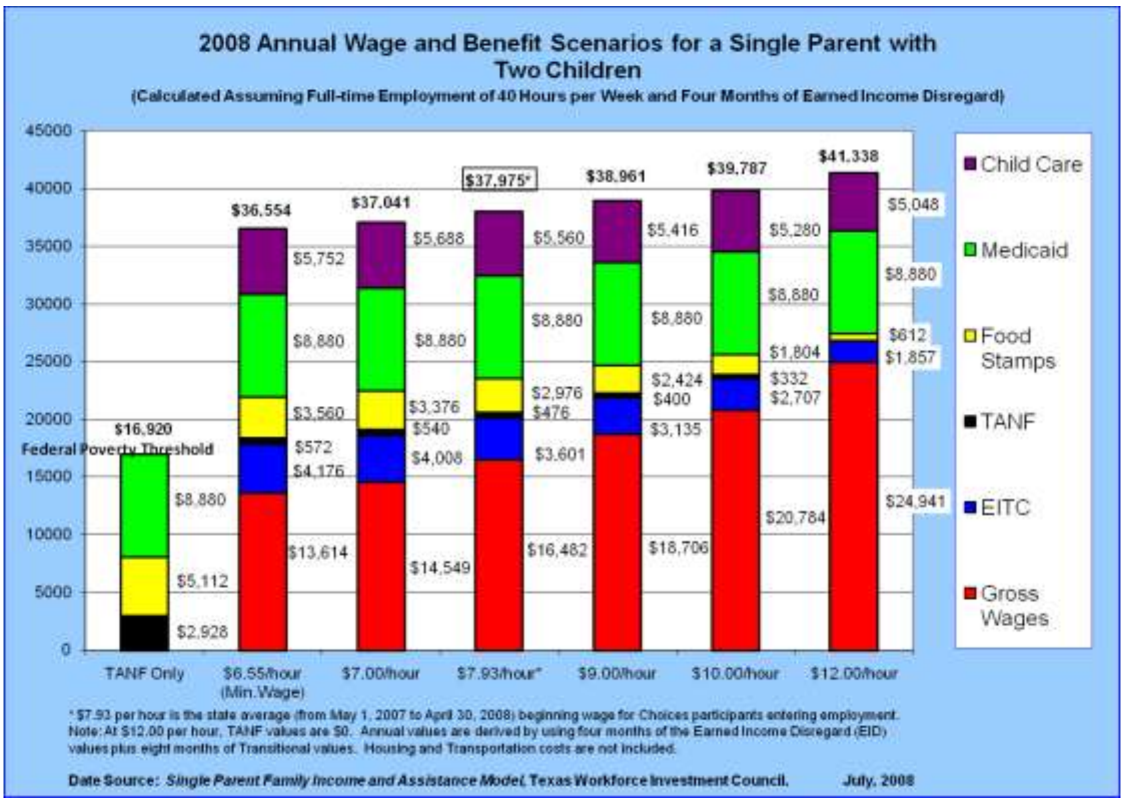
2. While regressivity is an important factor, the non-cash assistance that lower income Texans receive from the state and federal government are significant offsets that must be considered.

   According to a report by the Texas Workforce Commission, a single parent with two children can receive up to $21,176 annually in non-cash assistance including the Earned Income Tax Credit (EITC), Temporary Assistance for Needy Families (TANF), Food Stamps, Medicaid and Child Care assistance.

This Workforce data does not include other important, non-cash programs such as Early Childhood Intervention, Supplemental Security Income, and various mental health programs, as well as a Title IV-D child support enforcement carried out by the state or counties. The total value of these programs can annually exceed $20,000, depending on circumstances, but most assessments of regressivity only take into account direct cash income and calculate the effect on that basis.

The Workforce Commission chart follows:

3. Since most taxes are ultimately borne by the consumer and laborer, business taxes merely amount to "hidden" taxes as the Comptroller's office has argued. Certain business taxes, such as the previous franchise tax, are actually considered more regressive than the sales and use tax according to the Comptroller's Tax Incidence study.



The Border Issue

Other critics of raising Texas' consumption taxes to replace school district property taxes contend that Texans who live in close proximity to bordering states will cross state lines to make purchases in neighboring states with lower sales tax rates. They argue that this will harm businesses in Texas' border areas and drive some commerce out of the state.

However, these arguments are overstated. The percentage of the Texas population that lives close to other state is relatively small and in many locations is actually declining.

According to the State Demographer, only 884,000 Texans live within ten miles of another state. This is just 3.8 percent of the total state population. These states (Arkansas, Louisiana, New Mexico, and Oklahoma) have state sales taxes ranging from 4 percent to 6 percent, so they are already lower than Texas' 6.25 percent state sales tax. Indeed, at 4 percent, Louisiana has the lowest state sales tax of these four states, but the number of Texans living within 10 miles of Louisiana has declined from 191,000 in 2000, to 185,000 in 2007.[xxi]

As the examples below show, the savings that could potentially accrue to consumers who elect to cross state lines to make purchases are minimal when the relative tax burdens and travel costs are factored in:

Example 1: The City of Center, Texas, seventeen miles from the Louisiana border, where the median household income is $26,000 a year:

- On a $100 dollar taxable purchase in Texas, a resident of Center would pay $10 in state sales taxes if the rate was increased to ten percent.
- Making a trip to the closest Wal-Mart in Louisiana would require a 70 mile roundtrip to Mansfield, LA. The same purchase, but with the Louisiana sales tax rate of 4 percent, would yield a tax bill of $4, or a $6 saving over the tax in Texas.
- Factor in gas at $2 gallon and 18mpg fuel consumption, the cost of trip itself is about $8, wiping out all of the tax saving.

Example 2: The City of Muleshoe in the Texas Panhandle, which is almost 20 miles from the New Mexico border, and has a median household income of $25,500 a year:

- On a $100 dollar taxable purchase in Texas, a resident of Muleshoe would pay $10 in state sales taxes if the rate was increased to ten percent.
- Making a trip to the closest Wal-Mart in New Mexico would require a 75 mile roundtrip to Portales, NM. Because New Mexico imposes a Gross Receipts Tax instead of a sales tax, there would be no direct taxation on the purchase, thus yielding a tax bill to the consumer of zero and an apparent $10 saving over the cost of the purchase in Texas.
- However, factor in gas at $2 gallon and 18mpg fuel consumption, the cost of trip itself is more than $8, which would leave the tax saving at less than $2.

Note: Fuel consumption in these examples is based on a 2004 Ford F150 Truck, which, according to the U.S Department of Energy achieves a highway mileage of 18mpg and city mileage of 14mpg.

Although the State of New Mexico imposes no sales tax, its Gross Receipts Tax ranges from 5.125 percent to 7.875 percent, which is typically passed on to consumers. See the New Mexico Department of Taxation and Revenue: http://www.tax.state.nm.us/oos/GrossReceiptsTaxFAQ.pdf

Dedicating Surplus Revenues to Property Tax Relief

The Legislature is only required to pass a *balanced* budget each session. There is no requirement that every cent of tax revenue collected must be spent on new or existing government programs. Instead, surplus revenues should be constitutionally dedicated to property tax relief, with the aim of eliminating school district M&O property taxes.

Texas consistently generates surplus revenues that, if not returned to taxpayers, are simply used to grow government. Since the 1994-95 biennium, Texas has generated $36 billion in state budget surpluses.

As the chart below shows, these surpluses have been generated in spite of a budget deficit in 2004-05, which indicates that in the long-run the state's economy can be relied upon to generate more revenue than is required to fund existing state government programs:

Biennium	Surplus Revenue (in billions)[xxii]
2008-09	**$14.3**
2006-07	**$8.5**
2004-05	**$-7.4 (deficit)**
2002-03	**$5.1**
2000-01	**$5.6**
1998-99	**$3.6**
1996-97	**$4.5**
1994-95	**$1.8**
Total	**$36.0 billion**

Source: Comptroller of Public Accounts

This surplus revenue should be returned to taxpayers. Limited government is a key component of conservative philosophy. Returning surplus revenues to taxpayers is central to ensuring that government remains limited. By dedicating $14.2 billion to property tax relief, the 80th Legislature was the first Legislature that chose to return the surplus rather than use it to grow government. Returning revenues to taxpayers is an appropriate response in times of surplus, and if taxpayers have the potential to have surplus tax revenue returned to them, the incentive to demand efficient and limited government is greatly increased.

Texas is reliant on the sales and use tax, which in 2007 generated 55 percent of all state tax revenues. By comparison, the state's franchise tax, which is the next largest single tax in terms of revenue, generated just 8.4 percent of all state tax revenues in 2007. In announcing the General Revenue Fund 2007 year-end balance, the Comptroller noted that:

> With respect to the higher than anticipated revenues, state sales and use tax collections, which registered a 10.9 percent increase over fiscal 2006, have proved particularly robust, propelled in large part by vigorous activity in the mining, construction, manufacturing and trade sectors.[xxiii]

Since the state's tax revenues consistently generate surpluses, it is appropriate to amend the Texas Constitution (Article III, Section 49-g(c)) with language similar to that proposed by House Joint Resolution 53 (80R) so that half of all surplus revenues certified by the Comptroller are dedicated to the Property Tax Relief Fund:

> (c) Not later than the 90th day of each fiscal biennium, the comptroller shall:
> (1) transfer to the budget stabilization fund one-half of any unencumbered positive balance of general revenues on the last day of the preceding fiscal biennium; and
> (2) transfer the remaining unencumbered positive balance of general revenues on the last day of the preceding fiscal biennium to the property tax relief fund.

Filed legislation in the 81st Legislature – HJR 38 by King – proposes a constitutional dedication of 25 percent of surplus revenues to the property tax relief fund. Such a provision will allow property tax relief to be provided in times of surplus, while ensuring that whenever the state's tax structure does not yield anticipated revenues, government services and programs remain the first spending priority.

ENDNOTES

[i] "Fannie Mae Eases Credit to Aid Mortgage Lending," *The New York Times*, September 30, 1999.
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[v] U.S. Census Bureau Report on Residential Vacancies and Home Ownership, February 3, 2009; http://www.census.gov/hhes/www/housing/hvs/qtr408/files/q408press.pdf
[vi] "Homeownership Rates: A Global Perspective," Soula Proxenos, *Housing Finance International*, December 1, 2002.
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[viii] "The Social Benefits of Homeownership: Empirical Evidence from National Surveys," Peter H. Rossi & Eleanor Weber, University of Massachusetts at Amherst (1996).
[ix] "The Case for Property Tax Relief in Texas," Paul Bettencourt, Harris County Tax Assessor-Collector, April 2007.
[x] "Texas Property Taxes Past and Present," Texas Taxpayers and Research Association, May 2008
[xi] *Ibid.*
[xii] "Assessing the Appraisal Districts," The Texas Association of Counties, *County,* Volume 16, No. 2, March/April 2004.
[xiii] *Ibid.*
[xiv] Legislative Budget Board, Fiscal Size-Up 2008-09, p.197.
[xv] Testimony of Chairman Alan Greenspan before the President's Advisory Panel on Federal Tax Reform, Washington, D.C., March 3, 2005; online at: http://www.federalreserve.gov/BOARDDOCS/TESTIMONY/2005/20050303/default.htm
[xvi] *Ibid*.
[xvii] C.S.H.B. No. 1, General Appropriations Bill, 2008-00 Biennium, pg. I-21, B.Goal: Manage Fiscal Affairs; B.2.1 Strategy: Property Tax Program
[xviii] C.S.H.B. No. 1, General Appropriations Bill, 2008-00 Biennium, pg. I-21, A.Goal: Compliance with Tax Laws; C. Goal: Tax and Financial Info Technology.
[xix] SRC-JEC C.S.S.B. 2 78(R), Bill Analysis.
[xx] George Zodrow, PhD, *Texas Tax Options*; The James A. Baker III Institute for Public Policy at Rice University, January 2006.
[xxi] Data provided by the State Demographer.
[xxii] Biennial Revenue Estimates, Office of the Texas Comptroller of Public Accounts.
[xxiii] Comptroller of Public Accounts, October 9, 2007 letter; http://texasweekly.com/files/SCBalance2007.pdf.