AN ECONOMIC ANALYSIS OF A TEXAS PROPERTY TAX RELIEF PLAN FUNDED BY A SALES TAX INCREASE

A REPORT TO
TEXAS PUBLIC POLICY FOUNDATION

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March 2004

EXECUTIVE SUMMARY

A number of tax structure modification alternatives are under consideration by policymakers in Texas. One reform alternative is to fund a property tax reduction with an increase in the sales tax. The size of the property tax reduction being discussed is about 50% of the current levy for school maintenance and operations, or $8.5 billion in 2005. This paper examines the economic effects of this tax policy change, identifying how tax burdens change and the policy's strengths and weaknesses. The tax change is reviewed from the perspective of several recognized characteristics of good tax policy. Five alternative formulations (scenarios) of the tax shift are analyzed according to various sales tax rate and sales tax base-broadening alternatives.

Economic Effects on the Texas Economy: The analysis of the economic effects of an $8.5 billion tax shift from property taxes to sales taxes indicates that it would produce a modest negative effect on jobs and personal income in Texas but increase the state's gross regional product. The declines in employment and personal incomes are the combined effects of a shift in economic stimulus to capital-intensive industries while diminishing the stimulus in labor-intensive industries, combined with the effects of the loss of federal deductibility against the federal income tax. The increase in gross regional product is primarily due to the net stimulus of the capital-intensive industries. About 2/3 of the negative effects are due to the loss of federal deductibility.

Strengths and Weaknesses of the Policy Shift: On efficiency and equity grounds a reduction in the property tax should receive high marks. It would achieve the desirable objective of improving economic inefficiency while replacing the "Robin Hood" transfer device. Taken alone, a significant property tax reduction would improve the equity of taxation both at the business level and as measured by the economic incidence on Texas residents.

The substitution of the sales tax for a major reduction in the property tax, however, should at best get mixed reviews. Depending on the alternative being analyzed, several problems can result from increasing sales taxes. If the rate is increased too much tax avoidance in the form of cross-border and internet trading will occur. Adding to already-existing taxation of business inputs will further distort already distorted business decisions. Other alternatives would involve taxing food and medicine as well as health services (a political though not economic issue) and, if not structured carefully, will result in double taxation of consumer goods.

A scaled down tax shift of $5.6 billion, allowing the increased sales tax to apply only to consumer items, would result in positive impacts on employment, personal incomes and state gross regional product except for the effects of lost deductibility against the federal income tax.

A sales tax increase applied only to consumer items should get high marks as good tax policy because the tax is visible, uniformly applied, a stable revenue source, relatively easy to administer (the system is already in place) and avoids the economic distortions of many tax alternatives. Applying a sales tax increase to business inputs would add to existing economic distortions and should be avoided.

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