

Research Report

JANUARY 2004

Splitting the Difference

Residential and Business Property Taxes in Texas

By Byron Schlomach, Ph.D.

Chief Economist, Texas Public Policy Foundation



www.TexasPolicy.com

ABOUT THE AUTHOR

Byron Schlomach is the Chief Economist for the Texas Public Policy Foundation.

Raised in Texas, Byron received both his bachelor and doctorate degrees in economics from Texas A&M University.

Byron came to the Foundation from the Texas Education Agency. He has also served as a staff member in the Texas Legislature, most recently as the chief of staff to State Rep. Kent Grusendorf, the chairman of the House Committee on Public Education.

Previously, Byron was a researcher in the Office of the Texas Comptroller. There he conducted research into education and transportation, and was the principle author of a study examining the public school start dates. Byron has also served as an assistant lecturer in the Texas A&M Department of Economics, and has taught at Austin Community College.

He has also had a long-standing relationship with the Foundation, and was named a “Senior Fellow” in 2002.

Byron and his wife home-school their children. They live in Hays County.

ABOUT THE TEXAS PUBLIC POLICY FOUNDATION

The Texas Public Policy Foundation is a 501 (c)(3) non-profit, non-partisan research institute guided by the core principles of limited government, free enterprise, private property rights and individual responsibility.

The Foundation's mission is to improve Texas government by generating academically sound research and data on state issues, and by recommending the findings to opinion leaders, policy makers, the media and general public. The work of the Foundation is conducted by academics across Texas and is funded by hundreds of individuals, foundations and corporations.

The public is demanding a different direction for their government and the Texas Public Policy Foundation is providing the research that enables policy makers to chart that new course.

Introduction: Why Should Property Taxes Change and What Is a Split Roll?

For the last decade an issue regarding school finance receiving a lot of attention is the share of total public education spending that has been borne by the state, which is less than half. This, despite ever increasing state expenditures in education.

Today, the lion's share of public education spending on the Foundation School Program is borne at the local level and that share has been growing. According to the Legislative Budget Board, in fiscal 1998 the state bore its largest share over the last decade at 47.2%. In fiscal 2000, the state's share stood at 47%. Since then, the state's share of public education funding has markedly declined so that in fiscal 2003 it stood at 39.7%. The state's share of public education spending is projected to decline again to just over 36% in fiscal years 2004 and 2005.¹

The goal of increasing the state's share of funding for public education spending may or may not be worth pursuing. However, another goal of public education finance reformers is to eliminate the so-called Robin Hood school finance scheme whereby property wealthy (when wealth is measured on a per-student basis) school districts have significant sums of property tax revenues diverted to school districts that are relatively property poor. The only way to accomplish this goal is to significantly increase the state's share of public education spending.

The goal of eliminating Robin Hood cannot be accomplished with budget surpluses. Past surpluses disappeared and suddenly became a \$10 billion projected deficit in 2003. More importantly, the Robin Hood system exists due to spending inequity across school districts that naturally results from a system heavily dependent on local property taxes. Ending Robin Hood requires less dependence on locally-raised property taxes. For the state to shoulder a significantly larger burden with respect to public education, it must increase state-collected taxes in some way while simultaneously reducing the local property tax burden.

Several potential state taxes have been proposed. Among these are an income tax, a gross receipts tax, a business activities tax, a broadened and/or increased sales tax, and some kind of state-imposed property tax.² An income tax and a statewide property tax would each require a constitutional election since both are prohibited under the state's constitution. Texas is currently among 12 states that have no property tax of any kind at the state level.³

Split Roll Property Tax

Pros:

- Increases economic efficiency
- Ends competition among communities over tax abatements
- Reduces rent-seeking behavior
- Allows for elimination of Robin Hood
- Does not require a radical change in the state's tax administration

Cons:

- Splits property taxpayers into potentially rival factions
- Creates logistical problems for current tax abatements
- Continues to hide the true tax burden
- Creates opportunities for gaming of the system through property appraisals

Splitting The Difference

The reason that such a change is desirable to some is one whereby real and personal business property is “split” from real residential property. Typically, business property is taxed by the state using a legislatively-established property tax rate, while residential property is taxed locally. This structure would only apply to school taxes. City, county, and special district taxes would continue to apply uniformly at the local level to business and residential property, but since the bulk of property taxes are school taxes, a split roll system would represent a major change in property tax policy.

The reason such a change is desirable to some is clear when one considers that almost half (\$559 billion) of Texas’s \$1.16 trillion in total property value is business property even when multi-family dwellings (apartments) are included in the residential category.⁴ In fiscal 2002, \$14.4 billion in local property taxes funded public schools.⁵ Half that could be funded by a state business property tax (with no exemptions or deductions) at a rate of \$1.32 per \$100 valuation, using the Comptroller’s 2002 valuation for all property in the state.

The creation of a split roll property tax can be likened to a shell game. A split roll tax system does not, in itself, necessarily result in lower property taxes. It simply converts what was once local tax revenue into state tax revenue by moving business property from the local tax rolls to a new state property tax roll. For an overall property tax decrease to occur for both business and residential property owners, some other tax will have to be increased or created.

Since the exact details about whether or not the overall property tax burden would change are not known, only the concept of a split roll tax in isolation is considered here. Such a policy change can be analyzed in several different ways and there are three perspectives that are considered here. First is from a purely economic efficiency perspective. The question to be answered from an efficiency perspective: to what degree is a split roll system likely to result in a misallocation of resources through tax-instigated changes in the relative costs of goods and services when compared to the current system’s effects on allocation?

A second perspective from which a split roll system can be analyzed is also economic – the public choice perspective. Public choice analysis uses economic tools and assumptions to analyze government behavior. This makes it possible to get some idea of how a split roll system might change over time by considering the incentives it inherently produces for decision makers tasked with funding government. It helps us understand the potential effects of a split roll system for the state as a whole in the long run.

Finally, there are the practical aspects of such a system. Texas has a strictly local property tax system with an institutional structure already fully in place. There are practical considerations involved in transitioning to a system of statewide property taxation which also must be considered.

Economic Efficiency Considerations

A split roll system with a statewide tax on business property and local taxes on residential property is likely to result in greater economic efficiency within the state. The reason for this is

Splitting The Difference

simple: there are currently 1,033 taxing school districts in Texas, each of which independently sets its own local property tax rate. Such variation is economically inefficient because variations in the costs of doing business are significantly affected by a business' location in the state.

There is some considerable variability in property tax rates among school districts. In fiscal year 2002, the lowest property tax rate was 80 cents per \$100 valuation⁶ while the highest was \$2.00 per \$100 valuation. There were 45 districts taxing at less than \$1.30 while 289 school districts taxed from \$1.30 to under \$1.50, and 680 taxed at rates from \$1.50 to under \$1.80. Only 19 districts taxed at \$1.80 and above.⁷

The total tax on a facility worth \$10 million in a district with a \$1.25 tax rate will be \$125,000. The same facility taxed at \$1.80 per \$100 will carry a tax bill of \$180,000, a 31% difference in tax costs that persists as long as the respective rates remain in effect. The higher the value of a facility, the larger the effect of a tax differential on the bottom line (total profit). In turn, tax costs have a more significant effect on location decisions of businesses the more valuable are the capital investment choices.

Taxes are an artificial cost in that they are not determined by true resource costs. Regional tax disparities due to differential tax rates artificially distort location decisions; taxes do not reflect the true costs of transportation, labor, and other resources. Tax differentials, therefore, can result in different location decisions than would otherwise occur; a location that would be relatively low cost can be made high cost due purely to the level of taxation. These "distorted" location decisions are inefficient from an economic point of view because tax differentials interfere with true resource costs.

A statewide property tax on business property would eliminate differential tax cost considerations for businesses. Every location across the state would bear the same tax rate. Property value differentials that naturally occur would still affect the property tax burden but this would only reflect and slightly magnify cost differentials determined naturally in the market. In fact, relative commercial/industrial property values across school districts would adjust somewhat to reflect the equalized tax treatment and resource allocation (from an economic efficiency perspective) would increase even more.

Another cost of the current system is the cost of the artificial competition among communities with regard to tax abatements. Though school districts are currently limited to abating property used in manufacturing, research and development, and electric generation using renewable energy⁸ there is still some real potential for companies considering the appropriate investment to shop around for the best abatement deal. School districts can choose not to tax the full value of a property improvement for up to 8 years⁹ making it well worth a company's time and effort to determine where the best abatement deal can be made.

The resource allocation costs when compared to the Texas economy as a whole arising from tax abatements might or might not be that great. Other costs, though, arise from what economists call "rent-seeking" behavior. In general, rent-seeking refers to the activities that take place when special interests seek advantage over others through government activity. Rent seeking is costly.

Splitting The Difference

In this case it requires lawyers, researchers, and lobbyists. There are the added government expenses involved in administering abatement programs as well.

The stated purpose of the current property tax abatement law is to make Texas more competitive.¹⁰ However, the current law pits community against community within the state. A split roll system does not eliminate the possibility of property tax abatements. They would have to be administered at the state level, thereby pitting the state of Texas against other states. Rent-seeking and its consequent costs would not be eliminated, but could be reduced.

One last thing worth pointing out with regard to all business taxes, whether on property or receipts or inputs: they are all inefficient. Every tax is a tax on people, be they business owners, property owners, or consumers. Every tax is shared to some extent. A sales tax appears to be a tax on consumers that is collected by business, but a sales tax depresses the before-tax price a business can charge, so the business partly pays it. Though not as obvious, the same is true of property taxes. A tax on business property is not a tax just on business. It is a tax on the people of Texas and the cost of that tax shows up in lost economic opportunity due to increased business costs and the loss of competitiveness with other states and, for that matter, other countries. An attempt to accomplish government spending by “taxing business” really only represents an attempt to hide the true costs of that spending.

Long-term Institutional Considerations

Even though an explicit split roll property tax proposal has not been presented, the basic concept has received some serious consideration. Most business interests have already made clear their opposition to a split roll system. The reason is simple. Currently, all property owners are unified under the current property tax system in that a property tax rate increase negatively affects them all, homeowners and business owners alike. A split roll system would divide property tax payers into two factions whose interests would diverge. A property tax rate increase on one group would not necessarily translate into a tax increase for the other. In fact, if or when a tax increase is generally considered necessary, each class of property owners will have an incentive to push for a tax increase on the other class.

There are more homeowners than there are business owners. The political calculation is not hard. If you are an elected representative and you are seeking more tax revenues fewer voters are made angry by a property tax increase on business than on residences. So the risk for business property owners in a split roll system is clear: business owners are likely to eventually shoulder the lion’s share of property taxes.

One way to keep taxpayers more unified would be to link automatic residential property tax increases to business property tax increases passed at the state level. A number of ways to do this can be imagined. The problem, though, is whether such a linkage is real and whether residential property taxes are really locally controlled with this sort of linkage. Local property tax rate increases equal to any increase passed by the state legislature could be required. However, school trustees are likely to simply lower residential rates when the legislature increases business taxes. Another method might be to prohibit more than a certain percentage variation in state and local

Splitting The Difference

property taxes. This might be more effective, but the Legislature could be put in the position of being forced to increase business property taxes in response to local taxing policies.

While it is important to understand how a split roll system might affect the balance of influence over government for taxpayers, the overall effects become less clear when public choice analysis is used to comprehensively evaluate the incentives involved. One must realize that a split roll would result in the respective classes of property, business and residential, being taxed by different sets of elected officials. Business property would be taxed by the Texas Legislature. Residential property would be taxed by school trustees.

Business property owners could actually benefit from only having to deal with the Legislature with regard to property taxes to support school spending. While business owners would still face local property taxation by cities and counties, at least they could eliminate 1,033 school districts with which they might have to deal. Business owners taxed by the state would face the prospect of having their property taxes rise only once every two years. Currently, school tax rates can change every year. Instead of having to deal with multiple taxing jurisdictions, large companies with holdings in more than one school district could join with other businesses from the over-1000 school districts and concentrate their efforts on 183 elected officials in the state's capitol.

Naturally, school trustees (who are elected) would be loath to increase taxes on homeowners. In Texas, school boards have a very effective lobby that is funded out of district budgets by taxpayers. The likelihood is that this, combined with the fact that homeowners have greater numbers will result in higher property taxes for business than residences.

Practical Issues

Property tax abatements that have been agreed to by school districts will likely have to be honored and administered by the state. This would involve some cost to the state for administration. In addition, the Legislature would have to make the policy decision of whether new abatements should be made at the state level. Abatement agreements are filed with the state, so it would not be difficult to make such a transition. The bigger question would be whether new abatement agreements would or should be entered into by the state.

Another issue has to do with property value appraisals. Currently, county appraisal districts determine the value of property. The Property Tax Division of the Texas Comptroller of Public Accounts is responsible for ensuring properties are properly appraised. In other words, the basic structure for a statewide property tax system is in place. Governance of appraisal districts will have to be carefully designed to minimize the incentive for appraisal district officials to gain favor with the local community by undervaluing business property.

Under the current property tax system, there is an incentive for appraisal district officials, who answer to elected officials, to undervalue property since the "poorer" the school district, the more money it receives from the state. With a split roll system, appraisal districts could overvalue or undervalue residential property and it would matter little from a distributional point of view.

Splitting The Difference

Business property, though, if undervalued in a particular area, would have distributional effects since the tax on business property would be supporting the education system as a whole.

One State's Experience

The use of the singular in the section title is purposeful. According to the National Conference of State Legislatures only Minnesota has a split roll system at all comparable to what is being contemplated in Texas. Minnesota has a complicated classification system of property taxation very different from that in Texas. Texas taxes every dollar of value equally (except for abatements and homestead exemptions) whereas Minnesota taxes property progressively with a higher rate assigned to higher values, and different rates on eight classes of property. These classes include three different classes of residential property, agricultural property, resort and cabin property with various subclasses as well.¹¹

The Minnesota property tax system underwent extensive reform in 2001 that created the state-level taxation of business property. Two issues appear to have provided the impetus for reform. First, the property tax was deemed too high in general. Second, the tax on business property was believed to be damaging the economy since the rates on business were considerably higher than the rates on residences. The statewide property tax levy on business, limited to a specific inflation-adjusted total amount, was part of a tax package that lowered local property taxes for the support of schools by some \$1.1 billion.¹²

After Minnesota's property tax reform, property that is classified as Commercial/Industrial/Public Utility (excluding electric generation equipment), Seasonal Resorts, and Seasonal Recreational Residential are subject to a state property tax. Except for properties classified as Seasonal Recreational Residential (cabins) all properties subject to state property taxation are subject to local property taxation as well.¹³

As a result of the 2001 reform, all Minnesota property owners have seen their tax burden fall, but taxes on business property have especially decreased as a result of property values in the state increasing faster than inflation thereby reducing the rates required to meet the state levy. The state tax on business property, cabins, and resorts is not dedicated to education funding but goes instead into the state's general fund.¹⁴

The Texas and Minnesota property tax systems are so different it is difficult to draw any inferences from Minnesota's experience. Minnesota's statewide property tax on business is not dedicated, as Texas' would likely be. The Minnesota tax is capped, whereas Texas' is not likely to be. Minnesota taxed business property at a significantly higher level than residential property. Texas appears not to be learned from Minnesota the outcry came mostly from business (though residential property and the weights for the property tax burden are determined at the state level. Business bore (and still bears) a disproportionate share of the tax burden.

Conclusion

So, what can we conclude after this look at a split roll property tax system in Texas? The honest answer is: “not much.”

There is the advantage that a split roll property tax would be more efficient with respect to business taxation by removing much of the potential for distortion in a system that currently allows for so much discretion over tax rates and abatements at the local level. A good deal of rent-seeking behavior would be eliminated as well. On the other hand, there is a risk business property owners would find themselves targeted for taxation by numerically superior homeowners once classes of property are severed. Perhaps this is the lesson to be learned from Minnesota, where the classification system separates different classes of property and the weights for the property tax burden are determined at the state level. Business bore (and still bears) a disproportionate share of Minnesota’s tax burden.

A more fundamental question than the type of tax system is whether more money is even needed in public education. Related to this is the question of what constitutes an efficient and effective education system. Only then can the questions of how much money is required for public education in Texas and what proportion of it should come from the state can be answered. Once these issues are addressed, the search for an appropriate tax system can begin.

The issue of property taxation is more properly framed around the amount of money that the public education system seems to be insatiably able to swallow up rather than the structure of the property tax itself. In the final analysis, taxes are always a function of spending. Tinkering with the tax structure can be a worthwhile exercise only *after* reforms of the expenditure side of the equation take place.

Splitting The Difference

ENDNOTES

¹ Legislative Budget Board, *Fiscal Size-Up: 2004-05 Biennium*, Austin: 78th Texas Legislature, December 2003, p. 189, http://www.lbb.state.tx.us/Fiscal_Size-up/Fiscal_Size-up_2004-2005_1203.pdf. The Legislative Budget Board numbers do not include state expenditures for textbooks, instructional grant programs (such as the reading, math, and science initiatives) or the state's share of contributions to the Teacher Retirement System. Other financial reports indicate local revenues play a smaller part in total education funding. There is only about a five percent difference between state and local revenues for public schools when actual receipts, not budgeted expenditures, are examined. For 2001-02, the most recent year for which actual financial data was published by the Texas Education Agency, local taxes only contributed 45.5%; state funds provided 40.2% and, combined, state and federal funding underwrote 49.0%. (<http://www.tea.state.tx.us/adhocrpt/adfia02.html>).

² One such plan, by Senator Bill Ratliff, would have imposed a state \$1.40/\$100 valuation tax on all property in the state. See Wolfson, Monica, *Ratliff Proposes \$1.40 School Tax*, Corpus Christi Caller Times, April 4, 2002, <http://www.caller2.com/2002/april/04/today/texasnew/27684.html>.

³ U.S. Census Bureau, United States Department of Commerce, <http://www.census.gov/govs/qtax/qtx031t3.pdf>. The states are: Colorado, Connecticut, Delaware, Hawaii, Idaho, Iowa, New York, Oklahoma, South Dakota, Tennessee, Texas, and Utah.

⁴ Texas Comptroller of Public Accounts, Property Tax Division, *School and Appraisal Districts' Property Value Study, 2002 Final Report*, September 2003, p. 84, <http://www.window.state.tx.us/taxinfo/proptax/pvs02-2f/96-310.pdf>.

⁵ Legislative Budget Board, *Fiscal Size-Up: 2004-05 Biennium*, Austin: 78th Texas Legislature, December, 2003, p. 189, http://www.lbb.state.tx.us/Fiscal_Size-up/Fiscal_Size-up_2004-2005_1203.pdf.

⁶ This excludes Mirando City ISD whose tax rate fell from \$1.50 in fiscal 2001 to \$0.53 in fiscal 2002 due to the discovery of a natural gas field.

⁷ Texas Comptroller of Public Accounts, Property Tax Division, Microsoft Excel Spreadsheet.

⁸ Texas Property Tax Code Section 313.024(b).

⁹ Texas Property Tax Code Section 313.027(a).

¹⁰ Texas Property Tax Code Section 313.002.

¹¹ See <http://www.house.leg.state.mn.us/hrd/issinfo/clrate2002.htm> for a schedule of Minnesota tax rates and property classifications.

¹² Reed, Lynn, Executive Director, Minnesota Taxpayers Association, telephone interview, January 20, 2004.

¹³ House Research, Minnesota House of Representatives, *Class Rates for Taxes Payable in 2002*, <http://www.house.leg.state.mn.us/hrd/issinfo/clrate2002.htm>.

¹⁴ Property Tax Reform Coalition, Minnesota, <http://www.stand-your-ground.com>, 2002-2003. According to this publication, any *growth* (in real terms) in the state levy is dedicated to education.



We need your help!

The Texas Public Policy Foundation is a non-profit, non-partisan research institute guided by the principles of limited government, free enterprise, private property rights and individual responsibility. We seek to improve Texas government by producing academically sound research on important issues offered to policy makers, opinion leaders, the media and general public.

We do not take government funding or sell research outcomes, so we completely rely on the generous contributions of individuals, foundations and civic-minded corporations.

If you believe studies like this one are important for Texas, won't you consider a financial gift to support the Foundation and our mission?

Give generously today by visiting us online at
www.TexasPolicy.com,
or calling toll-free, (800) 694-8773.

And after supporting the Foundation with your financial gift, please pass this publication on to a friend and introduce them to our work!

Thank you for your generous support!

Log On to Learn More!

All of the Foundation's research and reports are available online at
www.TexasPolicy.com.

When there, be sure to sign up for the Texas Public Policy News. This free e-publication is issued every other Wednesday and includes information about upcoming events and publications.

Don't miss a single issue!



www.TexasPolicy.com